

# Investment Outlook: “The stock market STOPS panicking when central banks START to panic”



## Quarterly Performance Overview

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- The S&P 500 Index returned -4.88% during Q3 2022 and the MSCI All Country World Index fell 6.71%.
- While the S&P Energy Select Sector Index increased by 1.65%, the Bloomberg Commodity Index was down 4.11% and the Bloomberg Composite Crude Oil Index decreased by 18.68%.
- Longer duration assets such as the growth heavy NASDAQ-100 Index fell 4.42% while the S&P U.S. Government Bond 20+ Year Index declined 10.10%.
- The bond market fell as interest rates rose with the Bloomberg US Aggregate Bond Index declining by 4.75%.
- The yield on the US 10-year Treasury increased from 2.98% on 6/30/2022, to 3.80% on 9/30/2022, and the Bloomberg US Corporate Investment Grade Index was down 5.06%.
- The VIX Index rose 10.14% in Q3 amidst concerns of persistently high inflation, tighter monetary policy, and increased recession risks.
- The CPI (Consumer Price Index) rose 8.3% year over year in August, exceeding estimates but easing from July's increase of 8.5%. Month over month, August CPI rose by 0.1%, surpassing the expected 0.1% drop and up from July's flat reading.
- The PPI (Producer Price Index) rose 8.7% year over year in August, coming in softer than the consensus and cooling from July's gain of 9.8%. Month over month, August PPI fell 0.1%, printing in line with expectations but above July's decrease of 0.4%.

## Fed Actions

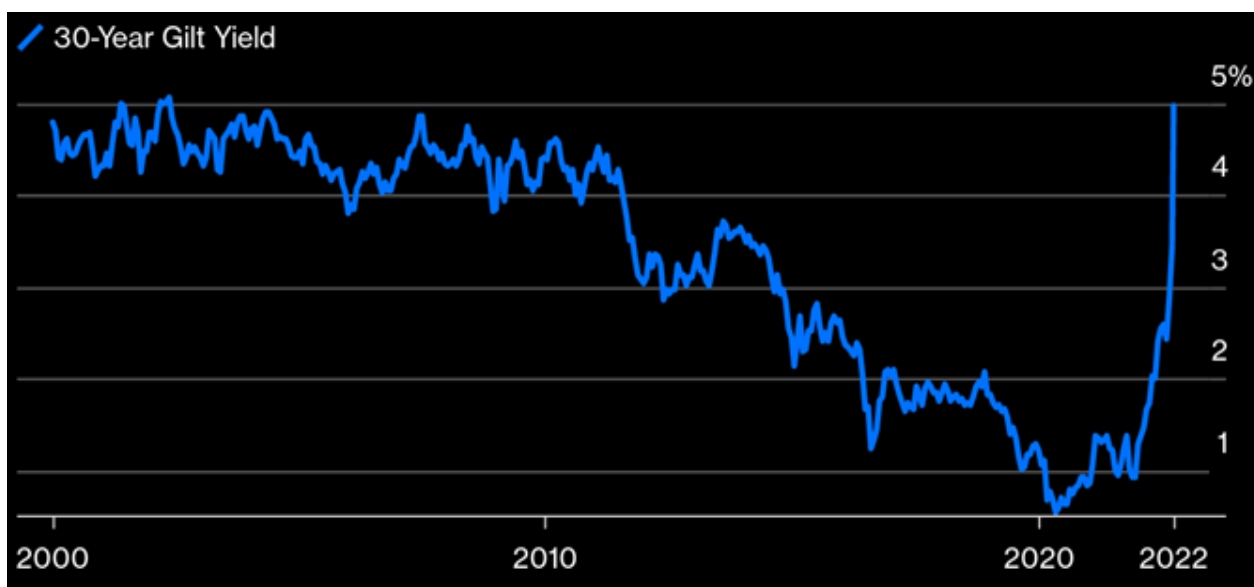
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- The Federal Reserve has been communicating an ever increasingly hawkish message since December 2021 as they attempt to rein in the highest inflation seen in the US since the early 1980s. This has led to a notable repricing in rate hike expectations.
- At the September FOMC meeting, the Federal Reserve implemented its third consecutive 75 bps interest rate hike, pushing the federal funds rate to the 3.00–3.25% range, its greatest level since early 2008. The increase was carried out despite slightly softer readings among August CPI (Consumer Price Index), PPI (Producer Price Index), and PCE (Personal Consumption Expenditures) data relative to the previous month.
- Given updated policy rate projections, Fed officials are suggesting that rates will continue to rise for the rest of 2022 and exceed higher than anticipated levels. Terminal forecasts for 2022 and 2023 show rates settling at 4.40% and 4.60%, respectively, which implies interest rates to increase by at least 1.25% between the remainder of this year's two meetings and a 25 bps increase throughout next year. Meanwhile, the market has been pricing in rate cuts in 2023.
- Chairman Jerome Powell seemingly acknowledged that recession risks have increased given his statement, “The chances of a soft landing are likely to diminish to the extent that policy needs to be more restrictive, or restrictive for longer.” He also suggested that economic ‘pain’ will be felt as forecasts for growth collapsed to 0.2% in 2022 and the unemployment rate is expected to increase to 4.4% at the end of 2023 from its current rate of 3.7%, where an increase of that magnitude has historically been associated with recessions.

