Choreo®

APRIL 2024

Market Perspectives: Inflation *Matters*

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"We do not expect that it will be appropriate to lower our policy rate until we have greater confidence that inflation is moving sustainably down toward 2 percent. Given the strength of the economy and progress on inflation so far, we have time to let the incoming data guide our decisions on policy."

~Federal Reserve Chairman Jerome Powell, April 3, 2024

- Since the early days of the COVID-19 Pandemic, with the benefit of hindsight, a set of economic conditions were created destined towards building inflationary pressures that have impacted virtually all goods and services.
- Inflation arose due to mismatches of supply and demand, loose fiscal policy and highly accommodative monetary policy, led by low interest rates.
- The Federal Reserve (the "Fed") initially identified the inflation problem as "transitory" and arguably was slow to begin raising interest rates to slow economic momentum, and the accompanying inflationary pressure.
- The Fed reversed course in March of 2022 and raised rates faster than any period in history. While policymakers may now be approaching the end of the rate hike cycle as the impacts of policy decisions work through the economy, inflation has proven to be "sticky," delaying the first interest rate cuts at least temporarily.

March Madness, the cultural phenomenon surrounding the NCAA college basketball tournaments (both men and women), has come and gone once again, with the typical surprises, storylines, thrilling games and ultimately crowning a champion (congrats to the men's champion, UCONN, and women's champion South Carolina. What makes March Madness so compelling is the unpredictability and excitement, where any team, regardless of its seeding or regular-season performance, can rise to the occasion and pull off stunning upsets. The tournaments can serve as a metaphor for the outlook of the economy and financial markets.

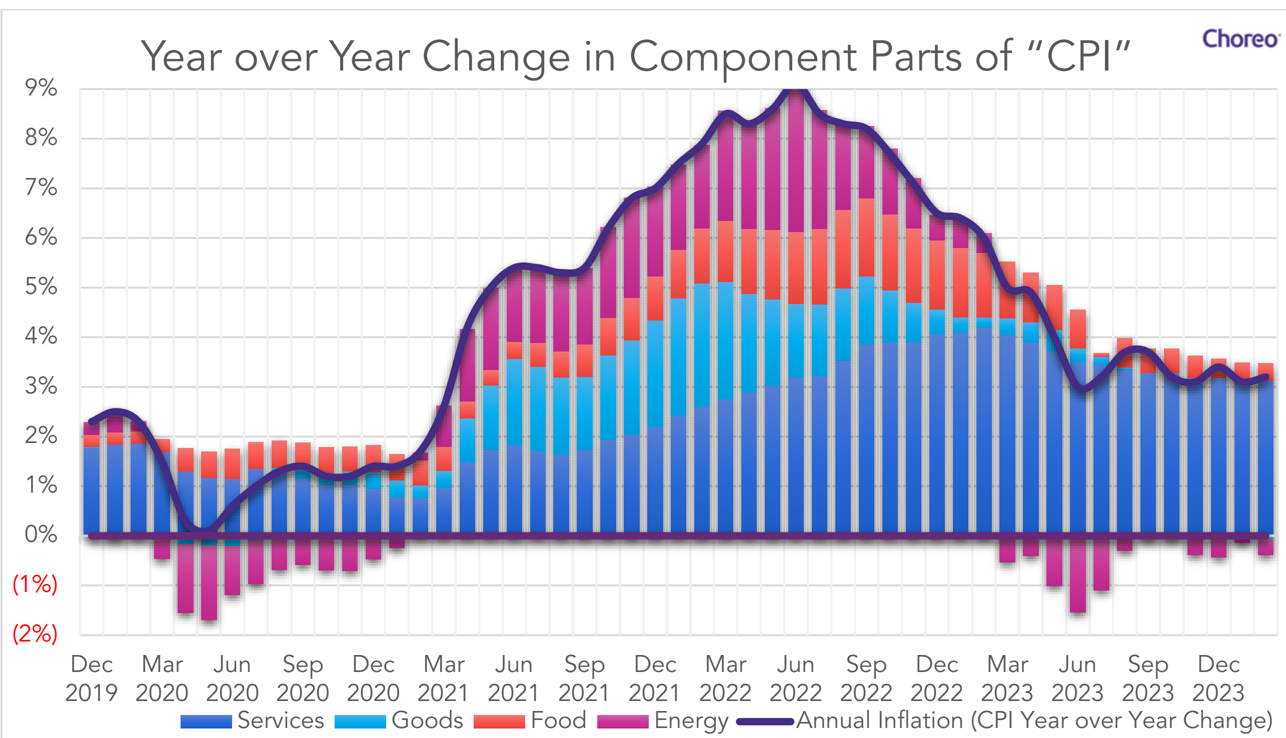
Just as in March Madness, the economic landscape is marked by uncertainty, where unforeseen events and variables can shape outcomes in unexpected ways.

