November 28, 2022 – Investment Commentary

Market Update: Bad News is Good News for now…

Last week saw further signs that risk appetite was continuing to grow among investors, aided by some positive macro data releases and further signals that central banks might not end up hiking as aggressively as feared. That was evident across multiple asset classes, as the EURO STOXX 600 (+1.9%) advance to a 3-month high, yields on 10yr bunds (-0.4pts) fall to a 2-month low (price up/yield down), while the dollar index (-0.9%) weakened to a 3-month low last week.

Moving to the US, although the week was shortened by the Thanksgiving holiday, markets rallied as weak economic data and the latest Fed Open Market Committee (FOMC) minutes (recession is our baseline over the next year) saw investors dial back their rate hike expectations. Signs of slower growth are seen as bringing fewer inflation pressures and hence fewer rate hikes. The prospect of less aggressive rate hikes proved good news for equities and fixed income, with the S&P 500 (+1.7%) advancing on the week. That took the index to its highest level in over two months. On the energy front, last week brought a decline in oil prices, with Brent crude coming down -3.3% to $84.71/bbl. Since a US and Eurozone recession is now the consensus expectation among economists (and leading indicators are increasingly pointing that way, too), contractionary data isn't as likely to be as surprising to markets as it normally is.

With the November data weakening, investors have pared back their interest rate expectations, with the terminal rate priced in for June 2023 closing the week at 5.02%. This, in turn, prompted a rally in US Treasuries, with the 2yr yield falling -38bps to 4.54% and the 10yr yield falling -11bps to 3.72%.

Looking Ahead

Investors are looking ahead to when the Fed eventually pauses, pivots and borrowing costs start to decline. We believe markets are displaying limited concerns about corporate earnings headwinds due to economic slowdown.

As the cost of capital has increased year to date the broader equity markets valuation excesses weakened and the euphoria in terms of SPACs, speculative tech and crypto have substantially declined. The S&P 500 went from 22 times forward earnings to about 18x, currently bouncing off lows earlier this year of about 16x. However, the stock market continues to trade above its long-term averages.

We believe investors are only now beginning to consider incorporating the earnings implications of the higher interest rates. At the time markets seriously reset 2023 earnings expectations there will be a better indication of market stability. The European market is at a large discount to the US, but valuations are not at prior trough levels and risks remain high and negatively-skewed: the ongoing war in Ukraine, the debt challenges in Italy and the eventual shift to quantitative tightening (QT- shrinking the balance) by the ECB.

Ultimately, investment opportunities depend on your time frame, liquidity needs, income requirements and behavioral tendencies. Hopes for receding inflation and fears about slowing earnings mean the near-term outlook is uncertain. But inflection points for inflation, interest rates, dollar and growth are all likely in the next twelve months. As we enter the new year, our positions reflect the evolving uncertain path. We favor defensives and value, quality income opportunities, and diversification with alternatives. We expect 2023 to prove challenging after the resilience in earnings this year. However, we anticipate in mid-year 2023 investors will begin to shift their focus to potentially improving growth in 2024 where the macro may be more certain and bottom-up fundamentals will play a bigger role in portfolios.

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Disclosures

Investment Commentary Sources: Bloomberg and Morningstar