2022

Q4

INVESTMENT OUTLOOK

The Great Moderation Is Over

The current market environment is arguably the most challenging we have experienced since the 1970s, a period characterized by stagflation brought on by negative oil shocks and bad monetary policy responses. The developed economies, particularly the United States, Canada and Western Europe, saw rapidly rising oil prices and shortages caused, first, by OPEC's oil embargo following the Yom Kippur War in 1973 and then by the Iranian Revolution of 1979. The Federal Reserve did not react rapidly enough to rein in inflation, necessitating a rise in the Fed funds rate to 19% resulting in a double dip recession in 1980 and again in 1981-82 which brought prices back under control.

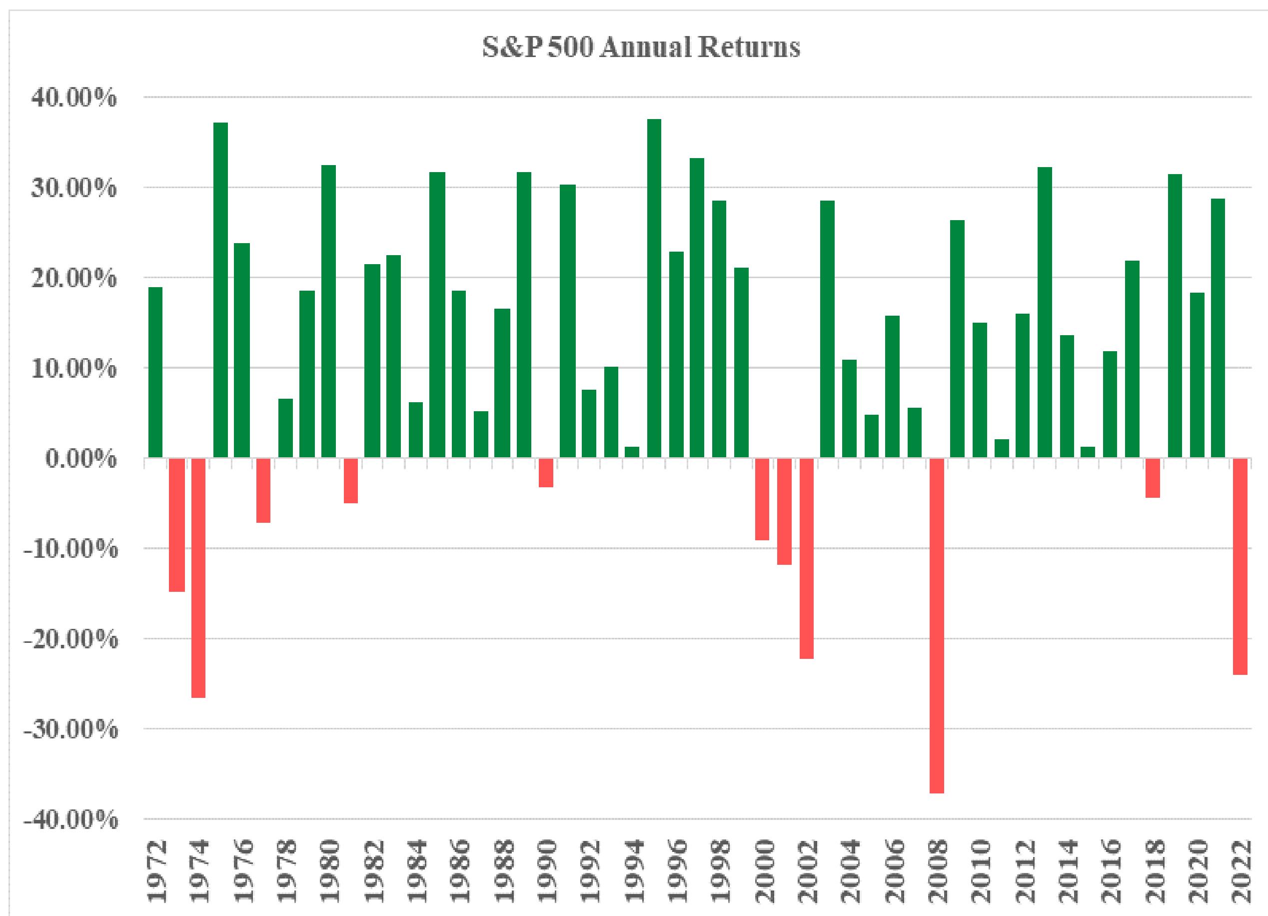
However, it is the period that followed the stagflationary '70s that formed the baseline for most of us, analysts and investors alike, in terms of our perception of what constitutes a "normal" market environment. From the early 1980s through the COVID recession of 2020, we experienced a period that some have called The Great Moderation. With the exception of the Great Recession of 2008-2009, this period was characterized by long periods of slow but steady economic growth, with short and shallow recessions; low and falling bond yields, and thus positive bond returns; and sharply rising valuations for both U.S. and global equities.

These (mostly) good times were aided in no small measure by the end of the Cold War, which ushered in a period of hyper globalization. China, Russia, India and other emerging economies became more integrated into the world economy, supplying it with low cost goods, services, energy and commodities. Freer global migration kept a lid on wages in advanced economies, and geopolitical stability, generally, allowed for production to move to the least costly locations without security concerns.

The Great Moderation began to crack during the 2008 global financial crisis, but the demand shocks that resulted allowed policymakers to maintain loose fiscal and monetary policies. The onset of COVID, the invasion of Ukraine, and rising geopolitical unrest generally are now threatening to undo much of the benefit of globalization, making the Fed's long term inflation target of 2% an even more daunting challenge. And oil shocks and COVID-era fiscal and monetary policies are causing us to once again face the specter of a period of rising interest rates, economic stagnation, and falling equity prices.

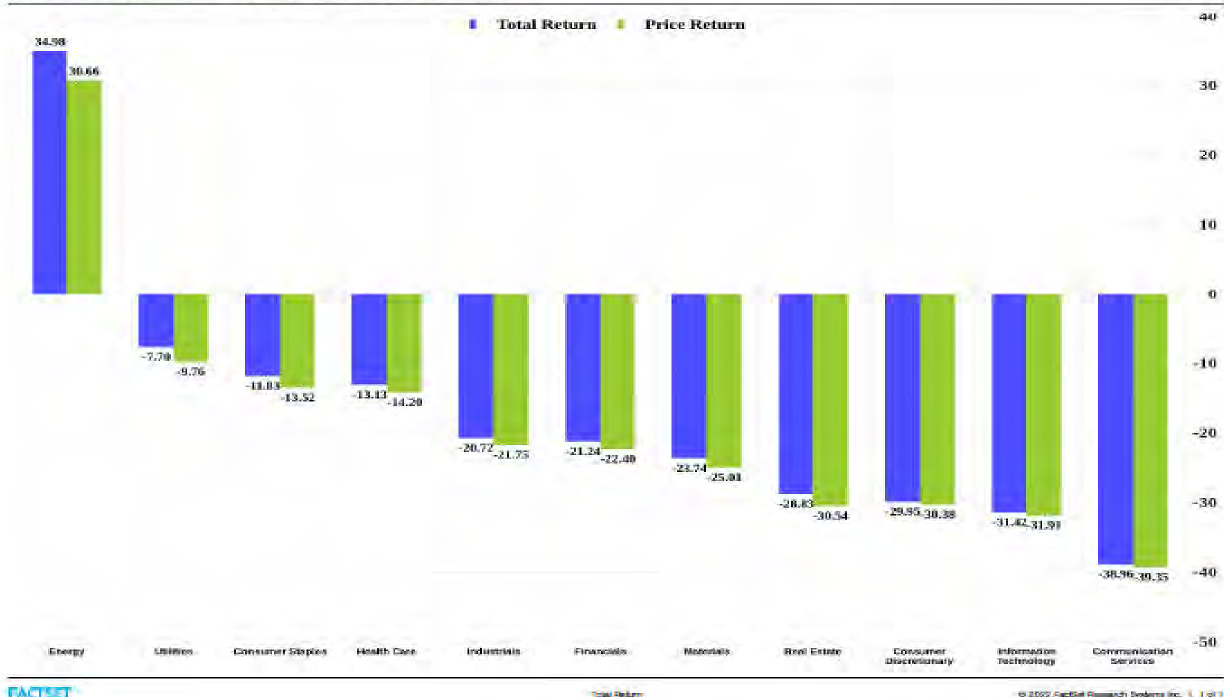
The Markets – Nowhere to Hide

Following the worst first half of the year in more than fifty years, stock prices continued to fall in the third quarter. The September declines for both the Dow Jones Industrial Average and the S&P 500 were their worst since March 2020, and the Dow officially joined the S&P and the NASDAQ in official bear market territory, ending the month 22% below its January 5th peak. Stocks are on pace for one of their worst ever years, with the Dow, S&P and NASDAQ down 22%, 25% and 33% year-to-date, respectively. None of these indices have ended a year down more than 10% since the aforementioned Great Recession of 2008.

