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Global X: On the Markets

Chief Investment Officer Jon Maier and Head of Thematic Solutions Scott Helfstein offer their perspectives on the current investing landscape in what has been an extremely difficult year for investors. Market conditions seem to grow more challenging by the day with inflation remaining high and persistent, the Federal Reserve (Fed) sounding more hawkish, and midterm elections approaching, among other issues. Jon and Scott have a wealth of experience in volatile markets, and they both agree: 2022 is distinct, but like in every downturn, cooler heads are likely to prevail.

Is this time different?

Jon Maier: It sure is. But every cycle is different, whether it's challenging or not. In my experience, different periods may rhyme with each other, but no period is exactly the same, which can actually provide investors a measure of comfort when looking for new opportunities. What remains the same is that investing isn't easy for anyone, in any market environment. Investors get bits of information, consider some history, and weave together what they think is a cohesive investment thesis. But then entirely unpredictable exogenous factors can derail the thesis.

Scott Helfstein: Each cycle has both unique and familiar elements. For example, systematic failures in the banking industry drove the 2008 Global Financial Crisis and write-offs on bad loans started in 2007. Excess liquidity and exuberant valuations caused the 2001 dot-com bust. Paying attention to liquidity, valuation, and lending usually makes sense. What makes this downturn unique is that this is the first crisis since the 1970s where inflation is a meaningful factor. Inflation and Fed tightening in the late 1970s and early 1980s led to a painful recession, but it also paved the way for go-go expansion with 5% real GDP growth from 1982–1987.[1]

When will inflation come down? How do we think about asset allocation with high inflation?

Maier: Inflation is a tough one. Nobody's gotten it right yet, certainly not the Fed. We know that credit expansion is inflationary, but pandemic-induced inflation is a completely different dynamic, especially intermixed with a war impacting energy markets. Forward inflation indicators have softened materially, even if reported numbers say different. But housing inflation is stubborn. High rents are a tough cycle to break when mortgage rates are 7% because they put homebuyers in the rental market. The only tool the Fed has is to tighten, but how hard the Fed can push is a question.

Helfstein: Signs suggest that producer prices have started to slow, and there are even hints of softening consumer inflation. That said, there's nothing magical about 2% inflation, other than it being the Fed target, which was established in 2012. Inflation at 2% is quite low historically, and likely reflects the deflation that was imported through the opening and industrialization of China in the late 1980s. The Fed keeps reiterating 2%, but they also spent months declaring that inflation was "transitory" and expectations were "anchored."[2] One solution to the Fed's tightening might be increasing the official inflation target to 4%. After a short period of adjustment, such a move might help the economy pick up steam.

Has the stock market already priced in a recession? Is it time to buy stocks?

Helfstein: We all wish we had a crystal ball to call market bottoms, especially this one. We know stocks have repriced. The S&P 500 forward P/E has declined from 23x to 16x this year.[3] The decline in the Russell Growth has been more acute, contracting from 34x to 22x.[4] When markets sell off 25% or more, the one-year returns are usually pretty good.[5] Some assets look like they're on sale, but the future may not look like the past, as fundamental shifts in areas like inflation or globalization might signal a regime change. Caution is advisable while looking for opportunities. Nominal assets, equities, and commodities are potentially compelling, depending on time horizon and risk tolerance.

Maier: September's Consumer Price Index (CPI) came in hotter than expected. Services inflation drove the print, as goods inflation remained flat, which is not the best news for market performance in the near term. For investors, there's some behavioral psychology at play in conditions like these because buying into a down market is unnatural. Conversely, when markets are moving up, investors' endorphins kick in and they get aggressive because they don't want to miss out. In downturns, key to remember is that valuation matters long-term, as it explains much of the subsequent 10-year S&P 500 returns. Like in other downturns, this bear market can be an attractive opportunity for long-term investors.

In conversations with clients, there is more focus on short-term rates with the 2-year around 4%. Does that make short-dated debt more attractive relative to equities?

Helfstein: Investing in a 4% bond with 8.3% inflation means the investor only lost 4.3% on the investment for the year, which is not an attractive real rate of return. The phrase real rate is important. According to behavioral economics, investors tend to think in nominal returns rather than take inflation into account and think on a real basis. The practical advantage to adding a 2-year bond at 4% is that the asset reduces volatility in the portfolio. For some investors, that is an attractive tradeoff. For others, the idea of locking in a negative real return may not be as attractive.

Maier: The answer really depends on an investor's time horizon. If inflation is annualized at over 8% and the investor earns 4% before taxes, they're losing money. But if they think there might be more room on the downside but aren't sure, a barbell approach of short dated and relatively high yield treasuries alongside companies or sectors with strong fundamentals can be effective.

What impact will the U.S. midterm election have on the market?

Maier: History suggests no impact because the outcome will likely be a divided government. Investors typically like divided government because it reduces the likelihood of major spending programs and changes in the regulatory environment and tax policy. But the government still has to function. Given the divisions between the parties, the simplest things that should get done, whether debt ceilings being raised, or budgets passed, may be delayed or controversy filled. Markets are unlikely to respond well to scenarios like these.

Helfstein: Traditionally, divided government is market positive. A risk to consider is that markets grew accustomed to stimulus since 2008, and a divided government would likely cut the fiscal flow. While the midterms are shaping up to split government, polling has been less than exact in recent elections and hotbed issues could mobilize voters on both sides. The impact of this election on markets may be less important than the information that it provides for political expectations going forward. Paying attention to races where candidates further out on the political spectrum, on both the left and right, run against centrists might make sense. Those races may provide a better diagnosis of the electorate going forward.

Footnotes:

1. Bloomberg, L.P. (n.d.). [Data set]. Data as of and retrieved on October 13, 2022.
2. Rugaber, C. (2021, June 22). Associated Press. Fed's Powell says high inflation temporary, will 'wane'. https://apnews.com/article/inflation-health-coronavirus-pandemic-business-6e7c813472a3eb706e0cdafe305c1477
3. Global X analysis with information derived from: Bloomberg L.P. (n.d.) [Data set]. Retrieved on October 13, 2022.
4. *Ibid*.
5. *Ibid*.

Definitions

Consumer price inflation (CPI): CPI measures the average change in prices that consumers pay for a defined basket of goods and services.

S&P 500 Total Return Index: The index includes 500 leading U.S. companies and captures approximately 80% coverage of available market capitalization.