Third Quarter 2022
American Portfolios Quarterly Market Commentary
by Chief Investment Officer Clifford T. Walsh, CFA®

THE THIRD QUARTER of 2022 was another wild quarter, containing a huge equity rally that ranged anywhere from 13-18% in the U.S., depending on the index, only to have it all slip away into quarter end and close at year-to-date lows (down 2-5% for the quarter). The markets bounced back and forth between concern over the Fed's hawkishness and hopes for a Fed pivot—or at least a pause to the recent aggressive rate hikes. U.S. bonds performed no better than U.S. equities, but both outperformed international stocks, down double digits. REITs underperformed as well (down 11% in the quarter and the worst asset class to date, down 28%), no doubt due to the surge in borrowing costs experienced in 2Q and 3Q[i].

ECONOMIC ACTIVITY, INFLATION AND THE FED

The Economy

There is nothing more important to the short- and medium-term performance of the financial markets than the grappling between Fed rate hikes and inflation, as well as the resulting impact on not only the U.S. economy, but economic and financial systems abroad. Inflation remained stubbornly high through the third quarter with the C.P.I. hitting 8.3% on an annual basis in August, rising 0.1% after a flat July[ii]. So, while inflation appears to be topping out or already done so, the Fed's aggressive action has yet to ease aggregate pricing, either. Despite sliding fuel prices, which pulled down the C.P.I. during the quarter, service industries are still raising prices, perhaps a delayed response to rising costs in its own inputs earlier in the year.

In the short term, the economy appears to be okay, or at least does so on the surface. The Atlanta Fed GDPNow forecasts 3Q:2022 GDP at 2.9% as of Oct. 10[iii]. The forecast ticked down for most of the quarter before spiking on a rise in net exports and then a lower unemployment rate, which fueled the highest forecast of the quarter at 2.9% growth. This would be a huge rebound following the 1.6% drop in 1Q and 0.6% rate in 2Q. We question the sustainability of export strength amid a stronger U.S. dollar, especially when the most recent boost appears to have come from the export of travel services from the summer travel season (albeit probably helped by the dollar strength). We think there is downside to this forecast and, even if it holds, it is probably safe to assume a contraction in economic activity during the coming six- to nine-month period.

Inflation

From an inflationary standpoint, Trans-Pacific shipping rates are now down 90% from September 2021 highs. Many other commodities have seen significant pullbacks as well: agriculture (-20%), aluminum (-40%), copper (-30%), iron ore (-35%), lumber (-70%) and total energy costs (-20+%)[iv]. C.P.I. has often been called a flawed statistic (even by Fed officials who use it as a basis for rate hikes). Regardless, one must see it for what it is—backward looking and offering no view of the future. We think early surges in commodity prices are circulating through the broader services economy with a lag and will soon provide downside pressure to the inflation measure. Supply-side issues in food production and the automotive industry might take longer to work out, but the Fed's rate hikes will also help hammer demand elsewhere. Not to mention, M2 money stock and commercial bank credit is drying up, providing further downside to economic activity and, as a result, prices.

The Fed

The Fed has raised the fed funds rate 300 bps in the past seven months[v]—so intense that history offers few similar periods to study. But given that it has typically taken up to a year for rate hikes to impact the economy, we're likely to see that negative impact soon. The Foundation of International Business & Economic Research (FIBER) spot-leading economic indicator recently fell to its lowest level since the recessionary period of April 2020, and we think this is likely to continue. Not only has the Fed fueled sharply higher debt and equity cost of capital, but the availability of credit is tightening up as well, none of which are good for the financial markets or the economy.

The Fed looks to hike at least 50 bps in early November[vi], and it could prove to be 75 bps with the recent employment measures, at least those most important to the Fed, showing ongoing strength. We think it's possible that the Fed could prove to be done hiking in November, but probably wouldn't say so until early 2023. We shall see where employment and inflation are at that time. While the markets would surge—at least temporarily, on a pause— in our view it's too early to invest with that in mind, but we are getting closer.

MEANWHILE, THE RISKS ARE MOUNTING…

The U.S. Dollar, Foreign Governments and Central Banks

In the past month, the financial markets experienced two interventions by foreign central banks: the Bank of Japan supported the yen, and the Bank of England supported the gilt market. Both operations addressed the fragile market state, exposed by the aggressive rate hikes in the U.S. this year. The near insolvency of the U.K. pension funds and capital concerns at Credit Suisse are probably just the start of mounting issues.

Bloomberg recently reported that a $1 trillion surge in debt service costs was expected into year-end as the record level of rollovers are negatively impacted by an average interest rate that is more than 150 bps above the current coupon rate[vii]. This is something to watch closely in the coming months.

The Housing Market, Credit and the U.S. Consumer

Mortgage applications sank 14% during the last week of September, the seventh decline over the previous eight weeks. On a year-over-year basis, applications were down 68%. The key purchase subindex tumbled 12.6% (down 37% year-over-year), breaking below the April 2020 low and establishing the new low since 2015[viii].

