MARKET PERSPECTIVE

OCTOBER , 2022

IN FOCUS:

Inflation Complicates Federal Reserve Monetary Stance

As inflation accelerated over the past year, the Fed attempted to front-run inflation by raising interest rates a combined 3.75% since March. However, the September CPI report indicated the Fed's policy rate hikes that began six months ago have not curbed the post-pandemic inflationary tendency in the economy. The report also showed rent inflation accelerating and raised the possibility that the post-pandemic run-up in rent CPI could be higher. This implies an elevated risk of inflation persisting into 2023.

The Fed will likely begin to telegraph a reduction in the pace of its restrictive policy stance by yearend, even if inflation remains persistently high. However, there is still a risk that they could wind up or be seen as falling behind the curve again. This could damage the Fed's policy credibility and put upward pressure on long-term bond yields into the second half of 2023. Many analysts think that such a "dovish pivot" at yearend could be a precursor to the end of this rate hike cycle.

It remains our view that the Fed may pause rate hikes for some time until there is enough evidence the economic expansion is continuing. Bringing inflation down to the target level of 2% could potentially force the Fed to ultimately hike rates above 5%. It is vital for the Fed to break the link between volatile monthly CPI reports and policy actions, if it wants to reduce the pace of rate hikes in December or January.

U.S. Dollar In Perspective:

Recent commentary from global Central Bank meetings - coupled with the sharp speed of U.S. rate hikes - has amplified global growth risks and contributed to meaningful stresses in global financial markets. Yields have risen in the U.S. more than continental Europe and this has had the effect of reigniting the rally in the U.S. dollar. This pattern could last for a few more months but the impending recession doesn't necessarily mean that the dollar rally won't completely reverse either.

Our Focus:

We expect the investment landscape will remain difficult in 2023 as central banks continue to ratchet interest rates higher amidst the ongoing slowdown in global growth. Nevertheless, oversold equities and bonds still have room for a yearend bounce.

Our base-case economic outlook is that global growth will be mostly sporadic over the next year, although we are not ruling out a shallow recession. However, we view the odds of a deep recession as being very limited given the healthy balance sheets (households, business and banks) in the U.S. and across the globe. The current economic cycle is less synchronized than in the past, but overall economic and capital market conditions are mostly analogous to late-cycle dynamics. Weak growth notwithstanding substantially better returns over the next 6-12 months is still fraught with plenty of headwinds.

Global equity and bond valuations have improved markedly this year, thereby reducing downside risk as both remain oversold. The upside for multi-asset portfolios would be that both equity and bond prices rise while in a mild recession scenario with easing inflation. Still, the investment climate remains challenging in the year ahead, with above-average volatility in both equity and bond prices continuing to persist.

CONCLUSIONS:

Earnings estimates are stubbornly high despite narrowing profit margins as a result of rising labor and input costs. At approximately 3850, The Standard and Poor's 500 implies a forward price to earnings ratio of 16.6 X and is consistent with a soft-landing scenario. The overall market doesn't appear overly expensive, despite the demise of U.S. growth stocks versus their value counterparts as we enter the home stretch of a dismal performance year. Given the strong tendency of the markets to perform well following midterm elections, we are still expecting better relative performance in the months ahead coupled with a relief rally in bonds, as yields ease. However, as long as earnings visibility is cloudy and central banks remain hawkish on forward interest rate guidance, a near term relative rally in growth stocks will be muted. The valuation gap between growth and value stocks remains high by historical standard and keeps growth stocks vulnerable in a volatile equity market. As a result, we maintain a late cycle low PE value bias and believe it remains too early to shift our focus into the "growthier" segments of the equity market.

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