The Weekly Market Update – 12/19/22: Fourth Quarter Equity Rally Loses Steam

Major Indices (Price Returns)	Close	Last Week	Quarter-to-Date	Year-to-Date	Trailing 12-Months	All-Time High	% to High
S&P 500	3,852.36	-2.08%	7.44%	-19.17%	-15.65%	4,796.56	24.5%
Dow Jones Industrial Average	32,920.46	-1.66%	14.60%	-9.41%	-4.53%	36,799.65	11.8%
NASDAQ Composite	10,705.41	-2.72%	1.23%	-31.57%	-31.10%	16,057.44	50.0%
Russell 2000	1,763.42	-1.85%	5.93%	-21.46%	-19.80%	2,442.74	38.5%
MSCI EAFE (USD)	1,936.53	-2.14%	16.55%	-17.10%	-12.91%	2,398.71	23.9%
MSCI Emerging Markets (USD)	957.30	-2.14%	9.31%	-22.30%	-21.04%	1,444.93	50.9%
Bloomberg Commodity Index	112.71	0.87%	1.09%	13.65%	17.65%	237.95	111.1%
Barclays U.S. Aggregate Bond	90.89	0.82%	3.62%	-13.22%	-13.64%	112.07	23.3%

Source: FactSet

U.S. equities have traded lower over the past two weeks, erasing early December gains, but remain positive in the fourth quarter. Through 12/16/22, the widely followed, large-company S&P 500 index was down 5.6% on a price basis in December, but, after gains in October and November, was still up 7.4% in the fourth quarter of 2022 (4Q22). At a closing price of 3,852, the index remained down 19.2% year-to-date (YTD) since closing 12/31/21 at 4,766. We attribute 4Q22 equity market gains to investor reaction to improving (lower) consumer inflation (consumer price index reported by the Bureau of Labor Statistics) and a perception that the U.S. Federal Reserve Bank (Fed) is closer (perhaps 1Q23) to pausing its aggressive pace of short-term interest rate hikes (since March 2022, the Fed has increased its overnight bank lending fed funds interest rate target by 425 basis points (bp), from 0% to 4.25%). We attribute the more recent pullback in December to economic challenges entering the New Year and a potential recession in 2023. To us, this means that the 2022 bear market in equities (which we define as a peak-to-trough index decline of at least 20%) is alive and well, and ongoing uncertainty is expected to contribute to continued market volatility ahead. Equity volatility and YTD declines, in our view, have come primarily from valuation compression and, to a lesser extent, lower 2022 earnings than were expected to start the year. At the end of 2021, the S&P 500 traded at 21.5x the FactSet consensus (from Wall Street analysts) 2022 earnings estimate for the index. This is the price-to-earnings, or P/E ratio. As of 12/16/22, the S&P 500 traded at 17.6x the 2022 consensus earnings estimate and 16.7x the estimate for 2023. As interest rates rise, we would expect P/E ratios to fall as the present value of future earnings is lower in a higher rate environment. While S&P 500 earnings are expected to increase 5.8% in 2022 vs. 2021, the estimate was for more than 9% growth on 12/31/21. We believe that it will take considerable time to return to previous market highs and that investors should continue to scale back return expectations for equity portfolios in 2023. We continue to favor high-quality (profitable and positive cash flow) companies and recommend being broadly diversified across industry sectors.

As expected, the Fed raised its fed funds target by 50bp on 12/14/22, a slower pace from 75bp hikes at the prior four meetings, but still the seventh consecutive Federal Open Market Committee (FOMC) meeting with a rate hike. While Fed Chairman Jerome Powell confirmed that the slower pace of hikes are likely to continue (perhaps a 25bp or 50bp at the next meeting ending 2/1/23), the median estimate of the 2023 year-end fed funds rate from FOMC participants suggests the potential for 75bp more of hikes in 2023 (ending the year at 5.1%). This is higher than many investors are pricing into the futures market, as the CME Fedwatch Tool, which calculates probabilities of future interest rates using the futures market, shows that investors see an 84% chance of the fed funds rate being 4.60% (at the midpoint) or lower by the end of 2023. While the Fed sees ongoing rate hikes as necessary to slow employment and wage pressure, it appears that the futures market believes that at some point in 2023 the Fed may need to reverse policy and cut rates.

The week ahead is a full trading week ahead of the Christmas holiday and includes a full calendar of economic data reports. We expect November reports on housing starts and existing home sales, vehicle sales, consumer confidence, durable goods, and personal income and spending. In addition, the Fed's preferred inflation measure, the PCE (personal consumption expenditures) price index, is due Friday. We wish everyone a joyous holiday.

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