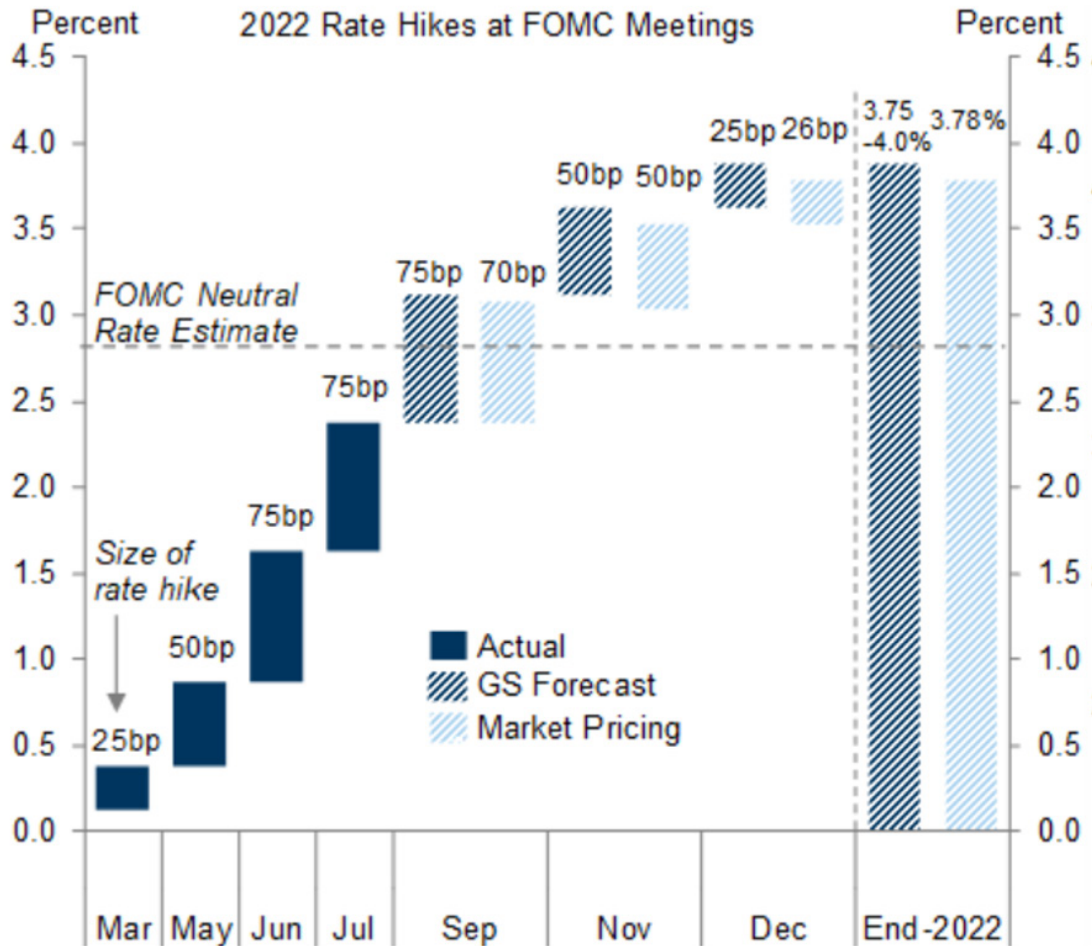
PALLAS CAPITAL ADVISORS

Week in Review

Friday, September 9th, 2022

1. Fed Funds Rate Expectations Rise into Year End but Could Reflect a Peak

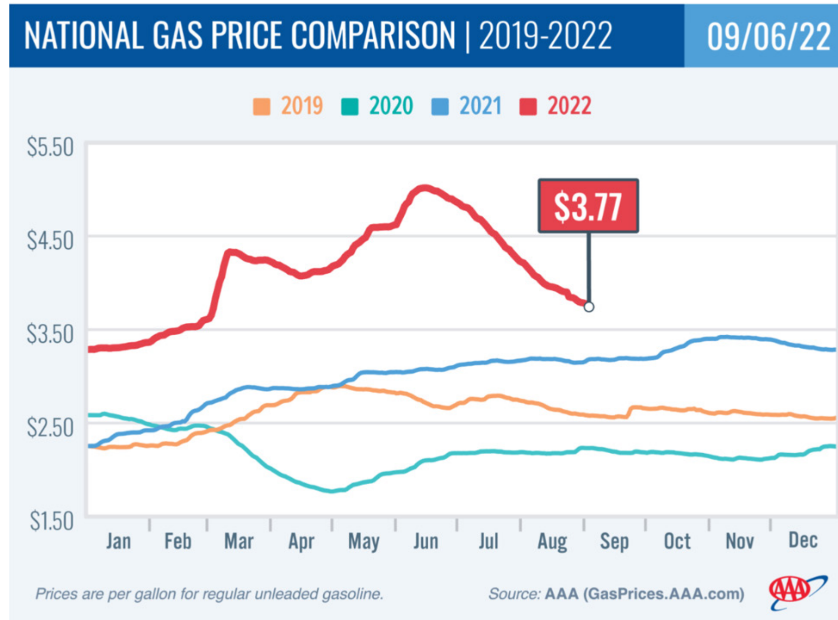
Following Jackson Hole and subsequent Federal Reserve commentary, the expectation for the Fed Funds rate has increased for the rest of 2022. The market is now pricing rate increases of 75-50-25 basis points in the next three Fed meetings scheduled for September, November, and December. If this path of rate increases comes to pass, the Fed Funds rate at the end of the year would be approximately 4.0%.



