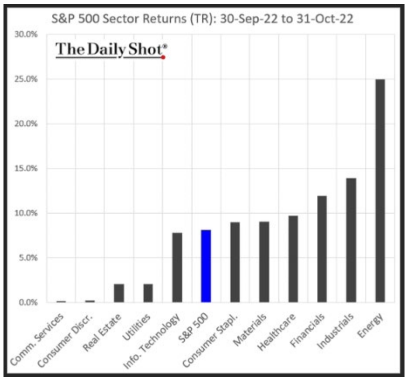
EQUITY MARKET UPDATE

As of 10/31/22 | Volume 11, Issue 10 | FFTAM.com

Stocks rallied sharply in October on hopes of a dovish pivot in interest rates from the Federal Reserve. Global financial risks also lessened after the UK government abandoned plans of an unfunded tax cut. Markets continue to react to persistent inflation and rising interest rates from the Federal Reserve. Economic data shows the US economy remains on firm footing although momentum is slipping in some areas. The combination of high prices from inflation mixed with rising interest rates from central banks worldwide have investors worried about a possible recession in 2023.

US Stocks Pop on Speculation of a Fed Pivot

The S&P 500 increased 8.10% in October on renewed hopes of a possible Fed pivot in interest rates. Gains were widespread with energy (+24.96%), industrials (+13.92%), and financials (+11.99%) experiencing the sharpest increases. All sectors rose during the month. In 2022, the S&P 500 is down 17.72% with energy (+68.05%) being the only positive area.



The Dow Jones Industrial Average jumped 14.07% for the month. That was its highest monthly increase since 1976. A higher allocation to healthcare, financials, and industrials aided results versus the S&P 500. The Dow also has a lower allocation to technology, which underperformed again. Year-to-date, the Dow is down 8.42%.

The NASDAQ gained a modest 3.94% in October. The index continues to struggle given its high exposure to unprofitable and poorly capitalized companies. The index has fallen every month so far in 2022 except for March, July, and October—all of which increased on hopes the Fed would stop tightening monetary conditions. Year-to-date, the NASDAQ is the worst performing major index with a total return of -29.31% as investors shy away from high valuation companies as interest rates rise. The index has also been hurt by disappointing earnings announcements from Meta Platforms, Netflix, PayPal, Alphabet, Amazon, and NVIDIA.

Middle-to-small-sized companies outperformed the large cap indexes last month with the S&P 400 Mid Cap Index improving 10.52%, while the S&P 600 Small Cap Index zoomed 12.37%. So far in 2022, this area has beaten its large cap peers with the S&P 400 Mid Cap Index dropping 13.29%, while the S&P 600 Small Cap Index is down 13.69%.

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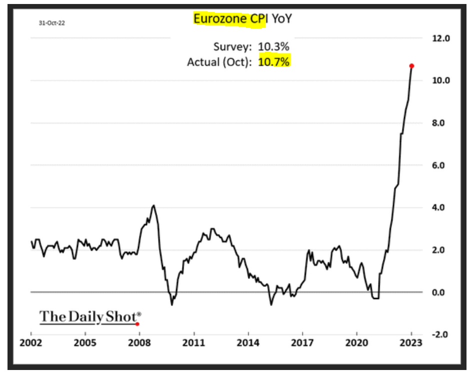

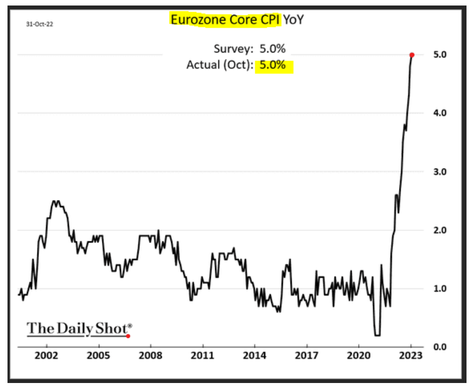

New High in European Inflation while China Remains Weak

The war in Ukraine continues to be the major source of price spikes in Europe. Inflation in the Eurozone reached a new record high of 10.7%. The acceleration came once again from large increases in the price of energy and food. Core inflation that removes the effects of food and energy was 5%. Businesses are unable to pass along the full extent of inflation, so profits are being squeezed. For example, Eurozone producer price inflation was 29.54% in October. Obviously, consumer prices cannot rise that quickly without crushing demand. The inflation is pressuring economic growth. Eurozone Manufacturing PMI slipped for an eighth straight month to 46.4, while Services PMI decelerated for a sixth month to 48.2. Both readings signal Europe's economy is contracting.

