



ALLUVIAL
PRIVATE WEALTH

Alluvial Corner

with Mary Ann Bartels

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“WINTER IS COMING, BUT FIRST, THE FALL.”

Since the days of Alan Greenspan, anytime the U.S. economy faced a crisis, the Fed would cut interest rates and print money (known as the “Greenspan Put” and then the “Fed Put”). But that approach is gone, as we’ve moved from Fed stimulus to fiscal stimulus – exemplified by Congress recently passing three key pieces of legislation: the semiconductor CHIPS and Science Bill, the Inflation Reduction Act, and the Student Debt Relief Plan. These stimulus packages will add nearly \$1.5-\$2 trillion dollars to the economy.

The Fed has pivoted to aggressively tightening monetary policy to get inflation back down to 2% by raising rates and quantitative tightening by selling assets on the balance sheet which ballooned to \$9 trillion dollars. The fiscal stimulus is likely adding to the staunch stance the Fed has taken to tightening monetary policy. There is a tug of war between the Fed fighting inflation and the stimulus on the fiscal side. Chair of the Federal Reserve Jerome Powell has been very clear with his message. This process of fighting inflation will cause pain. The Fed is likely to tighten until there are clearer signs that we are in a recession, or something somewhere breaks, and they begin to ease monetary conditions.

The Fed Put is Gone

Yield Curve Inversion the Worst in 22 years

The yield curve, which is the ratio of 2-year Treasuries to 10-year Treasuries, has gone below zero or has inverted. This historically has signaled a future recession as short interest rates are above long-term rates.



Source: StockCharts.com - As of 9/26/22

Growth of Fed Balance Sheet

When Ben Bernanke took over the Fed prior to the Global Financial Crisis, the Fed balance sheet was just under \$1 trillion. It has since ballooned, through the Covid crisis, to reach \$9 trillion and reached an historic 38% as a percentage of GDP— an extraordinary, unprecedented amount of assets on the balance sheet. Trimming the Fed's balance sheet is an additional form of tightening. The combination of higher rates and reducing the balance sheet will have a significant negative impact on the economy, employment, consumer spending and corporate earnings.



Source: Bloomberg - As of 9/27/22

Key Takeaway

Brace for a recession and continued downside risk in stocks and bonds but at some point in 2023, the course of higher rates and lower asset prices will reverse. Our estimate is stocks bottom somewhere in Q2-Q3 2023.

Keeping an Eye on the Big Picture

Bear markets are never fun. So it's important to take a step back and see the bigger picture. Taking an historical view of the secular trends of the equity market using the Dow Jones Industrial Average (DJIA), the market tends to run on long secular cycles that can last 15-20 years. The greatest secular uptrend was from 1982 to 2000 with a marginal new high in 2007. Then we entered the Great Financial Crisis with lows set in early 2009. A new secular uptrend began in 2013 as the DJIA hit record new highs, making this cycle less than 10 years old. We believe this contraction in the market is a traditional bear market and bears can contract on average 37%. We think this bear might range around a decline of 33%. Unfortunately, if you haven't gone to cash by now, we think it's too late.



Source: StockCharts.com - As of 9/26/22

So why stay invested? Because many investors can sell but most don't have the emotional constitution to buy the bottom because the news is so bad. Also, the probability of getting the two calls right – the buy and the sell – is very low. In addition, if you are receiving, you will lose this income and reinvestment power. The way to navigate a bear now is to be patient – they don't last forever!

What An Old-Fashioned Bear Market Looks Like

We believe we're currently three-fourths of the way through this bear market. What are the support levels within the marketplace? First support is the June low near 3600 but given the downside risk to earnings for 4Q22 and next year, we believe this level will not hold. The next range of support is 3500-3200. As you can see in the chart below, the uptrend in effect since the lows of 2009 would still be intact if the S&P 500 went as low as 3200. Essentially, the market will be given back the Covid stimulus rally. As we know: bears are painful. And while that pain will continue, we're three-fourths of the way through, with only about six months to go.



