Powell Puts Fed "Pause" On Hold

At the Jackson Hole Symposium on August 26, Federal Reserve Chairman Jerome Powell dashed any hopes that the Fed would pause its tight monetary policy actions any time soon:

> *"Today, my remarks will be shorter, my focus narrower, and my message more direct... While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain."*

Sounding like a father telling his children "I *really* mean it this time", Powell could not have been more clear about the Fed's intentions. In order to get inflation back down to the 2% range, the Fed is prepared to maintain a policy stance that "will be sufficiently restrictive to return inflation to 2%."

Since mid-June, equity investors seemed to be banking on the fact that indications of peak inflation would lead the Fed to pause – or even reverse – this year's policy tightening actions. This belief, as misguided as it turned out to be, led many investors to begin buying up equities following the sell-off that began the year.

Once it became clear on the morning of August 26 that the Fed wasn't about to ease anything, stocks immediately sank nearly 6% through the end of the month. While it remains to be seen whether the market goes on to take out the June lows, it would appear that the summer bounce in stocks was nothing more than a bear market rally instead of the start of a new bull market.

Tightening Fed policy is obviously one reason that stock investors have been on the defensive this year. The late Marty Zweig is credited with first saying "don't fight the Fed". In his 1970 book *Winning on Wall Street*, Zweig says "indeed, the monetary climate – primarily the trend in interest rates and Federal Reserve policy – is the dominant factor in determining the stock market's major direction."

For the foreseeable future, "not fighting the Fed" would mean that equities could experience another leg down in price. Aside from tight Fed policy, there are a few other factors that point to potentially more stock market volatility in the second half of 2022.

For one, global economic activity appears to be slowing down. In recent months, purchasing managers index survey data (aka PMI) indicate that a global slowdown is already underway in some regions. PMI readings above 50 indicate an economic expansion – the higher the reading, the faster the growth rate. A "50" indicates zero growth, while readings below 50 indicate a contraction in activity.

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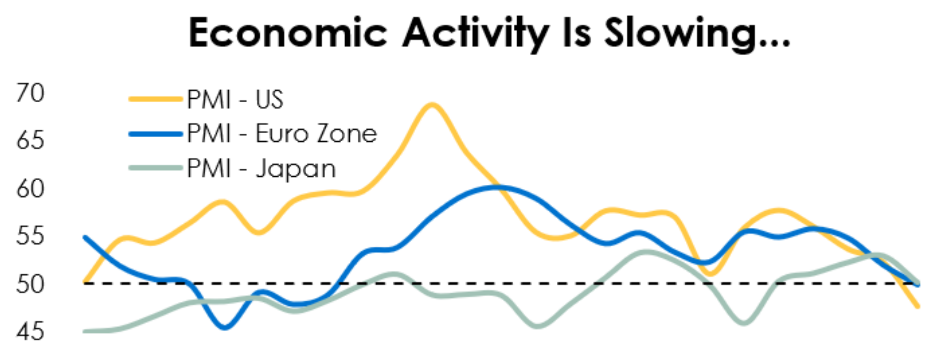
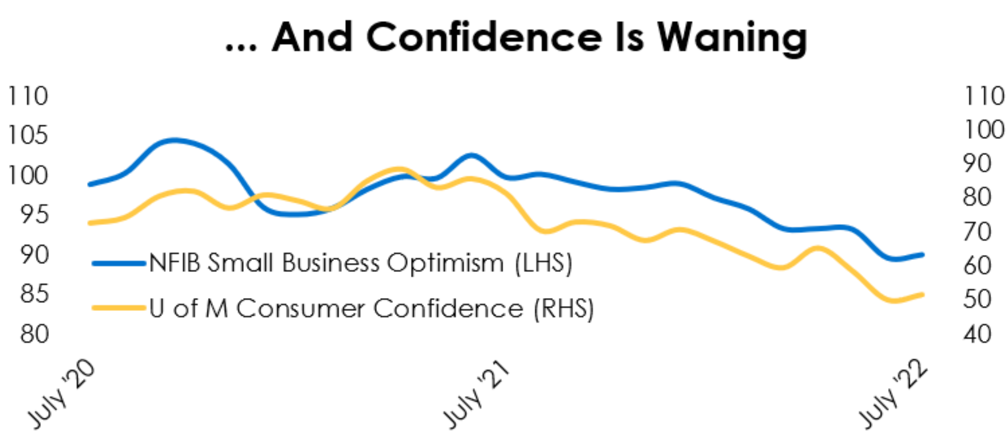
In the top chart below, PMI data from across the world indicates that economic activity is either contracting (below the dashed line) – the US and Euro Zone – or is essentially flat-lining (Japan).





Source: Factset

This slowdown in economic activity is also impacting confidence in both the C-suite and Main Street. As can be seen in the bottom chart above, confidence measures at both the corporate (blue line) and consumer (yellow line) levels have plummeted from earlier in the year.

In fact, if we had extended the consumer / corporate confidence data further into the past, we'd find that the last time that small businesses AND the consumer both lacked confidence to this degree was in the aftermath of the Financial Crisis in early 2009.

