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A rough quarter

The third quarter brought a brutal sell-off, with positive returns difficult to find in any asset class.

Negative sentiment

Negativity is understandable, but it can overshadow any glimmers of positive signs.

Six positive signs

I see multiple reasons to maintain some positivity even in this difficult market environment.

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The third quarter is finally over, and I venture to say most will not miss it. The quarter started off on a positive note, with a continuation of the stock market rebound that began in mid-June. However, that rally ended by mid-August. What followed was a brutal sell-off for equities. And it wasn't limited to stocks — bonds and equities fell globally in the quarter as central banks tightened aggressively and investors priced in higher policy rates, higher discount rates, and lower near-term growth. Commodities — especially energy — also finished lower, helped by the strong dollar and weakening global demand.

It's hard to find an asset anywhere in the world that posted positive returns in the third quarter; the main exception is the US dollar. This environment is weighing down sentiment in an extreme way. Many people I speak to are becoming extremely pessimistic. Some are drawing analogies to the Global Financial Crisis, some even suggesting this time could be worse. An old friend called the other day to complain about the market environment and lament that history is repeating itself. I wondered which part of history and he explained, "The 1920s! First the pandemic and now the depression."

I understand that it's human nature to react to the panic that we're hearing from all those around us. But I couldn't help but note that my friend's negativity caused him to completely overlook the Roaring Twenties — even a decade as notorious as the 1920s included a few good years. So in the spirit of identifying the positive in the midst of the negative, I wanted to share with you some positive thoughts in this difficult market environment.

Six positive signs I see in the markets

1. The AAI Sentiment Survey¹ indicated a dramatic increase in bearish sentiment in late September, rising above 60% in the Sept. 21 reading. This was the highest level reached since the 70.3% bearish sentiment reading on March 5, 2009. The Sept. 28 sentiment reading saw bearish sentiment remain above 60%, marking the first time since the survey's inception in 1987 that we saw two consecutive weeks of 60+% bearish sentiment. Why do I call this a positive sign? Historically, the S&P 500 Index has had above-average six-month returns following unusually high bearish sentiment readings.
2. The 3-month/10-year US Treasury yield curve, considered to be just as accurate a predictor of recessions as the 2-year/10-year curve, has not only not inverted yet — but it has actually widened modestly since mid-September.² This suggests to me that a US recession is not necessarily a fait accompli — and even if we do enter a broad recession, it may be relatively shallow.
3. High yield spreads are still relatively well behaved. The ICE Bank of America US High Yield Index Option-Adjusted Spread, while creeping up, is still well below its peak for the year.³ This is also true for the ICE Bank of America Euro High Yield Index Option-Adjusted Spread, despite significant economic headwinds facing Europe.
4. Some inflationary pressures have been easing, such as the New York Fed Global Supply Chain Pressure Index.⁴ Inflation expectations

are also easing, with the University of Michigan Survey of Consumers showing US consumers' five-year ahead inflation expectations decreased to 2.7% (the lowest since July 2021) and one-year ahead inflation expectations lowered to 4.7%.⁵ This could encourage the Federal Reserve to become less aggressive in tightening, which would likely help moderate the US dollar rally and ease some of the pressures globally.

5. Bad news is sometimes good news. Growth estimates continue to be lowered. For example, last week, the Organisation for Economic Co-operation and Development (OECD) released its forecast that the eurozone economy will grow by only 0.3% in 2023, while Germany is expected to contract by 0.7%.⁶ On Oct. 3, we got the Institute for Supply Management Survey results, which showed a significant deterioration in the manufacturing Purchasing Managers' Index (PMI). In particular, new orders (which can be viewed as the "canary in the coalmine" because they are a leading indicator of what's to come) dropped from 51.3 in August to 47.1 in September – well within contraction territory.⁷ Central banks want to see cooling demand because that is the only component of inflationary pressures that it can arguably control. For example, a worse-than-expected US employment report this Friday would likely be greeted positively by markets hoping for some data that could encourage the Fed to make even a subtle pivot.

