ECONOMIC & INVESTMENT PERSPECTIVES

AUGUST: VOLATILITY RESUMES

RECESSION WATCH: EARNINGS & EMPLOYMENT

Figure 1: 8/31/2022 Returns (source: Bloomberg)

Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	YTD	1YR	vs. 52-wk High	vs. 52-wk Low
US Aggregate Fixed Income	AGG	-3.0%	-10.7%	-11.6%	-13.5%	1.9%
Investment Grade Corp Bonds	LQD	-4.4%	-16.2%	-17.2%	-19.8%	2.0%
U.S. Treasury Bonds	GOVT	-2.6%	-10.8%	-11.0%	-12.4%	1.5%
U.S. 20+ YR Treasuries	TLT	-4.6%	-23.6%	-23.5%	-27.9%	3.5%
Muni Bonds	MUB	-2.4%	-8.1%	-8.1%	-9.7%	1.5%
High Yield	HYG	-4.3%	-12.0%	-11.6%	-15.5%	2.2%
Non-US Corp Bonds	IBND	-7.3%	-22.8%	-26.4%	-27.1%	0.3%
Emerging Markets Bond LC	EMLC	-0.5%	-13.2%	-18.7%	-22.7%	4.0%
Global Equity						
ACWI Global Equity	ACWI	-4.4%	-18.0%	-16.0%	-20.1%	5.7%
United States	VTI	-3.7%	-17.2%	-13.7%	-18.6%	9.3%
International Developed	EFA	-6.1%	-19.8%	-20.2%	-25.0%	3.6%
Emerging Markets	EEM	-1.3%	-18.6%	-23.0%	-26.4%	3.6%
Global Equity by Region						
United States	VTI	-3.7%	-17.2%	-13.7%	-18.6%	9.3%
Europe	IEUR	-7.5%	-23.1%	-23.5%	-27.3%	3.3%
Asia ex-Japan	AAXJ	-1.5%	-18.6%	-22.8%	-26.3%	2.5%
China	MCHI	0.0%	-20.4%	-28.9%	-32.8%	14.4%
Japan	BBJP	-4.4%	-18.7%	-19.6%	-27.7%	4.1%
Latin America	ILF	3.1%	8.1%	-8.3%	-22.2%	17.2%
US Equity						
US S&P 500	IVV	-4.1%	-16.2%	-11.3%	-17.6%	9.1%
NASDAQ 100 QQQ	QQQ	-5.1%	-24.5%	-20.8%	-26.8%	11.1%
US Large Growth	IWF	-4.7%	-23.3%	-19.2%	-25.1%	12.4%
US Large Value	IWD	-3.0%	-9.9%	-6.4%	-12.5%	7.1%
US Eqwt S&P 500	RSP	-3.5%	-12.7%	-8.5%	-14.6%	8.6%
US Mid Cap	IJH	-3.2%	-13.6%	-10.5%	-16.8%	11.5%
US Small Cap	VTWO	-2.0%	-17.2%	-17.8%	-25.1%	12.4%

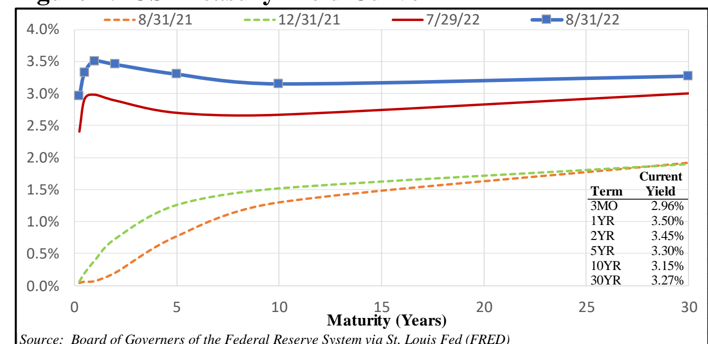
After rebounding strongly in July, the selloff in global financial markets resumed in August and intensified after Federal Reserve Chair Powell reiterated the Fed's unwavering commitment to fight inflation via tighter monetary policy. The hawkish rhetoric pushed interest rates higher and stock prices lower. Performance highlights for the month and year-to-date (YTD) are below.

- Bonds: The U.S. Aggregate index (AGG) fell 3.0% (-10.7% YTD). Corporate bonds (LQD) lost 4.4% (-16.2% YTD), and high yield bonds (HYG) lost 4.3% (-12.0% YTD) as credit spreads widened. Non-U.S. bonds (IBND) fell 7.3% (-22.8% YTD), under-performing as the U.S. dollar strengthened.
- Global equity (ACWI): -4.4% in August (-18.0% YTD).
- U.S. Equity: The broad market (VTI) fell 3.7% (-17.2% YTD); the S&P 500 (IVV) lost 4.1% (-16.2% YTD). Large growth stocks (QQQ and IWF) have under-performed as rising interest rates diminish the present value of future earnings growth. Small stocks (VTWO) fell 2.0% (-17.2% YTD). Only the Energy and Utilities sectors show gains for the month and YTD.
- Non-U.S. Equity: Developed market stocks (EFA) lost 6.1% (-19.8% YTD), led lower by Europe amid worsening inflation and currency weakness. Emerging markets (EEM) lost 1.3% (-18.6% YTD); Latin American stocks (ILF) rose, led higher by Brazil (less political uncertainty). Chinese stocks (MCHI) stabilized with new government stimulus and progress toward improved accounting transparency reforms.

