EARNINGS | GOVERNMENT POLICY | INVESTING | INTEREST RATES | MARKETS | ECONOMY

INVESTMENT STRATEGY INSIGHTS

Rising Late Cycle Risks

June 21st, 2022

Economic Turbulence Ahead

- As the odds of recession rise, investors should actively seek opportunities to reduce portfolio risk on market strength

Bull Makes Way for Bear

- Equity valuations remain relatively full given the rising risk of recession, implying further downside from here

Ratcheting Up Rates

- The path of inflation will be a key consideration in how quickly the Fed gets to, and how far it moves past, neutral

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Economic Turbulence Ahead

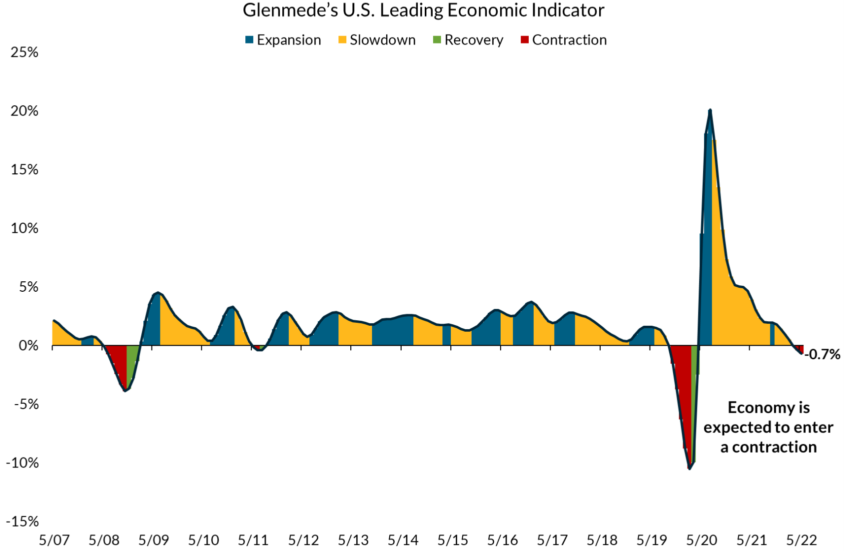
- **Recession Risks on the Rise.** Some leading indicators in the U.S. are beginning to show signs of slowing economic growth, as Glenmede's U.S. LEI*, which seeks to provide estimates of expected GDP growth over a 6-12 month window, is picking up on signs of economic turbulence ahead with its first negative reading since early 2020. This is driven by an all-time low in consumer sentiment, softening PMIs and tightening monetary policy beginning to flow through to the broader economy. As a result, the economic expansion, now in the late stage of its cycle, is quickly progressing to a more likely recession.
- **Market → Economy Feedback Loop.** As air continues to be let out from growth valuations, some tech companies that thrived during the pandemic are now beginning to pull back on hiring and capital expenditures. A handful of companies in recent weeks have announced considerable reductions in hiring, with some even taking the next step of instituting layoffs. This suggests a re-evaluation of near-term cost-management strategies is underway, as companies grapple with slowing revenue growth and higher rates.
- **Watching for Peak Earnings.** As economic risks have risen, earnings estimates appear not to have gotten the memo – next-twelve-month S&P 500 earnings per share currently sits at its post-pandemic peak of ~**$250**. There is now an increasing likelihood of an earnings downturn, particularly as persistent inflation begins to pressure profit margins and many retailers find their inventory stocks mismatched with consumer demand preferences. As the macroeconomic backdrop becomes more challenging, investors should expect downside risk to earnings.

As the odds of recession rise, investors should actively seek opportunities to reduce portfolio risk on market strength

**Leading Economic Indicator*

Chart of the Week:

Glenmede's U.S. LEI* suggests economic growth will turn negative



Source: Glenmede, FactSet Data through 6/17/2022

Glenmede's Leading Economic Indicator is a tool developed by Glenmede to help understand general economic trends. The main components are employment, business climate, monetary policy, housing, industrial conditions and consumer sentiment. Though created in good faith, there can be no guarantee that these indicators will be accurate.

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Rising Late Cycle Risks

Bull Makes Way for Bear

- **The New Bear Market.** The market's close last Monday officially christened the 11th bear market since the mid-1950s for the S&P 500. The empirical record suggests that bear markets have a history of further downside after crossing the -20% mark. The average of the ten prior bear markets is a decline of 36%, with two of the last four bear markets finding their trough after declines of almost 50% or more.
- **Nuanced Bond Positioning.** Markets have faced a perfect storm of falling equity and bond prices thus far in 2022. Historically, investment-grade fixed income has offered diversification benefits during declining equity markets, but higher inflation and rates have increased the correlation between both major asset classes year-to-date. Accordingly, investors looking to reduce the risk in their portfolios should focus on bonds with shorter terms to maturity that are less sensitive to changes in yields, which may be key given the uncertainty surrounding Fed tightening. In addition, the flat profile of the yield curve may allow investors to capture recently higher yields in short-duration bonds without the extra interest rate risk acquired from longer-maturity fixed income.
- **No Capitulation, Yet.** Glenmede's Market Sentiment Index has picked up on oversold conditions in domestic equity markets but has not yet signaled a full capitulation moment that is typically a hallmark of major market bottoms. In addition, certain equity asset classes, including large cap stocks, have yet to fully reach Glenmede's estimate of fair value. These are two important criteria to be met before investors can begin to get more constructive on risk assets.

Equity valuations remain relatively full given the rising risk of recession, implying further downside from here

Ratcheting Up Rates

- **FOMC Meeting.** Ending weeks of speculation, the Fed raised rates by 0.75% last week, consistent with recently realigned consensus expectations in the wake of the latest CPI report. While Powell indicated that he doesn't expect "moves of this size to be common," an increase of 50 or 75 basis points is now expected for the July meeting. This is a clear sign that the Fed recognizes it's still behind the curve on bringing inflation under control and is willing to take a more aggressive tack to defend its price stability mandate.
- **Rate Path Adjustments**. FOMC members indicated a much stronger path of rate increases as the Fed's newest dot plot now shows expectations for a total of 13 rate hikes for 2022 as opposed an earlier estimate for 7 in March. The federal funds rate is now projected to reach a peak of 3.8% by the end of 2023, before falling to 3.4% in 2024. This is a notable revision for rate expectations, as ongoing inflation trends continue to deviate from the Fed's rosier outlook for material price deceleration by year-end.
- **Assessing Neutral.** With the Fed now well along in its rate hike cycle and the balance sheet runoff underway in the background, monetary policy is approaching neutral and may surpass it by the end of 2022. The newly revised midpoint of the target range shows the Fed's benchmark rate will end the year at 3.4%, a level that closely resembles neutral. The longer it takes the Fed to bring inflation to heel, the odds of achieving a soft landing become incrementally more challenging, since a more aggressive tightening may incite macroeconomic risks that result from an increasingly restrictive posture.

The path of inflation will be a key consideration in how quickly the Fed gets to, and how far it moves past, neutral

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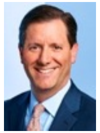

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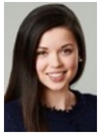

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Nearly $45 billion in assets under management as of 3/31/2022
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