Once Bitten, Twice Shy

August 29, 2022

Larry Adam, CFA, CIMA®, CFP®, Chief Investment Officer

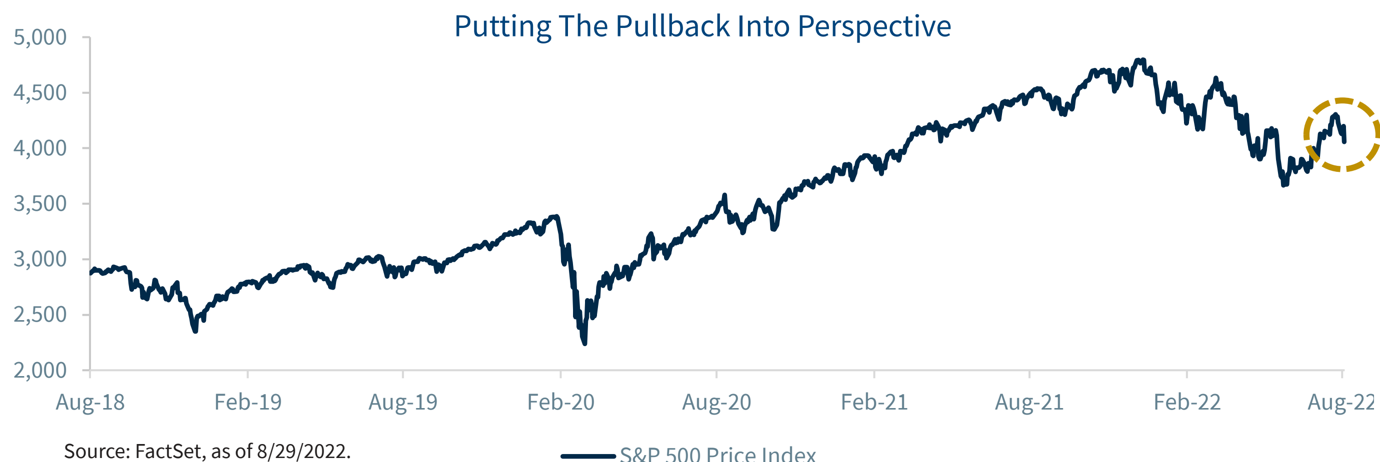
As we approach the 'unofficial' end of the summer with the upcoming Labor Day holiday, financial markets are 'laboring' after the recent bounce back in equities. However, we continue to stress three dynamics when it comes to investing—perspective, patience and probing beyond the headlines. In regards to perspective, investors had been enjoying a strong summer rally, with the S&P 500 set for its strongest two-month period (+15.3%) since August 2020 – a return that would fall in the 99th percentile over the last 20 years. But recent downside volatility, with the S&P 500 trading 6.4% lower over the last nine days, was not unexpected as the index's rapid rally took it above our year-end target of 4,180 and the market was in need of a digestive period. Patience is a virtue and neither the Fed, the economy nor financial markets can adapt as quickly as investors would like. It takes time to unwind from the pandemic and war-induced drivers of inflation over the last two years! And third, and most important, investors need to probe beyond the headlines to understand the true underlying fundamentals—and that is what we do with the following factors:

One Print Doesn't Make A Pattern

Many economists and financial market pundits deemed the Fed's use of the word 'transitory' as the "worst call in the history of the Federal Reserve." While the definition can be debated (e.g., how long is transitory?) and other factors such as the Russia/Ukraine war put undue pressure on energy and agricultural inflation, the result is that elevated inflationary pressures have lasted longer than the Fed originally expected.

