SSA Wealth Advisors

Market Outlook

29 September 2022

Key points

- Globalization being redesigned
- Global composite PMI at 49.3 indicates the case for a more severe recession is building
- Equity allocation further reduced
- Fed on fastest tightening cycle since 1980
- Buying short-term U.S. Government Bonds and TIPS

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Market Outlook

It has to be expected that recent events (Covid-19 crisis and Russia's invasion of Ukraine) will have long-term repercussions and lead to a redesign of the shape and structure of globalization. We are moving away from the dream that economic models around the world would converge towards the United States model of financial capitalism. Instead, it is now clear that China and Russia do not intend to adopt the American model and are willing to enhance their strategic independence even through war.

As the Financial Times wrote in its recent weekend essay: "The extraordinary post-cold war climate of optimistic liberal internationalism is coming to an end".

We are moving towards more regional frameworks which will in the west be organized around the U.S. and Europe (US-centric and China-centric blocs). The world will be much more fragmented than today and many global supply chains will have to be cut and reorganized within the new frameworks.

Multinationals' manufacturing operations around the world will be shifted from potentially hostile to more friendly but more expensive countries.

Such a development will not be beneficial to global Gross Domestic Product (GDP) growth and it has to be assumed that disinflationary forces (from when China, India and Eastern Europe entered the global economy) will be reversed and that we are moving into a higher inflation environment. This does – of course – not mean that inflation will remain forever at the high level we see currently. What it means is that it is very likely that we have seen the peak in inflation for the time being, but we will not go back to the very low inflation figures we have seen over the last three decades.

While this is more the scenario for the global economy in the medium- to long term, short-term, the risk of a very severe global recession has increased over the last few weeks.

In August, the global composite PMI[1)] slipped for the second straight month; down 1.5 points to 49.3. This was its lowest level and its first time in contraction territory since June 2020, led by weakness in both the manufacturing and services sectors. The latest reading in the PMI is historically consistent with just 0.1% annual global real GDP growth and indicates that the case is building for a more severe recessionary scenario.

Especially in Europe, most market participants expect that the energy shock will drive the economy into recession this coming winter. The Russian war in Ukraine was a game changer that effectively sent the entire region's economy into a tailspin. Hugely dependent on Russian energy, including half of its natural gas and a quarter of its petroleum needs prior to the COVID pandemic, the eurozone has been hit by massive supply shock inflation and the risk of being cut off entirely from its largest source of energy. This is likely making recession inevitable in Europe with the only question being just how deep it will be.

Regarding the U.S. economy, the case is a bit different and the outlook is less gloomy. However, the risk of a recession has increased in the U.S. as well. Inflation above 9% has forced the Federal Reserve System (Fed) into its most aggressive tightening cycle in four decades. Fed chair Jay Powell has repeatedly said that the Fed is prepared to push the economy into a recession to bring inflation under control. Given the Fed's poor track record of soft landings and the numerous forces outside its control within this cycle, the risk of a recession in the next year is elevated in the U.S. as well. In the best case, the U.S. might delay its recession into 2023, but the likelihood that the U.S. gets away with just a slowdown is very small.

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Equities

Within the first half of 2022, we have seen a double bear market (in equities and long-term bonds) adjusting to the end of easy money and rising inflation. As this first adjustment process to the new reality was done, the summer season has temporarily brought some relief to investors as the main equity markets had been rallying from the middle of June until the middle of August. Supporting this trend was a series of assumptions on key themes driving the market: inflation was assumed to be at its peak and starting to recede; growth was assumed to be on a soft landing path; and central banks were assumed to have done most of the work needed. Since September however, the narrative has changed, with a shift in focus to deceleration of growth and fears of inflation to remain high for longer than previously assumed.

As the overall view up to now was that we are just in a moderate global slowdown, the case for a more severe global recession is currently building. Unfortunately, some of the latest economic figures point in the direction of a further deteriorating economic environment (global composite PMI, technical constellation of the equity market, consumer confidence and others).

