Truist Advisory Services, Inc.

Market Perspective from the Investment Advisory Group

Risk/reward only slightly improved but not compelling as inflation scar tissue lingers

August 29, 2022

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Highlights

- Fed Chair Powell's speech is consistent with the view we've espoused that the Fed is unlikely to support the markets as quickly as investors had become accustomed to over recent decades. The scar tissue due to the inflation challenges of the past year is deep.
- Historically, once inflation is above 5%, it has generally taken a recession to bring it back down.
- With stocks trading in the middle of a multi-month range and given macro headwinds, the market's risk/reward still does not appear compelling.
- Now, the outlook is not all one sided to the negative, the recent momentum signal triggered and depressed positioning are partial offsets.
- We still advise a more conservative risk posture than the past few years (less equities, more bonds), a focus on staying up in quality within both equity and fixed income allocations, and more defensive sector positioning.

What happened

Global markets sold off roughly 3% last Friday, the worst one-day selloff since mid-June. The market decline has continued early into the new week. The initial decline occurred following Federal Reserve (Fed) Chair Jerome Powell's Jackson Hole speech. In a very direct speech, he refuted the notion the Fed would quickly cut the fed funds rate next year, the so-called "Fed Pivot". He maintained a myopic focus on tamping down generationally high inflation, even if this could cause short-term economic pain. Powell pointedly referenced history regarding the dangers of prematurely loosening policy as validation to keep rates higher for longer.

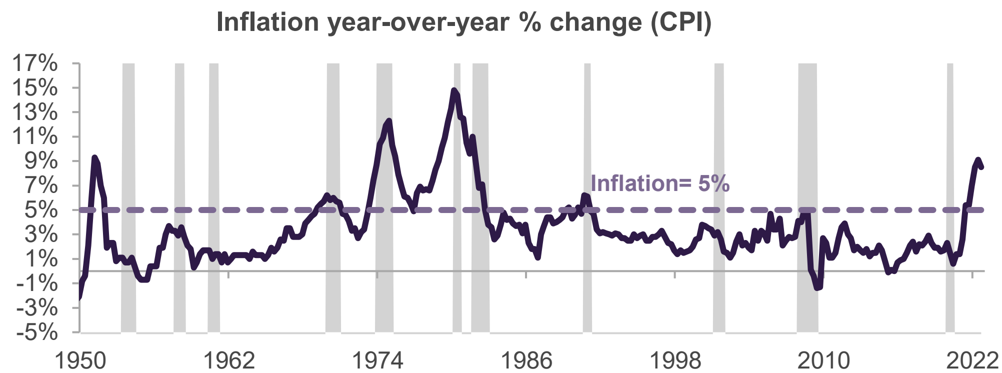
European Central Bank (ECB) officials struck a similar hawkish tone over the weekend, warning that interest rate policy would need to stay tight for an extended period to tame inflation, even if this risked recession.

Our take

Fed Chair Powell's speech is consistent with the view we've espoused that the Fed is unlikely to support the markets as quickly as investors had become accustomed to over recent decades. The **scar tissue** due to the inflation challenges of the past year is deep. Inflation remains enemy number one for the Fed. **This speech reinforced a key reason we've been more cautious recently.**

Historically, once inflation is above 5%, it has generally taken a recession to bring it back down. There are unique circumstances this cycle given the pandemic and supply chain challenges. So, while it could be different this time, elevated inflation and the Fed's aggressive shift indicate recession risks over the next 12 months remain elevated.

A recession has often been needed to tame elevated inflation



Data source: Truist IAG, Haver. Inflation is measured using the Consumer Price Index (CPI). Shaded = recessions.