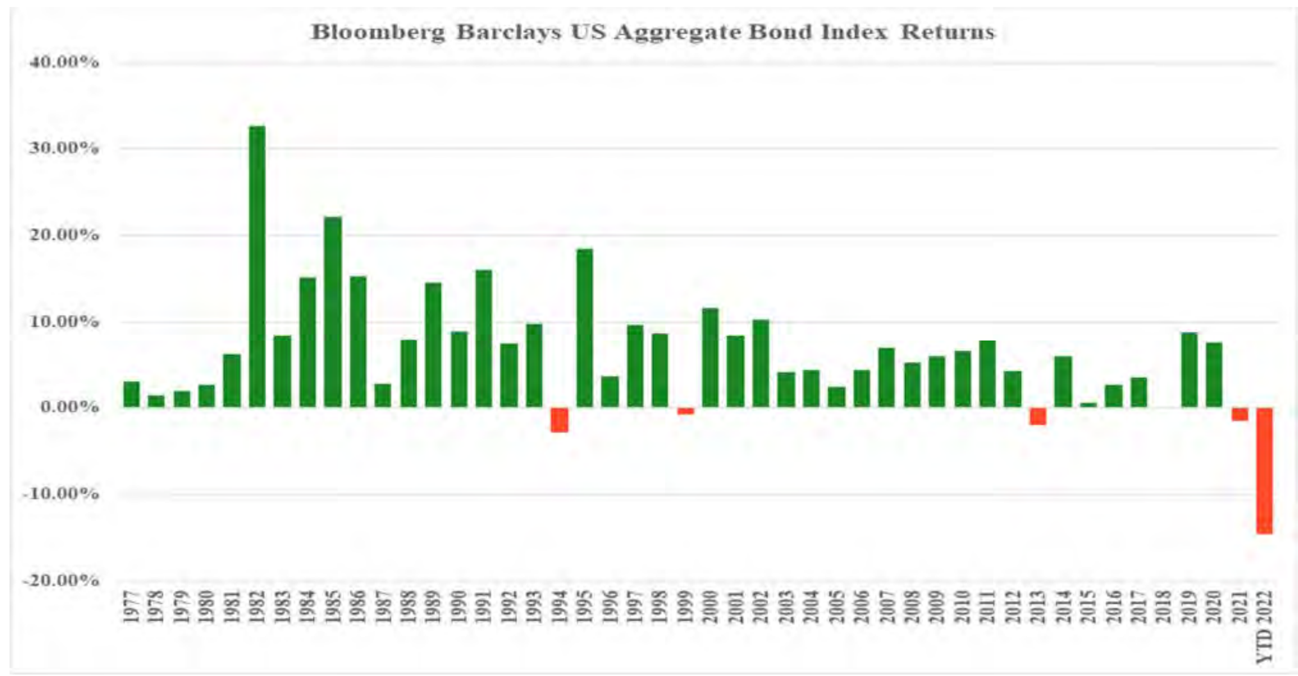


As usual, the market benchmarks only begin to tell the story, as many of the mega-cap stocks that drove the market's rise from the pandemic lows have fared far worse than the Index. Netflix is down more than 60% year-to-date and Nvidia is off by 58%. Amazon, Microsoft and Home Depot have all lost more than one-third of their value since the year began. Communication services companies were particularly hard hit in the latest quarter, driven by losses in index heavyweights Alphabet (Google), Meta Platforms (Facebook), and Verizon. Alphabet and Verizon are each off 35% from their highs, while Meta has fallen 64%. Caesars Entertainment and Carnival Shares have each declined more than 65%, as the travel and entertainment sector that was decimated by COVID, is being hit again by the prospect of a looming recession.

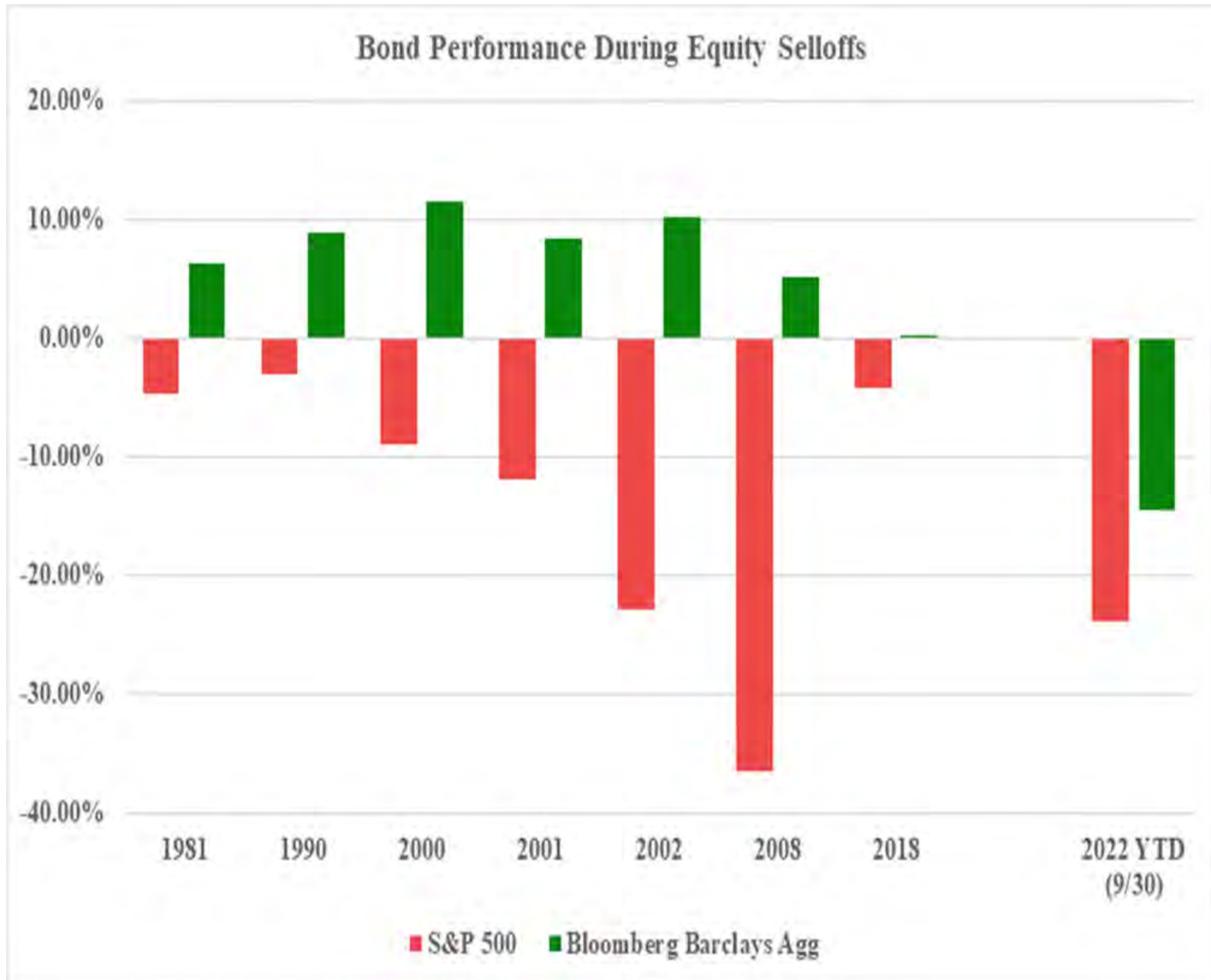
While losses were mounting in every other sector of the market, energy shares have soared. The Energy Sector ETF (XLE) rose just over 30% through September, and generated a total return of almost 35% including dividends. The gap has widened further since the quarter ended, as XLE shares have appreciated an additional 11% in October while the S&P has been virtually flat. With the energy sector as the outlier, the chart, below, tells the tale of the market in 2022. As the Federal Reserve continues to accelerate the course of its tightening policies to rein in inflation, the likelihood of a recession has increased to the point where it has now become the "base case." While stock prices are down in every sector but energy, the more defensive utilities, staples and health care sectors have declined far less than the market averages. On the other hand, those sectors that have fared the worst have been the economically sensitive communications, technology and consumer discretionary sectors.



While most investors' concern and attention has been focused on falling stock prices, the bigger story has been the deeply negative performance of the bond market. In past periods of equity market volatility, investors have looked to bonds to provide a measure of safety. The Bloomberg Barclay's U.S. Aggregate Bond Index has generated negative returns just four times since that benchmark was created in 1977. None of those years produced losses approaching even 3%, and none of those losses occurred in years when stocks were also negative. But as bond yields have risen across the yield curve, bond prices have collapsed.

