Market Strategy
by STRATEGAS A BAIRD COMPANY

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Private Wealth Management

Strategas Investment Strategy

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With market volatility elevated, Strategas answers a few of their most commonly-asked questions around the Fed, inflation, and their outlook for both equity and fixed income markets.

Strategas Research Team

ANSWERS TO OUR MOST FREQUENTLY ASKED CLIENT QUESTIONS

What's your most non-consensus view? We have high conviction in the idea that the "Fed put" (i.e. that the Fed will ease up if markets fall) is gone for the foreseeable future. In our opinion, the Fed is unlikely to stop tightening until its preferred measure of inflation, Core PCE, is closer to 3% than its current 5.2%, almost regardless of movement in markets. That may take a lot longer than the consensus believes—it's been a long time since the Fed had to deal with a CPI of 8.5%. The institution's credibility is dependent upon its ability to get control of a problem it's partly responsible for. In the near term, this is likely to have a bigger impact on earnings multiples than it will on earnings. We fear another 10% to the downside on the S&P.

The S&P has broken below 4200, what comes next? We're not big on levels—they're too precise for an imprecise business. Our thinking remains more around this theme: a lot of important stocks/groups have given back the majority of their Covid-19 rally, so should we be surprised if the S&P 500 does, too? It gets you to somewhere around 3500-3700 on the S&P—consistent with the 200-week moving average, roughly the 50% midpoint of the entire advance, and in step with the assumptions on both earnings and multiples detailed above. We're not dogmatic about any of this, but given the market setup, we'll continue to proceed cautiously. Further, many of the inputs we look at are borderline oversold, but not deeply washed out, and we're still not convinced that's "good enough" given the overall weakness. We've yet to see VIX above 40, a 99th percentile put/call reading, or a proper capitulation in the percentage of stocks trading to a new low. Time will be needed to repair broken trends.

What is the Fed thinking? Macro policy is generally aimed at getting supply and demand to balance. But extreme shocks have made this task very difficult of late, and inflation has been the result. Supply shocks have contributed significantly, and it's true that the first instinct of central bankers is to look through such inflation. However, if there's evidence longer-term inflation expectations are becoming unanchored, there's a need for action. If supply cannot rebound to meet demand, demand must fall to meet supply. So numerous central banks are already looking at more aggressive 0.50% rate hikes and other items.

Are we at peak 10-year yield for this cycle? Most portions of the curve are closing in on the 3% level, which would be consistent with a Fed funds rate terminating between 2.75% and 3.25%, and a recession no sooner than middle of 2023. This suggests to us that the 10-year Treasury yield will peak in the next 1 to 3 months, somewhere above 3%, but below 3.25%, while 2-year yields should peak there, or slightly higher, and perhaps a month or two later. Read more here.

What's your outlook for equities given recent market volatility? Last month, we trimmed our Equities exposure from 62% to 60% as the pre-recession progression intensified (read more here). We view the potential to be greater that odds of a U.S. Recession will rise in coming months and prolong equity market volatility. Further, high quality stocks have consistently proven to be the most reliable during market volatility. That does not mean that the best names will not get hit, but stocks that display higher quality features have historically outperformed in corrections and bear markets.

How does 2022's equity market decline compare to that of other midterm election years? At the start of every midterm election year, we grit our teeth knowing a big equity market correction is coming, though we don't know when. Midterm election years are the most volatile for stocks during the four-year presidential cycle, with an average intra-year correction of 19%. We have generally found midterm election years to be marked by declining presidential approval ratings, tighter monetary policy, tighter fiscal policy, and an increasing likelihood of a change in political party. This year is no different, although the timing has been faster and the scope of the decline has been deeper than usual. The 13% decline from January through April is the largest equity market drawdown in a midterm election year we could find on record. The good news is that the S&P 500 is up one year after its midterm low and by an average of 32%, and the faster and steeper the decline, the stronger the recovery.

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