Convergence Commentary

August 2022 Market Recap

Quick Hits:

- Markets were broadly lower in August with the S&P 500 and Nasdaq down about 4% and 4.5%. Despite the disappointing performance in August, the S&P 500 and Nasdaq are still up 8.25% and 10.27%, respectively, from their lows in June.
- Performance was strong through the first half of the month, but Fed announcements led the market downward.
- Inflation finally moderated some in August, but the Fed indicated the work may not be done yet, causing higher rates and more market volatility.
- Some key technical indicators have shown that the June low was possibly the low for the bear market, but the market looks like it will be driven by what the Fed is going to do and how the macroeconomy responds (Don't fight the Fed).

Market-Moving Highlights

The Consumer Price Index (CPI) came in below expectations in July, rising 8.5% year over year, compared to expectations of 8.7%. On a month-over-month basis, CPI was flat for July, finally showing the potential for some moderation in inflation as we move toward the end of the year. The deceleration of inflation in July was attributed to falling energy and gasoline prices (BLS). Other contributors included falling prices for used vehicles, apparel, and transportation. The declines in these parts of the index were enough to offset increases in the prices for food and shelter, which both have significant weighting. Overall, the CPI report for July was positive and gives us some hope that inflation is in the process of peaking and responding to the Fed's interest rate hikes. However, it will likely take several more months to get back down to the Fed's inflation target of 2%, so continued rate hikes should be expected. Nonetheless, demand does appear to be slowing, but improvements in the supply chain are still needed to drive down prices more substantially. Gas prices continued their downward trajectory in August. At the end of August, the national average was $3.83 per gallon, about 23% off the high set in the middle of June, and is now at a 6-month low (AAA). Prices have declined for 76 straight days through the end of August. This is the second longest streak on record, although it is still far behind the record set in 2014-2015. Continued declines in gas prices could be a leading indicator that inflation will once again be lower when it is reported in September.

Members of the Fed and other important global central bankers, economists, etc. met for the annual meeting in Jackson Hole. On the morning of Friday, August 26th, Jerome Powell delivered his much-anticipated speech. Markets were mixed all week leading up to the speech but reacted negatively. The negative reaction could be attributed to the general hawkish nature of the speech, where Powell said that they would continue to increase interest rates as long as inflation remains higher than their target of 2% annual inflation. His comments strongly pushed back against the increasingly dominant market sentiment that the Fed would reverse its stance and start to cut rates next year.

The 2-year treasury yield is near its highest level since 2007, just below 3.5%. The surge in the 2-year yield compared to longer-term term yields has caused the yield curve to become increasingly inverted. The yield curve initially inverted in April of this year, then inverted again in July, and has become increasingly inverted since. The yield curve inverts when investors buy more long-term bonds instead of short-term, which then pushes long-term rates down and short-term rates up.

Index Performance

Index	1 Month	YTD	1 Year	5 Year
S&P 500	(4.08%)	(16.14%)	(11.23%)	11.82%
Nasdaq Composite	(4.53%)	(24.07%)	(21.99%)	13.98%
Russell 2000	(2.05%)	(17.16%)	(17.88%)	6.95%
MSCI ACWI ex US	(3.19%)	(18.02%)	(19.10%)	2.15%
S&P US Aggregate Bond	(2.83%)	(10.75%)	(11.52%)	0.52%

All the major indexes were lower in August. The first half of the month saw very strong performance across the board. The S&P and Nasdaq both hit their highest levels since April during a strong stretch through the middle of August. The Nasdaq even entered a bull market on August 11th, which is defined as a rally of 20% or more off a recent low. However, the second half of the month saw indexes broadly decline in response to reignited fears of a recession and hawkish Fed commentary. A significant portion of the losses occurred on the day of Jerome Powell's speech. While the negative returns on the month are disappointing, it was unlikely that there would not be a pullback of some sort after the run the markets had been on since the low in June on top of the uncertainties the economy still faces. In fact, it is perfectly healthy for there to be some consolidation after a long stretch of strong performance.

