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If good news is bad, will bad news be good?

Economic data from the U.S. economy continues to worry equity investors. The news is far better than the market's reaction. For example, reports this month showed the U.S. added 263,000 jobs and the unemployment rate fell to 3.5% in August- better than expected. Equity markets took the news poorly.

Inflation is slowing; prices at the gas pump have fallen dramatically from their highs, real estate prices are lower in most major markets and the stock market, after a 15%+ return from the lows of June, ended the quarter slightly lower than the levels seen three months earlier. Estimates are that over 46 trillion dollars of value have been lost in stocks and bonds in the past 6 months despite this 'good news' and bearishness has rarely been higher.

The fight against inflation is Federal Reserve Chairman Powell's primary goal. His instrument of choice to bring inflation down is higher interest rates. Higher interest rates have a knock- on 'wealth effect' which usually translates into less spending as the value of homes and stock portfolios fall. Less spending helps in the fight against inflation.

Though inflationary pressures are abating Chairman Powell feels the Federal Reserve is not moving quickly enough so he has pledged to continue to increase rates regardless of the data. Moving from 'data dependent' to higher interest rates regardless of current indicators has unsettled investors, particularly those leveraged or with a short term investment horizon. "Don't fight the Fed" makes sense but trying to time the market doesn't.

Higher interest rates have a dampening affect on most asset prices, particularly high growth stocks. In the past several years these growth stocks have become increasingly influential in the weightings of major indices such as the NASDAQ, SP500 and the SP/TSX Composite Index. In addition, many hedge funds rely on borrowed money to increase returns and the combination of higher borrowing costs and disfavour among the high growth stocks tend to increase the volatility of equity markets. Volatility turns quickly to fear which can lead to oversold conditions. When the tide turns, it turns quickly.

Inflation data (Consumer Price Index – CPI) is released monthly and while last (August) month's indicator was higher than street expectations the rate of increase has slowed significantly. September's results will

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likely remain elevated, but the pace of increase will be dramatically slower. It is difficult to dampen demand quickly – it will take time, but progress is being made. Jeremy Siegel, Wharton's Professor of Finance, said recently that battle against inflation is succeeding. The CPI is a lagging rather than leading indictor and housing, which makes up approximately 40% of core inflation, is on the decline. Future expectations of inflation are steadily declining suggesting that the Fed Policy is working- just not as quickly as many equity investors would like. It is important to remember equity markets look forward not back.

There is always lot of worry about- interest rates, inflation, supply chain disruptions have been focal points until recently. More recent concerns centre around the escalating political tensions between the two U.S. political parties as the November mid term elections are fast approaching. It will be interesting to watch the outcome given the more noteworthy issues facing American voters; the ongoing investigations and current allegations against the former President as well as recent turnover in many States of the Roe vs Wade court decision may significantly influence undecided voters. Likely, the greatest concern to us all is the escalating threats made by Russia as their battle with Ukraine appears to be losing momentum. Nuclear rhetoric is often the sign of desperation however given the Russian's recently announced conscription, Russia's desperation is more palpable. The toil this war has taken on common Russians has mobilized dissent through public protests as well as leading business people speaking out against Russia's war against Ukraine.

In our last quarterly, we discussed sentiment. It was quite negative at the time and history suggests that at times of such extreme emotions investors are prone to pivot. From the June lows the SP500 gained more than 15% to the peak in mid August 2022.

From then to quarter end, equities have given up those gains. The level of bearishness, as measured by the American Institute of Individual Investors, is slightly higher than those levels mid June. Interestingly, in two consecutive weeks in September, bearish sentiment was over 60% which had never happened in the survey's 35-year history. As mentioned in our last quarterly, every time the reading exceeded 60%, the returns one year later were all positive.

At the height of the financial crisis in 2009 bearish sentiment reached just over 70%. This was the worst weekly reading in the history of the survey but the world presently, and the major North American economies, are no where near as close to the financial Armageddon that was within view back then. If anything, the US and Canadian economy will be pushed into a recession by central banks rather than fall into one. It is uncertain whether Central Banks will have to go that far to tame inflation.

Are there any bright spots on the horizon? Chairman Powell appears to be willing to raise interest rates even if inflation ebbs. What if inflation shows significant improvement in the months ahead and brings the likelihood of potential interest rates hikes ending sooner than expected? Institutions such as the IMF recently released estimates that, despite the various concerns rife in the marketplace, show the US and Canadian economy growing, though modestly, in 2022 and 2023. So, while Central Banks are doing their best to slow inflation, North American economies may continue to expand. Present equity prices are expecting a much worse outcome. US mid term elections are only weeks away. It presently looks too close to call but what if the Democrats were to keep their majorities? What would happen if the Russian-Ukraine conflict was mitigated, or somehow resolved?

Probably one of the hardest things to do is remain positive when so many are negative but to do so has paid handsomely in the past. Three months ago, things looked equally dire but rallied until it reversed based on Powell's post September CPI remarks. Pessimism levels have returned, and the market has absorbed another rate hike. How long will it continue, it is impossible to tell. So far good news has been bad for equites. Maybe a little more bad news will be all the is needed to be good news for equities.

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