Convergence Commentary

October 2022 Market Recap

Quick Hits:

- Stocks rebounded nicely in October despite a disappointing inflation report and mixed earnings results.
- Bond yields have stabilized some after aggressively rising for much of 2022.
- Big tech earnings have been disappointing overall, but the major indexes have held up due to positive surprises in other areas of the market.

Market-Moving Highlights

CPI increased 8.2% year over year in September, a slight deceleration from August when annual CPI increased 8.3%. On a monthly basis, CPI increased 0.4% driven once again by core inflation, which rose .6%. Core inflation hit a new 40-year high of 6.6% in September. Core inflation leaves out more volatile components like food and energy. Energy prices continued to fall in September and food was flat. The elevated core CPI reading was driven by price increases in services including shelter, transportation, and medical care. Like the CPI report in September, the report provided the market a mixed message. Some components are declining somewhat sharply, especially the early drivers like used cars and energy. However, the core components like housing have started to drive the headline number. The core components tend to be stickier, meaning they are harder to bring back down to acceptable levels, while components like food and energy tend to be more volatile. This has prompted some concern about the Fed's ability to reduce inflation, but it is important to note that the Fed uses lagged data when calculating CPI, specifically housing. Current data shows housing prices falling, but these price decreases are not likely to flow through to CPI for several months. Initially, the markets responded negatively to the disappointing CPI report. However, after reaching new YTD lows, the markets staged a significant intraday reversal and ended strongly positive on the day, which led to a more sustained rally over the course of the rest of the month.

Real GDP for the 3rd quarter rose 2.6%, which was above expectations and followed 2 consecutive quarters of negative growth. The increase in GDP was driven by Net Exports which added about 2.8 percentage points to the headline number. As expected, the services component held up well in the third quarter people continued to travel post-Covid. However, goods spending and private investment decelerated again in the third quarter. On the surface, higher-than-expected GDP for the third quarter is positive for a market that is struggling with recession fears. However, the underlying numbers suggest growth is still slowing, but perhaps not as quickly as some had forecasted. Nonetheless, an upside surprise for GDP is positive when there was a possibility of a third straight quarter of negative GDP.

Oil prices surged early in October when OPEC+ announced a cut in production by 2 million barrels per day, the largest production cut since the start of the pandemic. This announcement came at a time when sentiment started to shift toward oil price stabilization. However, the production cut makes it less likely that oil prices can stabilize at lower prices. The eventual reopening of the Chinese economy will also increase global demand, which could keep prices elevated. OPEC+ likely viewed this production cut as a hedge against slowing global growth and on hopes they could keep global oil prices at elevated levels. Meanwhile, in the United States, the Biden administration announced it would release an additional 15 million barrels from the Strategic Petroleum Reserve to help combat OPEC's decision. Since Biden's announcement, oil prices are up marginally.

Companies began reporting earnings in October for the third quarter and overall, the results have been mixed. Big Tech companies have been hit particularly hard, reflecting a slowing economic environment and a record high U.S. dollar that is impacting their international earnings. Other areas of the market have held up well. For example, Energy companies continue to report record profits and Financials held up much better than expected. Over half of S&P 500 companies have reported earnings and earnings are on pace for a 2.1% increase year over year, which is a higher estimate than the index had going into earnings season (LPL).

Index Performance

Index	1 Month	YTD	1 Year	5 Year
S&P 500	8.10%	(17.70%)	(14.61%)	10.44%
Nasdaq Composite	3.94%	(29.32%)	(28.56%)	11.32%
Russell 2000	11.01%	(16.86%)	(18.54%)	5.56%
MSCI ACWI ex US	3.00%	(23.96%)	(24.35%)	(0.13%)
S&P US Aggregate Bond	(1.30%)	(15.72%)	(15.68%)	(0.54%)

The major indexes performed well in October, especially the Russell 2000 and the S&P 500, but the rally was even more powerful off the lows in mid-October after the CPI report was released. The strong performance of the Russell 2000 reflects the outperformance of small cap companies relative to large cap companies. Meanwhile, the Dow posted its best monthly performance since the 1970s. The Dow is an index full of more mature companies, like Johnson & Johnson, McDonald's, JPMorgan Chase, etc., so when the Dow is outperforming, it indicates that the market is currently preferring value stocks over growth stocks. This can also be seen by looking at the underperformance of the Nasdaq, which is an index consisting primarily of growth-oriented companies in sectors like Technology and Communication Services. The Nasdaq initially rallied with the broad market but was more negatively impacted by the disappointing Big Tech guidance. Bonds were lower again as yields once again ended the month higher, but they did come off their highs. The cooling of bond yields coincided with stocks rallying.

S&P 500 Sector Highlights & Commentary

Best Performing Sectors		Worst Performing Sectors	
Energy	24.97%	Communication Services	0.67%
Industrials	13.89%	Consumer Discretionary	1.11%
Financials	11.92%	Utilities	1.94%

There were no sectors with negative returns in the month of October. Energy was by far the best performing sector in October. This was fueled by OPEC's decision to cut production as well as strong earnings reports across the sector. The Industrials and Financials sectors were also beneficiaries of above expectation earnings reports by companies within the sectors. Meanwhile, Consumer Discretionary and Communication Services struggled largely because of the disappointing earnings from Facebook and Google in the Communication Services sector and Amazon in the Consumer Discretionary sector. Tesla also weighed on the Consumer Discretionary sector as it has struggled with Elon Musk's acquisition of Twitter, which he financed partially with selling Tesla stock. These four companies make up a significant portion of their respective sector indexes.

