Happy Thanksgiving… Serving Up Some Broad Perspectives

Ahead of the Thanksgiving holiday, investors are getting a chance to catch their breath, as we emerge from earnings season and mid-term elections and look towards year-end. With these major events behind us, and a two-week lull before the next bit of inflation data, we thought it opportune to consider some of the factors – both bearish and bullish – that could determine the next directional move in the markets.

Presently, markets look indecisive from a technical chart perspective. The S&P 500 is sitting right in the middle of the 200-and 50-day moving averages, respectively shown by the red and blue lines below. The short-term trend for the market (green line below) has been positive, with several higher highs and higher lows since October pushing the S&P above the 50-day. The longer-term year-to-date trend (orange line), however, remains definitively bearish until markets break out above the August high.

Source: StockCharts.com. S&P 500 Large Cap Index.

With short- and long-term trends painting contradictory pictures, it would be reasonable for the market to break either way from here. Here is a sampling from the buffet of bearish and bullish factors at play:

Bearish

The Fed: Federal Reserve comments have trended increasingly hawkish, most notably St. Louis Fed President James Bullard in his remarks that rates need to go higher, possibly as high as 7%, to be “sufficiently restrictive” in bringing down inflation. While Bullard does not vote on Fed policy in 2023, his remarks carry weight, and the hawkish tone was echoed by other Fed speakers.

Earnings: The short-term uptrend is partially attributable to Q3 earnings that were good enough, albeit not great. With around 90% of the S&P 500 having reported, 25% of companies in the index missed estimates, which outside of 2020's COVID-affected first quarter is the worst showing since Q2 of 2013. Investors hoping for an upside earnings surprise will have to wait an entire quarter now, hoping that perhaps strong consumer spending during the holiday season will lead to Q4 2023 outperformance.

Economic Data Drought: Right now, inflation trumps all other economic releases, and we will not get another inflation reading until December 1st when the Personal Consumption Expenditure data is released. After that, Consumer Price Index (CPI) and Producer Price Index (PPI) data come out right before the December 14th FOMC meeting, where the Fed will announce interest rate policy. Inflation data has been trending lower, but the Fed is looking for a sustained downward trend before it will consider pausing on rate hikes, which will not happen before year end.

Deteriorating Housing, Consumer Health, and Manufacturing: The first casualty of the Fed's tightening campaign was the housing market, which has been eviscerated by the steep uptick in mortgage rates. As prices recede from bubble territory, new homebuyers are finding themselves underwater. Consumers are also carrying higher credit card balances and barring an extension, the student loan moratorium will expire at year end while loan forgiveness is tied up in courts. Adding to the pressure, many high-profile companies have announced layoffs, creating uncertainty that may limit consumer spending. Manufacturing has also rolled over. Housing and manufacturing account for a combined 20% of GDP, while consumer spending comprises 67%. Therefore, the consumer remains the primary driver of economic activity.

Bullish

The Fed: The four successive 75 basis point rate hikes from the Fed were to slam on the brakes on inflation. Now that most inflation measures are beginning to show signs of improvement, rate hikes will likely continue, but at a slower pace before eventually stopping. The worst of the rate hike cycle appears to be behind us; while the pivot is still not at hand, although the market acted as such on Oct 13th with a top-20 upward move day.

Stock Valuations: While the S&P 500 is down around -16% in 2022, the year-to-date maximum drawdown (defined as the decline from a stock's peak to its lowest point) for the average index member is roughly -34%. For the Nasdaq, the average stock has endured a peak-to-trough decline of -50% at some point in 2022. These are significant corrections and suggest much of the downside damage has already occurred. In addition, there is increased demand in the form of corporate buybacks, which are on pace to hit a record $1.25 trillion this year in the US alone. At these depressed prices, corporations are racing to buy back shares before the end of the year, after which a 1% excise tax will be imposed on stock repurchases.

High Yield Canary is Quiet: The high yield bond market is considered a "canary in the coal mine" for markets generally, with shifts in the high yield bond market frequently preceding similar moves in equities. High yield bonds are not presently flashing many of the recession warnings, largely because high yield issuers pounced on a gift from the Fed in 2020, when the central bank provided a backstop measure and went into markets bidding for high yield bonds for the first time in history. This move, combined with the Fed rate cuts, allowed many HY borrowers to refinance their debt at rock-bot-

tom rates. Therefore, little high yield debt is maturing in the next few years, which may enable the weakest corporate borrowers to weather a recession with minimal defaults.

Return to Normalcy: The economic stimulus that enabled the US to weather the depths of the COVID-19 pandemic had the unfortunate side effect of ushering a wave of rampant speculation, and in the worst cases, fraud. One by one, these excesses are unraveling, and the froth is working its way out of the economy. Consider Special Purpose Acquisition Vehicles, or SPACS, the blank check backdoor IPOs which dominated headlines in 2021. After growing to $162 billion in 2021, SPACs have evaporated to a $12 billion market in 2022. We are now seeing a similar collapse in cryptocurrencies, the vast majority of which are simply unregulated securities rather than actual currency alternatives. As these speculative bets implode, capital will flow back into traditional, regulated markets once again.

Forget Turkey; try the Black Swan

We would be remiss to ignore the Ukraine war, which for a moment appeared to have escalated into a possible NATO conflict. The war has become an afterthought in US media, with the collective short attention span of US citizens moving on to other matters. Not so for those suffering in it however, and our thoughts and prayers go out to them. The downside risk is obvious after a stray rocket veered into NATO-member Poland last week, but a positive resolution is potentially in play, particularly after Russia's defeat in Kherson, and the growing unpopularity of the war as poorly equipped Russians are conscripted into the conflict. Bottom line is the war could produce a major "black swan" volatility event to either the upside or downside. If nothing else, keeping the war in the forefront of our minds provides some much-needed perspective on why we, in the US, should be thankful this season.

Thank you, as always, for the opportunity to serve you.

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