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2022 4th Quarter Outlook

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Economy: Hollencrest continues to see a high probability of recession as a result of current economic conditions combining with the Fed's hawkish bias in tightening financial conditions.

- The stock market's Q3 "bear market rally" from June lows to August highs was driven by market participants beginning to question the Fed's resolve to tighten financial conditions to a point where inflation would be brought under complete control at the expense of economic growth. Beginning in August, and continuing through the end of Q3, the Fed made it clear that there is little that will cause them to change course. Instead, they have guided towards future economic "pain" that we also see as likely in our outlook. We believe that any sort of meaningful pivot before inflation is at acceptable long-term levels will need to be preceded by a deterioration in headline employment data, likely accompanied by a severe decline in general economic activity. Without these influences, the Fed may pause and maintain an overly restrictive policy for a prolonged period, eventually leading to a similarly negative outcome. Markets are once again beginning to price in a negative outcome as we exit Q3.

- The hoped-for soft landing, previously the best-case scenario, may now look more like what we refer to as a "rolling recession" - one that moves from industry to industry without a moment in time where the entire economy comes under extreme pressure. We have already seen a recession unfold in housing, with decreased activity and prices beginning to roll over. Tech has seen a slow down as well. With Q1 and Q2 printing mildly negative GDP figures and Q3 looking like it will print positive, it appears we may not yet officially be in a recession across the broad economy. However, we ascribe a low probability to the "rolling recession" outcome coming to fruition, if only because history provides little evidence that these outcomes actually occur. The more probable outcome is a traditional recession, marked by an escalation in defaults and job loss, neither of which have happened yet.

- Inflation's impact on everyday life for most Americans proved painful in Q3, however there are signs that it has peaked. Commodity prices have fallen sharply from highs, housing prices have shown consecutive months of decline, rents appear to be stabilizing and the cost of big purchase items like autos have shown evidence of peaking as well. Year-over-year data will continue to show high rates of inflation through year end as much of the increase is already baked in from early in 2022, but looking forward we expect inflation to moderate over the next 12 months as the Fed's demand destruction begins to take effect.

- We have held out hope over recent quarters that supply side issues in the global economy may suddenly abate, leading to a macro balance that would allow for reasonable growth with normalized inflation. Although certain indicators show supply chain dynamics are improving, like the cost to ship a container across the Pacific falling from $19,000 to less than $4,000, for example, it has become increasingly apparent that the way the world thinks about doing business has changed since the pandemic arrived. No longer is the sole focus on the lowest cost provider. Companies instead seek security and redundancies in their supply chain with a preference for keeping things domestic. These changes in thinking, and a major trend toward deglobalization, will make inflation hard to stifle permanently. With the Fed's tools focused only on domestic demand creation and destruction, there will be longer-term risks for more accommodative Fed and fiscal policies to reignite inflationary pressures.

Stocks: The S&P 500 ended Q3 at 3,585, now down 25% for the year. With our expectation of recession, we see potential for further downside as multiples drop and earnings forecasts begin to come under question.

- Markets have reset in valuation to account for the jump in risk-free and discount rates. There is now an alternative to speculative growth stock investing in the form of Treasuries that have meaningful yield, so valuations had to decline to allow for future growth that will lead to excess returns above Treasury yields. We do not believe the revaluation to date accounts for a decline in economic activity and the resulting impact on corporate earnings. As Fed tightening begins to take hold, demand will be destroyed and earnings will follow. We have not yet seen earnings multiples associated with recessionary market bottoms.

- Arguably the most notable characteristic of this bear market has been its lack of volatility. This may sound controversial as a market that has exhibited the losses seen year to date must appear volatile to the passive onlooker, however we have not seen the market reach extremely oversold levels as measured by standard deviations or divergences from major trend lines. Instead, the market has churned lower in an orderly fashion. Additionally, the VIX, which measures option premium pricing and is widely considered an index of volatility and fear in the market, has not reached levels anywhere near those associated with bear markets and their bottoms. Market psychology suggests more panic selling is required before weak holders of stock are sold out and a new, strong bull market can take hold. Although not an absolute requirement for a bottom, this is the kind of environment of which Hollencrest looks to take advantage and best sets up for a more investable long-term advance.

- We are increasingly convinced the market will likely return to at least pre-pandemic levels before a long-term bottom is in place. It now appears most of the advance to 4,800 on the S&P was attributable to Fed policy, and the economy is arguably in a worse position with the damage that has occurred to the supply side. Markets tend to overshoot when they come under selling pressure, and multiples have much further to fall if the earnings outlook changes, so there is a meaningful probability of an even larger drop.

- As described last quarter, Hollencrest has moved significant amounts of clients' managed equity exposure to cash equivalents. One of the best opportunities the current market has created is the ability to make a meaningful nominal return in short-term Treasuries that should hopefully match inflation over the coming quarters.

Bonds and Rates: After the 10-year yield briefly touched 4% in Q3, we see a meaningful chance that high could hold. We see short-term rates continuing to climb, but Fed Funds may not quite reach the Fed's current dot plot high in the upper-4% area.

- The Fed has moved rates very aggressively in 2022 to get to a target Fed Funds rate of 300-325 bps. They will likely increase target Fed Funds by another 50-75 bps in November with another hike possible before the end of the year. At the other end of the Treasury yield curve, longer-term inflation expectations should eventually fall, lowering yields on the 10-, 20- and 30-year bonds, although timing and scale could be impacted by Fed balance sheet reduction. Although we don't see reason for a pivot at this point, we do believe a pause to evaluate the effects of both prior rate hikes and the tapering of the Fed's balance sheet would be prudent. The effects of rate hikes and the moves in related index rates like SOFR and LIBOR take significant time to flow through the economy. It can take months before a borrower has to actually send payment at the new rate after a change occurs, and it may take multiple payments before working capital balances are depleted and a borrower begins to change their behavior. The biggest risk continues to be a Fed misjudgment of the impacts of their policies, just as they did in 2021 as inflation got out of control and policy was kept too easy.

- One of our favorite questions we ask of economists we meet with revolves around the impacts of "QT" - Quantitative Tapering, also known as the Fed's balance sheet reduction. Currently, they are electing to not refinance about $90 billion of Treasuries and mortgage securities each month, or about 1% of the assets they hold. This effectively takes cash out of the system as those bonds mature and the counterparties (the Treasury and mortgage industry) must issue new bonds. This effective increase in supply drives yields higher and makes liquidity less available, both of which act to depress activity and demand. This is an incredibly important piece of Fed policy that gets very little discussion, and, unfortunately, the answers we get from economists vary widely, lack conviction and usually involve a "we'll see" at the end. Our hope is the Fed has a better handle on the impacts, but we are not convinced. This lack of clarity adds to the risk that Fed policy will go too far and cause more damage than expected.

- There have been a couple of notable developments with "spreads," or yield premiums above Treasuries, for various classes of debt. First, both investment grade and high yield corporate spreads have remained notably low as stocks have declined. They do not yet indicate a pending surge in defaults, but if and when we fall into recession this will change. As spreads "blow out" buying opportunities are created. Spreads usually rise sharply in advance of the most severe declines in stocks, which helps fuel our case for stocks falling further. Second, the 30-year mortgage has approached a rate of 7% as the 10-year Treasury sits below 4%. This 300+ bps spread defies our prior expectations and points to the Fed's QT possibly being a driver of what seems like an anomaly, especially after Powell's recent comments pointing towards a drop in housing prices possibly being a healthy development.