Q3 2022 | Capital Markets Outlook

Jason R. Vaillancourt, CFA
Global Macro Strategist

Perspective on the global economy and asset classes with insight on market history.

After the fall

On the surface, the decision by the Federal Reserve Open Market Committee (FOMC) to increase the upper bound on the federal funds rate by 75 basis points (bps) at its June 15 meeting seems almost anticlimactic in hindsight. By that point, the S&P 500 was already in bear market territory, having fallen by more than 20% since the recent highs in early January. That said, we still think financial markets will produce more drama before the books are closed on 2022.

Our working thesis is that the equity market sell-off to date has had two parts: first, the popping of a valuation bubble that had inflated over a period when money was free — a bubble that then became super-charged during the pandemic — and, second, a more traditional market struggle with discounting the odds of recession over the next 12 to 18 months.

The outlook for valuations

In the aftermath of the European sovereign credit crisis more than 10 years ago, major central banks around the world held policy rates well below the prevailing level of inflation. They did so by keeping real fixed income yields negative and maintaining very large balance sheets. Both longer-term yields and credit spreads stayed low, creating a powerful incentive for companies to finance with debt and enticing investors toward private markets where they could reap higher yields and returns.

Some of this behavior had started to moderate during the tightening cycle that ended in late 2018, until the explosion of money growth that came with the stimulus response to the pandemic. The valuations of unicorn companies being bought and sold by venture capital and private equity firms hit a new gear by early 2021. Certainly, some of these companies had benefitted from work-from-home (WFH) trends that were beginning to reverse once Covid-19 vaccines became widely available. But the popping of this bubble impacted a much broader array of companies than just the major WFH beneficiaries.

Asset allocations

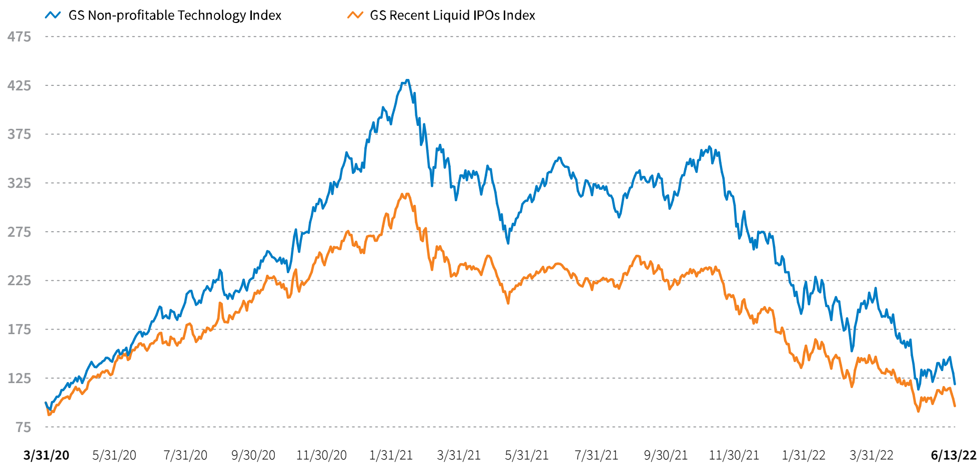
● *Current quarter*
○ *Previous quarter*
›› *Change from previous quarter*

	Underweight	Neutral	Overweight
EQUITY			
U.S. large cap	● ‹‹	○	
U.S. small cap	● ‹‹	○	
U.S. value		●	
U.S. growth	● ‹‹	○	
Europe	● ‹‹	○	
Japan	● ‹‹	○	
Emerging markets	● ‹‹	○	
FIXED INCOME			
Interest-rate sensitive			
U.S. government		●	
Non-U.S. developed country	●		
Emerging markets	○ ››	●	
Securitized			
Investment-grade corp. credit	● ‹‹	○	
High yield corp. credit	●		
Floating rate loans	●		
Residential mtge. credit		●	
Commercial mtge. credit			●
Prepayment risk			●
COMMODITIES			●
CASH		●	

Currency views

U.S. dollar versus	Favor other	Neutral	Favor dollar
€ Euro		●	
£ Pound			●
¥ Yen		●	

The end of free money deflates private markets



Source: Goldman Sachs. Past performance is not a guarantee of future results.