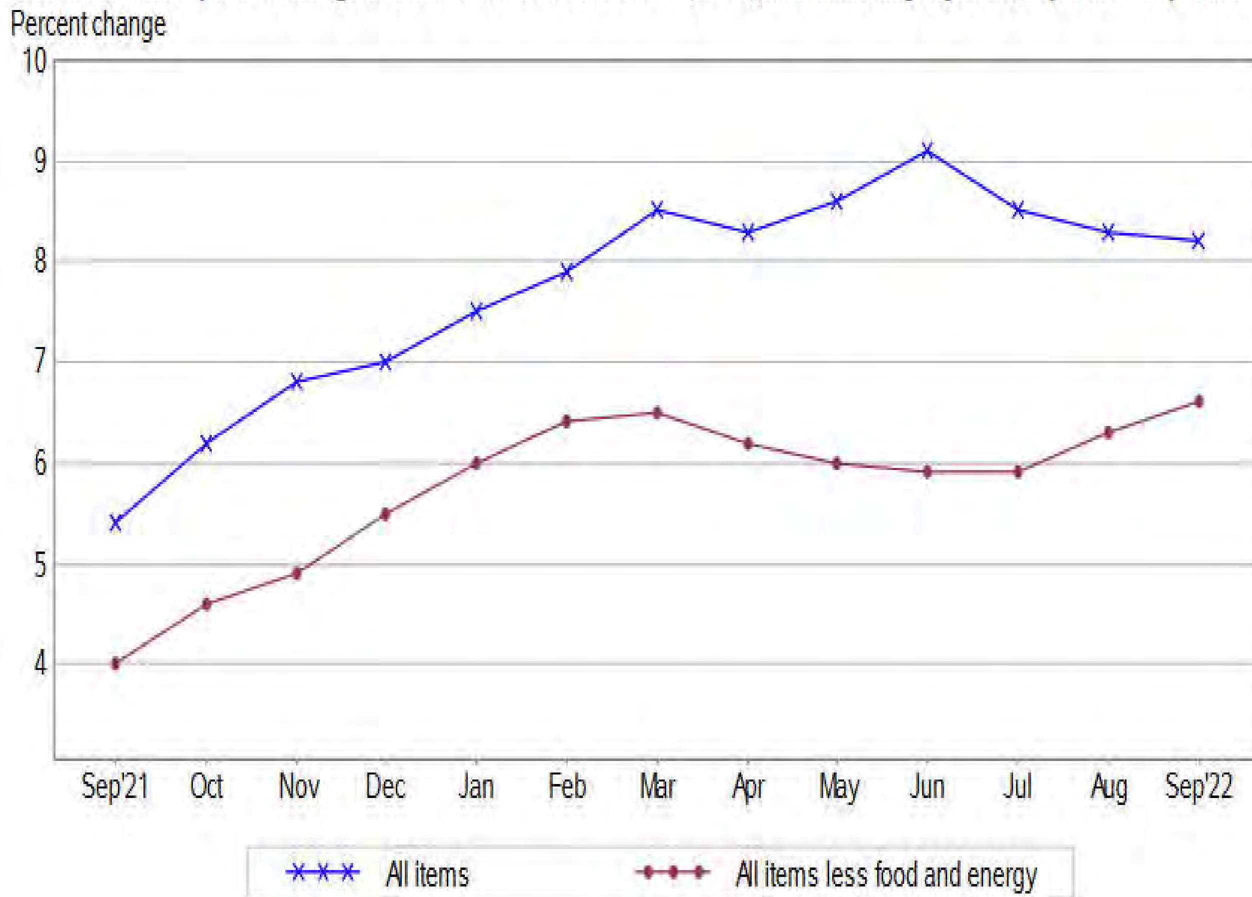


The Bloomberg Index was down 4.75% in the third quarter, alone, and is now off 14.6% year-to-date. On a price only basis, shares of the U.S. Aggregate Bond ETF (AGG) have fallen 17% since the year began.



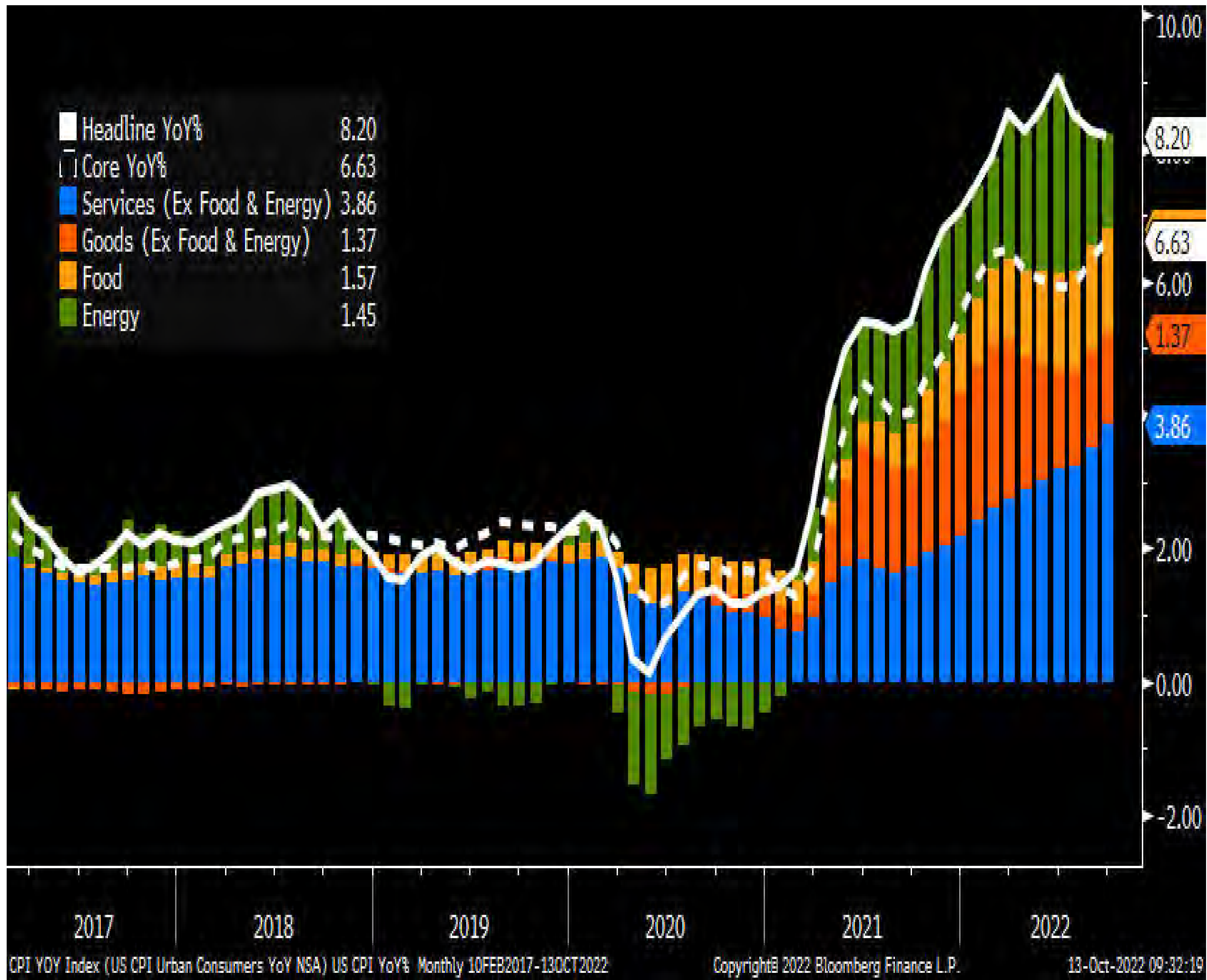
Inflation

In a market starved for positive surprises, stocks rallied briefly when a smaller-than-expected rate hike by the Reserve Bank of Australia raised hopes in some quarters that the Federal Reserve might also "pivot" to a more moderate pace of interest rate hikes. But Australia is not the United States, and any such hopes were surely dashed by September's report of the Consumer Price Index (CPI). Month-over-month increases in headline and core prices were 0.4% and 0.6%, respectively, 0.2% greater than expected in both cases. Year-over-year, headline inflation came in at 8.2%, down from the 8.3% reading of the prior month, but above the 8.1% that had been forecast.



Commentary from the Bureau of Labor Statistics cited increases in food, shelter and medical care costs as the largest contributors to the disappointing report. Painfully, these costs are non-discretionary, non-postponable, and represent the major portion of most household budgets. Food costs are up 11.2% over the last twelve months, and food at home costs are up 13%. New vehicle prices increased 9.4% and transportation services are up 14.6%. Shelter costs are up just 6.6%, but the rate of increase has risen slightly in more recent months.

Core inflation (dotted line, below), which excludes the more volatile food and energy costs, increased to 6.6%, above the 6.3% recorded the prior month and a new high for this cycle. Services inflation (blue bars), has risen steadily month by month, and it is not only the sector that will derive the least amount of benefit from any supply chain relief, but it is also the sector that will likely be the slowest to react to the Fed's course of rate hikes.



The latest reading of inflation at the wholesale level also suggests that inflationary pressures are still building. The Producer Price Index (PPI) increased 0.4% from August to September, twice as high as expected. The PPI is up 8.5% year-over-year, which is down from the peak reading of 11.7% in March. But it is important to note that the March report coincided with the Russian invasion of Ukraine which caused oil prices to spike. While oil prices have generally been trending lower in recent months, prices are expected to begin rising again as a result of the recent decision by OPEC and its allies to trim production levels.

The Federal Reserve – From "Softish" to "Expecting Pain"

It's safe to say that the Federal Reserve is among the most closely scrutinized institutions on earth, and it has come under increasing criticism, first for failing to recognize that inflation was persistent, not transitory; then for acting too timidly once it decided to change course; and now for possibly acting too aggressively in an attempt to catch up.

Mohamed El-Erian, President of Queen's College, Cambridge, and chief economic adviser at Allianz, the corporate parent of PIMCO, said in a recent interview on CBS' "Face the Nation" that, "…we risk a very

high probability of a damaging recession that was totally avoidable." He pointed to two errors made by the Federal Reserve: mischaracterizing inflation as transitory, and then not acting in a meaningful way once they realized that inflation was persistent and high. Not easing up on the accelerator last year means they've had to slam on the brakes this year, putting us in a position where good news for the economy is bad news for the markets. He went on to say that, "not only does (the Fed) have to overcome inflation, but it has to restore its credibility."