Sports pundits and economists alike often misfire on predictions, as the future is inherently unknowable. The Fed, which had initially thought inflation was transitory (i.e., it would normalize once post-pandemic conditions stabilized), recognized the misstep and began doing the challenging work to reign in rapidly rising prices. In other words, policy changes to reverse accommodating policy required some level of economic pain in the form of higher interest rates, which makes borrowing more expensive, thereby reducing consumer demand and putting downward pressure on the economy. As inflation has fallen in recent months, markets and policymakers alike have begun the waiting game for when rates may begin to fall. The work of accepting higher rates to calm inflation appears to be paying off, albeit with the caveat that the future path may or may not continue in a downward fashion.

There are many methodologies used to define inflation but in simplest terms:

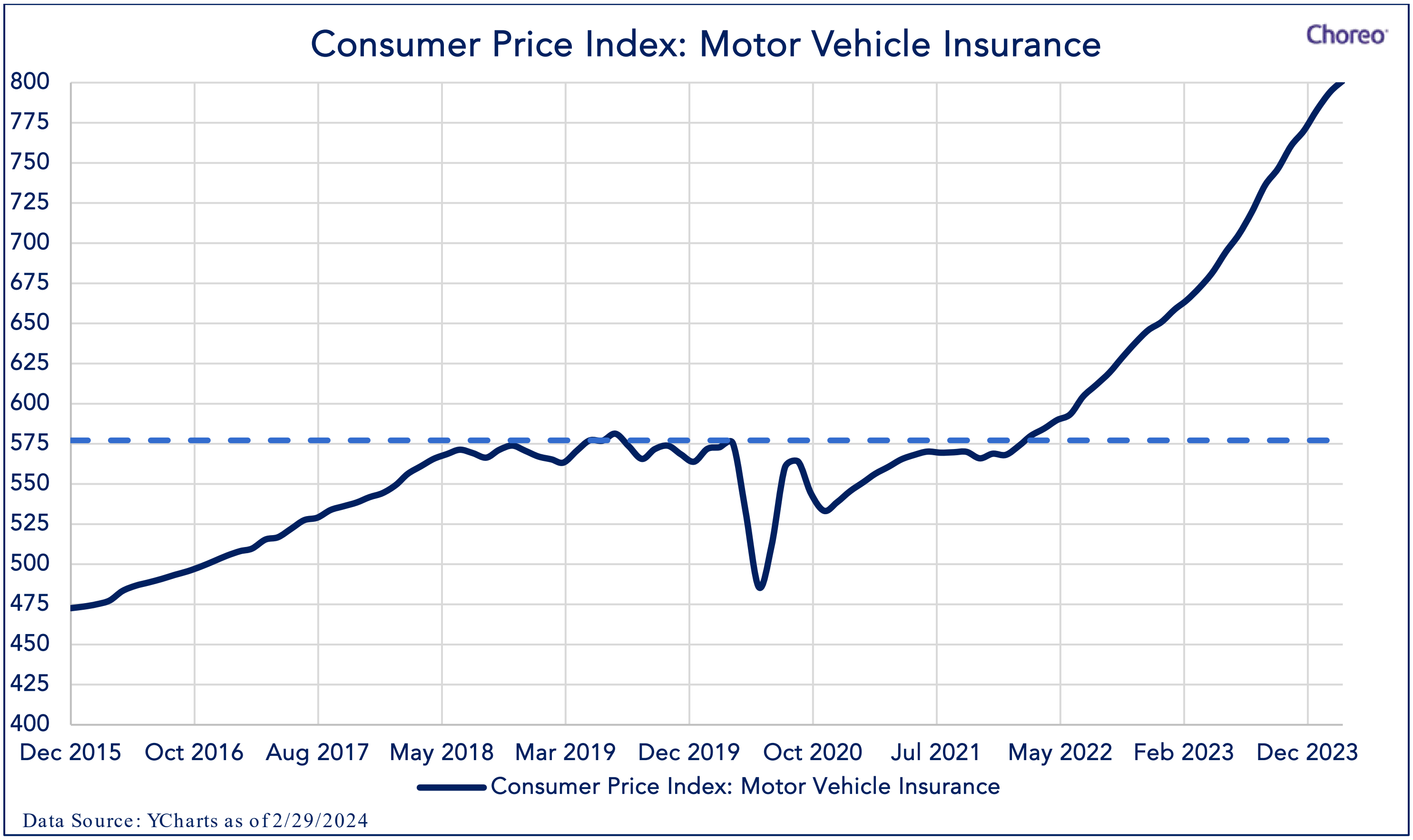
"Inflation can be defined as the overall general upward price movement of goods and services in an economy.[i]"

