Hamilton-Bates
Market Update

September 22, 2022

Can the Fed Brake the Economy without Breaking It?

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The Federal Reserve signaled this week that it will keep raising rates for the foreseeable future, leaving investors wondering what's next for stocks.

The U.S. central bank raised rates by 75 basis points, as was expected, and said it expects the fed funds rate to reach 4.6% next year before wrapping up its tightening regime. This news, along with Chair Jerome Powell's comments that the Fed is committed to lower inflation (thereby suggesting higher rates for longer), sent stocks broadly lower. The S&P 500 registered a 1.7% drop, and the Dow Jones Industrial Average lost more than 500 points. The major averages are not near their July lows.

The Fed, the Economy, and Interest Rates
The story of the year by far in the financial markets has been the rate hikes by the Fed. Like a parent finally deciding to make their child eat their veggies, the Fed is forcing rates higher to tamp down inflation. Like a child, the financial markets aren't liking it. In the long-run normalizing rates and getting away from a decade of ZERO rates is a good thing. But it was and will be painful. Rising rates pressure all assets, from bonds to stocks to housing. All are in the process of buckling under rising rates. The key question is whether the Fed can put the brakes on the economy to cool inflation-without completely breaking the economy ala 2008?

The good news is that in our opinion the economy, the stock market, and the housing market are in much better shape than they were in 2008. Balance sheets are better, home owners have significantly more equity, and there hasn't been a boom new ownership at high prices due to lack of supply. In fact, renting has been booming so eventually there will be buyers when/as housing prices moderate. We are not big fans of the Fed, but if they temper their rhetoric in coming months (as the economy slows), they very well could cool inflation without a 2008 style scenario.

It seems pretty clear to us the economy is headed for a recession if its not in one already. The Fed has never hiked as much as it has without a recession following, and the yield curve remains inverted (short -term yields are higher than long-term yields). These important signals tell us a recession is not a question of 'if' but 'when'. Leading inflation signals are starting to roll over so if inflation cooperates the Fed could be able to take their foot off of the rate hike pedal earlier than expected. Earnings season is upon us again and we will get a good picture of things over the next few weeks. Fed-Ex has already said the quarter was weak and in their opinion the global economy is heading into a recession. We agree with them. If Q3 ends up showing a drop in GDP it would likely end the talk of whether or not we are in a recession.

Stock Market Outlook and Investment Strategy
We came into 2022 not liking the bond market at all and severely underweight bonds. We thought the stock market would have a volatile year, but would end-up down by just single digits. We were at least half right; and our underweight of bonds and our early year portfolio moves have left client portfolios with a lot of cash. We also sold into the failed August rally to raise even more. Cash is now paying close to 3% thanks to the Fed. Cash is no longer trash. But, but, but, don't get too bearish here.

Yes the stock market has been weak all year, as have bonds which are having their worst year in over a hundred years. The economy is likely headed into recession if we are not there already, and the Fed is hiking rates. But, there are some very real positives. The stock market has had 2 down quarters in a row and we could have a 3rd depending on what happens over the next week. That is a lot of selling already done! At the July lows, the stock market had already declined as much as it has in the average recession since WWII. So outside of the Great Recession, one could argue most or all of the damage is already done. With stocks once again around those lows, we could be setting up the most bullish pattern there is, a potential double bottom. This would require the market to test and hold those July lows, or perhaps even slightly break them followed by a quick recovery. This would set the stage for a much stronger rally than most are expecting right now, and could last well into 2023. A little bit more downside action is all we need to see if we are correct, and this could happen over the next few weeks. Keep in mind everything we do is tempered, we are simply stating we see some light at the end of the tunnel.

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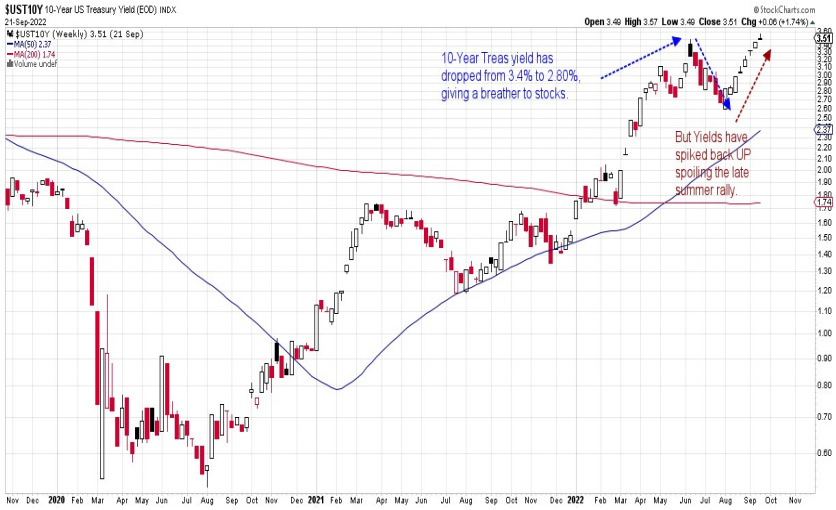
Market Charts

Bond Yields (Top)
Yields peaked in July and pulled back, taking the pressure off of stocks and we saw a strong rally into August. But bonds peaked at that point and stocks did as well, with both moving back toward their worst levels of the year. 10-year Treasury yields are now around 3.5%, their highest levels since 2011! As long as yields don't continue to spike higher (we think they will not) , there is a chance both bonds and stocks can bottom in Q4.



S&P 500 (Bottom)
Back August at the time of the last update, the market was testing the critical level of its 200-day average (red line). It failed that attempt and quickly rolled over. We actually sold assets right after the failed test. With the stock market now falling back toward the prior lows, its time to start making that BUY list. The market may have a tough couple weeks ahead, but a lasting low could be just ahead! We believe a low is shaping up and after sitting on a pile of cash for most of the year, believe a great buy opportunity is just ahead.