Former Treasury Secretary Larry Summers has said that today's market risks look eerily similar to those that surfaced just before the Great Financial Crisis, citing the Fed's "gradualism and tentativeness as contributing to the risks. "My feeling is that they're going to have to raise rates more," he said. Then this: "I think it would help if the Fed were more realistic and honest."

No one ever accused Mr. Summers of shying away from an interviewer with a microphone, but it is undeniable that inflation, interest rate hikes and currency shocks have led to increasing market volatility around the world.

Nouriel Roubini, emeritus professor of economics at NYU, achieved a measure of fame for predicting the 2007-08 subprime mortgage crisis in the United States two years in advance, as well as the global financial crisis that followed. Since then, he has earned a reputation on Wall Street as a perpetual pessimist, acquiring the nickname, "Dr. Doom." He wrote in a recent commentary that he expects an economic and financial crash, and that Federal Reserve policies will help spark the meltdown. He said his data "points to a sharp slowdown that will grow even worse with monetary policy tightening." He points to mounting signs of strain in credit markets as highly indebted firms, households and governments confront rising interest rates.

Unlike Messrs. El-Erian and Summers, whose negativism stems from their view of the Fed needing to do more than it has already committed to, Roubini's fear is that the Fed will be forced to abandon its fight against inflation due to unbearable stress in the world's credit markets.

The published views of these, and other widely regarded analysts, officials and policymakers, makes it clear that the Fed must become credible if its guidance is to be of any use.

As an example, the Federal Reserve releases its Summary of Economic Projections (SEP) following their Open Market Committee meetings in March, June, September and December. The SEP has become a significant means by which policymakers communicate their forecasts for GDP, employment, inflation and interest rates. The idea is that this information will turn market expectations in the direction that the Fed wants, but the Fed's purpose can only be served if the SEP's projections are believable. But the sheer speed of this rate hike cycle has rendered the Fed's own projections less helpful than normal, particularly when it come to the level which Fed officials think interest rates must reach to rein in inflation.

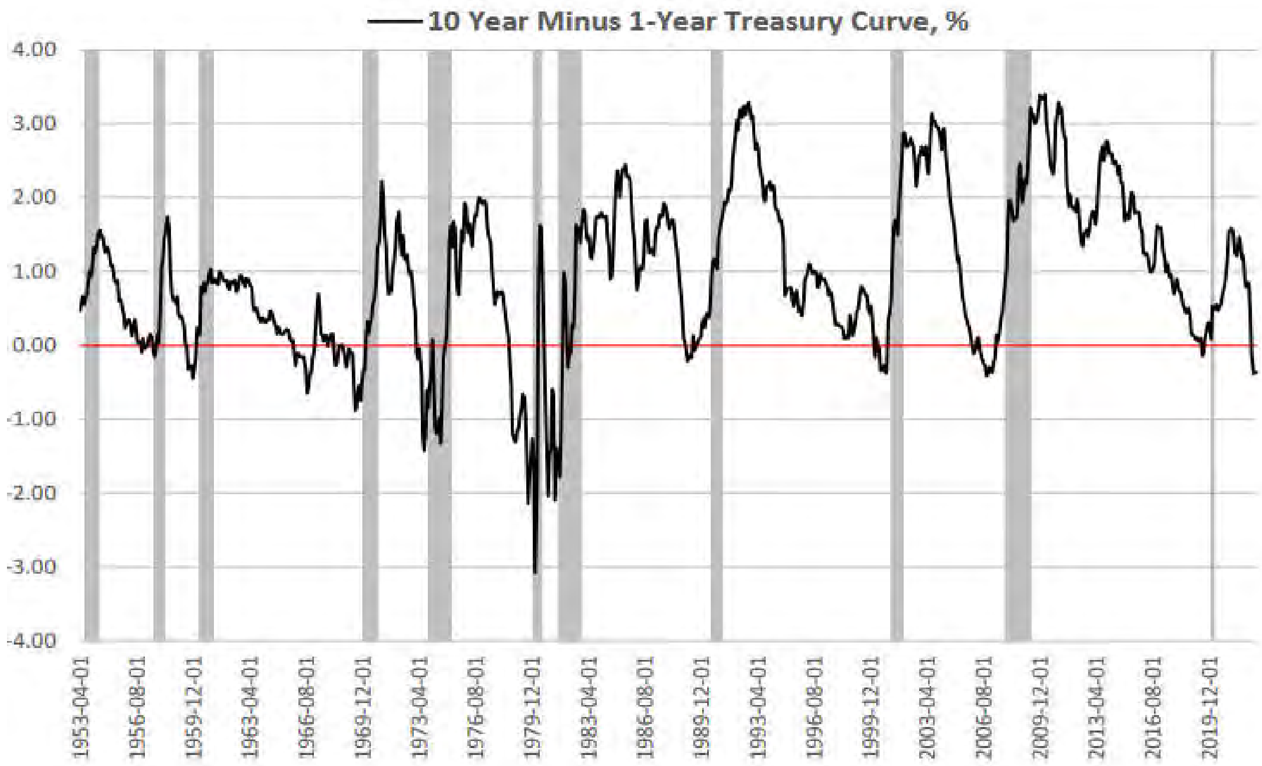
In March, the Fed's Open Market Committee (FOMC) members collectively signaled that the fed funds rate would likely reach 1.9% by December. By June, that projection had jumped to 3.4%. The new SEP released in September indicates that they now think 4.4% is more likely. The market is expecting a hike of 0.75% to 3.75%-4.00% when the Fed next meets on November 2nd, with the final meeting for this year to be held on December 14th.

At the same time, the Fed's projections for the *highest* level its target rate will reach before inflation falls – the terminal rate – has risen from 2.8% in March, to 3.8% in June, and now to 4.6% in September. Market volatility will remain elevated so long as there is uncertainty about how high interest rates are going to climb. Higher than expected inflation reports in recent months have kept expectations about the terminal interest rate on an upward trajectory. The current market consensus is that the terminal rate will peak at around 5% in the first half of 2023, about 40 basis points above the Fed's Summary of Economic Projections.

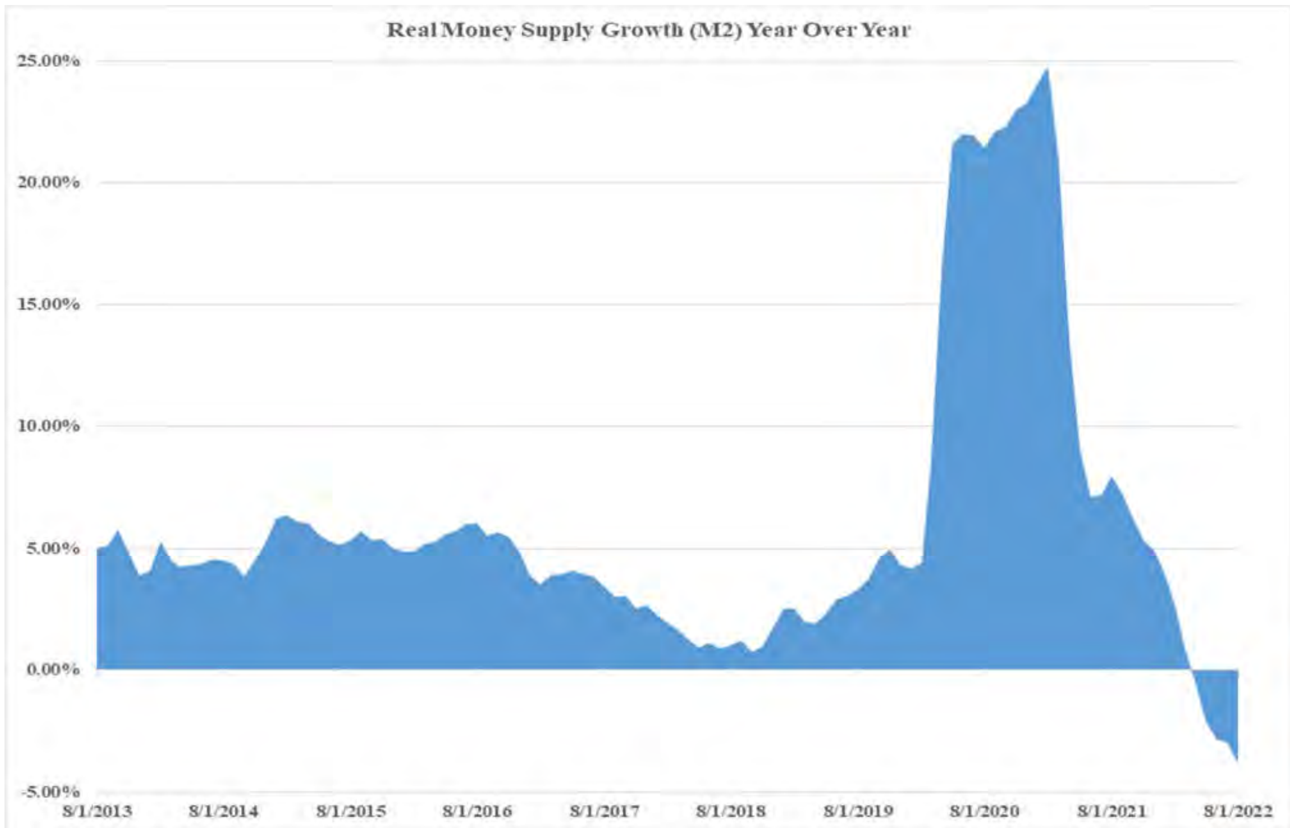
Historically, the peak of the Fed's rate hike cycles has not occurred until the target Fed funds rate is above the core inflation rate. The Fed does not use the headline CPI for this purpose, but rather the Personal Consumption Expenditures (PCE) Index, which lacks many of the biases of the CPI. The last PCE report measured the inflation rate at 6.2%, well above the market's expected terminal rate, and well above the Fed's projected rate of 4.6%. The bottom line is that current inflation readings have to fall further – or rates have to continue to rise – before the real Fed funds rate turns positive, i.e., above the rate of inflation.

