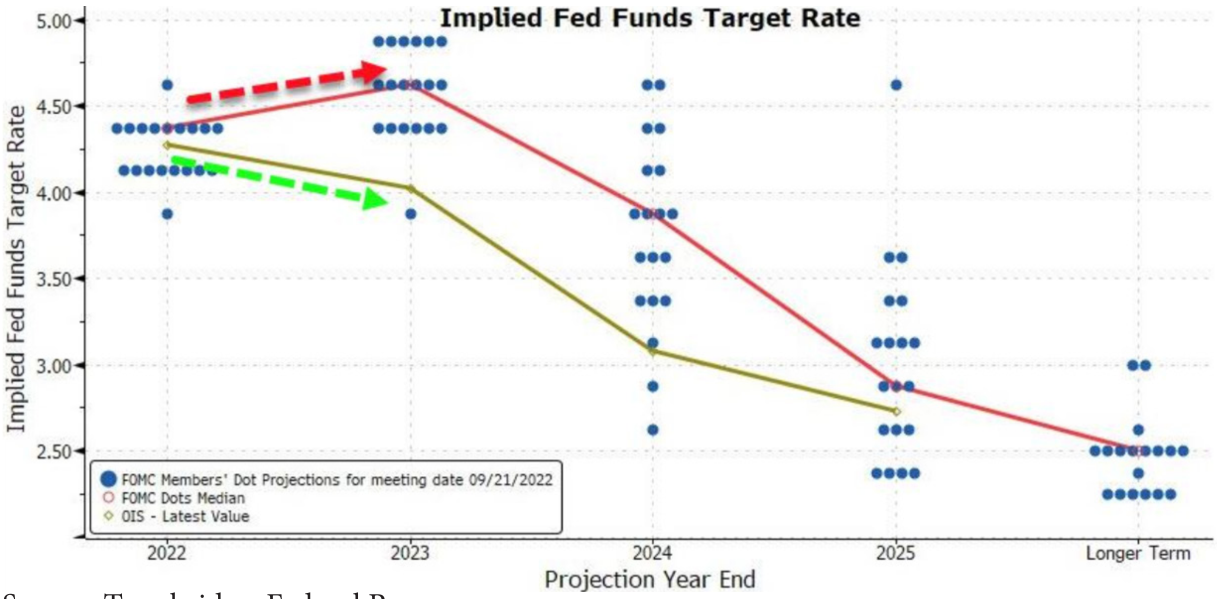
Week in Review

Friday, September 23rd, 2022

1. Hawkish Fed Policy Weighs on Financial Markets

The Federal Open Market Committee (FOMC) raised the funds rate target range by 0.75 percent to 3-3.25 percent, as widely expected. The FOMC also released projections for future rate increases, known as the dot plan. The median dot now shows a funds rate midpoint of 4.375 percent at the end of 2022 and 4.625 percent at the end of 2023. This path likely corresponds to a 0.75 percent hike at the November meeting, a 0.50 percent hike in December, and a 0.25 percent hike in January, which was well above forecasts from just several months ago.



Source: Trowbridge, Federal Reserve

After peaking in 2023, the median dot shows 1.75 percent of cumulative cuts between 2023 and the end of the FOMC's forecast horizon of 2025, but fifteen out of nineteen participants still projected a funds rate above the median longer-run dot (of 2.5%) in 2025.

