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October 17, 2022 – Investment Commentary

Market Update

This past week has seen various data releases and political events that fueled volatility across the globe. Starting with the US, headline inflation gains for the month came in above the expected reading and meant that the year-on-year CPI measure only ticked down to +8.2% (vs. +8.1% expected). The simple takeaway from the September CPI report is that a still-tight labor market is keeping core services inflation hot while goods inflation are appearing to soften. Second, and more concerning from the market's point of view, core CPI was also stronger than expected for a second month running, thus taking the year-on-year measure up to +6.6%, which is the fastest that core inflation has been since 1982. Against that backdrop, investors swiftly moved to upgrade their expectation of future tightening from the Federal Reserve, with a 75bp hike at the November meeting now fully priced in for the first time. In addition, markets placed a growing probability the Fed continues at a 75bps pace in December rather than slowing down. As for next year, markets are now pricing in a 5.0 percent terminal policy rate, to be reached by the end of Q1. An indication of the market's myopic focus on near term CPI data is the intraday trading of the S&P500 index which had a remarkable trading range of 5.5%.

During the week, S&P500 fell 1.5% while the tech heavy NASDAQ declined 3.1%. The non-US developed markets (EAFE) fell 1.3% while emerging markets fell 3.8% with China falling 6.2% and Brazil falling 5.0%. Investment grade US fixed income sectors had mixed returns. Municipals eked out a 0.1% gain while US Investment Grade Corporates fell 1.6% on rising rates and widening credit spreads. High yield bonds fell 1.1% as spreads widened and bank loans fell 0.3% amongst increasing recession concerns. Emerging market debt fell 1.9% as the dollar rose and credit spreads widened.

Given the monetary and geopolitical issues, investors are less focused on the historical patterns of S&P500 returning a positive 17% during the 12 months following midterm elections (usually slightly stronger during divided governments than when one party has unified control). However, investors should pay attention to third quarter earnings season and guidance which kicked off last week. The US banks reported better than expected Q3 earnings, implying the economy is still growing despite the many challenges. In addition, net interest margins are boosting bank earnings. We believe equities in the aggregate have not priced in a material slowdown in growth and earnings. This year's market performance can be almost entirely explained by the change in interest rates (higher cost of capital). However, it is important not to ignore the possibility of an incremental improvement in inflation and labor market data as markets are typically forward looking by approximately 6-12 months ahead of a macroeconomic bottom. Equity investors should be prepared for an eventual bottoming process when markets begin to perceive a cooling in wage growth and employment.

While there is plenty of focus on the US, Europe also experienced its share of volatility. Starting by the UK, the Prime Minister carrying out a few U-turns on her economic plans and termination of her Chancellor of the Exchequer. Moving to continental Europe, President Lagarde confirmed that discussions on quantitative tightening (QT) had started. Finally, a new hurdle for global oil markets will come on December 5 when Europe is scheduled to ban most Russian oil imports. The continued uncertainty of import enforcement levels, climate temperatures and strategic petroleum reserve levels below pre pandemic levels will add to near term volatility. The Italian government 10-year yield sits at 4.79% though the Italian BTP-German Bund “stress spread” declined 6bps to 2.45%, off recent highs. In China, growth prospects tilt more to the downside as President Xi focuses on security and prior policy initiatives.

Portfolio Construction

As the pandemic crisis subsided in 2021, central banks didn't pivot toward interest rate normalization fast enough. They now must tighten “too much, too fast,” risking a policy overshoot. An illustrative 60/40 portfolio (60% bonds & 40% Equities) has generated the worst performance year to date in decades. The key premise of the “60/40 portfolio” is that stock and bond markets rarely go down at the same time as in 2022 — typically these asset classes move in opposite directions. This historic relationship is described by certain investors as a low (or negative) correlation.

We believe the ramification of this shift will last well beyond 2022 performance, as it implies a rising demand for less correlated alternative investment solutions including real assets, distressed credit and certain hedge funds. In addition, we believe the current stress in markets is distorting historical risk/reward profiles. As a result, we believe there are certain public and private investment opportunities to earn income and grow capital for investors with a thoughtful financial plan, well-understood risk tolerance and patient time horizon. Specifically, in periods of declining earnings, quality companies with high margins, low leverage and strong free cash flow generation tend to be more resilient. Finally, equity market volatility has historically clustered, where the best performance periods in a calendar year often follow the worst. As a result, being invested in the best days often requires withstanding the worst days and staying invested.