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Monday Macro Markets

Markets retreated from dovish hopes last week as the Fed reaffirmed its hawkish stance, anchoring terminal rates to a "minimum level" of 5-5.25%. St Louis Fed President Bullard, warned markets about its overoptimism on a single soft inflation print. Market expectations recalibrated post the announcement with futures pricing for the terminal Fed funds rate moving back above 5% for the first time since the CPI report last week. The prospect of a 5%-plus terminal rate had a noticeable effect on Treasuries (price down), with the 10yr yield regaining all losses, rebounding by +12.8bps to 3.82% (bonds prices and yields move in opposite directions).

With the increasing doubts surrounding the Fed pivot well cemented into market expectations, the S&P500 fell -0.9% on the week, led by cyclical sectors as the NASDAQ (-2.1%) lost even more ground. Large Capitalization stocks finished the week at 17.3% below their record high on 1/3/22, Mid Cap at 13.7% below their record high on 11/16/21, and Small Cap at 16.9% below their 11/8/21 record high. Last week's bearish moves came in spite of US producer price inflation easing more than expected as monthly headline inflation surprised to the downside with a +0.2% reading (vs. +0.4% expected). As a reminder, October was the best month for domestic stocks since 1976. The S&P and Nasdaq indices performed well but were also hampered by poor earnings results and/or guidance from the mega-cap tech names like Amazon, Microsoft, Meta/Facebook, and Google. The market is increasingly focused on bottom-up fundamentals and the consequences of higher rates on earnings growth.

The US Index of Leading Economic Indicators (LEI) peaked at a record high during February and is down 3.8% over the past eight months through October. It has had a good track record of calling the past seven recessions before the pandemic lockdown. On average, it peaked 14 months prior to the next recession. As a result, the LEI suggests recession risks are elevated in the near term putting the start of the most "well telegraphed" next recession around March 2023.

In Europe however, despite signals from central bankers that inflation was far too high, there was a positive story on the equities front, with the Euro STOXX 600 up +0.3% to its highest level in over two months, the UK FTSE 100 up +0.9% on the week, the French CAC 40 up +0.8% and the German DAX showed an even greater move higher, up +1.5%. 10-year German Bund yields saw a steep decline falling -14.6bps on the week as 10 year Italian OATS fell -18.6bps with yields falling -26.3bps. This marks the second consecutive weekly decline for core European yields, despite rising inflation prints.

The UK saw October CPI release surprise to the upside, coming in at +11.1%, the highest reading since 1981. The UK government further released its Autumn Statement announcing £55bn of fiscal tightening, split between £30bn of spending cuts and £25bn of tax rises as they seek to further regain market credibility following September's mini-budget debacle.

Now What?

It is our belief that the Fed's strong inflation response will likely have future consequences, and it appears that those effects are beginning to surface. A few examples include the news of the UK's pension system almost going insolvent requiring government intervention, the crypto winter meltdown of $2 trillion+, and the yield curve breaking or rather inverting where various yield curve metrics such as 10yr-2yr or 10yr-3month and other curves indicate US recession is likely. We believe that given the lagged and variable impact of central banks tightening financial conditions other cracks are likely to reveal themselves.

Global markets appreciated in October on hopes that policy makers were finally changing course and a slowdown to the historically large rate hikes was in sight. However, we do not expect October's extreme strength to persist as broad-based, sticky inflation, a hawkish Fed, slowing growth, continued rate hikes, challenging Treasury and fixed income liquidity conditions and geopolitical considerations continue to pose risks to price levels and credit spreads. Overall, equity markets have never bottomed before a recession has begun. However, equity markets tend to be forward looking and rebound before a recession ends. We believe *that means there is more equity market volatility to come.*

The Investment Office is always mindful that as mentioned above, markets can move in the opposite direction of the economy and markets tend to advance well before economic contraction abates. However, if the market bottoms out here, it will also be an uncommon event based on equity valuations alone. Since 1990, the S&P 500 has found its low in a range of 13 to 14 times forward earnings. At a current level of 18x forward earnings, that would project an S&P 500 market trough of ~25% lower than current prices. That forward earnings number, however, assumes that earnings will grow by ~5% in 2023. Further downward earnings projections due to margin compression could potentially move earnings expectations lower.

Portfolio Implications

We continue to ask the question of how to navigate a shifting market. Contingency portfolio construction captures risk management, asset class allocation, manager selection and alternative strategies for both the encouraging and the challenging scenarios. We believe to accomplish this is to have exposure to sectors with defensive characteristics such as healthcare, inflationary “hedging” features of energy and certain technology companies with a track record of pricing power and superior free cash flow generation. The ballast characteristics of high-quality fixed income municipals are also an important pillar. We also believe certain qualified purchasers should consider investing in alternatives to provide access to differentiated returns in distressed credit, real estate and hedged equity strategies that attempt to be less correlated from market declines but have the ability to attempt to capture the rebound once the market bottoms.

From only the perspective of the markets, we remain thankful during this holiday season that the US economy continues to grow and consumers continue to spend. The multi-family housing and single-family rental sectors remain resilient, and the auto industry appears to be doing fine despite tighter credit conditions. The various supply-chain disruptions that had fueled high inflation appear to be correcting. And the US fossil fuel industry is not only meeting domestic energy needs but exporting to help meet Europe’s challenges. However, we also recognize hope is not a strategy and attempt to deliberately construct portfolios to address various goals and market outlooks.

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