We see the housing market as a huge risk to the economy. While the income generated from this economic sector is relatively insignificant compared to larger industries, the negative swing appears likely to be quite large; more important, the wealth effect (or lack thereof) from significant pricing declines amid skyrocketing mortgage rates is likely to weigh on cash-out refinances and consumer sentiment in a big way.

Meanwhile, the U.S. savings rate is at record lows and credit card debt seemingly sets new records monthly. This does not paint a pretty picture. Unsustainable credit-fueled spending is supporting the current level of economic activity and a means to keep up with inflation. Either inflation or the consumer will break, or the consumer first and then inflation.

BUT WHAT OF THE LABOR MARKET?

Many point to the strength or seeming strength of the labor market as a reason for optimism. Since March 2022, payrolls are up about 2.2 million. However, full-time employment is down by 57,000. U-6 employment (measures unemployment, underemployment and discouraged workers) is much higher at 6.7%[ix]. We would argue that both would be much higher had many not dropped out of the labor pool during COVID-19. This—and discouraged workers, which reduce the unemployment count—make the labor market appear stronger than it really is.

As with many things related to the financial markets, the importance is not necessarily where things are, but changes on the margin. Recently, U.S. companies have cut the workweek and replaced full-time jobs with part-time jobs. Also, the huge difference between non-farm payrolls and the household survey indicates that many workers have gotten second jobs to keep up with inflation. With earnings expectations likely to decline (discussed below) and profit margins likely to contract, we think the labor market will shrink in the coming quarters, providing yet another economic headwind.

Earnings Expectations

One of the major issues we've cited as reason for avoiding market risk over the past few quarters has been earnings expectations that were simply too high, not reflecting the negative impact of a Fed hellbent on squashing inflation with higher interest rates. The good news is we are starting to see progress here. October consensus estimates for the S&P 500 dipped by about 7 percentage points (just under 10% to roughly 3% growth). This is the biggest cut to quarterly earnings forecasts since the second quarter of 2020[x].

The bad news is there are still significant cuts likely to be made and, depending on how much the economy contracts in the coming quarters, analysts may continue to have to play catch-up. As of this publishing, earnings are expected to grow by 8% in 2023, despite all of the aforementioned economic headwinds. We are watching this closely. Once we see more reasonable expectations (or equity prices that reflect lower expectations), we will look to take on more risk.

Midterms

With so many volatile areas to focus on—the Fed, inflation, interest rates, Ukraine/Russia and the housing market—the midterm elections have remained below the surface. While we think gridlock—achieved by a Republican win in either the House or the Senate—would benefit the economy in 2023, we are not as confident in making that projection as we were earlier in the year.

The Supreme Court's overturning of Roe vs. Wade has ignited the Democrat base. Polls show a surge in women's support of President Joe Biden and the broader party. It's a toss-up as to whether this surge will last and overcome the ongoing economic concerns and geopolitical risks abroad. Our current view is that Republicans eke out a House win, but do not regain control of the Senate.

PUTTING IT ALL TOGETHER…

While sentiment is extremely weak, the Fed is not yet ready to pivot on the interest rate front; and while earnings expectations have come down, there is still more work to be done if we are to buy at current valuations.

We continue to look for a tradeable bottom in equity prices. We are not convinced that the next bottom will be a long-term buy and hold, but we do think conditions are percolating for a short- to medium-term tactical opportunity. So far we've seen only short-covering rallies and technical bounces off oversold lows with little staying power; these are the rallies of bear markets, not bull markets.

Looking at the past seven cycles dating back 50-plus years, not once did the S&P 500 bottom when the Fed paused or even on the first rate cut, but there were very tradeable risk-on opportunities. The ultimate market lows have typically occurred much closer to the final rate cut, not the pause or first cut. Still to come are contractions in credit, consumer spending and corporate profits. Until those are factored into prices, the next trade is tactical, in our view.

The good news is that the fixed income markets are finally offering opportunities. The total return of U.S. Treasuries was the first to peak in 2020 and will be the first to rebound from the unprecedented market slump across both stocks and bonds. We think rates have peaked or are close to doing so. We believe this asset class is the most out of whack with the current economic reality and provides an attractive investment opportunity relative to both the broader fixed income markets and equities. Those who have been searching for more yield these past few years finally have it and we expect the hated Treasury market to begin seeing some love.

Looking at corporates, we continue to favor quality over high yield as the recession is not yet fully factored into high yield prices or spreads, and the sector has significant energy exposure; we expect to see more pressure as economic activity pulls back. We anticipate the next selloff will be a solid purchase, given our current outlook.

As we stated last quarter, our outlook is not a positive one in the short-term. However, we do see conditions shifting in the coming months to provide tactical trading opportunities and the basis for a more optimistic view and healthier investing climate perhaps later this year, but more likely at some point in early 2023.

QUESTIONS AND COMMENTS

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