JANUARY 19, 2022

# ON THE RADAR

## FAQs on the Markets and Economy

# How Bad Is the Inflation Situation?

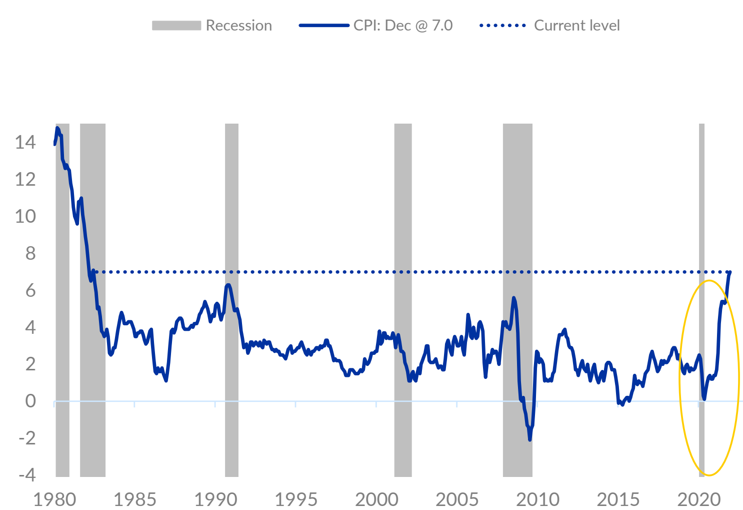
The 7.0% annual change in CPI is the largest increase in nearly 40 years. The yearly change in inflation has been accelerating due to very supportive base effects.

Small monthly gains from Q4 of last year have been replaced with higher inflationary pressured sectors impacted by pandemic-induced shortages. For example: used cars (37.3% y-o-y), new cars (12.0% y-o-y), and apparel (5.8 % y-o-y).

Inflation has proven to be more stubborn and widespread than the Fed expected. The last time inflation was this high, it was falling from a peak of nearly 15% (chart). It was a different story then. Oil prices had shot up from the Iranian revolution. This time, shortages from pandemic-induced supply chain issues combined with unprecedented demand from consumers flush with cash from government stimulus programs have driven prices higher.

**Consumer Price Index**

*% change, y-o-y, seasonally adjusted*




Source: Bureau of Labor Statistics, as of December 2021 .

## KEY QUESTIONS

**What Is The Fed Planning?**

**What Is Driving Recent Market Volatility?**

**What Is a "Real" Interest Rate?**

We believe inflationary pressures will soon slow, but significant decreases in the annual inflation rate will not happen until the second half of the year; supply chain issues will be slow to improve, and the strong base effect of Q2 2021 (from the reopening of the economy) will need to fall off the annual calculation.

# What Is The Fed Planning?

## The Fed is getting ready to raise interest rates.

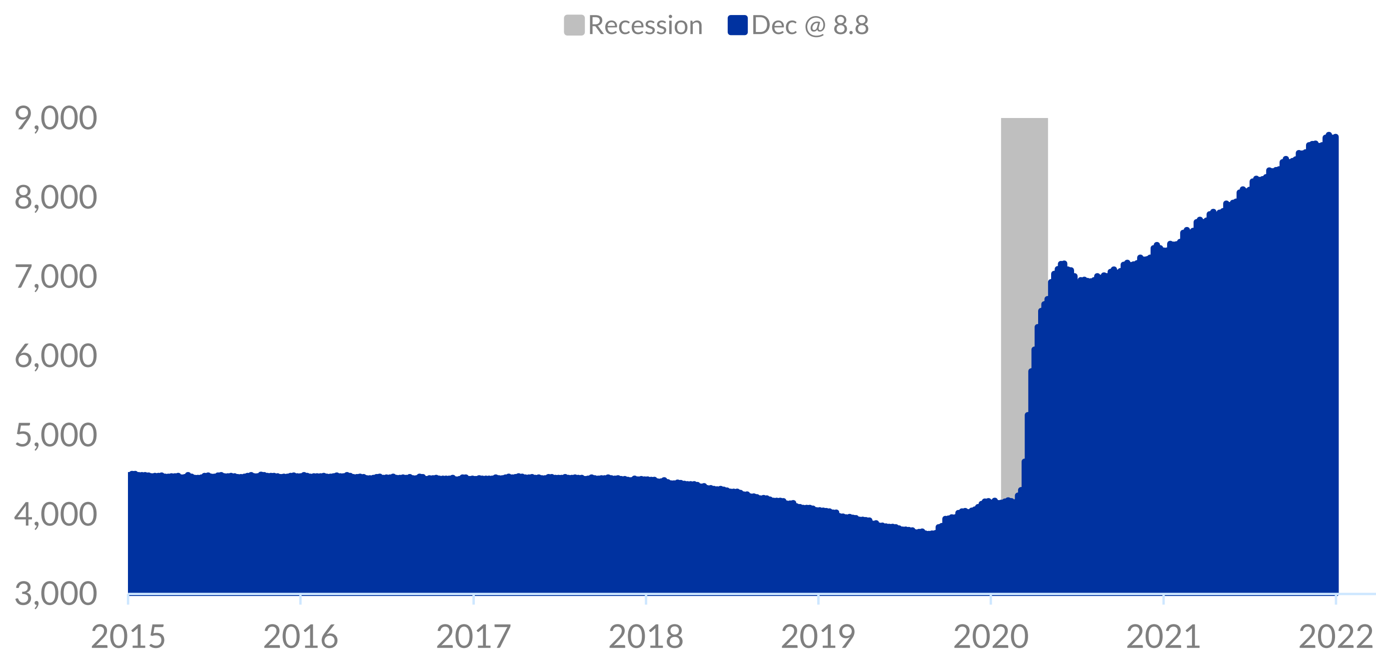
The Fed has decided that ultra-low interest rates are no longer needed. Chairman Powell believes that the high rate of inflation is a “severe threat” to the overall economy. He wants to push up interest rates to help reduce the risk of the higher rate of inflation becoming entrenched.

