
Market Update Research Note | July 2022

Dan Golosovker, Dane Rook

James Liu (Clearnomics)

Inflation and Slowing Growth

This market update is the first in a series provided in partnership with Clearnomics, a market insights platform for asset and wealth managers. Our goal is to help you stay abreast of ever-changing markets by putting current conditions into the context of economic and market history. We'll share these research notes monthly, addressing key topical issues clients are asking about, as well as offering insights you can use directly with your clients. Each market update will also provide practical historical stress-testing scenarios, which may offer you a broader understanding of the range of potential outcomes that portfolios may experience in the current environment. For additional details on how this research can be effectively implemented in your portfolio, we plan to publish an Addepar Research brief on stress-testing best practices.

As August begins, investors continue to grapple with inflation, higher interest rates, Fed tightening, a stronger U.S. dollar and the possibility that we're already in a recession. The most important of these concerns for investors is likely how the Fed will continue to react to today's economic challenges. The Fed is caught between a rock and a hard place, as it cannot simultaneously choke inflation and balance its growth targets.

As shown in our [Asset Allocation Research Note](#), the average investor has more than 80% of their risk exposure in equities (i.e., public or private equity investments). The dynamics at play today are particularly challenging for these investors because recessions, high inflation and sharp tightening of monetary policy are all scenarios in which equities historically perform poorly. Investors should consider the potential implications that this perfect storm of economic factors may have on their portfolios.

Many leading indicators suggest that growth is decelerating due to rising prices, geopolitical events and the natural end to a strong recovery. To combat inflation, the Fed has now hiked rates 75 basis points at two consecutive meetings (a largely unprecedented move) to a range of 2.25% to 2.50%, which has wide-ranging implications for investors. These sharp-tightening moves flow directly through to discount

