CETERA® INVESTMENT MANAGEMENT

COMMENTARY

June 16, 2022

Risk of Fed Policy Error Increases

- The Federal Reserve hiked interest rates by 0.75% for the first time since 1994 to slow inflation.
- A Fed policy error could push the economy into a recession.
- The initial reaction from markets was positive, but volatility returned today, driving stocks lower.

The Federal Reserve's (Fed) FOMC meeting concluded yesterday with the first 0.75% rate hike in 28 years to address persistently high inflation, pushing the federal funds rate to a range of 1.50% to 1.75%. The Fed also updated their economic projections. Compared to their March projections, they expect higher inflation, slightly higher unemployment, and slower growth by the end of the year. Markets were expecting a 0.50% rate hike, which the Fed was telegraphing in prior comments, but expectations increased to a 0.75% hike after last Friday's May CPI inflation report indicated that headline inflation rose to a new cycle high. During yesterday's post-meeting press conference, Fed Chair Jerome Powell mentioned that the data-dependent Fed increased rates at a higher rate because inflation is not slowing, and consumer inflation expectations are increasing based on the most recent University of Michigan consumer sentiment survey. The closely watched Fed dot plot, which is a chart plotting the projected interest rate path from Fed voting members, showed a median interest rate projection of 3.4% by the end of the year. That is a significant increase from the Fed's previous projection of 1.9% in March. The median interest rate projection increased to 3.8% for 2023 and 3.4% for 2024.

The Fed is willing to sacrifice economic growth and negatively impact the strong labor market to crush inflation. While Chair Powell said gas and food price inflation is largely out of the Fed's control because commodities are priced in global markets, the Fed would attempt to control this type of inflation by slowing economic growth, leading to reduced demand. This was a big shift in the Fed's thinking. They previously looked at core inflation data, which excludes food and energy, because these are more volatile and largely out of the Fed's control. Now they are looking more at headline inflation and making decisions based on this more volatile metric. This could prove to be a mistake and the risk of a policy error, or the Fed hiking rates too aggressively and pushing the economy into a recession, is without question higher at this point. The Fed is also behind the curve and missed an opportunity to ease into a rate hike cycle when inflation began to rise last year. Now the Fed is forced to be more aggressive at a time when the economy is slowing.

Markets are forward-looking and that is why the S&P 500 fell into a bear market, despite the economy adding nearly 2.5 million jobs in the first five months of the year. Investors are concerned that a recession might be on the horizon. In our view, if a recession does occur, it would likely be mild because there is still a lot of labor demand and consumer balance sheets are healthy. Moreover, a soft landing is a possibility too. A recession was avoided in 1994 despite the Fed aggressively hiking interest rates. This was the last time the Fed increased rates by 0.75%.

While the Fed significantly increased interest rate projections, there is a chance they won't have to be so aggressive if inflationary pressures begin to ease. Higher rates are already slowing the housing market, there are signs of supply constraints easing, wage growth is decelerating, and consumer spending on durable goods is slowing. Moreover, used car price growth is declining (an outlier driver of last year's inflation) and the sky-high pace of vacation-related inflationary pressures are not likely to be sustained.

Stocks are in a bear market for the first time since March 2020 and volatility remains elevated. Stocks initially responded to the Fed's interest rate hike by advancing higher, but the gains didn't persist, and equities declined sharply the next morning. Today's market weakness is that markets are realizing that yesterday's news from the Fed is not as positive as initially perceived. In other words, the Fed is willing to sacrifice economic growth to combat inflation. While steep stock market declines are scary, the best long-term opportunities can arise after big declines. Looking at the last six bear markets since 1982, U.S. equities had strong returns a year after the bear market ended.

Figure 1:
Returns at Start of Bull Market

	1-Year Return (%)			
Bull Market Start Date	**Large Cap Growth**	**Large Cap Value**	**Small Cap Growth**	**Small Cap Value**
Aug-1982	62.2	61.1	99.3	89.6
Dec-1987	18.1	28.5	26.7	33.1
Oct-1990	36.4	27.0	50.8	40.0
Oct-2002	35.5	40.2	67.3	55.1
Mar-2009	68.1	78.3	88.3	98.8
Mar-2020	85.3	78.9	117.2	121.8
Average	***50.9***	***52.3***	***74.9***	***73.1***

Source: Cetera Investment Management, Morningstar, Russell Investments. Returns shown are total return, which includes dividends. Large Cap stocks are represented by the Russell 1000 Index. Small Cap stocks are represented by the Russell 2000 Index.

Though it cannot be known when market declines will end, the longer-term outlook improves when valuations are at more attractive levels, as is the case at present. It is important to have an allocation that is aligned with your risk tolerance, and we advise that you work closely with your Cetera investment professional for guidance through these volatile times.

About Cetera® Investment Management

Cetera Investment Management LLC is an SEC registered investment adviser owned by Cetera Financial Group®. Cetera Investment Management provides market perspectives, portfolio guidance, model management, and other investment advice to its affiliated broker-dealers, dually registered broker-dealers and registered investment advisers.

About Cetera Financial Group

"Cetera Financial Group" refers to the network of independent retail firms encompassing, among others, Cetera Advisors LLC, Cetera Advisor Networks LLC, Cetera Investment Services LLC (marketed as Cetera Financial Institutions or Cetera Investors), Cetera Financial Specialists LLC, and First Allied Securities, Inc. All firms are members FINRA / SIPC. Located at 655 W. Broadway, 11th Floor, San Diego, CA 92101.

Disclosures

Individuals affiliated with Cetera firms are either Registered Representatives who offer only brokerage services and receive transaction-based compensation (commissions), Investment Adviser Representatives who offer only investment advisory services and receive fees based on assets, or both Registered Representatives and Investment Adviser Representatives, who can offer both types of services.

The material contained in this document was authored by and is the property of Cetera Investment Management LLC. Cetera Investment Management provides investment management and advisory services to a number of programs sponsored by affiliated and non-affiliated registered investment advisers. Your registered representative or investment adviser representative is not registered with Cetera Investment Management and did not take part in the creation of this material. He or she may not be able to offer Cetera Investment Management portfolio management services.

Nothing in this presentation should be construed as offering or disseminating specific investment, tax, or legal advice to any individual without the benefit of direct and specific consultation with an investment adviser representative authorized to offer Cetera Investment Management services. Information contained herein shall not constitute an offer or a solicitation of any services. Past performance is not a guarantee of future results.

For more information about Cetera Investment Management, please reference the Cetera Investment Management LLC Form ADV disclosure brochure and the disclosure brochure for the registered investment adviser your adviser is registered with. Please consult with your adviser for his or her specific firm registrations and programs available.

No independent analysis has been performed and the material should not be construed as investment advice. Investment decisions should not be based on this material since the information contained here is a singular update, and prudent investment decisions require the analysis of a much broader collection of facts and context. All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy. The opinions expressed are as of the date published and may change without notice. Any forward-looking statements are based on assumptions, may not materialize, and are subject to revision.

All economic and performance information is historical and not indicative of future results. The market indices discussed are not actively managed. Investors cannot directly invest in unmanaged indices. Please consult your financial advisor for more information.

Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards.

A diversified portfolio does not assure a profit or protect against loss in a declining market.

The Russell 1000 index is a stock market index that tracks the top 1,000 stocks by market capitalization in the Russell 3000 Index, which represent about 90% of the total market capitalization of that index.'

The Russell 2000 index is comprised of 2000 small-capitalization companies. It is made up of the bottom two-thirds in company size of the Russell 3000 index.