Back in December, the Fed made a sharp pivot toward a hawkish approach toward monetary policy. They announced plans to raise interest rates three times in 2022; back in September, they planned just one increase. But since that meeting, a number of the policymakers at the Fed have given speeches hinting at even more hawkish plans. CNR believes the Fed will start increasing interest rates as early as March.

Also being discussed by the Fed are plans to reduce the size of its balance sheet (chart). Since the pandemic began, the Fed has bought bonds to help bring down intermediate- and longer-term interest rates. That buying program is scheduled to end in March. Its balance sheet is almost $9 trillion in size (chart). It is expected to start reducing the bond holdings this summer.

**Fed Balance Sheet**

*$, billions, not seasonally adjusted*




Source: Federal Reserve, as of December 2021.

# What Is Driving Recent Market Volatility?

## Equity indices, particularly growth stocks, have sold off to start the new year with a more hawkish than anticipated Fed, rising bond yields, and the uncertain economic impact of the Omicron variant sparking worries among investors.

The backup in yields has been the most notable development and reflects changing expectations for monetary policy, with policymakers now expected to start the rate hike cycle as soon as March while also looking to reduce the Fed's $9 trillion balance sheet.

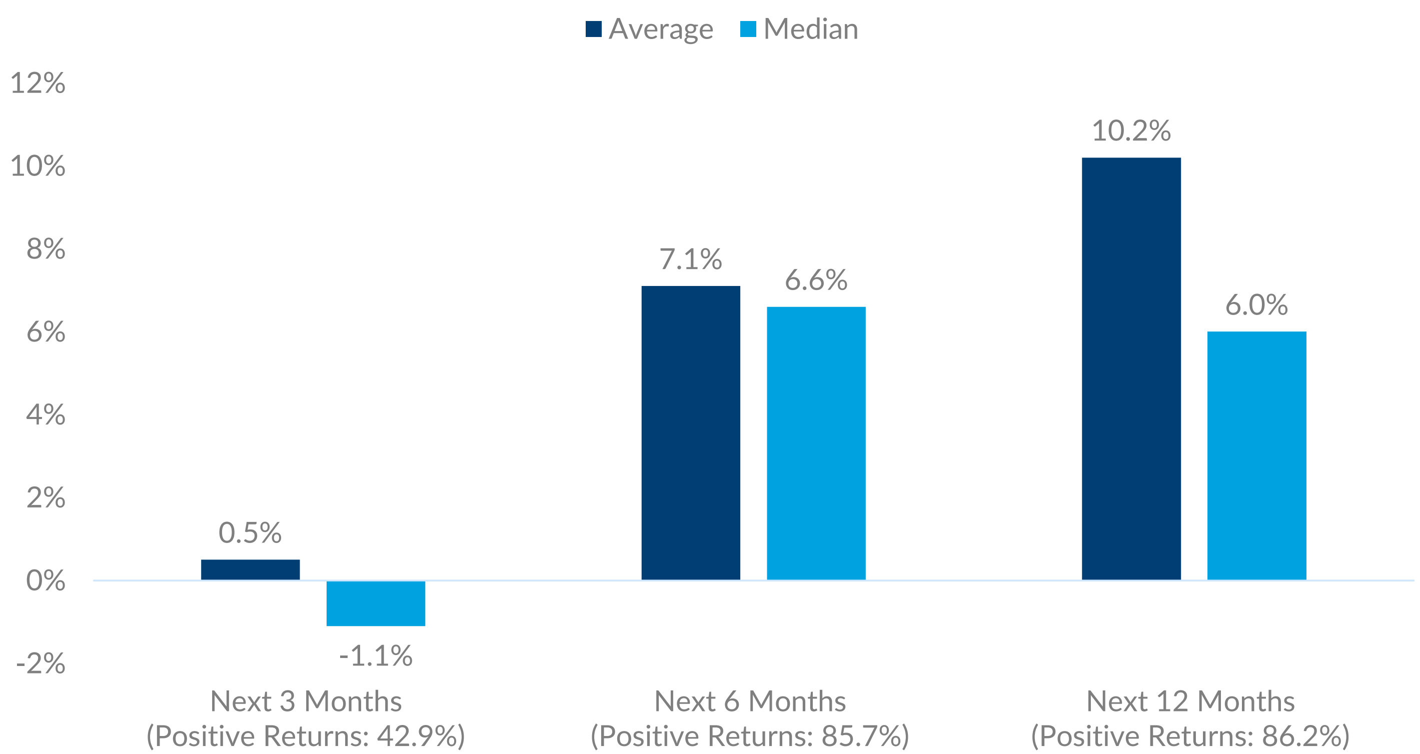
This has put pressure on sectors that are considered long duration and have loftier valuations, like parts of tech, as well as on sectors that are considered "bond-like," such as real estate and utilities, that have high yields and more stable cash flows.

As the market continues to adjust to tighter monetary policy, more volatility is likely. Higher interest rates will be an increasing headwind for valuations going forward, and we expect returns to moderate from last year's outsized gains.

At the same time, we don't think the Fed will be quick to tighten to the point that will undermine the broader bull market. Historically, stocks can struggle initially after the first rate hike, but returns after 6 to 12 months have been positive over 85% of the time.

Indeed, we continue to find prospects for equities as attractive, especially relative to bonds, driven by sustained economic growth and robust earnings, the likelihood that pandemic risks fade as 2022 progresses and our expectation that inflation will be more manageable by the latter part of the year.