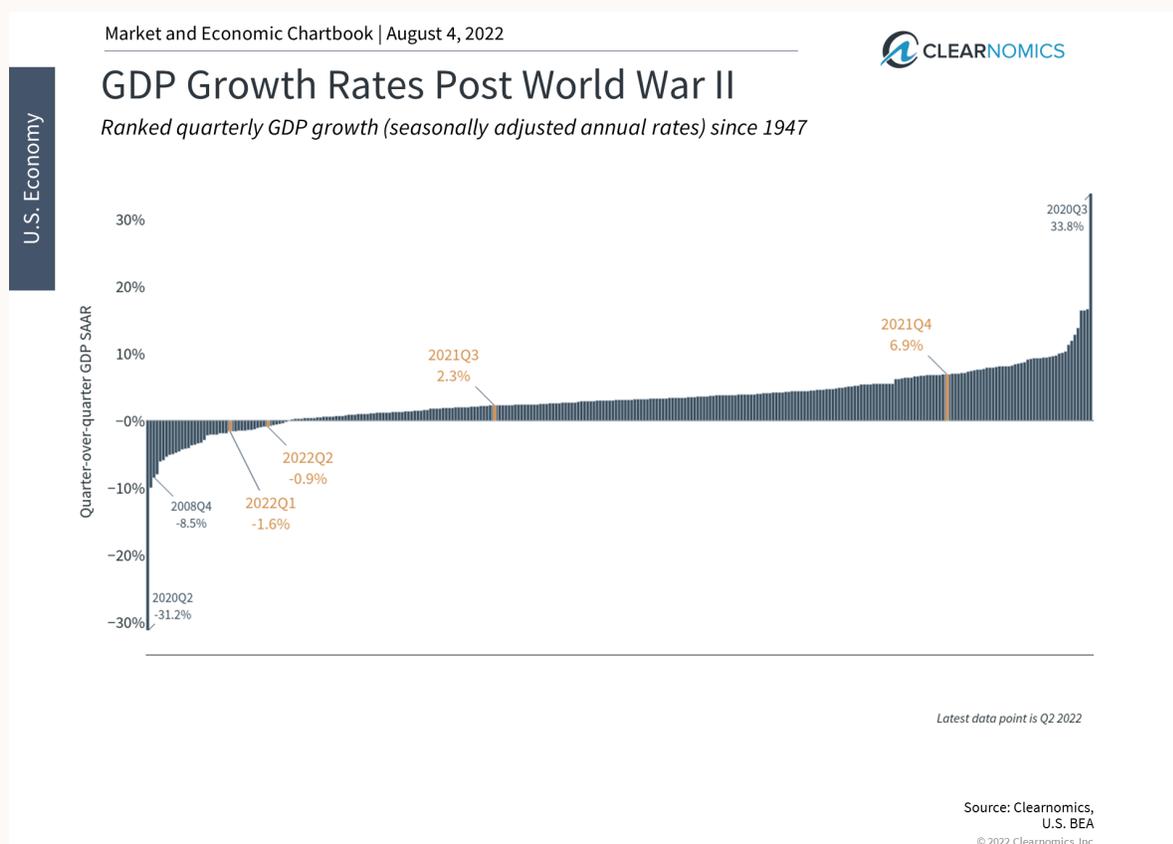


rates, at which future cash flows are net-present-valued (NPVed) and thereby reduce equity valuations (which, in turn, have generated the equity sell-off to date).

Tightening may also instigate a slowing of growth. The second-quarter GDP report showed that the economy shrank by 0.9%, and thus contracted across the first half of the year. As the chart below suggests, these declines are still small compared to historical recessions.

It's always the case that GDP reports, while closely followed, are backward-looking because they reflect events that took place in the previous quarter. However, it's valuable to scrutinize this report for another reason—to determine whether or not we're already in a recession. Although we've experienced two quarters of negative