Source: StockCharts.com - As of 9/26/22

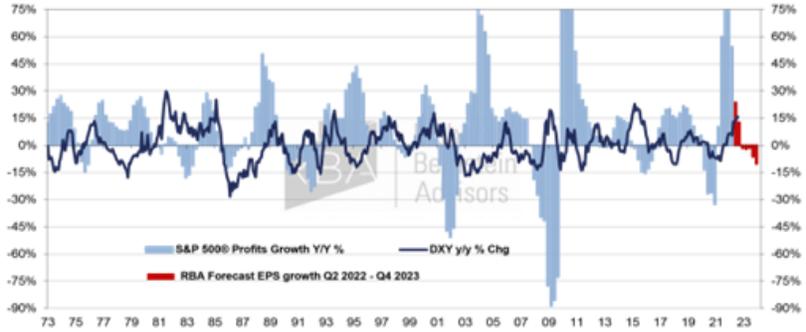
Meanwhile, we also continue to enjoy a secular bull market, meaning that when we complete this bear market, we will again see all-time market highs. So, it's not a time to panic, but to be patient.

It's Earnings Season. Or "Duck" Season.

We can expect downward estimate revisions to abound this season due to multiple economic forces putting the squeeze on companies. The Fed wants to slow down the economy, which in turn will lead to a slowdown in earnings. In addition, the U.S. Dollar is very strong and is also likely to put downward pressure on earnings. The risk is as we move into earnings season in October, many companies will be offering negative comments, just as FedEx did in mid-September, when it withdrew its FY23 earnings forecast, citing a volatile operating environment – an action that moved the market and tanked the stock more than 20% the next trading day.

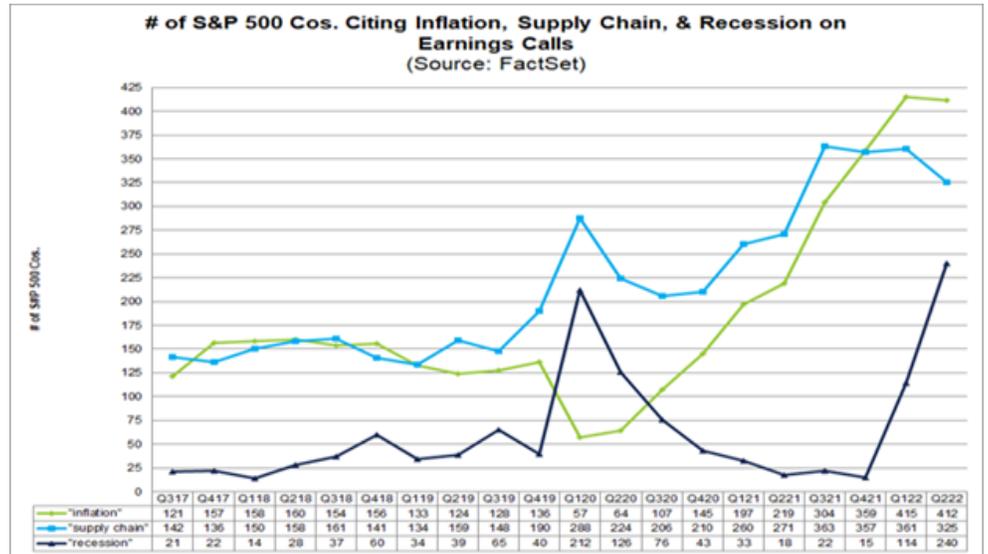
The takeaway is October could be a bit tricky, but historically major important market bottoms have been set in this month.

