ambwealth

Wealth Advisory Market Update

October 4, 2022

ambwealth

Market Update

Market volatility continued through the 3rd quarter. The equity markets, measured by the S&P 500, finished down 9.21% for the month of September and down 4.88% for the quarter. For the year ending September 30th, the market is now down 23.86%. We have gotten a reprieve the first two days of the 4th quarter as the equity markets have reversed nearly 600 basis points while rates have dropped on the 10-year Treasury from 4.1% to 3.5% as of the writing of this letter. The question is whether this move has staying power or is just another bear market rally. Looking at history, bear markets have a 26-month duration and a 30% drawdown on average. So, from those metrics it doesn't seem like we are quite there yet. There are however other factors we need to look at, both positive and negative. Let's start with the positive.

The Bank of England (BOE) pivoted last week. This is not exactly a positive thing for the economy or the UK population but it is for a market starving for liquidity. The UK was seeing major stress in its bond markets, as GILTS exploded higher last week. This put a lot of pressure on pensions funds as they began to get margin called. To quell the stress, the Central Bank started Quantitative Easing (QE) once again announcing it would be purchasing $100 billion of longer dated GILTS. This was the first Central Bank to blink in the current rate-hike cycle and they would not be the last. The Reserve Bank of Australia hiked rates 25bps, which was below the market consensus of 50bps. This was our second dovish move in the last five days. The question now is whether the Federal Reserve may pivot next. Markets have begun pricing in fewer rate hikes in the US and more rate cuts, which would lead to easier financial conditions and more liquidity than what had been priced in. So, from a market perspective this is a positive, although the reasons are not so positive.

Another positive that cannot be ignored is positioning. Markets like to cause the most pain to the most participants, which is why being a contrarian investor has been a net benefit throughout history. This just means when all you see are green shoots you should probably be selling and when there is red in the streets you should be buying. Investor behavior however is usually the opposite. Right now, mutual fund cash balances are currently at 2.5%, which is the highest since 2008 and is a bullish sign. Market participants getting caught underinvested tend to chase markets higher.

Sentiment is also approaching one of severe pessimism. Analysts have cut 3rd quarter earnings estimates across the board and for good reason. Recent warnings out of FedEx and Amazon are the most notable due to their size and industries. If global freight and consumer discretionary sectors are in a downturn, so is the global economy. However, the market will usually overshoot to both the downside and the upside. If pessimism continues to grow, at some point in the near future the market will overshoot to the downside presenting buying opportunities. It is also important to note that markets tend to bottom before a recession and tend to be in recovery mode before the economy is out of the recession. If the US will be in a recession in the first quarter of 2023, then buying opportunities should present themselves in the next few months.

Let's now consider the negative factors. Currently the Federal Reserve has given no indication of slowing down interest rate increases. Because of this, a strong US Dollar is steamrolling everything in its path and hitting 20-year highs in the process. A strong dollar sounds good in theory, but is detrimental to the global economy. It puts enormous stress on other currencies. As of right now, currencies other than the US dollar look like emerging market (EM) currencies. Why is this a problem? The main reason is that most commodities are priced in dollars. As the dollar moves up, the more expensive it becomes for foreign currencies to purchase commodities, thereby increasing energy costs for other countries and driving input costs higher for nearly every industry. Also, most EM debt is denominated in US dollars. When that debt matures, it takes more of the foreign currency to pay back the principal and make the interest payments. So, when the reserve currency is strong, it worsens economic conditions in the rest of the world. That is why it is being talked about daily on the news. This is unlikely to change unless the Federal Reserve tempers its rate hike trajectory over the next few meetings.

Another negative factor is related to valuations. Companies are still trading above historical norms on a valuation basis, even after the 20% selloff. Our position remains the same on this subject. Forward multiples on the market need to come down to a more normal valuation. Historically that has been in the 12-14x range, which would put the S&P 500 between 3200-3400, depending on earnings. With rates at decade highs, market participants are paying too much for current and projected future cash flows, especially with the current economic outlook. We estimate coming down to this range for the S&P 500 sometime in the 4th quarter if the Federal Reserve continues its hawkish trend. If, however, the Federal Reserve pivots to a more dovish position, our estimate would change.

The potentially greatest negative factor, and serious risk in the market, remains geopolitical. Russia's invasion of Ukraine continues to cause political turmoil across the globe. The Western sanctions on Russia seem to have backfired as Europe faces an unprecedented energy crisis this winter. The recent sabotage of Nord Stream pipelines makes Germany more dependent on US energy and increases tensions globally as the blame game for the sabotage continues. In addition, tensions remain high between China and the US regarding Taiwan. The US administration has indicated that it would defend Taiwan if China attempted invasion. This would put the US in direct conflict with China if it occurred. Obviously, this type of geopolitical risk cannot be forecasted and could cause a lot of volatility in global markets.

This is not an inclusive list of all positive and negative factors that could influence markets in the short-term, but they are some of the most notable. Also, this snapshot of current trends does not mean that present conditions will remain long-term. Economic data coming out in the near future could alter our outlook. If this occurs, we will be quick to assess and make adjustments to our portfolios. As always, we continue to navigate this difficult environment to the very best of our ability. We at AMB thank you for your support and for allowing us to partner with you in reaching your financial goals.

Matthew J. Roach, CFA®
Chief Investment Strategist