The Bear Market Continues

In response to the global pandemic in 2020, the Federal Reserve and Congress acted rapidly by slashing interest rates to zero and implementing enormous stimulus plans. These actions not only drove a V-shaped economic recovery, but also reignited long dormant inflation pressure, as Covid-weakened global supply chains collided with strong consumer spending. The Russian invasion of Ukraine further complicated the inflation outlook, both in the U.S. and globally, as the price of oil, natural gas and many other commodities skyrocketed. In addition, China's zero covid policy, which shut down major parts of that country this Spring, resulted in further strain on supply chains.

The Fed began 2022 looking to gradually end the emergency zero-interest-rate policy, with the U.S. benchmark Fed funds rate initially expected to end the year at 0.5%. Instead, the events described above drove higher than expected inflation to force an abrupt policy pivot and raise rates several times (it is now expected to end the year at 4.4%.) These actions by the Fed are an attempt to rein in inflation by raising interest rates to slow consumer spending while also trying to avoid triggering an economic recession.

During the third quarter, equity markets experienced significant volatility as investors continued to face an uncertain environment. Corporate profits remain supportive and overall earnings for the S&P 500 are expected to grow 8% this year. This growth, coupled with a 24% decline in the S&P 500, have made valuations more attractive. We believe volatility is likely to remain elevated for the remainder of the year and we have adjusted portfolios accordingly, however, we are cautiously optimistic that the outlook for the next 12-18 months will begin to look better post-Election Day.

Figure 1

2022 Performance by Sector

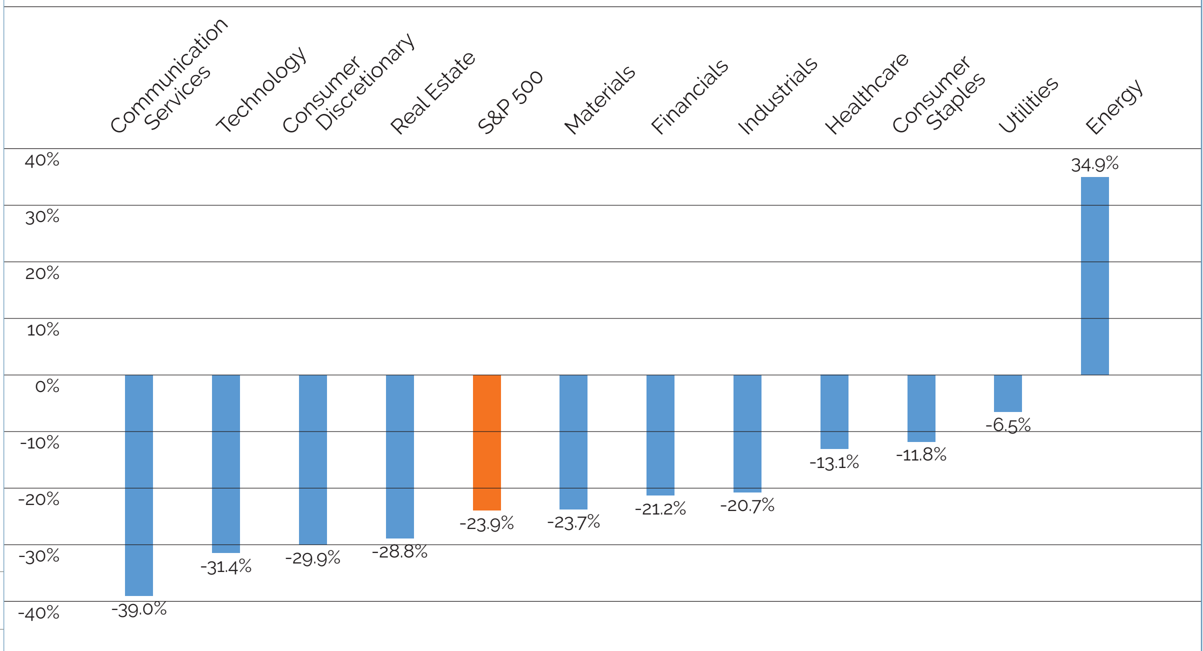

Figure 1 Source: Bloomberg. All performance based on total returns. Data as of 9/30/2022.

Inside

Interest Rates Explode Higher
The "Soft Landing" Scenario is Still Possible
Midterm Election Stock Market History
Course of Action

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As of the end of September, the S&P 500 Index was down 23.9% for the year (Figure 1), remaining in a bear market — defined as a decline of 20% or more from recent highs.

