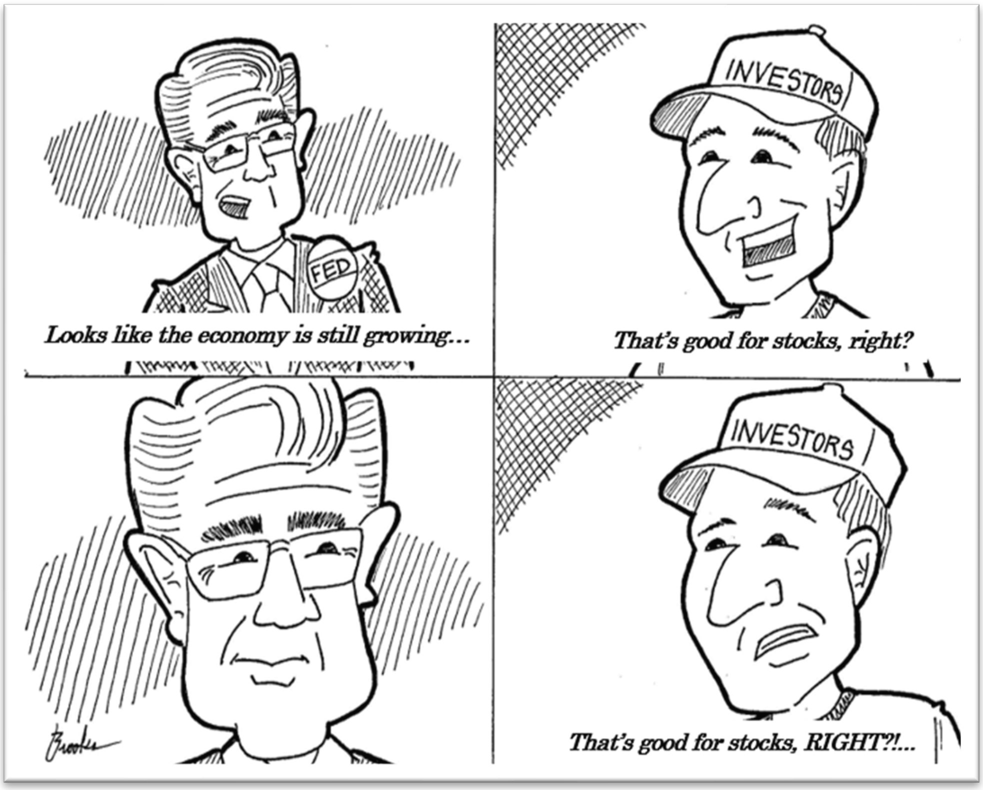
Late rally wards off bear market on peak inflation hopes.



A monstrous late month rally helped the stock market recover from year-to-date lows and earn a deceptively impressive 0.2% gain in May. After starting the month with three consecutive weeks of steeper declines and a May 20th intraday visit to bear market territory (generally recognized as a 20% pullback), the S&P 500 rebounded roughly 8% to finish slightly higher and end the seven week streak of losses that started in April.

Many of the same themes that worried investors in April carried over to May. The Fed's early month commitment to aggressive rate hikes caused a brief pause in the downward moving markets. A larger than expected April CPI print exacerbated inflation fears and restarted market panic in the following week. A bevy of downbeat guidance from major retailers in the third week helped the market move increasingly lower.

A mix of less aggressive Fed speak regarding rate hikes and less conservative retailer outlooks turned the market around during the last week of the month. The nearly 7% rally was the largest weekly gain since November 2020. The continued outperformance of both dividend and value stocks suggests that investors are still taking a defensive position. Most growth sectors underperformed in May while Energy regained its mojo posting a 16% gain.

Inflation peaking as impact grows

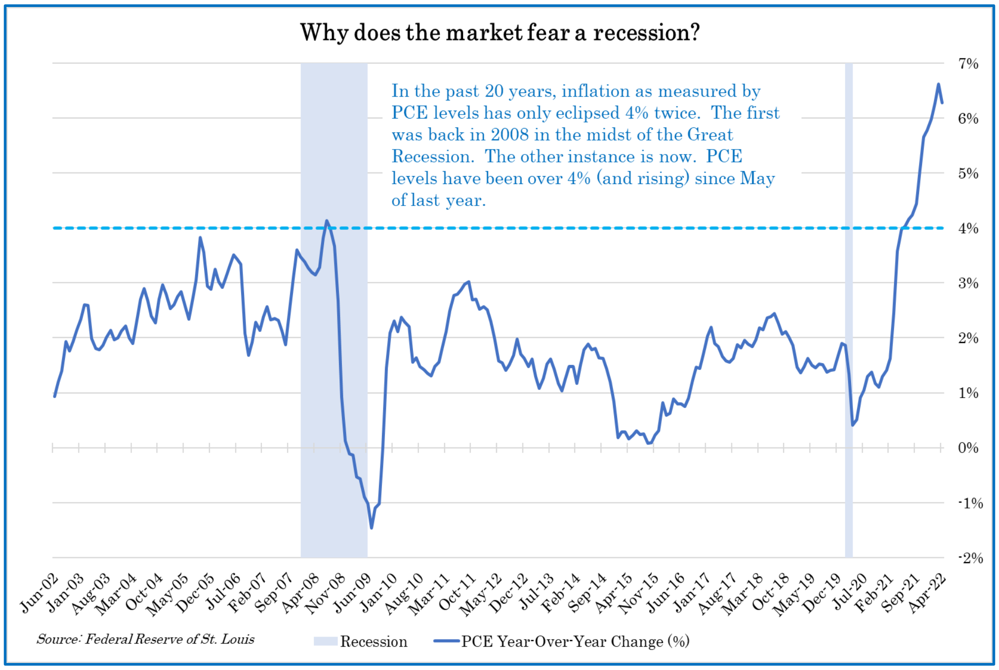
Although core prices rose above consensus in April, monthly CPI growth decelerated relative to the growth rate observed in March. With a year-over-year drop in consumer spending also observed, the possibility of peak inflation became a popular topic of discussion.