CHART 3:
S&P 500 Reported EPS Growth & DXY Y/Y % Change
(Mar. 31, 1973 – Aug. 3, 2022)

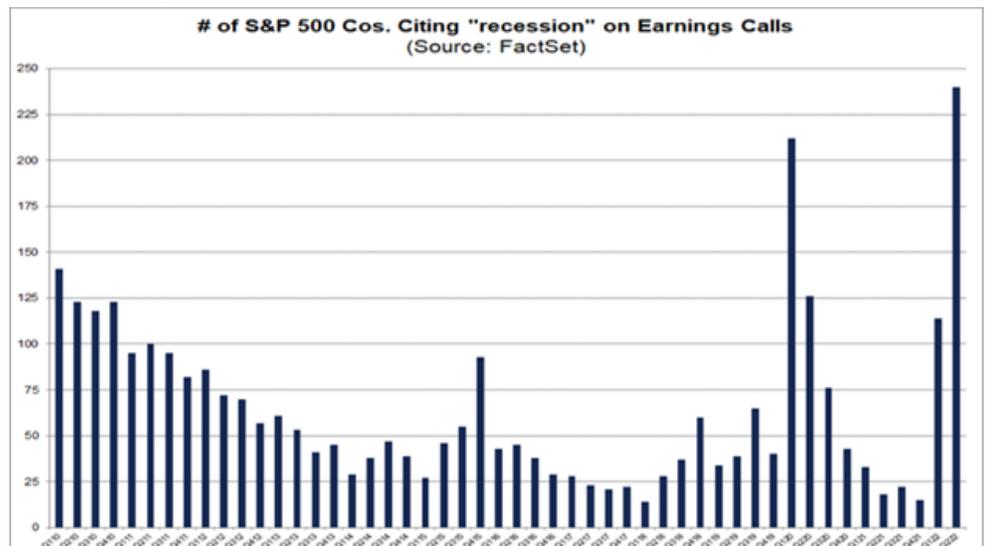


Source: Richard Bernstein Advisors LLC., Standard & Poor's, Bloomberg, Factset.

Source: Richard Bernstein Advisors LLC., Standard & Poor's, Bloomberg, FactSet - As of 8/3/22



Source: FactSet - As of 9/23/22



Source: FactSet - As of 9/23/22

Hot Inflation Hot CPI

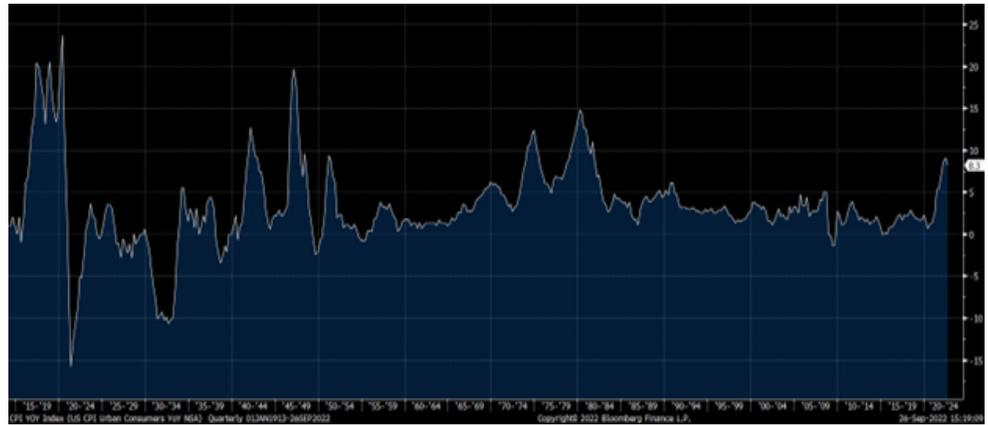
Commodity prices are on fire, rising steeply in a short amount of time like never before. It's going to take time to absorb the increase, as the Fed has confirmed its commitment to wrestle inflation from a 40-year high, down to a level tolerable for markets and consumers alike.



