INVESTMENT STRATEGY INSIGHTS

Tracking the Bear

October 31st, 2022

Calibrating the Bear Market

- Markets have declined significantly since the start of the year, but the bear market may still not be quite over

The Fed Pivot Reprise?

- The Federal Reserve should soon consider slowing its rate hikes, but rates are still likely to become meaningfully restrictive

Earnings Resilient…for Now

- While earnings continued to grow in the third quarter, a difficult economic environment still lies ahead

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- **Another Bear Market Rally?** With the S&P 500 up over 9% from its mid-October low, the market appears to be staging another bear-market rally. This rebound comes after sentiment reached an extreme low, suggesting that the market was oversold at the time, so such a rebound should not be unexpected. Such sentiment gauges have since shifted back to neutral following the robust rally. Despite the recent rebound, the S&P 500 remains down 19% from its peak, suggesting investors are not yet out of the woods.
- **A Historical Perspective.** The current market appears to be following the trajectory of the average historical bear market so far. The average bear market since World War II has lasted a little over fourteen months and resulted in a decline of 35.7% from the previous high. At approximately 10 months and 21%, the current bear market appears to be close to 2/3rds of the way through the typical bear-market decline.
- **The Rest of the Story.** Of course, the length and depth of the decline are not the only ways to gauge a bear market. Valuations have declined from peak levels to close to their 60th percentile for U.S. large cap stocks, but such valuations normally decline to below fair value during recessions. Similarly, growth stocks, which had reached extreme valuations relative to value stocks, appear to have seen around 2/3rds of their excess valuation erased by subsequent declines. Perhaps just as important, the Federal Reserve is also around 2/3rds of its way through its rate hike campaign and will be even closer to its final peak fed funds rate by the middle of next week.

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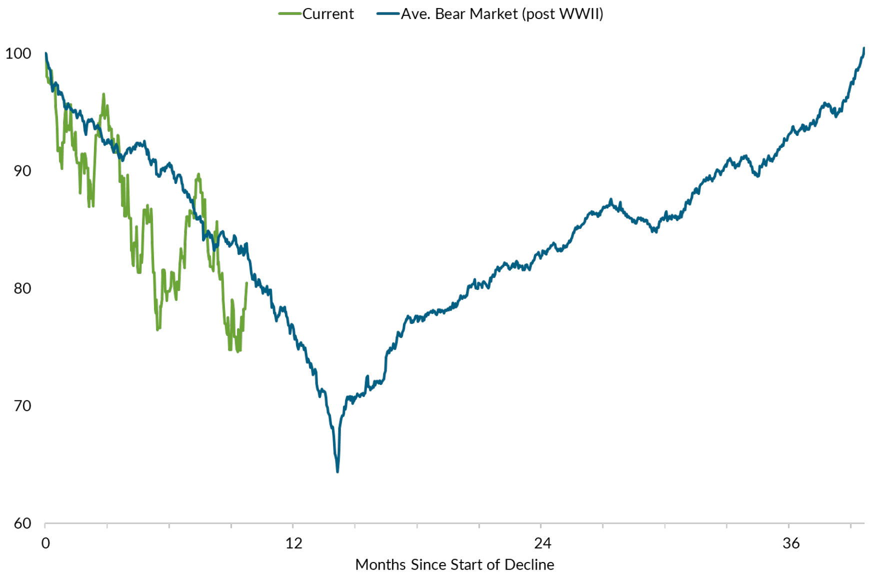
Chart of the Week:

Tracking the Bear Market's Decline



Source: Glenmede, FactSet | Data through 10/30/2022

The left panel shows the S&P 500 Index during the current bear market in green, as compared to its performance during the average bear market since World War II in blue. The right panel shows a summary of bear markets since World War II. Bear markets are defined as market declines of 20% or more. The S&P 500 is a market capitalization weighted index of U.S. large cap stocks. Past performance may not be indicative of future results. One cannot invest directly in an index.

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The Fed Pivot Reprise?

- **Another Rate Hike Coming.** The Federal Open Market Committee will likely take the next step in its policy shift this week with a fourth consecutive 0.75% rate increase. However, it appears that some regional Fed presidents have shifted the focus of their communications to emphasize the need for a slower pace of rate hikes. As some Fed officials begin to calibrate their rate setting, the debate then will likely center around whether and how to signal plans to approve a smaller increase in December.
- **The Fed's Dilemma.** Given that interest rate changes typically take time to filter through to inflation, the apparent lag of monetary tightening creates the risk that the Fed may prematurely reverse course on its intent to slow the pace of rate hikes. However, lags carry the opposite risk too, as the Fed may hold interest rates too high for too long, past the point when economic output has weakened enough and the anticipated decline in inflation is already in the pipeline. With a large portion of the economy yet to display much response to higher interest rates, this is likely to cause the Fed concern going forward as it attempts to balance the risks of under- and over-tightening.
- **Surpassing Neutral.** While estimates for the level of the "neutral" policy rate vary, Glenmede estimates that the fed funds rate now sits quite close to neutral and will meaningfully eclipse neutral with any subsequent rate hikes. Notably, futures market expectations for the fed funds rate by year-end rose to 4.4%, with a terminal funds rate of 4.8% by May of next year. It is important to note that 4%+ interest rates will sit firmly above the neutral level and should restrict the economy alongside inflation.

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Earnings Resilient…for Now

- **Q3 Earnings Season.** Another earnings season is underway, providing some of the first glimpses of profit trends for the second half of 2022. With more than 53% of companies reporting so far, the blended year-over-year earnings growth estimate for the S&P 500, which combines actual results with consensus estimates for firms that have yet to report, currently sits at 2.1%. The driving forces for growth are likely to remain inflation sensitive sectors such as energy, industrials, materials and real estate.
- **Big Tech in the Spotlight.** Last week's earnings reports likely set the tone for the remainder of the season, with several big tech companies signaling a slowdown in the U.S. economy. For example, Google's parent, Alphabet, missed expectations for Q3, while Microsoft provided weaker guidance amid softening demand. Given the wide belief that 2023 will see a recession, weaker-than-expected reports from some of the largest earnings contributors suggest a similar trend in other companies set to report in coming weeks.
- **Earnings Weakness Ahead.** The 2023 earnings per share estimate for the S&P 500 dipped lower last month as it now sits just below $239, down from its $250 estimate as of the beginning of Q2 earnings season. While earnings estimates for next year have moved lower in recent weeks, the pace of this decline is likely to ramp up in the coming quarter as companies begin to feel the pressure of an increasingly challenging macroeconomic environment. As such, forward guidance will be an important factor to observe in Q4 earnings season when companies begin to provide further insight to profit trends in 2023.

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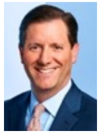

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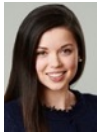

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