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Things That Matter

Cerity Partners Investment Committee

October 3, 202

Another difficult week in the markets ended a tough month and the third consecutive down quarter as the summer advance turned out to be merely a bear market rally when the Fed became even more aggressive in both its rhetoric and actual tightening stance to fight the sticky published inflation numbers.

Europe Struggles Greatly & the UK is Playing with Fire

The concern that the monetary authorities will tighten "until something breaks" became a little too real last week and into this week. The UK gilt market pushed back strongly on the new government's tax cutting initiatives as they will cause burgeoning budget deficits if not accompanied by spending cuts. Along the same lines, the pound sterling also sold off sharply until the Bank of England intervened mid-week and announced they will purchase long-dated gilts to stabilize the market. It also said it would delay bond sales in their balance sheet reduction plan.

  - This effective resumption of Quantitative Easing worked (at least for now) in stopping the bleeding, but at a big hit to the UK's credibility. Standard & Poor's put UK government debt on credit watch Friday evening, and the government this morning was forced to backtrack on one of the proposed tax cuts…and may even have to scrap the plan as the "bond vigilantes" have returned to the global fixed income markets as the central banks slowly remove themselves.

- Europe has a worse inflation problem than we have in the US as sharply higher energy prices caused September inflation to accelerate to 10.0% year-over-year, from 9.1% in August as energy was up 40.8%(!) and food was +11.8%. Core inflation also rose to 4.8% year-over-year from 4.3% in August. This should embolden the ECB to increase the magnitude of its rate increases at upcoming meetings.

- In what is being described as Europe's potential "Lehman Moment", Credit Suisse saw a spike in its credit default swap yields and a record low in its stock price, on concerns about its financial strength. While capital appears ample at an over 13% Tier I ratio, confidence in the ability to provide liquidity – and ultimately solvency – is so important to the bank's ability to operate effectively in the capital markets.

- Oil prices spiked higher this morning as OPEC + Russia are reportedly set to cut output by as much as 1.5 million barrels per day at this week's meeting. This is an apparent reaction to prices breaking below levels seen prior to the Russian invasion of Ukraine. The effectiveness of production cuts in meaningfully increasing prices remains to be seen, but it should at least stop the declines in oil and gasoline prices that were brought on by slower global economic growth.

The Fed Remains Laser Focused on Inflation

- US economic statistics reported last week confirm an economy that grew in the third quarter, but at a rather slow rate with inflation showing signs of declining, but not yet fast enough for the Fed to take its foot off the monetary brakes.
  - There is little doubt that the housing sector is in recession, but any downturn should not be nearly as deep as seen during the financial crisis, as inventories are not nearly as bloated. August new home sales saw a big surprise to the upside and were up 29% month-over-month, likely due to the mid-summer dip in mortgage rates. Pending home sales declined 2.0% on the month to the lowest level since 2011, and importantly, home prices appeared to have begun their inevitable decline this summer as the July Case Shiller home price index was down 0.8% while the FHFA index was down 0.6% month-over-month. It will take some time for these price declines to translate into the shelter inflation statistics.
  - Business spending is holding up rather well, as reflected in the August durable goods report. While the headline number was down 0.2% and in line with estimates, core (non-defense, ex-aircraft) orders were up 1.3%, well over the estimate of no growth, and there was a nice upward revision to July. Inventory replenishment continues at perhaps too high a rate, which should remove some inflationary pressures.
  - Consumer sentiment and spending is also defying calls for a collapse, as the summer decline in gasoline prices plus continued jobs and wage growth helped both the Conference Board and U. of Michigan surveys to improve month-over-month in September. Inflation expectations in these surveys saw declines, although this could be largely due to recency bias from lower gasoline prices. August personal income was +0.3% and in line with estimates while consumer spending was +0.4%, double the +0.2% estimate as consumers reached further into their savings to make purchases. Within this report is the closely followed PCE inflation, which like the August CPI reports earlier this month, showed only scant improvement.

Inflation, Employment...and Earnings

- As we anxiously await the third quarter earnings season, there were some pre-announcements of note, that were reflective of mid-year macroeconomic trends. Nike reduced their gross margin guidance by 200 bps to reflect markdowns needed to clear excess inventory. While the company maintains that demand remains strong, this is a trend seen in several goods producing companies where very strong 2021 demand was extrapolated into this year, as consumers shifted their purchase preferences away from goods toward services. Along the same lines, Apple scrapped their plans to increase iPhone 14 production and Micron guided down on weakening end market consumer demand for semiconductors.