Source: StockCharts.com - As of 9/23/22

CPI Year on Year Hit 8.3% - Highest level in 40 years

When Ben Bernanke took over the Fed prior to the Global Financial Crisis, the Fed balance sheet was just under \$1 trillion. It has since ballooned, through the Covid crisis, to reach \$9 trillion and reached an historic 38% as a percentage of GDP— an extraordinary, unprecedented amount of assets on the balance sheet. Trimming the Fed's balance sheet is an additional form of tightening. The combination of higher rates and reducing the balance sheet will have a significant negative impact on the economy, employment, consumer spending and corporate earnings.



Source: Bloomberg - As of 9/27/22

Volcker Reincarnated

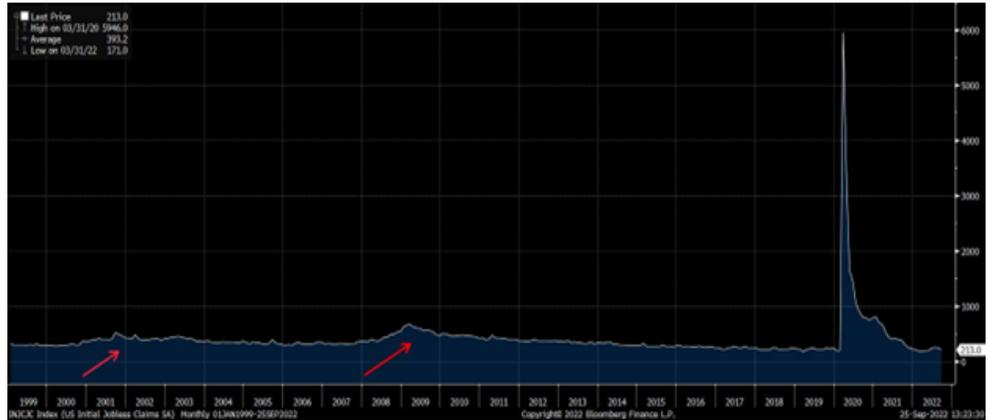
Yes, there's a specter from decades past in the form of inflation, but this is not the 1970s. Interest rates are not expected to go as high as they did in either the '70s or even the early '80s.

But the question remains: What is the terminal rate? That is, what's the target rate where the Fed will feel comfortable enough to cease its periodic rate hikes? As of now, the market is pricing that rate as 4.5% for April – resulting in the highest rates since 2008. Chair Powell said in his recent press conference that he personally thought rates would hit 4.6% next year.

The absence of a crystal ball on the Fed's terminal rate will continue to lead to episodic volatility in stocks and bonds and now the currency markets. It's an understatement, but worth repeating as markets don't like uncertainty.

Employment

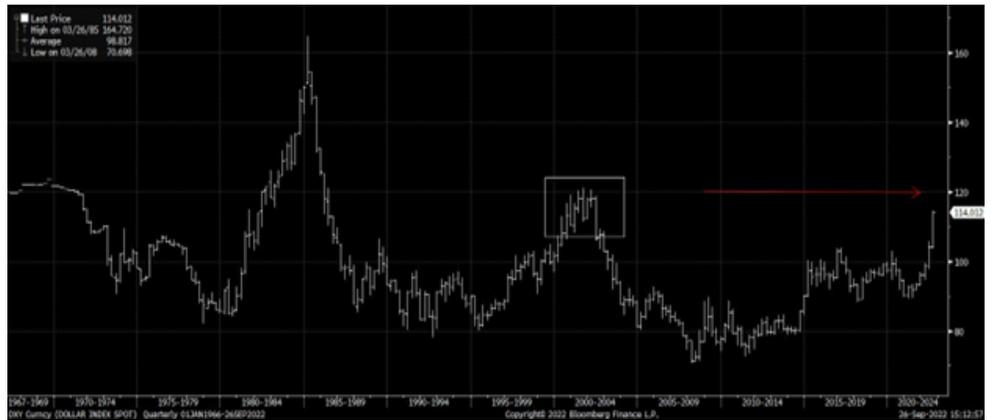
Conversely, the Fed needs unemployment to go up, a measure that will impede overheated growth. The chart below is initial jobless claims and a leading indicator of employment. This measure is likely to rise in the months ahead. The Fed Governors are targeting a 4.6%-5% unemployment rate.