As I have discussed in the past, the European Union gets 35% of its total energy needs from Russia, so prices have skyrocketed as the region scrambles to find new sources. They have struck deals with the US, UAE, Qatar, and Canada. Unfortunately, none of these solutions provide an immediate fix, so Europeans face several years of elevated prices to wean itself off Russian energy. In the near term, Europe has done a good job in filling their storage tanks with sufficient natural gas to get them through the winter if weather conditions are normal.

To protect citizens and small businesses from skyrocketing energy prices, both the UK and the European Union announced plans to cap energy prices. UK Prime Minister Liz Truss resigned after 50 days in office due to market dysfunction over her plan to cut taxes in hopes of stimulating business activity. She was replaced by Rishi Sunak who has promised to submit a more stable funding plan for the government. This calmed the markets and led to a rise in the British pound; however, it continues to linger near its lowest levels since 1985 versus the US dollar.

Persistently high inflation and a sinking euro has pressured the ECB to raise interest rates once again by 0.75%. Despite the weak economic data, the ECB must continue to hike rates to tame inflation. They are proceeding much slower than the Fed, and the interest rate differential has caused the Euro to plunge below parity versus the US dollar. They must proceed with caution since interest rate spreads between Italian and German bonds have widened. Unlike the Fed, the ECB faces the unique challenge of rate hikes disproportionately hurting highly indebted countries in Southern Europe. ECB Chairwoman Christine Lagarde signaled at the last meeting the central bank may reduce the pace of interest rate hikes to avoid putting too much pressure on the economy. This dovish statement, along with a smaller than expected rate hike from the Bank of Canada, fueled hopes we are nearing an end to tight monetary conditions.

The Chinese economy continues to struggle from the effects of extreme drought, constant lockdowns to combat the spread of COVID-19, and a depreciating property market. As the month ended, 24.5% of the country's GDP remains under COVID related restrictions. Economic results are feeble. China's Manufacturing PMI ticked down to 49.2, while data showed further shrinkage in export orders with a reading of 47.6.

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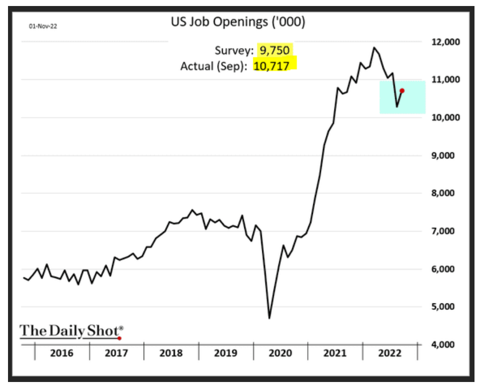
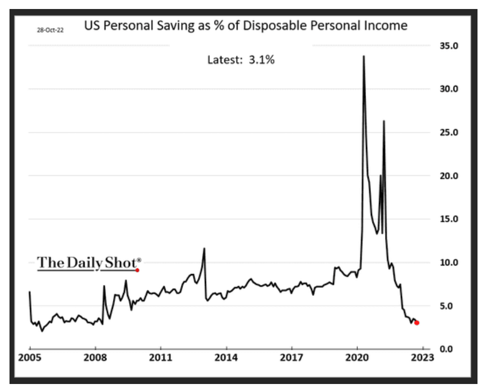
Service activity slipped back into contraction territory with a reading of 48.7. Job growth remains a challenge with youth unemployment of 17.9%. That is very concerning considering China's shrinking workforce due to an aging population. Home sales fell for a 16th consecutive month despite recently announced stimulus measures. With the economy stumbling, officials reported 3.9% GDP growth, well below the 5.5% target to start the year. To make matters worse, President Xi did not signal a change in COVID policy when he was appointed to a third term as China's leader. President Biden also announced new export controls on advanced US semiconductors that can be used in Chinese military equipment. This is a significant setback for China since these chips can also be used in many other high-tech products that President Xi listed as future priorities for the nation.