Source: Federal Reserve, Goldman Sachs Global Investment Research

This level of Fed Funds rate is well above expectations coming into 2022 due to much higher inflation. The higher-than-expected rate path has been a significant weight on the financial markets with both equities and bonds seeing material declines driven by valuation resets. Looking forward, inflation trends will be the determinant of whether the current expectations will signify a peak. In that regard, there is reason to believe that the trend for inflation will be towards moderation.

One area driving inflation in the first half of the year that has come down is fuel prices. AAA released data this week that shows gas prices have retraced a significant portion of the rise in 2022. Going forward, the delta in year-over-year comparable price will become easier.



Consumers are also getting some pricing relief in other areas since the beginning of the summer, which also should temper inflation as illustrated by a compilation of data put together by CNBC.

10 things that are cheaper now than they were a month ago

Item	Change
Boneless, skinless chicken breast	–23.6%
Butter	–13%
12 large white eggs	–9.3%
A gallon of milk	–2.5%
Hot dogs	–6.1%
Tomatoes	–2.5%
Car rentals	–9.5%
A gallon of unleaded regular gas	–8%
Airfare	–7.8%
A night in a hotel	–3.2%

Table: Gabriel Cortes / CNBC
Source: Prices for chicken breasts, butter, eggs and milk from the U.S. Department of Agriculture's retail market reports from Aug. 12, 2022. All other prices from the U.S. Bureau of Labor Statistics' Consumer Price Index for July 2022.

However, offsetting areas of decline for consumer prices, expectations are that labor and housing costs will continue to pressure consumer prices well above the Federal Reserve's long-term target of 2%. Investors will be paying close attention to upcoming economic data. On September 13, the latest inflation data will hit the wires, and markets hope to see the rate of price increases decline. In July, the consumer price index rose 8.5%, which was down from an increase of 9.1% in June.

While there will be a lot of attention on the near-term CPI releases, it is reasonable to see inflation on a year-over-year basis moderate meaningfully in 2023. With a Federal Funds rate now expected to end the year at near 4%, the probability is high that inflation in 2023 may come in below the Fed Funds rate, setting the stage for a peak in this tightening cycle and opening the possibility of future cuts in the rate. Historically financial performance has generally been positive following a peak in the Fed Funds rate.

