



Kristina Hooper
Chief Global Market Strategist



Disconnects abound

In today's market environment, there are so many disconnects that raise uncertainty about a variety of issues.

Disconnects aren't always negative

After all, they can present investing opportunities as the chasm between conflicting expectations has to close one way or the other.

I'm hearing the term "disconnect" more frequently lately, describing a lack of communication or agreement. I can definitely relate on a personal level: I just returned home after nine days on the road attending two back-to-back basketball tournaments with my daughter, and I discovered a great disconnect between my definition of a "clean" house and the definition used by my husband and two teenage sons, who were left on their own for more than a week.

Disconnects aren't always quite that unpleasant, however. In markets, many investors welcome disconnects. After all, they can present investing opportunities as the chasm between conflicting expectations has to close one way or the other. When that happens, some investors may tactically benefit from the actions they take in anticipation of their version of reality.

Five disconnects I see today

In today's market environment, there are so many disconnects that raise uncertainty about a variety of issues. Here, I highlight five.

1. Recession. Is the US going into recession? There's definitely a disconnect on that question. For example, the 2-year/10-year US Treasury spread has inverted, suggesting the US is headed for recession. But the 3-month/10-year US Treasury spread, while falling, has not inverted and is therefore not signaling a recession — at least not yet. And BBB spreads, which tend to signal recession when they rise quickly have actually fallen in recent weeks to below 200 basis points.¹ In addition, US unemployment remains very low. However, nearly 70% of economists polled in June by the Financial Times and the University of Chicago Initiative on Global Markets expect the US will go into recession in the next year.² Even different regional Federal Reserve predictors of recession differ. The Atlanta Fed GDPNowcast points to two consecutive quarters of negative gross domestic product (GDP) growth — fitting the original technical definition of a recession.³ However, the St. Louis Fed's Real GDP Nowcast and NY Fed Weekly Economic Index suggest growth is slowing but still relatively resilient.⁴

2. Inflation. There also seems to be a disconnect on US inflation. We recently got much-improved longer-term US consumer inflation expectations — not just from the University of Michigan survey but also from the NY Fed survey. But that came after a higher-than-expected Consumer Price Index print, which caused confusion among some. In that case, the disconnect probably relates to a time lag — it seems consumers see high inflation as relatively temporary.

3. The US consumer. There is definitely a disconnect regarding the US consumer. Assessments of the American consumer were rather positive from a number of financial companies reporting earnings this quarter — despite dismal consumer sentiment. For example, consumer

finance bellwether Synchrony Financial reported that “... the consumer from all aspects, whether you look at spend, whether you look at credit, at this point in time, is still really strong.”⁵ And financial giant Bank of America reported that “US consumers remain quite resilient.”⁶ The disconnect on the US consumer seems as wide as the Grand Canyon, given that the University of Michigan consumer sentiment reading hit a record low of 50 in June.⁷

4. European monetary policy. The biggest disconnect of last week seemed to come from the European Central Bank (ECB), which surprised markets by raising rates by 50 basis points. I had expected the ECB to tread more carefully, given competing interests of fighting inflation and avoiding recession given its weakened economy. However, ECB President Christine Lagarde shared, “We expect inflation to remain undesirably high for some time owing to continued pressure from energy and food prices and pipeline pressures in the pricing chain ... the most precious good we can deliver — and we have to deliver — is to bring inflation down to 2% in the medium term.”⁸ This is perplexing to me given that Europe’s brand of inflation is largely being driven by commodity prices rather than demand, so it is largely outside the ECB’s control — but causing a recession is arguably much more within its control. It’s worth noting that eurozone area Composite Purchasing Managers Index (PMI) is now in contraction territory, having dropped to 49.4 in July from 52 the previous month.⁹ S&P Global economist Chris Williamson signalled a warning, “The eurozone economy looks set to contract in the third quarter as business activity slipped into decline in July and forward-looking indicators hint at worse to come in the months ahead.”¹⁰ Adding to the uncertainty is that Mario Draghi resigned from his position as Italy’s prime minister, creating a leadership vacuum for the eurozone’s third-largest economy.

Now, I feel obligated to add that the ECB did more than raise rates, and some of its other policy decisions made more sense to me. The ECB introduced its much-awaited anti-fragmentation tool — known as the Transmission Protection Instrument — and it has surprisingly broad eligibility, including private securities, which is positive for financial stability. In addition, the ECB announced an extension of reinvestment of Pandemic Emergency Purchase Program (PEPP) proceeds and flexibility around that reinvestment, which should also be supportive as it appears it could be used to help target support for a particular eurozone country under stress if needed.

