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Monthly Market Commentary
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The markets have enjoyed a recent bump namely due to an October CPI report that finally reflected a softening inflation. However, in our view, there are several unresolved issues that need clarity before we would feel comfortable with a sustainable market recovery.

Commentary Summary

- China's "Zero COVID" policy is eased, ending lockdowns, and allowing growth to recover.
- Inflation both peaks, and starts to decline, and we see softening rate hike rhetoric from the Federal Reserve.
- Geopolitical tensions decline, obviously in Ukraine but also with China.
- The projected "corporate earnings recession" isn't as bad as feared.

Despite the 2022 sell-off the stock market isn't a bargain by historical standards, when measured using the Price/Earnings ratio, and the bond market yield curve is still inverted, indicating a potential recession. In our view, the market volatility and recovery still has a long way to go.

Part 1 of 4: China "Zero-COVID" policy comes to an end

Since the start of the pandemic, China has adhered to what we view as a draconian, isolationist COVID policy that has pushed the Chinese economy into a recession and reduced sales for multi-national companies in one of the largest economies in the world. Despite geopolitical tensions between the US and Chinese governments, the two economies are tightly intertwined, as China is the third largest US trading partner (depending on the measurement methodology, Canada and Mexico are the top US trading partners)[1]. For the markets to recover, companies world-wide need an open, consistent trading partner in China to shore up sales lost during the pandemic and re-start reliable exports to global partners. For us to feel comfortable that China's policies are changing, we would need to see the following:

1) Substantial changes to Covid policies, namely an end to lockdowns targeting entire cities, shorter quarantine times for international travelers, importation of mRNA COVID vaccines and less use of the Sinopharm vaccine which has significantly lower efficacy.[2]
2) Chinese Purchasing Managing Index (PMI) shows signs of expansion, meaning that manufacturing firms start purchasing more inputs and materials to support increasing demand domestically and internationally.
3) The Chinese yuan normalizes back towards 6.50 CNY to USD versus the current level of ~7.18 CNY to USD. China is an export-focused country that relies on a cheaper currency to make exports more attractive to countries like the United States. The Chinese have been manipulating their currency in 2022 by artificially making it cheaper to support lagging imports.

Part 2 of 4: Inflation must peak and then also decline, followed by softening rate hikes by the Federal Reserve

In early November, the Consumer Price Index (CPI) rose 0.4%, and Core CPI (excluding energy and food) rose by 0.3%, while year-over-year inflation increased by +7.7%.[3] The market rally reflects unprecedented times: a standalone CPI increase of +7.7% would normally be unbelievably high, but this increase is *slower* than the CPI increases of +10.3% in August and +10.5% in September. Inflation is still very, very high, but the pace of inflation appears to be slowing and *declining*. "Declining" is critical, as inflation needs to drop a lot, not just be stuck at a level slightly less high than the previous reports.

Equally important is the Federal Reserve. If the Fed sees that inflation is declining, the markets expect the Fed to either stop raising rates so quickly, or even pause rate hikes. In market speak, you may hear words like "peak hawkishness" meaning a peak in the pace or level of rate hikes.

For now, nothing is definitive, in our view. The Federal Reserve tests the waters through various channels like Federal Reserve officials comments, or via Nick Timiraos at the Wall Street Journal (who often serves as the Federal Reserve "mouthpiece"). In response to the softening October CPI figure, we are starting to see the Fed test the waters on reducing the December rate hike from 0.75% to 0.50% with no change to the January rate hike at this time.

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The Federal Reserve terminal rate is also important. The terminal rate is the target federal funds rate once the rate hikes are complete. As of this newsletter, the bond market yield curve implies the target rate is just under 5%. This is derived from looking at the 10-year US Treasury yield curve along with a poll of US Economists. In November, the Federal Funds Rate range was 3.75 – 4.00% and now the bond market yield curves imply that the Federal Funds Rate will likely be increase to 4.00 – 4.50% in December and 4.25% - 4.75% in January. You may start seeing Wall Street speak of "disinflation" which is a fancy way saying that prices need to drop, and they need to drop a long way before the Fed changes course on their rate hikes, in our view.

Part 3 of 4: Geopolitical tensions decline

Geopolitical tensions sadly seem to be something we need to contend with almost constantly. The most obvious stress is the Ukraine/Russia war due to the tremendous volatility in commodities, namely oil, natural gas, and corn/wheat. There is also a fair amount of headline risk, the most obvious recent example being the missile explosion in Poland but also the investigation into the Gazprom pipeline explosions in the North Sea. The markets don't like surprises, let alone negative surprises from a war in Europe and this will continue to be a distraction. Until this can be resolved, in our view it could negatively impact the direction of commodity prices and markets.

China has also been an increasing negative source of global tension. President Xi confirmed an unprecedented third term as president, effectively cementing his dictatorship. His party must confront headwinds that are creating waves that global markets don't need right now:

- A significant recession in real estate, particularly multi-family residential.
- Tensions with the US over technology theft and using state-owned enterprises for spying.
- A decline in Chinese global investment due to domestic recession and asset controls.
- Military tensions in the South China Sea, Japan, and Taiwan.
- An implicit endorsement of North Korea's nuclear weapons testing.
- Emerging market country's resistance to the Belt and Road Initiative.
- China's currency manipulations.