For the quarter, the S&P 500 Index was down 4.9%. Growth areas of the market — Consumer Discretionary, Communication Services, and Technology — continued to be the detractors. The Energy sector remains the outlier, with year-to-date performance up almost 35%.

There have been few places to hide this year as performance remains a struggle not only for global equities but fixed income as well. The asset class is off to its worst start in history, as evidenced by the Barclay's fixed income indices, both of which are down double digits for the year (Figure 2).

Figure 2

2022 Performance by Category

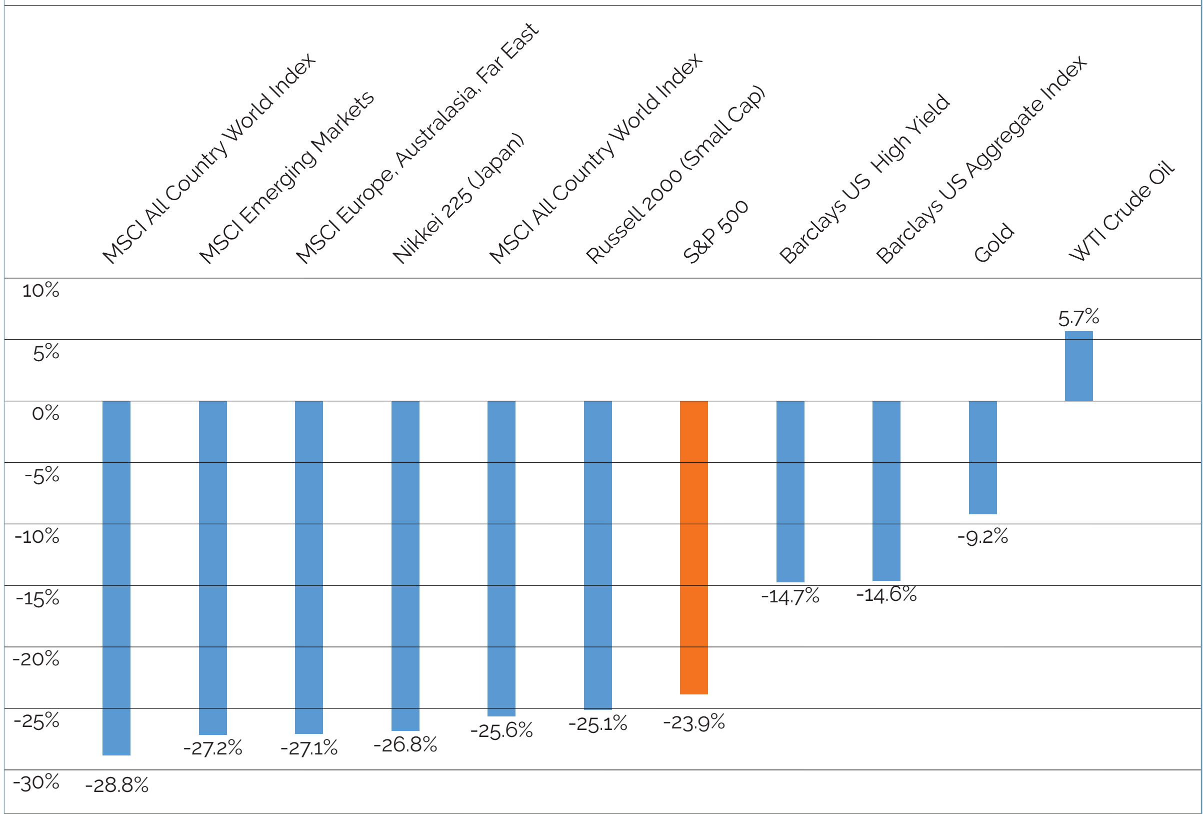

Figure 2 Source: Bloomberg. All performance based on total returns. Data as of 9/30/2022.

Interest Rates Explode Higher

Equity and fixed income markets experienced significant volatility over the summer. In July, the Fed raised its benchmark rate by 75 basis points for the second month in a row, marking the largest rate hikes since 1994. However, many investors interpreted Chairman Powell's comments during the Q&A portion of the press conference as dovish, signaling that the aggressive pace of monetary tightening would moderate in the relatively near future. This, coupled with better than feared earnings reports, drove a powerful bear market rally in the S&P 500 during late July and August. Unfortunately, the rally abruptly ended in late August after comments from Chairman Powell in Jackson Hole made it clear that investors had misinterpreted his message and reinforced that the Fed is fully committed to getting inflation back down to the 2% target, even at the risk of putting the economy into a recession.

