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Investment Insights Monthly

From The Desk of Bill Hornbarger, Chief Investment Officer

December 2022

What Are the Markets Trying to Tell Us?

As the year winds down, a great amount of uncertainty remains surrounding the economy and the markets. On the economic front, a relatively strong job market, better second half readings, and an improved outlook for GDP are offset by signs that manufacturing is contracting along with eight consecutive months of negative results for the leading economic indicators. The S&P 500 remains lower for the year but rallied strongly off the mid-October lows before faltering more recently. And in the fixed income markets, the 10-year Treasury yield has declined almost 50 basis points from its 2022 highs, despite the expectations of multiple additional rate increases.

These cross currents have resulted in a wide range of outlooks for the economy and markets in 2023. Top of mind for most investors is the question of whether the Federal Reserve will tip the economy into recession or be able to successfully engineer a soft landing, and what that means for stocks and bonds. Opinions on these topics are easy to come by, and it is hard to know who or what to listen to, particularly in this supercharged political divide.

In our opinion, market-based indicators are often an important clue as to what is happening. They represent the collective views of market participants from around the globe and correspond to real capital at risk. Surveying the current landscape, here are a few that stand out and how we interpret them.

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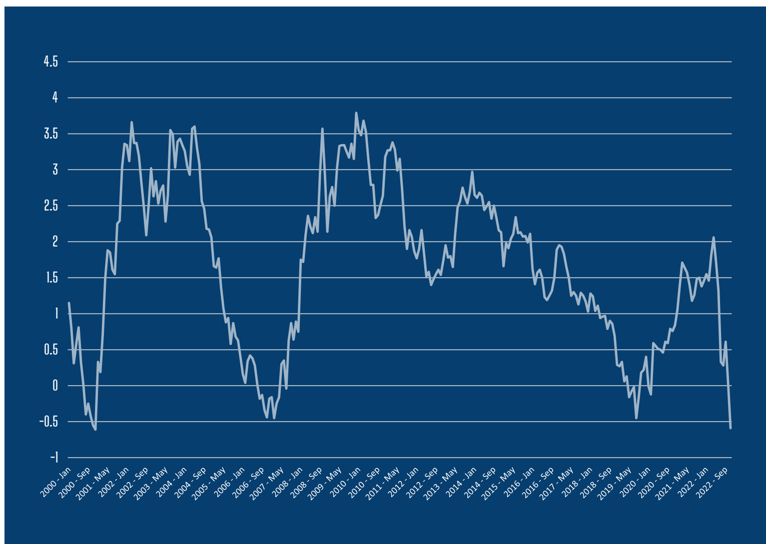
The U.S. Treasury yield curve remains deeply inverted with short maturities all yielding more than the benchmark 10-year note. At the end of November, the 3-month Treasury bill and 10-year Treasury note yielded 4.27% and 3.68%, respectively, and the inversion between the two had accelerated to what was then the widest point in more than 40 years (see chart). The deepening of the inversion in recent weeks has primarily been a result of yields on longer maturities declining. The 10-year yielded 4.25% in late October versus 3.5% recently.

We believe that, consistent with the expectations theory, the yield curve is indicating that while inflation is currently uncomfortably high and the Fed has more interest rate increases coming, longer term monetary policy will slow the economy, inflation will decline, and monetary policy will feature lower rates in the future.

The Yield Curve (2000 to Current)
10-Year Treasury less 3-Month Treasury (%)



Source: Haver

The message of the yield curve is consistent with the behavior of the commodity markets. The Commodity Research Bureau Spot Commodity Index (the CRB) has been steadily declining since reaching a record high earlier this year, and the same general pattern is seen in industrial metals and oil prices. The pattern is similar to what was observed in the second half of 2008 and during other periods when the economy was slowing or in recession, resulting in reduced demand for commodities.

The credit upgrade versus downgrade ratio measures the relationship between corporations that have seen their credit rating upgraded versus the number that have seen their credit rating downgraded. According to credit rating agency Standard & Poor's, the ratio has been deteriorating through 2022 after a strong start to the year and a strong 2021. This is another potential indicator of a slowing economy.

