EARNINGS
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Crossing the Rubicon

November 7th, 2022

The Death of the 60/40 Portfolio?

- While 2022 may be one of the worst years on record for a 60/40 portfolio, reports of its death are greatly exaggerated

Stepping Beyond Neutral

- Investors should not underestimate the Fed's fortitude in getting inflation under control, which may require even tighter policy

Election Day in America

- The most likely outcome of the midterm is gridlock, though an unclear resolution could lead to near-term volatility

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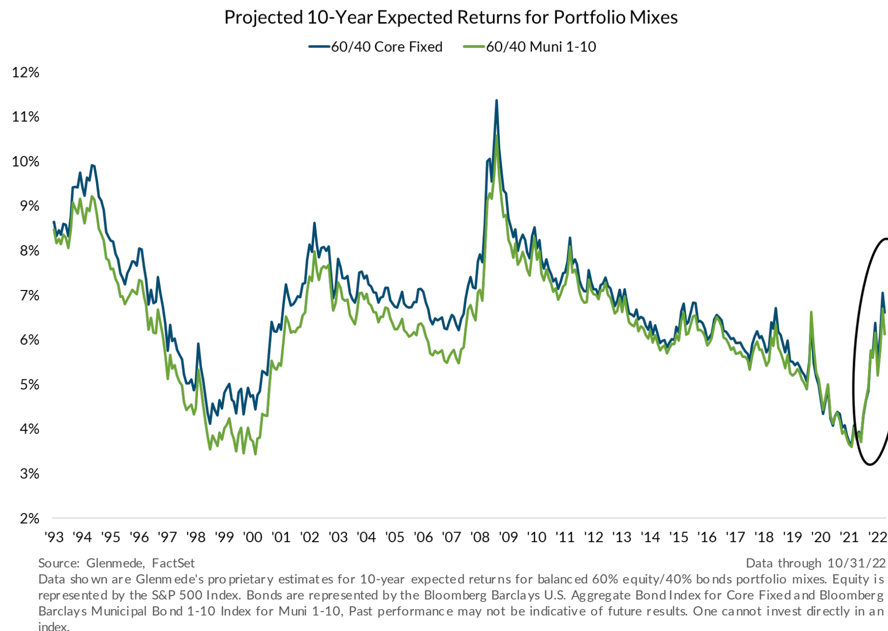
Crossing the Rubicon

The Death of the 60/40 Portfolio?

- **Poor Performance.** Markets have experienced a tough year with the S&P 500 declining -20.9% and investment-grade bonds* not far behind at -16.0%, combining to make a difficult year for a 60/40 portfolio (i.e., 60% stocks, 40% bonds). This year is shaping up to be the second in U.S. history when large cap stocks and core investment-grade bonds both post negative annual total returns. This downturn continues to be driven by a hawkish Fed seeking to bring inflation under control, upending the typically inverse relationship between stock and bond returns.
- **Better Value Ahead.** According to Glenmede's Global Expected Returns Model, large caps experienced a considerable rerating in valuation, falling to near their 60th percentile, down from the 93rd to start the year. Meanwhile, interest rates have risen in U.S. bond markets – core fixed yields have climbed to 5% from 1.8% year-to-date and core municipals have settled at 3.6%, up from 0.8%. Fairer valuations and higher yields should translate to a more constructive prospective return profile for stocks and bonds.
- **Primed for a Comeback.** Although this year has been quite unsettling, the reset in valuations and move higher in yields sets investors up for higher longer-term expected returns going forward. Glenmede's expected returns model now estimates that 10-year returns for stocks and bonds will be well above year ago levels, leading to a total expected return for a simple 60/40** portfolio of near 7%. Investors can further enhance that return profile by adopting a more diversified approach that includes allocations to small cap and international stocks as well as non-core fixed income.

While 2022 may be one of the worst years on record for a 60/40 portfolio, reports of its death are greatly exaggerated

Chart of the Week:



Source: Glenmede, FactSet Data through 10/31/22
Data shown are Glenmede's proprietary estimates for 10-year expected returns for balanced 60% equity/40% bonds portfolio mixes. Equity is represented by the S&P 500 Index. Bonds are represented by the Bloomberg Barclays U.S. Aggregate Bond Index for Core Fixed and Bloomberg Barclays Municipal Bond 1-10 Index for Muni 1-10, Past performance may not be indicative of future results. One cannot invest directly in an index.

*As represented by Bloomberg Barclays U.S. Aggregate Bond Index
** As represented by a portfolio composed of 60% S&P 500 Index and 40% Bloomberg Barclays U.S. Aggregate Bond Index

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Stepping Beyond Neutral

- **FOMC Meeting.** The Federal Open Market Committee followed through with another widely expected 0.75% rate hike last week, definitively placing U.S. monetary policy on a restrictive footing. New clauses in the statement appear to recognize that the Fed is not on autopilot with its tightening, accounting for "the cumulative tightening" and "the lags with which monetary policy" has its effects. The statement also noted the need for monetary policy to get "sufficiently restrictive to return inflation to 2%," though there remains uncertainty regarding what amount of rate hikes meets the "sufficient" mark.
- **Inflation is Key.** Thus far, the Fed has orchestrated a regimented march higher in rates, but that should now be giving way to a reactionary strategy in which further adjustments to rates will likely be more dependent on realized inflation prints and measures of inflation expectations. Notably, the Cleveland Fed's Inflation Nowcast is expecting headline CPI releases of 0.76% and 0.67% for October and November, respectively. If those releases print in the ballpark of those estimates, the Fed is likely to react to that meaningful inflation pressure by leaning in favor of another .75% rate hike in December.
- **Getting Restrictive.** The Fed now faces a challenging communications objective, given that they will need to slow the pace of rate increases at some point, but must do so without letting markets develop yet another "pivot" narrative. More so than ever, investors will attempt to dissect the language from the statement and press conference for hints of a dovish or hawkish tilt. All else equal, whether the terminal rate sits at 4.5%, 5% or beyond, monetary policy is poised to have a negative effect on the economy heading into 2023.

Investors should not underestimate the Fed's fortitude in getting inflation under control, which may require even tighter policy

Mid-Term Elections

- **Election Day is Here.** Voters across the country will head to the polls this Tuesday with control of Congress for the next two years at stake. FiveThirtyEight, a nonpartisan site dedicated to polling research and data, places only a 15% chance of a status quo outcome where Democrats maintain control of both chambers of Congress. That site further estimates an 84% chance that the Republicans take control of the House and coin-flip-like odds regarding control of the Senate.
- **Gridlock is Good (for Markets).** At a high level, the most likely implication from the prevailing election odds is gridlock in Washington for the next two years. Split Congress is a difficult recipe for reaching consensus on legislation. Even if the GOP sweeps Congress, it is unlikely that they win enough seats to pass legislation that can overcome President Biden's veto power. Historically, the S&P 500 has performed best during periods of split control in Washington, as government inaction from gridlock tends to maintain the status quo and reduce the volatility attributable to policy uncertainty for investors.
- **Risk of Delayed Resolution.** Given that a few key states have mail-in ballot policies that may lead to delayed results on election night, it's possible there may not be a concrete picture of the composition of Congress come market open on Wednesday. In addition, there could be another runoff election in Georgia that flips the needle for Senate control. The possibility of no immediate resolution on election night could lead to uncertainty in the near-term but is unlikely to prove overly disruptive beyond that.

The most likely outcome of the midterm is gridlock, though an unclear resolution could lead to near-term volatility

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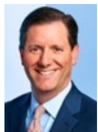

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