Source: Bloomberg - As of 9/27/22

King Dollar is Back

The U.S. dollar is extremely strong and breaking key technical levels as rates across yield curve continue to sharply rise and are expected to continue go up. This is causing episodic volatility in the currency markets as well. The British pound has hit a record low while the euro and yen also continue their sharp declines or what is known as depreciation. Many years ago, as Europe went to the Euro, the currency markets became a model of three major currencies. This created a three-factor model of dollar, euro and yen. So, if one currency is extremely the strong or weak, the other two currencies would move to the opposite.



Source: Bloomberg - As of 9/27/22

Today, we have one very strong dollar, and this is leaving the euro and yen and most other world currencies weaker, including Chinese yuan. We have seen some intervention by the Japanese to slow the pace of the yen decline and this is likely to continue. The United Kingdom is likely to raise rates aggressively to help stem the decline in the pound. Weaker currencies do help stimulate economies as their goods become cheaper. But markets never like big fast moves in currencies as it is challenging to shift businesses and economies as quickly. We do expect the U.S. dollar to continue to strengthen. The dollar index could go back to the levels last seen in 2002-2001 at 120-121.

Sector Focus and Positioning

We continue to advise investors to remain defensive: stay with Quality across asset classes, Value and Dividends as we ride through this bear market. Now is the time to stay away from high growth, high PE stocks. Yes there are some high growth stocks to consider, but they're likely to stay under pressure for some time. FANG is broken



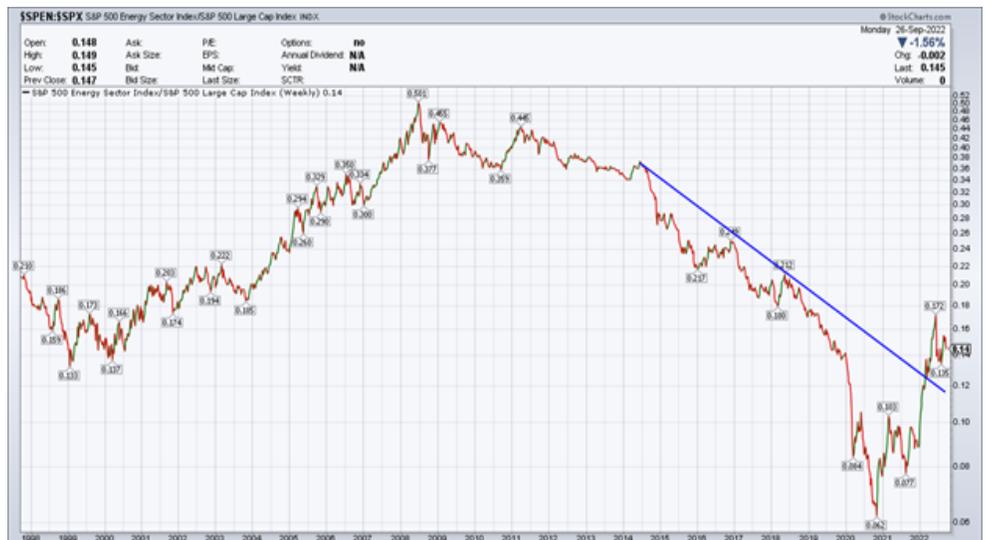
Source: StockCharts.com - As of 09/27/22

The Crude Realities of Energy – Most Bullish Sector

We see Energy as the best performing sector by far, as it remains cheap, has bullish pricing, and offers dividends. Even Warren Buffett has been a buyer in the sector. The first chart below is the S&P 500 Energy sector, which is challenging its old all-time highs. Should the sector breakout, it would be one of the most bullish charts in the market. The second chart is the Energy sector relative to the S&P 500. The sector downtrend has been broken indicating the bear cycle is over. We believe energy represents the best value in the market today.