## "The stock market stops panicking when central banks start to panic."

- The title of this section refers to an old Wall Street saying. The Fed seems to be panicking in recent months, and we believe at their September meeting they made a mistake. The 75bps rate increase was already priced in, but Powell seems to have indicated that a crash landing is unavoidable. The better approach would have been to acknowledge that some economic and inflation indicators are showing weakness, and a near-term pause would be plausible.
- Moreover, the Bank of Japan (BoJ) and Bank of England (BoE) both recently stepped into the market to defend their currency and bond markets. The chart below portrays the 30-year gilts recently turning parabolic. The BoE simply wouldn't let their bond yields go to the moon. No one expected these draconian measures, but such is unpredictable when dealing with soaring inflation, currency wars, and skyrocketing yields.

**Exhibit 1: UK Bonds Chart—30-year gilts have surged to a 5% yield, for the first time in two decades**



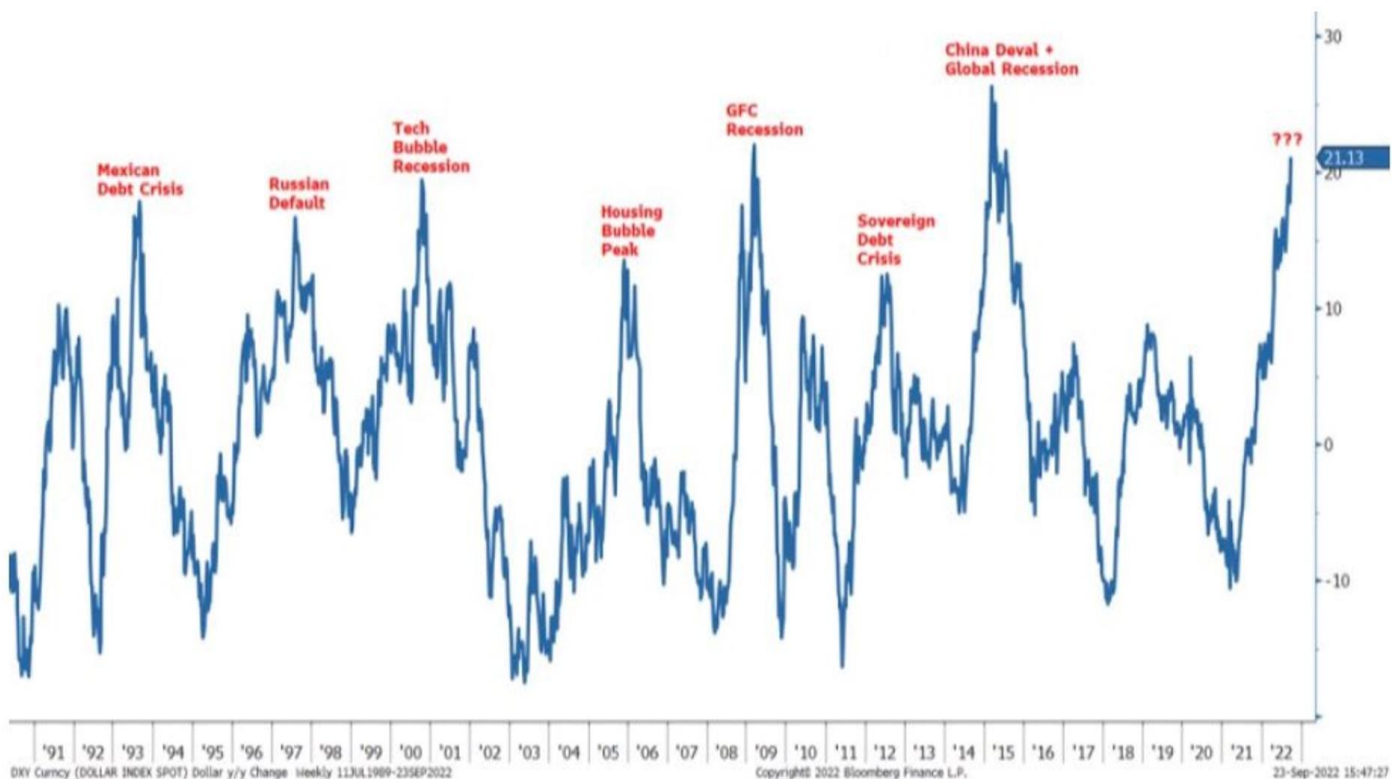
Source: Bloomberg Opinion

- Most of the forward-looking inflation indicators Astoria monitors are falling, and some quite rapidly. Hiking aggressively while the economy is slowing is rare. Typically, monetary policy becomes tighter when the economy is expanding.
- Most of what investors will read in the near term will be negative and bearish. Those suggesting that you buy are few and far between. However, the time to be bearish was when CPI doubled last year, the economy was booming, and the Fed was still buying bonds while holding rates at 0%; these were signals to de-risk.
- Astoria feels that we may be close to the end of this tightening cycle. Will inflation stay structurally higher and for longer? Sure, but we believe we are 75% through this market downturn. When the Fed panics, usually that implies we're close to the end of the market downturn.
