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Weekly Market Commentary
October 3rd, 2022

The Big Old Grizzly Bear May Be Camping Out

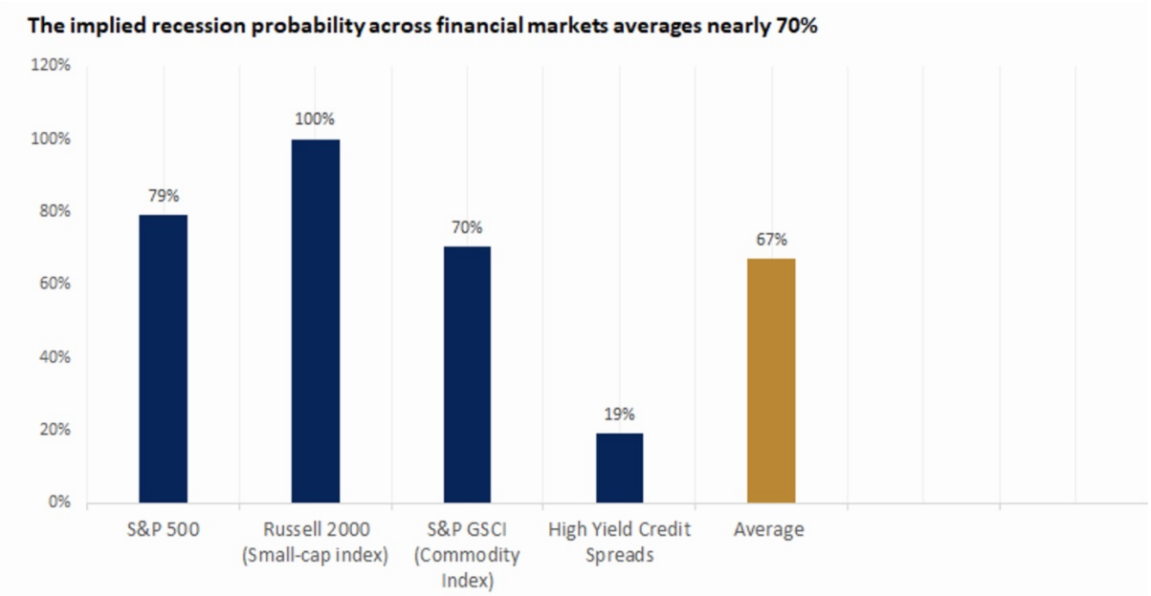
Markets pricing in a new base-case scenario: Economic downturn

Over the past several weeks, and especially since the last FOMC meeting, market volatility has reemerged. The S&P 500 has entered bear-market territory once again, down about 23% for the year. And while there had been debate around whether the economy could emerge from this tightening cycle in a "soft landing," financial markets now broadly seem to be pricing in a new base-case scenario: A recession is on the horizon (see chart below).

Perhaps the silver lining here is that a pending recession has been well advertised by many market participants, including Fed Chair Jerome Powell. As Powell noted in his last press conference, "The chances of a soft landing are likely to diminish to the extent that policy needs to be more restrictive, or restrictive for longer." And now the focus may shift to when and how deep a potential economic downturn may be.

Barring any external shocks to the system – which are typically difficult to handicap – we do not yet see the scope for a deep or prolonged recessionary environment in the U.S. The labor market continues to show resilience, the banking and financial system are structurally sound (and in better shape than prior to the great financial crisis in 2008), credit markets appear orderly, and the economy is less reliant on foreign energy sources than others around the globe. Last week we did see stress in the U.K. credit markets that caused the Bank of England to step-in and stabilize markets. While credit markets in the U.S. have not shown similar signs of distress, the probability of a financial disruption rises as central banks continue to aggressively raise rates.

Figure 1. Financial markets are pricing in higher probabilities that a U.S. recession is on the horizon



Source: FactSet, Edward Jones calculations, past performance is not a guarantee of future returns.

This chart shows the probability of a recession being priced across asset classes with the average around 70%, indicating a high probability of recession in the future. An interesting callout is the high yield credit spreads which have remained contained and a very low probability of recession compared to other asset pricing.

