Graves Light Lenhart
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October 4, 2022

Graves Light Lenhart October '22 Market Commentary

Stocks Rally in October, but "Santa Pause" Isn't Coming to Town

Market Overview:

Markets rallied strongly during October, driven in part by a new policy "pivot" narrative which revolved around the potential slowdown in the pace of rate hikes being implemented by the Federal Reserve (Fed). This occurred despite the sting in September's tail which was caused by surprisingly bad US inflation numbers, which at the time, dampened optimism that the Fed would soon have to dial back its campaign on interest rate hikes. So what changed? While there were a myriad of mentioned culprits, much of the narrative was caused by the market's interpretation of comments from a select few Fed governors suggesting the time could be nigh to at least pause rate increases while allowing their effects to ripple through the economy given the typical lag between monetary action and the resultant economic and inflationary impacts. While the chances are that the Fed will eventually decrease the rate at which it raises rates at future Federal Open Market Committee meetings, the stark reality is that interest rates will remain at higher levels for the foreseeable future, particularly as inflationary pressures remain somewhat "sticky". While markets reacted positively during the month October, subsequent hawkish remarks reminded the markets that the Fed is far from accomplishing its goal to defeat inflation.

Coinciding with the market's ascent, S&P 500 earnings growth has generally been better than expected. We note that expectations entering the 3rd quarter had been lowered substantially. According to Refinitiv data, from a late-June high of more than 11% year-over-year growth, the blended estimate (combines actual reports with estimates for not-yet-reported companies), sank to 4% as of October 28th. Excluding the Energy sector – which is benefitting from higher oil prices – earnings are actually expected to *decline* by nearly 4% during the 3rd quarter. While spectacular disappointments (particularly for some major large-cap stocks) have outnumbered successes, plenty of investors were worried about an all-out earnings crash which had not transpired as of the end of the month.

While the month was littered with market moving events, the "mini-budget" crisis witnessed in the UK provided a noteworthy example of the systemic risks which can quickly become prevalent following the recent era of stimulative monetary policy. The chaos observed in the UK bond market stoked volatility elsewhere, as global markets continue to watch very carefully what happens next in the UK.

Asset Performance:

Despite a series of disappointing earnings for a number of "Big Tech" companies and still-elevated inflation, tentative hopes for a slowing pace of US rate hikes drove the S&P 500 to its best month since July, with the domestic benchmark returning 8.1% for the month. As volatility remains elevated, compounded by ongoing earnings releases, there were once again significant divergences witnessed across market segments. Every S&P 500 sector finished higher for the month with Energy in the lead (+25.0%) while Communication Services (+0.1%) eked out a positive return despite significant earnings misses from key constituents. The S&P MidCap 400 and S&P SmallCap 600 were up 11% and 12%, respectively, on improved sentiment coupled with attractive valuations entering the month.

Key US Index Returns	YTD '22	October '22
S&P 500	-17.7%	+8.1%
Nasdaq	-29.3%	+3.9%
Dow Jones Industrial Average	-8.4%	+14.1%

Relevant Fixed Income Yields	YE 2021	October '22
US 10-Year Treasury Note	1.51%	4.07%
Investment Grade Corp. (C0A0)	2.4%	6.0%
High Yield Corp. (H0A0)	4.3%	9.1%

Source: Factset as of 10/01/22

Interest-rate levels across most points of the rate curve continued their ascent during October. For example, the 10-year US Treasury rate increased another 0.27% to 4.07%. The Treasury curve's parabolic increase has caused pain for investors in 2022, particularly in long duration fixed income securities. However, the subsequently lowered prices coupled with higher rates has also created some interesting opportunities within the asset class. Elevated yields result in bonds offering higher income, and by extension, the higher entry yield provides the potential for improved total returns going forward (4Q22 Client Newsletter). While US fixed income index performances were mostly negative during October, notable exceptions include High Yield, as lower credit spreads (compensation for default risk) *more* than offset the negative impact from higher interest rates. The Merrill Lynch US High Yield index gained 2.9% for the month, while the US Bloomberg Aggregate (Investment Grade) declined by 1.3%.

Closing Thoughts:

We believe the "pivot" narrative was spuriously placed. The Fed has hiked a long way in quick fashion, and it's generally accepted that monetary policy affects with a lag. We can already observe the impact of tighter monetary policy in some areas of the economy (i.e. housing activity, which has slowed), but it does take longer to manifest in other industries. Ultimately, the Fed does not want to risk inflation becoming entrenched. Raising interest rates less incrementally should not be conflated with a more supportive Fed, but rather that monetary policy is at a point in which it's considered restrictive to growth. This is far from a pivot(!). Irrespective of how large the next rate hike is, financial conditions will remain tight/restrictive, which by nature should be followed by a period of below-trend economic growth. The best catalyst to buoy the markets will be inflation indicators which reveal signs of moderating while being absent of a significant economic downturn.

Warm regards,

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