Part 4 of 4: A potential US Earnings Recession

The US Economy has been remarkably resilient in 2022. People forget that the economy has been so resilient that the Fed's rate increases have, until very recently, NOT slowed down the economy as much as the Fed would like. In our view, US consumers and companies are finally feeling the full effects of inflation and rising interest rates, and we have concerns that this could finally impact both corporate sales and corporate profits, which may impact stock and bond prices. The Price to Earnings ratio is useful here because it's a simple calculation of stock price divided by corporate earnings. The stock market run-up in October has been in response to potentially softening inflation and smaller rate hikes, but earnings have yet to be reported. If stock prices don't reflect potentially softening earnings, then the Stock Price to Earnings ratio is lopsided and we could be in for a reversal in market direction. Stated differently, if company fundamentals have eroded during a time that stock prices have gone up, this needs to be reconciled, and stock prices may take a hit.

Wrapping it all up

We've presented four factors that we feel need resolution before we would feel comfortable that any market rebound would be considered sustainable. Unfortunately, simple measures from both the stock and the bond markets reflect our skepticism.

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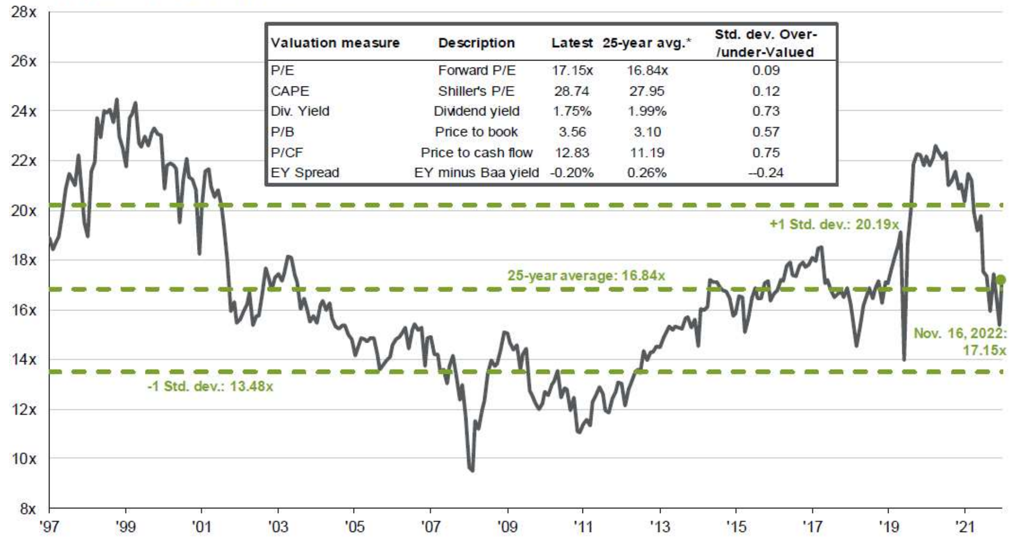
Despite the 2022 sell-off, the S&P 500 is *still* too expensive by historical standards. The S&P 500 is currently trading at 17.15x future earnings but the 25-year historical average is 16.84x. Even at the market low in early October, S&P 500 future earnings were about 15.5x, which isn't a significar discount by historical standards. If the stocl market is expensive, a we are walking into a earnings season, then by pure price standards alone, we don't feel optimistic that the recent rally is sustainable if corporate earnings are indeed declining.



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	17.15x	16.84x	0.09
CAPE	Shiller's P/E	28.74	27.95	0.12
Div. Yield	Dividend yield	1.75%	1.99%	0.73
P/B	Price to book	3.56	3.10	0.57
P/CF	Price to cash flow	12.83	11.19	0.75
EY Spread	EY minus Baa yield	-0.20%	0.26%	–0.24

Source: JP Morgan, FactSet as of 11/18/2022

The bond market isn't waving a green flag either, in our view. Recall that a very important measure in the bond market is the yield curve difference between 2-year treasuries and 10-year treasuries. If the 2-year treasury yield exceeds 10-year treasury yield, then the yield curve is inverted, which has correctly signaled a recession many times. The yield curve inverted in late summer 2022 and has only worsened since. We may have seen an improvement in inflation figures, and the stock market may have enjoyed a positive month, but the bond market isn't buying it. We continue to remind clients that the bond market is much bigger and much more sophisticated than the stock market, and the bond market's pessimism should not be ignored, in our view.

Source: St. Louis Federal Reserve, as of 11/24/2022

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Final Comments

It is important to remember that markets are anticipatory and forward looking. The stock market has historically started improving before an economic recession ended or before a crisis peaked. Think of it like catching a ball: you don't go where the ball is now, you go to where it is moving. The markets may eventually price in the aforementioned issues before they are resolved, but we just don't feel like that time is now.

Regardless of the outcome, timing the markets and forecasting are generally futile efforts. We continue to remind clients that we are in unprecedented times, particularly in interest rate and bond market conditions. We didn't think the market volatility would resolve itself quickly and this has been true. The best client outcomes require time, resilience, and patience. Success comes from having a plan, sticking to a plan, and never making investment decisions based on emotion.

Questions & comments are welcome.

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Sources & Disclosures

[1] Net trade-weighted basis. United State Census Bureau, Bureau of Economic Analysis.
[2] World Health Organization
[3] Bureau of Labor Statistics, November 10, 2022.

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.
Investing in stocks involves risk and their returns and risk levels can vary depending on prevailing market and economic conditions.
While stocks generally have the potential for greater return than government bonds, they involve a higher degree of risk. Government bonds, unlike stocks, are guaranteed as to payment of principal and interest by the U.S. government if held to maturity. Although government bonds are considered free from credit risk, they are subject to interest rate risk. Bond prices rise as yields fall.
Bloomberg U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.
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