PMI INSIGHTS

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- Investment Management
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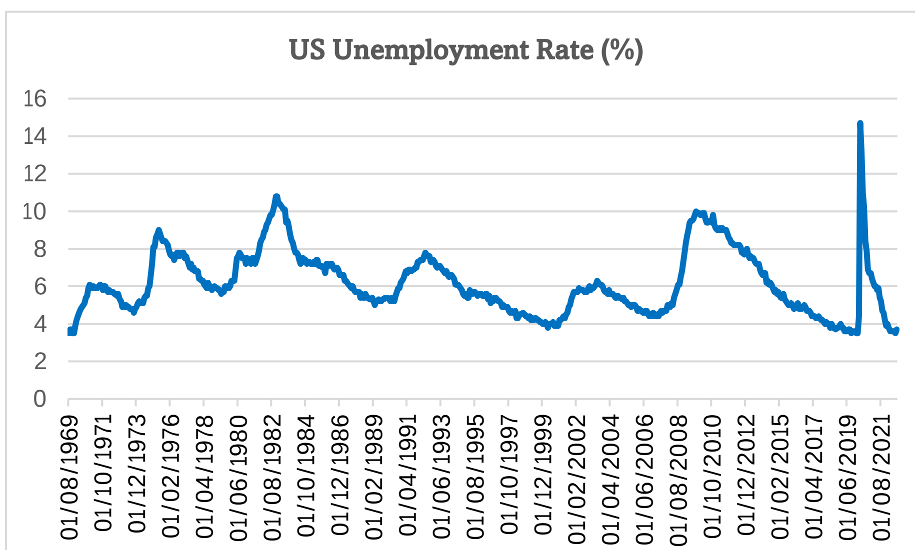
ARE WE THERE YET?

by Ryan Seale, BBA, CIM - Senior Portfolio Analyst with PMI

As 2022 proves to be a volatile year for the equity markets (with major indices on a year-to-date basis back in bear market territory), some investors are hoping for a market bottom courtesy of a Fed pivot. With the economy out of alignment, the Fed is undertaking a delicate balancing act, trying to reign inflation in with higher interest rates while attempting to avert an outright recession. As higher inflation proves to be more persistent than expected, the Fed still has its work cut out for it and calls for a pivot anytime soon may be premature. These calls are further complicated as the US labour market remains robust, with unemployment still at 50 Year historic lows.

> August inflation hotter than expected with a Consumer Price Index (CPI) print of 8.3% YoY versus the Fed's inflation target of 2%

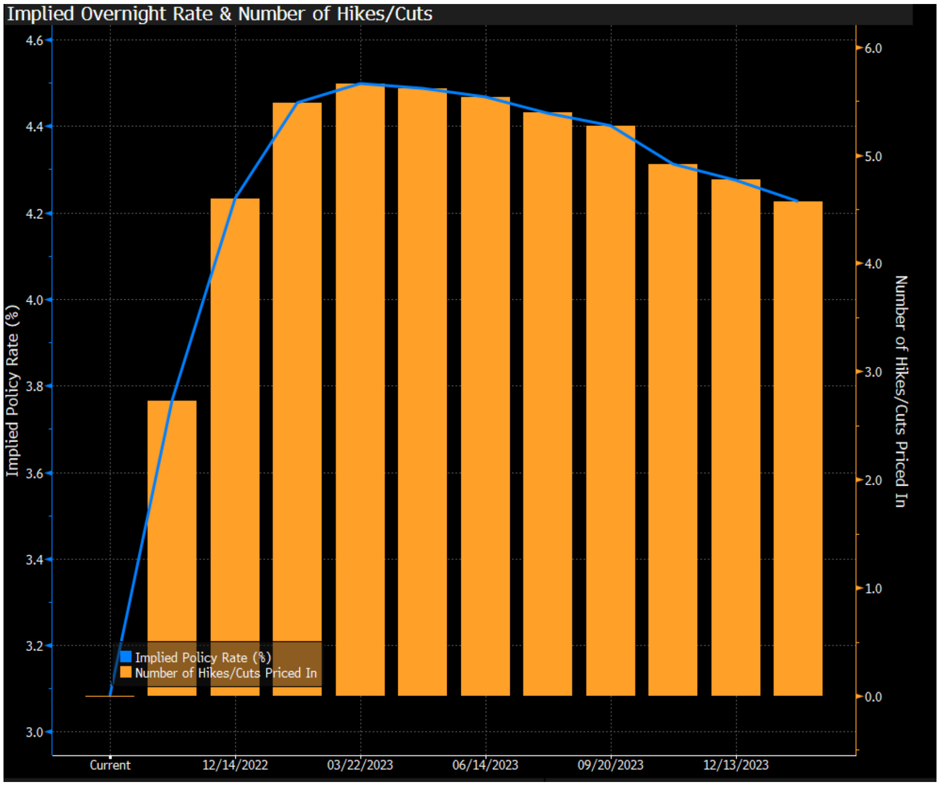
Figure 1



Source: Bloomberg/PMI

Therefore, where is the market in terms of a possible bottom in the absence of a Fed pivot? The market is now pricing in a terminal Fed rate of 4.50% early next year (See Figure 2).