The Fed delivered a third 75 basis point hike in September, as telegraphed, and Fed policymakers expect interest rates to reach 4.4% by the end of the year with the intent to remain at that level in 2023. We are now on pace for the quickest hiking cycle in two decades (Figure 3). Following these moves, comments from the Fed once again suggested they would be willing to drive the US economy into recession, if necessary, to constrain inflation.

Figure 3

2022 Hiking Pace is the Fastest in Decades

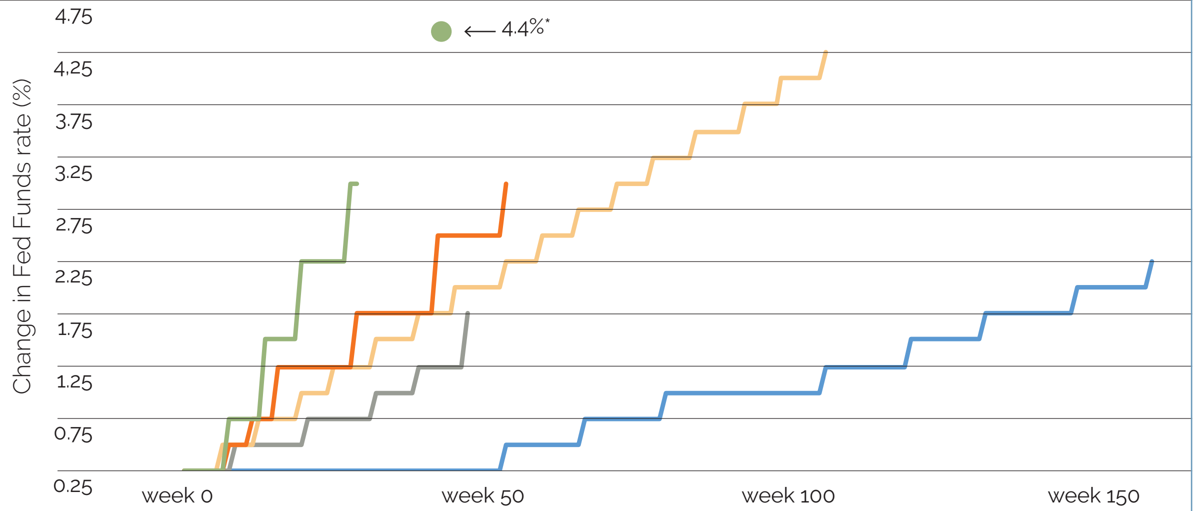

Figure 3 Source: Bloomberg. Data as of 9/30/2022. *Note: 2022 data point of 4.4% is the estimated year-end consensus.

After the Fed decision, the S&P 500 re-entered bear market territory, the 2-year U.S. Treasury yield jumped to 4.3% (a level not seen since 2007), and the 10-year U.S. Treasury yield briefly touched 4%. As interest rates increase, the price of bonds moves down. Given the magnitude of rising interest rates, many fixed income indices are also now in a bear market.

Bonds historically provided some ballast in portfolios and were an important part of an asset allocation discussion. For many years, available returns in the fixed income markets were suppressed by the Fed's quantitative easing programs. The Fed purchased Treasury bonds to inject liquidity into markets, but they are now looking to reverse this process by selling bonds and withdrawing liquidity. We can now find some relatively attractive valuations in bonds and are looking for opportunities to add them to portfolios where appropriate.

The "Soft Landing" Scenario is Still Possible

Whether we have a "soft landing" or a recession (hard landing) continues to be a key focus for investors. A soft landing is when the Fed attempts to raise interest rates just enough to slow the economy and tame inflation, without causing a significant increase in unemployment and an economic contraction. The U.S. economy seems to be slowing from the post-pandemic liquidity inspired boom, but for now, the job market remains healthy. It is possible that the economy is "normalizing" and we avoid a typical recession — which is defined as a contraction in economic output for at least two quarters coupled with rising unemployment.