With many challenges facing international markets, investors are proceeding with caution. The MSCI EAFE Index gained 5.38%, while the MSCI Emerging Markets Index fell 3.09%. Year-to-date, the two indexes are down 22.75% and 29.22%, respectively.

US Economy Grows, But Momentum is Slipping



The labor market remains strong. Last month, the economy added 261,000 jobs. The unemployment rate rose to 3.7% as labor force participation declined slightly. Average hourly wages grew 4.7% from one year ago, an amount that far exceeds pay raises seen pre-COVID. The JOLTS report showed there are 10.7 million jobs available but unfilled. That is a sharp decline from the summer highs, but it still equates to 1.9 job openings for every unemployed person—near all-time high. The demand for labor is far outstripping supply in most industries which signals tightness in the labor force and intense competition to recruit and retain employees. This is something the Fed is paying very close attention to because wage inflation is the most durable and hardest to defeat type of inflation.



Consumer inflation was hotter than expected with prices jumping 8.2% from one year ago. Unlike Europe, US energy prices fell in October and was the largest detractor. Rising prices for homes and rent worsened. Core inflation that removes food and energy prices rose by 6.6%, also hotter than predicted. PCE data, the Fed's preferred measure of inflation, showed similar results with total prices climbing 6.2%, while prices ex-food and energy increased 5.1%. The data presents a major challenge for the Fed. It shows that despite the strong labor market and higher wages, consumers are struggling to keep pace. Inflation adjusted income has declined in 9 of the last 12 months, while the savings rate has plunged to 3.1%, a 15-year low. Credit card balances have returned to the levels seen pre-COVID. With more of their paychecks going towards everyday essentials (food, shelter, and energy), consumers are running out of discretionary income. Consumer spending, however, rose 0.6% last month as expenditures on services remained brisk.

Business investment data is mixed. The ISM Manufacturing PMI slowed to 50.2, while new orders (49.2) contracted for the fourth time in five months. Prices paid remained high with the producer price index (PPI) jumping 8.5% on a 12-month basis. The ISM Service PMI (54.4) was a stronger than its manufacturing cousin. Finally, housing starts and mortgage applications fell as the 30-year mortgage rate remained above 7%.

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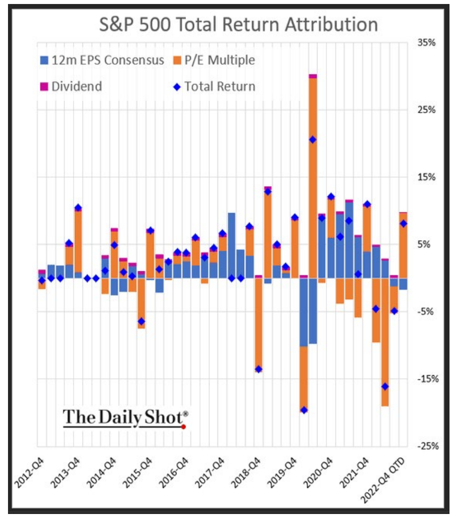
The Fed responded to the hot inflation data by raising interest rates by another 0.75%. During the press conference, Chairman Jerome Powell stated the Fed is purposefully moving interest rates into restrictive territory and will leave them there for considerable time to ensure inflation is defeated. He reiterated that “pain” would likely be felt by households and businesses, and it was “very premature” to expect the Fed to pause further rate hikes. He said the Fed would not waver until unemployment rose, wage inflation reverted, and housing corrected. Once again, this blew-up the market’s hopes that the Fed would consider stopping interest rates increases anytime soon. The market is now pricing-in a terminal interest rate of 5%. The Fed is currently at 4%. It is important to remember that further interest rate hikes are coming on top of the Fed’s quantitative tightening program that involves shrinking the balance sheet by $95 billion each month.

