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Dan Golosovker, James Liu (Clearnomics)

Monthly Market Update

Takeaways

- The historic jump in interest rates this year represents a seismic shift in the pattern of falling yields over the past 40 years.
- The Fed is expected to continue its policy of hiking interest rates in response to inflation, impacting all major asset classes.
- Investors should consider three key Fed tightening scenarios as they manage their portfolios in the months ahead.

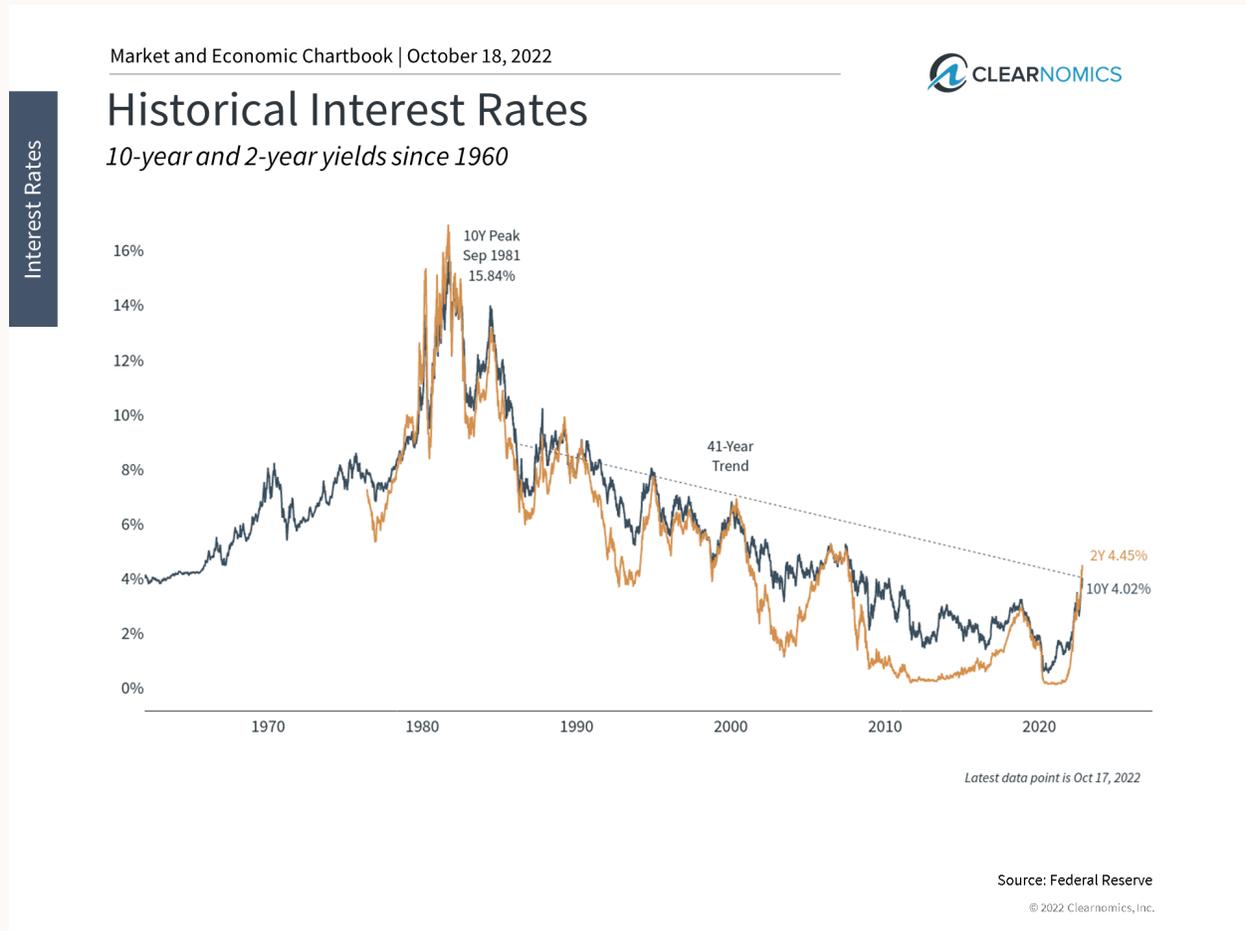
Market Update

This market update is provided in partnership with Clearnomics, a market insights platform for asset and wealth managers. Our goal is to help you stay abreast of ever-changing markets by putting current conditions into the context of economic and market history. Every monthly update will address key issues clients are asking about and share real-time insights you can use with your clients. The updates will also provide practical historical stress-testing scenarios to help you explore potential outcomes for portfolios in the current environment.

