KRILOGY

WEEKLY MARKET RECAP | August 29, 2022

Week in Review

Equity Markets:

As anticipated, the past week's move was going to rely on the outcome of the Fed's Jackson Hole Symposium. Although the narrative was not negative, it did not put investors' minds at ease. The S&P fell over 3% on Friday, ending the week down 4%.

The market bounced off the mid-June lows in ferocious fashion and the run was likely to falter at some point. Future earnings estimates have come down as the economic outlook has slowly weakened. Extreme negative market sentiment was a large driver for the push higher before Chairman Powell's tough inflation-fighting comments on Friday cooled the rally.

Q2 earnings season is nearly complete and has fared much better than expected. The earnings surprises are in line with the 5-year average. Earnings growth has held up quite well at ~8.7% according to data compiled by Bloomberg. This is nearly double the estimates from the beginning of the quarter.

Fixed Income Markets:

The Jackson Hole, Wyoming Symposium was the most important headline for the week. Treasury yields increased on the back of Fed Chairman Powell's comments. The chairman emphasized the Fed's commitment to battling pricing pressures. Inflation has begun to show signs of peaking, but the absolute level remains well above its long-term target of 2%.

The rhetoric leaving the symposium drew heavy attention and had market participants questioning the outlook for rate hikes and future policy action. To quote Jerome Powell on the potential effects on the economy from Fed policy, "pain could be felt." This shows that the Fed has decided to dig in and is willing to push its policy action to the edge in order to bring inflation back to its target. The 10-year yield ended the week at 3.11% and the 2s/10s spread remains heavily inverted.

Economic:

A key inflation data point showed signs of slowing this past week. The PCE (Personal Consumption Expenditures index) came in at 6.3%, down from the June level of 6.8%. Inflation is showing signs of peaking but the year-over-year numbers are still somewhat concerning. Personal income and spending missed expectations, and it could be a leading sign that the underlying strength of the consumer is waning.

Looking Ahead

Equity Markets:

The market rally over the past two months has been built on a belief that policy action will pivot sooner rather than later. Corporate earnings have surprised to the upside but it has been followed with caution over the coming quarters. We anticipate earnings estimates to come down as policy action will likely have a negative impact on corporate earnings. We are not in the game of calling tops or bottoms, so we could still see further downside from the mid-June lows. However, we do know that both the consumer and corporations are in a much stronger position to withstand an economic slowdown than we have seen in the past. Corporate profit margins are still healthy and the consumer is generally not stretched as thin as in the past. This tends to lend itself to a mild market reaction, barring an unforeseen economic breakdown.

Risk still remains relevant and for this reason, we believe investors should remain committed to their strategic long-term target allocations. It is also wise to utilize a disciplined rebalancing strategy to purchase assets as they become oversold and yet still present long-term opportunities. The recent rally could lead to the psyche of trying to catch up on the lost return, but our conviction on not taking excessive risk remains high. A well-diversified portfolio that aligns with a defined risk tolerance is the most prudent approach until further visibility increases and we work through this cycle.

Fixed Income Markets:

Following the Jackson Hole Symposium, our long-standing rate call remains unchanged. The move back to 3% took longer than expected but with the recent statements from the Fed Chairman, we still believe the 10-year yield will spend the majority of the time over the next 12-18 months in the 3.25-3.5% range. We see 3.5% as being near the peak of the current rate cycle because of secular and structural deflationary pressures.

With the 10-year moving past 3%, we believe bond yields are becoming more attractive yet again and could become good entry points for yield-driven investors. We see a choppy, but upward trend in yields as the Fed takes action to cool inflation. Policymakers have made it clear that their number one goal is to battle inflation. Inflationary pressures are becoming "stickier" as time passes and it appears the most effective way to combat this is for the Fed to dampen demand through policy action.

Economic:

With earnings season nearly complete, the economic calendar will be at the forefront as we head into the next policy-setting meeting by the FOMC. The JOLTs report will be closely watched as the labor market is a major input for Fed policy action. We will also get a reading on consumer confidence and ISM manufacturing data.