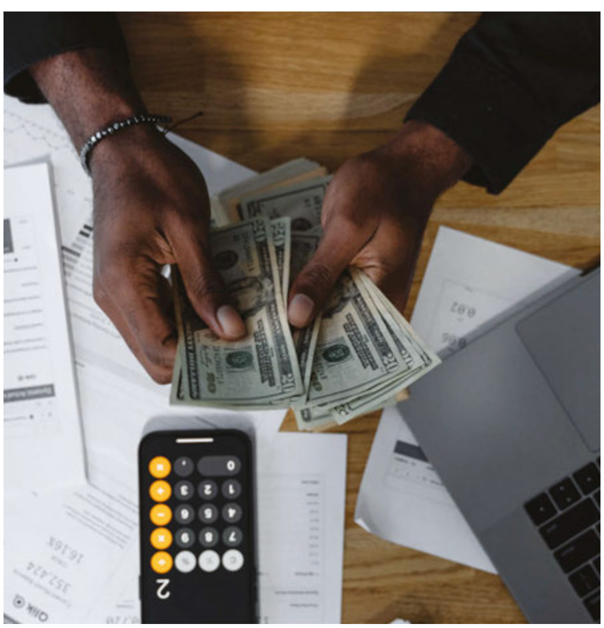
INVESTMENT INSIGHTS

Analysis, Insights, and a Different Perspective

July 2023

KEY POINTS

- With the Federal Reserve raising short-term rates, economic growth is expected to slow with inflation moderating.
- While Consumer Price Index (CPI) inflation is improving, the Fed still has some time until its 2% inflation goal is reached.
- Inflation for goods is moderating. Service inflation is stickier and has yet to entirely moderate and be reflected in the CPI.
- Inflation is an important macro-economic variable to follow and must be considered when making investment decisions to pursue your goals.



FED POLICY AND INFLATION UPDATE

FED UPDATE

As the Federal Reserve (Fed) raises rates to keep the economy from overheating, it expects economic growth to slow and unemployment to rise. Earlier this month, the Fed released its quarterly Summary of Economic Projections (SEP), which includes key economic variables such as gross domestic product (GDP), unemployment, inflation, and the federal funds rate. The Fed is expected to raise the federal funds rate to approximately 5.6%, slightly above its March expectations of 5.1% by year-end.

Variable	Median			
	2023	2024	2025	Longer Run
Change in Real GDP	1	1.1	1.8	1.8
March Projection	0.4	1.2	1.9	1.8
Unemployment Rate	4.1	4.5	4.5	4
March Projection	4.5	4.6	4.6	4
PCE* Inflation	3.2	2.5	2.1	2
March Projection	3.3	2.5	2.1	2
Core PCE* Inflation	5.6	4.6	3.4	
March Projection	5.1	4.3	3.1	
Projected appropriate policy path:				
Federal Funds Rate	5.6	4.6	3.4	2.5
March Projection	5.1	4.3	3.1	2.5

*Note that the Fed's preferred measure for inflation is Personal Consumption Expenditures (PCE), while Consumer Price Index (CPI) is better known. Given they have similar general trends, we use them interchangeably in this newsletter.

Source: June Summary of Economic Projections by Federal Reserve.

Cornerstone
WEALTH SERVICES

The most recent Consumer Price Index (CPI) shows that it has been roughly cut in half since last summer. CPI rose at approximately 8.5% on a year-over-year basis in May 2022 and 4.1% on a year-over-year basis in May 2023. However, the not-so-good news is that, while the Fed has made some great progress on inflation, it does not expect to reach the inflation target of 2 percent until after 2025. Core CPI (CPI excluding Food and Energy) only declined from 6% in May 2022 to 5.3% in May 2023 because some components of inflation, like services, are "sticky," which means it effects on CPI and overall inflation stick around for longer than other areas of inflation. Let's take a closer look at these dynamics.