Source: StockCharts.com - As of 09/26/22



Source: StockCharts.com - As of 09/26/22

TINA has left the building and TARA enters

As interest rates fell to zero, it left investors with no other investment alternative but stocks. There Is No Alternative or TINA was born. Now, with interest rates the highest in decades, the 60/40 asset allocation model is coming back, and we have There Are Relative Alternatives or TARA.

U.S. 10-year Treasury yields look to rise to the 4-5% range. We believe there will be rebalancing opportunities in 4Q22. You won't have to look to only dividend paying stocks to generate income and cushion your portfolio. Once we get through this process, there will get great opportunities in both the bond and stock markets.

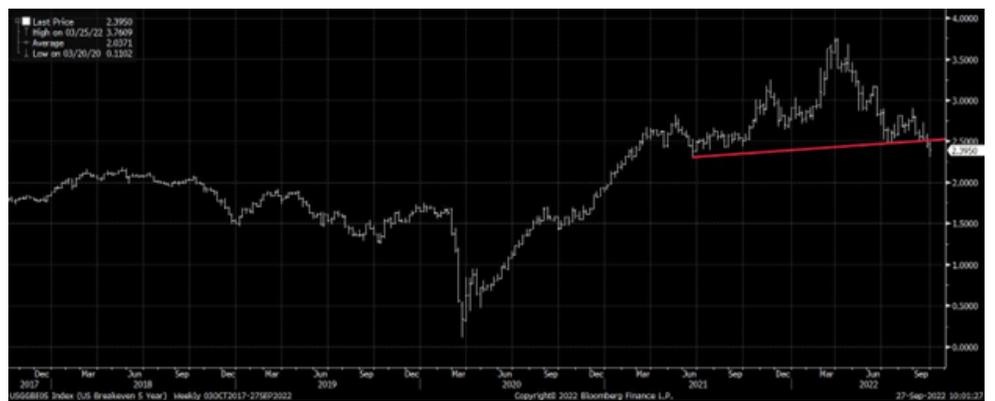
A new regime for 10-year Treasury Yields



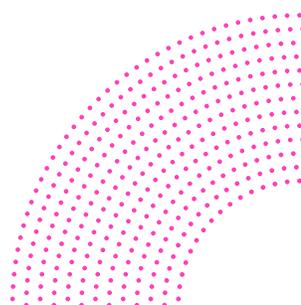
Source: Bloomberg - As of 9/27/22

The Good News: The 5-year U.S. Treasury Breakeven inflation rates are pricing in lower inflation ahead

As we move into 2023-2024, there will come a point the Fed pauses on rate hikes and begins to lower rates again. The 5-year Breakevens are already pricing in lower rates ahead.



Source: Bloomberg - As of 9/27/22





Last Words

Data out on the last trading day of September pointed to inflation remaining at a high level. The personal consumption expenditure (PCE) index rose to 6.2% year on year and, excluding food and energy, it was up 4.9% year on year. The PCE is a gauge the Fed watches closely, and these fresh numbers are much higher than the 2% the Fed has been targeting.

So with the specter of bad news continuing for some time, what should investors do? Stocks and bonds have already fallen sharply down into bear market territory, so we would not be aggressive sellers here. We would review some tax loss harvesting opportunities. We continue to believe that the 4th Quarter into the 1st Quarter of 2023 will offer rebalancing opportunities with a particular focus on locking in attractive rates in the bond market.

Be patient. Focus on high quality, value, and dividends. The fourth quarter will be a good time to revisit asset allocation repositioning for next year. The bond market will be the big story for 2023 – with rates we haven't seen for quite some time, and opportunities across bond asset classes: treasuries, corporates, munis, and credit.

Thank you.

Mary Ann Bartels
Chief Investment Strategist

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