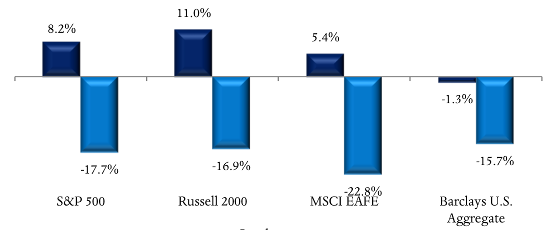
PAPAMARKOU WELLNER
ASSET MANAGEMENT, INC.

October / November 2022 Issue # 234

Markets

Financial markets ended October on a more positive footing, optimistic that the Federal Reserve will be less aggressive in raising interest rates leading to an increased chance of a soft economic landing. In addition, global supply chain constraints continued to ease, and European governments took further steps to dampen the impact of the energy crisis. Equities rallied broadly, with value oriented stocks leading the way. The S&P 500 advanced +8.2% in October (-17.6% ytd). But the venerable Dow Jones Industrial Average was the star, rising +14.1% (-8.4% ytd). Conversely, the tech-heavy Nasdaq struggled to keep up on account of several high profile earnings misses, recovering +3.9% during the month (-29.3% ytd). Overseas, the MSCI EAFE index bounced +5.4% (-22.3% ytd), aided by the Euro Stoxx 600 benchmark which rallied +6.4% (-12.8% ytd). Meanwhile, emerging market equities fell -3.1% (-29.2% ytd), with Chinese stocks coming under pressure as the Communist Party Congress signaled no let-up in the zero-Covid policy and cemented President Xi's authority (Hong Kong's Hang Seng index fell -14.7% during October (-35.2% ytd).

The combination of high inflation and solid labor markets led the Federal Reserve and the European Central Bank to raise short term interest rates by 75 basis points (bps). In the US, this was the sixth straight hike and fourth consecutive 75 bps increase, with the target band now at 3.75 - 4.00%. The market currently anticipates that the target rate will be in a range of 4.25 - 4.50% at year-end, and peak around 5.00% in early 2023. This would result in the fastest and steepest rate hike cycle in the Fed's history. In a further tightening of money supply and liquidity, the central bank continued to reduce the size of its balance sheet via Quantitative Tightening (QT) at the rate of $95 billion per month (thus far reducing its $9 trillion asset base by a mere $242 billion or 3%). As a result, government bond yields made new cycle highs with 10-year yields reaching 4.2% and 2.4% in the US and Germany, respectively, before retracing some ground by the end of the month. During October the Bloomberg Barclays US Aggregate index declined by -1.3% (-15.7% ytd).



Commodities posted the second best performance among major asset classes in October, rising +6.2%, with higher energy values offsetting weaker prices for agriculture and precious metals.

Geopolitics

On the US political scene, Republicans appear poised to wrest control of the House of Representatives in midterm elections, as Americans prepare to cast their ballots on November 8. Democrats, led by House Speaker Nancy Pelosi, have held the majority since 2018, when they won control in then-President Donald Trump's first midterm election. Now the GOP only needs a net gain of five seats to win the chamber, and they are trying to win dozens. The outlook is murkier in the Senate, where the majority party is still likely to have the slimmest of margins. A Republican-led Senate could pass bills sent over by their colleagues in the House, putting political pressure on President Biden. Alternatively, a stalemate would ensue. Voters have indicated high inflation and the risk of recession are the two most important issues, ahead of abortion rights, gun violence and immigration.

China's 20th Communist Party Congress, which determined the country's leadership for the next five years, reappointed Xi Jinping as President for a third term, breaking the existing two-term limit. In turn, Xi packed the party's top leadership with his most loyal allies, evicted all remnants of factional opposition, and established complete control over the party and the country. Premier Li Keqiang, who was widely seen as the chief remaining dissenter to Xi within the system, was forced into retirement, as was Li's factional ally Wang Yang, whom many observers had expected would become Premier. Instead, Li Qiang, Shanghai Party Secretary and Xi's chosen protégé, will likely take over this role and leadership of the State Council. In the process, many of the more market-reform-oriented members of the Party's top economic experts were ousted. Overall, the clear picture to emerge is of a Chinese state fully aligned behind Xi's vision of "comprehensive national security" and a "fortress economy," with the focus firmly on preparation for geopolitical confrontation and competition.

Ukrainian forces continued their advance against the Russian military in the southern Kherson region, pushed back Russian mercenaries from Bakhmut in eastern Donetsk, and gained new momentum in Luhansk. Yet despite continuing losses, there is no evidence that Russia, which has retaliated by targeting Ukrainian infrastructure around civilian centers, including Kyiv, is considering suing for peace. European and NATO allies continue to support Ukraine militarily and through infrastructure repairs ahead of winter.

United States

The US economy continued to grow, but showed signs of softening in October. Both manufacturing and services data decelerated, with the latest surveys falling to 50.2% and 54.4%, respectively, the lowest levels of expansion since early in the pandemic.

Headline and core consumer price indexes rose 8.2% and 6.6% (the highest since 1982) respectively, mainly due to strong services prices, partially offset by falls in goods and energy prices. A slowdown in both housing starts (-8.1% to 1.44 million annualized units in September) and home sales (2022 estimates call for a decline of -16% for new construction and -12% for existing stock) highlight how inflation and higher mortgage rates are weighing on the sector.