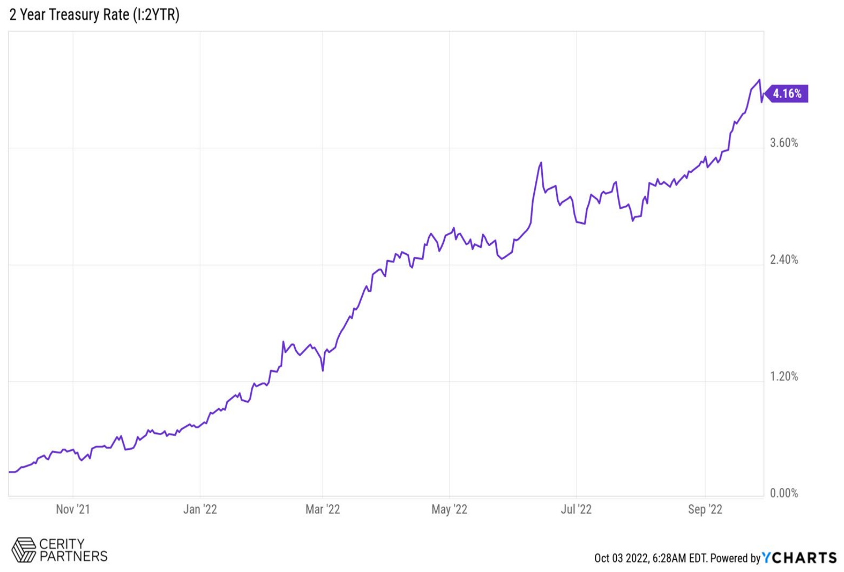
Thoughtful Investing in Turbulent Times

With everything going on in the world – Inflation, Ukraine, Earnings, The Fed, etc. – it can be easy to get caught up in the moment. It is important at times like this to remember that timing the markets is often a fool's errand. The history of investing has continually had terrible events occur. It is better to focus on time in the market as opposed to timing the markets.

The Tightening Continues

Rising rates and the dollar continue to tighten financial conditions

2-Year Rates



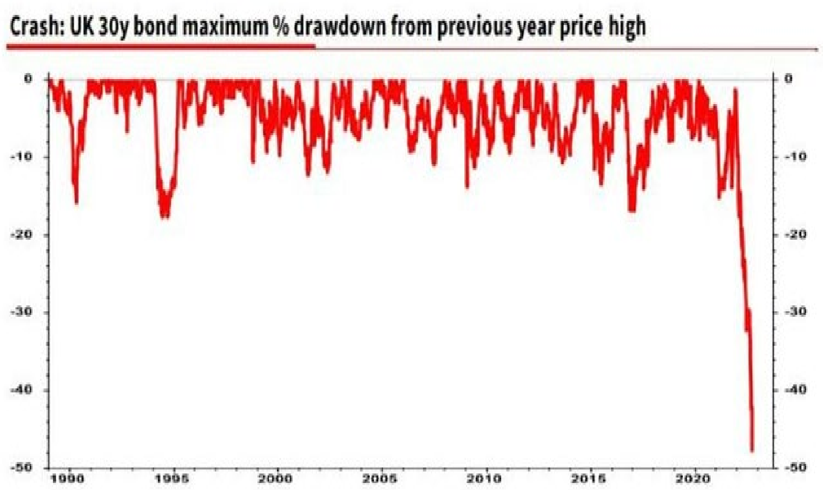
The Dollar Index

Source: YCharts

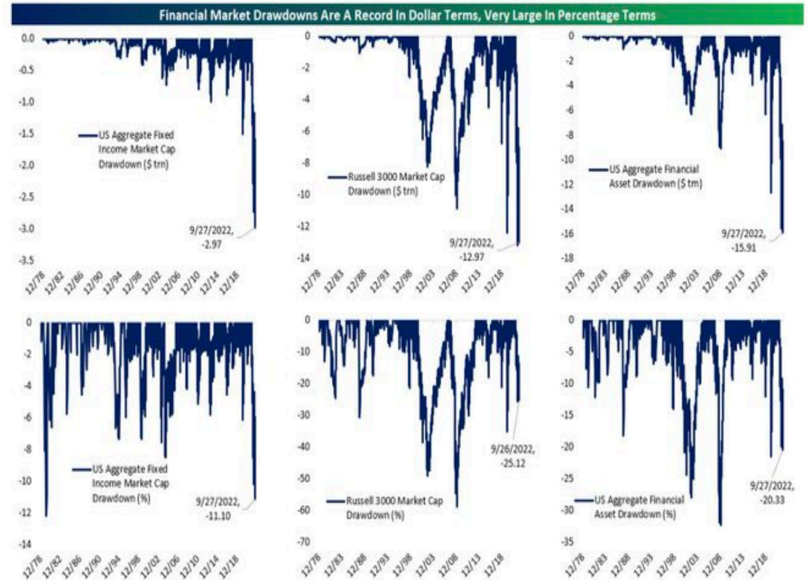
The Pressure from the Fed Is Hitting Asset Markets