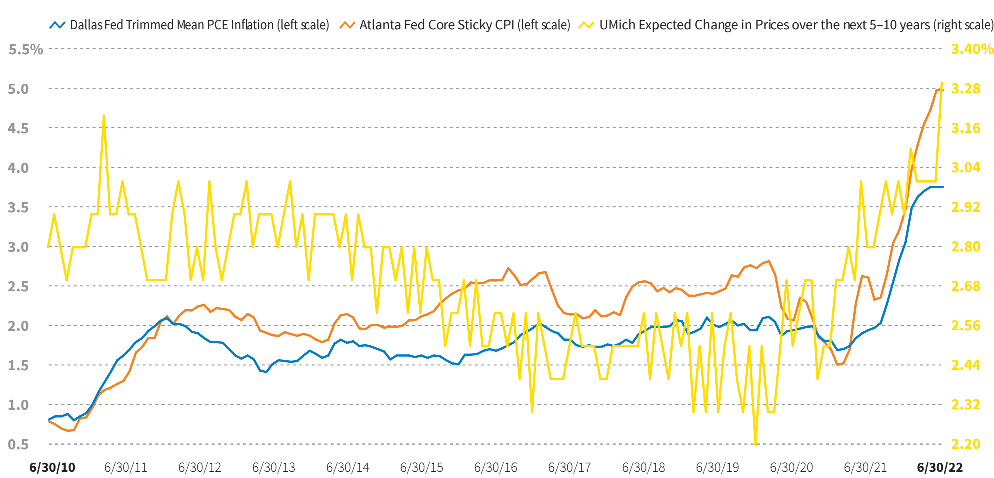
The good news is that it appears as though a good portion of the work has already been done to restore some semblance of sanity to the valuations of these companies. At the very least, they have given back all of the gains made during the pandemic. The bad news is that history would suggest that valuation bubbles don't typically revert to fair value and then stabilize — they usually overcorrect.

The potential for recession

With respect to the market pricing in the probability of recession, we probably are not quite as far along in that discounting process. High-yield spreads are less than 600 bps, well short of the 800 bps that marked the widest levels seen during the 2011 and 2016 growth scares.

The discounting process is all part and parcel of an *intentional* strategy by the FOMC to tighten financial conditions and curb demand, which has outstripped supply and thus led to the hot readings on inflation. Now that Fed Chair Jerome Powell has made the committee's reaction function clear, it is easy to see how the last batch of data immediately preceding the June meeting rattled FOMC members enough to cause them to front-load their tightening path. To paraphrase Powell in his May 4 press conference, the committee will "get to neutral expeditiously."

Higher inflation expectations prompt the Fed to tighten faster



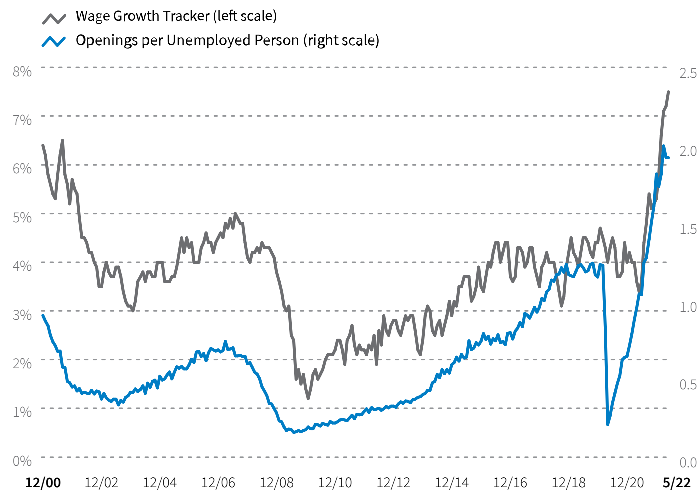
Sources: Federal Reserve Bank of Atlanta, Federal Reserve Bank of Dallas, and University of Michigan Surveys of Consumers.

For use with institutional investors and investment professionals.

The challenge for the FOMC over the coming months will be the harsh reality first described by Milton Friedman in 1961 that "monetary actions affect economic conditions only after a lag that is both long and variable."* The first source of inflationary pressure, which we discussed in our Q4 2021 outlook, is likely a housing market that, while beginning to soften, was still experiencing price increases at a 20% annualized rate as recently as April. House price increases take 12 to 18 months to work their way through to the pricing of rents, which make up an outsized portion of the core consumer price index.

Secondly, wages have accelerated in nominal terms given the tight labor market. In his most recent press conference, Powell described a Fed trying to thread the needle with respect to the Beveridge Curve.** We view the probability of success as aspirational at best.

Surging wages are likely to fuel inflation



Source: Federal Reserve Bank of Atlanta.

Watch for short-term bear market rallies

We expect through the course of the summer, as risk assets may occasionally become oversold, any inkling that inflation is easing will be tinder for a bear market rally. But ultimately, real relief will likely only come once the Fed and other developed market central banks can declare victory over inflation and restore credibility in their ability to maintain price stability. We view this as a likely outcome *at some point*, but this is a process that will take quarters, not weeks.

