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Prudent Market Update:
Is It Just Inflation?

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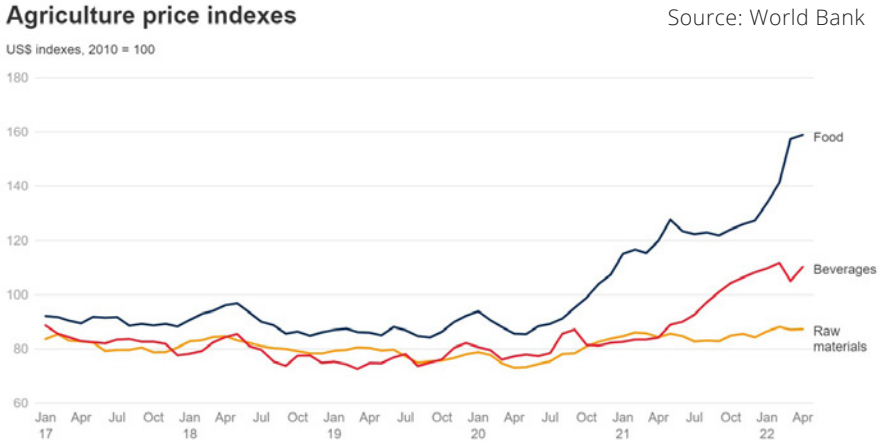
This month the Federal Reserve implemented the US central bank's largest rate increase since 1994, increasing the fed funds rate by 0.75% to a range of 1.50% – 1.75%. Although initially intending to increase by just 0.50%, May's consumer inflation data rose to an alarming 8.6% warranting more aggressive action.

Rising Inflation

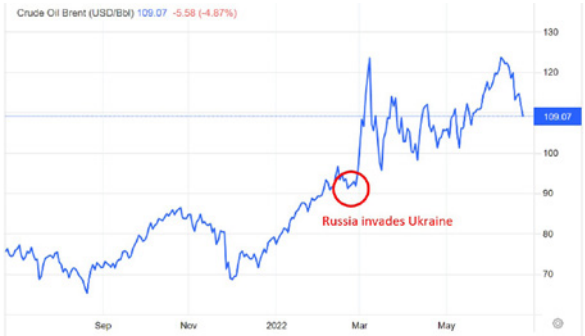


Other central banks around the world followed suit. Both the Bank of England and the Swiss National Bank similarly raised rates, and the European Central Bank is expected to raise its target rate for the first time since 2011. While exceptionally accommodative monetary policy in recent years has undoubtedly contributed to higher prices, inflation has been sharply exacerbated by the war in Ukraine. Blocked shipping ports have impacted food prices in a very direct

way. Russia and Ukraine, the world's third largest and eighth largest wheat producers, respectively, combined to account for 30% of the world's wheat trade. The two countries are also both among the world's ten largest producers of maize. With the supplies of both wheat and corn declining this year, food prices have skyrocketed. The World Bank estimates food prices will rise 20% this year before easing in 2023.

Oil Prices

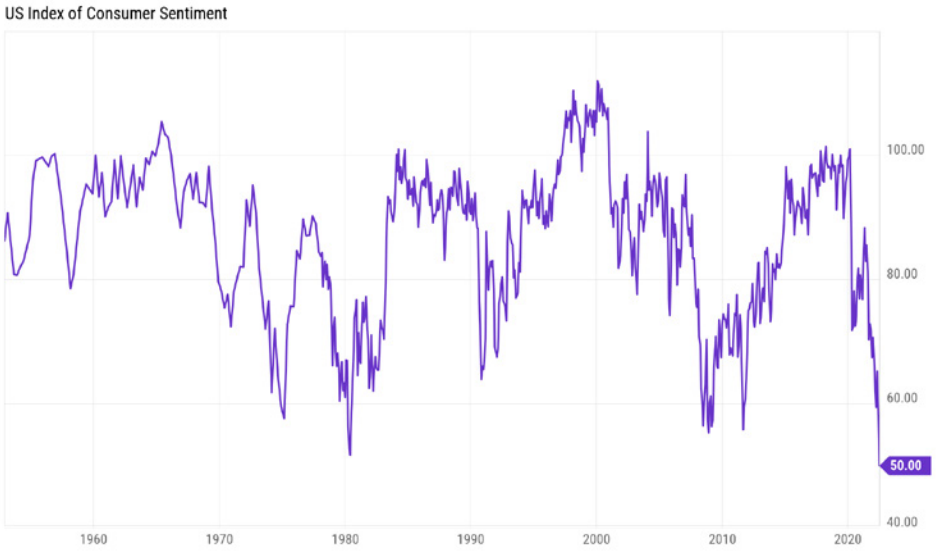
Even more dramatic than the rise in food prices, gas prices have risen over 60% from a year ago. The biggest contributing factor, of course, is the price of oil, which was increasing during the recovery from the pandemic but spiked following Russia's invasion of Ukraine.