- Just remember, as markets correct, valuations improve, and forward expected returns become more attractive. It's logical to be more bullish as the market goes lower, but many market pundits are preaching the opposite.

- Other signposts of capitulation to watch:
  - A full-blown earnings recession
  - The highest quality large cap stocks collapse
  - A Fed acknowledgment that forward looking inflation indicators have fallen (the irony here is that most of them have fallen significantly, i.e., money supply, gasoline, timber, housing market, etc.). Look at the dollar: it reached a 20-year high in September. There are a multitude of signs showing that inflation on the margin is declining. What is the Fed looking at!
- Regarding which high quality stocks to potentially watch, Apple was one of the market's darlings through this past market cycle. It checks all the boxes: everyone understands its business; it's a high quality stock; it produces significant free cash flow; and it was never grossly expensive throughout the previous cycle. How could you berate a Portfolio Manager for owning such a high quality stock?
- However, based on our tenured investing careers, we know that bear markets don't end until the grizzly mauls stocks in every corner of the market. If Apple were to significantly decline, that could be a sign that this bear market is nearly complete: a healthy sign. This downturn which began in February 2021 (when speculative tech stocks peaked) is getting long in the tooth for many.
- In conclusion, Astoria prefers dividend payers, value over growth, defensive quality stocks, and we are finally warming up to bonds after years of shunning the asset class. We are beginning to buy laddered US treasuries, IG credit, and munis—all short-dated paper. As always, we continue advocate including alternatives and to be diversified across factors. Astoria will be hosting our initial market outlook call in a couple of weeks. Click [here](#) for details.

