

Are things Getting Better or Worse?

April 2022

This is going to run long so I'll get right to it. Inflation is still the topic of the day. In the financial press you're going to start hearing about "inverting yield curves" if you haven't already. Simply put, an inverted yield curve is when short-term interest rates are higher than long-term interest rates. As of this writing, the 5-year treasury rates are higher than the 30-year treasury rates. Normally that's not the case. In normal interest rate environments, the longer the maturity (or term) the higher the rate. "Flattening" the yield curve is one way the Federal Reserve slows economic growth and fights inflation. Instead of flattening, sometimes it inverts. Quite often, inverted yield curves precede recessions. So, the financial press will be talking about that too.

Late last year I spoke to my friend Vahid Fredrick, one of the steady hands at, the venerable, Capital Group. He said something like this: "4% inflation is high, 6% is scary, 8% is dangerous". Currently inflation sits at 7.9%. Surely the Federal Reserve sees this and, I think, regrets not acting sooner and feel like they are behind the curve. Hence, the enclosed article.

Reading the papers, there's a lot to worry about. On top of inflation and, the ominous sounding, "inverted yield curve" we have World War III talk, the pandemic is still with us, gas is at record highs, groceries are outrageous and we've just had about a 13% selloff in the S&P 500 from peak to trough. All of which make for very low expectations for the stock market. I think low expectations are a good thing. I learned from one of the old timers in this business, Jeff Saut, the best question to ask myself is not "Are things good or bad"? but, "Are things getting better or worse"?

So, a few things to consider when answering that question that are a little concerning.

First, in my career (going on 28 years) and maybe in the Federal Reserve's history, the Fed has never embarked on an interest tightening journey while the economy is slowing. That's not necessarily bad but its new territory.

Second, looking at long-term charts, interest rates and inflation have been coming down since the very early 1980's. I want to emphasize this point: there are very few people managing money today who were in the business when both interest rates and inflation were rising for a sustained period, including yours truly. Again, not necessarily bad. I've advised clients through the ".com" bubble of 2000, the September 11th attacks, the Great Recession of 08-09 and a global pandemic. I've worked with many of you through all of those. Each one was a first for us, was scary and different from the other. We survived.

Then a few things that bothered me until I dug a little deeper.

Earlier, I mentioned that Federal Reserve interest rate hiking often leads to a recession. I brought this up to one of the smarter number crunchers I know on the research side of the business. He confirms my concern, but reminds me that the lag time is between 2-3 years from the beginning of the rate hiking cycle to the beginning of a recession.

Energy/Oil/Gas is a large part of daily American life. It's gotten very expensive but it's springtime now. It's going to get warmer, demand for energy that heats our homes should ease. That is somewhat black and white. Now, let's get into a gray area. Usually, high energy prices are caused by high demand. This time it seems energy prices are driven by supply constraints. There are some pipeline issues getting energy from Canada and getting oil/gas out of wildlife areas. This is not a political statement, and again it's a gray area, but much of the talk about drilling more seems to be political posturing. Asking around, smarter people than me are telling me that we are at, or near, record production levels. Also, recently the price of **large, industrial size**, batteries have come down, a lot. This makes renewables much more competitive. On energy, I'm hearing the surprises will be the good kind – how fast energy prices can come down. That's the end of the gray area.

So that concludes what I'm hearing from people that work in glass towers. Here's what I'm hearing from people that live in the real world. Quickly:

My contact in the agriculture industry who likes to remain anonymous, we'll call him George, (even though his name is Jesse) says he is dealing with shipping issues, fuel surcharges and shipping rates that are good for a week when they are usually seasonal rates. Other contacts report they are paying about double what they were paying this time last year. The business runs on credit but if you're a new produce company you must pay cash.

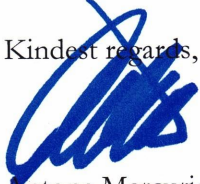
Contractors, it's a little gray. Some report a slowdown but no big problems getting materials. Others report "tons of issues around getting materials and appliances". They report plywood prices 2.5 times what they were pre covid (down from 4 times pre covid). Similar to the agriculture industry, they report bids they give to clients, or get from sub-contractors, are good for a week only because prices are moving so fast.

Real Estate contacts say it has been insanely good, has cooled a little and not as crazy. (My guess is we will be discussing issues in the real estate market before long)

My friend, and new client, in the oil industry based in Alaska says America has plenty of oil and we know where it is. It was found because of exploratory permits. But they need drilling permits to get it out of the ground. If those permits were issued today, it would take 6 months, maybe a little less, before it makes it to the gas station as fuel.