6. Whether they want to admit it or not, government institutions have risen to the occasion as backstops when truly needed. They continue to show a willingness to step in and respond to major crises — and even work pre-emptively to avert them. Think of the intense response to the pandemic on the part of so many governments. In the last several weeks, Japan's Ministry of Finance stepped in to support the yen and the Bank of England temporarily abandoned its quantitative tightening efforts in order to buy gilts and bring down sky-high yields. What we have learned in recent years is that in the face of serious crisis, restoring financial stability will likely trump other central bank goals such as controlling inflation. The Bank of England's pledge to buy bonds at "whatever scale necessary" is reminiscent of former European Central Bank President Mario Draghi's pledge about a decade ago to do "whatever it takes" to support the euro.

An additional driver for the fourth quarter

I think it's fair to say that central banks have been the key driver of markets so far this year, as "fast and furious" rate hikes have caused multiple compression and sent stock prices lower. As we enter the fourth quarter, I expect there to be an additional driver of stock market performance: earnings. I don't expect earnings season to be pretty — but the question is how much is already priced into stocks.

Analysts have already materially lowered estimates for third quarter earnings since June. The estimated earnings growth rate for the third quarter is now just 2.9% (down from 9.8% as of June 30), which, if it comes to fruition, would be the lowest rate since the third quarter of 2020.⁸ While more S&P 500 companies have issued positive earnings guidance for the third quarter than they did for the past two quarters,⁸ I'm still prepared for earnings to modestly disappoint relative to current expectations, although that largely appears to have been priced into stocks. I'm more concerned about forward guidance and how the fourth quarter evolves. In other words, earnings reports will join central bank meetings and speeches as the equivalent of "must see TV" as we assess the damage that high inflation and rising rates have wrought, and hear about expectations for the fourth quarter.

Notes

¹Source: American Association of Individual Investors, as of Sept. 28, 2022

²Source: Bloomberg, L.P., as of 9/30/22

³Source: Bloomberg, L.P., as of 9/30/22

⁴Source: NY Fed Global Supply Chain Pressure Index, as of 8/31/22

⁵Source: University of Michigan Survey of Consumers, 9/30/22

⁶Source: Organisation for Economic Co-operation and Development, "Interim Report September 2022: Paying the Price of War"

⁷Source: Institute for Supply Management, 10/3/22

⁸Source: FactSet Research Systems, as of 9/30/22

Important information

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

The American Association of Individual Investor's AAI Sentiment Survey offers insight into the opinions of individual investors by asking them their thoughts on where the market is heading in the next six months.

The ICE Bank of America US High Yield Index tracks the performance of US dollar-denominated, below-investment-grade corporate debt publicly issued in the US domestic market.

The ICE Bank of America Euro High Yield Index tracks the performance of euro-denominated below-investment-grade corporate debt publicly issued in the euro domestic or eurobond markets.

Option-adjusted spread (OAS) is the yield spread which must be added to a benchmark yield curve to discount a security's payments to match its market price, using a dynamic pricing model that accounts for embedded options.

The New York Fed's Global Supply Chain Pressure Index (GSCPI) integrates a number of commonly used metrics with an aim to provide a more comprehensive summary of potential disruptions affecting global supply chains.

The Survey of Consumers is a monthly telephone survey conducted by the University of Michigan that provides indexes of consumer sentiment and inflation expectations.

An inverted yield curve is one in which shorter-term bonds have a higher yield than longer-term bonds of the same credit quality. In a normal yield curve, longer-term bonds have a higher yield.

The Organisation for Economic Co-operation and Development is an intergovernmental organization that collaborates to develop policy standards to promote sustainable economic growth.

The Manufacturing ISM® Report On Business® is a monthly report of economic activity in the manufacturing sector based on data compiled from purchasing and supply executives nationwide. It is published by the Institute for Supply Management.

The Purchasing Managers' Index (PMI), a commonly cited indicator of the manufacturing sectors' economic health, is calculated by the Institute of Supply Management in the US.

Tightening is a monetary policy used by central banks to normalize balance sheets. UK gilts are bonds issued by the British government.

The opinions referenced above are those of the author as of **Oct. 3, 2022**. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.