It must be said that in addition to the challenges facing the Fed due to the uniqueness of the current economic situation and its own tardiness in recognizing the danger of rising inflation, there is also a process issue involved, as well. The Fed looks at current economic and labor market data that is largely reflective of monetary conditions that existed 6-9 months ago, or more. *The impact of current monetary policy or any changes thereto won't be evident for another two or three quarters, at least.* The real economy – demand, employment and output – reacts to changes in monetary policy with long and widely varying lead times, while Fed policy changes, *real or anticipated*, impact the capital markets immediately. It's not so much that the Fed might overshoot or undershoot its target, it's that the target is constantly moving.

With the Fed reacting to coincident or lagging indicators and spurred to more aggressive action by persistently high inflation and a strong labor market as a result of monetary policies long ago abandoned, there is a strong likelihood that interest rates will overshoot on the upside. A recession within the next six months has become the most likely result, and the most reliable indicators of a recession are already in place: the yield curve is inverted, there is growing weakness in home sales and other cyclical areas of the economy, and there is negative growth in the real money supply. The question of whether the recession will be mild or whether it will be deep and damaging depends on whether the Fed gets interest rates to "restrictive" levels and keeps them there longer than necessary – a growing risk given the backward-looking data they are relying on.


10 Year Minus 1-Year Treasury Curve, %
4.00
3.00
2.00
1.00
0.00
-1.00
-2.00
-3.00
-4.00
1953-04-01
1956-08-01
1959-12-01
1963-04-01
1966-08-01
1969-12-01
1973-04-01
1976-08-01
1979-12-01
1983-04-01
1986-08-01
1989-12-01
1993-04-01
1996-08-01
1999-12-01
2003-04-01
2006-08-01
2009-12-01
2013-04-01
2016-08-01
2019-12-01

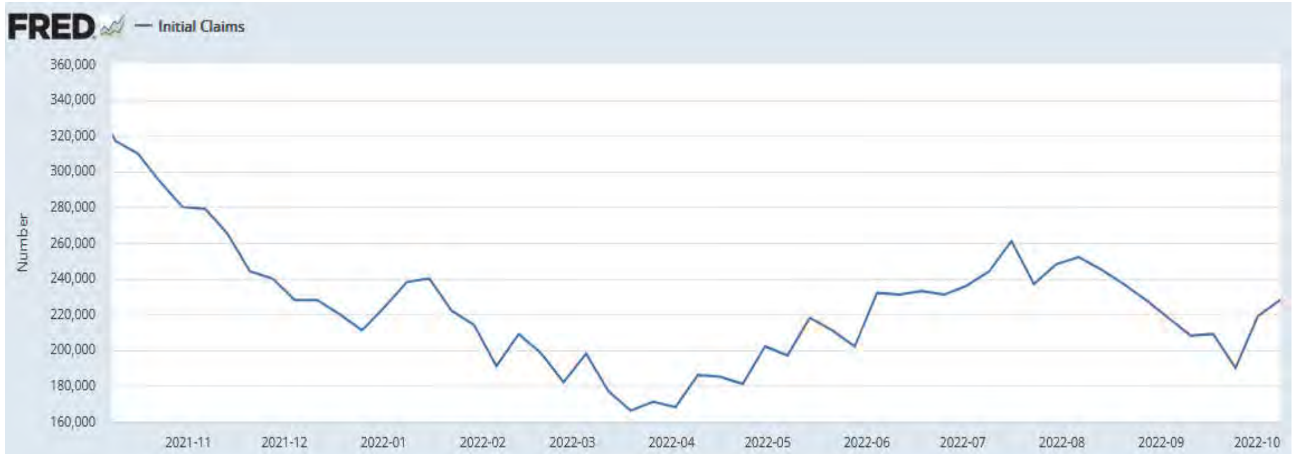
Last Price
US New One Family Houses Sold Annual Total SAAR - on 8/31/22 (L1) 685.00
US Existing Homes Sales SAAR (L2) 4.71
US Pending Home Sales Index SA - on 8/31/22 (R1) 88.4
7.50
7.00
6.50
6.00
5.50
5.00
4.71
4.50
4.00
3.50
'99
'00
'01
'02
'03
'04
'05
'06
'07
'08
'09
'10
'11
'12
'13
'14
'15
'16
'17
'18
'19
'20
'21
'22

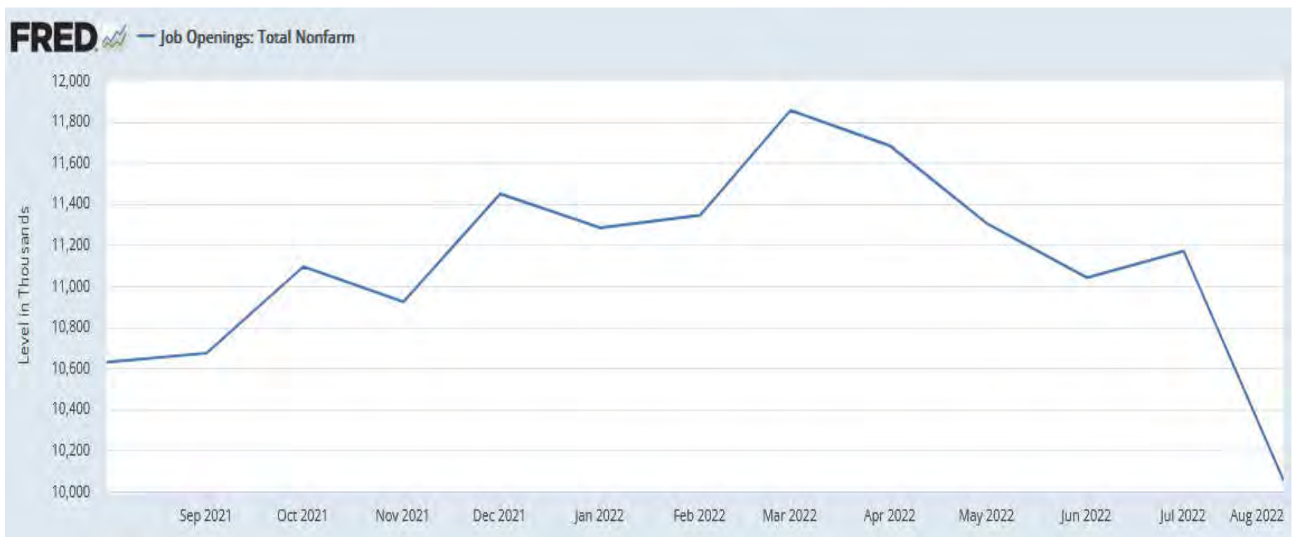


Jobs and the Economy

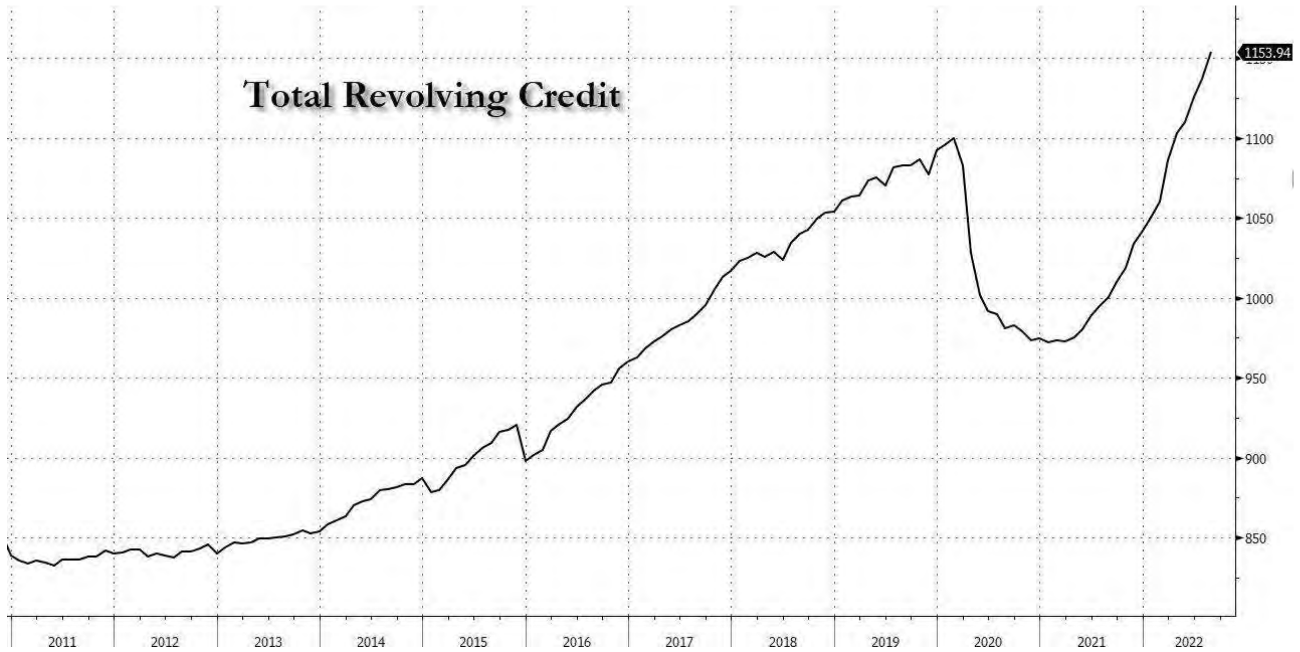
The September jobs report was an example of a "good news is bad news" event, characteristic of a bear market. Non-farm payrolls rose by a solid 263,000, with the unemployment rate falling back to a cycle low of 3.5%. The continued strength in the labor market is evidence of an economy that is not in recession, despite two negative quarters of real GDP growth. Many pundits and politicians have fostered the notion that two consecutive quarters of negative growth is the definition of a recession, but the simple fact is that a recession occurs when the National Bureau of Economic Research (NBER) declares it. And there has never been a recession that was not accompanied by a rising unemployment rate.