growth, the National Bureau of Economic Research has a more nuanced definition of recession that includes a broad set of economic factors.

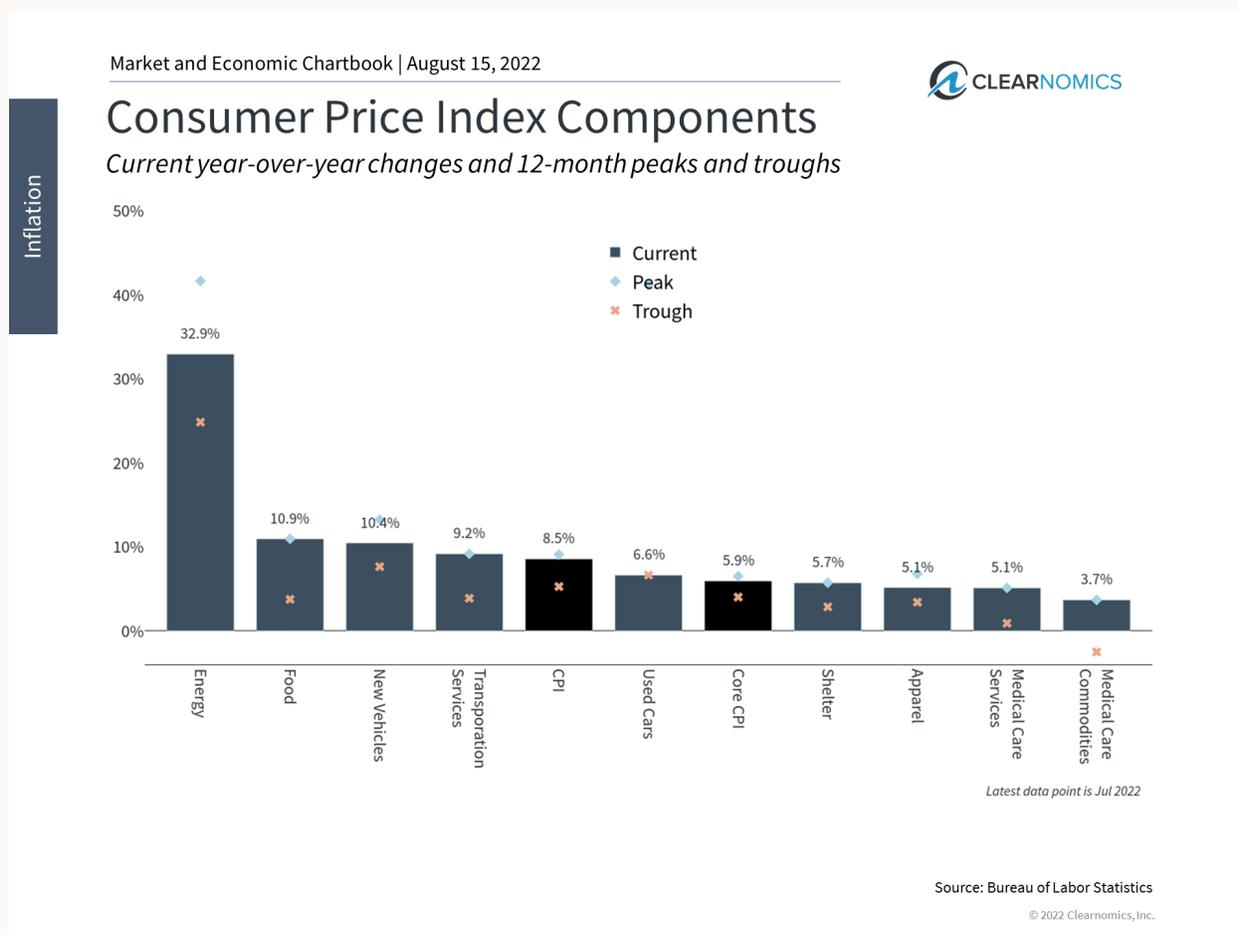
The fact that the economy shrank last quarter is not exactly a surprise. This economic slowdown is driven in large part by rising inflation and interest rates, and their impacts on consumers and businesses. In turn, there are many factors driving prices higher including supply chain disruptions, higher energy prices and central bank policies over the past few years. What makes it more difficult to interpret is that the growth numbers are relatively small compared to historical recessions, and the labor market has been exceptionally strong. Thus, the focus continues to be on inflation and whether pricing pressures may ease.