What to Watch in November

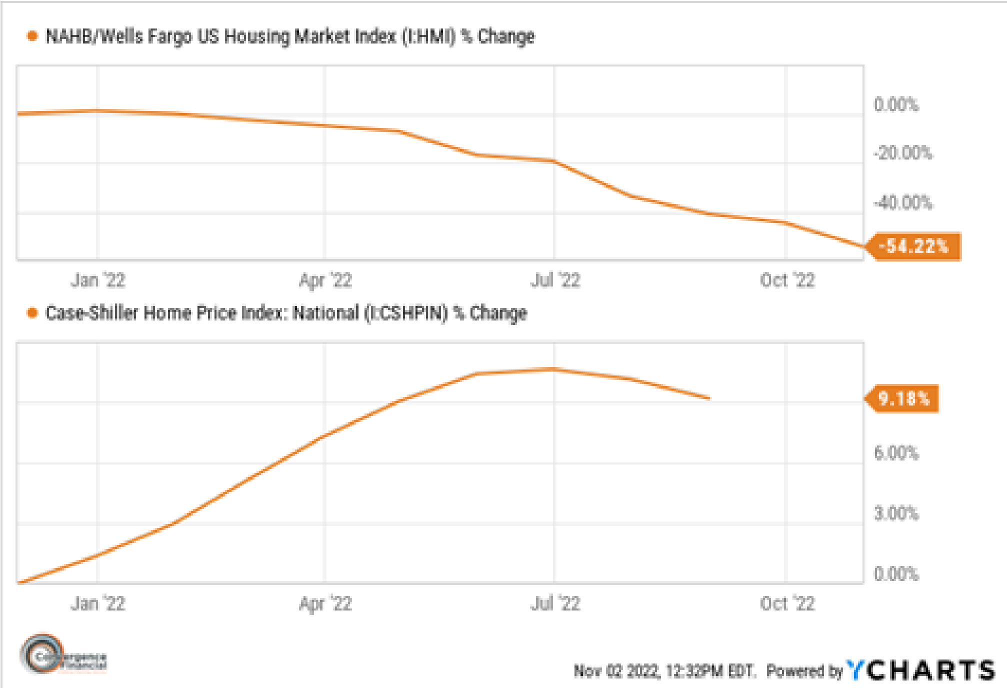
Midterm elections take place on November 8th. Because there are so many other uncertainties currently facing the market, there has been less talk about the midterms than usual. However, regardless of the outcome, the midterms will no longer be an uncertainty facing the market and the market always prefers certainty.

The Fed will be increasing rates again in early November. The market has already priced in a 75-basis point hike, but commentary regarding the Fed's plan for future hikes will be closely watched.

CPI data for October will be released on November 10th. The market would likely react positively to a downside surprise as it would show the Fed's rate hikes are starting to work, but we have still yet to see the annual rate decline significantly at the headline level.

Market Wrap

While the markets were able to breathe a sigh of relief in October after a difficult September, there is still significant work to be done with inflation. The lack of a significant decline in inflation coupled with the Fed's desire to bring inflation down at the cost of economic growth if necessary is the primary driver of the market right now. Until there is some clarity on inflation and how far the Fed will need to go to bring inflation down, markets will continue to be volatile. The good news is that it does appear that inflation is going through its peaking process, although we cannot say with certainty how long this will take. As we briefly touched on earlier, CPI is reported using lagged data. This is especially evident for the housing component, which makes up about 40% of core inflation. Jeremy Siegel, who is a professor at Penn, first brought this to light during a CNBC interview, when he described the phenomenon (CNBC). Because the Fed uses stale data to compute CPI, inflation that already occurred in the real economy months ago is now being reflected in the data. This does not mean that the inflation did not occur but tells us that there was more inflation in the economy in the past that was not being reported at the time, and instead, is showing up in the data now. Why does this matter? There are more current measures of housing than the calculation the Fed uses such as the Case-Shiller Home Price Index and the Wells Fargo US Housing Market Index. The Case-Shiller Index tracks sale prices of homes and the Well Fargo Index tracks the sentiment of home builders. At its peak, the Case-Shiller Index was up 40% from the start of the pandemic, while Housing CPI was only up 7.3% during the same period. This suggests that there was more inflation in the economy, and it is just now being reflected. As a result, with housing prices now falling according to more up to date metrics, we can expect this to positively contribute to declining inflation in the future, but the time it will take to see this reflected in the CPI data is unknown. In the chart below, we can see that the sentiment of home builders has declined rapidly in 2022, while the Case-Shiller Index started rolling over through the summer.



We are still maintaining a cautious view of the market, but a positive month provides hope that we are starting to move forward from what has become a challenging year so far. Nonetheless, inflation is still present, the Fed is still hawkish, earnings were better than expected but not great, the economy is clearly slowing, and there is still geopolitical risk present with the ongoing War in Ukraine and China's zero-Covid policy. We expect volatility to persist until some of these uncertainties begin to subside, especially declining inflation and a less hawkish Fed. It does appear that most of the damage has already been done, especially when looking at the performance of individual stocks. The Big Tech companies were the last major companies outside of Energy to decline significantly and it appears they are in the process of being "washed-out". It's not ideal that the biggest companies by market capitalization in the United States are struggling after earnings reports and disappointing guidance, but it is good to see that the rest of the market held up well enough to maintain a positive month across all sectors.

Sources

Mixed Results from Big Tech | Daily Market Update | October 28, 2022 (eloqua.com)
Watch CNBC's full interview with Wharton's Jeremy Siegel

Your Investment and Research Team

The Convergence Financial Investment and Research team is composed of investment professionals who seek to understand market trends and position our clients' portfolios appropriately. A core tenet of our investment philosophy is that no one can beat the market on a consistent basis, so sticking to disciplined investing habits and maintaining a long-term focus is our top priority.

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