

ECONOMIC OUTLOOK

Summary

The Fed has been expeditiously pushing the overnight borrowing rate to its highest levels since 2007 in an attempt to slow the economy and rate of inflation. With that context, and following the negative GDP growth during the first two quarters of the year, it may have been a surprise to see a 2.6% increase in GDP during the third quarter. What may be even more surprising is that, while still very early in the quarter, the Atlanta Fed's GDPNow is currently projecting 3.6% growth for the fourth quarter. While better-than-expected GDP growth is certainly good news, the implication is that a stronger economy can accommodate and will require a more aggressive stance by the Fed in their battle with inflation.

However, the effects of the Fed's various rate hikes are still working their way through the economy. Textbook thinking says the impact from any rate hike can have a lag of between 6 months to 18 months before it shows in the data. If that is accurate, at the earliest end of the spectrum, the economy has only digested the initial 25 basis point (bp) and 50 bp hikes from March and May, respectively. At that point, a 0.75% to 1.00% overnight rate was likely well below the "neutral" policy rate, so it would make sense that the economy could still be growing at a decent clip.

Since then, there have also been continuously strong non-farm payrolls, the unemployment rate has barely budged and the year-over-year inflation data (CPI and Core PCE) is only marginally lower than it was in March; in fact, in the case of Core CPI, it has actually increased. We've also seen four consecutive historically large 75 bp rate hikes and at some point in the not-too-distant future those hikes will have a negative influence on the economic data.

The Fed has intentionally frontloaded this rate hiking cycle. They now need to decide if they will continue focusing on backward-

looking data points or if they will be more forward-looking and account for their actions already taken. They recently acknowledged the pace of their rate hiking cycle will likely slow within the next two meetings but countered with the fact that peak rates are likely to be higher than previously discussed. Overall, this is a positive development since they risk materially overshooting the "neutral" rate if they keep pushing the overnight rate higher without first seeing its impact in the data. If that were to occur, we could see a more severe economic downturn than the Fed had anticipated.

Positives

3rd quarter GDP came in 0.2% better than expectations (2.6% vs. 2.4% est.)

October non-farm payrolls beat expectations by 68,000 jobs (261k vs. 193k est.)

September retail sales (excluding autos and gas) beat expectations (0.3% vs. 0.2% est.)

Negatives

The unemployment rate was slightly worse than expected (3.7% vs. 3.6% est.)

ISM Manufacturing has declined for five consecutive months (50.2)

Pending home sales year-over-year have collapsed (-30.4%)

EQUITY OUTLOOK

Summary

The month of October saw a sharp rebound for equity markets following big declines the previous two months. The S&P 500 rallied 8.1% for the month with value stocks outperforming their growth peers by a wide margin. The Russell 1000 Value Index climbed 10.3% while the Russell 1000 Growth Index rose 5.8%. The question of the moment for stocks is whether this is yet another bear market rally like we witnessed over the summer or whether this could mark the beginning of a new bull market.

Last month we highlighted the importance of third quarter earnings and the potential impact those announcements might have on equity markets. To date, earnings results and perhaps more importantly forward guidance has been fairly resilient. Certainly there have been some disappointing results as indicated by the wide disparity of sector returns in October. Take for example the best returning energy and industrials sectors soared 25.0% and 13.9% respectively while the laggards, consumer discretionary and communication services, eked out mere 0.2% and 0.1% gains. While there are still several hurdles to overcome, overall earnings results to date increase our conviction the market recovery may be underway.

Economic uncertainty and lingering questions about the path of Federal Reserve tightening will undoubtedly continue to

weigh on capital markets. However, putting the mid-term elections in the rearview mirror should be a positive catalyst for stocks. Attractive valuations along with reasonably stable fundamentals should provide a healthy backdrop for long-term equity investors.

Positives

Sentiment, as a contrarian measure, is quite negative

Equity valuations

Negatives

A few more rounds of rate hikes are expected, reminding us of the mantra “Don’t fight the Fed”

European energy crisis looms

Unknowns

Inflation components diverging

FIXED INCOME OUTLOOK

Summary

Volatility continued in October as the 61 basis point (bp) closing level trading range of the 10-year Treasury yield was almost twice the 30-year average. In fact every month this year has seen the trading range at or above the long-run average with nearly double the range in each of the past three months. Yields dropped about 20 bps across the curve during the first two days of the month but then moved sharply higher as strong labor market and inflation reports reinforced that the Federal Reserve has a lot more to do in their fight against inflation. Fed speakers were consistent in their messaging that it was premature to think about easing next year. Global yields also increased as central banks around the world hiked rates. Overall for the month, the 2-year and 10-year Treasury notes increased by just over 20 bps as the 30-year increased by nearly 40 bps. Credit spreads followed the same pattern by tightening a handful of bps before moving wider by 13 bps, only to come back in and end the month nearly unchanged.

With yields higher and spreads little changed, the broad market index returns were again negative as they have been in eight of the 10 months this year. With the back-up in yields and spreads, long-maturity corporate bonds have become much more attractive to the traditional buyers in this segment of the market, namely pension funds and insurance companies. Their interest led long-maturity corporate bonds to much better performance than comparable maturity Treasury notes. In the intermediate maturity range, these two sectors had comparable monthly returns. For the calendar year overall, the 2-year Treasury note yield is up 3.75% from the 2021 closing level. The 10-year is about 2.50% higher and the 30-year is 2.25% higher. The decline in value for bond investors has been about five times greater than the previous largest yearly decline which was in 1994. The good news is that bonds are contractual obligations with maturity dates. The decline in value will be made up as they approach their maturity date.

The Fed again increased the overnight rate by 75 bps in early November. Their accompanying Federal Reserve's Open Market Committee (FOMC) statement set up expectations for a moderation in the pace of hikes. But then during Chairman

Powell's Q&A session he set a decisively hawkish tone leading to the need for more rate increases and staying wherever needed for a longer period. While it is now set to increase just 50 bps, he let it be known this does not indicate an end of the tightening process or even a pause. He also made an effort to clearly close the door on any reversal of policy. All considered, the market is currently reflecting this renewed elevated and elongated path of the overnight rate. We expect the move higher in yields will occur not when the markets catch up with the Fed, but rather when the Fed catches up with inflation. Whether we are fully there yet or not, we believe the bulk of the bond price destruction is likely behind us. Yields should peak sometime soon if they haven't already. Corporate bonds look exceptionally attractive at these levels barring a severe recession, which we are not expecting. Bond math should begin to work in favor of investors who have weathered this tough market.

Positives

Long-run inflation expectations remain anchored

U.S. corporate bond yields are the highest in 15 years

Bonds should offer an increasing diversification benefit

Negatives

The Fed focused solely of rear-view inflation data

Overnight rate to remain elevated through next year

Unknowns

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

Resolution of the Russia/Ukraine war and escalation of hostilities with China