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Market Outlook: Fed *Put* is now A Fed *Punch*

Mike Tyson (former heavyweight boxing champion) famously said, "Everybody has a plan until they get punched in the mouth." Jerome Powell's Jackson Hole speech was shorter, narrower, and a more direct uppercut than any since he took over as Federal Reserve Chair in 2018. Global equities dropped 3.3% last week with losses across all major regions. Credit spreads rose with high yield spreads up 0.41% to 4.95% and investment grade spreads increasing 0.07% to 1.35%. **The Investment Office expects the Federal Reserve to continue raising policy rates towards 4.0% pushing the U.S. economy towards a demand recession to bring inflation under control and potentially higher downside risks to markets.** The market is beginning to shift away from the idea that the Fed will start cutting interest rates in 2023. Investors expect the ECB to increase its rate between 0.50% and 0.75%.

Markets on the Ropes

The year so far has elevated uncertainty and macro-economic and geopolitical headwinds. In August, the U.S. dollar gained 2.2%. Stocks, bonds, and commodities finished lower. The S&P 500 Index fell 4.1% following July's 9.2% rally, and the Bloomberg Aggregate Bond Index declined 3.0%. The yield on a 2-year Treasury note rose 60 basis points to end the month at 3.48%, its highest level in 15 years. The 10-year Treasury note yield rose 53 basis points in August, finishing at 3.18%. The Bloomberg Commodity Index is 10% below the high set in May, and the price of Brent crude oil fell in August for the third straight month. Global bonds (Bloomberg Global Aggregate Total Return index of government and investment grade bonds) have entered the first bear market (falling more than 20% since its 2021 peak) and biggest drawdown since its inception in 1990. European government bonds had their worst month on record, with the Bloomberg Pan-European Aggregate Total Return index losing 5.7%. Meanwhile, the Bloomberg US Aggregate Bond Index has now fallen 12.5% from its highs, more than twice any previous peak-to-trough drawdown going back to the 1970s. However, bond yields are now at their highest level since the global financial crisis. The yield on 2-year Treasuries pushed above 3.5% last week to the highest level since 2007. Historically, the starting level of yields has provided a good guide to future returns, suggesting that the outlook now is more attractive than it has been for most of the post-GFC era.

Investment Office Trainer and Cornerman

Our base case is further volatility, slowing growth and slowing but persistently high inflation. As a result, the Investment Office’s portfolio positioning includes several year-to-date tactical decisions including focusing on high-quality equity and fixed income holdings. The reasons are that we believe rates will stay higher for longer creating burdensome debt costs for many businesses, earnings downgrades will increase and margins will compress. We believe that, collectively, these issues will raise default rates over the course of the next year, especially in Europe. Russia used to provide about 40% of Europe’s natural gas. Until Europe finds other sources of fuel the supply shortage will continue to increase and maintain elevated prices across the globe. Simply put, the more consumers spend on energy the less funds are available to purchase other goods and services. Markets are struggling with tight fossil fuel supply and concerns of a pending global recession.

In equities, we emphasize US exposures toward value, quality income, and defensive sectors such as healthcare while maintaining targeted growth allocations. Finally, **we increasingly recommend diversifier and risk management alternative strategies including stressed/distressed credit managers, real estate and hedge funds, where suitable.**

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Disclosures

Investment Commentary Sources: Bloomberg and Morningstar

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