

November 2022

## A Volatile Year Approaches Its End

2022 has proven to be a tumultuous year for investors. Rampant inflation and central banks' efforts to combat it have weighed heavily on the bond and stock markets alike. The S&P 500 ended 5.28% lower for the quarter and remains in bear territory, meaning down more than 20% from recent highs. The deep losses in the bond market have also continued. The Bloomberg US Aggregate Index is down 14.61% year-to-date through the end of the third quarter. Year-to-date, the standard investment portfolio consisting of 60% stocks and 40% bonds has had the third-worst year since 1926.



There have been early signs that the Fed is winning the fight against inflation. October's reading of the producer price index (PPI), which tracks wholesale inflation, came in lower than expected, and while the 8% annual increase seen in October is historically high, the month saw the smallest annual increase since last July and down from an all-time peak of 11.7% in March. Other inflation components, such as energy and commodity prices, have started to roll over, but sticky components, like housing, will take longer to fall. This puts the Fed in the difficult position of either slowing the pace of interest rate increases and pivoting to a more accommodating stance or maintaining its current aggressive stance until there is more evidence that inflation has been tamped down, even if it increases the chance of a recession.

We anticipate that by the spring or summer of next year, it will be clear that inflation is coming down. The M2 money supply, which exploded during the era of pandemic stimulus and caused inflationary pressure to surge, has declined at an annualized rate of 2.2% over the past six months and declined 4% over the last three months. This is the slowest M2 growth since at least 1960. Today, the M2 money supply is about 22% higher than its pre-pandemic long-term growth trend, whereas earlier in the year it was nearly 30% above trend. This means that the amount of "excess" money is rapidly falling and all but guarantees a decline in inflation is on the horizon.

Financial markets are forward-looking, and we anticipate that things will stabilize once it becomes apparent to investors that inflation is trending back down to the Fed's 2% target, even if it remains elevated above that for some time. The biggest unknown facing investors is how long the Fed



will maintain its current aggressive stance and whether its fight against inflation will tip the economy into a recession. The Fed's track record with "soft landings"—meaning bringing the inflation rate down without causing a recession—is abysmal, with most economists agreeing that the Fed has managed this feat just once out of 11 attempts over the past 60 years. After insisting that inflation was "transitory" for much of 2020 and 2021,

the Fed found itself behind the curve with regard to inflation and is now acting aggressively to catch up. The Fed has already made the unprecedented move of raising interest rates by 75 basis points at four consecutive meetings, and rhetoric from Fed officials suggests that they will maintain their aggressive stance until inflation comes down. The markets are anticipating a less aggressive, but still restrictive, 50 basis-point increase in December, but many economists argue that unless the Fed pivots to a more accommodating stance, they continue to risk over-tightening and causing a deeper slow down than is necessary.

It is clear that the economy is slowing, and the risk of a recession is on the rise. The Leading Economic Index (LEI), published by the economic research group The Conference Board, has fallen below a threshold that typically signals an impending recession. The LEI, which tracks 10 economic metrics like stock market performance, manufacturing orders, and unemployment claims, has fallen for the past six consecutive months and is down 2.8% from March. The housing market is in the midst of a potentially sizable slowdown. Mortgage rates have more than doubled over the past year, pricing many potential buyers out of the market. Applications to purchase a home have plummeted, falling to the lowest level since 2015, and the traffic of prospective buyers is at its lowest point since the early days of the pandemic. New construction of single-family homes is down 27.6% since February and has not posted a monthly increase since then. This has all manifested in U.S. home prices falling by 1.1% in August, the biggest monthly decline since 2012, when the last housing market crash hit its bottom. Retail sales have seen moderate growth, but official figures are not adjusted for inflation, so this growth is likely due to higher prices. Credit card balances exploded in the third quarter, which suggests that consumers are being stretched to maintain spending in the face of higher prices. Meanwhile, commodity prices are falling, the dollar is soaring, and real GDP growth is anemic. The yield curve between short-term and long-term Treasuries has inverted, which historically signals an impending recession.