The rise in interest rates this year represents a seismic shift in a 40-year pattern of falling yields. The period following the stagflation of the late 1970s and early 1980s, often referred to as the “Great Moderation,” experienced relative economic calm. Inflation was low and business cycles were long, with shallower contractions and steeper expansions. With the inflation story reversing since the pandemic, it's no wonder that financial markets have been volatile as they adjust to a new economic period marked by increasing price pressures, a higher cost of capital and slower economic growth. How can investors navigate changing markets by drawing upon the appropriate historical perspective?



In recent weeks, markets have continued to struggle and major indices are near their lowest points of the year. The latest Consumer Price Index data for September, which showed that headline inflation rose 8.2% year-over-year and core inflation climbed 6.6%, all but guarantee additional rate hikes at the Fed's remaining two meetings this year and into 2023.



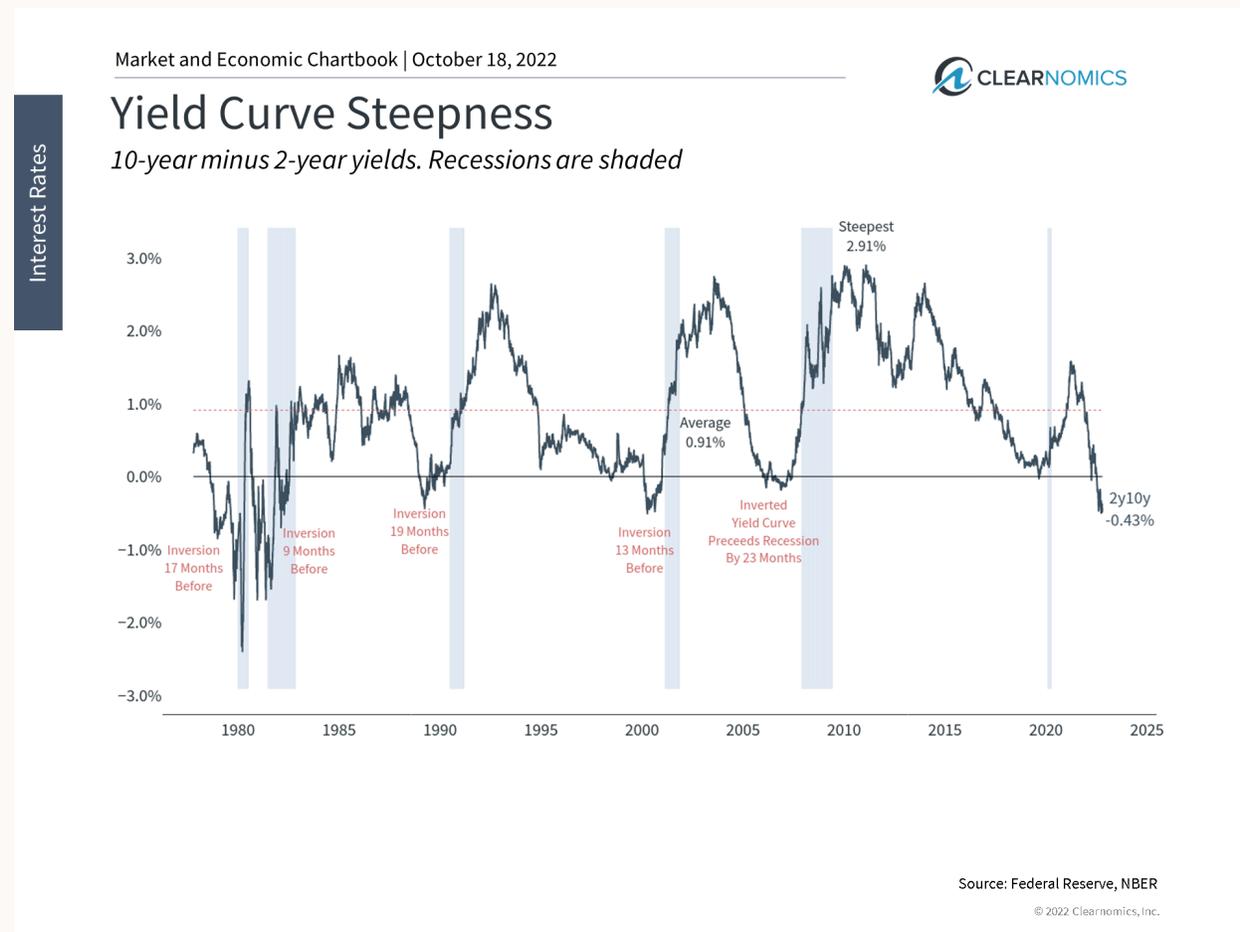
Sources: Clearnomics, Federal Reserve

As a result, interest rates have all shifted upward. The 10-year U.S. Treasury yield is hovering around 4% for the first time since 2008. The 30-year bond is above 4%, pushing the average 30-year fixed mortgage rate past 7% for the first time since 2000. The 2-year Treasury yield is above 4.4% resulting in a yield curve that's significantly inverted, often a sign that a recession is on the horizon. All these yield-curve movements are sizable and disrupt the historic pattern.