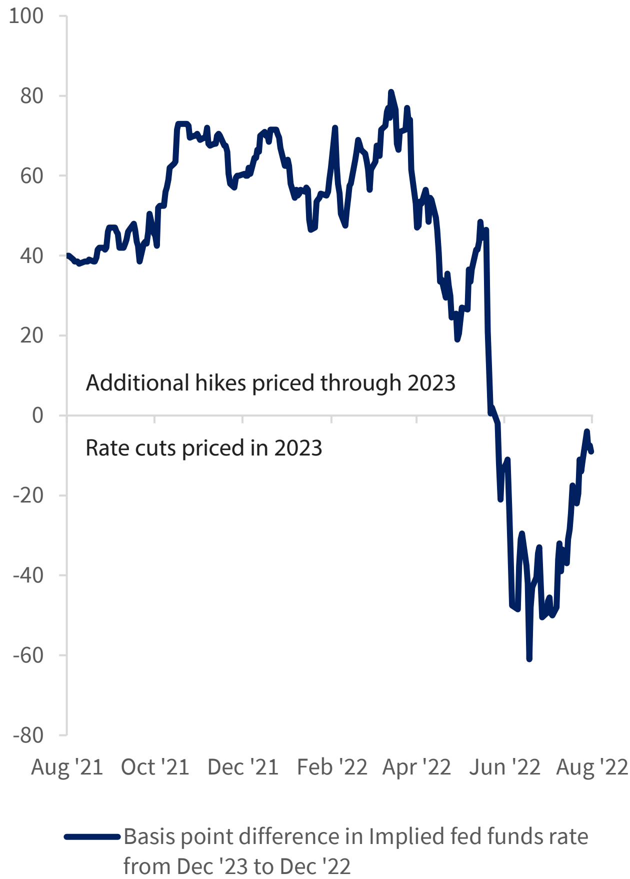
Therefore, Chairman Powell's rhetoric at the Jackson Hole Symposium this past Friday may be a reflection of the committee being "once bitten, twice shy." In other words, psychologically, the Fed and Chair Powell do not want to make a second incorrect call and jeopardize their credibility. As a result, to exude confidence and control of the inflation and policy narrative, it is understandable that Chairman Powell would not declare premature victory over inflation and reaffirmed that interest rates would remain higher for longer until a sustainable, consistent streak (e.g., more than the one-month improvement we have seen in official inflation data) of easing pricing pressures was realized. By our lens, that pattern could well develop this fall and lead the Fed to eventually become less aggressive about raising rates as we go into 2023. Another aspect that frustrated the Fed was the fact that with the tightening cycle not even completed yet, the futures market was reflecting 50 basis points of interest rate cuts in 2023. But Chairman Powell's latest commentary reined in these expectations, as the market's prospects of cutting interest rates next year was erased.

To be clear, the good news is that we are seeing the early signs that inflation is beginning to moderate, as gasoline is down over $1 per gallon from its recent peak and both the Consumer Price Index and the Producer Price Index declined on a monthly basis for the first time since mid-2020 in July. Our expectation remains that the Fed will raise interest rates 50 basis points at the September FOMC meeting (September 20-21), which from a historical perspective, is still aggressive.



Source: FactSet, as of 8/29/2022.

In fact, out of the 61 rate hikes dating back to 1985, only 20% of them have been of this magnitude or greater (only 12% have been 0.75% or greater). The economy still has to digest all the interest rate hikes this year as monetary policy acts with a lag of six to nine months. As a result, our economist reiterates his base case expectation of the fed funds rate peaking at 3.5% this year and remaining on hold throughout 2023.



Source: FactSet, as of 8/29/2022.