Fortunately, however, a recession is not inevitable. Industrial production and job creation are still growing at healthy rates, recessionary signals like 2-year credit swap spreads are still in normal territory, and real interest rates are not prohibitively high. Rather than an outright recession, it is possi-

ble that we will see something of a “rolling recession” where different areas of the economy contract at different times for different reasons, which creates conflicting data. This “rolling recession” could well give way to an outright recession, particularly if the Fed continues to aggressively tighten. Amid such conflicting economic data, the Fed is likely to keep its eyes firmly on the unemployment rate and may not reconsider its current course until the labor market cools, which may lead to a more severe economic downturn than is necessary.



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Regardless of whether the economy falls into a recession, it is likely that we will see corporate earnings slow considerably and possibly contract. The third quarter earnings among S&P 500 companies highlighted the difficulties facing the markets and the environment, such as weakening consumer demand, high input and labor costs, the impact of a stronger U.S. dollar, and the Fed’s aggressive rate hikes. The number of companies reporting a positive earnings surprise (meaning higher than expected) and the magnitude of these surprises are both well below historical 5-year and 10-year averages. On a year-over-year basis, Q3 reported the lowest earnings growth since Q3 2020, when the economy was still struggling with the pandemic. Earnings projections have been slashed over the course of the year, but even with diminished expectations, just 73% of companies that have reported earnings thus far have beaten expectations by a collective 4%, a steep decline from early last year, when companies were beating expectations by more than 20% on average.

The recent downturn in the market has been dominated by steep losses among growth stocks, particularly in the tech sector, led by high profile earnings misses among titans like Amazon and Meta. However, the downturn has been broad-based, with booming energy stocks masking the severity of the downturn. The second quarter saw impressive earnings growth of 8.4%, but when the energy sector is excluded, earnings were down more than 2%. Seven of the 11 S&P 500 sectors are expected to see a contraction in earnings for both the third and fourth quarters. Earnings are expected to continue to slow, and we may potentially see an earnings recession. Growth stocks are likely to suffer the most, as they have come to rely on an accommodating Fed to justify their sky-high valuations. Com-

panies that derive much of their revenue from international sources will continue to be held back by the relative strength of the dollar. Research from Goldman Sachs estimates that every 1% change in the value of the dollar has an inverse impact of 0.5% on S&P earnings per share.



We anticipate volatility in the market to continue until investors believe that inflation is trending back to normal levels. Again, markets are forward looking and will begin to stabilize in anticipation of inflation cresting and more a accommodating Fed, which will likely be 6 to 9 months from now. In the meantime, we will maintain a defensive position, reallocating equity holdings to companies that are poised to do well in the high-interest rate, low growth environment and staggering our bond holdings to better manage climbing yields and higher inflation. The recent downturn also presents an opportunity to harvest tax losses and make client portfolios more tax efficient. Among equities, we expect growth to be slower moving forward. A less accommodating Fed means less liquidity to pump up stock valuations, and while this is resulting in steep losses now, it will make many stocks more attractive as their sky-high valuations come back down to realistic levels. Our current preference is for mid-sized U.S. stocks, an arena that is not as dominated by tech. We believe value stocks are better positioned to perform well than growth stocks. We will maintain our overweighted allocation of energy stocks, which have performed extremely well this year. They will remain an important hedge against inflation and the hefty dividends they are paying make them attractive, even as energy prices stabilize.

### **Hanover Advisor Bulletins**

#### **Special Reminders to all Hanover Clients**

- ◆ Hanover's annual ADV form has been filed with the SEC. This important disclosure document allows clients to learn more about Hanover's investment practices and compensation model. The form can be accessed at [hanoveradvisorsinc.com](http://hanoveradvisorsinc.com).
- ◆ We invite all clients to schedule an online portfolio review. Because we respect your time, we offer three different meeting formats that vary in length and level of specificity. For more information or to schedule a meeting, please contact us.
- ◆ The Hanover Advisors website can be accessed at [hanoveradvisorsinc.com](http://hanoveradvisorsinc.com). There you will find our latest newsletter and investment commentary, articles, our blog, and videos. You can also learn more about our services, access both the Black Diamond performance reporting system and your Pershing brokerage account(s).
- ◆ All Hanover clients have free access to our internet-based reporting system known as Black Diamond. This robust system provides comprehensive performance reporting, asset allocation and risk assessment on clients' portfolios. Our office is available to assist in accessing and utilizing the Black Diamond system.

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