A Predictable Pullback

Larry Adam, CFA, CIMA®, CFP®, *Chief Investment Officer*

September 27, 2023

Downside equity market volatility can be unsettling, but it is important to put the pullback in perspective and identify the drivers of the negative market reaction. First and foremost, the equity market was due for a modest pullback. In fact, historically (dating back to 1980), the S&P 500 experiences an average of three to four pullbacks of 5% or more in a year. Prior to this most recent ~8% decline, the S&P 500 only had one other pullback of 5% or more which occurred during the banking turmoil back in March. In addition, after the S&P 500 notched its best start to a year (through July) since 1997 and rallied well above our year-end target of 4,400, we cautioned investors in our August 4 Weekly Headings to prepare for a potential pullback in equity prices. We highlighted four main reasons for our caution that included elevated expectations for the economy (remember that the Atlanta Fed GDPNow indicator had at one point estimated 3QGDP at 5.9%), optimistic bullish sentiment (remember many Wall Street analysts raised their S&P 500 targets), expensive valuations (the P/E multiple rose to ~20x on a trailing basis), and the negative seasonal patterns (August and September tend to be the weaker months of the year, September in particular has now been in negative territory for each of the last four years).

It is difficult to time a bottom and downside volatility may continue in the near term. But given that we have had a pullback, the current upside to our year-end target of 4,400 and 12-month target of 4,650 is ~4% and 10% respectively on a total return basis. The reason we remain modestly constructive on the equity market is that none of our forecasts that take us to those levels have changed.

- **Economy |** We have not changed our call for a mild recession in the first half of 2024—driven by slowing job growth, depleted excess savings and the lagged impact of higher borrowing costs. Importantly, we are already starting to see a moderation in the consumer as September consumer confidence declined for the second consecutive month and forecasts suggest a weaker holiday shopping season. However, as we expect the second mildest recession in history (both in time and magnitude of the economic contraction), earnings should remain resilient throughout the recession. This should allow the S&P 500 to avoid retesting the October 2022 lows.
- **Federal Reserve |** The Fed is in the late innings of its tightening cycle, with possibly one more rate hike this year before ultimately cutting interest rates in mid-2024. The important point is that, historically, the S&P 500 rallies after the last Fed rate hike.
- **Interest Rates |** Yes, the 10-year Treasury yield has risen to ~4.60%, but our expectation is that it will not stay there long as we expect longer-term interest rates to fall toward 3.5% over the next 12 months. Recessionary concerns, decelerating inflation and the Fed ending its tightening cycle should force interest rates lower. This will be significant as higher rates are likely the biggest factor negatively impacting the P/E multiple of the S&P 500 and causing the recent equity decline; so, if interest rates fall, the P/E multiple should move higher.
- **Inflation |** We expect inflation to continue to trend lower over the next several quarters. Yes, the 'headline' inflation trend has risen due to higher energy prices but now that oil prices have reached our year-end target of $85 to $90/barrel, the future impact should be less. We expect core prices to continue on a disinflationary path even if headline inflation moves higher. A continuation of goods prices falling and shelter/rent prices decelerating should contribute to the downward trend. Reduced inflation should drive interest rates lower and take pressure off the Fed.
- **Changing Seasonality |** The negative seasonality pattern should turn more favorable as we enter the fourth quarter. Historically, mid-October through the end of the year has been strong. In addition, it does appear as if the market in the near term is oversold as market sentiment has moved to more negative levels and the 14-Day RSI declined into oversold territory (a level below 30).

Other than the Fed meeting, the last few weeks have been void of important economic and fundamental data for investors to assess. But that changes over the next several weeks as we get more economic data and earnings season ramps up in mid-October. From an economic perspective, we anticipate the data will confirm an economy that is slowing (not imploding) and that inflation is on a firm downward path. Important catalysts to watch to support our view include PCE (this Friday), ISM on Monday 10/2, JOLTs on 10/3, the employment report on 10/6, PPI on 10/11, and CPI on 10/12. From an earnings perspective, we expect earnings growth to stabilize and grow for the first time in four quarters. The important thing to watch is that companies are likely to beat their earnings on the back of expense management, normalizing supply chains and falling input costs. The point is that we do not expect guidance to suggest a steep decline in earnings moving forward. While we are well below consensus earnings for 2024 ($220 vs $247), our earnings estimate supports our 12-month target of 4,650.