CONSUMER PRICE INDEX - CHANGE FROM A YEAR

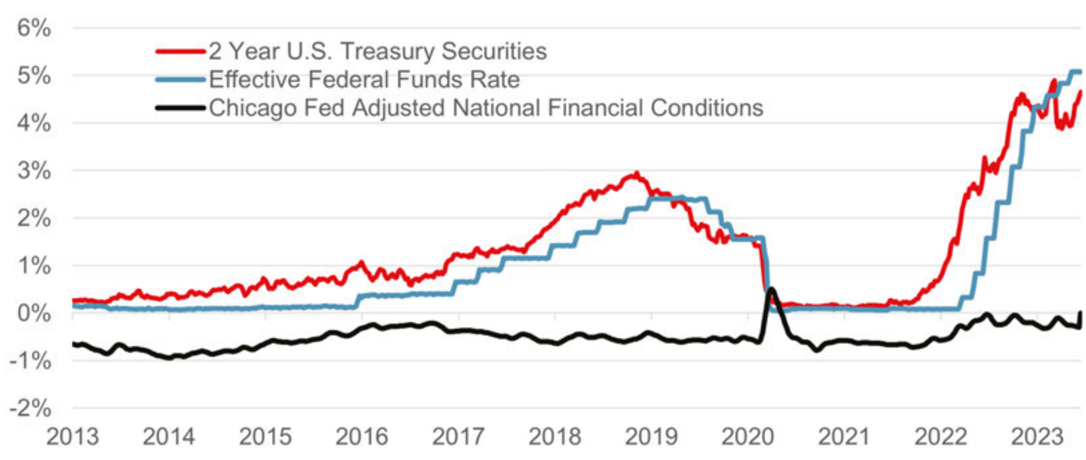
Source: U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in U.S. City Average, retrieved from FRED, Federal Reserve Bank of St. Louis and U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items Less Food and Energy in U.S. City Average, retrieved from FRED, Federal Reserve Bank of St. Louis.

RATES

Before we analyze the drivers of inflation, we must revisit the Fed's mechanism to control the pace of the economy. The Fed uses the federal funds rate (represented by the blue line in the graph below) as one of its primary tools for promoting economic growth because it impacts the demand for goods and services. As the economy picks up steam with inflation well above its target, the Fed raises interest rates to slow a potential overheating of the economy. Currently, the fed funds rate is between 5.00-5.50% and is expected to rise to 5.6% by year-end. Given that markets are forward-looking, the short-term rates (represented by the red line below) have increased rapidly.

Rising rates mean tighter financial conditions as the cost to borrow is higher. For evidence, we can look at the financial condition index (represented by the black line below), an aggregation of different metrics in the financial market. This indicator considers anything above zero restrictive (slowing economic activity). As you can see, as the Fed increases rates, the financial conditions continue to tighten, resulting in lower overall demand and slower economic growth.

FINANCIAL CONDITIONS

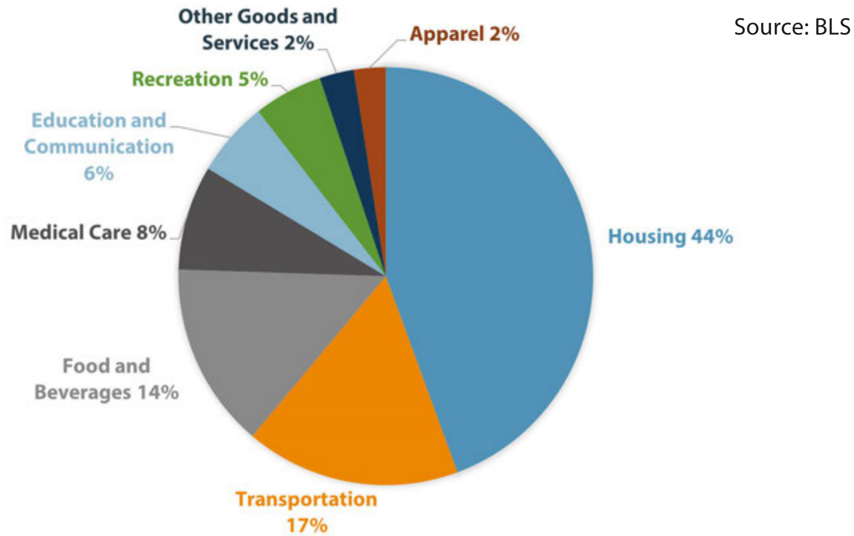


Source: Federal Reserve Bank of Chicago, Chicago Fed Adjusted National Financial Conditions Index, Federal Reserve Bank of New York, Effective Federal Funds Rate, and Board of Governors of the Federal Reserve System (US), Market Yield on U.S. Treasury Securities at 2-Year Constant Maturity, quoted on an Investment Basis, all retrieved from FRED, Federal Reserve Bank of St. Louis.

