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An extraordinary environment

The market is feeling the effects of extraordinary tightening by global central banks.

Rapid rate hikes

With rate hikes coming fast and furious, market participants are rapidly trying to re-value assets.

Potential opportunity

Substantial mispricing can occur in times of disruption, presenting potential opportunities for those with a long enough time horizon and cash on the sidelines to deploy.

Anatomy of a financial market disruption

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Well, it turns out I was a cock-eyed optimist. There was no 50 basis point Federal Reserve rate hike last week, as I had hoped; in fact, there was not even a kernel of dovishness to be found in the press conference that followed its 75 basis point hike. Like Captain Ahab's pursuit of Moby Dick, it seems Fed Chair Jay Powell is singularly focused on controlling inflation — no matter what gets destroyed in the process.

The Fed has been referred to as the central banker to the world. While it doesn't seem to see itself that way — at least not these days — I believe it's an accurate description given its impact on so many asset classes in so many places around the world. Of course, it's not just the Fed that's tightening. In the past week, a number of central banks including the Bank of England and the Swiss National Bank (SNB) hiked rates (the SNB took 75 is the new 25 to heart – hiking rates another 75 basis points last week after a surprise 75 basis point hike back in June).

So let's look at the impact of this extraordinary tightening environment — the one the World Bank warned about a few weeks ago.

The market impact of tightening

Stocks. Global stocks fell 5% last week.¹ However, stocks have been giving up ground since their summer peak in mid-August. Key drivers have been hawkish Fed rhetoric and stubbornly high inflation readings, which have likely also helped push stocks lower. The stock market sell-off accelerated over the course of last week, driven by the most recent Federal Open Market Committee meeting. Not only did the Fed hike rates by 75 basis points, but the “dot plot” indicated expectations of more rate hikes than had previously been expected by the end of 2022 (and beyond).

Fixed income. Yields have risen in recent months on central bank tightening while prices have, of course, fallen. Consider the 10-year US Treasury yield: The US 10-year yield was 1.51% at the start of the year and last Friday saw an intraday peak of 3.82%² Global bonds fell 2.3% last week.³ The UK budget was released, which resulted in surging gilt yields. This helped to pull up yields around the world – and cause significant bond market losses for the UK and Europe (in addition to pushing stocks lower). As I've said before, Western Europe is facing particularly difficult economic challenges because of the energy crisis it is facing. Fiscal support to help households and businesses survive crushing energy prices may be necessary, but it complicates the situation and may force the Bank of England and European Central Bank to tighten monetary policy even more.

The US dollar. The dollar keeps going from strength to strength, despite no longer being supported by widening yield gaps. The Fed's hawkishness last week only helped contribute to dollar strength. However, the big story last week was the depreciation of sterling in reaction to the new, interim UK “mini-budget.” Tax cuts exceeded expectations, causing concerns about whether the UK will be able to find buyers for the debt it must issue to pay for this largesse. At a

minimum, we think the UK will have to pay up, through a cheaper currency and higher bond yields to entice demand. The currency market reaction is bringing back memories of the currency disruption of the mid-1980s. The pound/USD exchange briefly fell through the 1985 low of 1.05 to about 1.03, then bounced back sharply on reports that the Bank of England was preparing an emergency statement.⁴ We think it's unlikely the Bank would intervene directly in the foreign exchange market — it simply does not have the resources to defend the pound, but it could raise rates more sharply.

The yen. The yen was also weakening further last week, as the Bank of Japan continued to make clear it would not tighten monetary policy. Even so, Japan's Ministry of Finance decided to intervene late in the week and buy yen for the first time in decades. This was a monetary policy version of the old adage "trust but verify." Up until that day, I think many market participants believed Japan was bluffing when it said it would defend the yen. There was no verification so there was no trust. However, that changed when Japan actually intervened — and it was relatively successful in strengthening the yen. So I suspect shorting the yen will not be as popular going forward, as the authorities have verified its willingness to intervene as needed. I think that action to support the yen is intended to create more two-way movement in the yen, and that will make shorting the yen less of a one-way bet. But that said, that kind of trust may not last all that long. After all, the Bank of Japan is one of the few major central banks not tightening — in fact it's maintaining accommodative policy by sticking with its cap on Japanese government bond yields, so shorting the yen is a rather tempting trade. That means Japan may need to prove its credibility by occasionally intervening as needed if it expects to be believed going forward.