What history tells us about returns during shallow downturns

While every cycle is unique, history can offer some guideposts on returns around recessionary periods. Historically, market downturns in average or shallow recessions tend to be around -25% to -35%, and last around 10 to 15 months. The recovery period can also range from nine months to two years. Keep in mind that in deep recessions, the losses and recovery times can nearly double, but typically they are accompanied by some structural or systemic issues, which have not yet emerged in the U.S. economy. With equity markets down over 20% currently, much of the work to the downside may have been put in already, as financial markets price in the economic downside ahead.

Three signals to heed in a market-bottoming process

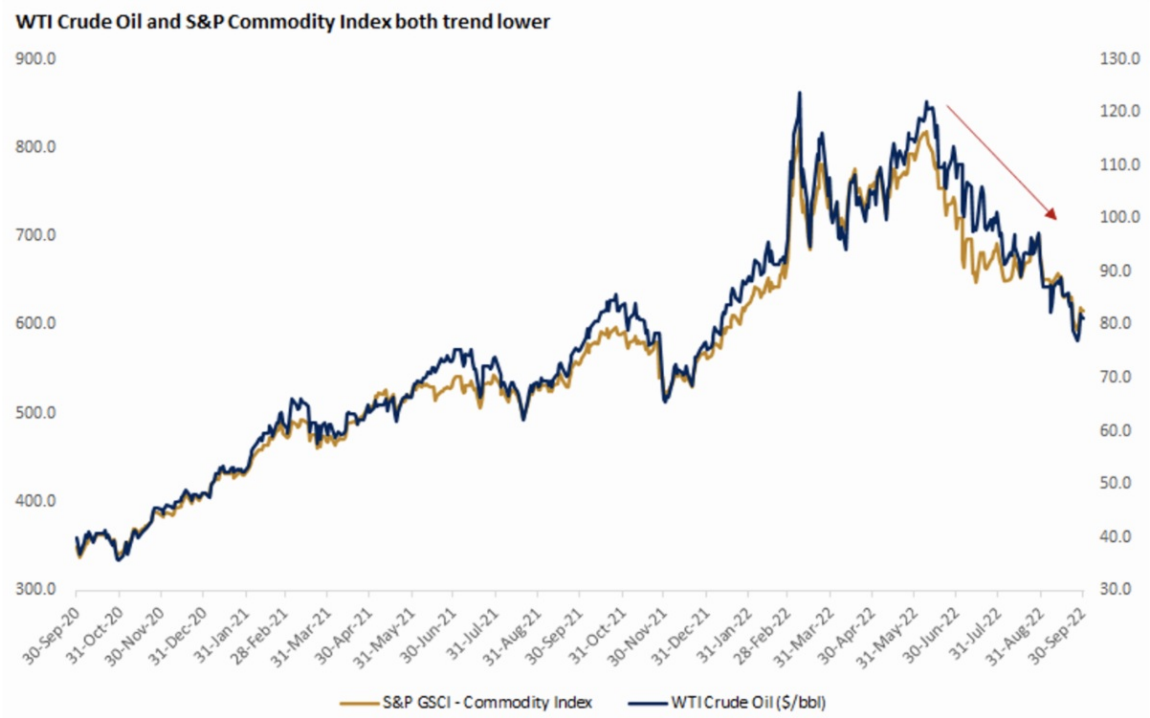
While the economy may continue to soften in the coming months, history also shows us that markets tend to be forward-looking and can start to recover even as economic and earnings measures continue to decline. The question that investors may be asking now is, "What are the key signals to look for that show a market bottom is in place?"