Past performance does not guarantee future results

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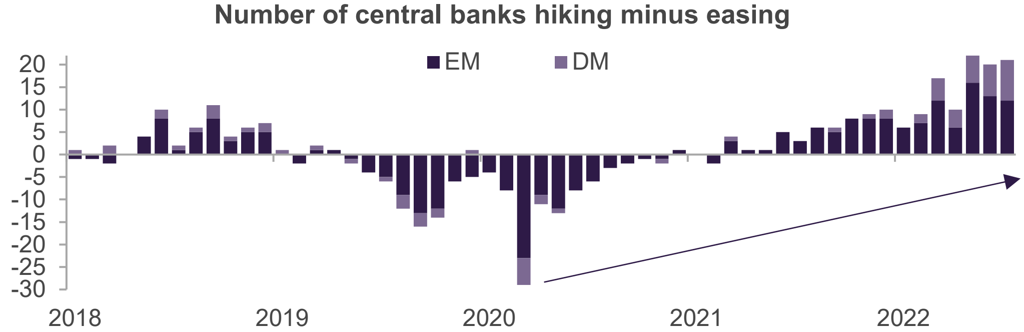
Moreover, by most accounts, including last week's comments from the Fed and the ECB, the most aggressive global central bank tightening in decades is set to continue. All this tightening works with a lag, and it's hard to see how this doesn't weigh on economic growth over the next six to 12 months.

Sharpest global monetary tightening in decades set to continue and weigh on future economic growth



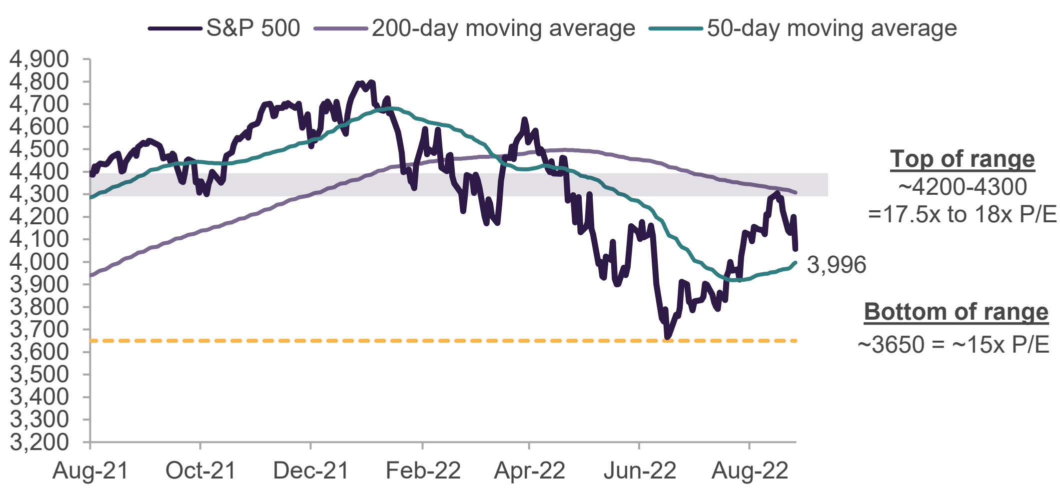
Data source: Truist IAG, Haver. Series constructed using predominantly countries in the MSCI All Country World Index; EM = Emerging markets; DM = Developed markets. Past performance does not guarantee future results.

Market perspective – where to next

Headed into the speech and over recent weeks, our view has been the market's risk/reward has become less favorable. Markets went from pricing in a recession at the June lows to fully embracing a soft landing and a Fed pivot early into 2023. **This left little room for error in a time of unusually wide potential outcomes.**

Indeed, prior to the selloff, **the S&P 500 bumped up against the upper end of our estimated S&P 500 range of 4200-4300, and a lot of good news had been priced in.** After touching its 200-day moving average and trading slightly above an 18x forward P/E (the upper end of the non-pandemic range of the past 20 years), stocks have turned down sharply.

S&P 500 reversed sharply from top-end of our estimated range; 50-day moving average first potential area of support



Data source: Truist IAG, FactSet. Past performance does not guarantee future results

With the selloff, **at least the market is starting to reprice some of the many uncertainties that remain.** Still, with stocks trading in the middle of a multi-month range and given macro headwinds, **the market's risk/reward does not appear compelling.**