Reasons for optimism:

- U.S. household finances are generally healthy. Internal data at Bank of America suggest balances in checking and savings accounts remain well above pre-pandemic levels.
- Inflation is showing some signs of easing. For example, lumber has declined 75% from its peak in May of '21; and copper, a good bellwether of the global economy, is 30% off its high from March of '22. Additionally, excess inventories at retailers are resulting in some discounting.
- Companies remain in good shape with robust balance sheets, perhaps making many less dependent on credit growth as interest rates rise.
- The banking system is generally in good shape. Stress test results released in June demonstrate that the banks are well-positioned and have adequate capital to withstand a recession.

The yield curve, which shows the interest rates that buyers of government debt demand over various periods of time, has proven to be one of the most reliable indicators when assessing the state of the economy. The three-month Treasury bill is directly connected with the Fed's benchmark rate, while the 10-year Treasury embeds a forecast of economic growth and inflation. Although the 10-year Treasury yield is currently less than the 1-year, 2-year and 5-year yields — signaling concern about growth and/or a recession — the difference between the 10-year Treasury yield and the three-month Treasury bill rate remains in positive territory and suggests there will be a soft landing (Figure 4). If the Fed raises rates to a level that pushes this into negative territory, the market may become more concerned about a recession.

Figure 4

10-Year minus 3-Month Treasury Yield Curve and Recessions

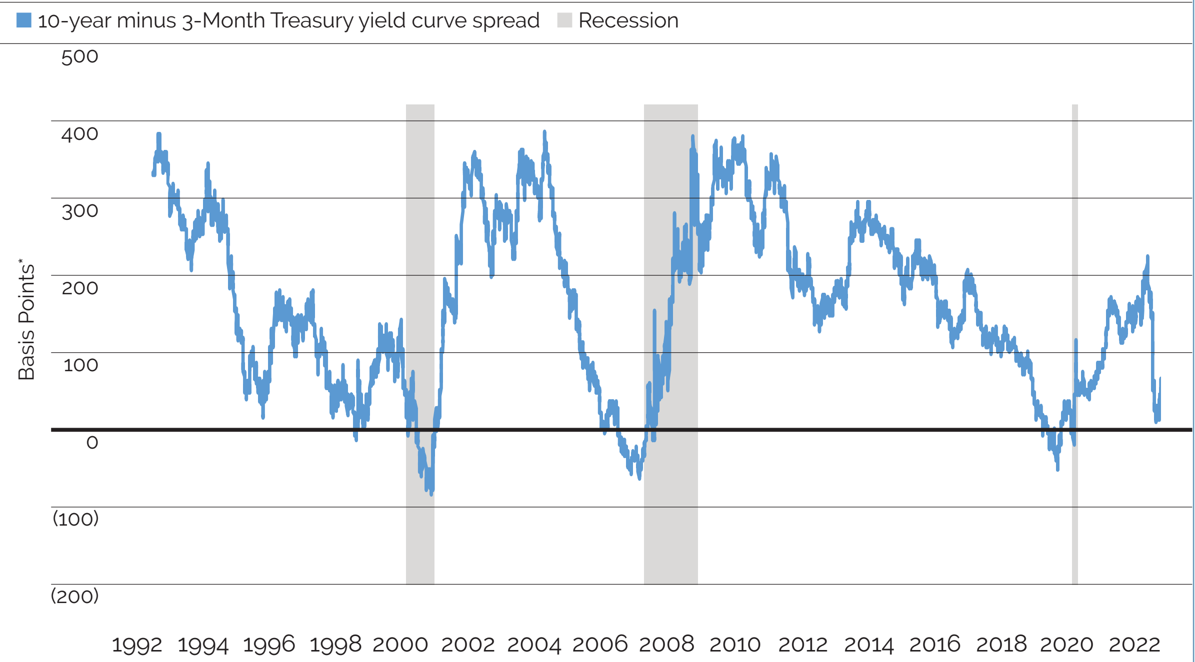

Figure 4 Source: Bloomberg. Data as of 9/30/2022. *Basis Points are defined as one hundredth of one percent.

Midterm Election Stock Market History

The S&P 500 has historically underperformed in the year leading up to midterm elections, with an average annual return of only 0.3% over the last fifteen instances. Post-Election Day, the S&P 500 has an average return of 16.3% over the following twelve months (Figure 5).

Some of the weakness prior to an election can perhaps be attributed to the political party in office orchestrating a slowdown during the President's second year in order for the economy to recover during years three and four. Many of these periods have coincided with the Fed raising interest rates to slow growth.