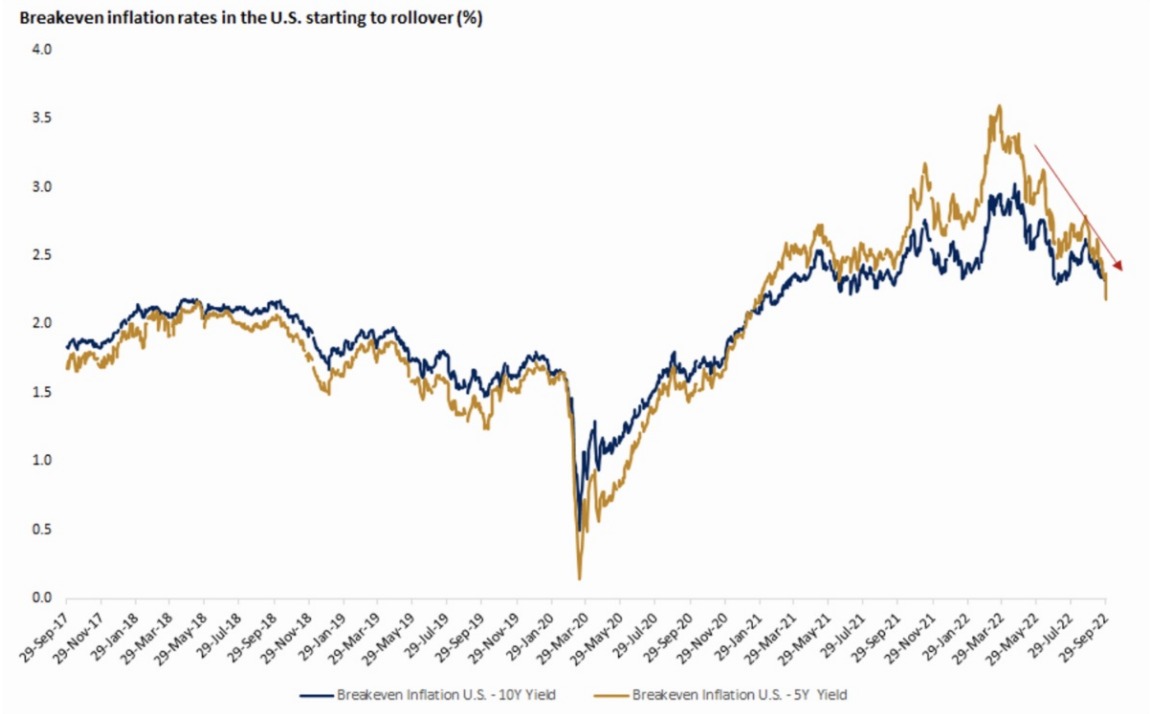
Market bottoms (and market tops) are notoriously difficult to time. In our view, it is better for investors to have time in the market than to try to time themselves in and out of the market. Nonetheless, there are signals to monitor that may help indicate that a bottoming process is underway. We highlight three of these below:

1. **Inflation moving lower:** Inflation has been an overhang on markets all year, as consumer price indexes have soared close to 40-year highs. The Fed and central banks around the world now view bringing down inflation as their No. 1 priority when setting monetary policy. The Fed has already indicated that it will continue to raise rates until it sees "clear and consistent" evidence that inflation is abating. This likely means that the Fed would want to see three to four readings lower in inflation before pausing its rate-hiking campaign. In our view, this type of consistent move lower in inflation would be a signal that markets may be in a bottoming phase and could mount a more sustainable rally.

Perhaps the good news is that inflation is starting to show early signs of rolling over. We have seen oil and commodity prices move directionally lower since mid-June, while gas prices at the pump continue to cool. Other measures, including supply-chain pressure indexes, break-even inflation rates, and inflation expectations are all moderating as well. One portion of inflation that remains persistent, however, is the shelter and rent components of core CPI. In our view, while these parts of inflation may take longer to come down, the underlying trends seem to be softening. The housing market, for example, is showing signs of a slowdown, as mortgage rates climb higher (with 30-year mortgage rates heading towards 7.0%) and home-price appreciation moderates. Over time, these trends should be reflected in core CPI figures as well.

Figure 2. Measures like oil and commodity prices and break-even inflation rates indicate that inflation may be moderating





Source: FactSet, past performance is not a guarantee of future returns. The S&P GSCI index is unmanaged and cannot be invested in directly.

