

October 10, 2022 – Investment Commentary

Market Movement

The Investment Office believes an era of low inflation, low interest rates and supportive fiscal and monetary policy has ended. We believe interest rates will probably need to stay higher for longer to tackle sticky inflation and weigh on economic growth. However, investors experienced another volatile week as global markets were once again focused on near term data metrics which pushed in both directions by the prospect of an altered rate hiking path. This past week provided data that supported the adage that “bad news is good news and good news is bad news” for the risk markets. Early last week markets appreciated with macroeconomic ISM and JOLTS data that was interpreted as weakening signaling to investors that the Federal Reserve (Fed) decision to raise rates and pause would arrive sooner than planned. However, later in the week the September jobs report caused many investors to become much more skeptical about a dovish pivot from central banks. The persistent gain in the September jobs report could keep alive the dream from some for a soft landing. However, the tighter labor conditions will likely keep the Fed on track for another aggressive rate hike next month.

As a result, the market priced in by the end of 2023 a Fed Funds rate of 4.39%, up 25bps from earlier in the week. That backdrop led to a sizeable cross-asset selloff as the 10 year US Treasury yields bounced back up from its mid-week low to end the week higher at 3.89%. The S&P 500 fell -3.8% from its mid-week high closing up 1.6% for the week. The energy sector did outperform however as Brent crude rose +15.4% on the week hitting a 1-month high as OPEC+ cut output. A similar story was seen in Europe as 10 year German bund yields were up by +32.3bps from their mid-week lows as the European STOXX 600 index fell -1.33% on a broad-based decline, closing up 0.9% for the week. The Italian 10Y yield sits at 4.7% and the Italian government BTP- German government Bund spread was up 10bps achieving recent highs at 2.51%.

We look forward to US CPI next week as one of the major factors influencing Fed decisions at their November meeting. Market pricing anticipate a +75bps move in November as the likely outcome. A strong jobs report and/or CPI print this week could cement those expectations.

Portfolio Construction

In this inflationary environment, we have implemented ongoing portfolio adjustments to emphasize holdings that we believe are well-suited to protect and grow capital. One of the worst parts about any bear market is it feels like there’s always something else to worry about that hasn’t even happened yet that could make things even worse. The future concern everyone has had on their list of risks is a recession caused by the Fed. We believe the Fed will continue its path of raising rates until it tackles inflation and will only pivot beforehand if there is deep foreign financial market contagion (eg. persistent sovereign debt dislocation), massive market liquidity issue (eg. unusually wide bid-ask spreads), or material credit market disruption (material spikes in credit spreads).

Stock market valuations have declined year to date and are almost always some function of price to another variable. Price to earnings. Price to sales. Price to cash flows. Price has already come down year to date but what happens when the earnings, sales and cash flows come down next? Over the very long-term the stock market is driven by fundamentals such as earnings, dividends and cash flows. But over various time frames, those fundamental drivers don’t always have the impact you would assume. As we approach earning season and fourth quarter guidance, the Investment Office expects the year to date rally in the U.S. dollar to hurt corporate financial results, potentially presenting another obstacle to stocks in a year that has experienced a

painful market decline. As a reminder, the S&P 500 generates approximately 30% of their sales from outside the U.S. Large big tech companies generate the biggest percentage of sales outside the U.S. and are especially worth watching for dollar impact in the coming earnings season. We also believe there is broad based complacency in the pricing of credit risk, as measured by spreads over the risk free rate, which are largely consistent with the long-term averages since the Great Financial Crisis.

A set of economic and geopolitical catalysts for equity and credit market volatility are in place. Several examples include whether European countries will be able to manage through the winter season without major energy-related shutdowns and if there will be any policy changes resulting from the China Communist Party Congress election on October 16th. These catalysts and others will produce considerable risks but will also produce great opportunities for the disciplined investor with a thoughtfully designed portfolio that incorporates solutions that include dividends, value and certain alternative strategies such as distressed credit and real assets. We encourage investors not to overreact and focus on long-term goals and near term liquidity considerations.

Disclosures

Investment Commentary Sources: Bloomberg and Morningstar

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