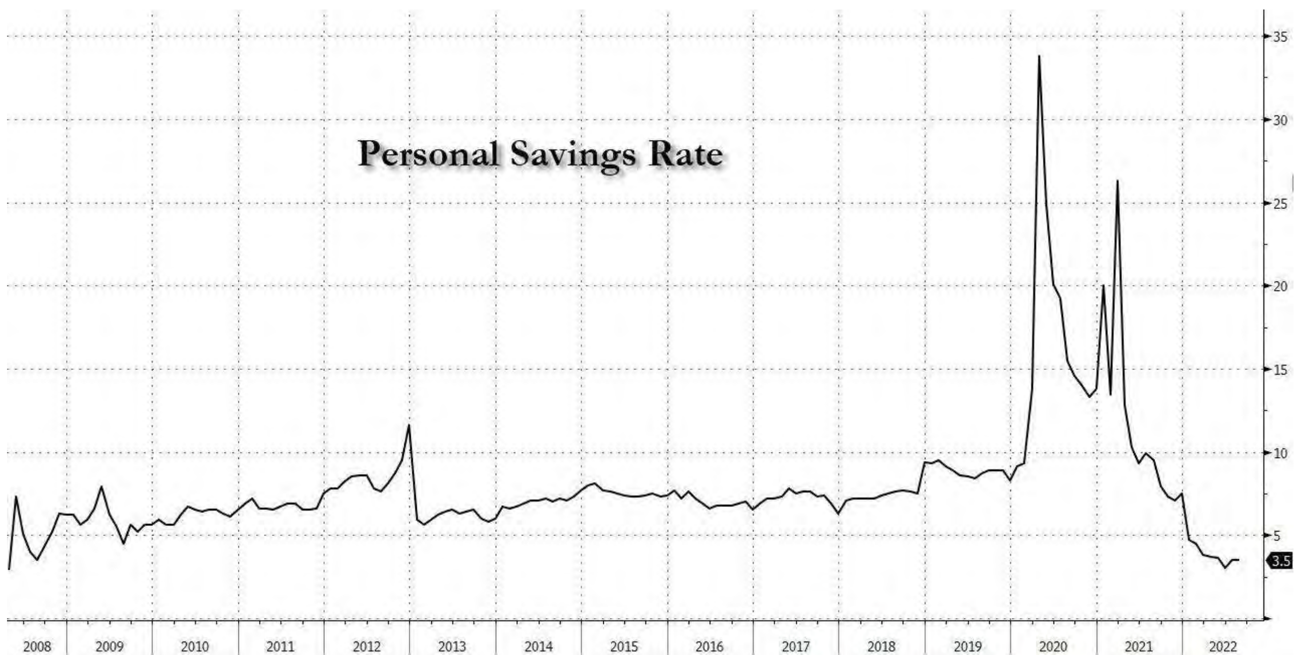
The most recent jobs reports do provide some hope for the "bad news is good news" crowd, in that initial unemployment claims rose slightly, and job openings have remained in a downtrend that began in March and has seen just one minor uptick in July (charts, following). Still, the number of job openings compared to the number of available workers remains historically high, and gives investors a reasonable basis for believing that we will be entering any coming recession in a better place, economically, than has been the case in past cycles.





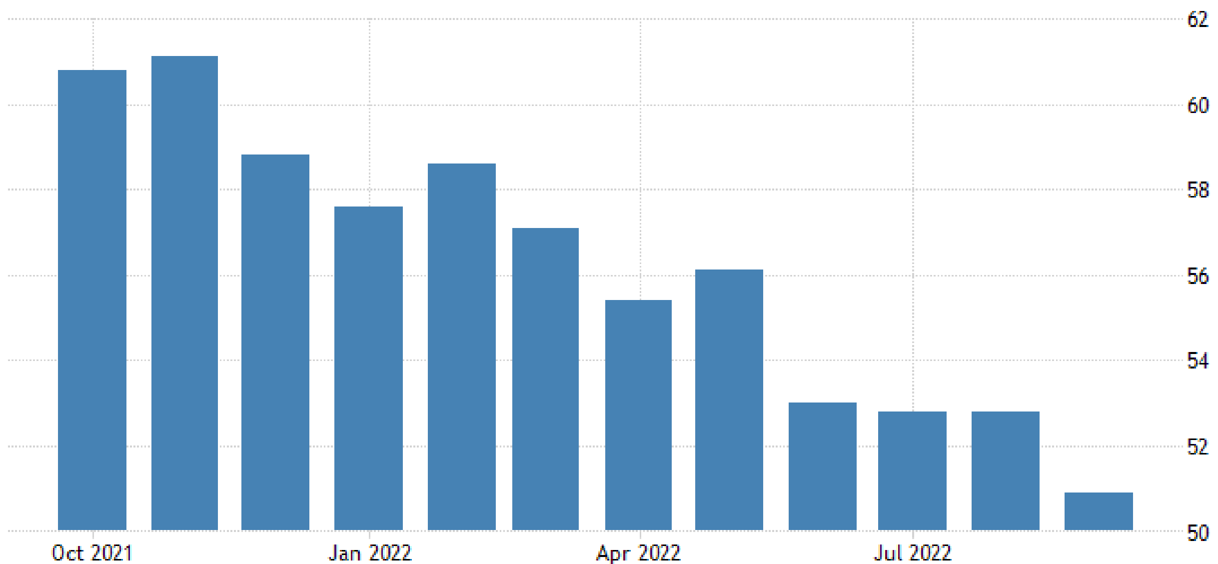
Household wealth is on track for its first significant reduction since the financial crisis of 2008. Global assets are expected to decline by 2%, according to Allianz, which means that household wealth will decline by about 10% this year. Household debt, meanwhile, has been on the rise, and rising borrowing rates on top of rising costs, generally, pose a growing risk to household balance sheets. There may be more coal than usual in our holiday stockings this year.





The ISM Purchasing Managers Index (PMI) fell unexpectedly to 50.9 in September, the slowest growth in factory activity since the COVID recession in 2020. The reading is below the level of 52.8 achieved in August as well as the consensus forecast of 52.2. Any number above 50 indicates a sector that is growing, but the path has been downward over the last year, and is trending more rapidly toward contraction. The new orders index was 47.1 in September vs. 51.3 in August, and the manufacturing employment index fell to 48.7 from 54.2, indicating a loss of manufacturing jobs. There was more bad-news-is-good-news in the commentary that accompanied the report, which said, "Following four straight months of panelists' companies reporting softening new orders rates, the September index reading reflects companies adjusting to potential future lower demand. Many Business Survey Committee panelists' companies are now managing

head counts through hiring freezes and attrition to lower levels, with medium- and long-term demand more uncertain.”