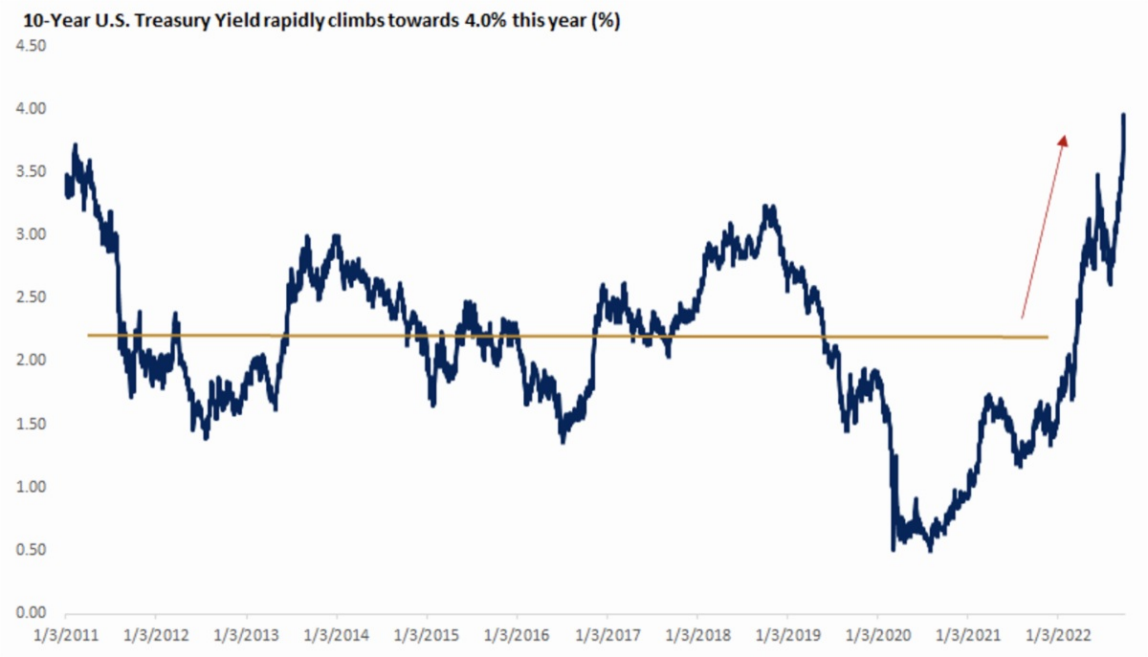
Prices for crude oil, WTI, and Commodities have been falling recently from highs reached earlier in the year. WTI crude oil reached over $120/barrel in Feb & June and is now trading around $80.

2. **Bond yields stabilizing and ultimately coming down:**Since the last big crisis -- the Great Financial Crisis in 2008-2009 -- bond yields have remained relatively contained and, in some cases, even near zero. For example, the 10-year U.S. Treasury yield averaged about 2.0% in the 10 years prior to 2022. This had supported financial markets, especially equity markets, as investors and companies could borrow at lower rates, had ample liquidity, and were being rewarded to take on risk.

However, bond yields have moved steadily higher this year, as the Fed and global central banks have raised interest rates to slow demand. The 10-year Treasury yield this year went from 1.5% to nearly 4.0% for the first time since 2008. The rapid move higher in yields has put downward pressure on equity markets and valuations, especially the higher-valuation and more speculative parts of the market.

In our view, if 10-year yields stabilize and ultimately start to move lower, this could be a signal of a bottoming process for markets. Historically, yields tend to move higher until about two months ahead of the final Fed rate hike. A stabilization in yields may indicate a potential pause in Fed rate hikes is forthcoming, and perhaps over time a potential pivot lower.

Figure 3. If long bond yields stabilize from current elevated rates, this could support a more sustainable rebound