Will the 3rd stool of monetary policy, financial stability, start to matter?

So Much for Risk Fee



Wealth Creation in Reverse

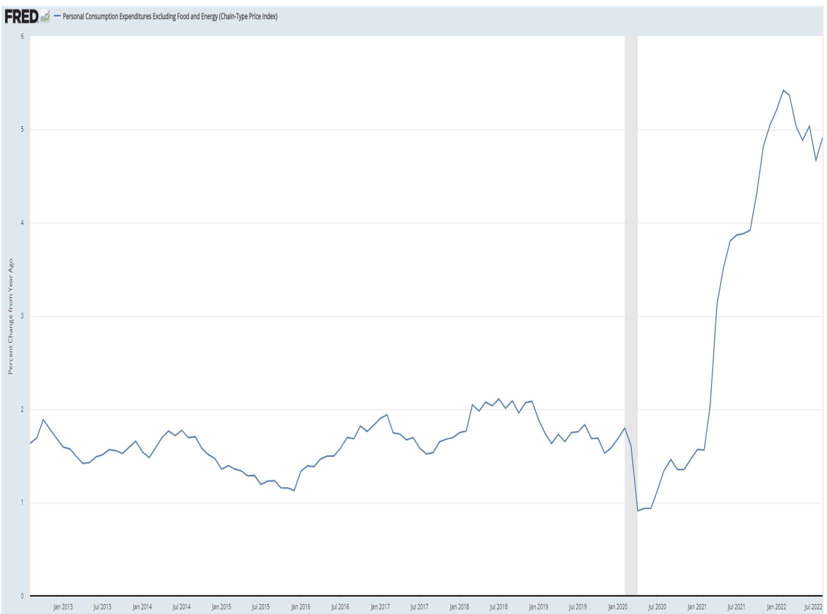


Source: Datastream, @MacroAlf; @carlquintanilla, Bespoke Investments

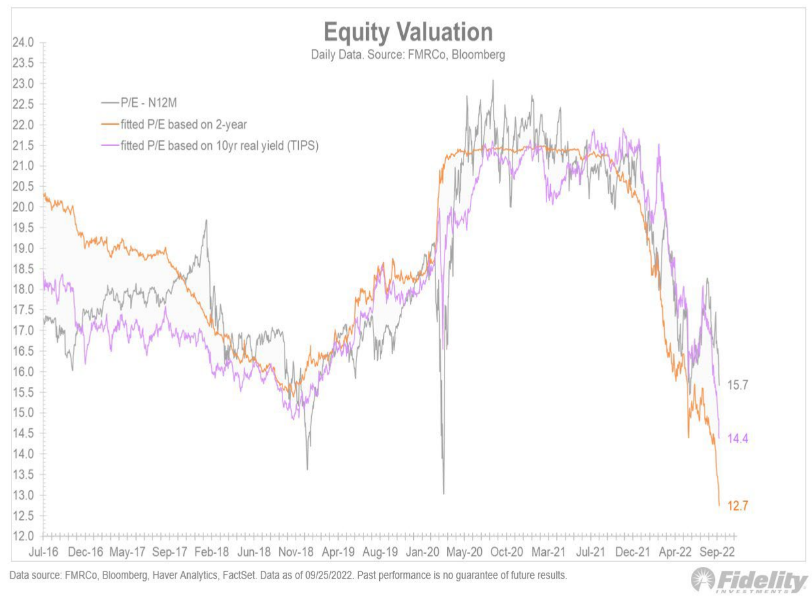
Inflation Persists

The buoyancy of inflation has boxed in the Fed

