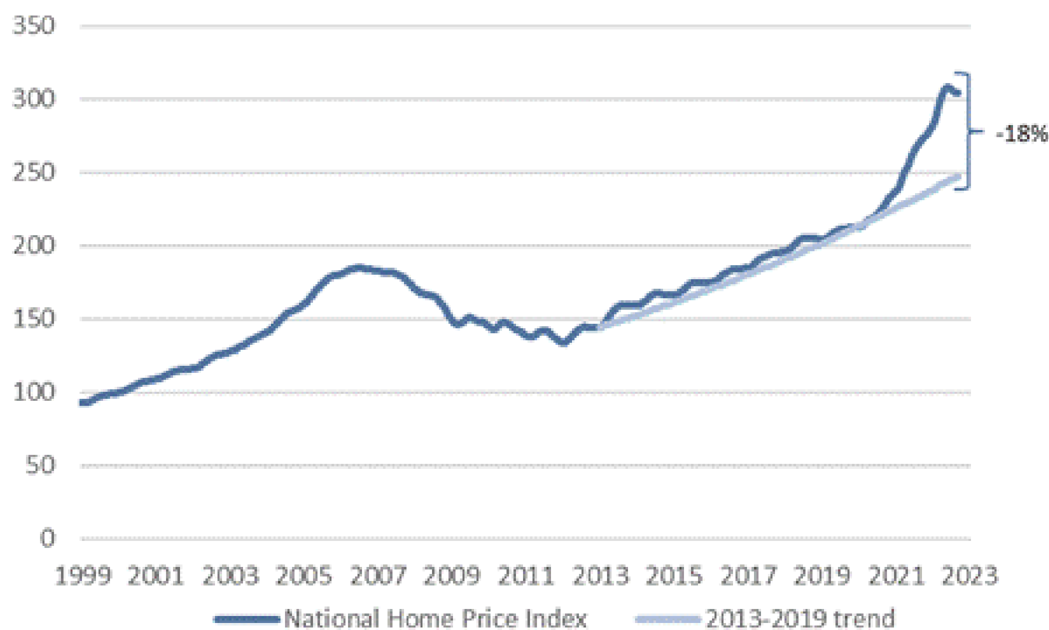
MARKET REVIEW

- Equity markets rallied strongly in October. US equities and value equities led, whereas internationally developed market equities posted modest gains. Emerging market equities posted further losses following China's 20th Party Congress.
- Interest rates moved up across the yield curve. Yields on 1-year and 10-year Treasuries are hovering around 4.5% and 4%, respectively.
- Commodity prices stabilized after advancing sharply in Q1 and declining in Q2 and Q3. The energy market remains very tight. Supply cuts from OPEC+, Russian retaliation to price caps, and Chinese reopening remain potential factors that could drive prices higher.

ECONOMIC UPDATE: HOUSING IS THE PIVOT

Housing is the main transmission mechanism for Fed policy, and by all accounts, it has been hit very hard this year. National home prices have fallen for the last two months and fell in all parts of the country in August. The overall decline is relatively small so far (-1.5%), but some areas are hurting. Prices in San Francisco have fallen -8.2% since May. National prices would need to fall 15-20% to go back to the pre-COVID trend and we're starting to see more forecasts in that range from housing economists.