The above-average stock market performance following midterm election years can be attributed to several factors:

- If the President's party has control, typically economic growth is prioritized during the final two years of a President's term via fiscal policy, which includes government spending, tax cuts, etc. A strong economy increases the likelihood of reelection.
- The government is divided and gridlock may be viewed as a goldilocks scenario. The stock market hates uncertainty and minimal changes to the fiscal budget and taxes may be welcomed.
- The Fed interest rate hiking cycle ended around Election Day.

Figure 5

Midterm Election Stock Market Performance Since 1962

	Year of Midterm	President	Party	President's Party: House Seats	President's Party: Senate Seats	Before-midterm S&P 500 Price Performance Nov. 1 - Oct. 31 (12 Months)	S&P 500 Price Performance Nov. 1 - Oct. 31 (Following 12 Months)
1	1962	John F. Kennedy	D	-4	+3	-17.6%	30.9%
2	1966	Lyndon Johnson	D	-47	-4	-13.2%	17.1%
3	1970	Richard Nixon	R	-12	+2	-14.4%	13.0%
4	1974	Gerald Ford (Nixon)	R	-48	-5	-31.8%	20.5%
5	1978	Jimmy Carter	D	-15	-3	0.9%	9.3%
6	1982	Ronald Reagen	R	-26	+1	9.7%	22.3%
7	1986	Ronald Reagen	R	-5	-8	28.5%	3.2%
8	1990	George Bush	R	-8	-1	-10.7%	29.1%
9	1994	Bill Clinton	D	-52	-8	1.0%	23.1%
10	1998	Bill Clinton	D	+5	0	20.1%	24.1%
11	2002	George W. Bush	R	+8	+2	-16.4%	18.6%
12	2006	George W. Bush	R	-30	-6	14.2%	12.4%
13	2010	Barack Obama	D	-63	-6	14.2%	5.9%
14	2014	Barack Obama	D	-13	-9	14.9%	3.0%
15	2018	Donald Trump	R	-40	+2	5.3%	12.0%
Average Seat Change				**-23**	**-3**		
Midterm Average						**0.3%**	**16.3%**
Non-midterm Average						**10.7%**	**6.4%**

Figure 5 Source: Bloomberg. Data as of 9/30/2022.

Course of Action

As the summer rally faded, the S&P 500 and Dow Jones traded to new lows. Almost 90% of stocks on the New York Stock Exchange have broken a key technical indicator, the 200 day moving average, which we have only experienced during other periods of extreme stress in the markets (Figure 6).

Our approach is to invest in a core group of companies that we believe will create long-term value for shareholders. Given the rapidly changing environment experienced this year, we remain cautious that fundamentals for some companies may deteriorate. We have spent considerable time on downside scenarios but also continue to look for opportunities. Through our bottom-up research process, we have selectively added to the Technology and Consumer Discretionary sectors. These growth-focused sectors have been particularly challenged this year and valuations have contracted for many quality companies. We also continue to have significant exposure to the Healthcare sector, with many companies benefiting from secular tailwinds.

Figure 6

Percent of NYSE Stocks Closing Above 200 Day Moving Average

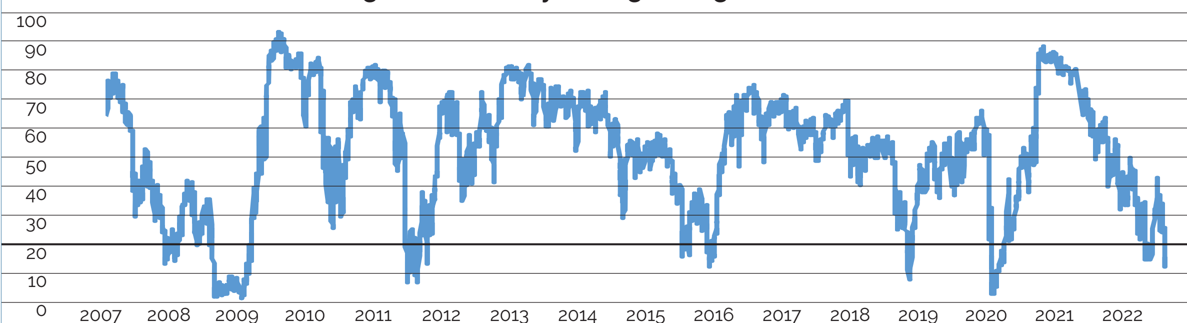

Figure 6 Source: Bloomberg. All performance based on total returns. Data as of 9/30/2022.

Important Disclosure Information

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