S&P 500 Sector Highlights & Commentary

Best Performing Sectors		Worst Performing Sectors	
Energy	2.65%	Information Technology	(6.21%)
Utilities	0.53%	Health Care	(5.77%)
Consumer Staples	(1.85%)	Real Estate	(5.62%)

Energy had a strong month after being the worst performing sector in the month of July, largely due to the sector's strong 2nd quarter earnings reports. Despite the sector posting a strong performance, the price of oil was down over 8% on the month due to recession fears. With the overall market becoming a bit more defensive in August on the back of recession fears, it is no surprise that Utilities and Consumer Staples were also strong performers.

Meanwhile, Health Care, Technology, and Real Estate were the three worst performing sectors. Both Tech and Health Care had rebounded strongly since the low in June, and both likely benefited from the market believing that the Fed would pivot to a more dovish monetary policy. However, both sectors declined after Powell's speech when he indicated there were no plans to stop increasing rates soon. The Real Estate sector is getting hit by weakening housing data and rising mortgage rates. Because of rising mortgage rates, it is becoming less affordable to buy a house, and as a result, new home sales are falling rapidly. In July, new residential sales fell by 12.6% compared to June and are about 30% lower from July 2021. On the supply side, inflationary pressures are causing home builders to produce less. In July, new residential construction fell 9.6% compared to June. Housing is an essential part of the economy because of the level of importance it has on consumer behavior. Housing makes up almost 20% of GDP and shelter, a subsector of housing that consists primarily of rent, makes up about 33% of the CPI index. Therefore, continued declining prices in the housing market could contribute to falling CPI, but at the expense of reducing housing's contribution to GDP.

What to Watch in September

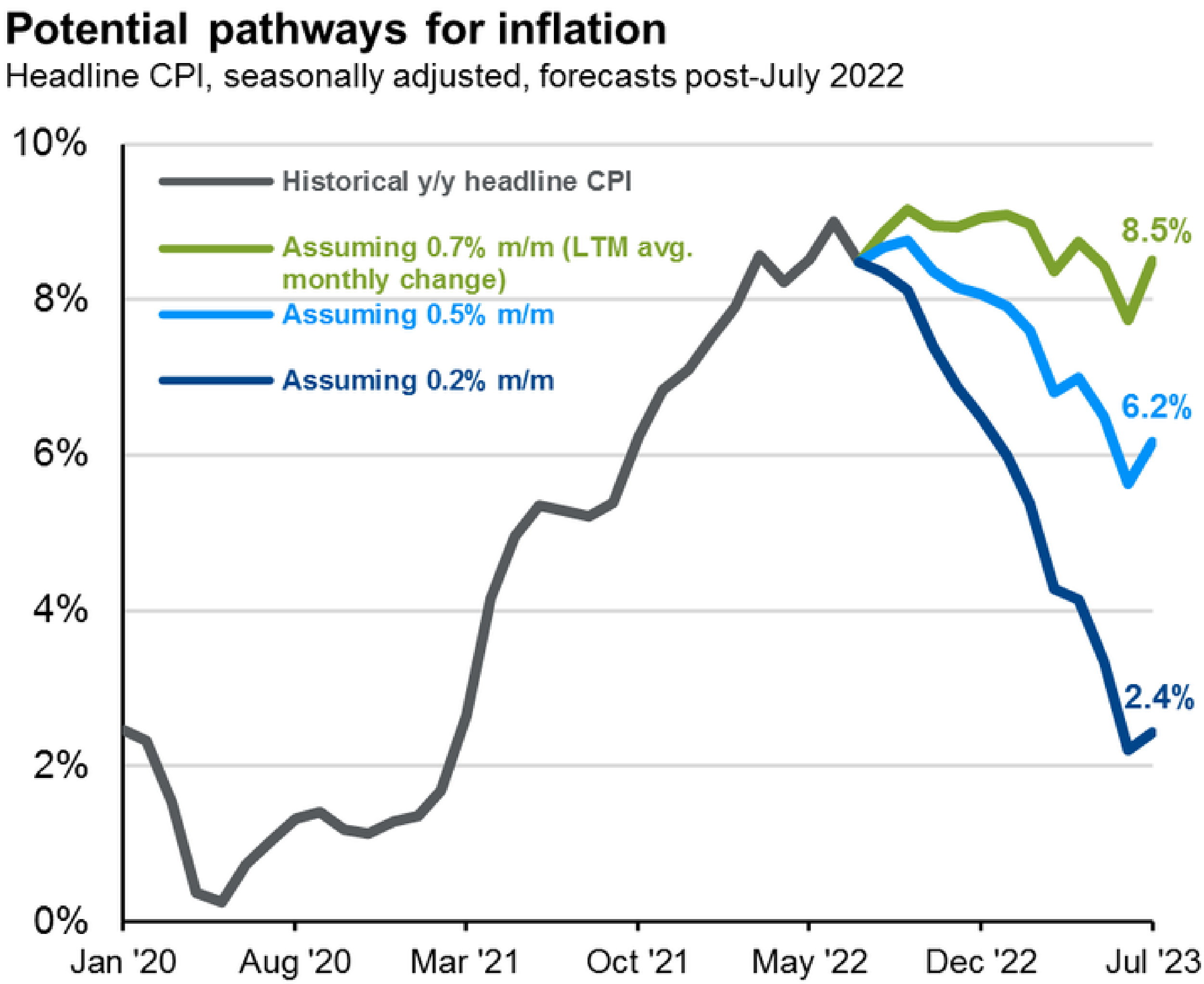
CPI for the month of August will be released on Tuesday, September 13. We are cautiously optimistic that the downward trend in inflation will continue its downward trajectory or at the very least remain unchanged.