Fig. 1: Case Shiller National Home Price Index

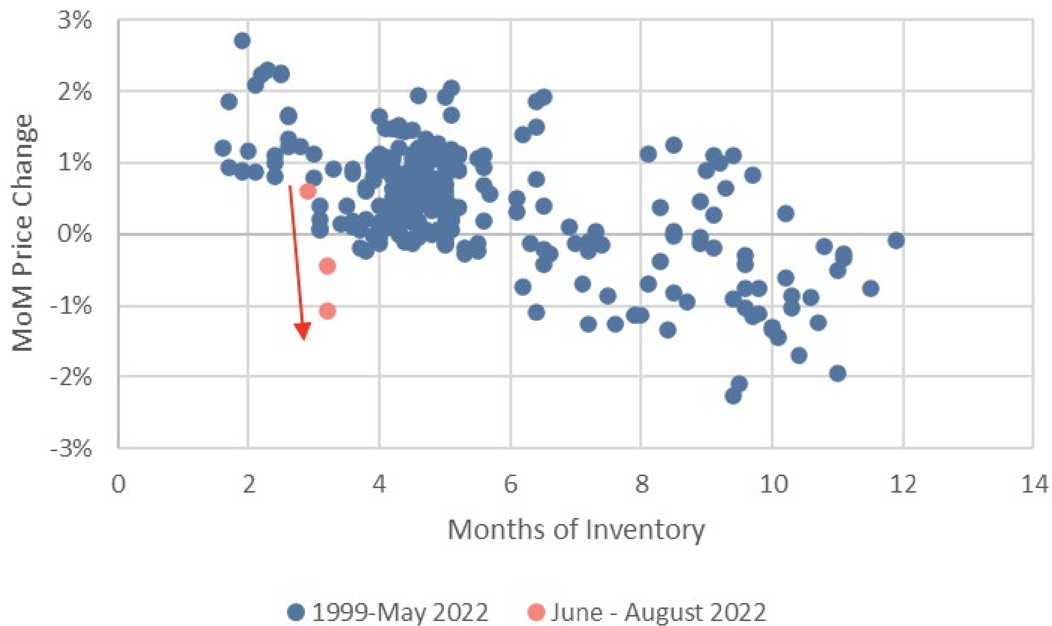


Sources: Bloomberg, Mill Creek.

Home price indices have large lags, so the on-the-ground situation is likely much worse than the current index indicates. The index is a blend of three months (June, July, and August) and includes transactions that went into contract in April. For context, average mortgage rates were 4-5.5% for contracts in April versus 7.2% today.

Price declines are quite unusual at current (very low) inventory conditions, but the conditions are not (yet) in place for widespread forced selling and mortgage defaults. Income growth remains strong, lending standards were much higher than in 2000-2006, and home equity extraction has been modest during this cycle.

Fig. 2: Housing Market Inventory vs. Price Change



Source: Bloomberg, Mill Creek.

The housing slowdown is a good sign for the Fed that monetary policy is having an effect and increases the probability of a "wait-and-see" Fed Funds rate pause around 4.75-5%. Accordingly, market participants are slowly pricing in Fed pause at the beginning of next year. We'll be paying attention to see if Chairman Jerome Powell leans into a possible pause at the FOMC meeting this week.

Recent economic data indicates inflation is taking a toll on the economy, but consumption spending continues to track above the pre-COVID trend and the labor market remains very tight. Broad-based inflation remains high - in the 4-5% range – which is a far cry from the FOMC's 2% target. Powell has placed the Fed's credibility on getting inflation back to target and therefore should be hesitant to message anything that will bring "animal spirits" back into the economy and financial markets.

CURRENT POSITIONING

This guidance refers to model portfolio positioning approved by the Mill Creek Investment Committee and does not reflect specific client circumstances, tax situations, or other constraints.

- We are neutral duration and overweight high yield in our taxable bond portfolios.
- Our taxable bond portfolios are also neutral duration and contain a high yield municipal bond position.
- We are overweight US, value, and low volatility equities.
- We continue to see value in private debt and private equity allocations in the current environment.

THE MIDTERM ELECTION

We recently held a Livestream with Bryan Wood, a Director in the Public Policy Group at BlackRock, and myself. These are our five main takeaways from that call:

1. The two most likely outcomes are a split Republican House and Democratic Senate or a full Republican House and Senate.
2. From a market perspective, the differences between these outcomes are negligible. In both cases, we expect legislative gridlock and no tax hikes.
3. The debt ceiling and government funding will likely become major points of political contention following the midterms.
4. A failure to raise the debt ceiling, which will likely need to occur before the end of the third quarter, represents a significant market risk in 2023.
5. Support for the war in Ukraine and an adversarial position toward China will likely be two areas of cooperation between the parties over the next two years.

QUICK LINKS

Taking Advantage of Higher Bond Yields
Preparing for a Recession with Low Volatility Equities
The Faintest Glow at the End of the Tunnel
Q4 2022 Outlook

This week's contributor: *Michael Crook, CAIA*

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