

ECONOMIC OUTLOOK

Summary

Could we be reaching a point where disappointing economic data actually seems like good news? The Federal Open Markets Committee (FOMC) is in the process of expediting a rate-hiking cycle to fight inflation, and they are showing the resolve to move forward until inflation is lower, or something “breaks.” Their ultimate goal is to slow demand in the economy through higher rates, which should also put downward pressure on the labor market and wages. They believe that decreased consumption and reduced wage pressures will get inflation back to target levels, while acknowledging that there will be “some pain” throughout this process. With 1.25% in additional rate hikes expected by year-end, and the potential for more in 2023, any data that can provide evidence to the Fed that the economy is slowing, and putting pressure on inflation, could reduce their appetite for future rate hikes.

With that context and a bit of twisted logic, the best economic news of late might be the decline in job openings in the recent U.S. Job Opening and Labor Turnover Survey (JOLTS). The Fed has a dual mandate of taking into account price stability (inflation) and maximum employment. The labor market remains strong and Chairman Powell has often referenced that there are two jobs available for every person seeking employment. The Fed feels it needs to see a shift in this imbalance before they will consider any sort of “pivot” in their policy stance. With that, the over one million decrease in job openings in August was a welcome sight and the largest such decline since April 2020. While that doesn’t get the overall level of job openings where the Fed would like to see it, it’s the most meaningful move in the right direction in some time.

Still, overall economic data remains mixed. Retail sales exceeded expectations in August, showing continued resolve from consumers. The housing market is experiencing pain due to the highest mortgage rates in 20 years. Additionally, manufacturing Purchasing Managers’ Indexes (PMI) are

declining, yet we’ve seen an increase in services PMIs. This is all to say that the Fed still has more to do before they are able to declare “mission complete.” Just remember the silver lining: With every bit of bad data, the Fed is one step closer to the end of their damage to the economy.

Positives

Retail sales in August exceeded expectations by 0.4% (0.3% vs -0.1% est.)

Consumer sentiment moved higher, though remains historically low

Long term inflation expectations remain anchored

Negatives

August headline CPI was higher than expectations (8.3% vs. 8.1% est.)

August Core PCE was higher than expectations (6.2% vs 6.0% est.)

Global composite PMIs are in contractionary territory

EQUITY OUTLOOK

Summary

The S&P 500 officially retested the mid-June lows and marked new closing lows as the month of September drew to a close. September, which historically has been a weaker month for the S&P 500, finished lower by 9.2% which caused the index to be down 4.9% for the full third quarter. Equity performance by style (growth/value), size (large/mid/small) and geography (domestic, international, emerging markets) were tightly bunched with most major indexes falling between 9.0% and 10.0% for the month.

One of the biggest reasons for the equity market pullback was a change in tone from the Federal Reserve. The market's expectation had been for Fed officials to pivot to an easier monetary policy by next year. In the statement following the September meeting, hawkish language made it clear the Fed plans to continue to raise and then hold rates higher, and for longer, than the markets had anticipated. That messaging sent shockwaves throughout the capital markets although many argue the Fed is a step behind as inflation pressures may soon be moderating.

Earnings season will kick off in a couple of weeks with an elevated level of significance. Last quarter's earnings were surprisingly resilient but some economic conditions have deteriorated leaving room for a more cautious outlook. Corporate executives have reasons to reset the bar lower when it comes to forward guidance, even if the current quarter's results are in line with expectations. Poor guidance could be a near-term hindrance for stocks.

We continue to believe many of the factors that have lead equities lower in 2022 are currently priced into the market. Stocks are historically attractive from a valuation standpoint, as long as corporate earnings remain intact. Equity markets appear well positioned to rally as we head into the November elections and to close out the year.

Positives

Stock valuations reasonable

Crude and gasoline prices receding

Negatives

Hawkish Fed

European energy crisis looms

Unknowns

Earnings outlook

FIXED INCOME OUTLOOK

Summary

With the 10-year Treasury yield failing to pierce the mid-June highs, coming into September there was hope that the bond waters were safe to swim in again. These hopes evaporated following the release of the stronger-than-expected August Consumer Price Index (CPI) report. At double the consensus estimate, this inflation report removed any doubt the Federal Open Market Committee (FOMC) would soon hike the overnight rate by another 75 basis points (bps) and that there would be much more to come in an effort to crush the stubbornly high and persistent inflation.

For the month, the 2-year note rose 79 bps to end at 4.29%. The 10-year increased by 64 bps to close at 3.83% and the 30-year ended at 3.78%, 48 bps higher on the month. This was one of the top 10 largest monthly moves in yields in the past three decades. The hits kept coming with credit spreads increasing as well on the fear the Fed would over-tighten and cause a recession. The broad investment-grade bond market indices had their worst, or second-to-worst, monthly return in the past 30 years.

The front end of the bond market reacts quickly to revisions in the forecast for the path of the overnight rate. The Fed is now expecting an overnight rate of 4.38% at year's end. This is a full 1.0% higher than they anticipated back in June. There is currently a fair degree of consensus among the Fed speakers that the rate will reach 4.50% to 4.75% by mid-2023 and stay there for an extended period. The 2-year yield already reflects this path and should only swing wildly again if that forecasted path changes. To some degree, longer yields can get pulled around by shorter rates as the curve will only invert to a certain level before longer maturity buyers throw in the towel. If short rates stabilize, longer yields should as well. Intermediate-maturity, investment-grade corporate bonds now offer their highest yield in more than 13 years at just over 5.50%. As painful as the past few years have been, we believe this yield level will look attractive for years to come. We are maintaining a neutral duration policy with an eye towards adding duration if yields move much higher.

Positives

Treasury yields appear attractive relative to long-run inflation expectations

U.S. corporate bond yields are the highest in 13 years

Bonds should offer an increasing diversification benefit

Negatives

The Fed has consistently underestimated the stickiness of inflation

The Fed will still be increasing the overnight rate sharply through the year's end

Unknowns

Impact on market liquidity as the Fed's balance sheet run-off accelerates

Resolution of the Russia/Ukraine war

Hostilities and deteriorating relationship with China