WRITTEN BY: DAVID Y. SUN, CFA

As we moved through the start of the third quarter, equity markets were experiencing a steady recovery towards our updated Dow Jones Industrial Average upper range target of 36,200. However, this trend was interrupted by recent inflation readings that reflected the impact of higher oil prices. When interpreting inflation reports, one must realize that not only do oil prices have a direct impact on costs associated with fuel consumption, but they also have an indirect impact on the retail price of other goods & services as these energy related costs are passed onto consumers.

Given that oil prices have hit recent highs driven by supply/demand factors, which includes the combination of OPEC+ maintaining output cuts and occasional low inventory readings, higher fuel cost readings were not a surprise. In addition to the supply/demand dynamic, newly developing geopolitical forces have also played a role in the volatility of oil prices. These include the recent conflict in the Middle East, where uncertainties now surround the current talks between the U.S. and Iran. Even the recently announced preliminary open channel between the U.S. and Venezuela can have implications on oil prices. We do not believe higher oil prices will be maintained for the long-term, given our target price is in the mid $70s. This eventual softness will ultimately be a contributing factor to friendlier inflation readings.

The Fed's expression of "higher rates for longer" did not bode well for establishing positive near-term market sentiment, fueling the current setback in both equity & bond markets. To be clear, our interpretation of this statement is that rates should stay at current levels for longer, not necessarily along the lines of additional rate increases over an extended period. We believe our perspective is less extreme when applied to a longer-term outlook and any near-term overreaction to economic reports can provide opportunities for the future.

There are multiple reasons why the Fed Funds rate should remain steady for at least another few quarters. Absent a given time frame for the Fed to drive down inflation to a questionable level of 2%, the current rate should be given more time to work itself through our economy. Signs of effectiveness have already been observed in areas where higher rates have an immediate impact. The Fed must also realize there are areas where higher rates will not have an impact on pricing such as the price of eggs and other scenarios involving supply chain issues.

Capital markets have also assisted the Fed by trading the yield on the 10-year Treasury higher, recently touching 4.8%+. Concerns surrounding another government shutdown and reemerging inflation worries were enough to cause this recent spike. The higher yield on Treasuries also reflects the perceived additional risk associated with U.S. Government debt should another downgrade occur from a rating agency. It appears that Congress has been put under a microscope by these rating agencies and the resulting higher cost of lending will most certainly impact the economy if another downgrade were to occur.

We believe a friendlier inflation environment with relatively lower interest rates is on the horizon. It is just a matter of when. Please continue to contact your advisor if you have any questions about these topics and their impact on your investment portfolio or financial plan.

This report was written by David Y. Sun, CFA. It is a recap of the market conditions from the previous quarter and is for information purposes only.