5. Investor sentiment. From my perspective, perhaps an even greater disconnect came in the results of the most recent Bank of America Fund Manager Survey. Bank of America characterized the mood as a “dire level of investor pessimism.”¹¹ Key takeaways included that equity allocations have fallen to levels that have not been reached since the 2008 Global Financial Crisis, and that there is more cash in portfolios than there has been in more than 20 years. I started my career in late 1995 and so I have had the opportunity to see these different market environments first-hand. I can safely say that the current environment, while filled with uncertainty and headwinds, is nothing like the Global Financial Crisis. It strikes me as ironic that investors are more pessimistic today than they were at the start of the year, before stocks started their precipitous decline.

I do think we may see another leg down for global stocks, as I have said before, but I also believe opportunities are already beginning to present themselves. I believe the chasm will close at some point later this year, and I expect it to benefit those who maintain a diversified portfolio, with adequate exposure to equities.

In short, I believe investors can benefit from looking for the disconnects and taking advantage of them. And there is no shortage of disconnects in this environment of uncertainty and pessimism.

Looking ahead

This week will largely be driven by the Federal Reserve and earnings. A meaningful decline in longer-term inflation expectations (from both the Michigan and NY Fed surveys) was welcome news to markets, as it took pressure off the Fed to follow in the Bank of Canada's footsteps and hike rates by 100 basis points. I think it's safe to assume the Fed will raise rates by 75 basis points – what will be important is their messaging about the future, especially the potential to pivot to a less aggressive tightening path later this year. This could happen relatively soon, in my opinion, given that the Fed is very data-dependent. It's not just about falling inflation expectations and inflation peaking. It's also about an economy that is weakening quickly, with the flash reading of the US Services Purchasing Managers Index having fallen into contraction territory — actually a 26-month low — in July.¹²

This will be a critical week for earnings, especially tech earnings, as many of the giants in the industry report. I think we will see a continuation of the same theme we have heard thus far — earnings are lackluster, but not as bad as feared — although there are likely to be some outliers among these companies. I think it is worth noting that tech companies that have already reported earnings have eked out 1.4% earnings growth this quarter.¹³ Interestingly, the sector with the highest level of “buy” ratings is technology at 65%.¹⁴

Have a great week and keep your eyes out for disconnects that could create opportunities.

With contributions from Arnab Das, Paul Jackson, and Adam Burton

Notes

¹ICE Bank of America BBB US Corporate Index Option-Adjusted Spread, St. Louis Fed Federal Reserve Economic Data, as of 7/22/22)

²Source: Financial Times, "Economists warn US set for recession," 6/13/22

³Source: Atlanta Fed, as of 7/8/22

⁴Source: St. Louis Fed, NY Fed, as of 7/7/22

⁵Source: Brian Doubles, Synchrony President and CEO, Synchrony earnings call 7/19/22

⁶Source: Brian Moynihan, Bank of America CEO, Bank of America earnings call 7/18/22

⁷Source: University of Michigan Survey of Consumers, as of 6/24/22

⁸Source: European Central Bank press conference, 7/21/22

⁹Source: S&P Global Composite Euro Area, as of 7/22/22

¹⁰Source: S&P Global Flash Eurozone PMI Press Release, 7/22/22

¹¹Bank of America Fund Manager Survey, July 19, 2022

¹²Source: S&P PMI, 7/22/22

¹³FactSet Earnings Insight, 7/22/22

¹⁴FactSet Earnings Insight, 7/22/2

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.

Diversification does not guarantee a profit or eliminate the risk of loss.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another.

The BBB spread is the difference between the yield on a Treasury bond and the yield on a BBB bond, which is the lowest tier of investment grade debt. The higher the spread, the riskier the BBB bonds are perceived to be. This spread, like all spreads, moves continuously and can give a sense of current risk sentiment, as well as expectations for the economy.

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

The New York Fed's Survey of Consumer Expectations is a nationally representative, Internet-based survey of a rotating panel of approximately 1,300 household heads.

The European Central Bank's Pandemic Emergency Purchase Program (PEPP) is a non-standard monetary policy measure initiated in March 2020 to counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area posed by the coronavirus (COVID-19) outbreak.

The Bank of America Fund Manager Survey is a monthly report that canvasses the views of approximately 300 institutional, mutual and hedge fund managers around the world.

The Consumer Price Index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics. Core CPI excludes food and energy prices while headline CPI includes them.

Purchasing Managers Indexes are based on monthly surveys of companies worldwide, and gauge business conditions within the manufacturing and services sectors.

A basis point is one hundredth of a percentage point.

The opinions referenced above are those of the author as of July 25, 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.