With significant weakness in the outlooks for consumer spending, and for earnings of both large and small companies,† it looks quite likely that forward earnings estimates need to come down after rising 7% year to date.

See rallies as bond-buying opportunities

With the Fed not coming to the rescue anytime soon, we continue to advocate caution: sell equities amid rallies and add duration to portfolios. Yields on 10-year Treasuries are near 3%, and we are seeing more periods when the correlation between stock and bond prices is negative, restoring some semblance of diversification potential. Aside from stocks and bonds, the outlook for commodities is becoming a bit more challenging. Physical markets for refined products remain extremely tight, but signs of a global macroeconomic slowdown will likely exert downward pressure on overall futures prices, which tend to be dominated by crude oil.

* Friedman, Milton, "The Lag in Effect of Monetary Policy," Journal of Political Economy 69, no. 5 (October 1961): p. 447.

** The Fed is trying to bring down job openings without increasing the unemployment rate. The Beveridge Curve charts the relationship between unemployment and job openings.

† Examples include University of Michigan Consumer Sentiment surveys, the CEO Confidence Survey, and the National Federation of Independent Businesses Sales Expectations survey.

Visit putnam.com for continuing market updates, expert insights, and investment commentaries.

Find us

This material is prepared for use by institutional investors and investment professionals and is provided for limited purposes. This material is a general communication for informational and educational purposes only. It is not designed to be a recommendation of any specific investment product, strategy, or decision, and is not intended to suggest taking or refraining from any course of action. The material was not prepared, and is not intended, to address the needs, circumstances, and objectives of any specific institution, plan, or individual(s). Putnam is not providing advice in a fiduciary capacity under applicable law in providing this material, which should not be viewed as impartial, because it is provided as part of the general marketing and advertising activities of Putnam, which earns fees when clients select its products and services. The views and strategies described herein may not be suitable for all investors. Prior to making any investment or financial decisions, any recipients of this material should seek individualized advice from their personal financial, legal, tax, and other professional advisors that takes into account all of the particular facts and circumstances of their situation. Predictions, opinions, and other information contained in this material are subject to change. Actual results could differ materially from those anticipated. All investments involve risk, and investment recommendations will not always be profitable. Putnam Investments does not guarantee any minimum level of investment performance or the success of any investment strategy. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results.

 The information provided relates to Putnam Investments and its affiliates, which include The Putnam Advisory Company, LLC and Putnam Investments Limited®.

Issued in the United Kingdom by Putnam Investments Limited®. Putnam Investments Limited is authorized and regulated by the Financial Conduct Authority (FCA). For the activities carried out in Germany, the German branch of Putnam Investments Limited holds a permit as a financial investment broker in accordance with Sec. 34f para. 1 sentence no. 1 of the German Trade Ordinance and is registered under the registration number D-F-16077N8-19 in the publicly available broker register. Putnam Investments Limited is also permitted to provide cross-border investment services to certain EEA member states. In Europe, this material is directed exclusively at professional clients and eligible counterparties (as defined under the FCA Rules, or the German Securities Trading Act (Wertpapierhandelsgesetz) or other applicable law) who are knowledgeable and experienced in investment matters. Any investments to which this material relates are available only to or will be engaged in only with such persons, and any other persons (including retail clients) should not act or rely on this material. Furthermore, this material is only intended for the recipient receiving it directly from Putnam Investments Limited and should not be forwarded to, or relied upon by, the recipient's underlying clients.

Prepared for use with wholesale investors in Australia by Putnam Investments Australia Pty Limited, ABN 50 105 178 916, AFSL No. 247032. This material has been prepared without taking account of an investor's objectives, financial situation, and needs. Before deciding to invest, investors should consider whether the investment is appropriate for them.

Prepared for use in Canada by Putnam Investments Canada ULC (o/a Putnam Management in Manitoba). Where permitted, advisory services are provided in Canada by Putnam Investments Canada ULC (o/a Putnam Management in Manitoba) and its affiliate, The Putnam Advisory Company, LLC.

This material is prepared by Putnam Investments for use in Japan by Putnam Investments Japan Co., Ltd. ("Putnam Japan"). Putnam Japan is registered with Kanto Local Finance Bureau in Japan as a financial instruments business operator conducting the investment advisory and agency business, and is a member of Japan Investment Advisers Association. This material is prepared for informational purposes only, and is not intended as a solicitation to invest in any securities or other financial product in Japan, or to enter into with Putnam Japan an investment advisory contract or a discretionary investment management contract.

A world of investing.®

Putnam INVESTMENTS

For use with institutional investors and investment professionals.

Putnam Investments | 100 Federal Street | Boston, MA 02110 | putnam.com

TL001_IN 330326 7/22