The distinction between a moderate global slowdown and a deeper recession is very important. As Ned Davis Research points out, global slowdowns have seen global equities fall a median of about 20% from peak to trough (this would have been "achieved"). For severe recessions, we have usually seen equities fall between 30% to 50% (with an average decline of about 35% over 15 months).

As at this point in time, we do not see a lot of positive triggers to reverse the downtrend and as the implication of a more severe recession coming implies that the stock market could drop another 10% to 15%, we decided before the last Fed meeting to reduce our equity exposure further in order to protect the portfolios from more downside risk. In practice this means that we reduced our equity exposure for a Balanced portfolio from 40.5% to 33%.

Chart: S&P500 (September-2020 to September-2022) with 50- & 200-day moving averages / source: Refinitiv

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Looking ahead, the probability of downside risks remains high. Any further fundamental deterioration could trigger another correction, as the equity market is already in a very fragile constellation.

On the other hand, any signal that a U.S. recession may be avoided or postponed further could lead to a tactical relief rally in upcoming weeks.

However, while short-term relief rallies can never be ruled out, for the market to turn for more than just a few weeks, macro factors would have to turn in the market's favor as well; bear markets do not just end on their own. Therefore, to become more optimistic, we would need to see inflation, the Fed, the economy, earnings, and geopolitics improving.

We do currently not see any of this happening, indeed, we think the market's earnings expectations are still too optimistic, even after the recent downward revisions. Pressure on earnings will probably increase moving into 2023 as inflation will still be high (although decelerating), financing costs will be higher after rate hikes, and the economic outlook could have deteriorated further.

Fixed Income

As expected, on September 21st the Federal Open Market Committee (FOMC) raised the fed funds target range by 0.75% to the range of 3.00% - 3.25%, the highest since Q1 2008. It was the third straight 0.75% increase for a total of 3% this cycle. That made it the fastest increase in the policy rate since December 1980 and more hikes are coming. Ned Davis Research expects a terminal range of 4.5% - 4.75% in 2023.

Rate cuts, due to the weakening economy by then, are only expected in 2024 and 2025. The Fed seems to have somehow resigned itself to the fact that controlling inflation will push the economy into recession. GDP was marked down to nearly flat this year and a sluggish 1.2% for next year. Inflation, however, is expected to take longer to subside with estimates for headline and core both revised higher. Moreover, inflation isn't expected to return to the Fed's target until 2025.

Therefore, looking already ahead, next year may bring heightened challenges. Although Consumer Price Index (CPI) rates will probably peak this year, inflation will likely remain historically elevated as supply shocks are unlikely to be alleviated in the near term. This would keep central banks on the hawkish side.

In conclusion, we continue to be in the phase when central banks have to assert credibility, and this is also a function of the pain in the market. So, investors should resist the temptation to take bold steps, as the tightening of financial conditions is not over yet. However, we believe that Central Banks may stop hiking earlier than expected in an attempt to avert more economic damage, and at that point, some further tactical opportunities may arise. Looking long term, inflation will likely continue to be above central bank targets. For investors, the need to keep the inflation focus at the core of their investment strategies remains important. With this outlook, inflation-linked securities and floating rate notes are part of our portfolio construction for building portfolios that are more resilient to inflation. We have thus reinvested part of the cash from the equity reduction into Treasury Inflation Protected Securities (TIPS)[2)]. A modest real return, along with inflation and principal protection looks like a good deal in this environment. Also, after the great repricing in the first half of the year and as we move to an environment with a higher risk of recession, short-term U.S. government bonds have become attractive as well and we reinvested part of the cash from the equity reduction into 1 year U.S. Treasury Bills (current yield 4%)[2)].