The Fed's Favorite Measure of Inflation



Rates Driving Multiples

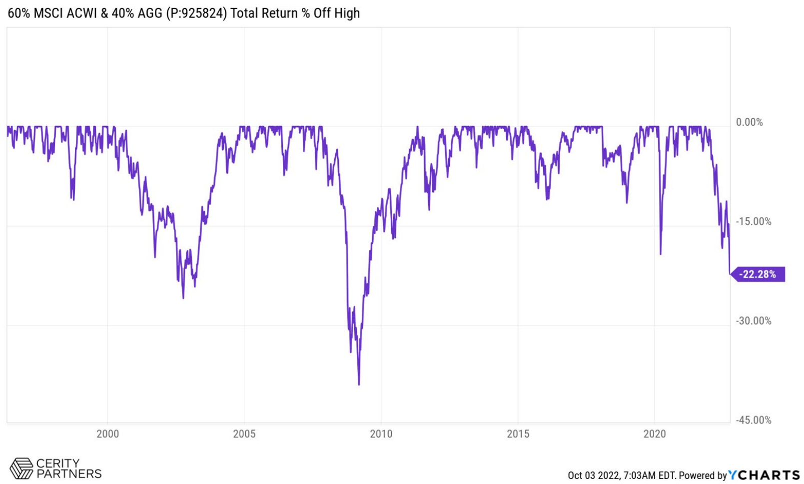


Source: FRED, Fidelity @TimmerFidekity

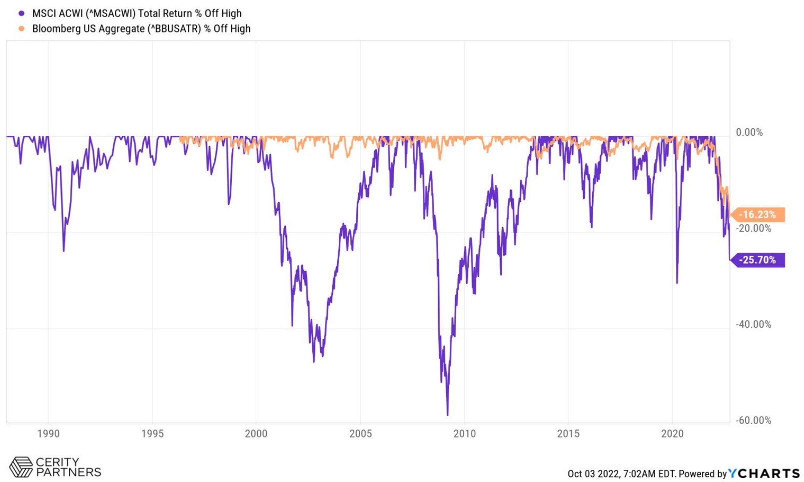
Not As Bad as 2008

A 60/40 portfolio has struggled in 2022

60/40 Drawdown



Stocks & Bonds Drawdown

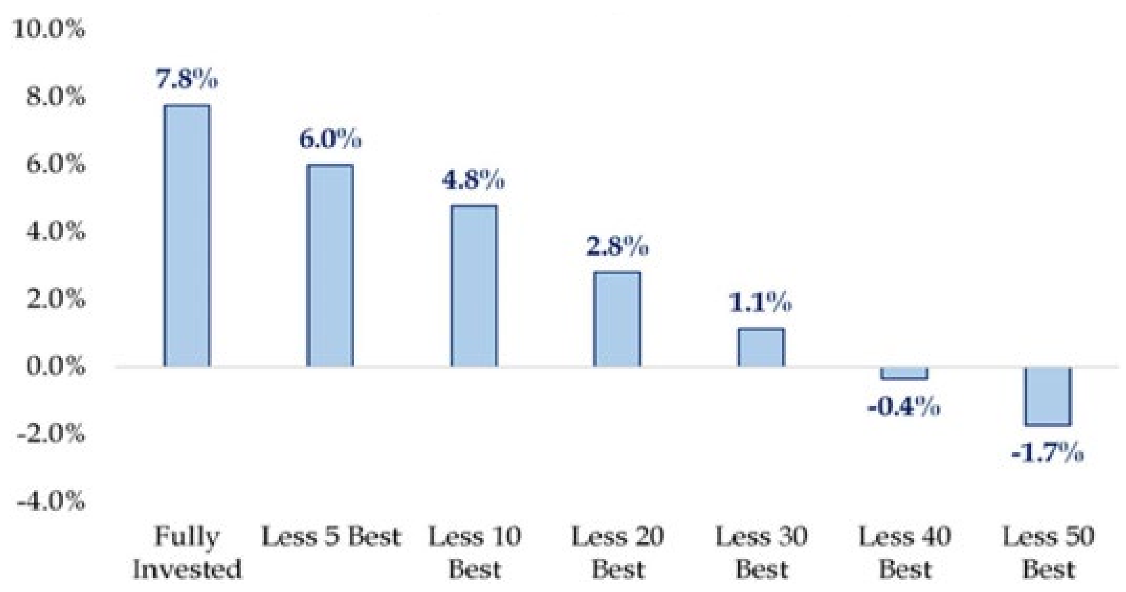