Interest Rates and the Economy

The yield curve (Figure 2) plots the yields (Y-axis) for various maturities (X-axis) of U.S. Treasuries. Hawkish speeches from Chair Powell and other Fed officials clearly indicated that the Fed will continue to raise interest rates aggressively in order to tame inflation. While the Fed Funds rate is currently 2.25-2.50%, the futures market now indicates that short-term yields are likely to rise to roughly 3.75% or higher by early 2023. The curve remains inverted with the 10-year Treasury now yielding 3.15%.

Figure 2: US Treasury Yield Curve

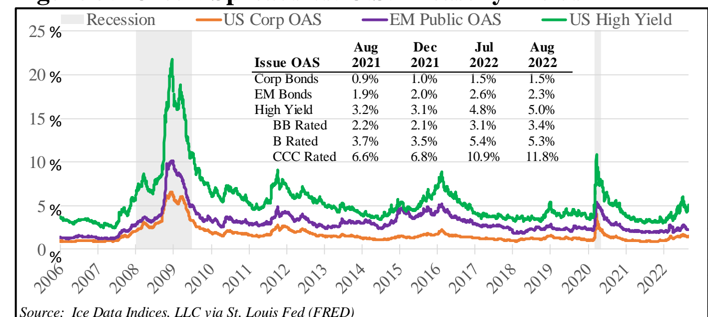


Source: Board of Governers of the Federal Reserve System via St. Louis Fed (FRED)

The bond market provides other risk metrics, including the option-adjusted spread (OAS) between various bond yields and Treasuries of comparable maturities. Low or narrowing spreads signal optimism while high or rising spreads signal fear. Spreads have widened this year but were relatively stable in August.

- Investment grade corporate bond spreads held steady at +1.5% this month but remain higher than +1.0% spreads at year-end.
- High yield (non-investment grade) spreads widened to +5.0%, still elevated but not at panic levels. The riskiest bonds (rated CCC & below) spiked to +11.8% over Treasuries and are significantly above 2021 year-end spreads of +6.8%.
- Emerging market bond spreads narrowed to +2.3%; despite relatively stable credit spreads, emerging market debt has under-performed due to the strength of the U.S. dollar YTD.

Figure 3: Credit Spreads vs. U.S. Treasury Yields



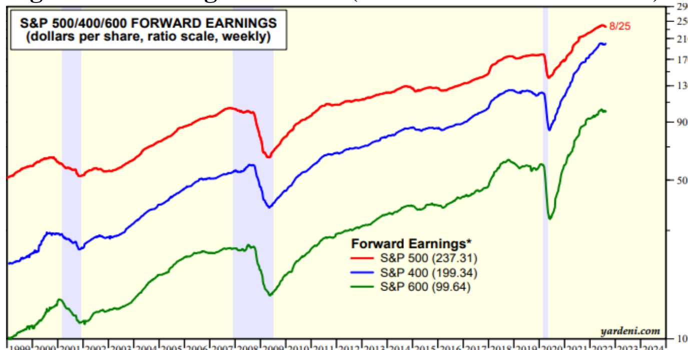
Source: Ice Data Indices, LLC via St. Louis Fed (FRED)

Recession Watch: Earnings & Employment

Global economies and markets continue to face significant challenges as central banks seek to tame decades-high inflation by raising interest rates and reducing or ending bond purchase programs. The renewed selloff in global markets reflects investors' fears that rapidly rising interest rates will derail economic growth and push the U.S. and other global economies into recession.

After two successive quarters of negative real GDP growth, there is much debate about whether the U.S. economy is already in recession, but most economists agree that robust employment data continues to indicate underlying economic strength. Because personal consumption accounts for approximately two-thirds of U.S. economic activity, strong employment and wage growth should continue to support growth in consumer spending and economic growth. But employment and GDP metrics are backward-looking, while financial markets are forward-looking, trading on expectations about future growth. An analysis of equity earnings forecasts offers insight into investors' expectations. Figure 4 plots the growth of one-year forward earnings forecasts for large (S&P 500), mid-cap (S&P 400) and small (S&P 600) U.S. stocks.