October 2022 Economic Statistics

	Oct-22	Dec-21	Dec-20
Federal Funds Target Rate	***3.75 - 4.00%***	0 - 0.25%	0 - 0.25%
Consumer Confidence Index	***102.5***	115.8	88.6
Manufacturing PMI Index	***50.2%***	58.7%	*60.7%*
Unemployment Rate	***3.7%***	3.9%	*6.7%*
JPY/USD	***148.71***	115.08	*103.24*
USD/EUR	***0.9883***	1.1368	*1.2213*
Gold/oz.	***$1,633.12***	$1,828.39	*$1,896.49*
Oil (WTI)/bbl	***$86.53***	$75.21	*$48.52*

The labor market remains solid as seen by ongoing job additions, with October hiring coming in at 261,000 an above average gain. The unemployment rate ticked up to 3.7% and average hourly earnings rose 0.4% from September (4.7% higher year-over-year). There are still challenges in hiring qualified workers, but some companies are holding off on backfilling open positions.

Europe

Europe announced new plans to tackle its energy crisis, including initial price caps and a collective purchase system. These measures, together with targeted support of €40bn, should help both households and businesses. With storage tanks nearly full and autumn proving unseasonably warm so far, gas prices continued to move lower (-60% from their peak in August), but still remain extremely elevated. Germany also launched its own €200bn fiscal stimulus package. This was seen as insular by other European countries that argued a coordinated effort across the union would have been equally effective while reducing the risk of economic and social fragmentation.

On the macroeconomic data front, eurozone PMI surveys reached levels that are consistent with recession. October's composite PMI registered a fall to 47.3%, with the manufacturing index at 46.4% and services at 48.6%. Inflation in the Euro Area rose to 10.7%, and core inflation at 5.0%. Prices of energy continue to have the biggest impact (+41.9%), followed by food (+13.1%), industrial goods (+6.0%), and services (+4.4%).

In the UK, Rishi Sunak was appointed as the new prime minister. Concurrently, the new chancellor, Jeremy Hunt, reversed many of his predecessor's tax cuts and vowed to deliver a much more restrained budget. Market expectations for the Bank of England's rate hikes moderated, with interest rates now expected to peak at around 4.75% next year. The composite flash PMI fell to 47.2%, a contractionary indicator, while the latest headline inflation report showed an increase of 10.1% year-over-year.

Asia

China's economy continued to decelerate within the context of it being out of sync with the rest of the world, post-pandemic. Services activity contracted again in October as Covid-19 containment measures hit businesses and consumption. This overshadowed the third quarter's economic rebound, where GDP growth recovered to 3.9%, led by manufacturing. Headline inflation remained subdued at 2.8%, leaving room for the People's Bank of China to pursue more accommodative monetary policy with new interest rate cuts expected in 2023.

Outlook

Economic data has begun pointing towards a cyclical slowdown in many developed markets. While recession risks are clearly rising, there are factors that may help to mitigate the depth of any downturn. In the US, labor markets remain strong, with accompanying wage growth, bolstering consumer balance sheets. Recently, US 30-year fixed rate mortgage rates exceeded 7%, last seen twenty years ago. Yet, the US housing market is supported by existing long-term fixed interest rate borrowing. Mobility may be affected, but a housing crisis is not in the cards. Inflation is likely to recede over time as demand wanes and affordability declines, especially for items traditionally purchased on credit. Commodities are slowing, supply chain issues resolving, wage growth moderating, spending slowing, and housing/rent has likely peaked. But, it will be quite some time before inflation reaches 2%. In Europe, government support measures should help to moderate the threats to disposable income posed by high rates of inflation, driven by soaring energy bills. The biggest uncertainties around markets and inflation in 2023 are the Fed being unreasonably aggressive, and geopolitical tension from China and Russia.

Equity markets have already priced in a significant amount of potential negative news that may arise from the challenging economic and geopolitical backdrop. Today, the equal-weighted S&P 500 price-to-earnings multiple (which neutralizes the top-heavy technology growth stocks that trade at high valuations) stands at 13x, which is below the 35-year average of 15x. While the current environment is dynamic and will likely test investors' mettle, our research indicates that there are compelling opportunities for long-term oriented stockholders.

Over the past twelve months, bonds have produced the worst annual decline in the last 120 years, twice as bad as the next worst year in the 1970's. As a result, fixed income markets now offer improved options for investors, with 2 to 5 year US Treasury Notes offering circa 4.5% yields and modestly risky credit, the potential for high single digit annualized returns over the short and intermediate term.

We remain conservative with regard to portfolio construction. Stock picking should be a worthwhile endeavor going forward. Higher interest rates and elevated volatility should benefit non-market correlated alternative assets. And, at long last, short duration, risk-free sovereign bonds offer respectable yields. Commodities will likely continue to perform well, with the agriculture sector supported by inflationary trends and food security concerns. For long-term investors, seeking to capitalize on disruptive technology trends, there are opportunities in the food and beverage, edu-tech and cybersecurity sectors. We also wish to reiterate the impressive growth prospects of the companies in our Nordic Technology and Innovation Fund, whose valuations now rest at 10-year lows.

Sources: Barclays, Bloomberg, Bureau of Labor Statistics, Conference Board, Department of Agriculture, Federal Reserve, Financial Times, IMF, Institute for Supply Management, MSCI, Reuters, Russell, Standard & Poor's, and the Wall Street Journal.