Positive signs can be found in the recent performance of the equity markets and in market-based inflation expectations. Domestic equities rallied strongly off the year's lows into the beginning of December. The Dow Jones Industrial Average, S&P 500, and Russell 2000 were up 6%, 5.6%, and 2.3%, respectively, in November, and all three indices are now out of bear market territory for the year.

Both survey and market-based measures of longer-term inflation expectations remain well contained and have been noted by the Fed. The University of Michigan consumer sentiment index surveys respondents on one- and five-year inflation expectations. And while short-term expectations remain elevated, the five-year reading has remained at 3% or lower in recent months. The implied inflation rate that can be calculated using the relationship between Treasury Inflation Protected Securities (TIPS) and fixed rate Treasuries paints a similar picture. The five-year spot inflation rate currently stands at 2.4%, while the longer-term rate (years six through ten) is 2.37%. The Fed watches these closely, and they can provide important clues to consumers' potential spending habits.

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Like many of the economic indicators, the market-based indicators provide a mixed message. Both are important inputs and should be weighed accordingly. It is important to remember that the stock market (and the bond market) is not the economy, and while much of the economic indicators are looking in the rearview mirror, the markets are forward looking.

The optimal outcome for the Fed in this tightening cycle is a soft landing: slowing the economy enough to bring inflation down, while not tipping the economy into recession. This is an extraordinarily difficult path to walk, and signs such as the yield curve and the leading indicators point more towards recession. Others are more upbeat, such as the recent rebound in stock prices and the tight labor markets. We remain cautious in this environment and expect the volatility to persist until a clearer picture emerges. However, the stock market is a leading indicator attempting to reflect future economic conditions. That is why equities tend to bottom during a recession and not after.

With those thoughts in mind, we look for the environment to remain frustrating for both the bulls and the bears. Stating the obvious, we believe the way forward is contingent on the Fed and monetary policy. The consensus base case is for the Fed to raise rates another 100 bps and stop before pivoting late in the year. That would mean inflation is coming down meaningfully and the Fed was successful in engineering a soft landing. The next most likely scenario is a modest recession because of the Fed having to tighten more than expected or monetary policy remaining restrictive for longer than expected. The third scenario (and least likely in our opinion) is the Fed makes a policy mistake by tightening too aggressively, leading to a deeper recession. Our opinion is that the markets will continue to churn until that question is answered, and we don't discount the possibility of seeing the old lows again if the news deteriorates significantly.

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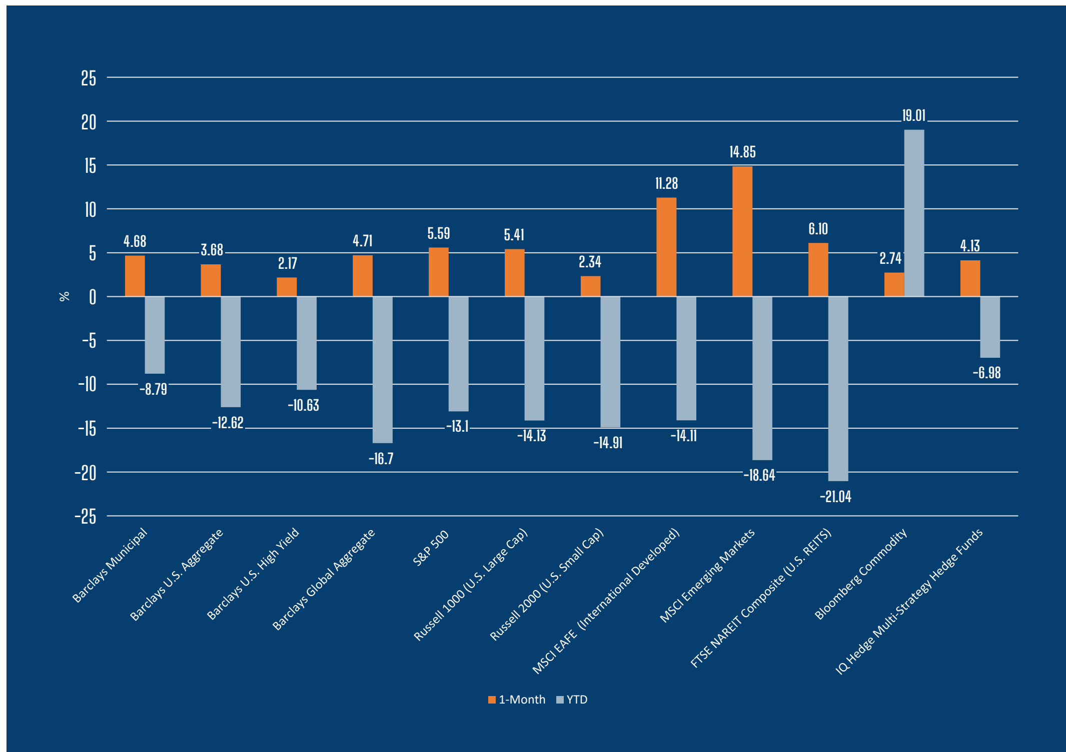
Asset Class Returns as of November 30, 2022