Figure 2



Source: Bloomberg

Did you know?.......

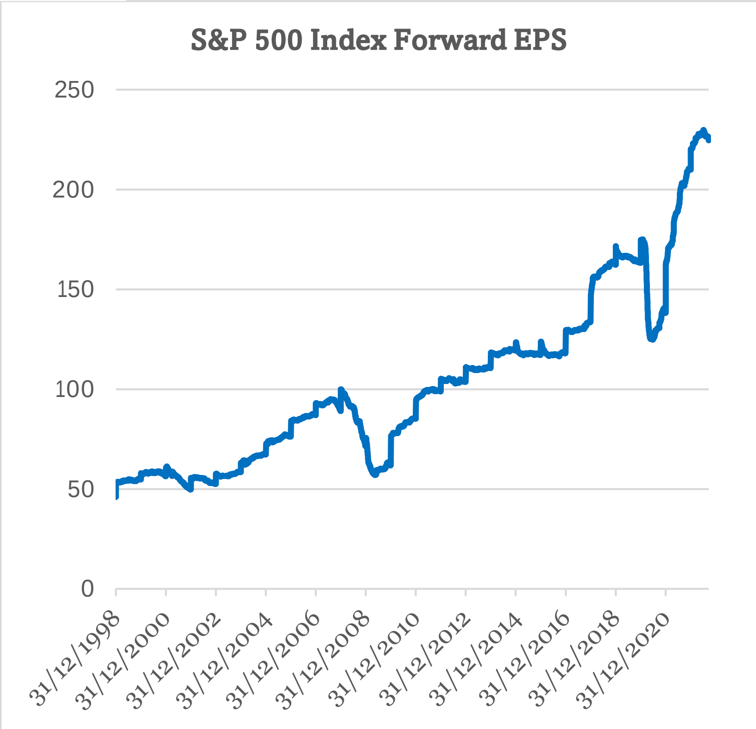
- **Bear market** - typically describes a sustained period where stocks are in a decline of -20% or greater. It is a market condition where falling prices are caused by economic decline, consumer pessimism, and negative investor sentiment.
- **Hard-Landing** - refers to a marked economic slowdown or downturn following a period of rapid growth leading to a recession.
- **Recession** - a slowdown in general economic activity that is recognized after two consecutive quarters of negative GDP growth.
- **Terminal Fed rate** - the peak spot where the federal funds rate will come to rest before the central bank begins trimming it back.

For the markets, higher real interest rates should lead to a re-rating in equity valuations (sending them lower) and bring down corporate earnings.

The equity market in this scenario may be viewed as slow to respond. The S&P 500 Index forward P/E multiple at 16.68, while lower than the 2022 peak, is not representative of an undervalued condition that typically indicates a major market bottom. This suggests that the index may have further downside as multiples continue to contract.

In addition, while down slightly (See Figure 3), forward corporate earnings still signify analysts' over-optimism about future earnings. They are not where one would expect, as an increasing cost of capital will lead to an inevitable material earnings slowdown. This also suggests that until we see an increase in downward earnings revisions, the market may experience a further decline.

Figure 3

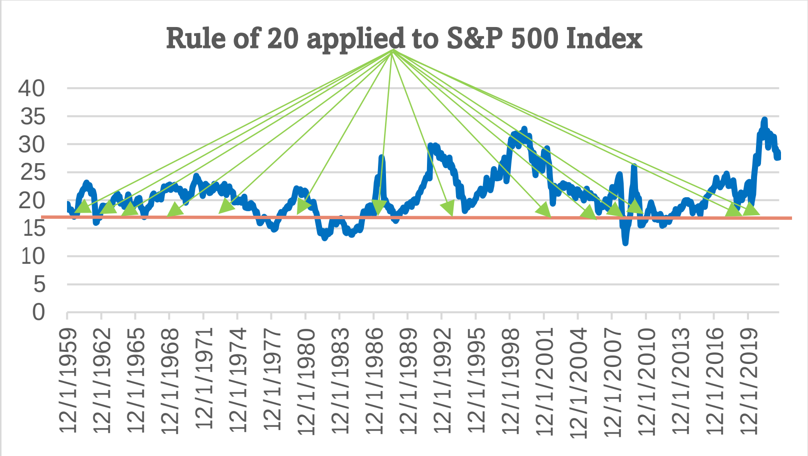


Source: Bloomberg/PMI

The Rule of 20

As a predictor of the market bottoming, the Rule of 20 has a perfect track record. This popular market indicator views the market as being "fairly-valued" when valuations measured by trailing P/E plus inflation (as measured by the CPI) equal 20. A value above 20 means the market is "over-valued," and a value below means the market is "under-valued." Figure 4 charts this indicator for the S&P 500 Index from Dec. 31, 1959 to Aug. 31, 2022. While simplistic in its approach, the Rule of 20 is currently above the "20" threshold, indicating that the market is "over-valued" and there is room for further decline.

