MARKET INSIGHTS

from Ziegler Capital Management

Our Perspective On The Federal Reserve

Written: October 5, 2022

Reality

As we approach the fourth quarter of 2022, with the S&P 500 total return down nearly 24% through three quarters this year and many risks ahead, all eyes are on the Federal Reserve as they combat inflation levels the U.S. hasn't seen since 1981. As 2022 began, the markets viewed the Fed as behind the curve. On September 21, 2022, the Fed announced the targeted Fed Fund Rate was increased by 75 basis points for the third consecutive meeting and aggregate hikes of 300 basis points in 2022. Cumulatively, these were the largest rate hikes in a six-month period since 1980. Additionally, Chairman Jerome Powell backed up the move with stern language illustrating the Fed's commitment to bring inflation in line with the 2% target.

"Reducing inflation is likely to require a sustained period of below trend growth," Chairman Powell said in the post FOMC press conference. "And, it will very likely [mean] some softening of labor market conditions."

He went on to clarify that the Fed is resolved in its inflation fight even if that means a hit to the labor market or even a recession.

"Restoring price stability is essential to set the stage for achieving maximum employment and stable prices over the long run," Powell said. "We will keep at it until we're confident the job is done."

"No one knows whether this process will lead to a recession or if so, how significant that recession would be. That's going to depend on how quickly wage and price inflation pressures come down, whether expectations remain anchored and also if we get more labor supply."

Paul Volcker
Fed Chairman 1979-1987

Jerome Powell
Fed Chairman 2018-Present

KEY TAKEAWAYS

- The Jerome Powell led Fed has been very clear that inflation is in their cross hairs, and they have the resolve to bring as much pain as needed to stabilize the market.
- The pain of the current reality is tough, but with a little perspective history gives us hope.

ABOUT ZCM MARKET INSIGHTS

A series that provides a glimpse of our internal thought process through current topics affecting our clients and colleagues.

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These are strong words that should be backed up by action. The markets reacted quickly to these comments and began to factor in the increased probability of a recession. Following the Fed meeting, interest rates increased, economically sensitive consumer discretionary and tech stocks underperformed, along with energy and commodities which historically have underperformed ahead of a recession.

We actively monitor the capital markets and are prepared to respond accordingly. As we have stated in the past, we continue to advise our clients to adhere to their long-term plans and objectives.

Perspective

Inflation impacts the behavior of consumers, entrepreneurs, and businesses. In 2022, its effects are painfully visible in the steep rise in mortgage rates, consumer finance costs, and corporate borrowing expenses. With resources diverted to pay more interest, consumers adjust their spending habits and create additional risk for investors including stagnating economic growth, decelerating earnings, market dispersion, and potentially P/E multiple contraction.

That said, the Fed's decisive actions directed at returning to price level stability are likely to result in a period of short-term pain and increase the risk the economy enters an official recession as economic growth remains weak. Historically, such moves proved worth it over a market cycle. Price level stability has the advantage of eliminating one risk component, enhancing economic stability. Although the S&P 500 declined in the early stages of both Fed rate increasing periods during the 1980s, over the decade it produced an annualized return of 13.9%, illustrating the equity market's affinity for strong Fed action.

Notice Chairman Powell's reference above to the benefits "over the long run" from restoring price level stability. For perspective on his point, let's look at perhaps the most acclaimed period of inflation fighting in the U.S. and the results that followed.

Starting in October of 1979, the Paul Volcker Fed famously broke the back of double-digit inflation with tight monetary policy. YOY CPI peaked in 1980 at 14.8% and fell to 1.1% in 1986, illustrating the success of his Committee's bold Fed actions. However, it is easy to forget that in the late 1980s inflation surged again with CPI peaking at 6.2% in 1990, which remained the high mark until recently. The 10-year Treasury yield peaked at 15.8% in 1981, but was over 9.0% in 1990, a full 11 years after Volcker took over at the Fed. A 9% 10-year Treasury yield indicated bond investors remained concerned about future inflation. This data gives perspective on how long it can take to bring down inflation expectations from extreme levels and the importance of the Fed's current strong actions.

Hope

Over the next three decades, investors grew confident in the Fed's stated objective of price level stability or as Chairman Alan Greenspan once said, "We want inflation so low that it doesn't matter." What does that mean?

The benefits of low inflation expectations are what Chairman Powell referenced above. Specifically, it means that the US had three decades where consumers, investors, and entrepreneurs had one less risk to evaluate in their decision making. Currently, inflation is resulting in each group adapting their decisions for the impact of this risk. In contrast, decades of price level stability resulted in sustained economic growth, strong employment, rising corporate profits, rising equity markets, and declining interest rates. The Fed appears to be focused on this goal.

Importantly, Chairman Powell is a student of monetary history and a devotee of Chairman Volcker. He recently said, “Who isn't an admirer of Paul Volcker? I knew him just a little bit and have tremendous admiration for him. He had the courage to do what he thought was the right thing.”

Although we are living through a period of financial market stress, the good news is that the Fed is acting decisively to displace inflation from the top of everyone’s mind. If history is a guide, we believe there is hope ahead, following this battle. In such a time, the markets can focus on fundamentals over fear.

Inflation and Performance During the 80s

	Annual Real Return on Inflation Rate	Bond Returns (Baa Corporate)	Stock Returns (S&P 500)
1980	12.52%	-3.32%	31.74%
1981	8.92%	8.46%	-4.70%
1982	3.83%	29.05%	20.42%
1983	3.79%	16.19%	22.34%
1984	3.95%	15.62%	6.15%
1985	3.80%	23.86%	31.24%
1986	1.10%	21.49%	18.49%
1987	4.43%	2.29%	5.81%
1988	4.42%	15.12%	16.54%
1989	4.65%	15.79%	31.48%
1990	6.11%	6.14%	-3.06%

Data Source: https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html
*Stocks represented by the S&P 500. Bonds represented by Baa Corporate Bonds.

S&P 500: The Standard & Poor’s 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. **US Baa Corporate Bonds:** Investment grade debt securities issued by US corporations. Baa bonds occupy the lowest tier of investment grade corporate bonds. The bonds make up slightly more than 50% of investment grade corporate bond indexes. **Consumer Price Index (CPI):** A measure of the aggregate price level in an economy. The CPI consists of a bundle of commonly purchased goods and services. The CPI measures the changes in the purchasing power of a country’s currency, and the price level of a basket of goods and services. **10-year Treasury note:** A loan you make to the U.S. federal government. It's the only one that matures in a decade. The note is a type of bond, which is the most popular debt instrument in the world. It's backed by the U.S. "Full Faith and Credit Clause." Compared to sovereign debt from other countries, there is little risk that the U.S. would default on these obligations.

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Printed Internally