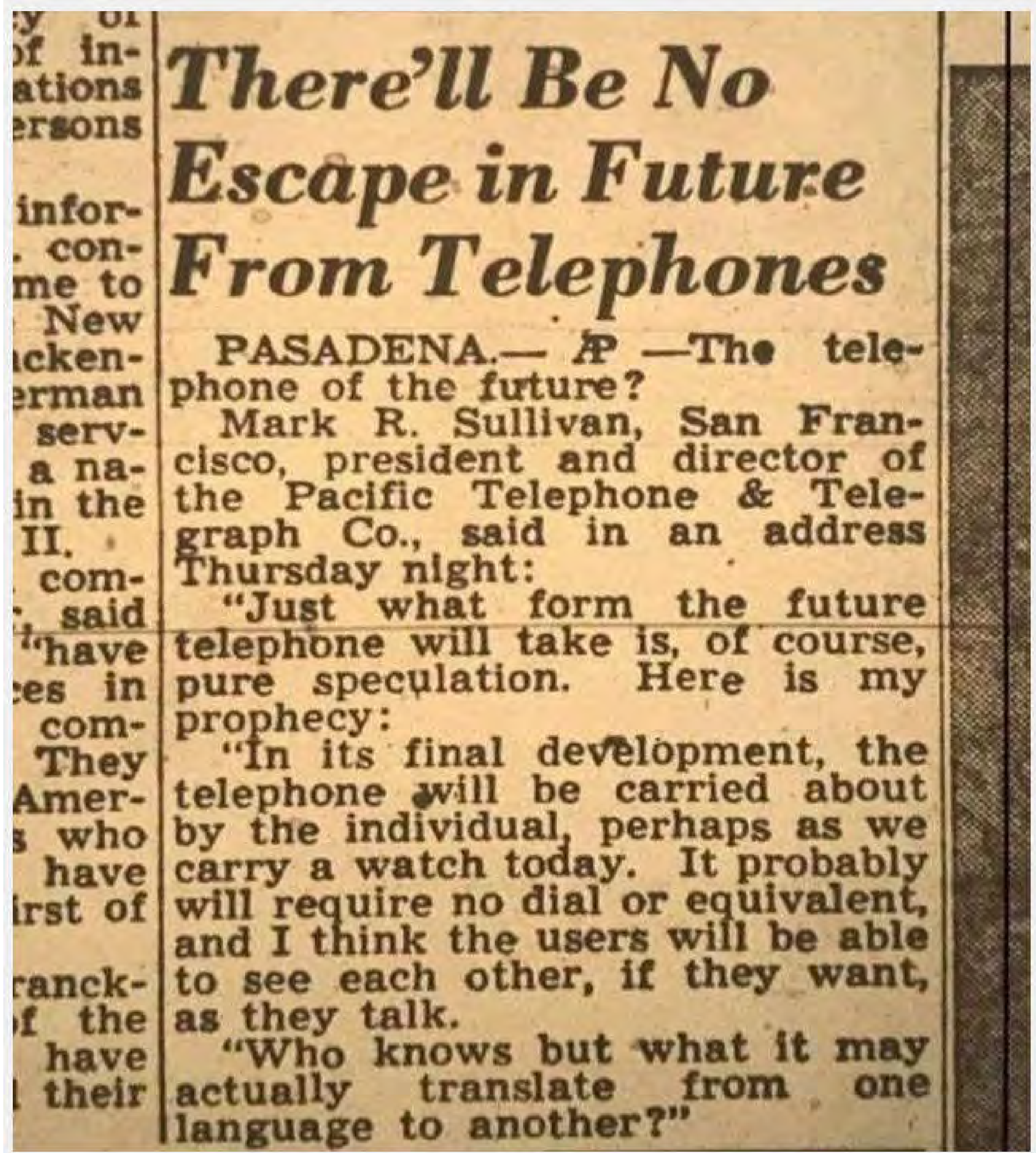


In all, the current economic readings evidence an economy that is growing in nominal terms, but is showing unmistakable signs of weakening. Manufacturing activity is approaching the point of contraction, and home sales are nearing levels achieved during the 2008 and 2020 recessions. So for the Fed, the tug-of-war between growing economic weakness and rising inflation appears likely to continue, which would seem to be the very definition of being between a rock and a hard place.

<u>In Case You Missed This Back in 1953</u>

From time to time we feel the need to share items that we come across that are interesting or even amazing, even if they might seem at first glance to have no relevance to the concerns of the moment.

At the time the article, below, appeared in the Pasadena, California newspaper in 1953, telephones still had rotary dials and most subscribers shared party lines with three or more other households. Most of the country had not yet been assigned area codes and direct dialing was just in the process of being rolled out. As prescient as Mr. Sullivan was, and as preposterous as his notion must have seemed at the time, even he could



There'll Be No Escape in Future From Telephones

PASADENA.— AP —The telephone of the future?

Mark R. Sullivan, San Francisco, president and director of the Pacific Telephone & Telegraph Co., said in an address Thursday night:

"Just what form the future telephone will take is, of course, pure speculation. Here is my prophecy:

"In its final development, the telephone will be carried about by the individual, perhaps as we carry a watch today. It probably will require no dial or equivalent, and I think the users will be able to see each other, if they want, as they talk.

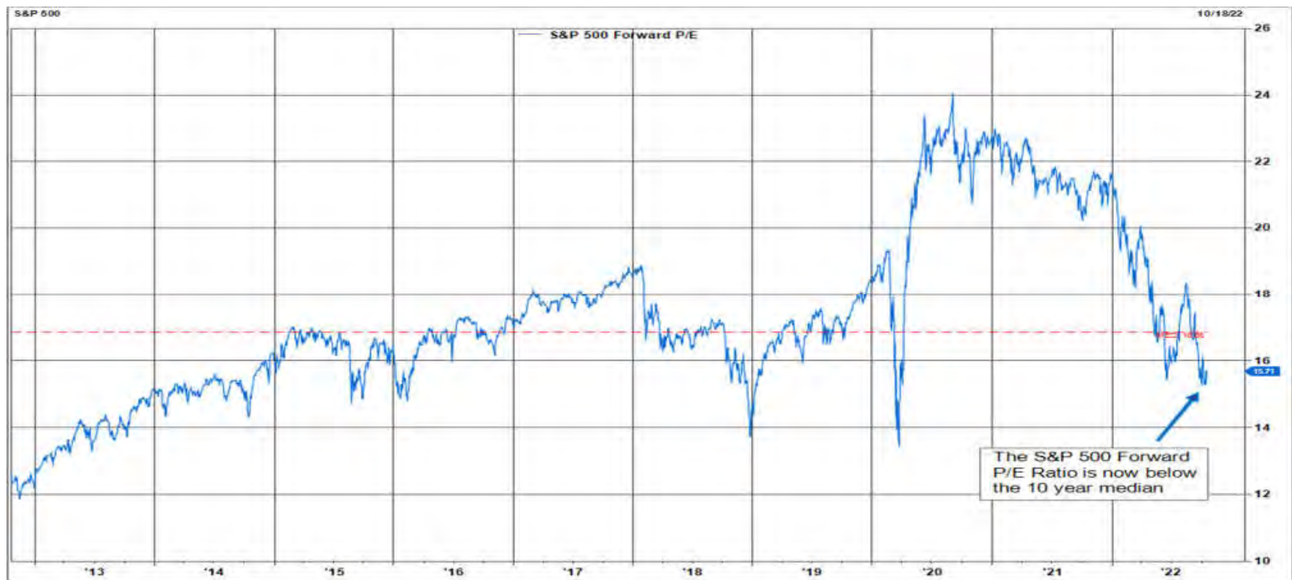
"Who knows but what it may actually translate from one language to another?"

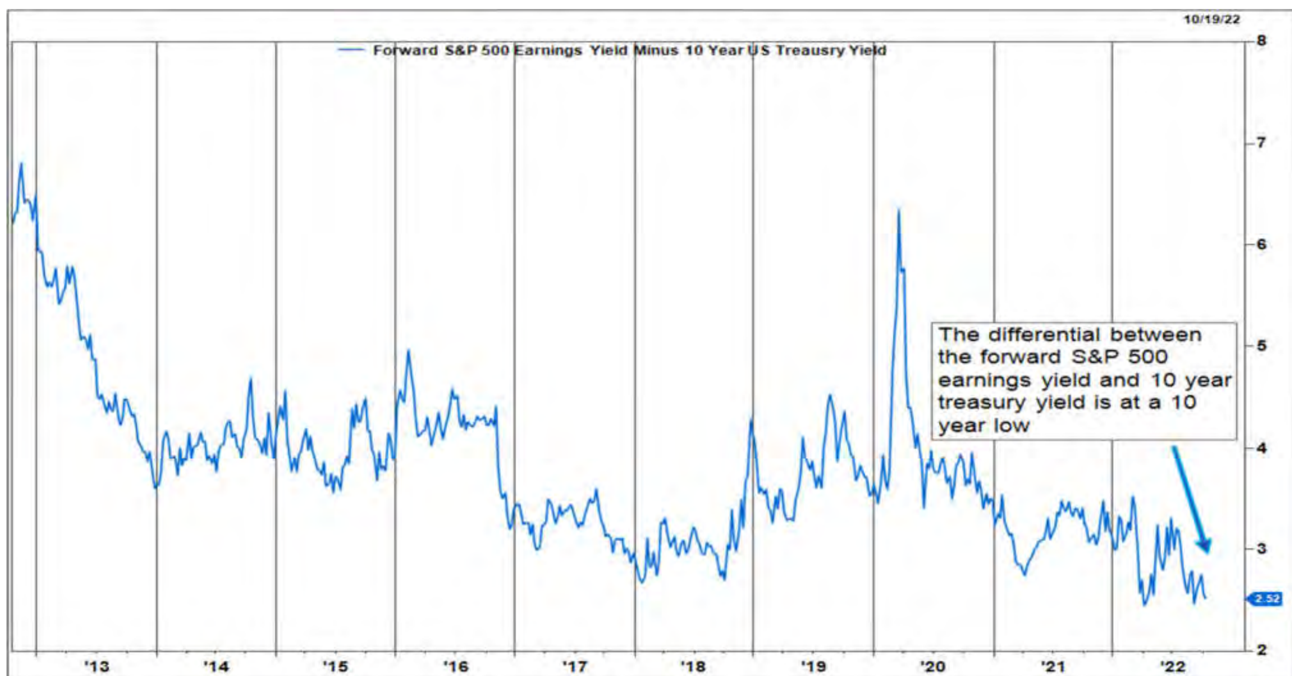
not have envisioned that his telephone of the future would also serve as a computer, camera, television, stereo, road atlas, portable library, personal shopper, travel agent, calorie counter, bank teller, stock broker, newspaper and remote garage door opener. That is just a partial list of what we carry around in our pockets every day.