Market Rally Increases Valuation, While Earnings are Weakening

The recent rally has the S&P 500 trading at 16.34x 12-month estimated earnings. This is below the 5-year and 10-year average multiple of 18.58x and 17.11x, respectively. It is also less than the pre-COVID PE ratio of 19.4x.



We are in the thick of earnings season. Analysts have forecasted third quarter profit growth of 2.9%, a sharp revision from the 9.8% increase they were expecting when the quarter started. So far, 52% of S&P 500 companies have reported, and year-over-year earnings growth has been a disappointing 2.2%. If you exclude the energy sector, earnings would be down 5.1%. If this holds, it would be the second straight quarter of annual profit declines when backing out the results from energy companies. Earnings are being negatively impacted by the poor showing in communications. The sector reported year-over-year profit erosion of 18.9%, far worse than the analyst forecast of -13.2%. Major misses from Meta Platforms and Alphabet account for the bulk of the shortfall.

The market has finally gotten serious about the Fed and inflation by removing the premium valuation on stocks. Even though the current valuation appears attractive, it is based on profit growth estimates coming to fruition. The debate has intensified between economists that argue the economy is showing signs of heading towards recession, while company specific analysts forecast continued prosperity for at least the next two years, although they are less bullish today than a few months ago given the Fed’s tough stance on interest rates. This tells me three things. First, stocks are ripe for continued price volatility, especially among the higher valuation growth names. Second, the market has already priced-in the likelihood that several companies will continue missing upcoming earnings estimates and will guide their future numbers lower. Finally, the market is telling you if a recession occurs, interest rates will not return to 0% given the structural shortages in food, housing, energy, and labor that are powering the upward push on inflation. This last point is important to keep in mind since it means we will not see PE ratios for the overall market expand back to the 20s; therefore, most of the future total return for stocks will come from earnings growth and dividends paid.

Our Outlook & Strategy

The biggest challenge for stocks is central banks navigating how to remove emergency stimulus policies needed during the depths of the pandemic without tipping the global economy into recession. Russia’s invasion of Ukraine and global drought complicates matters by pushing energy and food inflation even higher. The prospect of higher interest rates raises the attractiveness of bonds, which reduces the PE multiples investors are willing to assign to stocks. This places outsized stress on stocks trading at lofty valuations, especially those that cannot clear the earnings growth hurdles analysts have forecasted.

We believe the stock market has fully accounted for the competition being provided by higher interest rates. However, as we stated above, projections for future earnings growth may be too optimistic. For example, analysts are still forecasting 2023 earnings growth of 6.4% with consumer discretionary names expanding profits by a whopping 35.5%! That seems highly unlikely given the Fed's comments on keeping interest rates at elevated levels for an extended period and the increased odds of a recession. Therefore, if analysts have to ratchet down their earnings forecasts, the sectors seeing the sharpest downward revisions are ripe for further losses, especially in the names that have above average valuations and no dividend yield.

We believe the recent decline presents some opportunities. Several of the companies we follow now trade at valuations only seen in the depths of recession. This is most clear when looking at the difference in valuation between defensive and economically sensitive stocks. The current disparity indicates investors believe a Fed mistake and a soon coming recession is a certainty. We believe the Fed is right to raise interest rates quickly to address inflation; however, it appears the market is struggling to believe the higher rates can be left in-place for an extended period. Historically, stocks have bottomed when the Fed pivots from tightening interest rates to holding steady or cutting. Any indication that the Fed will not need to raise rates as high as the dot plots forecast will be viewed as a dovish signal and result in a rally for stocks, especially among select cyclicals and technology. Therefore, we are using this sell-off to invest some of our excess cash. We continue to slowly trim our defensive holdings in consumer staples and utilities to boost select positions in industrials, financials, and real estate. We are also monitoring a few names in natural resources as several key materials needed for future economic development and the proposed energy transition remain in critically short supply.