Source: YCharts

Time in the Markets vs. Timing The Markets

January 1, 1995 – September 29, 2022

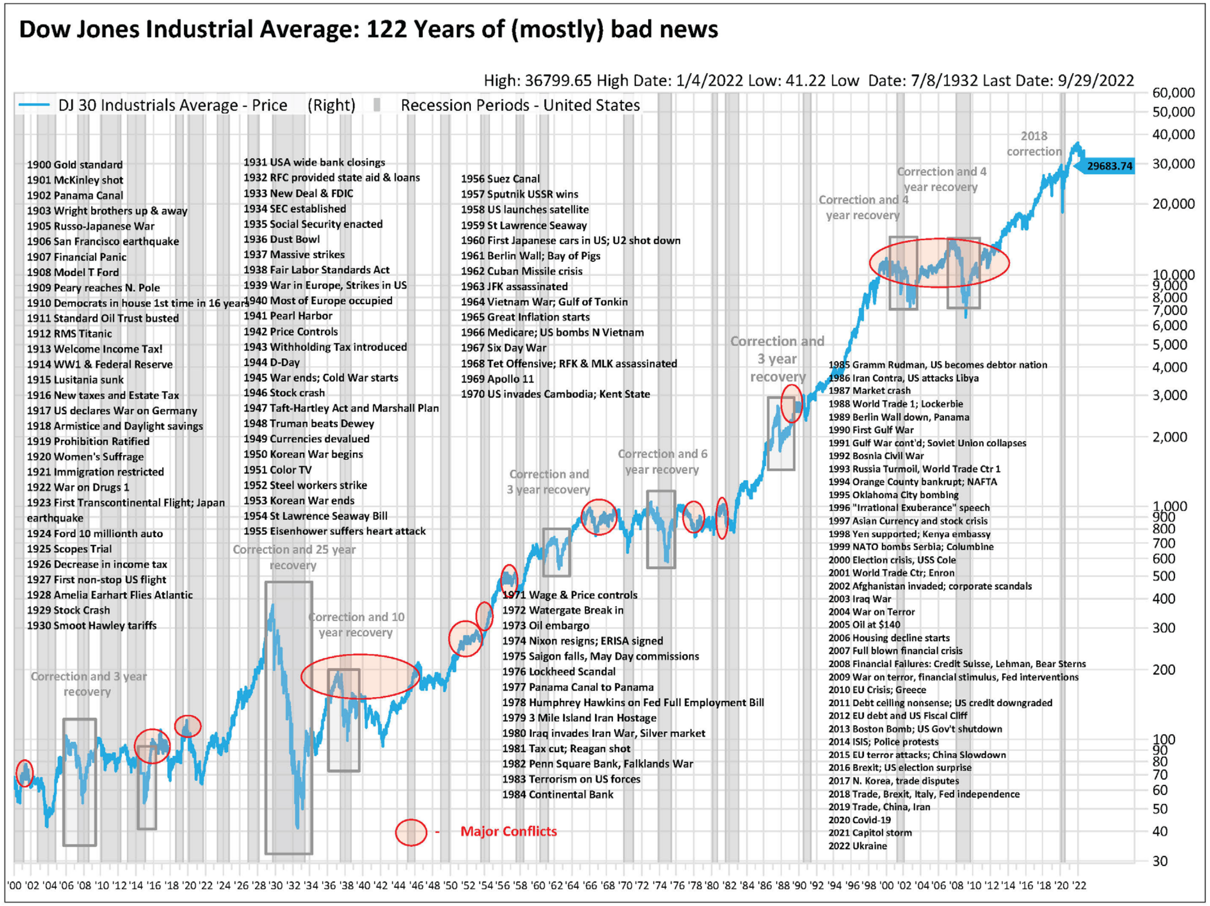
S&P 500 Compound Annual Growth Rate



Source: Strategas

Dow Jones Industrial Average

122 years of (mostly) bad news



9/29/2022

Source: FactSet

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