COMPONENTS OF INFLATION

Inflation measures the rate at which the prices of goods and services rise over time. Inflation is not a measure of price increase for just a few goods and services but reflects the price increase across the broad economy. The most widely followed measure of inflation is the Consumer Price Index (CPI). The CPI tracks consumers' price changes and is reported by the U.S. Bureau of Labor Statistics (BLS). BLS calculates CPI by first determining which items to include. Since CPI tracks consumer prices, it excludes items purchased by businesses, governments, and other countries (items exported by the United States). Once the broad category of items is determined, BLS defines how to weigh each item by surveying more than 24,000 consumers across the country. The graph below shows these categories and their relative importance.

RELATIVE IMPORTANCE OF CPI COMPONENTS FEBRUARY 2023



STICKY VS FLEXIBLE COMPONENTS OF INFLATION

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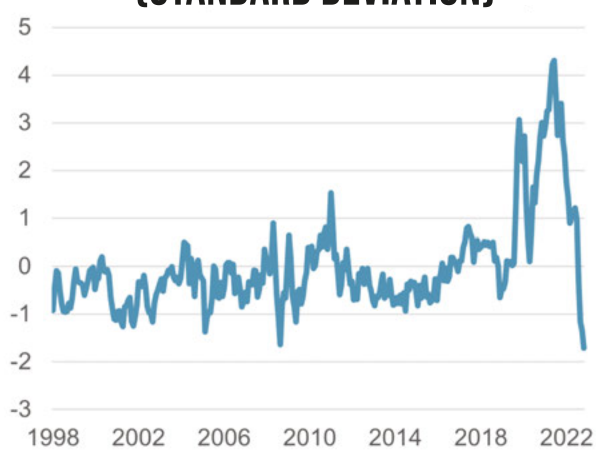
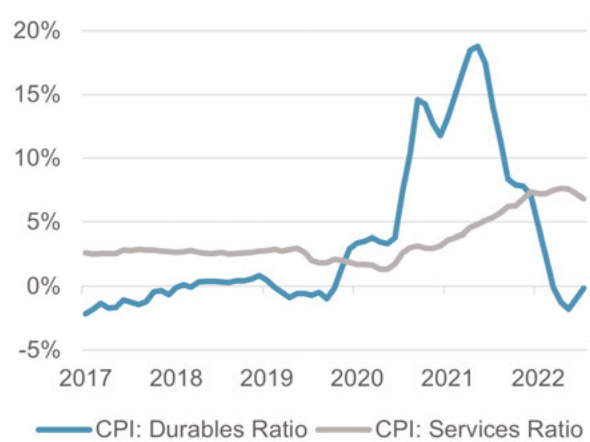
GLOBAL SUPPLY CHAIN PRESSURE INDEX (STANDARD DEVIATION)



