Graves Light Lenhart
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Graves Light Lenhart August '22 Market Commentary

Markets Slump as Rates "Pop"

Market Overview:

Markets entered August in rebound mode but reversed course to end the month in negative territory after a hawkish Federal Reserve (Fed) weighed on performance. The initial mid-summer rally saw investor sentiment across both equities and bonds improve with July's momentum proceeding into the new month. This proved to be a short-lived, however, as financial markets were hit by a cold blast when Fed Chair Jerome Powell gave his opening remarks at the Kansas City Fed's annual conference at Jackson Hole. Delivering a carefully scripted speech, he simply sounded more hawkish – favoring higher interest rates – than the markets had expected. Less than a month earlier, at his July 27 press conference, Powell seemed to be pivoting towards a more dovish stance, with markets at the time interpreting that the Fed's tightening cycle could be ending sooner rather than later. In August, he obviously concluded that he needed to walk back, stressing that the Fed's top priority is to bring inflation back down by pushing interest rates up quickly, even if doing so risks causing a recession. Market assets adjusted accordingly.

While the markets got cold feet, there was actually surprisingly good domestic economic data released during the month. To name a few items, producer prices for finished goods (as represented by the PPI) suggested a sharp drop after reaching its recent peak in June which was the highest level since the oil embargo in 1973(!). Additionally, the American Automobile Association announced that the average price of unleaded gasoline at the pump had dropped below $4 per gallon for the first time since the invasion of Ukraine. For employment data, there are very early signs that the strength in the labor market is coming off the boil. The number of new claims for unemployment insurance remains quite low, but the trend is directionally upward. Layoffs are running at their fastest rate of the year, albeit from historically low levels. This is not great news in of itself, but this does buoy hope that a softening labor market will ease increasing pressure on wages and prices. We do believe the evolution towards less oppressive inflation (barring a draconian recession) will take some time. For example, even in a scenario in which headline inflation (measured by CPI) grows at a consistent 0.5% month-over-month rate, which would imply a decelerating/disinflationary trend versus the 12-month average, the year-on-year growth figure would take a full 12 months to come down to just above 6% from July's 8.5% reading! Even if the peak has been scaled, the issue of the descent now confronts us.

Asset Performance:

Market performance was weak across the board during the month of August. While the S&P 500 declined by -4.1% for the month, we once again observed a divergence across various subcomponents of the markets which was very similar to first half (2022) performance. To this extent, the S&P 500 Growth Index declined by -5.3% compared with the S&P 500 Value Index which declined by -2.8%. The relative performance of these two risk factors remains closely linked to the evolution of interest-rates, a breakaway from the long-term trend of little correlation between the two. Additionally, international performance was relatively poor, with the MSCI EAFA Index declining -4.7%. Performance was particularly weighed on by Europe. The MSCI Europe Index, which captures large and mid-cap constituents across 15 developed European countries, sank -6.2% over the month as a near-term recession appears likely (even as it's increasingly "priced-in").

As interest-rates soared during the month, fixed income assets swiftly de-rated as bond markets repriced for a more aggressive rate hiking cycle. The policy-sensitive 2-year US Treasury rate increased 0.54% to 3.44% along with expectations for the future path of Fed hikes. With rates also rising across the Treasury yield curve, the Bloomberg US Aggregate Index experienced a -2.8% decline, its ninth decline in twelve months as we have yet to see a sustained rally in bond prices over the last year. Lastly, commodities were largely mixed with renewed strength in agricultural commodities and the continued rally in natural gas being largely offset by a late month decline in oil prices.

Key US Index Returns	YTD '22	August '22
S&P 500	-16.1%	-4.1%
Nasdaq	-24.1%	-4.5%
Dow Jones Industrial Average	-12.0%	-3.7%

Relevant Fixed Income Yields	YE 2021	August '22
US 10-Year Treasury Note	1.51%	3.13%
Investment Grade Corp. (C0A0)	2.4%	4.9%
High Yield Corp. (H0A0)	4.3%	8.5%

Source: Factset as of 09/01/22

Closing Thoughts:

The recent short-term rally proved to be transitory. Looking at market-wide positioning, there was a strong case to be made that the mid-summer bounce was more a result of oversold market conditions (i.e. depressed sentiment coercing buyers into the market) as opposed to improved underlying fundamentals. We believe the case for a new bull market is much less clear than the backdrop coming out of the 2020's market trough. Historically, it's uncommon to witness a bull market begin well before a Federal Reserve rate hiking cycle is over. In most cases (1982, 2003, 2009, 2020), the Fed has already commenced cutting interest rates for an extended period by the time the market low was in and the bear markets started. Additionally, broad market valuations are historically high for a bear market bottom. Currently, quantitative tightening (or balance sheet runoff) has just begun, and further rate hikes are considered likely. In this context, we do anticipate further volatility until markets obtain more clarity through the inflationary clouds.

Warm regards,

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