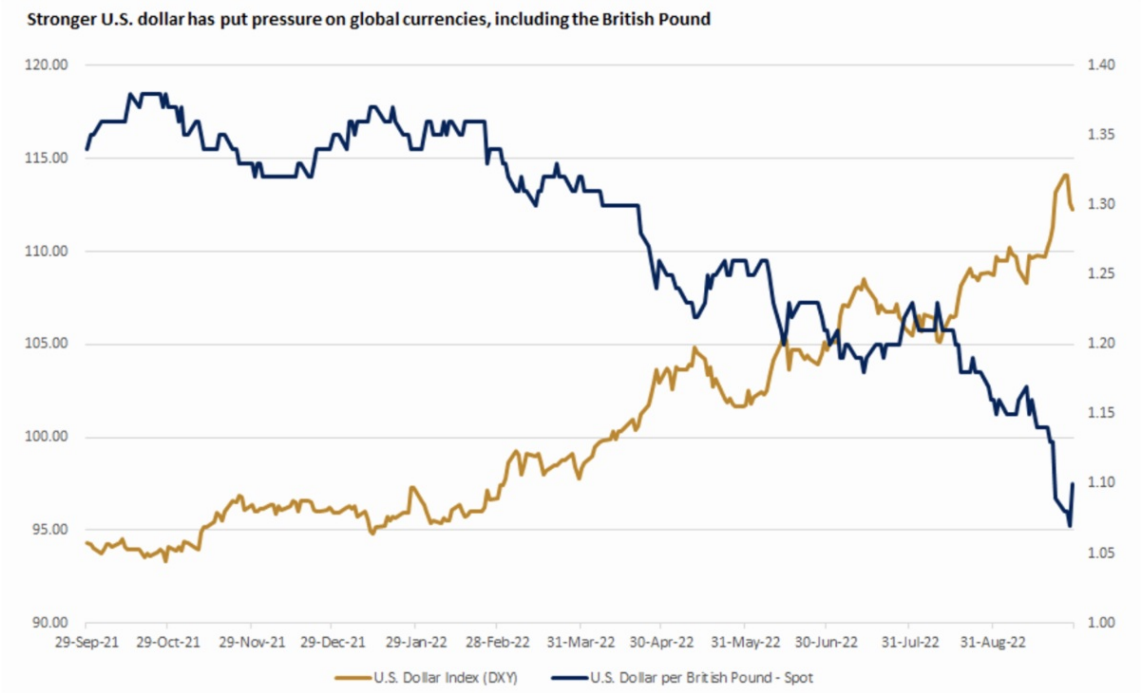
This chart shows the U.S. breakeven inflation rates as they've started to roll-over after reaching a high earlier in the year along with oil and the CPI. Breakeven rates are approaching the 2% Fed target.

3. **U.S. dollar softening:** The U.S. dollar has been moving higher all year as well, with the DXY dollar index up nearly 17% this year and up 25% since early 2021. This move has been driven by several factors, including the relative rate moves by the Fed versus global central banks and the relative resilience of the U.S. economy. The dollar also tends to be a safe-haven currency for investors, especially when global growth is weakening.

There have been some disruptions in global markets due to a higher dollar, as major currencies around the world have weakened, signaling less confidence in those economies. In addition, the stronger dollar has put downward pressure on emerging-market equities, with the MSCI Emerging Market Index down nearly 30% this year. And U.S. companies that export goods or services have also been hurt by the stronger dollar, which makes their products more expensive abroad.

Thus, another signal to watch for as part of a market-bottoming process is if the U.S. dollar stabilizes and ultimately moves lower, which may also occur ahead of a pause in the Federal Reserve rate-hiking cycle. This would ease financial conditions and support a potential market recovery.

Figure 4. A strong U.S. dollar has driven many global currencies weaker, including the British pound



Source: FactSet.

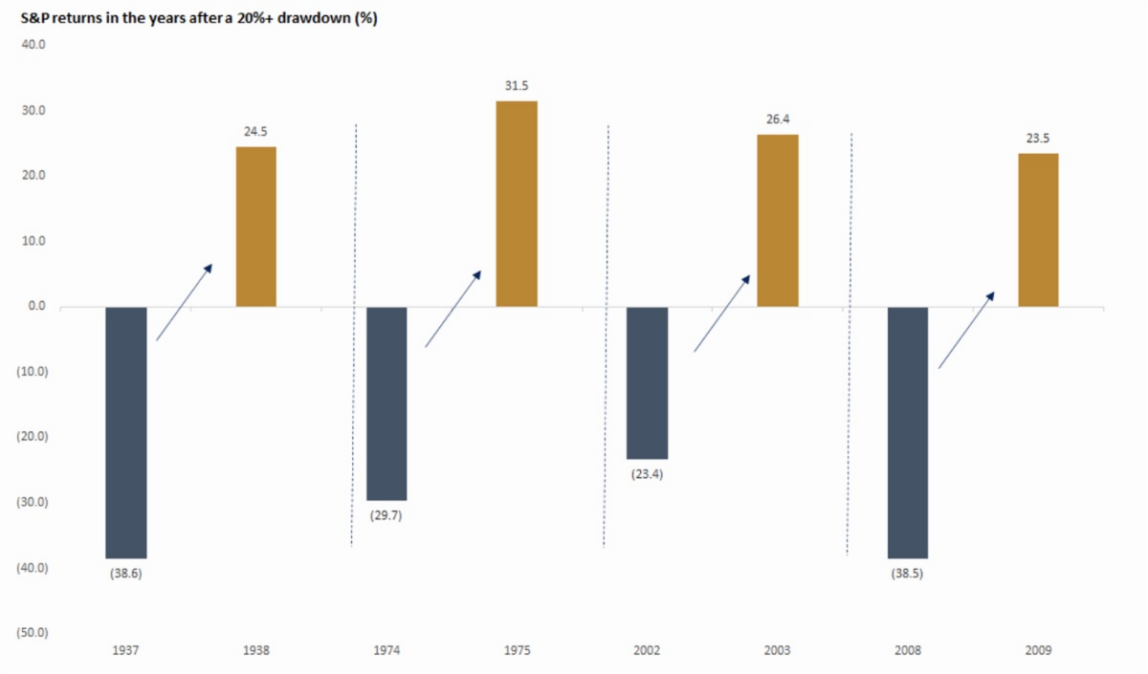
This chart highlights the swift move in U.S. and Canadian 10-year treasury rates toward 4% as the Fed and Bank of Canada has embarked on its aggressive rate hiking cycle.

