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Markets Recoil as Inflation Report Raises Stakes for Fed

S&P 500



Data delayed at least 15 minutes • Source: FactSet • By: Ella Koeze

Stubbornly high inflation has loomed over the stock market for months, but some investors had started to think that the worst was over. They cited scattered signs of moderation in price increases and a belief that policymakers could rein them in without sinking the economy.

A report on Friday pierced that view, showing that inflation re-accelerated last month, with consumer prices rising 8.6 percent from a year earlier.

The S&P 500 fell 2.9 percent in the wake of the Labor Department's release, a drop that dragged the index to a weekly loss of just over 5 percent, its worst since January, and to its ninth weekly decline in the past 10 weeks. Government bond prices sank, too, on expectations that the Federal Reserve may have to raise interest rates, and faster, to get inflation under control.

For investors, the critical question is what a rapid rise in borrowing costs could mean for the economy. By raising interest rates high enough to contain inflation, the Fed could also trigger an economic slump, taking the market down with it.

"Save more than you think you'll need." -Clark Kendall, CEO of Kendall Capital

two increases since March, and the debate among investors and economists has been over when it will start to moderate the pace of those increases. Friday's inflation report "kills any last vestiges of hope that the Fed could pivot" to a more measured pace of increase at its meeting next week, said Ian Shepherdson, the chief U.S. economist for Pantheon Macroeconomics.

Speculators now see a decent chance that the Fed's key rate could rise by 1.75 percentage

The central bank has already raised its benchmark rate to the current level from near zero with

current target of between 0.75 percent and 1 percent, implying a supersize series of increases not seen in decades.

Mr. Shepherdson said it was still possible that the May report was something of an aberration

points by September, to a target range of between 2.5 percent and 2.75 percent, from its

a slower pace starting at its meeting in September, he said.

But Edward Yardeni, an independent Wall Street economist, said the report showed inflation had become entrenched.

and would be followed by more moderate readings. That would enable the Fed to raise rates at

Mr. Yardeni said trading in the bond market — where rates on short-term government bonds

"Inflation is no longer transitory or persistent," he said. "It is protracted."

rose more quickly on Friday than those on longer-term bonds — indicated that investors expect the Fed to raise rates aggressively over the next year before a significant slowdown in the economy begins to lower inflation.

On Friday, the yield on the two-year Treasury note jumped to 3.06 percent, up about a quarter

Ultimately for investors, the concern is how high prices and rising borrowing costs will affect consumer spending and corporate profits. Absorbing the costs would hit company profits, but

of a point, while the yield on 10-year notes rose to 3.16 percent, up about a tenth of a point.

passing them along could aggravate problems in the economy, said Yung-Yu Ma, the chief investment strategist for BMO Wealth Management in the United States.

"This is a very difficult moment," Mr. Ma said. Most companies are unlikely to maintain their profit margins in the face of rising energy costs, he said.

Stock market analysts have been making what Mr. Ma called "wildly optimistic" projections for profits, which, he said, are likely to be revised in the months ahead and reflected ultimately in lower stock prices.

This week, Target's stock fell after it cut its profit forecast for the second time in three weeks, as inflation and shifts in customer habits ate into its margins and left it with too much unsold inventory, which it said it would try to sell at a discount.

The S&P 500 is now down 18.7 percent from its Jan. 3 record, bringing it back within reach of bear-market territory — a drop of 20 percent from a high — which signals a serious shift in investor sentiment on Wall Street. The index briefly dipped into bear territory last month, before recovering to close just above that psychologically significant level.

Phil Orlando, the chief equity strategist for Federated Hermes, an asset management firm, said in an interview that he expected the market to decline further, perhaps 10 percent lower than current levels over the summer. He favors so-called value stocks, like those in the energy, financial and health care industries, over growth stocks, like tech companies, because they have

financial and health care industries, over growth stocks, like tech companies, because they have cheaper valuations and more promise in this environment.

At the same time, because he also expects to see more losses in the bond market, he is

emphasizing holding cash, which hasn't been this attractive relative to stocks and bonds for more than 20 years, he said.

While the markets fluctuated in response to Friday's inflation report, as they typically do when

wrong-footed by numbers, strategists suggested that the underlying realities for investors were unchanged.

"Save more than you think you'll need," Clark Kendall, a fiduciary adviser, said in a note on

Friday.