Monday, May 9, 2022

Good morning:

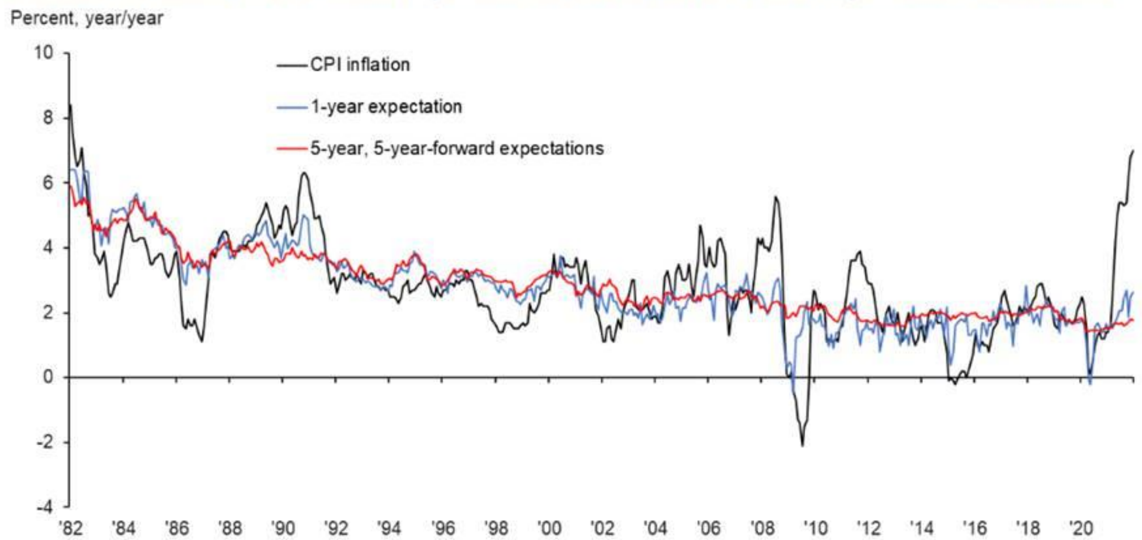
In discussing the current correction last week in the face of rising interest rates, we suggested that the market may do something counterintuitive and actually rally in response to the Fed's forthcoming rate hike. In a climate where traders were clearly selling the rumor, then buying the news of a 50-basis point Federal Funds rate increase, equities, in fact, staged an impressive 3% surge on Wednesday afternoon after Chairman Powell's comments dampened expectations for a series of more aggressive rate hikes to come.

Unfortunately, hopes that this move higher signaled the end of the equity correction were short-lived as 10-year Treasury bond yield surged above 3.00% on Thursday causing traders to once again sell stocks. This was particularly true among aggressive and leveraged hedge funds that may have been forced to raise capital and deleverage. By week's end, major averages had given up all of Wednesday's gains and finished again in the red for the week. Although it certainly seemed worse due to the extreme volatility, the S&P 500 lost a mere 0.18% and the Dow 0.21% on the week. The NASDAQ posted a loss of 1.50% continuing the recent trend of large cap technology companies leading the market lower.

We also suggested that market bottoming is often a *process* whereby stocks trade down to a level of support and then trade sideways for a while before starting a new uptrend. With the 10-year Treasury moving up to above 3.15% earlier in today's trading, equities are again moving sharply lower to start the week. All of the major equity averages are now down to 52-week lows in spite of a fairly positive Q1 earnings season. In this oversold market environment where we continue to expect heightened volatility in both directions, we are watching for two additional possible scenarios.

One is the spike in the VIX (CBOE Volatility Index) above 40 which may signal the capitulation washout often seen at market bottoms. The other is a surprise announcement that triggers a positive change in market sentiment. This could come in the form of a resolution to the war in Ukraine or a change in leadership in Russia, both of which seem unlikely at this time. However, it also could more plausibly come this Wednesday with the release of April CPI data. The expectation is that inflation will begin to decline from March's red hot 8.5% level, but a bigger decline may signal that inflation has peaked and will continue to fall as the year progresses, confirming current 1 and 5 year inflation expectations.

Headline CPI Inflation, 1-Year Inflation Expectation and 5-Year, 5-Year-Forward Expectations Guide Outlook



NOTE: CPI is Consumer Price Index.
SOURCES: Federal Reserve Bank of Cleveland; Bureau of Labor Statistics.

Federal Reserve Bank of Dallas

We concur with the majority of market strategists who see the equity market navigating through this difficult period to end the year higher than where we are today, and possibly where we started the year. Bonds will remain challenged as rates continue to rise, while cash loses over 8% in purchasing power due to inflation. As unpleasant as market corrections are to endure, they do not last forever and are exceedingly difficult to effectively time. Focusing on higher quality dividend strategies may provide some protection from this pullback.

Have a great week!

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