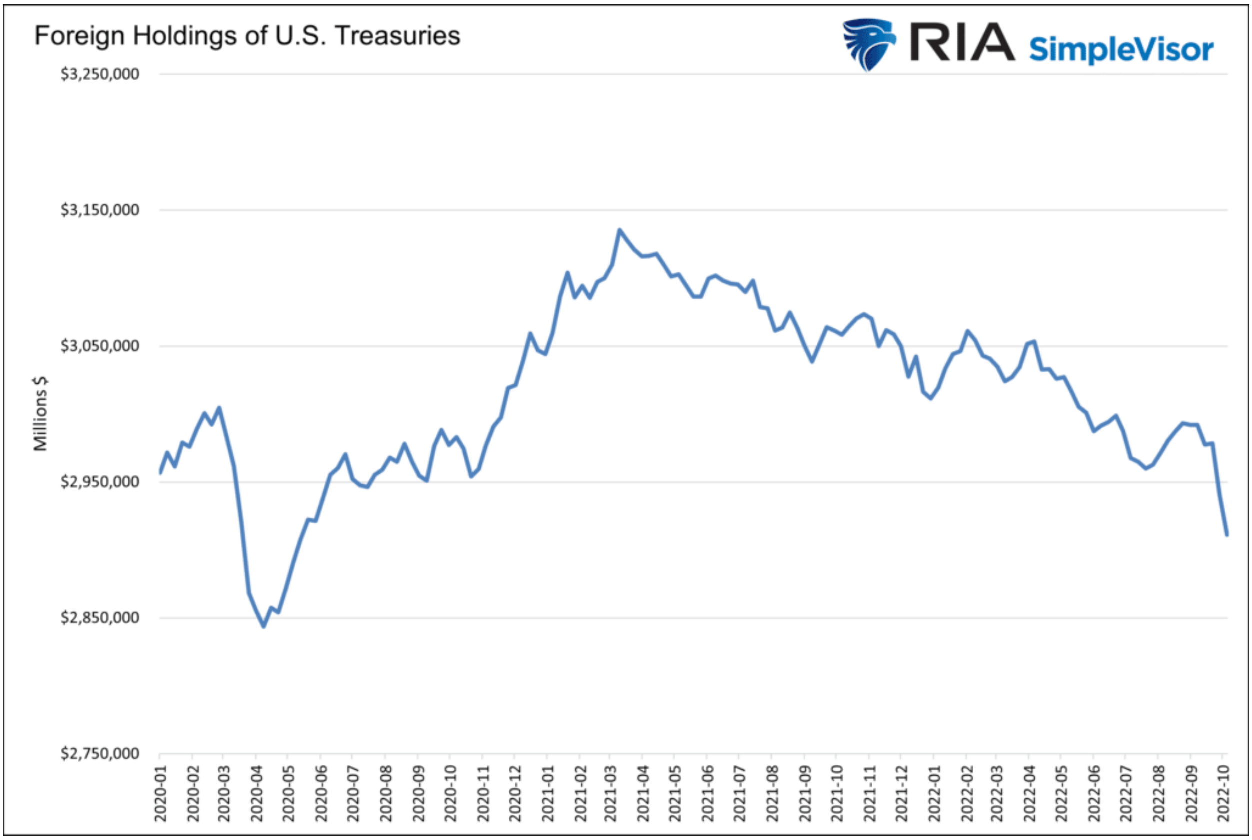
Foreign Banks Are Selling Bonds

In our article Bond Yields Are Defying Yesterday's Logic, we walked through traditional drivers of bond yields and determined yields are too high. We concluded that foreign central banks were selling and largely responsible for recent poor bond performance. As a result, yields were rising beyond what fundamentals would typically dictate. Per the article: "*We suspect that the ECB and BOJ have been selling dollar assets, predominately Treasury bonds, to prop up their currencies.*"

As shown below, foreign banks have sold nearly $90 billion in U.S. Treasury securities since June 1, 2022. $80 billion of the sales occurred in just the last four weeks. Foreign banks are likely to raise cash to intervene in the currency markets. Foreign banks must hold U.S. dollars and Treasuries to support foreign trade. Therefore while the trend looks terrible, the downside in aggregate Treasury holdings and bond prices is somewhat limited.



What To Watch Today

Economy

- 6:00 a.m. ET: **NFIB Small Business Optimism**, September (91.6 expected, 91.8 prior month)
- 10/11-10/18: **Monthly Budget Statement**, September (-$39.2 billion expected, -$64.9 billion prior)

Earnings

Show only confirmed?