The broader point is that silicon was thought to have little practical use in the 150+ years since it was discovered in 1824, and it now virtually drives the global economy. Even in the most challenging times, we should never doubt the magic of discovery, or underestimate a free economy's limitless capacity to use discovery to create wealth and opportunity and make our lives better.

The Stock Market

As the air has been taken out of market valuations, especially those of the mega-cap growth stocks that drove market returns upward over the last 3-5 years, Price/Earnings ratios have fallen back to more reasonable levels. The S&P's current forward P/E of 15.5 has fallen sharply from its elevated level at the beginning of the year, and is now below its 10-year average. But we take little comfort from these lower valuations for two reasons. First, the market's forward P/E is based on earnings expectations that we believe to be unrealistic, given the growing likelihood of a recession. And second, while the market appears to be undervalued compared to historical norms, it is not undervalued relative to bonds as a result of the sharp rise in bond yields that has occurred this year. The market's expected earnings yield (forward earnings divided by price, the inverse of the price/earnings ratio) minus the 10-year Treasury yield is at or near a 10-year low (charts, below).





The declines in stock prices that we have experienced so far this year have been almost entirely due to lower Price/Earnings multiples as interest rates have risen. Markets sold off sharply in the first half of the year as the 10-Year Treasury Rate doubled from 1.66% to 3.49%, then rallied from mid-June to mid-August as rates fell back to 2.75%. From that point to now, rates have risen again and are now above 4%, while the S&P 500 has fallen another 14% to new cycle lows. Logic and experience tell us that Price/Earnings multiples are unlikely to expand until the Fed is in a position to pivot from its current course

There is another shoe that has not yet dropped, and that is that earnings estimates for 2023 are virtually unchanged from the beginning of the year to now despite the fact that virtually every economic model shows that recession odds have risen from virtually nil to a virtual certainty over the last nine months.

The consensus earnings estimate for the S&P 500 in 2023 began the year at $246, and has since dropped to $238, a drop of just over 3%. Still, the downward revised estimate represents an 8% increase over 2022's estimate of $222. Earnings in past recessions have declined by as little as 5% and by as much as 91%, **but they have never increased by 8%.** The average earnings decline over the last ten recessions has been 30%.

If we assume that the recession will be mild and/or brief and the hit to earnings is limited to, say, 10% below 2022's results, or $200, that would imply an S&P target of 3,100, 16% below its current level, if P/E multiples remain unchanged. Optimists could even argue that P/E multiples are usually elevated at earnings troughs, and the market's implied P/E multiple of 18.5 based on the lowered earnings expectations already discounts the likelihood of a mild recession. But if the recession is even average by historical norms and earnings fall 30% below this year's level, the downside risk to the market remains high, despite the already steep decline.

Be Realistic, but Don't Lose Faith

John Kenneth Galbraith said that "The function of economic forecasting is to make astrology look respectable."

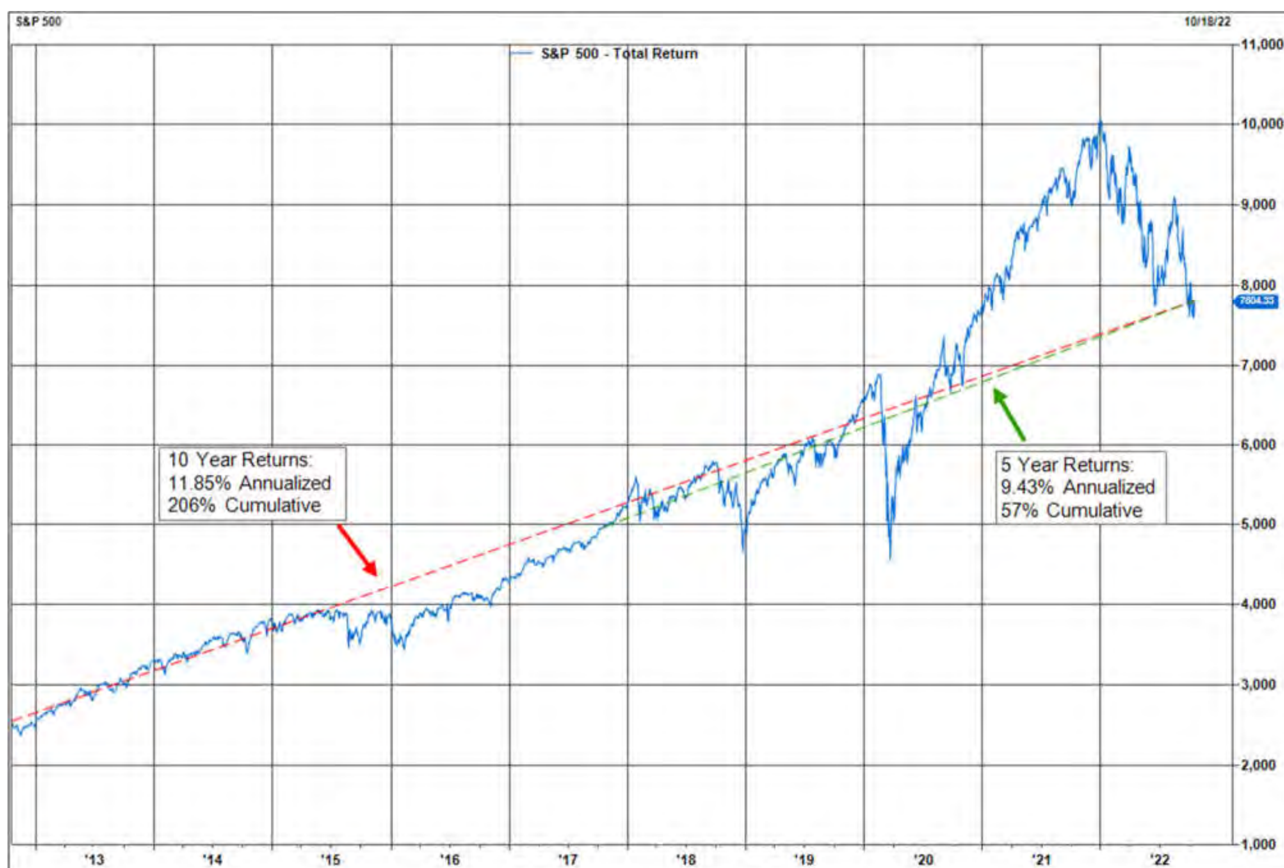
Peter Lynch, the legendary former manager of the Fidelity Magellan Fund, put it more colorfully, saying that, "Thousands of experts study overbought indicators, oversold indicators, head-and-shoulder patterns, put-call ratios, the Fed's policy on money supply, foreign investment, the movement of the constellations through the heavens, and the moss on oak trees, and they can't predict the markets with any useful consistency, any more than the gizzard squeezers could tell the Roman Emperors when the Huns would attack."

Of course, we can't expect that our outlook will come to pass exactly as we have presented it. It's not impossible that we and the consensus are wrong about the likelihood of a recession – it wouldn't be the first time, or the last. If so, we will have erred on the side of caution. Perhaps the Fed will not overshoot in this rate hike cycle, and a soft(ish) landing is still achievable. Perhaps earnings can come in at a level at or near current expectations, or perhaps much of what concerns us is, in fact, already priced into the market. Perhaps a positive surprise in the next report on inflation will give the Fed a reason to tone down the hawkish rhetoric and consider the potential impact of the steps it has already taken.

We can hope for any or all of this to occur, but hope is not a useful investment strategy. We do not believe that enough of the potential risks are already priced into the market, even if only some of what we expect to happen comes to pass.

But if hope is not an investment strategy, neither is fear. We know from experience that bull markets are born in times of stress, and that the market will bottom before any upturn in the economic environment is apparent. When that happens, great companies will be available at great prices.

Meanwhile, we urge you to look at the graph, below, and consider not where the market is compared to where it was at the beginning of the year, but compared to where it was five and ten years ago. Bear markets have been described as a process whereby stocks are sold by the impatient to the patient. Even after the current decline – as well as the 30% plus decline in early 2020 – patient, long term investors are still up 57% over the last 5 years, and more than 200% over the last ten years.



The market overcame the distress of the 1970s, and all of the problems that have arisen in the half-century that has followed. It overcame Black Monday in 1987, the dot.com bubble of the early 2000s, the Great Recession of 2008-09, the European debt crisis of the 2010s, the COVID recession of 2020, and too many other global currency and debt crises to mention. Hope and fear are not viable investment strategies, as we have said, but faith is the essential quality possessed by every successful investor. Have faith that today's concerns will be overcome in time. We can't tell you how, just that it has always been the case.

Joseph J. Tascone
Senior Vice President &
Senior Investment Officer
JTascone@chemungcanal.com

Michael D. Blatt, CFA
Vice President &
Senior Investment Officer
MBlatt@Chemungcanal.com

Peter M. Capozzola, CFA
Vice President &
Senior Investment Officer
PCapozzola@capitalbank.com

John E. Shea
Vice President &
Investment Officer
JShea@chemungcanal.com

Kevin W. Brimmer
Assistant Vice President &
Investment Officer
KBrimmer@chemungcanal.com

Shelby M. Fay, CFP®
Assistant Vice President &
Investment Officer
SFay@chemungcanal.com