At a more granular level, goods, services, and other inputs move prices, some more than others. The graph below shows the contribution of each of the main categories of the Consumer Price Index ("CPI") over the last four years:

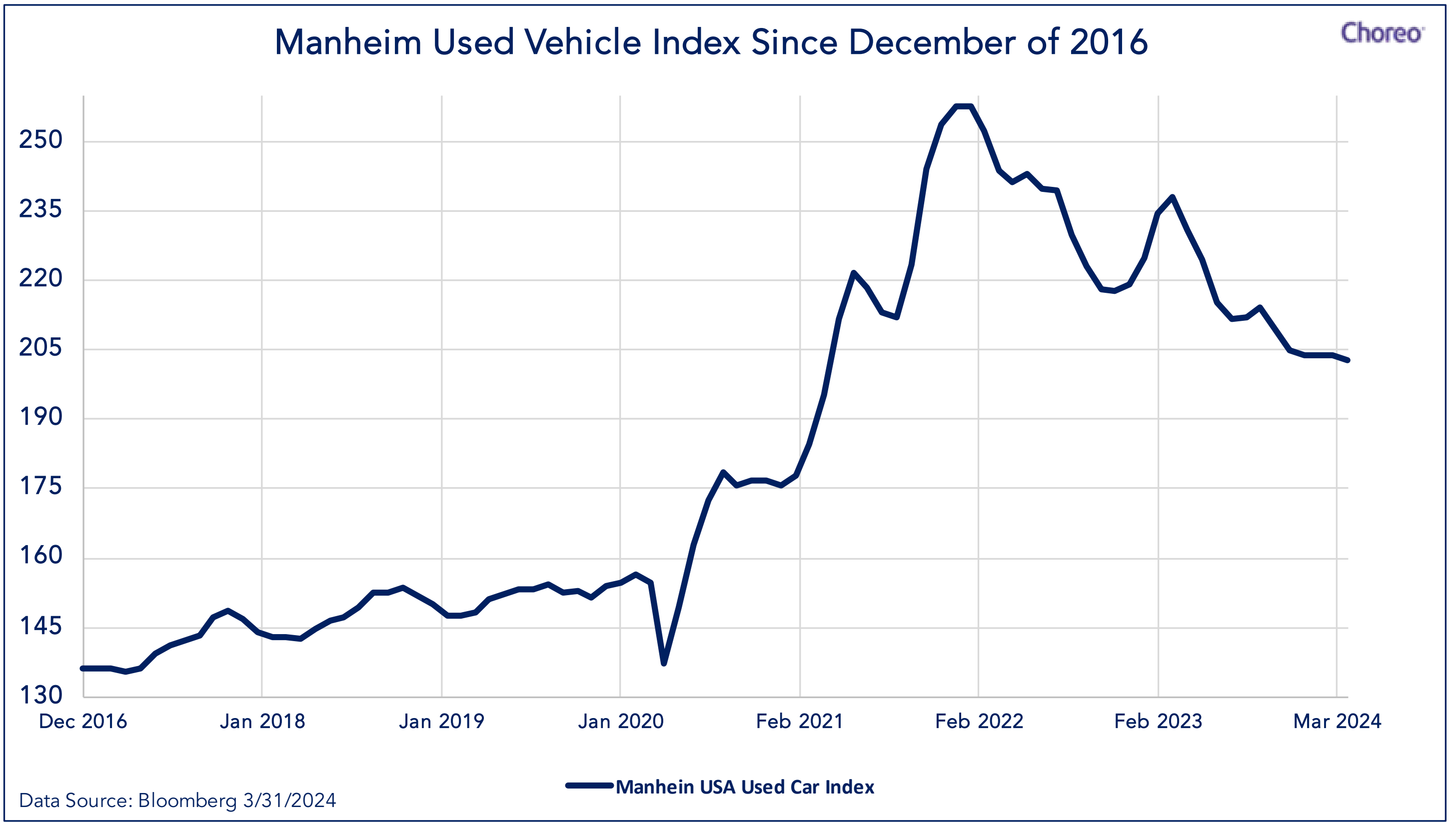


Data Source: Bloomberg 4/10/2024

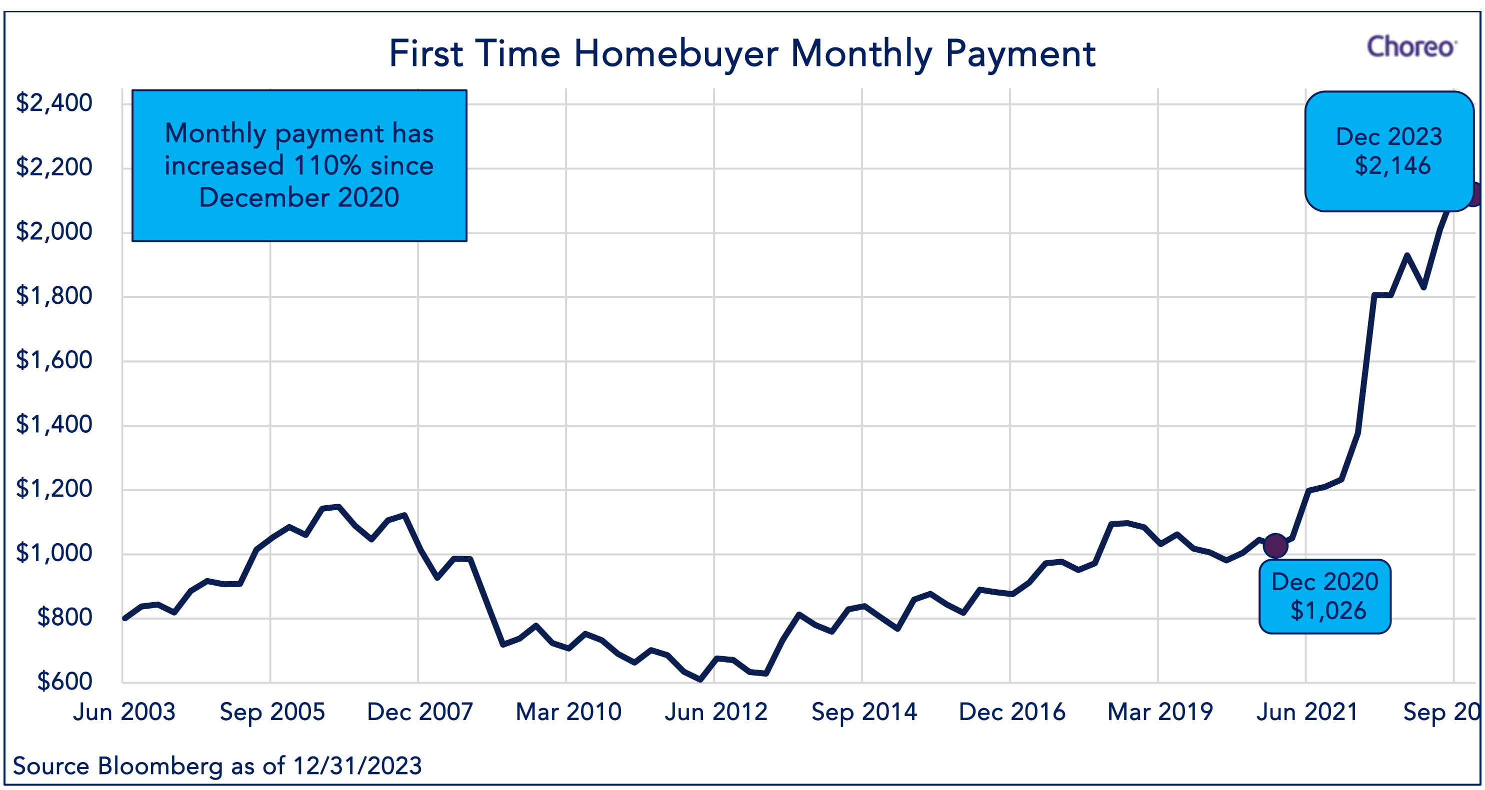
At the height of the pandemic, individuals and corporations alike were buying goods, largely in an environment with a temporarily broken supply chain. These purchases shifted towards the services sector once people resumed travel, visiting restaurants, etc. but the damage and backlogs to the goods sector was done. As a prime example, several years ago, automotive lots sat vacant and that lack of availability of new cars served as a force to drive used car prices up dramatically as shown in the graph below.