**S&P 500 Performance After First Fed Rate Hike**



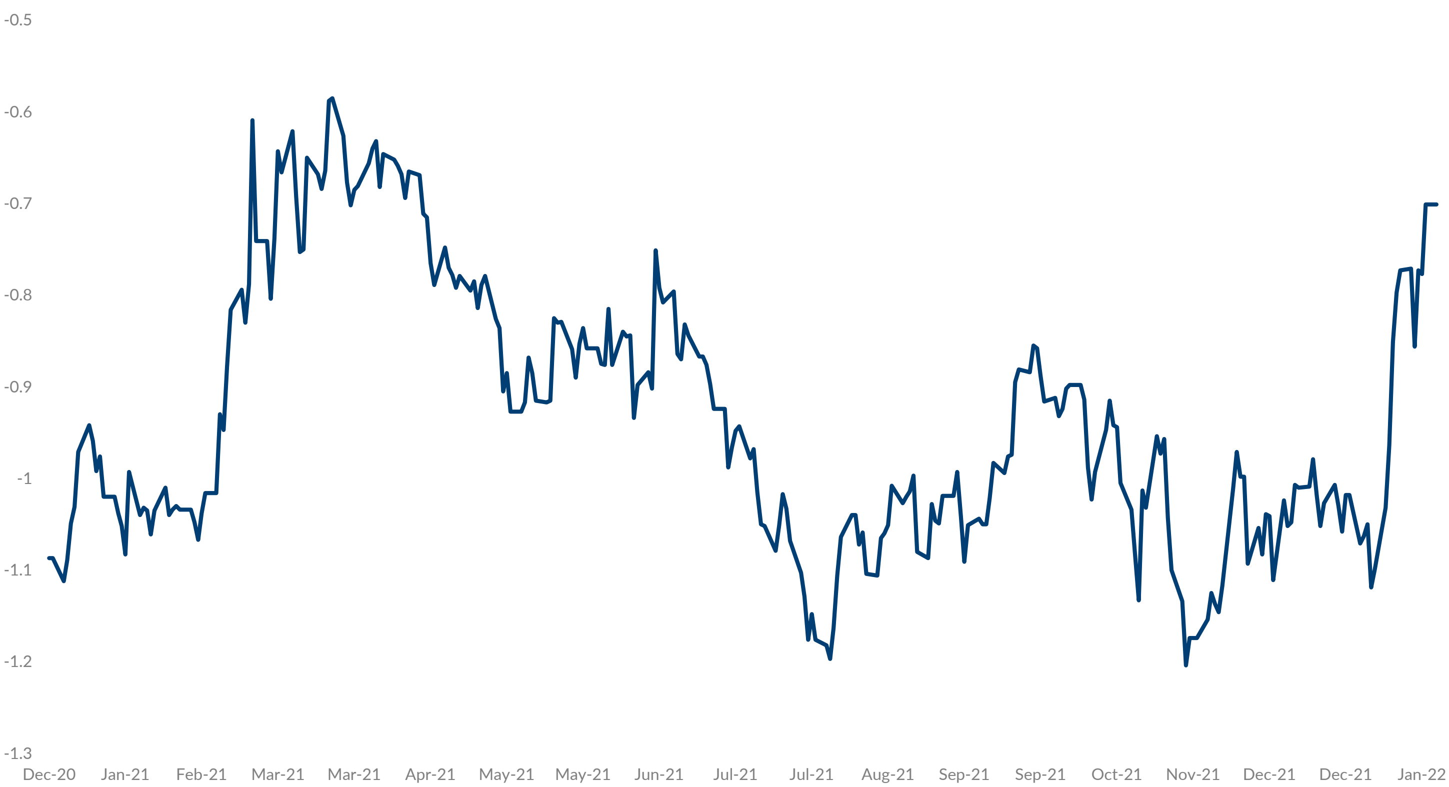

Source: Bloomberg.

# What Is a "Real" Interest Rate?

## The Fed's abrupt shift toward tighter policy has led to an increased discussion on the concept of real interest rates.

The easiest way to think about a real rate is to select a maturity on the U.S. Treasury curve and adjust it for inflation. The most precise market-based measure of this is provided by the Treasury Inflation-Protected Securities market. Today, the 10-year level is approximately -0.64%. The lower the rate, the higher the level of monetary accommodation in the economy. At times of stress when growth is low, negative real rates help to stimulate economic activity. However, it comes with a downside when growth is high and spending is robust. The need for monetary accommodation is reduced and, if unadjusted, it can result in persistent inflationary pressure. The Fed is facing this downside and is acting decisively to push real rates into positive territory. The good news is that after touching a historical low in 2021, real yields have begun to move higher. We can expect the Fed to continue reducing accommodation until real rates reach sustainably positive levels.

**10-Year TIPs Yield - "Real Yield"**




Source: Bloomberg.

TIPS: Treasury inflation-protected securities.

## IMPORTANT DISCLOSURES

The information presented does not involve the rendering of personalized investment, financial, legal, or tax advice. This presentation is not an offer to buy or sell, or a solicitation of any offer to buy or sell, any of the securities mentioned herein.

