Weekly Investment Highlights: 10th November 2022

Powell's Remains Hawkish

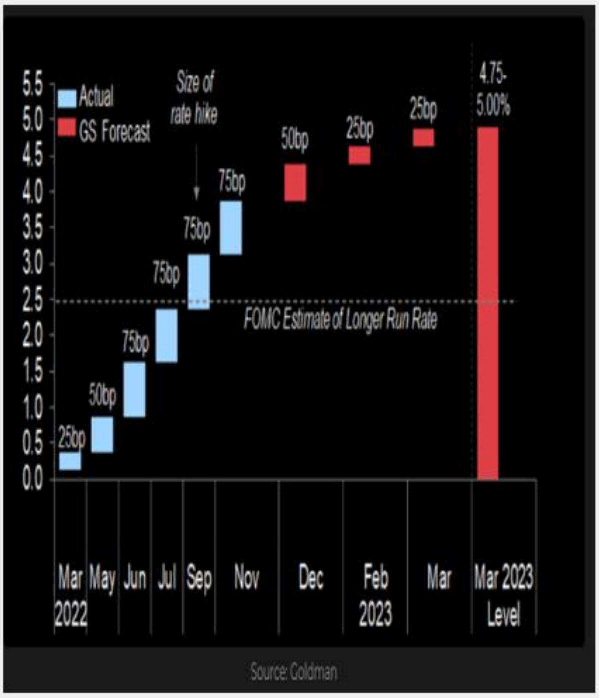
Fed remains hawkish and hiked 75 bps for a fourth time in a row. Powell suggested that the ultimate level of interest rates will be higher than previously expected.

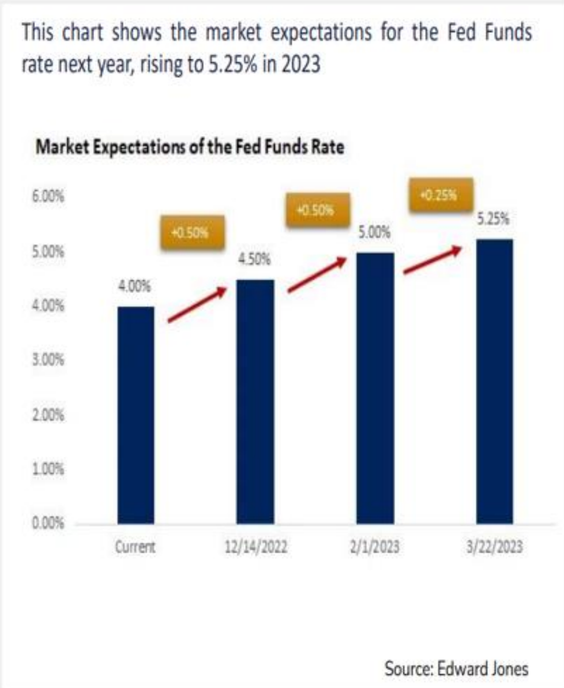
His remarks shift the focus away from the size of the next rate hike to where they will peak and how long they will have to stay at those levels

"It is very premature to be thinking about pausing", he said while also noting it could be appropriate to slow the pace of increases " as soon as the next meeting or the one after that"

Markets now pricing a 50bps hike in December followed by two 25bps hikes during Q1 '2023

SUMMARY - "Powell sent a clear message to markets at the Nov. 2 FOMC meeting: Don't expect us to continue raising rates by 75 basis points every time, but we're not making a dovish pivot either."