Back to the original question, are things getting better or worse? I believe the Fed is going to be aggressive on interest rates. I think inflation will come down. Not as fast, or as much, as the Federal Reserve says. By that measure we could be 2-3 years away from a recession. On Ukraine, it sounds callous but, markets tend to quantify, discount and move past these sorts of issues. So, I think things are getting better. We've had a recent, garden variety, selloff in the stock market. We are likely to lose 8 cents of every dollar we keep in "safe" cash to inflation. If the Fed is aggressive, as I believe, bonds will have a tough road ahead. That leaves equities/stocks as the least ugly of the ducklings and give us a fighting chance. We will invest accordingly with slightly more stock exposure and slightly less bond exposure than normal. In short, diversified stock exposure, high quality, shorter maturity bonds. Sorry about the length of this letter. To me, it's important to get you the best information I can.

Kindest regards,



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Why we think the Fed is still behind the curve

The U.S. Federal Reserve raised the federal funds target rate by 25 basis points to a range of 0.25% to 0.50%, marking the start of what is expected to be a forceful path of monetary tightening. The central bank faces the challenge of taming inflation even as a commodities shock in the wake of Russia's invasion of Ukraine dampens the outlook for global growth.

Fed chairman Jerome Powell reinforced in his comments that the central bank's primary goal is to tamp down inflation – which is running at a 40-year high – and that it will do what it takes to bring it closer to target. The central bank chief also talked positively about growth and the labor market. "All signs are that this is a strong economy," Powell said. "Indeed, one that will be able to flourish ... in the face of less accommodative monetary policy."

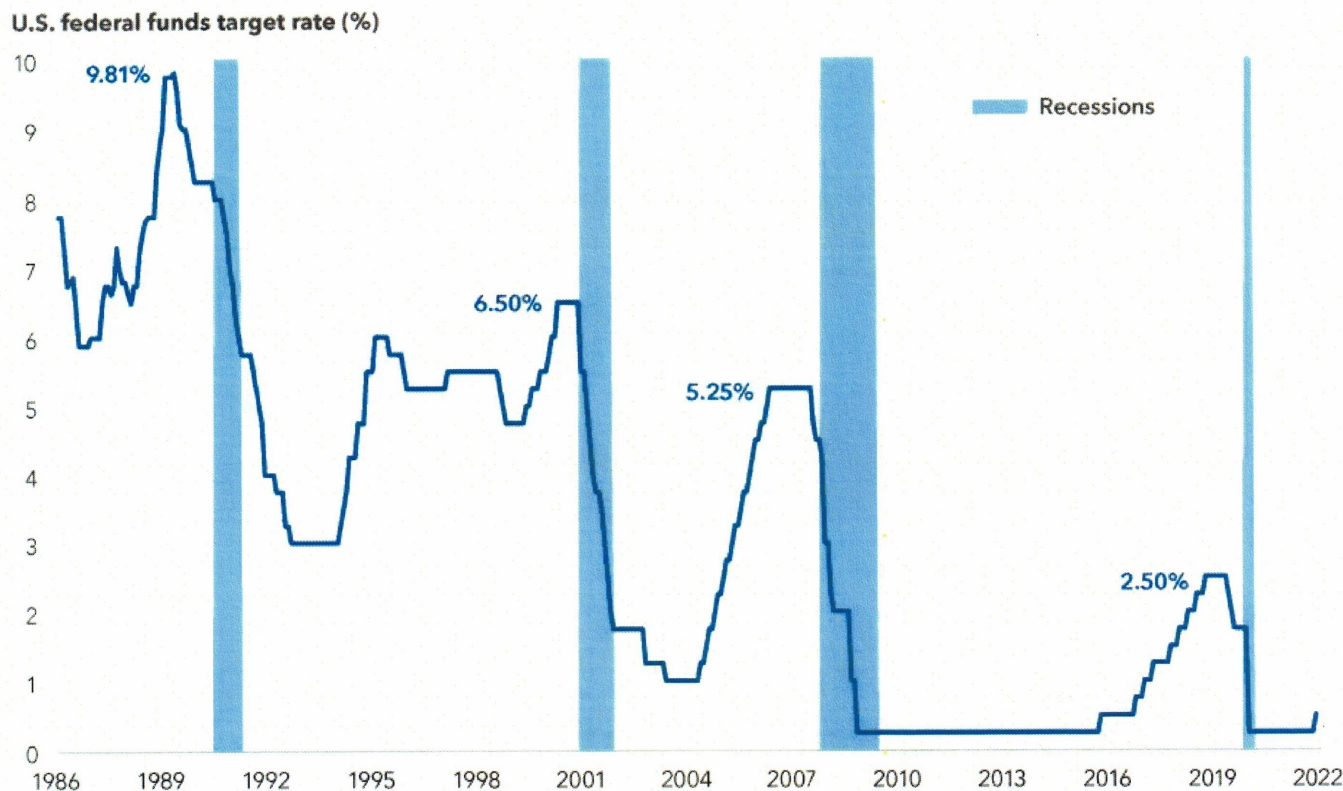
We maintain our view that inflation will remain elevated and that monetary policy is behind the curve. Markets are pricing in about seven 25-basis-point rate increases in 2022. Powell seems confident that the U.S. economy can withstand higher rates, and so barring a major fundamental shock, we expect the Fed will continue on its tightening path for the rest of 2022. He left open the possibility of a 50-basis-point hike but did not specify what might trigger such a move.