Certain statements contained herein may constitute projections, forecasts, and other forward-looking statements, which do not reflect actual results and are based primarily upon a hypothetical set of assumptions applied to certain historical financial information. Certain information has been provided by third-party sources, and although believed to be reliable, it has not been independently verified, and its accuracy or completeness cannot be guaranteed.

Any opinions, projections, forecasts, and forward-looking statements presented herein are valid as of the date of this document and are subject to change.

There are inherent risks with equity investing. These include, but are not limited to, stock market, manager, or investment style risks. Stock markets tend to move in cycles, with periods of rising prices and periods of falling prices.

Investing in international markets carries risks such as currency fluctuation, regulatory risks, and economic and political instability.

There are inherent risks with fixed income investing. These may include, but are not limited to, interest rate, call, credit, market, inflation, government policy, liquidity, or junk bond risks. When interest rates rise, bond prices fall. This risk is heightened with investments in longer-duration fixed income securities and during periods when prevailing interest rates are low or negative.

Investing involves risk, including the loss of principal.

As with any investment strategy, there is no guarantee that investment objectives will be met, and investors may lose money.

Past performance is no guarantee of future performance.

This material is available to advisory and sub-advised clients, as well as financial professionals working with City National Rochdale, a registered investment advisor and a wholly-owned subsidiary of City National Bank. City National Bank provides investment management services through its sub-advisory relationship with City National Rochdale.