Week in Review

Equity Markets:

The S&P finished the quarter down ~9%. 2022 has been a tale of what seems to be a slow bleed followed by a run-up, but the rally never takes hold. The emotional roller coaster this year for investors is historically unprecedented. Year-to-date, the S&P is down nearly 25%. But the Bloomberg Barclays Aggregate Bond Index is also down 14%.

Major companies have come out over the past few weeks with negative guidance, most notably, FedEx and Apple. Q3 earnings season will get underway soon and the focus will be on corporate earnings stability in order to withstand the current market levels. Earnings expectations have declined steadily this year. Current expectations for Q3 earnings are for year-over-year growth of 2.9%. This is in stark contrast to the 9.8% on June 30th, according to FactSet.

Fixed Income Markets:

The fixed income markets experienced a volatile week. The 10-year treasury yield briefly exceeded 4% before dropping to 3.71% in the midst of one trading session. This spike and ultimate drop in yields were due, in part, to the Bank of England's decision to enact an easing policy of bond buying to stabilize their financial markets. This decision followed the announcement that the U.K. may seek to cut taxes significantly. Both of these measures go directly against the fight against inflation, which has exceeded 10% in the Eurozone.

The 10-year treasury yield ended the week at 3.8% while the short end of the curve remained above 4%. The 2-year treasury note is currently yielding over 4.2%. The 2/10's spread remains near historic levels at -0.41%.

Economic:

The Personal Consumption and Expenditure Index (PCE) surprised to the upside this week. The PCE is the preferred inflation gauge by the Fed and the elevated reading increased the odds of tighter Fed policy through the end of the year. The PCE rose 4.9% in August, a slight increase from the 4.7% in July.

The University of Michigan's Consumer Sentiment Index's final reading for September was surprisingly revised lower. The final reading came in at 58.6 versus the anticipated reading of 59.5. Another downside miss was the Chicago PMI reading, which returned to a contraction range of 45.7. This missed expectations of a decline to 51.8 from August's reading of 52.2. A reading below 50 is considered to be a contraction environment.

Looking Ahead

Equity Markets:

Earnings expectations have continued to decrease over the past three months. Analysts' earnings expectations for Q3 currently stand at slightly over $55 per share. This would be a ~3% year-over-year growth rate. This would be the lowest earnings growth since the pandemic in 2020.

We believe we are the in the midst of more earnings revisions. The current estimates for S&P earnings are likely to be revised lower as we move through the earnings season. A macro view of the inflation environment and monetary policy tells us that historically, Fed rate hike policy takes six-plus months to show up in the data. We currently stand approximately six months from the first rate hike by the Fed. We have launched from a 0% Fed Funds rate to over 3%. This parabolic move was bound to impact corporations and we believe we are in the midst of these effects. Since 1957, the average recessionary drawdown has been ~30%. Recessionary odds have shifted from an if to a when question. Are we currently in a recession or will it occur in the next two to three quarters?

In our opinion, this should not be the focus for investors. The depth of a drawdown is important to note but if we drop to the historical drawdown of 30% (which is only 6% from current levels) or slightly more, the fact remains that the long-term outlook on corporations remains positive. For this reason, investors should remain disciplined and optimistic for the future. The weakening data actually provides some clarity.

So far this year, many aspects of the market have been difficult to reconcile. Why is the labor market so strong with inflation running at a multi-decade high? Why do corporate earnings remain strong in the midst of the most aggressive Fed since Volcker in the 1980s? We believe the answer to the disconnect is a function of where we started from. The labor market was extremely strong, corporate balance sheets and profit margins were at a historic strength, and the consumer was more stable than in previous cycles coming out of the pandemic. It is most important to remember, historically for long-term investors, the most opportune times to invest have been in the depth of bad news. As bad news compounds, we recommend investors take a step back from the headlines and look out for three to five years. We believe an investor will likely not have regrets if they were to invest at the current suppressed market levels.

Fixed Income Markets:

Central banks across the globe are struggling with the fight against inflation, while attempting to not stifle economic growth.

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The U.S. is included in this group. Despite softening data, the fixed income markets are pricing in a ~55% probability of a fourth consecutive 75 basis point rate hike at the next FOMC meeting.

The moves in the fixed income market have confirmed our conviction that we are near the top of the current rate cycle. We have slightly revised the rangebound levels for the 10-year to the 3.5-3.75% range. This slight upward revision is due to the Fed's expectations for the Fed Fund's rate to battle inflation. We do believe there will likely be brief periods that the 10-year will move out of this range, for instance, this week, but are likely to moderate back to our target range. We still strongly believe that we are better long-term buyers of bonds at the current levels. Investors are seeing yields last seen over a decade ago. For investors who would like a guaranteed return stream, treasury yields are looking attractive.

Economic:

This week the labor market will be in focus. The JOLTS report will be released on Tuesday, followed by ADP's labor report on Wednesday and concludes Friday with the September labor report. Timely data from the manufacturing and services sectors will be released by the ISM and S&P Global throughout the week.

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