Powell emphasized that he wants to see the month-over-month inflation numbers come down. The Fed is increasingly concerned about inflation becoming unmanageable, and its latest projections indicate it may move rates above its estimated long-term neutral rate of 2.4% by next year. The neutral rate is a theoretical federal funds rate at which monetary policy is considered neither accommodative nor restrictive.

Consistent with this view, we favor positioning bond portfolios for tighter financial conditions by maintaining a short duration focused on two-year maturities. We expect the Treasury yield curve to flatten further, led by a rise in shorter maturities while long-term interest rates remain in a range.

We also anticipate quantitative tightening (QT) plans could be unveiled in May and begin in June following another rate increase at the Fed's May meeting. The central bank will likely shrink its balance sheet by not replacing maturing bonds. While actively selling securities is a possibility, it is not its preferred path.

Peak fed funds rate has declined with each successive hiking cycle



Sources: Capital Group, Federal Reserve Bank of St. Louis, National Bureau of Economic Research. As of March 16, 2022.

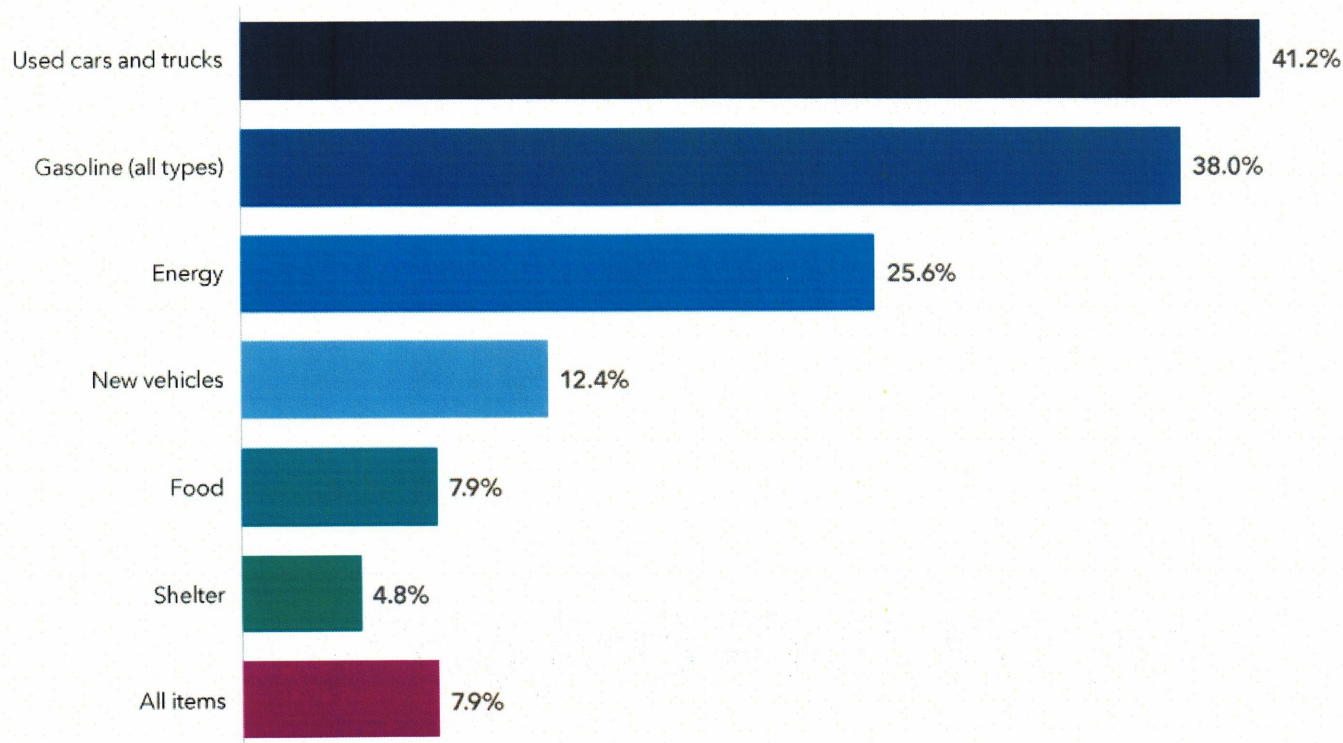
Tight labor markets complicate inflation picture