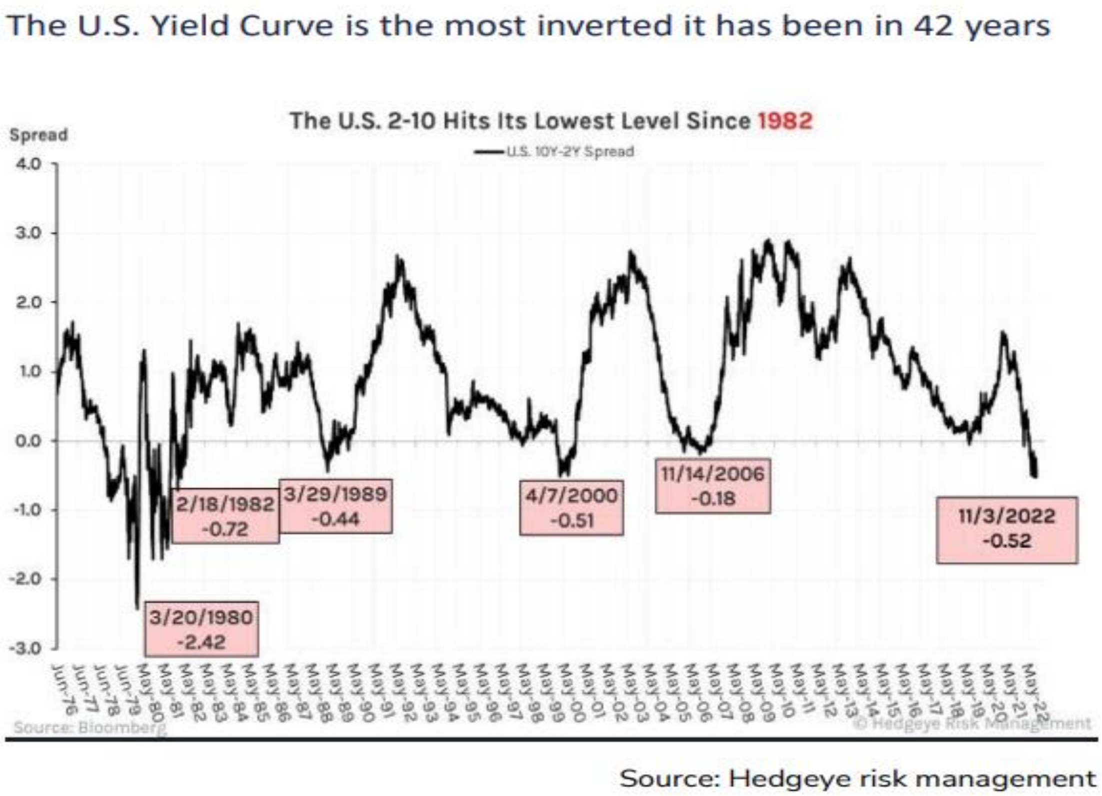
Source: Goldman Sachs

US Yield Curve Most Inverted Since 1980's

The policy-sensitive two-year has led this year's relentless rise in Treasury yields, with the latest bout of selling coming after Fed Chair Jerome Powell indicated that policy rates will likely rise more than previously anticipated and stay elevated as the central bank seeks to bring down inflation. US 2yr rates are trading at 4.71% (highs seen last in 2007-2008)

As a result, the two-year note's yield exceeded the 10-year note's by as much as 52.6 basis points (see chart)

This level of inversion was last seen about forty years ago when then Fed Chair Paul Volcker's rate hikes to break inflation tanked the economy. Curve inversions have a track record of preceding economic downturns by 12 to 18 months so a likelihood of a recession in 2023 are getting stronger.



