

## September 26, 2022 – Investment Commentary

### Markets: Buckle up for continued higher macro and market volatility

Persistent “whack-a-mole” inflation and a tight labor market are forcing central banks to be more aggressive than markets anticipated. We expect volatility to remain elevated as the Federal Reserve maintains a hawkish stance and continues to tighten financial conditions. Markets are currently pricing in 71.4bps of hikes at the November meeting and 47.1bps of hikes at the December meeting, both just shy of the median dot plot forecasts. 2yr Treasury yields rose 31.7bps on the week crossing the 4% threshold for the first time since 2007, while 10yr Treasuries surged by +22.5bps to a post-2011 high of 3.69%.

Stock markets, as well as those for bonds and commodities, have been struggling with the Fed's announcement last week that it will continue to raise interest rates until inflation is under control, regardless of the risks of a recession. During the past two weeks, both nominal and real 10-year US Treasury yields have surged by 40 bp while the S&P 500 has dropped by 9%. Last week, the Nasdaq and the S&P 500 have now both entered into bear markets. The Nasdaq fell 1.8%, or 32.3% below its most recent peak 10 months ago. The S&P dropped 1.72% to 3,693, down 23% from its January peak. Last Friday, it briefly dipped below its mid-June closing low of 3,666, erasing a summer rebound in U.S. stocks, when the markets believed inflation “peaked”, before recovering losses and closing above that level. Last week, Europe faced a similar outcome with the STOXX 600 down -4.37% on the week, falling beneath its July lows to close at levels unseen in over 20 months.

Already this year, the central bank has hiked rates at a speed and magnitude not seen for a generation, in the hopes of slowing down the worst inflation the country has experienced in 40 years. Powell said “...we're committed to getting inflation back down to 2% because we think that a failure to restore price stability would mean far greater pain later on.” Markets are increasingly assigning higher probabilities to a hard landing scenario where the timing, severity, and duration of a potential recession remain unknown. Housing data this week will mostly look back at August when there was a brief respite in the upward climb of mortgage rates. Now that the 30-year fixed rate is over 6 percent, it will be a qualified buyers' housing market with more supply and with more power to negotiate prices and terms.

The CBOE Volatility Index, known as Wall Street's fear gauge, on Friday shot above 30, its highest point since late June but below the 37 average level that has typically marked peaked levels of selling in past market declines since 1990. We believe there is more volatility ahead because central banks are tightening monetary policy into a global economy that already appears to be weakening.

A key signal to watch over the coming weeks will be how steeply estimates of corporate earnings fall. The S&P 500 is currently trading at around 17 times expected earnings, above its historical average, which suggests that a recession is not yet been priced into the market. The Investment Office will be especially focused on the next round of tech earning results, starting in October. This should offer more clarity on the health of the tech industry, and the broader economy.

### Europe: Self-Inflicted Wounds

The UK is hitting the accelerator (fiscal stimulus) and the brake (central bank tightening) at the same time with a government focused on growth with ~ 10% of GDP over the next five years (via tax cuts) and the Bank of England (BoE) willingness to generate a recession to bring down inflation.

The British pound declined to a record low against the US dollar on 9/26/22 on growing fears about the stability of UK government finances. The decline of nearly 5% to just above \$1.03, which extended a 3.6% dive from Friday, increasing predictions the pound could plunge to parity with the US dollar.

Euro zone government bond yields also jumped to multi-year highs amid expectations that central banks will keep tightening their monetary policy despite recession risks. After the recent Italian election, the euro also hit a 20-year low. Meanwhile, the Investment Office has been reporting on the spread between Italian and German yields which widened after the rightist coalition won a clear majority in Sunday's elections raising concerns about cohesion within the European Union. Italian bond (BTP) prices are also more susceptible to shifts in interest rate expectations, given the country's vast debt burden. The Italian BTP German government Bund spread increased by almost about 10 bps reaching 239 bps approaching its recent 2022 high of 250bps. Germany's 10-year yield hit its highest level since December 2011 at 2.13%, while the 2-year yield rose to its highest since December 2008 at 2.01%.

### Investment Outlook and Portfolio Implications

Volatility expected. Uncertainty remains around the peak for interest rates, the trough for earnings, and the outlook for energy prices. We expect markets to remain volatile.

Inflation persisting. Higher-than-expected US CPI data is weakening hopes of a rapid fall in inflation and undermining optimism about a soft landing.

Growth headwinds. Europe faces a combination of high inflation and negative growth, with Russia cutting off gas supplies. China's recovery continues to stumble, given its zero-COVID policy and real estate challenges.

Asset allocation. We stay invested but also selective, and focus our preferences on the themes of defensives, income, and value while emphasizing U.S. geographic exposure. We remain defensive across our portfolios incorporating certain alternative strategies while acknowledging that there is room for rates to move higher as monetary policy becomes more restrictive. We remain mindful of ongoing inflationary pressures and maintain our position in below benchmark duration core fixed income in an effort to dampen volatility while offering increasingly attractive yields as economic growth continues to slow.

#### Disclosures

*Investment Commentary Sources: Bloomberg and Morningstar*

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