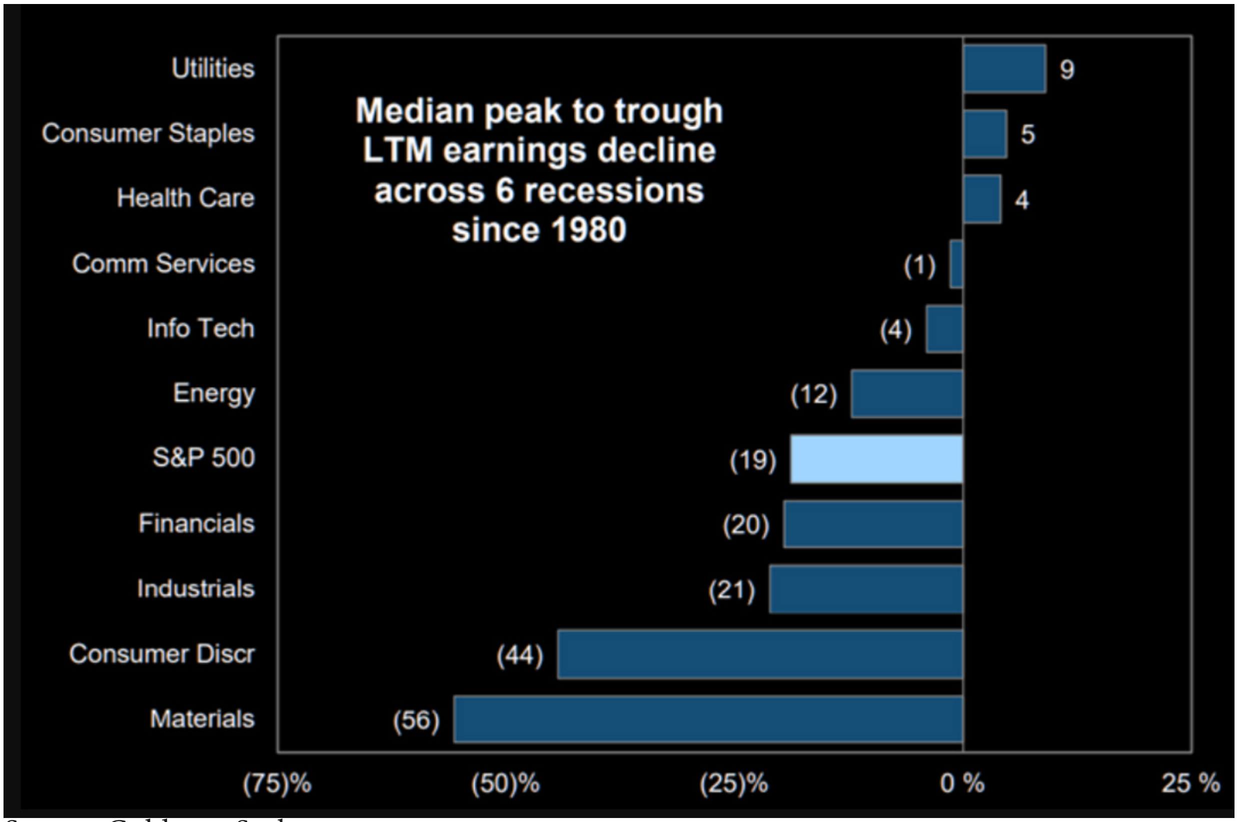
The primary takeaways from this week's rate hike were hawkish. Expectations are being reset for a higher and longer backdrop for the Federal Funds rate driving a further tightening of financial conditions and keeping the path of least resistance for risk assets lower.   Also playing into concerns are worries about recession and the potential for a hard landing scenario for the economy.

In the immediate afтermath of the release, financial market volatility prevailed. In the fixed income markets, the direction for short-term rates has been upward while longer-term yields have stabilized resulting in an elevated inversion (short-term rates greater than long-term rates) of the yield curve. In the equity markets, defensive posture was reinforced. Globally, the dollar continued its appreciation relative to foreign currencies, pressuring international investments in dollar terms.

2. As Recession Concerns Grow Investors Can Look to History for Earnings Trends

As interest rates move higher for longer, corporate earnings are likely to play an increasingly bigger role from a directional standpoint for financial markets given the debate about the extent to which consensus estimates still need to come down to reflect a softening macro backdrop and inflation/margin pressures. Of growing concern is that the myriad of issues facing the economy will precipitate a recession.