As the market adapts to this shift in regime and how it might affect the economy in the long run, investors should anticipate continued volatility. Small shifts in current conditions can have large impacts because of their implications for the path of monetary policy, especially if there isn't an



immediate return to the Great Moderation. This is why many investors' hopes were dashed in mid-August when Fed Chair Jerome Powell communicated that rates would stay higher for longer.



Sources: Clearnomics, Federal Reserve, National Bureau of Economic Research

In this context, it's important to emphasize that specific asset classes can still recover and perform well once investors adjust to shifting rate expectations. The brief market recovery from May to August was a sign that this is possible even as rates continued to rise, subject to evolving economic data and Fed guidance. What scenarios might investors expect from the Fed's actions with regard to interest rates during the coming year?

Scenario 1: Steady rate hikes. As of the last Federal Open Markets Committee (FOMC) Summary of Economic Projections in September, the anticipated fed funds rate by year-end 2022 and 2023 were 4.4% and 4.6%, respectively. Market expectations have continually been higher than Fed expectations and have climbed further since the last Fed meeting. The futures market suggests that the fed funds rate could reach 5% in the first quarter of 2023 before falling in the second half



of the year. These numbers would imply two additional 75-basis-point rate hikes this year, followed by another percentage point of hikes in 2023 before achieving the peak rate.

This scenario would play out if the Fed is able to regain control of inflation—especially core inflation—over the next several months, with limited harm to the economy. This is often referred to as a “soft landing” scenario because unemployment would rise only slightly (4.4% at the end of 2023, according to the Fed’s projections). If there are signs that price pressures are easing, then the Fed would be able to take its foot off the brake more gradually in 2023.

Scenario 2: Runaway inflation. Of course, these market-based expectations can change over time and are highly dependent on the path of inflation. If core inflation further worsens, or categories such as energy experience price surges, then the Fed may have to do more. In fact, this has been the trend throughout 2022: market and Fed rate expectations have shifted upward since the start of the year when it was believed that inflation would be transitory.

It's also important to keep in mind that the Fed isn't just raising rates. The Fed is also allowing its balance sheet to “run off”—that is, it's no longer reinvesting principal from maturing bonds—which effectively tightens fiscal policy further. This could put additional upward pressure on yields as demand from the Fed for Treasury and mortgage-backed securities declines, especially at the longer end of the yield curve.

In this scenario, rates would rapidly continue their upward trajectory, and equity markets would need additional time to adjust and re-price. This would be made worse if a “hard landing” occurs, in which unemployment spikes and growth is further stymied by rising rates. In this worst-case scenario, the economy could require several quarters to recover and markets would have to reach a new equilibrium before rebounding.

Scenario 3: Moderation. At the moment, the positive news is that survey and market forecasts of longer-run inflation have eased. The TIPS breakeven inflation rate suggests that investor expectations for average inflation over the next five and ten years have declined sharply, both falling to 2.5%. The University of Michigan's Surveys of Consumers also show that consumer expectations of inflation have declined somewhat to 5.1% over the next year. While market and survey-based results are subject to change and largely influenced by near-term factors such as falling gasoline prices, this may nonetheless help prevent a damaging inflationary spiral.

If inflation does cool the way surveys anticipate, the Fed would be able to ease much sooner, avoiding the need to make a tough decision between inflation and recession. Interest rates would slowly rise in a cyclical fashion as the economy begins to pick up steam again, allowing the yield



curve to re-steepen. This would help drive corporate earnings growth, which would also boost equity markets.

Conclusion

The potential for a reversal in the 40-year trend of declining interest rates has bred much of the market turmoil this year and particularly since August. Unfortunately, this situation is unlikely to resolve itself in the short term and investors should remain ready for continued volatility. However, the market has shown that it can rebound at unexpected times as it digests changing market conditions.

Stress-testing Scenarios

History-driven simulation provides a principled, systematic way for advisors and investors to quantitatively stress-test their portfolios based on these effects and understand the spectrum of likely outcomes. Please contact Addepar Research at research@addepar.com to model your portfolios through our new beta stress-testing capabilities. We'll continue to add new scenarios every month.

New Scenarios:

Scenario	Description
Inverted Yield Curve	Performance of assets after a yield-curve inversion. Based on previous six historical yield-curve inversions.



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