The Fed meets again on September 20-21 and will be announcing further rate hikes. The market does not have much conviction behind the size of the rate hike, but it is most likely that they will announce an increase of 50 or 75 basis points. More clarity on this will likely come once new economic data comes out between now and then, as Jerome Powell has repeatedly stated that the Fed will be data-dependent.

Market Wrap

August was a tale of two halves. The first half was filled with optimism and the belief that the Fed would be able to make a dovish pivot as soon as later this year, which would help lead the markets back to all-time highs. However, the Fed put this belief to rest when they stated they would continue to fight inflation back to their target level. The market looks to have gotten ahead of itself regarding what the Fed might do throughout the rest of the year and into 2023. "Don't fight the Fed" is an old saying that says investors should not try to invest against the Fed's policies, whether it is expansionary or contractionary. In this case, it looks like the market tried to fight the Fed and the Fed had to fight back against it. With that being said, we did see some positive technical indicators in August that indicate the possibility that the bottom in June could ultimately be the bottom for the current bear market. The S&P 500 retraced more than half of its bear market decline, which historically, has indicated the start of a new bull market. More than 90% of stocks briefly moved above their 50-day moving averages in mid-August, another indicator that a new bull market could have started. Since 1990, when more than 90% of stocks have moved above their 50-day Moving Average, stocks have been higher 12 months later 94% of the time (LPL). Technical analysis has a strong conviction that the June low was the market bottom. This can only be confirmed with the fundamental economic indicators that the Fed is watching.

The chart below from JP Morgan shows a couple of different paths forward for CPI. The green line shows the path of inflation through next year if the monthly change in inflation maintains its average for the last 12 months. The light blue line shows where it could be if it moderates more gradually, and the dark blue line indicates where it could be if inflation moderates at a more rapid pace. In our view, the light blue line seems to be the most realistic of the three, as we have already seen some moderation, and the darker blue line would likely require rapid supply chain improvements. In addition, there are still significant risks to the upside for inflation, specifically relating to the cost of energy as we move into the winter, so we will still be watching inflation metrics very closely.



Sources

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