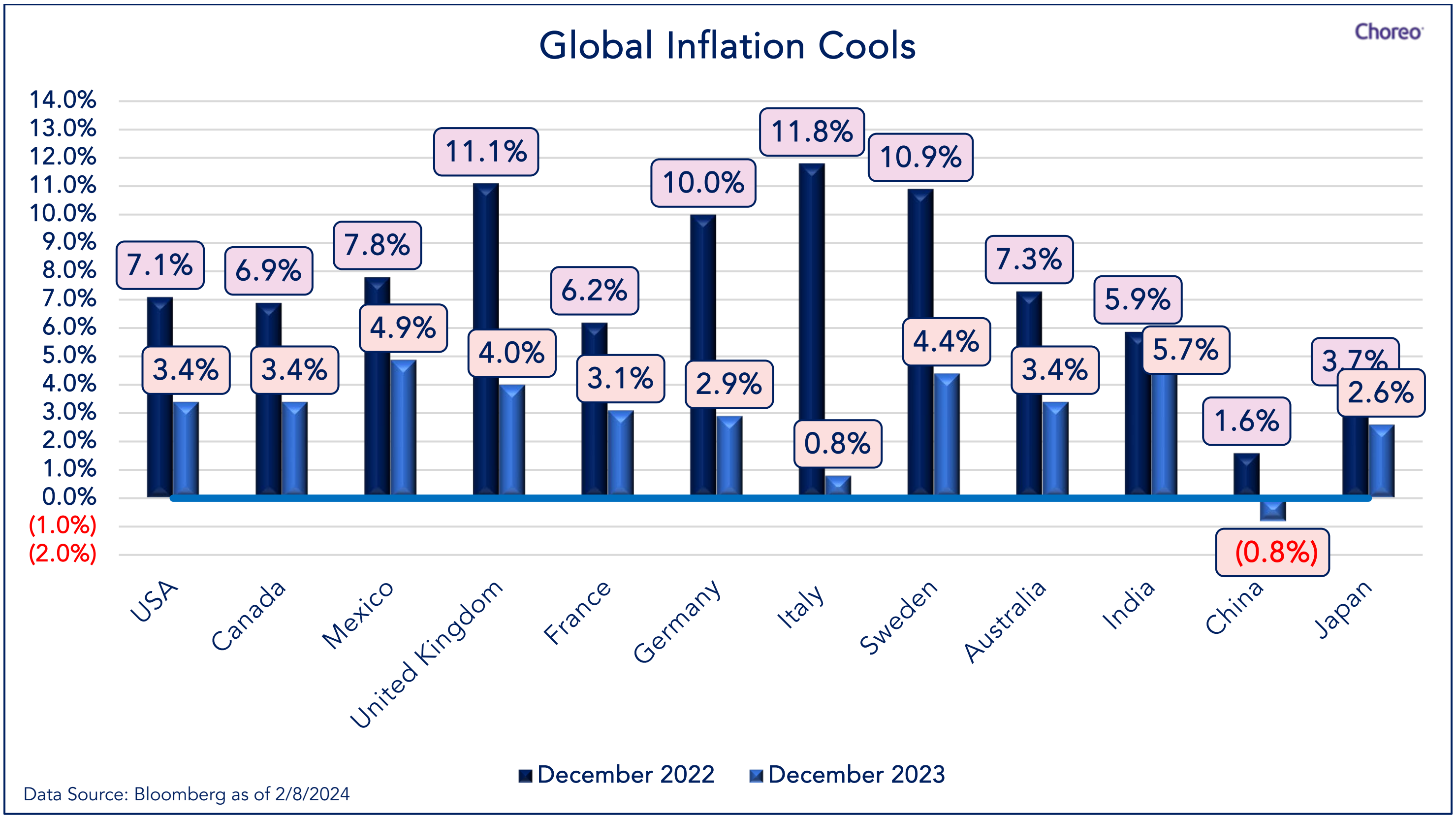
With used car prices elevated, the entire automobile industry experienced cost pressures. For example, a derivative of higher auto prices is the cost of insuring vehicles. Any consumer seeing an auto insurance renewal now is undoubtedly experiencing a real-world example of the impact of inflation, and the lagged impact of fiscal and monetary policy. Incidentally, the same has been true for most insurance related products in recent months. This trickle-down effect is another reason inflation is not moving more swiftly to the Fed's two percent target level.



