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Market Performance

Following a 28% drawdown from the January 4th high to the October 13th low, the S&P 500 has now gained approximately 16% for the second time this year from the June and October lows. Risk markets have been seesawing with each new data print and central bank comment.

In what marked the final week before the Fed blackout period, we have seen a very dovish indication from central bankers, with Fed Chair Powell signaling for "[moderation] in the pace of rate increases" as soon as this month's meeting. This cemented market expectations away from a 75bp hike, now only forecasting slightly above 50bps, with the terminal rate down from 5.01% to 4.92%. Risk assets surged post Powell's comments, with the S&P500 gaining +3.1% on the day to its highest level since mid-September. The advance was broad-based, led by cyclical sectors, with the NASDAQ (+4.4%) and the FANG+ Index (+7.3%) seeing even larger gains. It further prompted a substantial fall in Treasury yields, with the 10yr yield down -20.3bps on the week. Central bankers in Europe struck a different tone, with ECB President Lagarde cautioning around the pre-emptive assumption that inflation had peaked, warning that there remained "too much uncertainty". The EU-wide flash CPI measure came in at 10.0%, just shy of its recent historical record of 10.6%. It was also the first time in over a year that Euro Area inflation had slowed relative to the previous months.

The signs of decelerating inflation led investors to price in a growing chance that the ECB would slow down the pace of their hikes to 50bps in December. Yields on 10yr German Bunds fell - 11.8bps on the week with French OATs (-12.5bps) and Italian BTPs (-8.5bps). Our Investment Office believes European inflation will remain elevated through next year. During November, all eleven sectors in the S&P 500 had positive returns, with materials (+12%), industrials (+8%) and financials (+7%) leading the way. Non-US developed countries (MSCI EAFE) markets also continued their strong run and rose 11.3%, led by Australia (+1.2%) and Europe (+11.4%). Emerging markets rose 14.8% as China rallied an impressive 29.7% on hopes of lifting COVID restrictions and reopening the economy. From a valuation perspective, the S&P 500 (US Large Cap) and NASDAQ trade above their 20-year averages based on forward price earnings (P/E) ratios, while the Russell 2000 (US Small Cap) trades below, as does the MSCI EAFE (Non-US Developed Market Equities) and MSCI EM (Emerging Market Equities). US Investment Grade Corporate debt returned 5.2% (down 15.4% YTD) and municipals returned 4.2% (largest one-month rally since mid-1980s; down 7.4% YTD).

Optimistic equity buyers believe inflation has peaked, and the Fed will likely pivot to a lower rate policy. But investors believing the "inflation is peaking" narrative should be mindful of the yield curve, which last week inverted to new lows for this cycle. The 10year – 2year curve is now at -78 bps, which is the most inverted it has been since 1981. We believe the implication is that if the economy contracts, earnings likely will contract with it. S&P 500 consensus earnings growth is approximately 5% in 2023. But the business cycle (like the yield curve) suggests otherwise, where the full impact on margins due to higher interest rates, labor, and supply chain costs are still to be determined. As a result, it seems premature to expect a bottom for earnings anytime soon. If earnings contract further, then current prices for risk assets may be too optimistic.

The benign perspective for inflation or the Fed's reaction to it is currently pricing the S&P500 at ~17x forward EPS. If inflation does not quickly trend below 4-5%, the Fed may feel compelled to pause around 5% for longer than the market currently is contemplating. In other words, we believe investors have been too focused on the speed and target level of rates and have yet to pay significant attention to the duration period the Fed may need to pause.

In sum, it is worth remembering that "Wall Street is not Main Street," where the labor market generally lags trends in overall economic activity, financial markets tend to be forward-looking. In eight of the last nine recessions, the stock market hit a trough before the trough of the economic recession. In nine of the last nine recessions, the unemployment rate peaked after the trough in the stock market.

Turning the Corner Into 2023

Global growth will likely continue to slow into 2023 as more countries fall into recession, even if shallow, leaving central banks needing to balance tighter monetary policy against economic growth. We expect market volatility during a slowdown to continue. As interest rates have climbed, municipal and corporate fixed income has become interesting again. One interesting scenario to contemplate for 2023 is if inflation falls while growth remains somewhat resilient (soft landing). In this scenario, even if inflation falls rapidly, we believe the Fed will struggle with the decision to ease policy, as they would be cutting rates/stimulating into a full employment, full demand economy. This situation would likely be coincident with an equity market where EPS may be more resilient, but there is more downward pressure on valuations (which are today above long-term averages) given the Fed would be maintaining tight liquidity conditions.

Above all, investors should beware of being too optimistic and pessimistic. Selectivity and composure, as well as a patient and thoughtfully diversified integration of alternative strategies, could help navigate the quickly changing macro regimes and uncertainties of 2023. All recessions bring pain, but not all are long-lasting or deep.

Disclosures
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