

July 25, 2022 – Investment Commentary

Last week, the MSCI AC World Equity Index gained 3.2% on the back of rising recession expectations and declining 10-year Treasury rate. US Treasuries reacted to economic data releases where investors became more pessimistic on the ability of the Fed to keep hiking rates as the 10yr Treasury fell -26.9bps from its mid-week highs to 2.76%. High yield credit spreads have compressed a bit over the week, however they're materially above the range we saw for 2021. We continue to watch these for possible contagion effects in other markets.

The S&P 500 is up about 8% since its mid-June lows. The Nasdaq 100 is up over 11% in that time. If you look at when the stock market bottomed, it almost perfectly corresponds to the top in gasoline prices which declined 12%, as measured by AAA. Several factors have pushed gas prices down, including a drop in oil prices as recession fears grow and a smaller-than-expected impact from Western sanctions on Russia. Supply has also improved relative to demand, which has slightly fallen in recent weeks and remains at levels lower than a year ago, according to data from the US Energy Information Administration. Although prices at the pump have declined, natural gas prices remain problematic for food supply. To the extent to which natural gas prices are significant input costs in the production of fertilizer and other industrial products especially in Europe.

Moving across the Atlantic, last week marks a new turnaround for European rates as the European Central Bank (ECB) hiked rates by 50bps on Thursday. The move takes the deposit rate out of negative territory for the first time since 2014. The ECB also announced their new Transmission Protection Instrument (TPI) with the goal to counter market dynamics that pose a threat to its monetary policy. They further hinted at purchases potentially being unlimited. In other key news around Europe, Mario Draghi resigned as Italian Prime Minister after his attempt to form a coalition failed. On the back of this political turmoil, Italian spreads widened with the gap between 10yr Italian yields and Germany bunds ending the week +14.3bps wider at 2.29%. The Investment Office is monitoring this market metric as part of the mosaic of European stress indicators. Finally, Russian gas supplies resumed despite markets growing anxious over the past few weeks as the Nord Stream pipeline went into maintenance. The line is however only running at 40% of capacity as before but Putin did say that supplies could be cut again if there are more delays in the return of the turbine from Canada. Other eye-catching developments include Pakistan (the world's fifth most populated country) teetering on default.

Earnings Season

With a very big week for Europe now past, the next big focal point for markets comes with the Fed's next decision on Wednesday. Additionally, more than 170 S&P 500 companies will report earnings this week while 2nd quarter GDP and the Fed's preferred measure of inflation- the Core PCE- will also be announced. At this early stage of the reporting period, it would be fair to say that earnings are coming in better-than-expected. Still, it is early where 21% of the companies in the S&P 500 have reported EPS, only 11% of the market's largest and most critical sector – Technology – have announced earnings.

We will all learn quite a bit about the state of the economy, monetary policy, and profits in the next five days and commentary surrounding these events is likely to set the tone for the midterm elections this November. We are cautious on the market because while we feel that earnings multiples have largely discounted higher inflation, earnings estimates have not yet begun to discount what would seem to be some obvious pressures on profit margins.

Portfolio Construction

- Fixed Income. Focused on investment grade credit exposure
- Equity Region. Favor the US over Non-US Developed/EM.
- Equity Sectors. Favor defensive sectors.
- Style. Favor quality/value/dividends over growth with an emphasis on US Large Cap.
- Alternative Strategies (Single Family Rental). The Investment Office expects apartment asking rent to continue to remain elevated, as rising mortgage rates and still high home prices have contributed to a home affordability issue, potentially pricing out marginal homebuyers who may be forced to rotate toward renting.

Disclosures

Investment Commentary Sources: Bloomberg and Morningstar

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