

October 24, 2022 – Investment Commentary

Market Performance

Global equities rose 3.2% as short-term yields declined. U.S. S&P 500 led the way with a 4.6% gain, the Nasdaq advanced 5.8% followed by the Stoxx Europe 600 increasing 1.3% and a slight gain in emerging markets. Treasury yields touched new year-to-date highs, but shorter-term yields turned lower near the end of the week. For the week, the two-year yield fell 0.02% to 4.5% while the 10-year Treasury yield rose 0.2% to 4.2%. On October 17, 2022, the key rates on the yield curve¹ (2-, 5-, 10-, and 30-year rates) all closed above 4% for the first time since 2007—almost 15 years later. As a reminder, bond prices and yields move in opposite directions. Municipal bonds produced modestly negative returns over most of the week as rising U.S. Treasury yields and a heavier-than-average new issue supply calendar presented headwinds for the asset class. Oil prices fell modestly.

Chinese President Xi Jinping was confirmed for a third five-year term with no indication of a potential successor. Emerging market investors were very disappointed that there were no major changes to expected near-term China policy, with the nation appearing to stick to its zero-COVID-19 policy and no apparent property market solutions. In addition, there was more emphasis on security (Taiwan, technology, and energy), implying economic decoupling from the U.S. and Europe is likely to continue.

Earnings Outlook

Third Quarter earnings season is generating sales on pace to rise 8.5% for the quarter year-over-year. However, earnings are only on pace for a 1.5% increase due to margin compression, after 20% of S&P 500 Index companies have reported. Banks made up the bulk of reports and their earnings have been strong overall, highlighting a generally strong demand backdrop. Earnings resilience continues to offer some support against an otherwise weak financial market backdrop. However, economic risks are prevalent and threaten further margin pressures moving forward supporting our expectation of downward earnings revisions over the next several months.

The S&P's three-month realized correlation—a gauge of how closely the top weighted stocks in the index move relative to each other—has climbed to its highest level since July 2020. The challenge is that, as correlations rise, it becomes increasingly difficult for fund managers to outperform the broader market in the near-term. In other words, the markets are increasingly dependent on where the biggest names in the benchmark are headed. This week's results from Apple, Microsoft, Alphabet and Amazon account for about 20% of the S&P 500 index's total weight.

Outlook

Upward pressure on real yields (nominal yields less inflation expectations) may continue for longer due to central bank activities including quantitative tightening (QT). This creates competition for equities and riskier assets where certain investors should consider redesigning their fixed income allocations and holdings. We have previously highlighted that we consider ourselves to be in a very different world, one that has not been seen for decades - a world of sticky inflation and de-globalization. The war in Ukraine amplified the threat of lower growth and energy prices fueled inflation further, leading to an unusual situation where lower growth is unlikely to mean lower inflation and lower interest rates. Over the last several months, we have been evaluating the implications of a weaker economy and have become more cautious on our outlook, notably the shorter-term outlook implied by weakening demand. We continue to monitor valuations, catalysts, and opportunities in the public and private markets. We believe market volatility will be heightened in this period creating opportunities for investors with a patient time horizon and well calibrated financial plan.

History tells us that markets usually need to believe there will not only be a pause in rising interest rates but also cuts before approaching the bottom. As a result, we continue to closely monitor the 2-year US Treasury yield. Federal funds futures markets are currently pricing a peak in rates at 5% in 2Q23. From a macro perspective, the Investment Office is monitoring multiple metrics including but not limited to new rents, wage growth and ISM manufacturing levels.

Portfolio Construction

For several months now, our asset allocation views have centered around the themes of increasing defensiveness, income, value, and alternative strategies as we have navigated an environment of tighter monetary policy and slowing growth expectations. At the start of 2022, 10-year US Treasury yields were at 1.5%, the S&P 500 forward price-to-earnings (P/E) multiple was 21.3x. The consensus 12-month-forward earnings per share (EPS) estimate was at \$223, with the S&P 500 trading around 4,750. Yields are now around 4.2%, the P/E has fallen to 15.6x. The consensus forward EPS forecast is currently \$236 (~5% year on year growth), with an S&P 500 level of ~3,700. Despite a 23% fall in the index year-to-date, we believe the S&P 500 has been impacted mostly by higher rates rather than lower earnings expectations.

Today, we focus on mitigating near-term downside risks while retaining upside exposure for the medium and long term. Within equities, we prefer value, quality income and certain hedged strategies. Globally, our least preferred views are non-US geographies, growth and speculative technology. Within fixed income, we prefer high-quality municipals and short-biased duration. Finally, we believe real assets may help complement existing public holdings and address inflationary pressures.

Disclosures

Investment Commentary Sources: Bloomberg and Morningstar

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