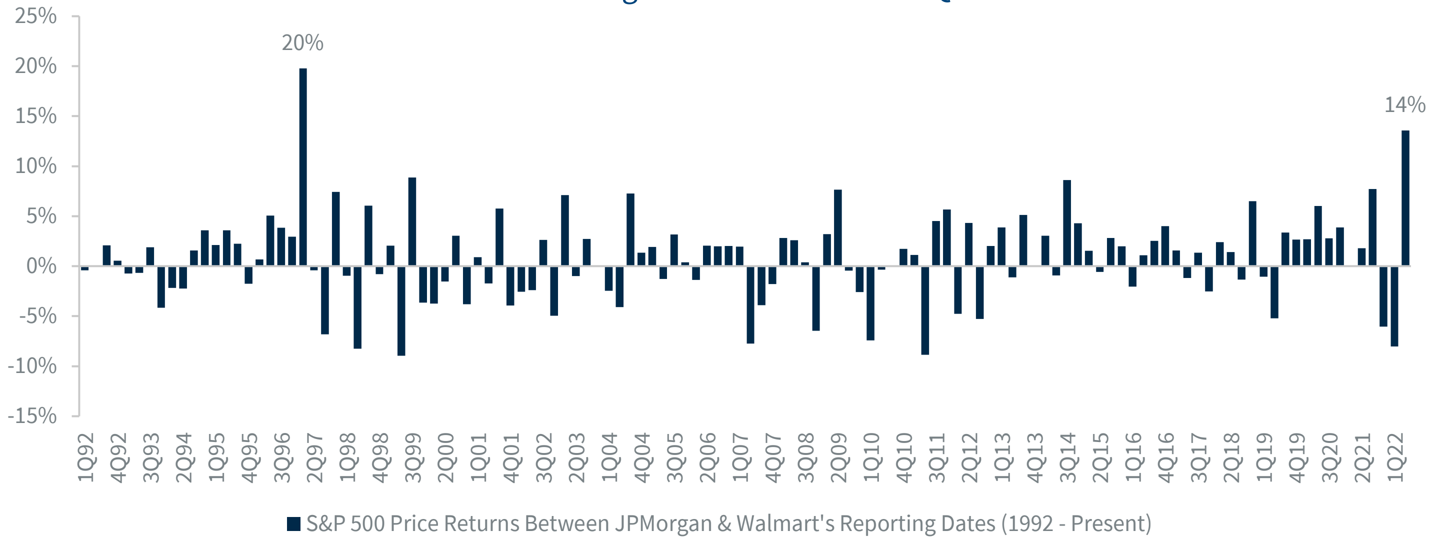
No Silo Mentality

The recent equity weakness is driven by more than the US economy, as other parts of the global economy have been on the brink of recession for months. More specifically, recessionary risks have been plaguing Europe, as elevated energy prices are prolonging the peak in inflation (e.g., the US is past its inflation peak and Europe is on the way to its peak), the weakening of the euro has compounded the reduction in purchasing power (especially for commodities priced in dollars such as oil), and the European Central Bank (ECB) is poised to raise interest rates into a visibly weakening economy. With double-digit inflation in nearly half of the EU countries, the ECB halted its bond buying program, launched a crisis tool to counter rapidly rising interest rates and widening sovereign spreads, and lifted interest rates by 50 basis points last month – its first rate hike in over a decade. Given that this move brought the target rate to 0%, the ECB is forecast to raise rates by a similar magnitude at its next meeting (September 8). Tightening monetary policy in a weakening economic scenario is a recipe that could, as central bankers around the world have argued, result in “some pain” and “sacrifice” on behalf of consumers and businesses. It’s worth noting that the ECB’s decision to increase rates will be preceded by the Bank of Canada (September 7) and followed by the Bank of England (September 15) and Federal Reserve (September 21). The coordinated tightening by more than 80 central banks this year has continually weighed on economies and the potential negative ramifications have kept investors on edge.

From Micro To Macro

The 2Q22 earnings season was under the microscope, as investors not only wanted to see the strength of corporate earnings but also needed to hear forward-looking commentary from CEOs about the status of the economy and their businesses. Why? To get more insights into the ‘boots on the ground’ status of the economy. The results? Robust 2Q earnings were not consistent with the recessionary conditions that headlines were insinuating and corporate guidance was much better than feared—at least not recessionary in the near term. And while 2Q earnings growth of 7% was not nearly as impressive as the double-digit quarters we saw through 2021, healthy sales revenues and margins highlighted the effectiveness of corporate America. In addition, contrary to expectations, there was evidence of resilient consumer spending patterns and healthy levels of credit usage despite pricing pressures. This better-than-expected outcome helped the S&P 500 rally 14% from the ‘unofficial’ start (e.g., big banks reporting) through the unofficial end (e.g., the big box retailers) of the reporting season—the best performance during the earnings season since 1Q97. Now, with earnings results no longer the focus, the equity market is transitioning its attention from the micro (e.g., earnings releases) to the macro (e.g., jobs, inflation, growth, etc.). With recessionary concerns and fears of too much tightening remaining consequential risks, the upcoming Consumer Confidence (August 30), ISM Manufacturing (September 1), employment (September 2), and CPI (September 13) reports could lead to some interim volatility.