The Fed remains focused on fighting inflation despite a dampened growth outlook given the war in Ukraine. Inflation rose sharply in February with headline and core metrics accelerating to 7.9% and 6.4% year-over-year, respectively. We continue to see broadening price pressures across major categories, and we see a 50% chance that CPI will accelerate in the coming months. In shelter, the largest component of the Consumer Price Index, prices have increased 4.8% year-over-year, the fastest pace since the early 1990s. Even if you strip out shelter and other high-inflation categories, CPI remains elevated and on an upward trend.

The surge in commodity prices – spanning energy, metals, raw materials and agricultural products – will also feed into inflation. The Bloomberg Commodity Index doubled in the past two years, an increase not seen since the early 1980s. The greatest impact is likely to be felt by lower income consumers as food and gas make up a large percentage of their spending.

Inflation is being driven higher by several components

Consumer Price Index, 12-month percent change, February 28, 2022



Sources: Capital Group, U.S. Bureau of Labor Statistics. As of February 28, 2022.

With supply chain issues likely to remain troublesome and the war creating upside risks to food and energy prices, market participants are pricing rising inflation risk premia (a measure of the premium investors require for the possibility that inflation may rise or fall more than expected over the period in which a bond is held) into bonds. Breakeven inflation on five-year Treasury Inflation-Protected Securities (TIPS) has risen from 3.0% to around 3.5% this year, the highest reading since the launch of the asset class.

Wage growth and a variety of other indicators point to ongoing pressure in the labor market, which Powell said Wednesday had reached an “unhealthy level” of tightness. In February, the U.S. added 678,000 jobs, bringing unemployment down to 3.8%. The labor force participation rate rebounded to 62.3% in February, its highest level since March 2020, indicating there are going to be fewer workers on the sidelines. We are also seeing historically elevated quit rates, signaling that workers have confidence in their ability to find other employment – often with better pay. Average hourly earnings stagnated between January and February but remain up 5.1% over the past 12 months.

We believe the Fed's most likely plan will be to move steadily toward restrictive policy with consecutive 25-basis-point hikes until policy rates are at or slightly above neutral. However, we are not ruling out the possibility that the central bank will move in a more forceful, Paul Volcker-esque manner. (In 1981, then Fed Chairman Volcker sharply raised rates to contain runaway inflation.)

In terms of societal impact, the Fed faces tough choices. If the Fed remains dovish, allowing inflation to run unchecked, food and energy prices would be among the most likely to accelerate. If it tightens aggressively and stymies growth, unemployment would likely move up and wage increases would be curtailed.

Global overview

The Fed is not alone in its path. Major central banks in Europe have signaled a more hawkish stance in recent weeks as inflation continues to outpace their targets.

The European Central Bank delivered a hawkish message at its March meeting, laying out plans to end its asset purchase program by the third quarter of this year and, in the process, paving the way for a potential rate hike.

Despite the downside risks to growth stemming from the war in Ukraine, ECB President Christine Lagarde focused her remarks on the upside risks to inflation and stressed "optionality and flexibility" in the governing council's policy stance. The front-end of the euro curve is pricing in roughly 30 basis points of hikes by year-end.

Meanwhile, we expect the Bank of England to deliver another rate increase this week, hiking to 0.75%. This follows the 25-basis-point hike and initiation of passive QT announced in February. All in all, these actions should lead to tighter financial conditions in most of the major developed economies.

Against this backdrop, we maintain a defensive posture in our fixed income portfolios. In U.S. core bond portfolios, in addition to a short duration and positioning for a flattening of the yield curve, we also favor a slight relative underweight to credit. Meanwhile, TIPS prices largely reflect inflationary expectations, so managers are more opportunistic based on where they see value along the maturity spectrum.

In many equity portfolios, depending on investment objectives and mandate, we are starting to see managers selectively add to investments in energy, materials, mining companies, consumer staples and other consumer-related companies with a degree of

pricing power.

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Bloomberg Commodity Index reflects commodity futures price movements. It is calculated on an excess return basis.

Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

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