Commodities. Commodities were down last week, reflecting ongoing growth fears and the strong US dollar. Prices fell for copper and other industrial metals. Perhaps most notable was a steep decline in oil prices, which bit into energy stock performance. West Texas Intermediate oil started the week at \$85.10 per barrel and finished at \$78.70.⁵

Gold. Gold also fell last week. One interesting feature of this year's environment is that gold has proven to be an ineffective hedge. I believe this can be attributed to the opportunity cost of owning gold, a non-yielding asset class, in a rising rate environment. In addition, the strong dollar has also played a significant role.

Where do we go from here?

If we take a step back, the stock market sell-off in the last month or so was the unwinding of the rebound that started in mid-June (which is looking increasingly like a "dead-cat bounce") and, therefore, a continuation of what was seen earlier in the year. The question becomes where we go from here.

There could easily be another leg down as classic signs of market capitulation, such as the VIX Index reaching the key 40 level, have not occurred — although we are getting closer. I suspect we are far closer to the bottom than we are to the top. While we are very likely to get downward earnings revisions, which can exert downward pressure on stock prices, some of this disappointment is likely already priced in.

I also believe that, despite the rhetoric, we are closer to the end of rate hikes than we are to the beginning; in addition, I believe major central banks have "frontloaded" rate hikes and we are likely to get relatively smaller rate hikes soon. All that should be a positive for

financial markets, which need time to digest all the tightening that has occurred as well as take in future rate hikes in more edible, bite-size pieces. One glimmer of hope comes from the Bank of Canada (BoC), which appears more satisfied with the progress it is making on fighting inflation, as August inflation, both headline and core, came in lower than expected. It seems there is a good chance for a pivot to a 25 basis point hike when the BoC meets in late October, especially given weakening consumer demand.

In summary, last week is emblematic of the cumulative effects of the tightening we have experienced for months, in addition to the problems created by the Russia-Ukraine crisis. However, I am encouraged that substantial mispricing can occur in times of disruption. With rate hikes coming fast and furious, market participants are rapidly trying to re-value assets, and can often get it wrong. With a long enough time horizon and cash on the sidelines to deploy, I believe this sell-off can represent potential opportunity for investors who can make tactical alterations to the margins of a well-diversified portfolio.

With contributions from Paul Jackson, Arnab Das and Ashley Oerth

Notes

¹Based on the MSCI World Index. Source: Refinitiv Datastream, as of 9/23/22. The MSCI World Index is an unmanaged index considered representative of stocks of developed countries. An investment cannot be made directly in an index.

²Source: Bloomberg, L.P., as of 9/23/22

³Based on the Bank of America Merrill Lynch Global Government Bond Index. Source: Refinitiv Datastream, as of 9/23/22. This index tracks the performance of public debt of investment-grade sovereign issuers, issued and denominated in their own domestic market and currency.

⁴Source: Bloomberg, L.P., as of 9/23/22

⁵Source: Bloomberg, L.P., as of 9/23/22

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.

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

Tightening is a monetary policy used by central banks to normalize balance sheets.

A basis point is one hundredth of a percentage point.

The Federal Reserve's "dot plot" is a chart that the central bank uses to illustrate its outlook for the path of interest rates.

UK gilts are bonds issued by the British government.

West Texas Intermediate (WTI) is a type of light, sweet crude oil.

The Federal Open Market Committee (FOMC) is a committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

A dead cat bounce is when a secular downtrend in the market is interrupted by a short-lived rally, but is quickly followed by a continuation of the downtrend.

The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Commodities may subject an investor to greater volatility than traditional securities such as stocks and bonds and can fluctuate significantly based on weather, political, tax, and other regulatory and market developments.

The dollar value of foreign investments will be affected by changes in the exchange rates between the dollar and the currencies in which those investments are traded.

Fluctuations in the price of gold and precious metals may affect the profitability of companies in the gold and precious metals sector. Changes in the political or economic conditions of countries where companies in the gold and precious metals sector are located may have a direct effect on the price of gold and precious metals.

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