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MARKET SIGHT LINES

Investors Seek Relief: Finding Balance

By Michael O'Keeffe, *Chief Investment Officer*

Early this year, we talked a lot about balancing acts, and as the year progressed, we highlighted how imbalances have kept inflation elevated and driven markets lower. Then last week, I wrote about finding balance as the midterm elections approach.

Want to go deeper?

Watch the **Investment Strategy Brief** video about Finding Balance.

In this week's Sight|Lines, we discuss how we may be finding balance in the coming months in issues that have challenged markets this year, perhaps leading to possible relief for investors.

THE TAKEAWAY: WE SHOULD FIND BALANCE IN SEVERAL AREAS, PROVIDING SOME RELIEF

Some imbalances should begin to resolve in the coming months, allowing investors to find balance:

- The midterm elections will clarify future priorities for Congress and President Biden.
- Easing supply chain pressures and other real-time data are signaling the potential for cooling inflation.
- Federal Reserve (Fed) messaging may be shifting subtly to a "pause and watch" policy.
- The solid labor market lessens the odds of the National Bureau of Economic Research (NBER) declaring a recession.
- Expected 2022 earnings growth has declined, but third quarter results and expected future earnings growth are holding up.
- We expect some relief and recovery in the markets as investors further assess these areas of balance.
- Geopolitical risks remain and should be closely monitored.

IN-DEPTH: IMPROVED BALANCE MAY WELL APPEAR IN MANY AREAS SOON

Republicans appear to have the advantage in the upcoming election, even as we see pressures easing at least modestly on the inflation front and Fed officials float the prospect of slowing rate hikes.

- *Midterm Elections*: In the House, Democrats hold 221 seats, Republicans hold 212, and there are two vacancies. The average gain for a minority party is 27 seats. Polls show the majority of voters see the country on the "wrong track," with concerns about inflation, the economy, immigration, and crime top of mind. We will have less uncertainty and a greater sense of balance post-election.

- *Inflation*: Measures of supply chain pressures have eased, with the Federal Reserve Bank of New York's Global Supply Chain Pressure Index (GSCPI) at 1.05, much improved from 1.51 in August and 3.24 in September 2021. It peaked at 4.30 in December 2021. Institute for Supply Management and S&P Global PMIs both show an easing in supply chain pressures. All this points to the prospect of improved, cooling inflation. Finding balance on the inflation front has been a top priority.
- *Fed Policy*: While Fed watchers still expect another 0.75% hike in November, there is potential for a slowdown at the December meeting. Vice Chair Lael Brainard and Fed officials Charles Evans and Neel Kashkari have mentioned an important policy discussion in December and the prospect of a smaller cut, or even a pause, then. Market measures show the fed funds rate peaking in 2023 and potentially falling from rate cuts. Most are anxious to see the Fed find balance with their policy going forward.
- *Recession Risk*: Investors, government officials, and the public at large depend on the private, bipartisan NBER to determine when we are in a recession. Their experts focus on measures like real personal income, nonfarm payroll employment, real consumer spending, and industrial production. And since all of these measures are positive as of mid-October and balancing other negative forces like housing activity and spending on goods, the NBER is less likely to declare a recession.
- *Earnings Growth*: Third quarter earnings season has been generally positive so far, with 72% of those S&P 500 companies reporting beating earnings expectations. While the fourth quarter annualized growth rate has fallen from over 14% at the beginning of the year to 2.5%, the forecast for 2023 growth has only fallen from 9.9% to 7.1%. If the economic slowdown ends up being a soft landing or a shallow recession, earnings will likely hold up better than in past recessions, providing balance for equity markets and the prospect of a relief rally.
- *Market Recovery*: The markets are admittedly hovering near their 2022 lows, but equities have recovered some, up 7.1% from those lows, and the 10-year Treasury rate has fallen from a high of 4.2% to a current level of 3.9%, providing some recovery in bond market values.
- *Geopolitical Risks*: Despite finding balance, as discussed above, we see geopolitical tensions worldwide. Our focus includes:
  - The Russia-Ukraine war and the risk of Vladimir Putin getting even more aggressive;
  - China policy shifts and territory tensions like Taiwan, Hong Kong, and the South China Sea; and
  - Shifts in UK leadership after imbalances between monetary and fiscal policy destabilized markets.

CONCLUSION

We intentionally framed 2022 to be about balancing acts, and imbalances have driven sustained, higher inflation through the year and other problems, driving both equity and bond markets lower. Last week, I wrote about finding balance as the midterm elections approach. And despite meaningful geopolitical risks ever present, we see the potential for finding balance in many areas, including inflation, Fed policy, economic growth, and company earnings. More balance may well give the markets a foothold to move toward recovery.

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