Inflation is pretty broad-based at this point, which may be indicative that it could be relatively persistent. Meanwhile, some signals—including falling fuel costs and an expensive dollar—point in the other direction.

As shown below, while the Consumer Price Index (CPI) rose 8.5% in July from the previous year, core CPI (which excludes the volatile components of food and energy) also rose swiftly at a rate of 5.9%. Both of these measures are at their highest levels since 1981 (when inflation was easing) and 1978 (when inflation was heating up). Consumer necessities such as new and used vehicles, shelter, apparel and other important categories all contributed. This has weighed on consumer sentiment, pushing it down to the lowest levels on record.



However, these indices have come off their recent peaks and there are signs that inflation could ease further later this year. When looking at overall CPI, oil prices have contributed the most to recent spikes. At its peak in June, the cost of energy for consumers rose 41.6% over the previous year, with gasoline prices jumping 59.9%. Since then, the price of oil has been stuck in a relatively narrow range and is now below \$100 per barrel, which is feeding through to gas prices.

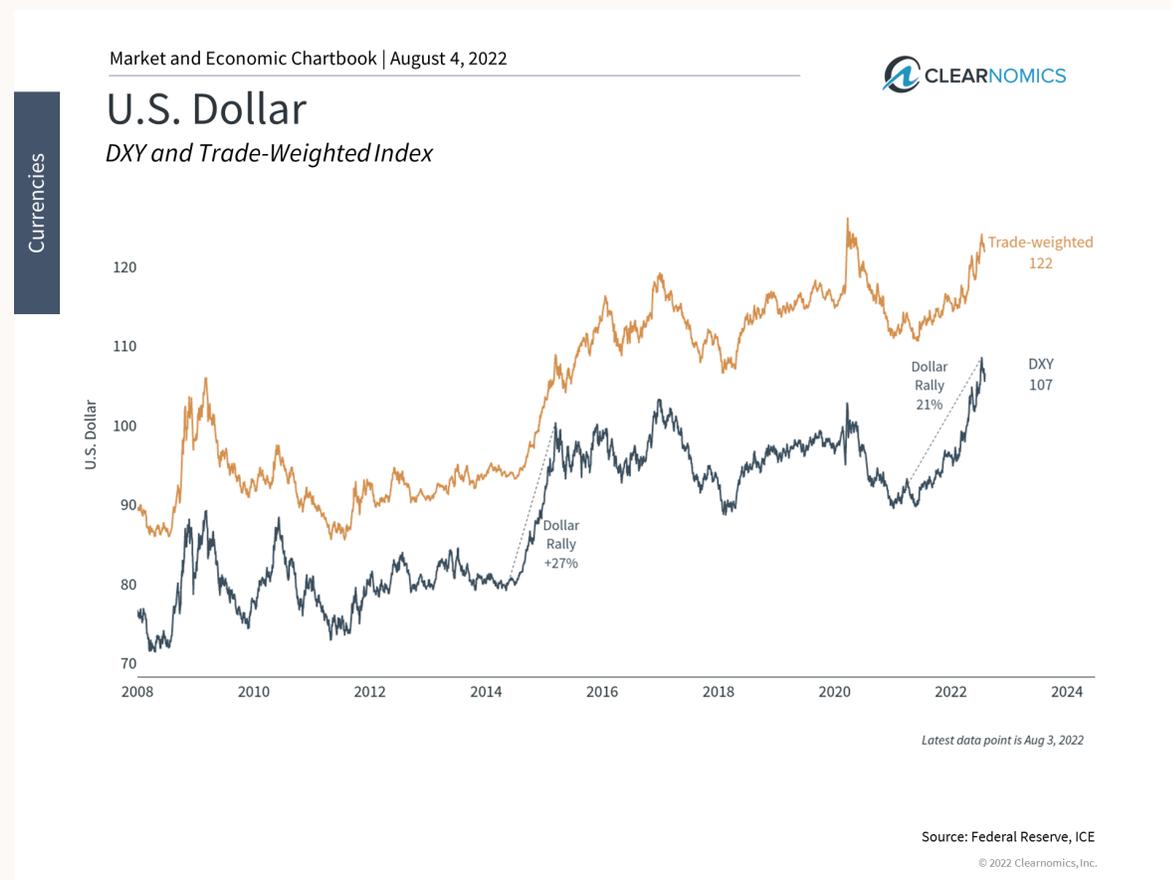


The price of wholesale gasoline, known as Reformulated Blendstock for Oxygenate Blending (or RBOB for short), has plummeted 30% from its June peak. Gasoline prices at the pump have also fallen from over \$5 a gallon for regular unleaded to around \$4. While these levels are still high and will continue to hurt consumer pocketbooks, there's reason to believe that some price pressures could soon ease.

As shown below, rising interest rates have pushed the U.S. dollar to its highest level since 2002. (Notably, the Euro recently dropped below parity with the dollar for the first time ever, albeit briefly.)

A strong dollar is great news for American travelers and for consumers buying foreign goods, who will find that their currency goes much further. This naturally lowers inflation since the prices that consumers pay will decline. A stronger dollar lowers oil prices too, because the commodity is mostly denominated in U.S. dollars, so each dollar represents more oil.

It's also the case that a strong dollar tends to slow the economy, because foreign buyers will find U.S. dollar-denominated products more expensive. While this may be negative for growth, it can also drive down inflation since there will be less demand for certain U.S.-produced goods and services. Thus, a stronger dollar naturally tightens financial and economic conditions. Although such tightening may slow the economy, it can also serve the important role of combating inflation.





The analysis within this initial Monthly Market Update underscores the usefulness of examining current market and economic conditions within the context of history. Although some market commentators have been trying to paint the present business climate as “unprecedented,” it’s crucial to understand whether or not that’s truly the case, and whether there are analogous historical scenarios that can provide some guidance on how portfolios may behave in the near-to-mid-term future. History-driven simulation provides a principled, systematic way for advisors and investors to quantitatively stress-test their portfolios and deepen their insight into the spectrum of likely outcomes.

Please contact Addepar Research to model your portfolios through our new stress-testing capabilities. We will continue to add new scenarios every month.

New Scenarios:

| Scenario | Description |
|-------------------------------|---|
| Stagflation in the 1970s | A combination of slow growth and rapidly rising prices (1965–1985) |
| Increasing inflation | All periods of inflation increasing as measured by previous month CPI to average of previous year (1970 to present) |
| Negative real GDP growth | All periods of real GDP contraction (1970 to present) |
| Last 75 basis point rate hike | Fed raises interest rates multiple times to generate a soft landing (Jan. 1994–June 1995) |



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