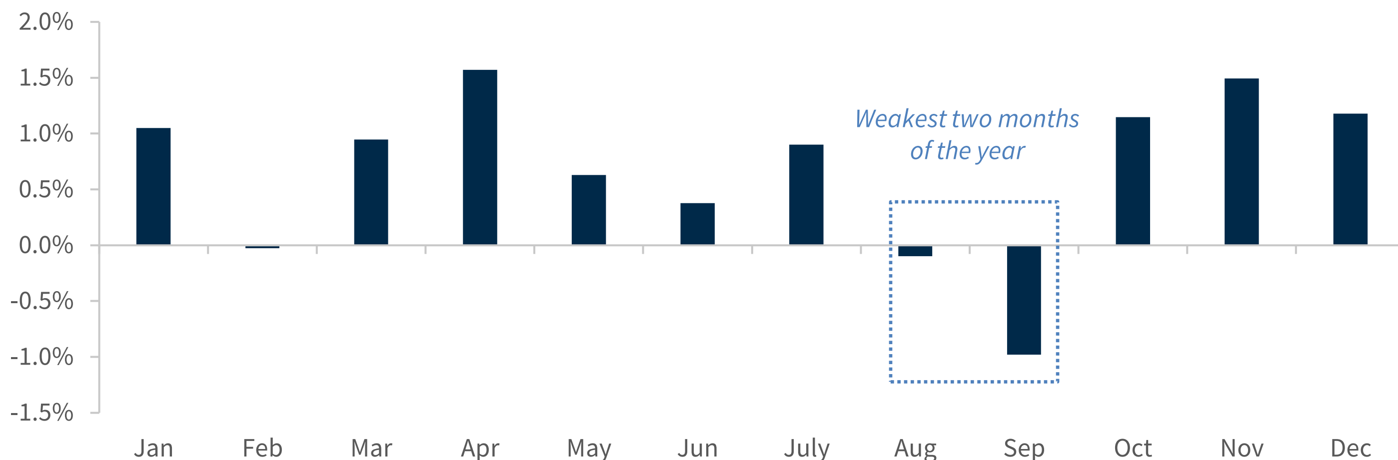
For a more detailed view on the economy and the Fed, interest rates and the equity markets, please see the next page for comments from our asset class strategists.

4,400
S&P 500
2023 Year-End Target

4,650
S&P 500
2024 Year-End Target

$220
S&P 500
2023 Earnings Estimate

$220
S&P 500
2024 Earnings Estimate



Source: FactSet, as of 9/26/2023

Eugenio J. Alemán, *Chief Economist*

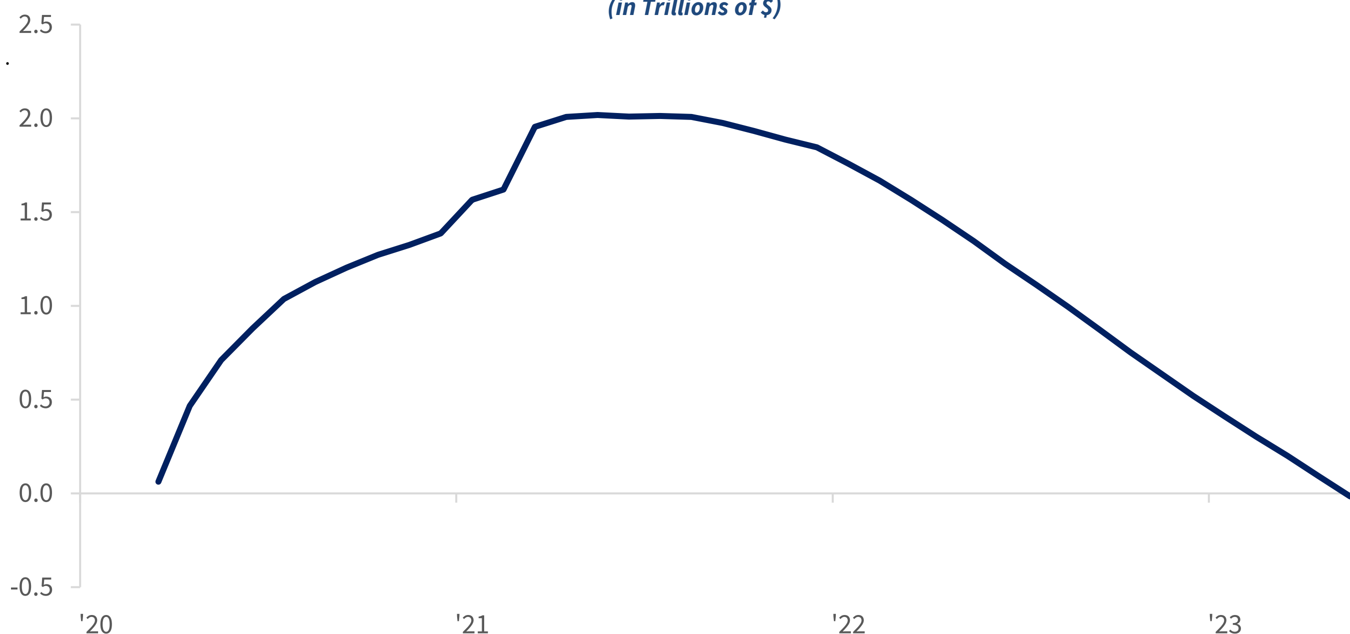
Economic actors seem to be starting to feel the pressure brought about by the Federal Open Market Committee's (FOMC) commitment to keep interest rates higher for longer, something the Fed has been talking about for many, many, months but now it has backed its commitment with an expectation that the economy is going to experience a soft landing rather than a recession.

