Bell Institutional

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Equity and Fixed Income Outlook

Jay Powell, the chair of the Federal Reserve, presented an unusually short and direct speech at the annual Jackson Hole symposium on August 26. Powell's message can be summarized in a few direct points:

1. The Fed is aiming to return inflation to 2%.
2. The Fed won't stop raising short-term rates until it sees meaningful progress toward the inflation goal.
3. There will be pain for households and businesses along the way.

Over the last 13 years, investors have been conditioned to buy into stock market declines, knowing the Fed would step in with interest rate cuts, bond purchases or additional liquidity to support the market and bring it back up. After the 20% decline in stocks during the first half of this year, the market appeared to feel that it was time for some of that Fed support once again. The stock market rallied nicely from the end of June into mid-August on this platform. The Jackson Hole speech confirmed the Fed's focus is solely on inflation, with no appetite to provide any accommodations to the economy until this inflation problem is in the rear-view mirror. The stock market sold off noticeably in the wake of this speech as investors digested the Fed's message.

Another factor that supported stock market gains in July was corporate earnings releases that were largely in line with estimates. There had been concerns that rising inflation would cut into consumer purchasing power, lowering corporate earnings. Instead, consumers tapped into savings and credit cards to support their spending, ultimately sustaining the earnings results. We are more concerned about corporate earnings pressure later this year, rather than in the first half of 2022 – now that savings are exhausted, consumer credit is elevated, layoff announcements are becoming more prevalent and consumers seem more cautious.

We suspect investment markets will remain unsteady – visible in ups and downs that are larger than normal, resulting in elevated volatility.

Bonds also continue to struggle in this environment. Investors are wrestling with conflicting desires: to buy bonds as protection against the prospect of a recession, or to avoid them on the prospect of rising interest rates (since the market value of bonds declines when interest rates rise). Right now, the fear of rising interest rates appears to be winning – perhaps supported by the Fed's next action of ramping up sales of bonds from its $9 trillion balance sheet.

Other popular investment sectors like real estate are also under pressure. There are very few places to hide successfully.

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In my grade school days, the kids in our neighborhood often played a game we called "ditch." Ditch involved moving among various hiding places to avoid being tagged. If you were seen moving between hiding spots, your only hope was to outrun the other team and "ditch" them so they couldn't catch you. If you had a great hiding spot, there was no need to move. If you could remain concealed and out of sight, your team would ultimately win. But we all know it's not much fun to sit in one spot. The thrill of the chase is way more exciting – even though it could mean losing the game.

Volatility presents the market in a similar light. As investors, we're often tempted to run from one asset class to another to avoid being caught by market declines – and when that doesn't work, we run to the next one. As investors, that's a game we should "ditch." Instead, set your asset allocation in a manner that supports your long-term goals … and use the boring strategy of staying put!

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