Comparing Recent Month and Year-to-Date Total Returns



Source: Morningstar

Fixed Income

- Fixed income had a strong month as yields fell across the board and spreads tightened.
- The decline in Treasury yields was positive for core fixed income and municipal bonds.
- Credit spreads have tightened sharply in Q3, leading to positive gains in investment grade, high yield, bank loans, and emerging market debt.
- U.S. dollar weakness provided an added tailwind for non-U.S. assets.

Equities

- Global equities surged higher in November led by non-U.S. equities and value stocks.
- Value beat growth in the U.S. and large cap stocks trounced small caps.
- The tech-heavy Nasdaq continues to lag year-to-date but posted better performance in November.
- Non-U.S. equities were the best performers last month, boosted by strong gains from China, Europe, and large caps.
- Unlike the U.S., the international developed growth index beat the international developed value index.
- Within emerging markets, large caps outperformed small caps, and November returns were largely driven by the 29.7% rebound in China.
- The weaker USD boosted international developed returns by 484 bps and emerging market returns by 315 bps.

Real Assets

- Domestic REITS posted positive returns in November, aided by lower bond yields and stronger equity markets.
- The commodity index was higher in November despite general softness in energy markets.

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November 30, 2022	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Barclays U.S. Treasury Bill 1-3 Month	0.31%	0.53%	1.16%	1.17%	0.63%	1.17%	0.69%
Barclays Municipal	4.68%	3.81%	-8.79%	-8.64%	-0.77%	1.40%	1.98%
BBgBarc U.S. Govt/Credit Intermediate	0.82%	0.70%	-3.87%	-4.02%	-0.30%	0.89%	0.87%
Barclays U.S. Aggregate	3.68%	2.33%	-12.62%	-12.84%	-2.59%	0.21%	1.09%
Barclays U.S. High Yield	2.17%	4.83%	-10.63%	-8.96%	0.92%	2.50%	4.26%
S&P/LSTA Leveraged Loan	1.24%	2.28%	-1.04%	-0.41%	2.94%	3.30%	3.70%
Barclays Global Aggregate	4.71%	3.99%	-16.70%	-16.82%	-4.47%	-1.69%	-0.53%
JPM GBI EM Global Diversified	7.11%	6.16%	-13.55%	-12.21%	-5.51%	-2.53%	-2.03%
U.S. Equity Indices							
DJ Industrial Average	6.04%	20.96%	-2.89%	2.48%	9.50%	9.71%	12.86%
S&P 500	5.59%	14.14%	-13.10%	-9.21%	10.91%	10.98%	13.34%
NASDAQ Composite (Price)	4.37%	8.44%	-26.70%	-26.19%	9.79%	10.78%	14.31%