Before this latest September FOMC decision and ensuing dot-plot changes, Fed officials were expecting a recession and thus markets had already calculated that, since the economy was going to enter a recession, interest rates were going to start going down earlier than Fed officials were expecting next year. However, in support of its new expectations for economic activity, Fed officials took away two 25 basis points decreases in the federal funds rate that had been in the June dot plot.

The consequences of higher long-term interest rates could weaken economic activity further going forward. That is, we should expect the housing market to start contracting again if mortgage rates continue to increase.

At the same time, the US economy is confronting several other risks, with a potential government shutdown in the offing if politicians do not produce an agreement during the next several days. Furthermore, Moody's, the only risk ratings agency that has not lowered the risk profile for the US has said that they may downgrade US debt if politicians do not come to an agreement to avoid a government shutdown.

All these issues add to recent increases in oil and gasoline prices plus the resumption of student loan payments in October of this year at a time when excess savings from the pandemic have been completely exhausted. As a result, we expect a mild recession in the first quarter of 2024 lasting six months.



Source: FactSet, as of 9/26/2023

Tracey Manzi, *Senior Investment Strategist*

The speed of the bond market's selloff has been unnerving. Treasury yields have steadily climbed over the last few months, with the 10-year yield rising to 4.55%—its highest level since 2007. Stronger than expected economic momentum, supply concerns and rising oil prices have been key drivers behind the recent leg up in bond yields. While the Fed paused its tightening cycle, yields marched even higher after policymakers left the door open for further rate hikes and signaled they are not in any hurry to move to a less restrictive policy stance.

Markets have also been increasingly focused on the fiscal policy dynamics. Moody's has signaled that a government shutdown, which looks increasingly likely, could negatively impact the US government's credit rating—and markets took note. While Moody's has not formally placed the US on watch for a downgrade, the news that the rating agency is closely watching developments in Washington further added to the negative sentiment in the market. Of note, Moody's is the last of the three big rating agencies that maintains a AAA-rating on US government debt.

While we have been wrong-footed with our call for lower Treasury yields as the recession has not materialized yet, we believe there are compelling reasons for yields to move lower in the months ahead. First, growth is unlikely to remain strong as headwinds (i.e., labor market rebalancing, depleted savings, higher gas prices, soaring borrowing costs) are building and could allow a pullback in yields. Second, Treasury yields generally peak once the Fed completes its tightening cycle. And finally, core inflation should move lower over the next year as the lagged impact of house price declines feed into the shelter component of the inflation index. We reiterate that the 10-year Treasury yield is likely to decline to 3.50% over the next 12 months.

Talley Léger, *Senior Equity Strategist*

As we expected, US stocks have pulled back modestly (~8%) from their year-to-date highs, but we may not be out of the woods yet. The S&P 500 Index has fallen below its 50-day moving average and the 200-day moving average (~4,200) is clearly in sight.