Best Earnings Performance Since 1Q97



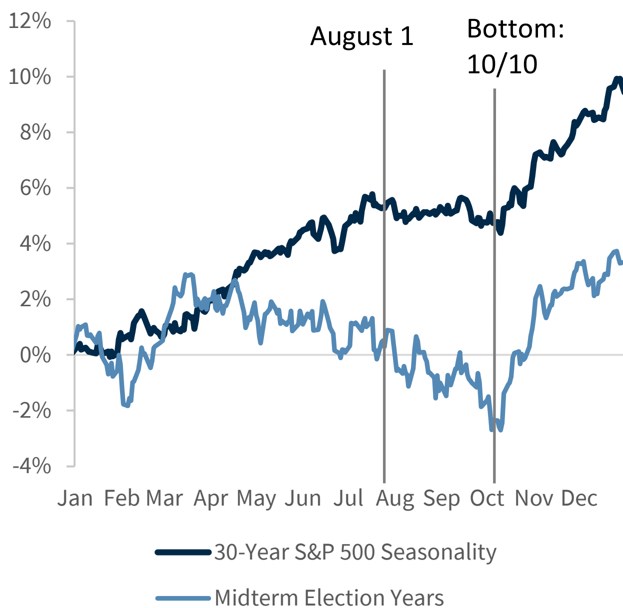
Source: FactSet, as of 8/29/2022.

September Slowdown

While we place more emphasis on the fundamentals, it is worth noting that the August through September time period has historically been the weakest two-month time period for the equity market. In fact, the S&P 500 has declined ~0.5% on average since 1950 while all other rolling two-month returns are positive. What doesn't help is that trading volumes are historically depressed during this vacation-laden period so any moves are exacerbated.

In addition, midterm election years like the one we are in now have historically compounded the pressure on the markets prior to the election. The good news is that from a historical perspective, both seasonal patterns tend to reverse themselves in the form of a post-midterm election and year-end rally (e.g., November/December). Let's hope that these patterns repeat themselves this year—especially if inflationary pressures recede as we expect.

Volatility Before Midterm Elections



Source: FactSet, as of 8/29/2022.

Bottom Line

The equity market notched an impressive rally after the major indices entered bear market territory, but investors may have gotten ahead of themselves – especially as the S&P 500 soared above our 2022 year-end target of 4,180. Moving forward, positive earnings growth, decelerating inflation, the conclusion of the midterm elections, and positive seasonal factors should help support equity prices by year end. As a result, if weakness in the equity market were to persist, long-term investors could look for buying opportunities should the S&P 500 fall below the 4,000 level. Assuming long-term interest rates are at or near a peak, valuations for equities remain attractive at current levels.

Eugenio J. Alemán, Ph.D., SVP, Chief Economist

The massive increase in interest rates produced by the Federal Reserve (Fed) during this year (up 225 basis points) has already started to affect economic activity. Furthermore, the Fed is expected to continue to move rates higher, by at least 100 bps by the end of this year. At the same time, the Fed has continued to pursue quantitative tightening, which has helped push mortgage rates higher and faster than if the Fed had solely used the federal funds rate as its monetary policy tool.

Thus, the economic effects of monetary policy tightening are already well underway, and the additional 100 bps of tightening before year end should help cool the economy further and ease inflation down from current levels. Perhaps the most important message from the Chairman of the Fed was that they are planning to stay at that rate for a longer period of time, or until there is ample evidence that the inflation dragon has been beaten for good.

Valuation is much more reasonable throughout the equity market, particularly if interest rates subside from their sharp ascent from the first half of the year. In the aftermath of Powell's speech, the 2-year yield's break to new highs and 10-year yield rising are creating some pause for investors, contributing to the current weakness. We believe that inflation and the 10-year yield have likely peaked, but their movements going forward (along with the 2-year yield) will be a large influence on investor confidence toward the outlook (and, in turn, valuation multiples). We also lean on the technical backdrop for clues on market movements. The underlying strength and participation in the recent rally bodes well for the overall market trend—increasing the odds that the lows are in. While we believe the worst of this bear market may be behind us, we do not believe that equities are set for unbridled enthusiasm to the upside. We expect setbacks and normal back-and-forth trading ahead, as investors gain more clarity on the path of inflation within a tightening cycle. With this in mind, we would refrain from chasing the rallies and use pullbacks in favored stocks as opportunity for the next bull market. In the current uncertain environment, the odds are high pullbacks can reach double-digit percentage declines.