Source: Federal Reserve Bank of New York

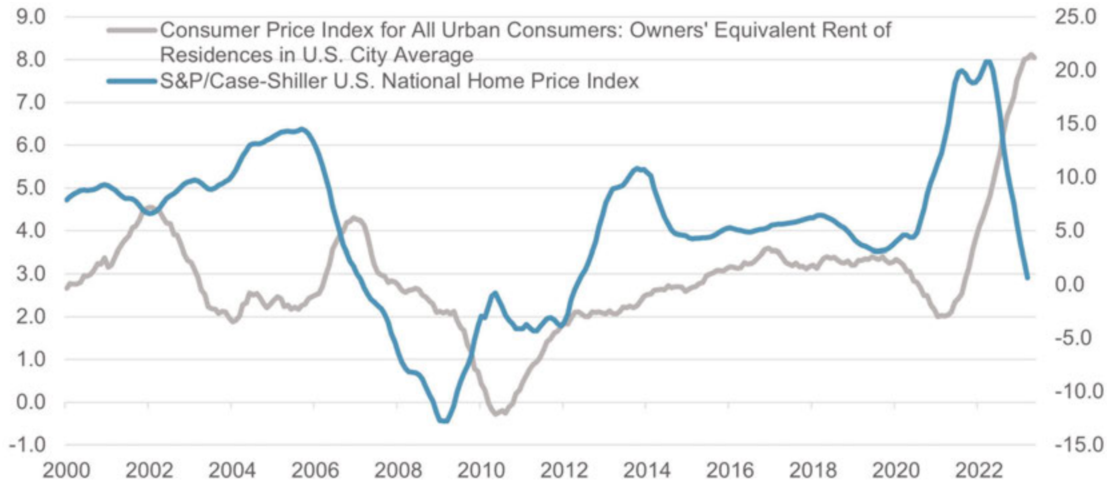
CPI: SERVICES AND DURABLES RATIOS



Source: Federal Reserve Bank of St. Louis (FRED)

Despite the moderation in goods inflation, it has remained elevated overall, primarily because service inflation has been "sticky." The largest component of service inflation is housing. While rising rates have already started to have a cooling effect on the housing market, it generally takes a long while before this is reflected in the CPI. This is why service inflation is known to be more "sticky," meaning its effects on CPI and overall inflation stick around for longer than goods inflation. BLS created a metric called owners' equivalent rent (OER) to track the increase in house prices for homeowners. This metric essentially measures how much a homeowner would pay in rent for a similar home. The graph below shows that, while house prices (blue line) have declined significantly, the OER remains elevated.

CPI OER LAGS HOUSE PRICES



Source: U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: Owners' Equivalent Rent of Residences in U.S. City Average, retrieved from FRED and S&P Dow Jones Indices LLC, S&P/Case-Shiller U.S. National Home Price Index, retrieved from FRED, Federal Reserve Bank of St. Louis.

INFLATION FORECAST

As consumers shift their spending from consuming goods to services, the inflation in the consumption of goods shows some clear signs of moderation. Inflation for services, however, has not declined much, as the price of services tends to be stickier than goods. While inflation is moderating, it is not moderating as many expected it would because a large inflation component is sticky. This suggests it may be a while before the Fed achieves its inflation target. However, market-implied inflation expectations are not significantly elevated above historical trends, as shown below, which implies market participants believe that inflation will once again moderate in the long run.

LONG-TERM INFLATION EXPECTATIONS

Source: Federal Reserve Bank of St. Louis, 5-Year, 5-Year Forward Inflation Expectation Rate, retrieved from FRED, Federal Reserve Bank of St. Louis and Federal Reserve Bank of St. Louis, 10-Year Breakeven Inflation Rate, retrieved from FRED, Federal Reserve Bank of St. Louis.

Inflation is one risk investors need to consider when pursuing their long-term goals. Even at moderate levels, inflation significantly impacts living costs over time. For example, assuming inflation of 2% per year, a 29-year-old who spends $50,000 per year would need $100,000 to maintain his or her lifestyle at age 65. While investing carries risk, it is also risky not to invest. Individuals should save enough to match the inflation rate to maintain their lifestyle, which is hard to accomplish without investing. To properly pursue long-term financial goals, such as retirement savings, most individuals need investments that can generate returns to cover the loss in purchasing power due to inflation. Contact your financial advisor to help you develop a plan based on your specific needs.

Important Disclosures: The information contained in this report is as of June 29, 2023 and was taken from sources believed to be reliable. It is intended only for personal use. To obtain additional information, contact Cornerstone Wealth Management. This report was prepared by Cornerstone Wealth Management. The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. Investing involves risk including the potential loss of principal. No strategy can assure success or protection against loss.

Stock investing involves risk including loss of principal. The payments of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time. IA SBBI US Lrg Cap Index is represented by the S&P 500 Composite Index (S&P 500) from 1957 to present, and the S&P 90 from 1926 to 1956. The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. S&P 90 was a value-weighted index based on 90 stocks. The Bloomberg Barclays US Aggregate Bond Index, which until August 24th 2016 was called the Barclays Capital Aggregate Bond Index, and which until November 3rd 2008 was called the "Lehman Aggregate Bond Index," is a broad base index, maintained by Bloomberg L.P. since August 24th 2016, and prior to then by Barclays which took over the index business of the now defunct Lehman Brothers, and is often used to represent investment grade bonds being traded in United States. Index funds and exchange-traded funds are available that track this bond index. Bonds are subject to credit, market, and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price. Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

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