Economic and Market Outlook

SEPTEMBER 2022

At a Glance

- The recession debate rages on, as the US economy continues to receive mixed signals across GDP, inflation, employment, and interest rates.
- That said, fighting inflation has become the primary focus of the Federal Reserve for the remainder of the year, with the US Central Bank taking a leading global role in this regard.
- Equities are also experiencing a large forecasting gap between top-down strategists and bottom-up securities analysts, as earnings (and additional data revealed in earnings forecasts) will be a key market driver moving into the fall.

World Economy

- The U.S. economy is indeed slowing, but it does not yet appear to be on the verge of collapse, as continued healthy jobs and wage growth support consumer spending. The housing sector is in decline as high prices and sharply higher mortgage rates are reducing demand. Businesses are showing greater hesitancy in growing their capital spending budgets, particularly in the goods-producing sectors where excess inventories have accumulated.
- Inflation has likely peaked and should begin to show a rather consistent decline through year-end, as retailers discount products to clear inventory, energy and food prices stabilize as production increases, and demand falters due to higher prices. Shelter prices though may prove sticky in their inevitable descent and geopolitically driven supply constraints are a constant risk to the improvement in inflation and inflationary expectations.
- European inflation has not peaked with higher prices driven largely, but not solely, by the dramatic spike in natural gas prices due to limited supply out of Russia. The full reopening of the European economies and an increase in exports due to weaker currencies have helped sustain economic growth in the first half of the year, but higher prices will negatively impact consumer spending and lead to some contraction in gross domestic product (GDP) over the coming quarters.
- Severe drought conditions have recently been added to the list of economic headwinds in China. Policymakers have been frantically trying to offset the detrimental effects of a “zero-COVID” policy and weakness in the property sector. It appears 2022 GDP will fall notably short of the Chinese government’s 5.5% goal and will likely settle closer to 3.0%–3.5%.

Monetary Policy & Currencies

- Given the strong labor market and still healthy consumer spending, fighting inflation has become the only priority for the Federal Reserve (Fed) for the remainder of the year. The Fed will continue to tighten policy until shown consistent and conclusive proof that inflation is abating. As the Fed has already been aggressive in front-loading higher magnitude federal funds rate increases this year, the magnitude of rate increases should decline after the likely increase of 75 basis points (bps) at this month’s Federal Open Market Committee meeting. Of course, future rate increases and the ultimate end of the tightening cycle will be very much dependent upon the expected improvement in the inflation numbers.
- The European Central Bank needs to catch up to the Fed and Bank of England in the magnitude of rate increases and is likely to raise its benchmark rate by 75 bps at its policy meeting early this month.
- The Bank of Japan stubbornly clings to an ultra-aggressive monetary policy despite the pressure it has put on the Japanese yen, which is down over 20% year to date. The People’s Bank of China has begun to implement slight interest rate decreases in an attempt to offset the slowdown, but it will tread more carefully to avoid provoking unintended currency weakness and resulting capital flight.
- The U.S. dollar continues to appreciate against most other currencies as the Fed is one of the most aggressive central banks in tightening policy. As the Fed is likely closer to the end of its rate increase program compared to many other central banks, the U.S. dollar should begin to stabilize around current levels.

Bond Markets

- Yields across the government bond curve have increased recently but the curve itself is still largely inverted, which is a sign of a weakening economy and a natural limit to any sharp advance in intermediate-maturity yields. Improvement in the inflation rate and a stronger indication the Fed is near the end of its rate increases are needed for the curve to regain its upward slope.
- Below-investment-grade yields have also risen with government bond yields, but the interest rate spread within the high yield asset class has remained stable, which can be viewed as a sign that investors are not expecting an economic decline that would cause a sharp increase in default risk. The asset class appears attractive at these yield levels.
- Further U.S. dollar appreciation in August hurt the price of emerging market debt but monetary ease in China helped cushion some of the blow and allowed the asset class to outperform its U.S. high-yield counterpart. Stability in the U.S. dollar would remove an important impediment to performance in the space.

Equity Markets

- After a sharp rebound from the mid-June lows, global equities weakened in the middle of August as it became apparent to markets that monetary tightening will continue at least through year-end. The second quarter earnings season turned out to be much better than feared, with S&P 500 Index earnings increasing close to 9%. While the advance was dominated by strong energy earnings, downward revisions to subsequent quarters were rather limited as management teams across many industries were still seeing healthy spending trends.
- The third quarter earnings preannouncement season, which should begin mid-month, will be particularly interesting to observe for any signs of demand decline and margin erosion, which would confirm the fears of the macroeconomic bears. A rather large gap remains between the top-down strategist earnings estimates and that of the bottom-up security analysis community.
- Greater exposure to the more “value” or cyclical sectors is a characteristic of the developed international equity markets as compared to less exposure to those sectors in the United States. This lower starting valuation level has helped international equities outperform U.S. equities in their local currencies, but the depreciation of their currencies during the year has more than wiped out this advantage. The pressure on domestic economies from higher energy prices and higher rates will only be partially offset by the benefits of a stronger U.S. dollar to their important export sector.
- Policy easing in China alongside some recent recovery in commodity prices should be supportive of emerging markets equities, although the bulk of the global geopolitical risk exists within the countries of this asset class. A weaker U.S. dollar and some success in the expansionary Chinese fiscal and monetary policy would help drive better relative performance of these markets.

Commodities

- Growing fears of recession and increased production out of the Organization of the Petroleum Exporting Countries and the United States have driven oil prices down, although natural gas prices have continued to rise due to the politicized disruption of supply coming out of Russia. Oil prices should bottom at these levels and trend higher in a still supply-constrained environment.
- Gold prices peaked right around the same time as core inflation in the United States and has declined rather steadily in what may be a harbinger of the declining inflation trend. Continued Fed tightening, which will push up real rates, is another headwind to gold prices that may last through year-end.

What This Means for Investors

A full recovery in equity markets will be largely predicated on consistent data supporting a decline in inflation, which would allow the Fed to take its foot off the monetary brake. The largest risk to the market will continue to be the Fed and other central banks tightening too aggressively into an already slowing economy. Slack needs to develop in the employment sector but this could be more a function of fewer job openings as opposed to a significant increase in layoffs. Corporate earnings will be more important than interest rates in driving equity markets through year-end. Continued cost discipline on the part of corporate management teams in a slowing sales environment will be imperative.