Company		Time	Estimate		Growth	Surprise		
PEP	PepsiCo, Inc.	6:00 AM ET	$1.85	$20.72 B	2.6%	+	=	-
WIT	Wipro Limited	9:50 AM ET	$0.07	$2.84 B	7.1%	+	=	-
DCT	Duck Creek Technolo...	4:05 PM ET	$0.02	$73.36 M	3.5%	+	=	-

Market Trading Update

As expected, after the end-of-the-week sell-off on Friday, we saw some additional follow-through selling early Monday as investors panic sell into the decline. The *"bearish rhetoric"* is getting rather extreme, which is usually a good contrarian indicator. Such is particularly the case heading into the Midterm elections, where a deeper market decline won't bode well for incumbents. This week we also have the September inflation report, which won't surprise me if it is a little softer than expected, given the early declines in rental and housing prices, and a cooling off in automobile prices. A weaker headline number is *"bullish,"* although everyone remains focused on the *"core"* inflation rate. The caps off with retail sales. Weakness in any of these numbers could be seen as bullish by the market, although we will just have to wait and see. Lastly, this week wraps up with the kick-off of earnings season, which will move into high gear starting next week. In other words, there will be a lot of data moving markets through the month's end.

For now, markets are back to oversold levels with extreme bearishness. While markets could certainly set new lows near term, the odds of a counter-trend rally are once again fairly high. With year-end approaching, there is a LOT of cash needing to be put to work by pensions, mutual funds, and professional managers. Any good news will likely cause a larger upward move than many expect.

Some Dovish Language From Brainard

We have noted recently that the one thing that will move the Fed away from its focus on *"inflation"* would be a rise in financial instability. Yesterday, Lael Brainard made a statement in this regard that sent stocks rallying off the lows.

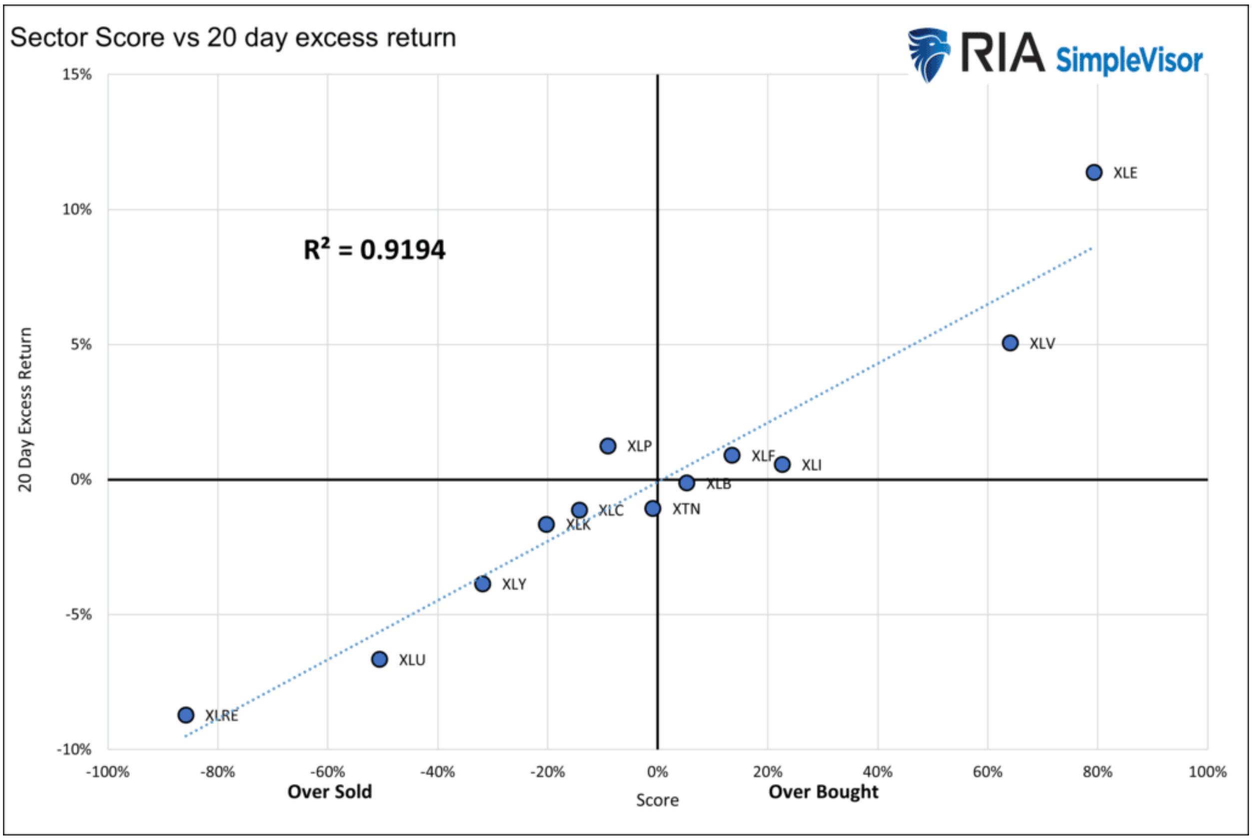
> ***"Fed is attentive to risks of further adverse shocks, aware that [market] moves could interact with financial vulnerabilities***."

