

Quarterly Market Outlook

October 2022

Historic Tightening Drives Broad Sell-off

2022 has seen the most aggressive tightening in four decades and the worst performance for risk assets on record. To understand why, it's helpful to recall how we got here. As a reminder, the government's response to Covid-19 was to cut interest rates to 0%, buy bonds and write checks on a massive scale. This unprecedented stimulus created a boom in demand while lockdowns, supply-chain bottlenecks and war in Ukraine constrained supply, driving prices higher. Financial assets also soared – often to bubble territory (meme stocks, crypto) as liquidity flooded the system.

The Fed started out behind the curve and kept rates at 0% even as inflation surged. Over the past year, however, the Fed's about-face has been dramatic. It has already hiked rates 3%, expects to end the year above 4%, and has quickly transitioned from "Quantitative Easing" (QE) to "Quantitative Tightening" (QT), selling bonds to drain liquidity instead of buying them. The result has been the biggest and fastest change in rates since Fed Chairman Paul Volcker famously "broke the back of inflation" in the early 80s.¹

Stocks and Bonds Down, Dollar Up

Nearly all assets have declined in 2022, leading to the worst return for the 60/40 portfolio ever (-21% YTD).² Global stocks are now off 25% YTD while the Bloomberg Aggregate Bond Index is down 15%. Foreign currencies have also been hit, as rate hikes and risk aversion have made the dollar and USD assets more attractive on a relative basis. Europe's dire outlook, Japan's yield-curve-control policy and the UK's deficits have only exacerbated currency pressures, leaving the euro, yen and pound down 14%, 18% and 21%, respectively, YTD.³

The asset-class sell-off is largely mechanical. When the risk-free rate was 0%, 2-3% asset yields looked attractive. Now with the risk-free rate approaching 4%, investors are no longer willing to pay higher prices to earn lower returns on riskier assets. As a result, all assets have repriced lower to offer forward-looking returns that can compete with the higher risk-free rate. While the losses seem shocking, they're exactly what we'd expect in response to a surprise tightening of this magnitude.

Inflation Still High

It takes time for tightening to bring inflation down. For now, prices continue to rise at an uncomfortable pace, up 8.2% YoY in the U.S. and 10.0% in Europe. Headline inflation may drop as commodity prices fall and bottlenecks resolve, but with labor markets tight (1.7 job openings per person seeking work) and nominal wages rising at a ~6% rate, core inflation may stay elevated. Meanwhile, energy capacity and inventories are at lows and risks are skewed to the upside with the ongoing war – all raising the potential for inflation to stay higher for longer.⁴

Growth Expected to Fall

U.S. balance sheets are healthy and nominal demand remains solid, supported by Covid savings and rising wages and credit. But real growth faces major headwinds from inflation and higher financing costs, and further tightening lies ahead. Economists now expect <2% real growth in the U.S. and no growth in Europe next year.⁵

Recession Likely

In the past, the Fed could cut rates and buy assets to offset a contraction. Now those tools would only exacerbate inflation. With the Fed committed to bringing inflation back to 2% even at the cost of rising unemployment and “pain to households,” a recession seems probable.

Higher Forward-Looking Returns?

While unexpected tightening is a headwind for all assets, much of that may be behind us. Real yields started the year at -1.1% and are now +1.6% – an unprecedented rise to a level that is starting to look attractive. Treasury and TIPS yields have hit 15-year highs, and investors can now receive 4% in T-bills for the first time since 2007.⁶

Stagflation Not Priced In

Nevertheless, portfolios still look highly exposed. In the past, inflation has never normalized without a recession, and a recession typically means rising unemployment and a material drop in earnings (20% on average). Yet today, while the stimulus that drove record demand and margins is now being withdrawn, expectations have yet to adjust, raising the risk of further market declines should growth disappoint. Meanwhile, bonds are pricing a quick return to ~2% inflation, which seems incongruous with strong earnings.

In the 1970s stagflation, stocks and bonds underperformed cash for a decade. With current discounting looking unrealistic, we believe investors will increasingly turn to inflation-hedge assets, lowly correlated active strategies and private-market alternatives for diversification.⁷

Notes

¹ Source: Bloomberg (FEDL01 Index, USGG2YR Index); <https://www.stlouisfed.org/publications/regional-economist/january-2005/volkers-handling-of-the-great-inflation-taught-us-much>.

² Source: Bloomberg (SPX Index, NDDUWI Index, LBUSTRUU Index, USGG10YR Index). Based on cumulative monthly returns for each calendar year since 1962 of a portfolio of 60% stocks, 40% bonds, rebalanced monthly. Stock returns reflect the returns of the MSCI World Index since inception (1970) backfilled with those of the S&P 500. Bond returns reflect the returns of the Bloomberg Agg since inception (1976) backfilled with 10-year Treasury bond returns, simulated using the 10-year Treasury yield and applying the returns calculation methodology articulated by NYU Finance Professor Aswath Damodaran at <https://people.stern.nyu.edu/adamodar/pc/datasets/histretSP.xls>.

³ Source: Bloomberg (MXWD Index, LBUSTRUU Index, USDJPY Curncy, USDGBP Curncy, USDEUR Curncy).

⁴ Source: Bloomberg (CPI YOY Index, ECCPMIUY Index, JOLTTOTL Index, WGTROVER Index); BLS (<https://www.bls.gov/charts/job-openings-and-labor-turnover/unemp-per-job-opening.htm>); <https://www.federalreserve.gov/newsevents/testimony/powell20220622a.htm>).

⁵ Bloomberg (EHGDUS Index, EHGDEU Index, ECGDUS Q222 Index, ECGDUS Q322 Index, ECGDUS Q422 Index, ECGDUS Q123 Index, ECGDUS Q223 Index, ECGDUS Q323 Index, ECGDEU Q222 Index, ECGDEU Q322 Index, ECGDEU Q422 Index, ECGDEU Q123 Index, ECGDEU Q223 Index, ECGDEU Q323 Index);

⁶ Bloomberg (GTII10 Govt, USGG10YR Index, USGG3M Index).

⁷ Bloomberg (USRINDEX Index, SPX Index – RR906); 5Y MSCI US Long-Term Earnings Growth estimate from I/B/E/S as cited by <https://www.yardeni.com/pub/int-mscina.pdf>; Bloomberg (USGGBE10 Index, MXWO Index, LBUSTRUU Index).

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