The double whammy of slowing growth and lagging confidence should be enough to make for a choppy back half of the year for equities. However – or perhaps "unfortunately" – for investors, other troublesome conditions exist that only increase the chances for another leg down in the market.

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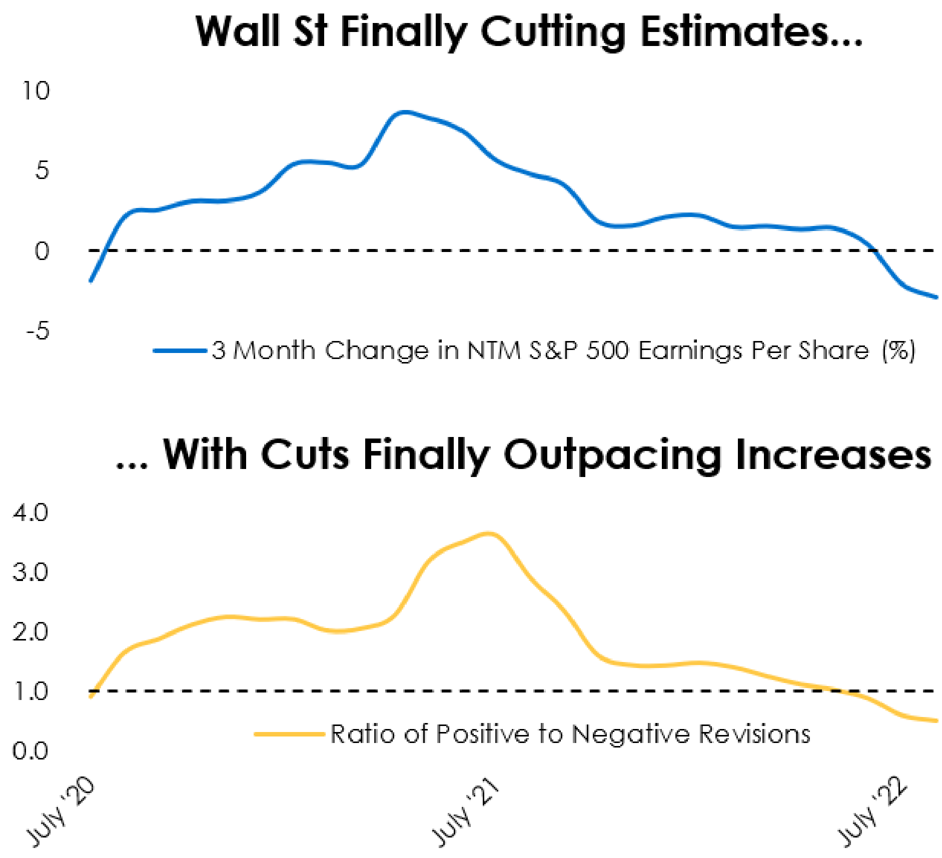
A slowing economy is one thing. But combining a slowing economy with persistently above-average inflation is something completely different. Second quarter earnings season provided the first glimpse of how inflation is impacting corporate America. Not only did demand suffer, but profit margins began to come under real pressure for the first time this cycle. Rising input and transportation costs, plus costs associated with companies right-sizing inventory levels, adversely affected profitability.

As the Fed continues to remain restrictive and inflation stays at elevated levels, these margin pressures are unlikely to dissipate. Yet only recently have forward-looking Wall Street earnings estimates begun to reflect this scenario (see the top chart below). Also, the pace of these negative earnings revisions could accelerate as the ratio of upgrades to downgrades shifts lower.



Source: Factset

Ceteris paribus, falling earnings means that equity valuations would only increase as the "E" in price-earnings ratios declines. However, history has shown that in a high inflation / rising interest rate environment valuation mulitples are usually much lower than the 17 multiple currently being applied to equities. This means that multiples are likely to contract further from here. As we've pointed out in the past, major bear market bottoms are usually accompanied by a market P/E multiple in the neighborhood of 12-14 times forward earnings. Obviously, prices still have a ways to go before multiples get to those levels.

In response to these circumstances, we have been careful to position our client portfolios for both the cyclical and secular environments. The cyclical environment is one of a maturing business and economic cycle, which leads us to position portfolios a little more defensively. Secularly speaking, we still believe that inflation is going to remain elevated so maintaining exposures that benefit from rising prices is necessary.

Recently, we've positioned portfolios more towards the cyclical environment by reducing exposure to riskier parts of the market. Specifically, we reduced exposure to equities and real estate investment trusts (REITs) and added exposure to fixed income.

Within equities, we continue to be slightly underweight with an emphasis on "value" and inflation beneficiaries as well as the more traditional "defensive" sectors. We also continue to avoid the expensive "growth" areas of the market.

Within fixed income, we remain underweight the riskier parts of the credit market – namely high yield and emerging market debt. We added some US Treasury exposure and lengthened duration in order to adopt a slightly more defensive posture.

Within the alternatives segment, we are overweight with an emphasis on more defensive areas. Our preference for diversified alternatives as a hedge against market volatility remains in place. Also, we remain overweight to commodities as a hedge against higher inflation. As mentioned earlier, we recently reduced exposure to REITs as a way to reduce overall risk in our portfolios.

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