## Spikes in FX volatility have historically coincided with major market downturns

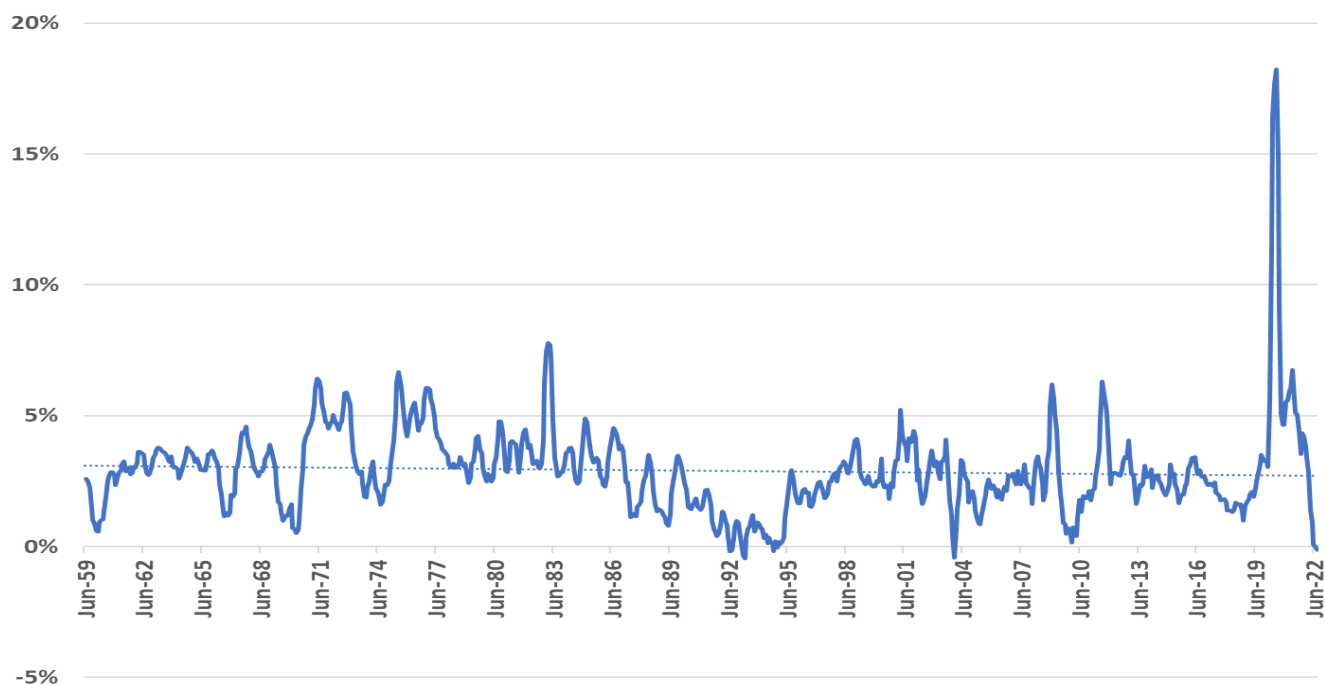
Exhibit 2: DXY Index Y/Y Change (%)



Source: Bloomberg, Morgan Stanley Research

## M2 Money Supply is declining, indicating that liquidity is coming out of the system

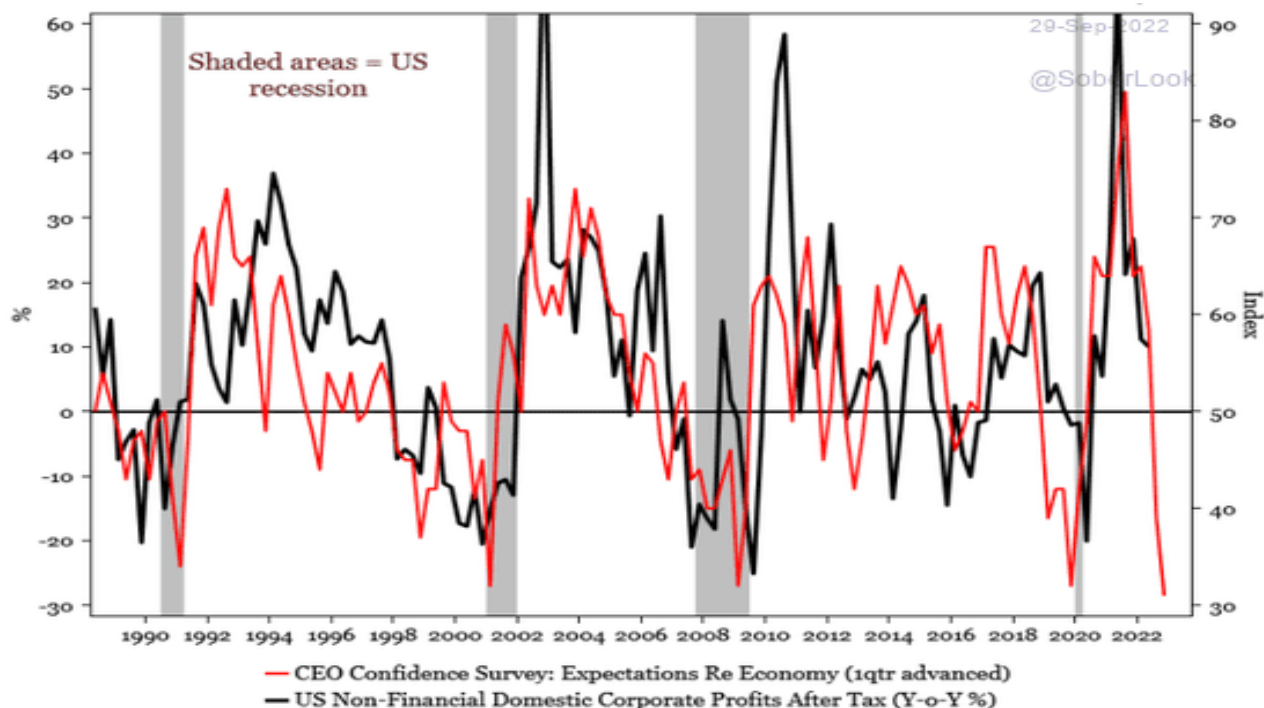
Exhibit 3: 5-Month Change in M2 Money Supply