Figure 4: Earnings Forecasts (source: Yardeni Research)



While the stock market has declined roughly 17% YTD, earnings forecasts have remained surprisingly strong, as illustrated above. Does this mean that Wall Street's professional analysts (whose research and forecasts are aggregated to develop the consensus earnings forecasts graphed above) do not believe that recession is likely? To answer this question, we dig deeper to look at consensus earnings forecasts for U.S. stocks at the sector level. Figure 5 (below) plots the one-year forward earnings forecasts for each of the eleven sectors that comprise the S&P 500. While this is a very "busy" graph, several high-level observations emerge:

- Three sectors have the largest impact on current S&P 500 earnings forecasts: Technology, Health Care and Energy.
- Technology and Health Care have been the primary drivers of equity earnings growth (and stock market returns) for years.
- Energy earnings forecasts have risen dramatically (with oil prices) since falling to zero in the early stages of the pandemic.
- After peaking in early 2022, earnings forecasts for all sectors except Energy are flat or declining measurably.

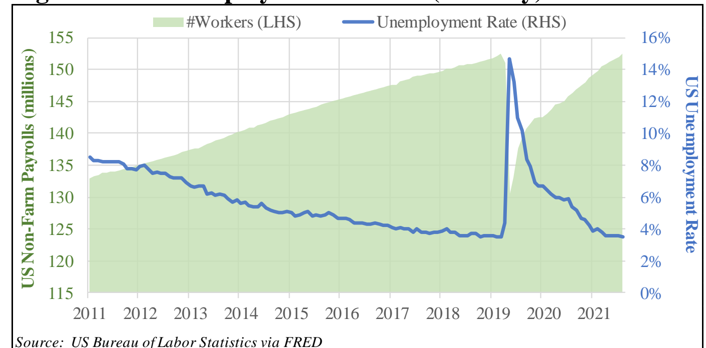
Corporate earnings forecasts are coming down, masked in aggregate by strong energy-related earnings driven by spiking oil and natural gas prices in the wake of Russia's invasion of Ukraine.

Bottom Line

The stock and bond market selloff resumed in August, intensifying in the wake of Chairman Powell's speech at the Fed's annual conference in Jackson Hole, WY, where he unequivocally reiterated the central bank's commitment to aggressively fight inflation via restrictive monetary policy. The bond and futures markets are now pricing in a terminal Fed Funds rate of 3.75-4.00% by early 2023, significantly above the current range of 2.25-2.50%.

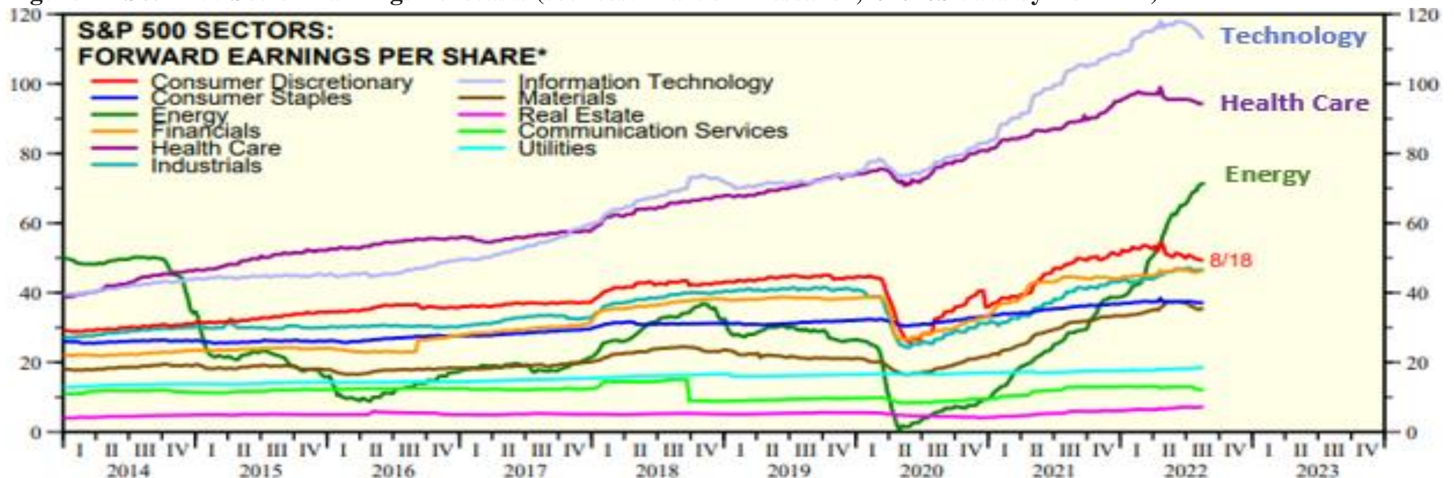
The economy is slowing, evidenced by two consecutive quarters of negative real U.S. GDP growth and declining corporate earnings forecasts outside of the Energy sector, but the labor market is still very strong. Unfortunately, unemployment must rise in order to reduce inflationary pressures. Figure 6 plots the full post-pandemic recovery of the job market, with the total number of workers reaching all-time highs and unemployment matching 50-year lows (3.5%). August employment data is due out this week.

Figure 6: U.S. Employment Metrics (monthly)



Recession remains likely; portfolio diversification is critical in this environment (global stocks, bonds, alternatives and cash).

Figure 5: S&P 500 Sector Earnings Forecasts (sources: Yardeni Research, I/B/E/S data by Refinitiv)



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