"The stock market stops panicking when the central bank starts to panic"

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Worst September for Equities Since 2002

Amid increased recession risks and additional interest rate hikes, equities tumbled in September as the S&P 500 Index fell 9.3%, posting its worst September since 2002. Broad-based emerging markets were among the worst performers (-11.3%), followed by US growth stocks (-10.5%), and US small-caps (-9.8%). Bonds also struggled as Treasury-inflation protected notes declined 6.7%, investment grade corporates returned -6.0%, and 7-10 year US Treasuries fell 4.7%. Aside from silver (+5.6%), commodities produced negative returns as crude oil was down 10.7%, broad-based commodities fell 8.1%, and gold declined 2.9%.

Exhibit 1: Trailing Returns as of September 30, 2022

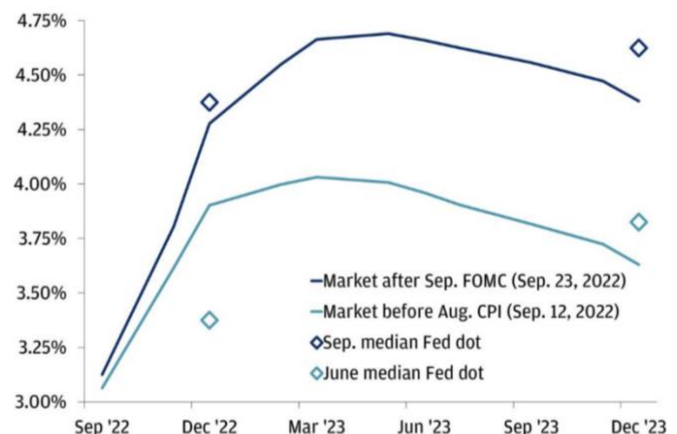
	Index/ETF	1-Mo	YTD	1-Y	3-Y	5-Y
Equities	US Value (IVE)	-8.49%	-16.66%	-11.25%	5.09%	6.00%
Equities	US Mid-Caps (SPMD)	-9.17%	-21.50%	-16.48%	6.27%	5.67%
Equities	US Large-Caps (SPY)	-9.24%	-23.93%	-16.51%	8.25%	9.16%
Equities	International Developed Equities (IEFA)	-9.64%	-27.93%	-26.35%	-1.86%	-0.93%
Equities	US Small-Caps (SPSM)	-9.75%	-23.04%	-19.98%	6.01%	4.79%
Equities	US Growth (QQQ)	-10.54%	-32.49%	-25.11%	13.31%	13.74%
Equities	Broad-based Emerging Markets (IEMG)	-11.31%	-27.35%	-27.34%	-1.40%	-1.77%
US Fixed Income	Municipal Bonds (MUB)	-2.81%	-10.64%	-9.98%	-1.52%	0.63%
US Fixed Income	High Yield Credit (HYG)	-3.74%	-15.25%	-14.67%	-1.95%	0.52%
US Fixed Income	US Aggregate Bond Index (AGG)	-4.14%	-14.38%	-14.45%	-3.25%	-0.29%
US Fixed Income	US Treasury 7-10 Year (IEF)	-4.73%	-15.65%	-15.42%	-3.98%	-0.49%
US Fixed Income	Investment Grade Corporate Bonds (LQD)	-5.98%	-21.24%	-21.11%	-4.40%	-0.38%
US Fixed Income	Treasury Inflation Protected Notes (TIP)	-6.72%	-13.90%	-11.80%	0.51%	1.75%
Commodities	Silver (SLV)	5.55%	-18.64%	-12.26%	2.26%	2.14%
Commodities	Gold (GLD)	-2.89%	-9.53%	-4.11%	3.11%	4.93%
Commodities	Broad-based Commodities (BCI)	-8.05%	12.35%	12.05%	12.60%	6.41%
Commodities	Crude Oil (USO)	-10.71%	20.09%	24.71%	-11.19%	-4.79%

Source: FactSet. Data as of September 30, 2022.

Chances of soft landing 'likely to diminish'

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% (see chart below), respectively, which implies interest rates to increase by at least 1.25% between the remainder of this years' two meetings and a 25 bps increase throughout next year. This further points to an absence of rate cuts until 2024, whereas the market has been pricing in decreases to occur 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.

Exhibit 2: The Fed's New Dot Plot



Source: FOMC, Bloomberg Finance L.P. Data as of September 23, 2022.

A Strong US Dollar

The Dollar Index (DXY), which measures the value of the US dollar relative to a basket of six major foreign currencies, reached a 20-year high in September. An aggressive Fed and higher rates have made US bond investment more attractive, in turn driving up the demand and value of the dollar. As the currency is seen as a "safe haven" in times of global economic stress, investors tend to purchase dollars and sell other currencies, further fueling the dollar's rise. Moreover, a stronger dollar is viewed as negative for the US stock market given many multinational companies make up the S&P 500, and a rising dollar will negatively impact their earnings.

Futures Big Net Short

Futures positioning for the S&P is heavily net short, hitting 2008 levels. Will these investors be proven right?

Exhibit 3: S&P 500 Futures Net Positioning

Source: Bloomberg

Composite Seasonality

The chart below shows that defensive assets tend to outperform risk assets around this point in the year. Hence, an allocation to liquid alternatives in portfolios may help cushion downside risk.

Exhibit 4: Composite Seasonality Patterns

Source: Topdown Charts, Datastream

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The title of this section refers to an old Wall Street saying. The Fed sure seems to be panicking in recent months, and we believe it may have just made a material mistake. The 75bps rate increase was already priced in, but Powell seems to have indicated that a crash landing is unavoidable. The more suited approach may have been to acknowledge that some economic and inflation indicators are showing weakness, and a near-term pause would be plausible. Most of the forward-looking inflation indicators we monitor 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 you will read will likely be negative and bearish. Those suggesting that you buy are few and far between. However, the time to be bearish was when CPI doubled, the economy was booming, and the Fed was still buying bonds while holding rates at 0%; these were signals to de-risk. We feel that we may be close to the end of this tightening cycle. Will inflation stay structurally higher and for longer? Sure, but perhaps we are 75% through this market downturn. When the Fed panics, usually, we're close to the end. Because of Powell's presser, we see a scenario where the market may bottom around 3200 on the SPX. Just remember, as markets correct, valuations should improve, and forward returns tend to become more attractive. It's reasonable to be incrementally more bullish as the market goes lower, but many market pundits are preaching the opposite. We prefer 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 buying laddered US treasuries, IG credit, and munis—all short-dated paper. As always, we continue advocate including alternatives and to be diversified across factors.

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