Source: Twitter @JeremyDSchwartz

According to the chart below, CEO confidence has declined significantly, suggesting corporate profits may follow suit. The latest survey measure has also hit levels associated with past recessions.

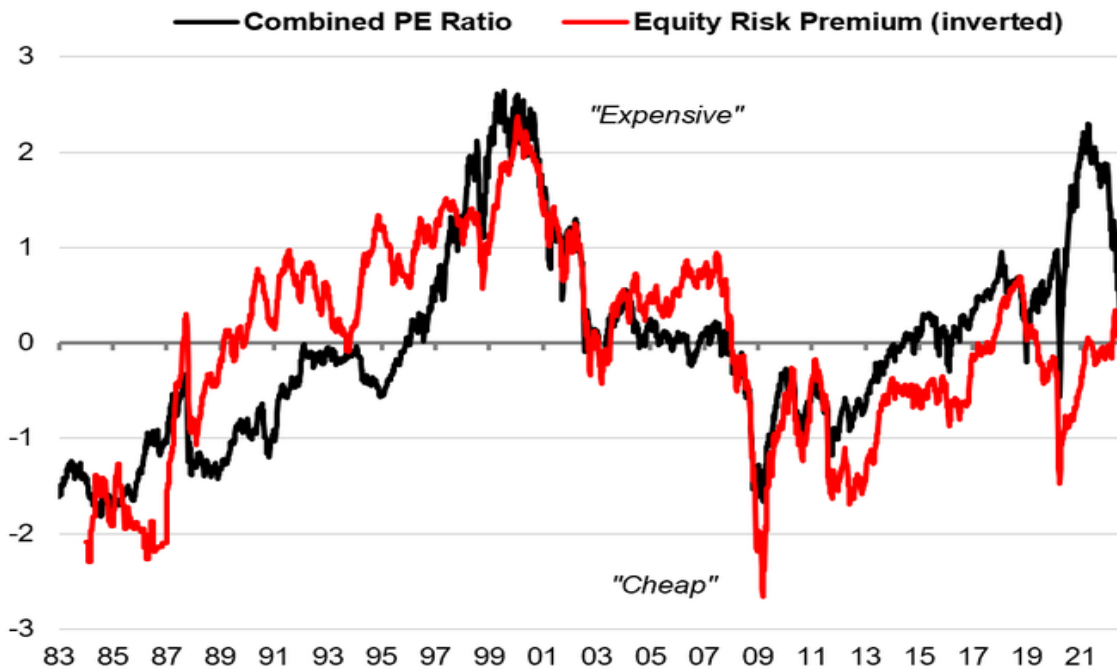
Exhibit 4: 5 US Corporate Sector Profits (Y/Y %) vs. CEO Confidence



Source: The Daily Shot, Longview Economics, Macrobond

## US equities are still not considered cheap

Exhibit 5: S&P 500 Valuations (Historical Z-Score)



Source: Topdown Charts, Datastream, I/B/E/S

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