Source: Hedgeye Risk Management

US Mid-Terms Take Center Stage

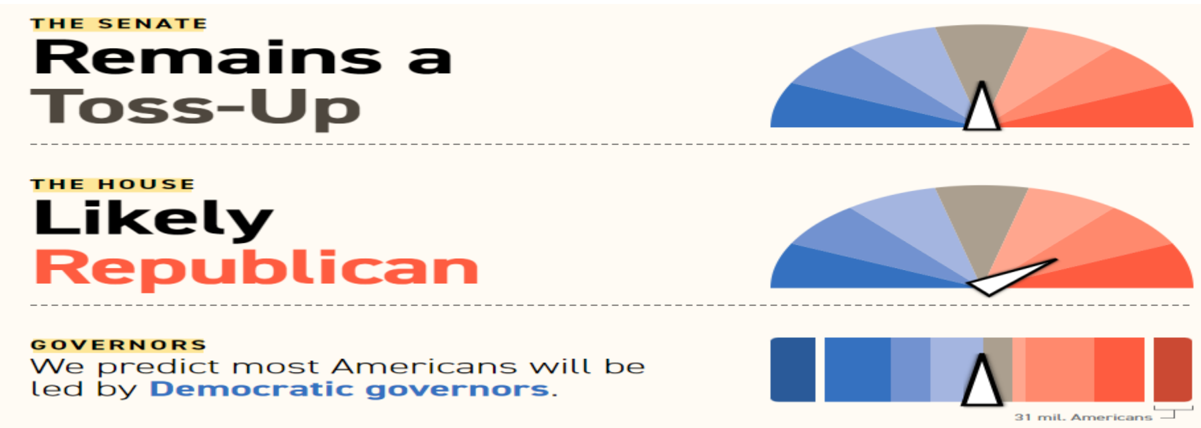
Americans head to the polls on Tuesday to decide control of both chambers of Congress, the governorship in 36 states, and countless other local races and ballot initiatives.

A "clean sweep" by the Republicans could greatly increase the chance of fiscal spending being frozen and historically high budget deficits being reduced, fueling a rally in 10-year Treasuries that can keep the equity market rising. Tighter fiscal policy is usually associated with lower inflation and makes government debt more attractive.

Be ready for a long night and maybe days of waiting before it's clear whether Republicans or President Joe Biden's Democrats will control Congress.

All 435 seats in the U.S. House of Representatives are up for grabs, as are 35 U.S. Senate seats and 36 governorships.
Republicans would need to pick up five seats to take a majority in the House and just one to control the Senate.

Politico polls suggest Republicans have a very strong chance of winning a House majority, with control of the Senate likely to be closer fought.



Source: Politico

US CPI Will Shape December FOMC

The upcoming October CPI report should be the most important data release this week and one of the more important economic indicators ahead of the December FOMC meeting (the November CPI comes out the first day of the two-day December meeting).

Markets are projecting a Headline CPI of 8% and Core at 6.5%

Below a summary from JP Morgan on the expected probabilities and the impact of the print on the markets. We believe US CPI comes down marginally and expect a 7.9-8% headline print.

- **5% Prints 8.4% or higher**: this would be a move back to July levels of inflation, which we may see on a MoM basis but think Equity investors care most about the Headline YoY level. This would represent the largest differential between actual and estimated in this cycle. **SPX down 4.5% - 6%.**
- **30% Prints 8.1% - 8.3%:** there have been 4x misses of 20bps or more and the SPX fell 1.6%, 2.9%, 40bps, and 4.3% which is a down 2.3% average. The 40bps outlier came when the SPX was ~3820 the day before the print. In the other 3 cases, the SPX was between 3930 and 4000. **SPX down 2% - 3%.**
- **40% Prints 7.9% - 8.0%:** I think bonds, and thus stocks, take this as a small positive since it meets expectations and does not reprice yields higher. Given that we are at the bottom of our Cash Trading team's range (3700 – 3900), we may see some covering leading to an uptick in stocks. **SPX higher 1% – 1.5%.**
- **20% Prints 7.7% - 7.9%:** this could be similar to the August 10 print which had a dovish beat by 20bps and triggered a 2.1% rally in SPX, 2.8% in NDX, and 2.9% in RTY. Cyclicals, Value Shorts, Momentum Shorts, and ARKK the best performers that day. Given the increased bearishness, the magnitude of move could be larger. **SPX higher 2.5% - 3.5%**
- **5% Prints 7.6% or below:** seeing a stepdown in inflation of this magnitude likely pulls the 10Y yield below 4% (currently 4.158%) and triggers a sharp rally in stocks. This may also reset the yield curve lower with terminal rate expectations falling under 5%. **SPX higher 5% - 6%**.

Source: JP Morgan

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