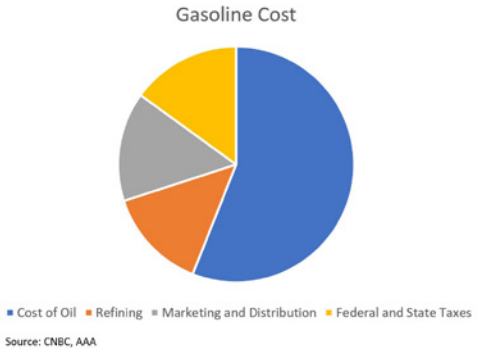
Due to sanctions by the US, G7 countries and the European Union, Russia has been forced to look for other ways to sell its crude. China, seeing an opportunity to purchase oil on the cheap while supporting an important geopolitical ally, has increased Russian crude imports by over 55% compared to last May.

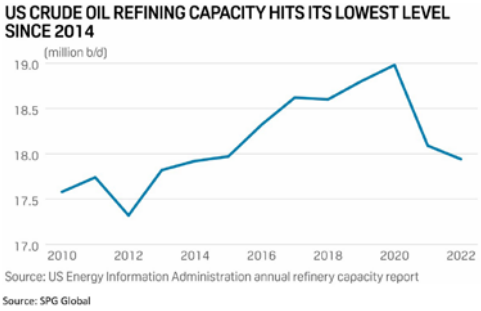
Supply Chain Issues

And it's not just oil where China is diverging from the rest of the West. Unlike Europe and the United States, which have returned to a fully open economy, China has continued its implementation of President Xi Jinping's zero-Covid policy. A strict two-month lockdown within Shanghai was only just lifted on June 1. The impact of these lockdowns will be felt for months, as the surrounding area of Greater Shanghai is one of the world's biggest electronic manufacturing hubs. An Apple supply executive, speaking anonymously to Nikkei Asia, stated that "in terms of production output, the entire April-to-June quarter was basically in vain." Without a change in China's policy, other lockdowns certainly will occur due to the increasing contagiousness of mutating Covid strains. As it is, the start and stop nature of these lockdowns has companies hastening their efforts to diversify production elsewhere.



This confluence of events is having an impact on the American consumer. The University of Michigan consumer sentiment index cratered from a May reading of 58.4 to 50.0, the lowest reading on record since the index began in 1952. 79% of consumers said they expect difficult business conditions going forward, which is the highest reading since 2009. Nearly half of those surveyed responded that the cause of their pessimism was related to elevated inflation. This corresponds to numbers on the manufacturing side where activity continues to slow. June's US composite purchasing managers index reading of 51.2 shows minimal expansion, as anything under 50.0 represents a contraction in manufacturing and services.

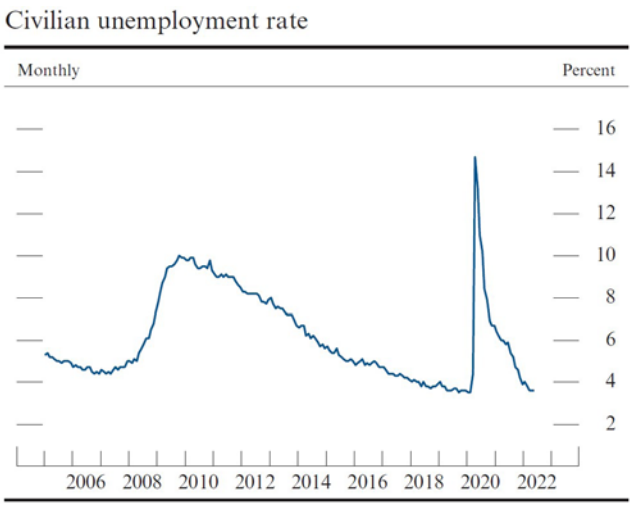




To try and ease the pain, the Biden administration has spent months lobbying OPEC to increase output. OPEC has agreed to increase July and August's supply by 50%. The White House is also exploring temporarily halting oil taxes to reduce the financial burden on American families. However, lowering taxes will only have limited impact on reducing overall costs.

This is because refining capacity in the United States is at its lowest level since 2014, due in part to the administration's cancellation of the Keystone XL pipeline. Fires, hurricanes, and a lack of demand in recent years has also resulted in closures across several refineries. Hurricane Ida alone, which struck in August of last year, accounts for about one-quarter of the reduction.

In terms of monetary policy, the Fed does have some room to work with. Unemployment remains at 3.6%, near its all-time lows. The current tightness of the labor market has as much to do with age demographics and a surge in pandemic-related retirements as it has to do with slowing population growth.



SOURCE: Bureau of Labor Statistics via Haver Analytics.

This means that the Fed can continue to raise rates to try and cool inflation without having to worry about stagflation (high inflation and high unemployment).

Of course, there's only so much the Fed can control. Tightening the monetary supply and raising rates does not address the inflationary pressures arising from geopolitical conflicts across the Atlantic. As long as fighting persists in Eastern Europe, and no imminent end appears in sight, food and energy prices will likely remain elevated and inflation could be stubbornly high. Investors should remain cautious and in times of market volatility, fiduciaries are encouraged to closely adhere to the mandates of the Uniform Prudent Investor Act (UPIA) for asset protection. Principles of diversification, appropriate risk allocation, protection against inflation, cost management, and managing liquidity, all part of the UPIA, will be vital for fiduciaries navigating an increasingly complex investment environment.

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