LEVERAGED FINANCE MARKET PERSPECTIVE LETTER

Inflation Fever

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SHENKMAN
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August was another tumultuous month for investors as the Federal Reserve continued to talk of ratcheting up interest rates. The old adage "don't fight the Fed" has again proven valid. In fact, from equities to bonds to commodities, investors have confronted the broadest market decline since December 1981. While there are some signs that headline inflation may have peaked, inflation fever has not yet broken. The reality is that underlying inflation may be structural as a result of three scarcities: workers, energy, and social stability. Hence, inflation may recede slowly as the gap between real and nominal economic growth becomes more pronounced. Two other key factors could worsen inflation and impede the economy: the Administration's recently enacted tax and spending legislation and the Fed's announcement of the accelerated unwind of its $9 trillion balance sheet. According to Chairman Powell, higher rates for a longer duration will be needed to subdue inflation. By encountering unprecedented economic conditions, the conventional investor playbook may have become somewhat obsolete. Whether the U.S. experiences a growth recession or stagflation, investors may be facing increased challenges given the probability of greater market uncertainty and volatility.

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