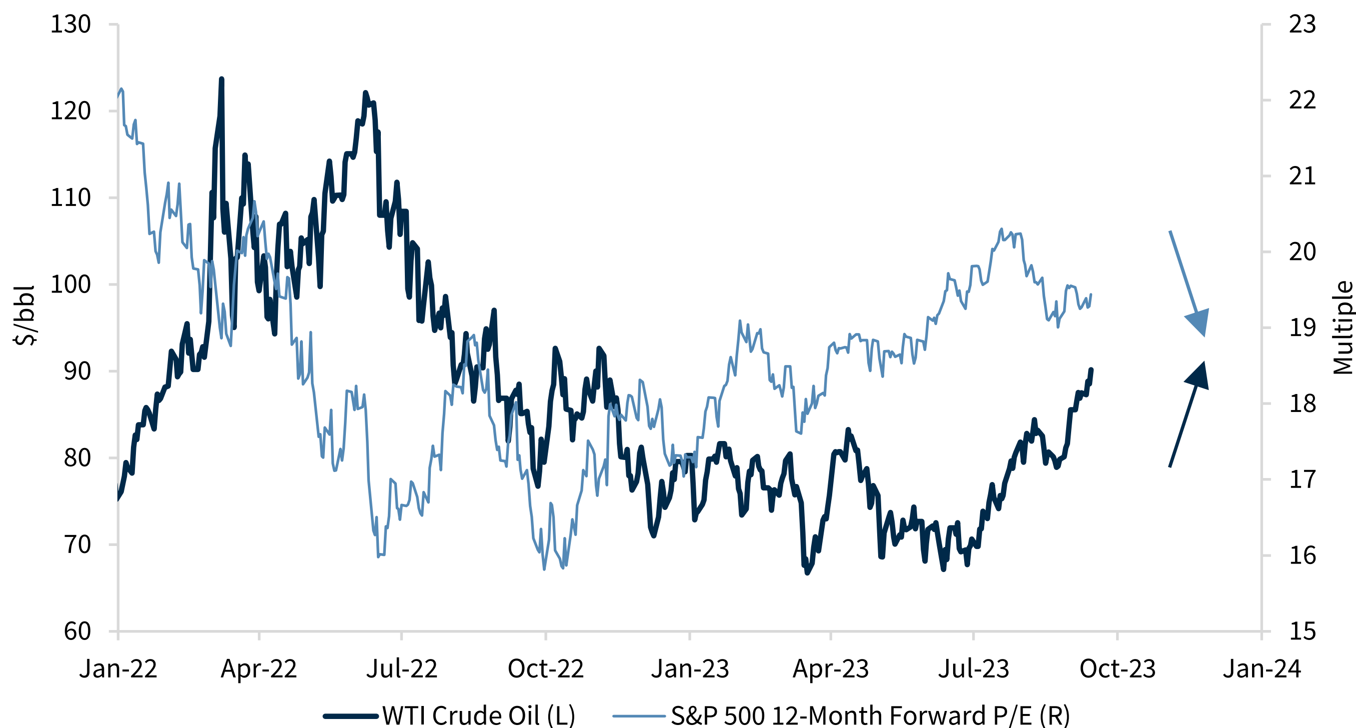
Where do we go from here? In our view, the macroeconomic forces that got us into this situation are likely to be some of the same ones that get us out.

Specifically, domestic oil prices have risen above $90 per barrel, thereby exacerbating already sticky headline inflation. In turn, stubborn inflation—coupled with a 10-year Treasury bond yield now above 4.5%—has placed downward pressure on equity valuations. Indeed, the S&P 500 forward price-to-earnings (P/E) multiple has compressed to 18.2x from its summer peak of 19.8x.

However, high and rising oil prices and bond yields are eventually self-limiting in the sense that they act as brakes on demand. Ultimately, softer demand should help the general level of prices in the economy to continue along their broader disinflationary trend, allowing equity valuations to stabilize.

Admittedly, the described sequence of events is unlikely to play out overnight, suggesting the S&P 500 Index could see the low 4,000s. From our lens, those levels would be consistent with a pre-recessionary drawdown, albeit mild, in the low double-digits. Looking ahead, softer oil prices, cooler inflation, and lower bond yields (i.e., the discount rate for stocks), coupled with another solid earnings season or two, might not only help this market find its footing but continue to march higher.

Supply-Constrained Oil Prices Have Weighed on Equity Valuations



Source: FactSet, as of 9/26/2023

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HIGH YIELD | Bloomberg US Corporate High Yield Total Return Index: The index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody’s, Fitch and S&P is Ba1/BB+/BB+ or below.

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