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COMMENTARY

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The Fed and Corporate Earnings Will Dictate Market Direction

- Equity markets have a strong October.
- Market direction will be driven by Fed rate hike plans and corporate earnings.
- Volatility will remain as we continue forward in this rate hike cycle.

The month of October saw the equity markets perform well with the Dow Jones Industrial Average having its best monthly gain since January 1975. Driving market strength was the combination of optimism that the Federal Reserve (Fed) may slow its pace of rate hikes and third quarter earnings season has not been as bad as investors feared. Looking forward, we continue to believe markets will take their cue from the Fed and corporate earnings.

The Fed and their anticipated rate hike plans remain of utmost concern to investors. Concerns around the Fed's rate hike plan to address persistently high inflation and the potential ramifications of high rates on the economy and corporate earnings have pressured equities this year. The Fed again meets this week to decide interest rate policy and the markets have priced in an increase of 0.75%. There has also been some chatter that the Fed may not be aggressive in their December meeting, though that meeting is so far from now. The key to this week's meeting is the press conference and whether the head of the Fed, Jay Powell, has a less hawkish tone about the Fed's outlook.

From our perspective, we continue to believe the Fed will prove less hawkish than they have suggested as signs of disinflation continue to emerge and the strong US dollar continues to hurt our economy. On the inflation front, though it is still uncomfortably high, goods prices and asking rent, a harbinger for current rent, continue to weaken. These are leading indicators of inflation and the impact on CPI and PCE inflation reports may not be felt until 2023. Dollar strength, along with the struggles of foreign economies facing increasing fiscal policy support and rising interest rates, will likely push our economy closer to a recession. Our base case is that if a recession does occur, it likely would take place in the first half of 2023 since it usually takes about 12-15 months for the economy to feel the full effect of Fed rate hikes. The Fed began this current rate hike cycle in March of this year. With that said, if we fall into a recession, we continue to expect it to be mild given the continued strength in the labor market, the still underlying strong homeowner balance sheets in an environment of deteriorating housing market fundamentals, and our belief that a recession will not affect the entire economy at once but instead roll through it in sections at a time. We don't expect a deep recession causing significant contraction.

The direction of corporate earnings is the other area likely to drive markets. Today, earnings estimates for the S&P 500 are expected to rise about 7 to 9% per year. In our opinion, these are a bit high given the Fed rate hike cycle, strong dollar, and generally slowing economic growth. Because earnings generally drive stock prices in the long run, a cut in expected earnings growth could pressure equity markets.

Looking forward there is good and bad news likely to weigh on investor minds and keep volatility elevated. On the good news front, if we have a recession, we anticipate it to be mild and similar to the 2001 recession. Since markets have priced in a steeper recession, a recession that is only mild could help equities. On the bad news front, similar to 2001, the stock market could still struggle on downward earnings revisions. Prior to the 2001 recession, earnings estimates were revised higher in the dot.com bubble (to levels well above pre-dot.com trends). This is comparable to today's work from home (WFH) environment when earnings estimates were revised above pre-WFH levels. Despite a mild 2001 recession, earnings estimates back then were revised sharply lower (below pre-dot.com levels) and 2023 could be a similar story. At the end of the day, corporate earnings, and any Fed policy shifts, will dictate market direction. In these volatile times, please continue to work with your financial professional to make sure you are properly diversified to help mitigate market volatility and your portfolio is aligned with your long-term investment objectives.

This report is created by Cetera Investment Management LLC. For more insights and information from the team, follow @CeteraIM on Twitter.

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