J. Michael Gibbs, Managing Director, Equity Portfolio & Technical Strategy & **Joey Madere, CFA,** Senior Portfolio Analyst, Equity Portfolio & Technical Strategy

Federal Reserve Chair Powell's speech at Jackson Hole on Friday should have been largely expected, but the hawkish tone resulted in higher Federal Reserve (Fed) expectations, a breakout to new highs in the 2-year Treasury yield, and sharp weakness in equities. We believe this volatility is par for the course in the current environment, as the Fed attempts to bring inflation under control within a slowing economic backdrop. Because inflation is so high and the Fed is likely to increase the fed funds rate by at least an additional 100 basis points by year end, we do not expect a sharp V-bottom recovery out of this bear market. It is normal to have back-and-forth trading as equities rebuild themselves for renewed upside. The last two bear markets (2018 and 2020) saw sharp recoveries from the lows, but inflation was low then and the Fed was able to ease policy- we do not have that luxury right now. Additionally, Fed tightening will act with a lag on the economy, as lending tightens and demand softens. This is likely to weigh on corporate fundamentals over the next year, and we believe current earnings estimates need to be revised lower. Market concerns may shift from inflation toward economic and fundamental growth. The question is how much negative news is priced in because we believe the market will bottom before the economy and fundamentals (stocks discount the future).

Tracey Manzi, CFA, Senior Investment Strategist, Investment Strategy

Federal Reserve Chair Powell delivered an unambiguous message to the markets that there will not be a quick reversal to rate cuts next year, stating that policymakers intend to keep interest rates in restrictive territory for some time. That is, until Federal Reserve (Fed) officials are convinced that inflation is on a clear trajectory back toward their 2% target. Given that inflation remains uncomfortably high and the labor market is still in relatively good shape, the Fed still has more work to do. However, it is important to note that this is largely priced into the market, as the fed funds futures curve is anticipating an additional 100-125 basis points of tightening. While the stock market was clearly spooked by the Fed's messaging of higher for longer policy rates, the bond market seems to have taken the news in stride as interest rates are only modestly higher. Also of note is that credit spreads remain relatively well behaved, with high-yield spreads substantially below their recent peak of 600 basis points, currently trading at a spread of 465.

While Treasury yields have moved off their early August lows, there is still a compelling case to be made that bond yields have peaked in this cycle. For starters, the 2-year Treasury is already trading near the expected peak fed funds rate.

And while longer-maturity yields, such as the 10-year Treasury, are higher, they remain well below the 3.48% peak reached in mid-June. This makes sense given that growth momentum has slowed, inflation is expected to move significantly lower over the next six months and global growth (i.e., Europe and China) is looking increasingly shaky. Although credit spreads have narrowed slightly from their recent peaks, the ongoing inversion in the 2-year to 10-year curve is typically not a great signal for risk assets, particularly against a background of weakening growth.

The main risk to our more favorable outlook for the bond market is an upside surprise to policymakers' expectations for the median peak fed funds rate (3.8%). Given that Powell noted the economy continues to show strong underlying momentum during his Jackson Hole speech, the upcoming labor market and inflation reports will be the key data points to watch before the Fed publishes its Summary of Economic Projections in September.

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HIGH YIELD | Bloomberg US Corporate High Yield Total Return Index: The index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

CREDIT | Bloomberg US Credit Total Return Index: The index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.

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NASDAQ COMPOSITE INDEX | The Nasdaq Composite Index is the market capitalization-weighted index of over 3,300 common
equities listed on the Nasdaq stock exchange.
S&P 500 | The S&P Total Return Index: The index is widely regarded as the best single gauge of large-cap U.S. equities. There is over USD 7.8 trillion benchmarked to the index, with index assets comprising approximately USD 2.2 trillion of this total. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.
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NAHB Housing Market Index | The National Association of Home Builders (NAHB) Housing Market Index (HMI) is a gauge of builder opinion on the relative level of current and future single-family home sales.

Chicago Fed's National Financial Conditions Index | The Chicago Fed's National Financial Conditions Index (NFCI) provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets, and the traditional and "shadow" banking systems.

Credit Default Swap (CDS) Index (CDX) | The credit default swap index (CDX), formerly the Dow Jones CDX, is a benchmark financial instrument made up of credit default swaps (CDS) that have been issued by North American or emerging market companies.

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