

November 14, 2022 – Investment Commentary

“Macro Matters” Market Update

Last week’s positive market reaction was boosted by a lower than expected US inflation result. US CPI came in at +0.4% (vs. +0.6% expected), pushing the year on year number down to +7.7% (vs. +7.9% expected), a further drop from the June peak of +9.1%. Of most significance from a market perspective was the deceleration in core CPI, the monthly reading fell to +0.3% (vs. +0.5% expected). With core at +0.27% that’s the slowest since September 2021. In turn, the year on year core CPI fell to +6.3% (vs. +6.5% expected). It’s also worth highlighting that the decline in inflation was broad based rather than being driven by outliers, and the Cleveland Fed’s trimmed mean measure saw its slowest monthly growth since April 2021. As a result, all major indices ended the week higher led by the tech heavy Nasdaq (+7.9%) and followed by the S&P (+5.9%). Yields on Treasuries dropped with the 10-year closing 35bps lower than last Friday at 3.8%, while the 2 year closed at 4.3%, 33bps lower over the same period. These treasury declines are the largest weekly moves since the early stages of the pandemic in March 2020. The US dollar index (DXY) declined 4%.

With inflation surprising to the downside, investors moved to dramatically reprice their expectations for Fed tightening over the coming months. Futures are now pricing in a hike of 50bps at the December meeting, following a run of 4 consecutive 75bps hikes. In response to the CPI release, various Fed officials communicated their usual “Fed speak” cautious tone, with Dallas Fed President Logan saying it was “a welcome relief, but there is still a long way to go”. Nevertheless, Logan validated market expectations that we’re about to see a downshift in rate hikes, saying that “I believe it may soon be appropriate to slow the pace of rate increases so we can better assess how financial and economic conditions are evolving”. We believe markets need to focus less on the *pace* of rate increases as a sign of easier policy and more on the terminal rate *destination* and *duration* it is maintained given its lagged impact on GDP and corporate earnings growth. Although the fall in CPI is encouraging, we believe it’s also critical to monitor layoff announcements and its impact on unemployment and the tight labor markets and impact the narrative around inflation potential for a 2023 recession. Finally, shelter prices which account for approximately 30% of the overall CPI basket calculation are expected to reflect current “real time” market declines in the next few months.

Moving over to Europe, news that Russia retreated from the city of Kherson in Ukraine has had a positive impact on the market. To date, markets have generally taken news of Russian losses as a positive, as it’s seen as raising the possibility of them negotiating, even if recent months have not exactly borne out this thesis. As with the US all European indices have ended the week up led by the FTSE closing at +5.0%, Euro Stoxx 50 at +4.9% and French CAC 40 at +2.8%. This sense that central banks were about to be more dovish was evident in Europe too, and downgraded expectations of future ECB tightening sent yields tighter on the week, led by the 10yr UK Gilt at 3.36% (down 18bps), 10yr Italian OAT at 2.67% (16 bps) and 10yr German Bund at 2.16% (14 bps).

As for implications for other markets, the FTX contagion spread hasn’t been meaningful, so far, outside the crypto ecosystem. The implosion of FTX has reminded us of not to replicate the risks and inefficiencies in traditional finance including leverage, liquidity, transparency, and integrity. We are monitoring the pre-pandemic Bitcoin high of around \$13,850, as an investor sentiment indicator. A year ago, it hit an all-time high above \$67,000 as compared with ~\$17,000 today.

Portfolio Construction

We believe market concerns are at the very beginning stages of shifting from risks focused on interest rate shocks (which drives positive correlations between stocks and bonds) to growth shocks (are we going to get a recession, how deep, for how long?). This provides an opportunity for quality credit to be increasingly more relevant in portfolio construction. We also believe market volatility will remain elevated with increasing fears about the risk to 2023 corporate earnings impacting the “price discovery” process. Within equities, we continue to prefer high quality-credit, dividend paying stocks and value sectors. Value has outperformed growth by approximately more than 15 percentage points through October 2022. We also believe certain qualified purchasers should consider investing in alternatives to provide access to differentiated returns.

Disclosures

Investment Commentary Sources: Bloomberg and Morningstar

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