Figure 4



Source: Bloomberg/PMI

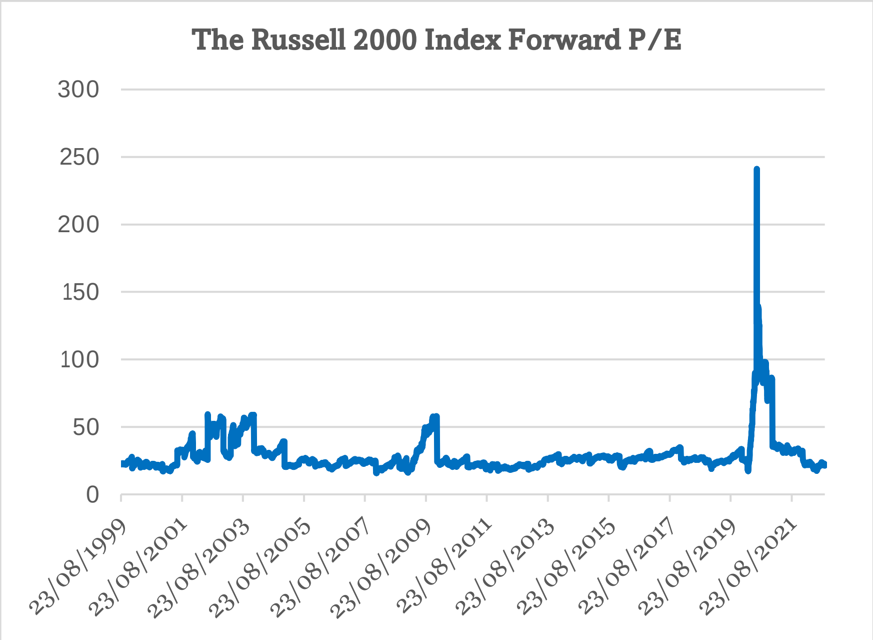
Therefore, it is highly likely that the S&P 500 Index has not yet found its lowest point within the current cycle.

With the Fed still having some way to go in tightening financial conditions, investors are reminded that each stage of the market cycle can present opportunities. This time will be no different.

Stock picking will become increasingly important, and opportunity may lie in those areas of the market that are believed to already seen the worst of the de-rating in the valuations process. For example, small-cap equities are looking very cheap in terms of valuations (See Figure 5).

Additionally, there is still hope if the Fed engineers a "Hard-Landing" leading to a US recession. Figure 6, as an example for **illustrative purposes only,** highlights a sample representation of some stocks that have outperformed the market, as measured by the S&P 500 Index during the last three recessions.

Figure 5



Source: Bloomberg/PMI

Figure 6

Ticker	Name	Sector	Returns March 01 to Nov 01 (%)	Returns Dec 07 to Jun 09 (%)	Returns Feb 20 to April 20 (%)
ODFL US Equity	OLD DOMINION FREIGHT LINE	Industrials	25.00	49.00	11.19
FFIV US Equity	F5 INC	Information Technology	188.13	31.00	14.04
ATVI US Equity	ACTIVISION BLIZZARD INC	Communication Services	67.53	14.04	9.68
SJM US Equity	JM SMUCKER CO/THE	Consumer Staples	38.00	13.41	11.81
WMT US Equity	WALMART INC	Consumer Staples	14.59	4.52	6.65
SPX Index	**S&P 500 Index**		**-7.28**	**-37.93**	**-9.26**

Source: Bloomberg/PMI

Don’t Fight the Fed

At its latest meeting, the Federal Open Market Committee reaffirmed its commitment to doing what it takes (i.e., higher interest rates) for as long as it takes to tame inflation while acknowledging a possible unemployment uptick due to collateral damage. As previously discussed, while we have seen some de-rating in equities, the market in terms of overall valuation is still not as cheap as we would like to see. Neither have we seen the magnitude in downside earnings revisions that would signal a bottom is in place. Bearing this in mind, PMI will continue to implement effective risk mitigation strategies within our clients’ portfolios as we navigate volatility within this part of the cycle. This will ensure that portfolios remain well positioned for longer-term out-performance, as attractive market opportunities continue to avail themselves. PMI