The silver lining: After a 20%+ drawdown, returns in the following year are strong

Overall, markets have been challenging this year, but history tells us we may be closer to the end of the downturn than the beginning. We will be watching inflation, yields, and the dollar as some of the key indicators that could signal a bottoming process in financial markets. Nonetheless, we would expect any sustainable market recovery to take time as well, as we unwind some of the dislocations from the pandemic period. In our view, this cycle takes on a more gradual "U-shaped" bottom and rebound versus recent sharper "V-shaped" recoveries.

But the good news for investors is this: Since 1935, any time the S&P has fallen more than 20% in one calendar year, the returns in the following year are positive, and by an average of about 25%. So for long-term investors, this bottoming process may also be an opportunity – to diversify, rebalance, or put new capital to work in quality investments at potentially better prices – ahead of a potentially robust recovery.

Figure 5. Since 1935, years, when the S&P 500 was down 20% or more, were followed by years with strong double-digit returns



(Source: oXYGen & Jones)

Markets For The Week

INDEX	CLOSE	WEEK
Dow Jones Industrial Average	28,726	-2.9%
S&P 500 Index	3,586	-2.9%
NASDAQ	10,576	-2.7%
MSCI EAFE	1,655	-1.9%
10-yr Treasury Yield	3.82%	.1%
Gold	$1,664	1.28%
Bonds	$96.26	-1.0%

Earnings Highlights This Week

Nike: Nike first fiscal quarter revenue was up 4% to $12.69 billion, beating estimates. Nike net income was down 22% to $1.5 billion. The sneaker giant said inventory on its balance sheet was up 44% to $9.7 billion, driven by continued supply chain issues.

Bed Bath & Beyond: Bed Bath & Beyond reported a 28% drop in quarterly sales and a wider-than-projected loss. The results came from the three-month period before the struggling retailer unveiled an aggressive turnaround plan. In late August, the company said it would change its merchandise strategy, close 150 stores and lay off some employees, as it also secured a new loan ahead of the holiday season.

Lego: Lego revenue jumped 17% during the first six months of 2022, reaching $27 billion Danish krone, or about $3.5 billion. Top building sets included models from Lego Star Wars and Lego Harry Potter, as well as its homegrown Lego Technic and Lego City. During the first half of the year, the company opened 66 shops worldwide, including 46 in China.

News and Notes:

October 1: It's Time To File Your FAFSA Forms

The Start Date Is Much Earlier

- Applications officially can be filed on October 1st vs. January 1st
- Make sure to check your state filing dates as well

How Will FAFSA Pull My Income Tax Returns

- For those filing 2023-2024 FAFSA (July 1, 2023 to June 30, 2024)
- You will use your 2021 Tax Return

Create Your FSA ID ASAP (www.fsaid.ed.gov)

- FSA ID is now a legal electronic signature for FAFSA (Parents/Students)
- Make sure you fill out the correct year on the application
- Have your Social Security number handy

Gather All Of Your Household Financial Data

- Know what NOT to include
- Equity in a primary residence, 401(k)'s, IRA's, business ownership

Prepare College Applications and Financial Aid At The Same Time

- List any schools you'll be applying to when filling out FAFSA
- The early bird gets the worm- FAFSA first come, first serve

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