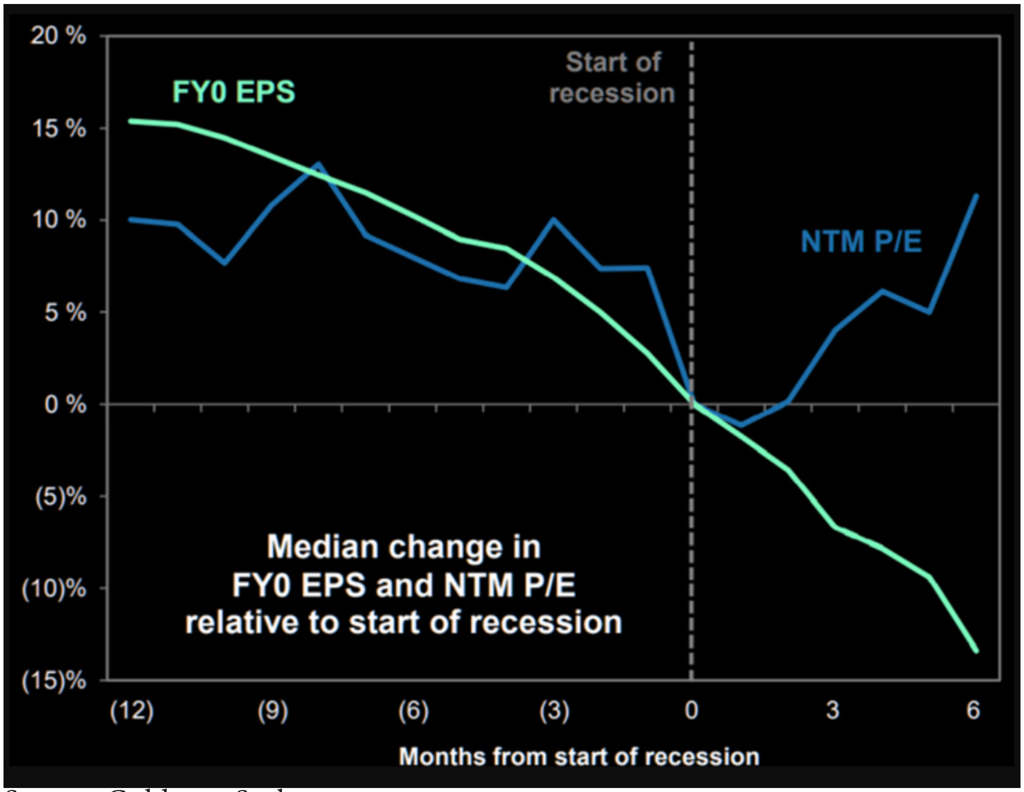
Recessions do not impact all sectors equally. The following chart from Goldman Sachs looks at the historical earnings impact on sectors from best to worst based on the six recessions since 1990.



Source: Goldman Sachs

The dispersion of impact is significant with the materials and consumer discretionary sectors realizing significant decline, while defensive sectors such as utilities, consumer staples, and healthcare were historically able to maintain positive growth.

However, earnings growth is only one side of the equation for returns through the cycle as multiples for the sectors deemed at greatest risk tend to compress prior to a recession, while defensive sector multiples may expand and then stagnate. Also of note, the market tends to position for a recovery well before the bottoming of earnings takes place. Historically, multiples are already expanding, particularly for the hardest hit sectors, shortly after the economy has entered a recession.



Source: Goldman Sachs

On the back of a higher funds rate path and tighter financial conditions, the probability has increased that the U.S. will face a recession in the coming year. Near term this will likely place further pressure on financial markets. Positioning portfolios in businesses with greater visibility and less risk of significant negative earnings revisions can be beneficial in the short run. Investors also need to balance the longer-term perspective as valuations and opportunities tend to be the most attractive when fundamentals are at greatest risk of deterioration. For the time being, the rise in short term yields and ability to get 4% returns with relatively low risk is a positive balance to the growing risk of recession.

Thinking Ahead

The increased trajectory of hawkish Fed policy continues to weigh on financial markets and elevate the risk of recession. For the equity markets, sectors, and businesses with high visibility for stability and growth may continue to be rewarded. However, history has shown that more cyclical businesses see valuations expand well before the full effect of earnings downturns have been realized. The difficulty in predicting the exact bottom in fundamentals and valuation tends to reward longer-term positioning for diversified portfolios.

Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.