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Forex / Gold

The USD has further strengthened over the summer (the USD Index has broken to its highest level in nearly 20 years) driven by expectations that real interest rates (interest rates – inflation) will soon return to positive levels in the U.S. Especially the fact that real interest rates are rising slower in other developed economies makes the USD relatively attractive. Therefore, although the USD is overvalued according to the well-known Purchasing Power Parity (PPP)[3)] theory against most currencies, the USD is likely to gain further in the near term, supported by the Fed's hawkish stance. We expect USD strength to continue as long as the yield differential speaks in favor of the USD. Moreover, geopolitical events and the outlook for a much more severe recession in Europe versus a more moderate one in the U.S. continue to support the USD uptrend in the near-term.
As far as Gold is concerned, as it is very often said, the USD and gold are negatively correlated. A return to positive real interest rates would therefore be a negative influence on gold, which doesn't pay interest and would be at a competitive disadvantage versus cash.
The reason why we still like Gold is that it serves as a good short-term hedge against geopolitical risk and as a non-traditional asset, it is a good diversification versus equities and bonds.

Chart: EUR/USD (September-2020 to September-2022) with 50- & 200-day moving averages / source: Refinitiv

Footnotes

1) The Purchasing Managers' Index (PMI) is an index of the prevailing direction of economic trends in the manufacturing and service sectors. It is a diffusion index that summarizes whether market conditions, as viewed by purchasing managers, are expanding, staying the same, or contracting. The purpose of the PMI is to provide information about current and future business conditions to company decision makers, analysts, and investors.

2) For investment profiles with the reference currency USD

3) The Purchasing Power Parity Theory is a model which compares a 'basket of goods' from one country to another.

Source: Ned Davis Research, Financial Times, Amundi, IMF, World bank, OECD

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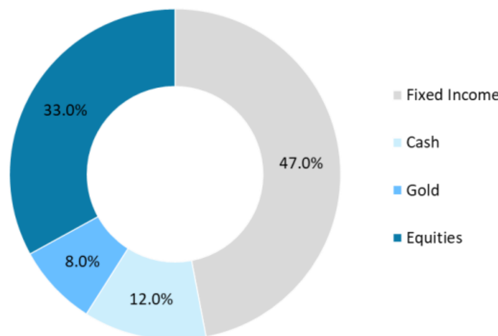
Asset Allocation

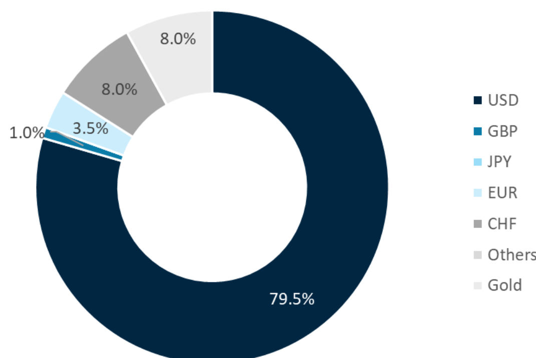
Given the factors described, we reduced our equity allocation further (USD and CHF Balanced details below).

Current Allocation USD Balanced

Asset Allocation

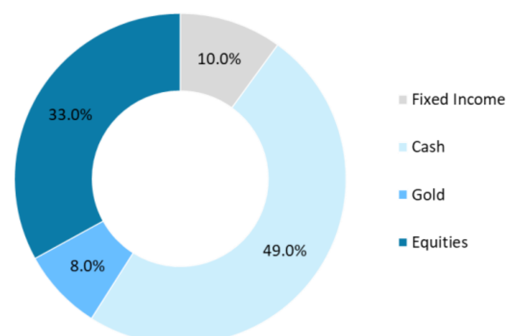


Currency Allocation

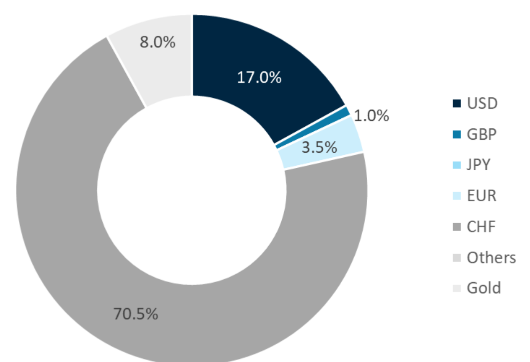


Current Allocation CHF Balanced

Asset Allocation



Currency Allocation



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