The rapid increase in interest rates has also significantly impacted the shelter portion of the CPI. This is also the largest component of the indicator. Housing prices have not fallen since few homeowners are willing to get out of their low-rate mortgages, which has kept existing home inventory levels exceptionally low. Accordingly, the average mortgage payment for first-time home buyers has almost doubled in the last few years.



Overall, despite the mixed signals, inflation has come down dramatically, not just in the U.S. but around the world. The graph below shows the progress made, but much still needs to occur.



Inflation touches almost everything that consumers and businesses do. A predictable path of price movements is essential to moving global economies forward in a measured manner. This mission is even embedded in the Federal Reserve's dual mandate: 1. full employment and 2. stable prices. Despite the challenges posed by evolving monetary policy and the uncertainty as to the expected inflation path, markets have demonstrated remarkable resilience. With the arrival of spring and the emergence of potentially new conditions, our team at Choreo remains steadfast in our commitment to helping our clients achieve their long-term goals and objectives. As we close, we offer the following insight regarding inflation from the well-known" king-of-the-one-liners":

"Americans are getting stronger. Twenty years ago, it took two people to carry ten dollars' worth of groceries. Today, a five-year-old can do it."

~Henny Youngman, Comedian March 16, 1906 - February 24, 1998

As always, we encourage you to reach out to your Choreo advisor with any questions or concerns, as we stand ready to provide guidance and support throughout your investment journey.

[i] Data Source: Bloomberg 2/29/2024

Disclosures

Opinions are as of the date referenced and are subject to change based on market or economic conditions. There is no guarantee that any of these expectations will become actual results.

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