November Investment Outlook 2022

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Market Conditions

Dow Posts Best Month Since 1976

The Dow Jones Industrial Average (Dow) rallied 14% in October, which was the best single month gain since 1976. As a measure of broad market performance, the Dow is somewhat less reliable, given the narrower selection of stocks that it tracks. Nevertheless, in October, other major equity indices were also solid. The S&P 500 rose 8.1% for the month, and international developed markets (EAFE) gained 5.4%. Emerging markets bucked the trend and were down -3.1% as China's markets lagged due to concerns over its strict COVID-19 lockdowns.

Despite the solid recovery in October, year to date the S&P 500 is down -17.7%, international developed markets have dropped -22.8%, and emerging markets have declined -29.2%. With interest rates continuing to rise, returns in fixed income remain elusive. Year to date broad fixed income markets have dropped -15.5%, providing further evidence that there are very few places to hide from market volatility.

A defining feature of the markets this year has been sharp movements from month to month, as investors digest volatile streams of data trying to determine the market's bottom.

Much of the economic data remains relatively tepid, with inflation running at an unacceptably hot pace. The Federal Reserve Board (Fed) continues to raise interest rates to combat inflation, which drives greater concerns of a potential recession. Focus has shifted to how much more monetary tightening the Fed and other central banks believe is necessary to ensure price stability. During October, anticipation of potentially less restrictive monetary policies helped drive markets higher.

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The Impact of an Election Year on Financial Markets

U.S. elections have the potential to significantly shape governmental policies, and midterm elections historically result in material shifts of political control and influence. According to an analysis by the Brookings Institution, the vast majority of the time this is a negative event for the incumbent president's party, usually resulting in fewer congressional seats. (https://www.brookings.edu/wp-content/uploads/2017/01/vitalstats_ch2_tbl4.pdf).

Historically, in the year leading up to the midterm elections, volatility is higher and returns are lower. In the year subsequent to the midterm election, the opposite has been true – volatility is lower and returns higher. Importantly, while shorter periods show some biases one way or another, the mid-term election effect is largely party-independent. The chart below shows this in more detail.

Midterm Election Year	Price Return Year BEFORE The Midterm Elections	Price Return Year AFTER The Midterm Elections	Relative Performance One Year After vs. One Year Before	Presidential Party
1930	-16.8%	-36.5%	-19.7%	R
1934	-3.5%	43.4%	46.9%	D
1938	15.8%	-5.4%	-21.2%	D
1942	2.9%	17.6%	14.7%	D
1946	-13.8%	3.1%	16.9%	D
1950	25.8%	15.2%	-10.6%	D
1954	36.4%	38.1%	1.7%	R
1958	31.5%	7.1%	-24.4%	R
1962	-16.3%	20.6%	37.0%	D
1966	-11.8%	12.3%	24.1%	D
1970	-14.1%	10.1%	24.2%	R
1974	-29.8%	26.5%	56.3%	R
1978	-3.4%	12.3%	15.7%	D
1982	12.6%	20.7%	8.0%	R
1986	23.4%	0.5%	-23.0%	R
1990	-6.9%	20.7%	27.6%	R
1994	0.3%	27.7%	27.4%	D
1998	21.3%	23.9%	2.6%	D
2002	-20.3%	15.4%	35.8%	R
2006	13.6%	3.9%	-9.7%	R
2010	9.5%	5.0%	-4.5%	D
2014	13.4%	-0.8%	-14.3%	D
2018	6.5%	14.3%	7.8%	R
Average 1930-2018	3.3%	12.9%	9.5%	
Average 1970-2018	2.0%	13.9%	11.9%	

Source: Bloomberg and Klingenstein Fields Advisors

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One explanation for this effect is that in the period leading up to the midterm elections, uncertainty prevails regarding the direction of the political path forward. Election results bring relief to investors, and the markets tend to react positively, irrespective of the outcome. The market reinforces the idea that, when it comes to midterm elections, the only thing to fear is fear itself. Of course, there are a limited number of data points, and some years the market has bucked the trend. On average, however, the market expresses relief when the midterm elections are over, and it tends to rally.

Our Investment Strategy and Approach

Macro Under Pressure but Areas of Positive Influence

High inflation remains the focal point for capital markets. The Fed is tasked with the dual mandate of price stability and full employment, and changes to short-term interest rates remain its primary tool to achieve these objectives. There are reasons to be optimistic that inflation may ease in the not-too-distant future and the Fed's pace on interest rate increases will slow down. Oil prices are currently $20 higher per barrel than they averaged in 2021 and have been a significant factor in higher inflation over the past year. But as 2022 draws to a close, oil will face relatively easier comparisons to prior year data, meaning that the rate of increase should slow significantly. In addition, other commodities also show sign of lower prices, which we believe will help to reduce inflation pressures looking forward.

GDP growth and corporate profits forecasts for 2023 have moderated, raising potential recession concerns. Despite the negative impact of higher rates and subsequent slower growth, there are areas of positive influence. Employment remains strong, with unemployment rates near historic lows. Although the Fed continues to aggressively raise interest rates, expectations are for rates to plateau by the end of next year and start to come down. Poor investor sentiment pervades the market, which is historically a good indicator of improving market returns. Overly pessimistic investors tend to exit equities or value them for less than their intrinsic value, creating potentially attractive buying opportunities.

A positive impact of the Fed raising rates is the ability to earn higher returns on shorter-term fixed income instruments. We continue to evaluate and reconfigure selected fixed income positions to take advantage of these higher yields.

In the equity markets, we have also seen significant dispersion between managers, sectors, and stocks. While we are not making significant shifts in overall equity exposure, we continue to use these dislocations to cycle managers and stocks out of portfolios in favor of higher quality alternatives that are now more attractive on a risk-adjusted basis.

The volatile state of the economy, markets, and geopolitics provides for an interesting investment environment. There are some bright spots, and the potential for a post midterm election bounce remains possible. We recognize there is justification for caution in the near term, but we remain optimistic in the long-term power of capital markets to grow and protect wealth over time, and look to dislocations brought about by uncertainty to upgrade and improve portfolios.

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What We Are Looking at Going Forward

Inflation and the Fed's actions to control it through rate increases remain the primary focal points for capital markets. In October, investors started to look through tightening actions to a time when the Fed might stop raising rates, and perhaps even start to ease. This is not expected for many months at a minimum, but as each month passes, the view is the Fed is closer to a potential "pivot" to a less restrictive monetary policy. The hope of easier monetary policy in the not-too-distant future was a significant driver of strong market returns in October.

On November 2nd, the Fed doused some cold water on those views by indicating that it is premature to talk or even think about a pivot in monetary policy, as inflation is still high and the Fed is not finished raising rates. The Fed has tried to dampen market enthusiasm before, and it certainly seems that they are attempting to keep the markets from getting too excited, which would make its job of controlling inflation more difficult. Therefore, a key component we are looking at moving forward is to what degree the Fed's rate increases first start to moderate, then flatten, and perhaps even ease. The current expectation is that the Fed Funds Rate will peak at around 5.1% by mid-2023 and then flatten out. But there is a great deal of uncertainty around this, and the environment remains very much in flux.

Other important factors we are watching include the employment picture, which remains strong despite news of corporate layoffs. Global GDP and corporate profit estimates continue to incrementally weaken, driving the probability of a recession higher. We are also keeping a keen eye on geopolitics, which remain a powder keg and could potentially spark a wider global crisis.

Uncertainty is high, but we believe during times like this it behooves investors to firm up areas of conviction, as well as explore new opportunities afforded by the market's fear of potentially worst-case scenarios.

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