The negative spin on decelerating price levels was provided by weak reports from major retailers such as Walmart, Target and Ross Stores. Greater than planned cost inflation, wage inflation, continued supply chain issues, and elevated inventory levels were all listed as reasons for declining margins and reduced forward year guidance.

The gloomiest takeaway from retail earnings was that inflation levels are starting to negatively impact consumer spending habits. Persistent rises in gas and food prices are reducing the reach of consumers' discretionary incomes making it harder for companies to pass on rising input costs.

Is the Fed's tightening the right fit for a husky economy?

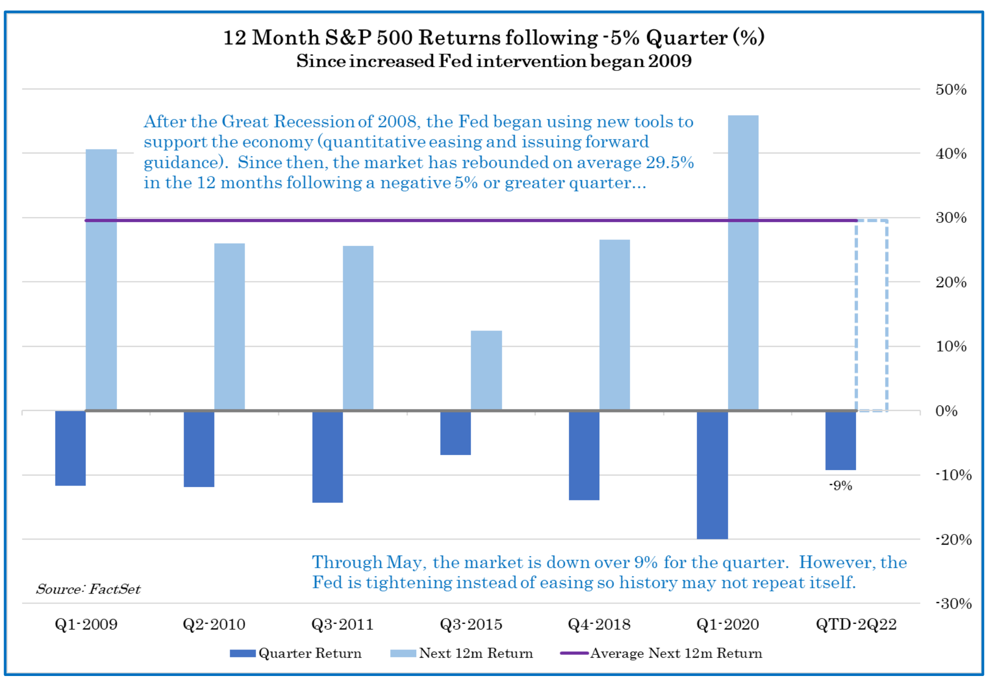
Investors continue to be concerned about the Fed steering the economy into recession by raising rates too far. Fed Chair Powell tried to calm these concerns with his commentary regarding minutes from the Fed's May meeting. The Fed announced a 0.50% rate hike likely to be followed by another of similar fashion but emphasized that he doesn't see the need for larger magnitude hikes and would even consider a pause in the tightening cycle if the economy cooled too fast.



Mid-month interviews from Fed Governors wafered between supporting 0.75% hikes and taking pauses. Markets rose in the last week of May as investors noticed that rate hikes were starting to cool off inflation without crashing the economy.

Outlook: Race to the bottom

"Are we there yet?" is the question that investors continue to ask regarding the market's proximity to a lasting bottom. Even as fund outflows continue to build, investors have been stepping in to buy the dip whenever the S&P approaches the -20% bear market threshold.



The Fed has stated multiple times that its priority is to tame inflation but thinks it can do so without causing a recession. Month over month declines in inflation levels and expectations seem to support this theory so far. The first pause in the tightening cycle may be the optimistic spark the market needs to have investors pile back into beaten up growth stocks and reverse market momentum.

However, with geopolitical uncertainties still causing commodity and supply chain volatility, the market bottom is likely still a few months away.