S&P Performance Around Date of Last Fed Funds Rate Hike

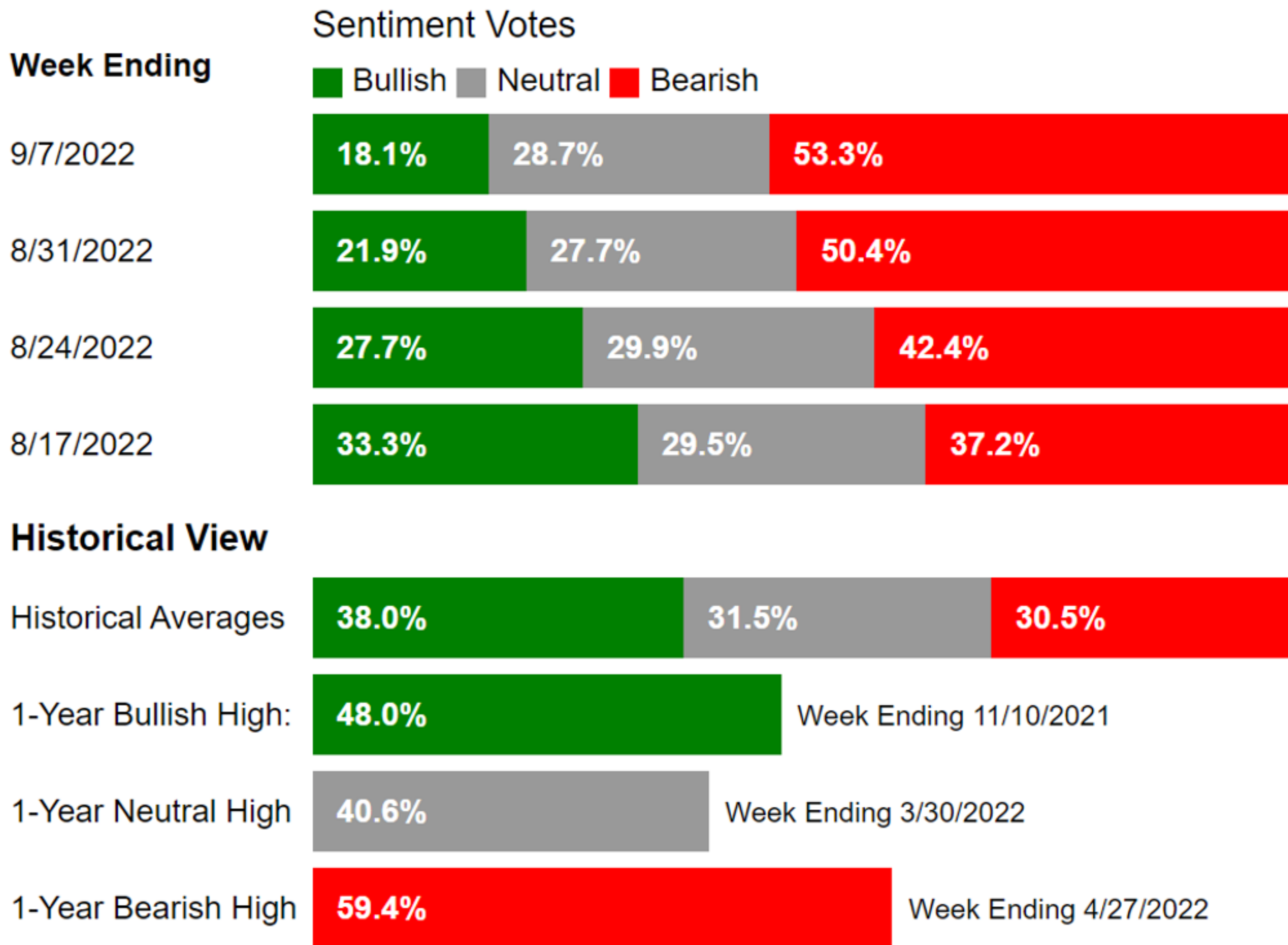
Source: Datastream, Goldman Sachs Global Investment Research

A path to visibility in the peak in the Fed Funds rate is positive, although we are not there yet based on current expectations for rate increases for the rest of the year. Near-term volatility in financial markets may continue as the Federal Reserve remains hawkish in its policy and messaging. Of course, adding to the volatility in the markets will be the path of the economy and earnings expectations. Estimates have come down for 2022 and 2023 on weaker corporate guidance and recession concerns, but for now reflect a soft landing for the U.S. economy, which supports a more constructive view for the longer-term investors.

2. Investor Sentiment Returns to Levels Near Record Lows

Recent trends in the AAII Sentiment Survey show a surge in bearish sentiment. Bearish sentiment is based on the survey of individual investors indicating an expectation that the market is heading down in the next six months.

AAII Investor Sentiment Survey



Source: AAII

The Sentiment Survey is a contrarian indicator. Above-average market returns have often followed unusually low levels of optimism, while below-average market returns have often followed unusually high levels of optimism.

The survey illustrates that sentiment has been very volatile this year and after improving during the summer rally, bearish sentiment is reaching the nadir level reached in late April. These levels are not only low for the year, but also among the lowest readings in the survey's 35-year history. While the reasoning for bearish sentiment is supported by a hawkish Fed and declining earnings estimates, the survey suggests that at least some level of headwinds is already reflected in the markets.

Thinking Ahead

As the Federal Reserve remains on its hawkish path and headwinds mount to earnings, financial markets remain in a period of likely heightened volatility. At the same time, the foundation for curbing inflation is likely to be put in place to allow a peak Fed Funds rate which historically has been correlated with more stable and upward-biased financial markets. Lower earnings revisions and fear of recession coupled with average valuation multiples remain risks, but negative sentiment suggests that these risks may to some degree be widely acknowledged.

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

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