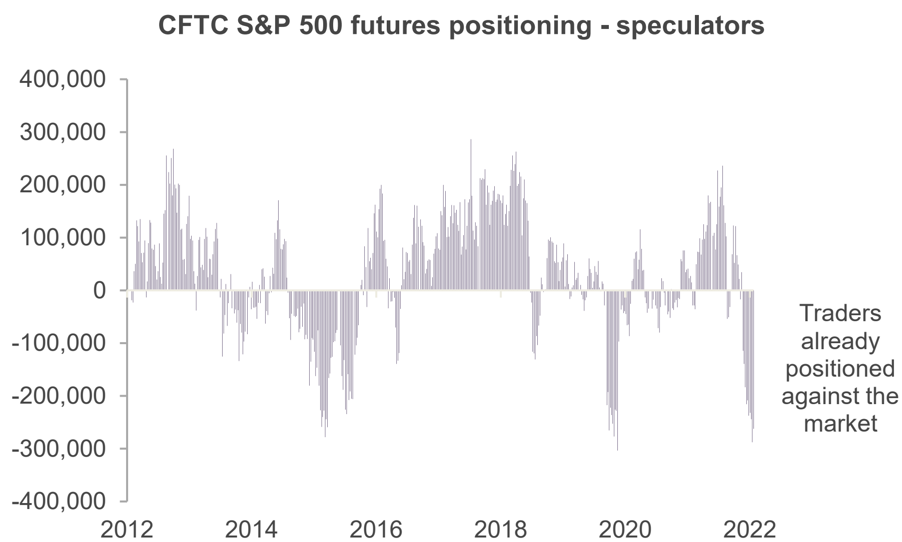
Fundamental perspective: The S&P 500's price-to-earnings ratio (P/E) is back down to about 17x from 18x, still a premium level given forward earnings that are at best expected to be flat (and likely have some downside) and continued monetary tightening. A 16x P/E based on current forward earnings projections would place the market at around 3800 (Friday's close = 4057). A further contraction in the P/E toward a 15x P/E would see the market trade near its June lows of just above 3600.

Technical basis: The first potential support level for the S&P 500 is around the 50-day moving average just below 4000. If that level fails to hold, there are pockets of support near 3900 and 3800, respectively, before the June lows around 3600 come into play (this is when the market was down 24%, in line with the median drawdown around recessions).

Now, the outlook is not all one sided to the negative. As mentioned in a previous note, the market just triggered a rare price momentum signal as stocks moved from indiscriminate selling to indiscriminate buying. This, historically, has been followed by strong market returns when looking out 12 months. But none of the prior price momentum signals were triggered while the yield curve was inverted, as is the case today, or while the Fed was in tightening mode. So, we respect the signal, but discount it somewhat given the unique macro backdrop.

Investor positioning and sentiment remains somewhat depressed, which from a contrarian standpoint is a positive. This suggests at least some investors are already braced for bad news and will not have to take aggressive selling action since they are already somewhat hedged. As one example, speculators in the futures markets—such as hedge funds, individuals, and large financial institutions—are still firmly betting against the market.

Depressed positioning should help to provide a buffer given many traders already braced for downside



Data source: Truist IAG, FactSet, Commodity Futures Trading Commission (CFTC).
Past performance does not guarantee future results

Bottom line and positioning

Our take heading into the Jackson Hole meeting, after such a sharp rebound, was that the market's risk/reward was less favorable. Chair Powell's speech as well as comments from ECB officials confirmed our view that scar tissue as a result of the elevated inflation of the past year will remain a significant influence on central bank policies going forward.

The market had too quickly priced in a soft landing and had little room for error left. Now at least the market is again starting to price in more of the uncertainty. **However, even after the pullback, it's too soon to say the risk/reward is compelling.**

Thus, our overall portfolio strategy remains intact. **We still advise a more conservative risk posture than the past few years (less equities, more bonds) with a focus on staying up in quality within both equity and fixed income allocations**.

Despite its own challenges, **given its status as the big blue-chip country, we maintain our long-standing equity bias to the U.S. relative to international markets**. Our focus within the U.S. includes **defensive areas, such as dividend stocks, and consumer staples and health care,** which are less reliant on the strength of the economy. We maintain our established **positive stance on the energy sector**; even though there are risks to the sector given the global economic slowdown, that is partially offset by low supply levels and geopolitical concerns.

Similarly, we remain focused on higher quality fixed income, such as government bonds, where yields are productive again, and have a **less favorable view on lower quality bonds**, such as high yield, given the risks to economic growth.

Disclosures

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CN2022-4923118.1 EXP 08-2023

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