Week in Review

Equity Markets:

The S&P 500 ended the week down 2% after a strong start. The market rallied on the softer-than-expected CPI report Tuesday and hoped this would lead the Fed to make a dovish pivot. The optimism was squashed following the press conference with Fed Chairman Jerome Powell. The hopes of a less aggressive rate policy shifted to worries around the Fed overtightening amidst softening economic data and pushing the economy into a recession. Q3 earnings season is essentially complete, as over 99% of companies have reported earnings. The focus is now shifting to Q4 earnings, with reports starting in a matter of weeks. According to FactSet, analysts are expecting earnings to decline by 2.8%. The current forward P/E is 17.3, slightly below the five-year average of 18.5.

Fixed Income Markets:

The headline event for the week was the FOMC policy meeting. They followed through with a 50-basis point rate hike, but a hawkish tone in the post-meeting press conference sent the markets into a downward spiral. Despite an improving inflationary environment, policymakers believe there is still more work to be done. Chairman Powell indicated they believe the peak Fed Funds Rate needs to be around 5.1%. The current range sits at 4.25-4.5%. A 5.1% policy rate indicates, at minimum, several more rate hikes into early next year. He also stated that the FOMC believes they will need to keep their policy rate higher through next year to dampen inflation to the desired target. This tone was not anticipated by market participants and the markets retreated.

Economic:

The CPI report came in slightly better than expected at 7.1% on an annual basis and 0.1% from last month. Core CPI rose 0.2% in November and 6% from a year ago.

The S&P Global U.S. Manufacturing PMI for December came in at 46.2, below the Bloomberg consensus estimates of 47.8. The services PMI fell to 44.4 versus the expected level of 46.5. Both of these readings remain in contraction territory (a reading below 50).

Looking Ahead

Equity Markets:

Analysts are expecting the lagging effect of monetary policy to take hold in Q4 earnings. At the start of Q4, analysts expected earnings growth of 3.7%, which has been revised down to a 2.8% earnings decline, according to data collected by FactSet. While corporate earnings have not been that great in 2022, strong parts of the market have overshadowed much of the weakness. The energy sector is expected to have earnings growth of 151% in 2022. If the sector were excluded from the S&P 500, the index would incur an annual earnings decline of 1.8% compared to 2022 earnings growth of 5.1%, according to FactSet.

Based on what we have experienced so far this year, maintaining a disciplined approach is necessary as we move into 2023. Volatility and market choppiness will likely remain high until the Fed has made a full policy pivot (pause and/or cut). We have already experienced a nearly 28% drop in the S&P. Earnings have weakened and will likely continue to do so into 2023. We've experienced one of the worst fixed-income markets in decades. The market appears to have already priced in a lot of bad news and expectations. While we are not suggesting the environment can't deteriorate more, the news would likely need to take a serious turn for the worst to experience significantly more downside. It is possible to retest the October lows, and potentially see a new low, but history tells us that we are on par with the average recessionary drawdown. It is prudent for investors to stay disciplined and committed to their appropriate long-term investment goals and allocations. When the market turns, the rebound will likely be very quick, and more importantly, likely to come before economic data and earnings reach their trough.

Fixed Income Markets:

Yields were relatively flat following the FOMC announcement. A large part of the move in interest rates has already occurred, in our opinion. Another move higher could still be in the cards. We believe that the 4.25% yield on the 10-year in October was likely the peak of the current rate cycle and that rates should stay rangebound until the Fed is finished with its rate hike campaign. Recession fears had an influence on the equity markets this week. If these fears turn into reality, we believe high-quality, longer-duration fixed-income has the potential to continue to rally over a longer time frame.

We remain in the "lower for longer" camp for rates and believe the secular impacts of high government debt, an aging demographic, and disruptive technology should keep rates compressed.

Economic:

This week will be a busy one with reports from multiple sectors of the economy. Housing will take center stage with November's existing home sales, new home sales, housing starts, building permits, and the NAHB Housing Market Index for December.

The closely watched Leading Economic Indicators report and the final reading for the GDP will be released on Thursday.

The consumer will be in focus as the Conference Board's Consumer Confidence Index and the final University of Michigan Index of Consumer Sentiment is set to be released this week. To finish the week, the Fed's preferred inflation reading, the Personal Consumption Expenditures Price Index is set to be released Friday.

**** *See Important Disclosures on following page.*

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