Russell 1000	5.41%	13.86%	-14.13%	-10.66%	10.56%	10.69%	13.17%
Russell 1000 Growth	4.56%	10.67%	-23.26%	-21.64%	11.79%	12.92%	15.01%
Russell 1000 Value	6.25%	17.14%	-3.65%	2.42%	8.40%	7.86%	10.97%
Russell Mid Cap	6.01%	15.42%	-12.59%	-9.02%	8.68%	8.50%	11.83%
Russell 2500	4.22%	14.22%	-13.21%	-10.36%	7.92%	7.27%	10.99%
Russell 2000	2.34%	13.60%	-14.91%	-13.01%	6.44%	5.45%	10.13%
Russell 2000 Growth	1.63%	11.27%	-21.31%	-20.96%	3.68%	4.91%	10.24%
Russell 2000 Value	3.06%	16.03%	-8.48%	-4.75%	8.33%	5.35%	9.67%
Non-U.S. Equity Indices							
MSCI World	7.00%	14.72%	-14.12%	-10.42%	8.04%	7.90%	10.12%
MSCI ACWI	7.80%	14.34%	-14.64%	-11.19%	7.13%	6.94%	9.22%
MSCI ACWI Ex-U.S.	11.82%	15.18%	-14.97%	-11.43%	2.22%	1.96%	4.71%
MSCI EAFE	11.28%	17.27%	-14.11%	-9.70%	2.39%	2.34%	5.48%
MSCI EAFE Growth	11.55%	16.38%	-21.82%	-18.43%	2.12%	3.43%	6.34%
MSCI EAFE Value	11.01%	18.18%	-6.17%	-0.57%	2.04%	0.84%	4.38%
MSCI Europe	11.37%	19.37%	-14.56%	-8.92%	3.23%	2.78%	5.48%
MSCI Japan	9.68%	12.94%	-16.55%	-14.95%	-0.03%	0.68%	6.42%
MSCI AC Asia	15.38%	12.06%	-18.29%	-16.99%	0.52%	0.37%	5.19%
MSCI EAFE Small Cap	9.93%	14.59%	-21.87%	-18.45%	0.53%	0.66%	6.91%
MSCI ACWI Ex-U.S. Small Cap	9.58%	13.15%	-19.73%	-16.30%	3.08%	1.66%	6.05%
MSCI Emerging Markets	14.85%	11.30%	-18.64%	-17.07%	0.51%	-0.04%	2.44%
MSCI EM Asia	18.72%	11.77%	-20.15%	-18.94%	1.61%	0.43%	4.35%
MSCI China	29.72%	7.91%	-25.67%	-28.01%	-6.47%	-5.01%	2.58%
MSCI EM Eastern Europe	16.53%	31.76%	-82.94%	-83.04%	-42.22%	-24.65%	-12.91%
MSCI EM Latin America	0.53%	10.27%	13.98%	20.86%	0.13%	0.99%	-0.79%
MSCI EM Small Cap	9.45%	9.38%	-16.74%	-13.19%	8.08%	2.44%	4.17%
MSCI Frontier Markets	5.24%	0.72%	-24.95%	-23.82%	-1.49%	-1.29%	3.95%
Hedge Fund Indices							
IQ Hedge Long/Short	7.06%	13.07%	-10.44%	-9.12%	3.07%	2.79%	--
IQ Hedge Multi-Strategy	4.13%	5.50%	-6.98%	-6.37%	0.25%	1.07%	2.29%
Real Assets Indices							
FTSE NAREIT Composite	6.10%	10.04%	-21.04%	-13.77%	1.57%	5.04%	7.69%
Alerian MLP	1.06%	15.53%	37.37%	42.25%	14.22%	6.06%	2.15%
Bloomberg Commodity	2.74%	4.78%	19.01%	23.20%	15.46%	7.60%	-1.30%
S&P Global Infrastructure	8.08%	13.53%	2.07%	8.83%	3.93%	4.16%	6.99%
Other							
Oil Price Brent Crude	-9.91%	-2.88%	9.84%	21.06%	11.02%	6.09%	-2.61%
CBOE Market Volitility (VIX)	-20.48%	-34.91%	19.51%	-24.31%	17.71%	12.78%	2.63%

Source: Morningstar

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