

November 7, 2022 – Investment Commentary

Market Performance

An eventful week as we saw not one, but two, major Central Banks hike by 75bps to their highest levels since 2008. We begin with the Fed who hiked for a fourth consecutive time by 75bps, now with a 4% policy rate. This was a widely expected phenomenon but saw risk assets sell off against hawkish central bank commentary. Chair Powell discussed the “premature” thought of a potential rate hike pause, mentioning how the data since September’s dots called for an even higher terminal rate. He further downgraded the Fed’s prospects of achieving a soft landing, upgrading the probability of a recession. Markets are now expecting a higher terminal rate of greater than 5% by mid-2023, a new cycle high.

According to Fed Chair Jerome Powell, incoming data suggests that the “ultimate level of interest rates will be higher than previously expected.” He added that the pace of increases may slow but that “no decision has been made.” Fueled by strong consumer spending data, the market’s expectation continues to increase for the terminal federal funds rate. The resilient consumer is evidenced in recent quarterly commentary by executives of the Cheesecake Factory who recently commented the company has not seen any changes in customer behavior, noting no signs of trade down, consistent average check trends and attachment rates (dessert, alcohol, appetizers) that are trending above 2021 and 2019 levels.

The Bank of England (BOE) who also hiked by 75bps to a 3% policy rate. Euro area inflation (CPI) for the month of October rose to +10.7%, +10.3% expected, its highest level since the formation of the single currency. This also marked the first month that inflation had been above 7% in every single Euro Area country at once. Hawkish sentiment in a week that markets had expected a continuation of the dovish Fed pivot, had a toll on the S&P500 down -3.7% last week and -21.7% year to date (YTD). Likewise, the Nasdaq is down -7.4% on the week and an even greater -34.2% YTD. European equities have fared better with the Stoxx600 actually up 2.1% on the week and down -14.9% YTD. The US 10year Treasury yields had been falling to begin the week as markets anticipated a potential “Fed pivot” given recent dovish commentary. However, the move quickly reversed post Powell’s commentary with 10year yields ending the week up 14.4bps.

While recent October equity gains have provided a welcome relief from the losses that have plagued markets this year, a combination of factors — downside risk to future earnings due to margin compression, relatively higher valuations and the likelihood of a recession in the coming quarters — points to a less positive outlook for earnings growth in 2023. And even with the Fed alluding to a slower pace of tightening after a fourth consecutive 75 basis points rate hike, “sticky” areas of inflation (rents, wages) and continued strength in labor markets will likely keep Chair Jerome Powell and his colleagues from considering a pivot any time soon.

Key notable events this week beyond the US CPI report will be the US mid-term elections on Tuesday. Since January 1926, the average fourth quarter US stock performance across election cycles has generated a positive 6.5% return in mid-term election years vs. 2.7% in non-election years.

Portfolio Considerations

Market volatility, Russia's war on Ukraine, China's zero-COVID policy, supply chain issues, and margin compression are all adding to negative headlines, but the fast increase in prices and the way central banks are responding still tops the list. Despite all the bad, let's take a moment to discuss some more positive dynamics in the economy right now.

Resilient consumers, coupled with near-record low unemployment levels and strong balance sheets (on a household and corporate level), continue to suggest that the economy is reasonably healthy looking backwards. However, until prices show convincing signs of cooling, the Fed is likely to grind their policy rate higher still (at the expense of economic growth, and in the near-term, markets).

As a result, while the Fed continues its hiking cycle, investors should expect more volatility. On that assumption, we continue to recommend to investors to consider quality short duration and intermediate investment grade bonds. Furthermore, investors today can consider locking in historically compelling yields that rival historic average equity returns in an asset class that typically provides a portfolio buffer in adverse events.

Disclosures

Investment Commentary Sources: Bloomberg and Morningstar

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