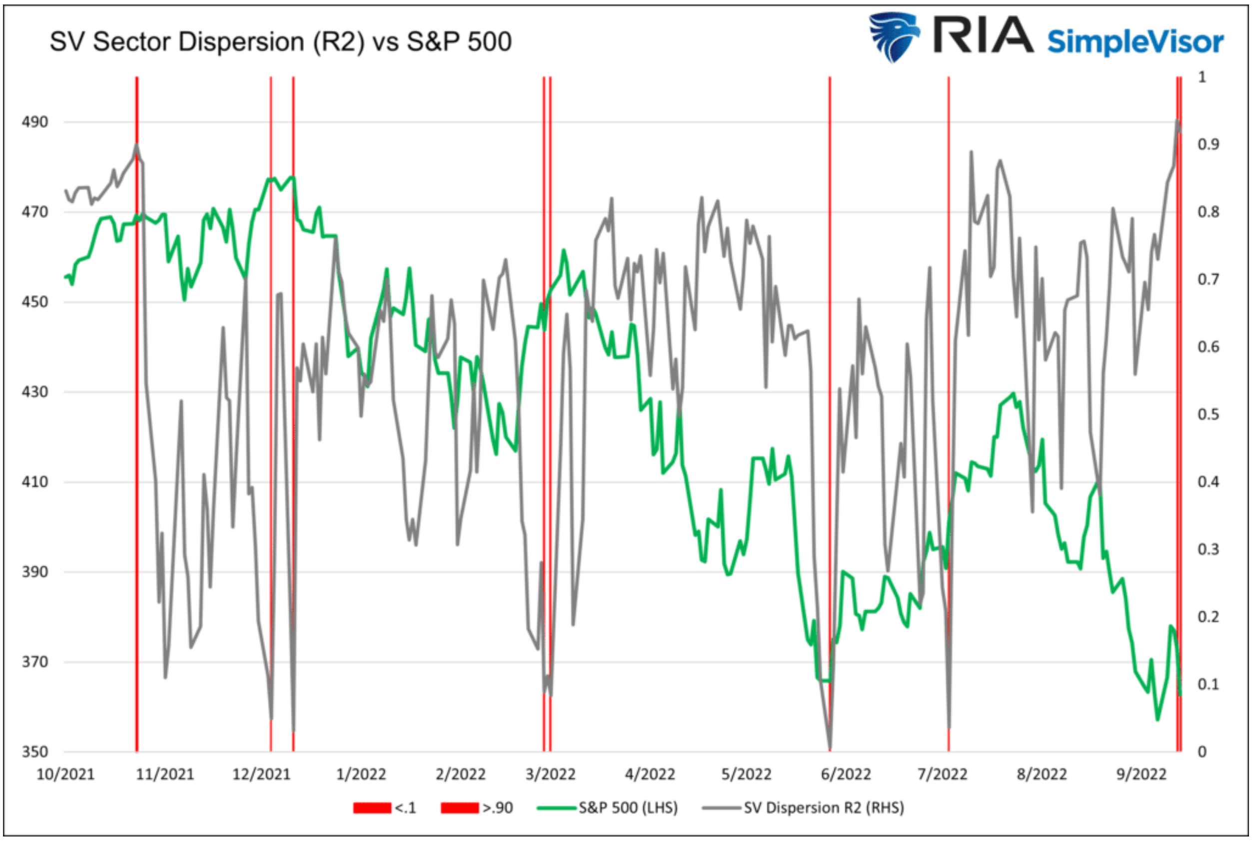
While she also noted that the ***"1970s taught [policymakers] that there are risks to easing prematurely***," this was the first more "dovish" line we have seen from the Federal Reserve since it went uber-hawkish following the Jackson Hole summit. With the midterm elections approaching, we may see more of this before November arrives.

Stay tuned.

Sector Correlations Argue for a Rally

The first graph below comes from our internal model, which measures our proprietary technical score for each sector versus the respective excess return versus the S&P 500. We show that the R2 statistical correlation is extremely high at .92. We have learned that markets tend to change trends when the correlation is extremely strong or weak. The second graph highlights in red instances where the R2 was below .10 or above .90. You can see the signal preceded strong moves in the S&P 500 (green).

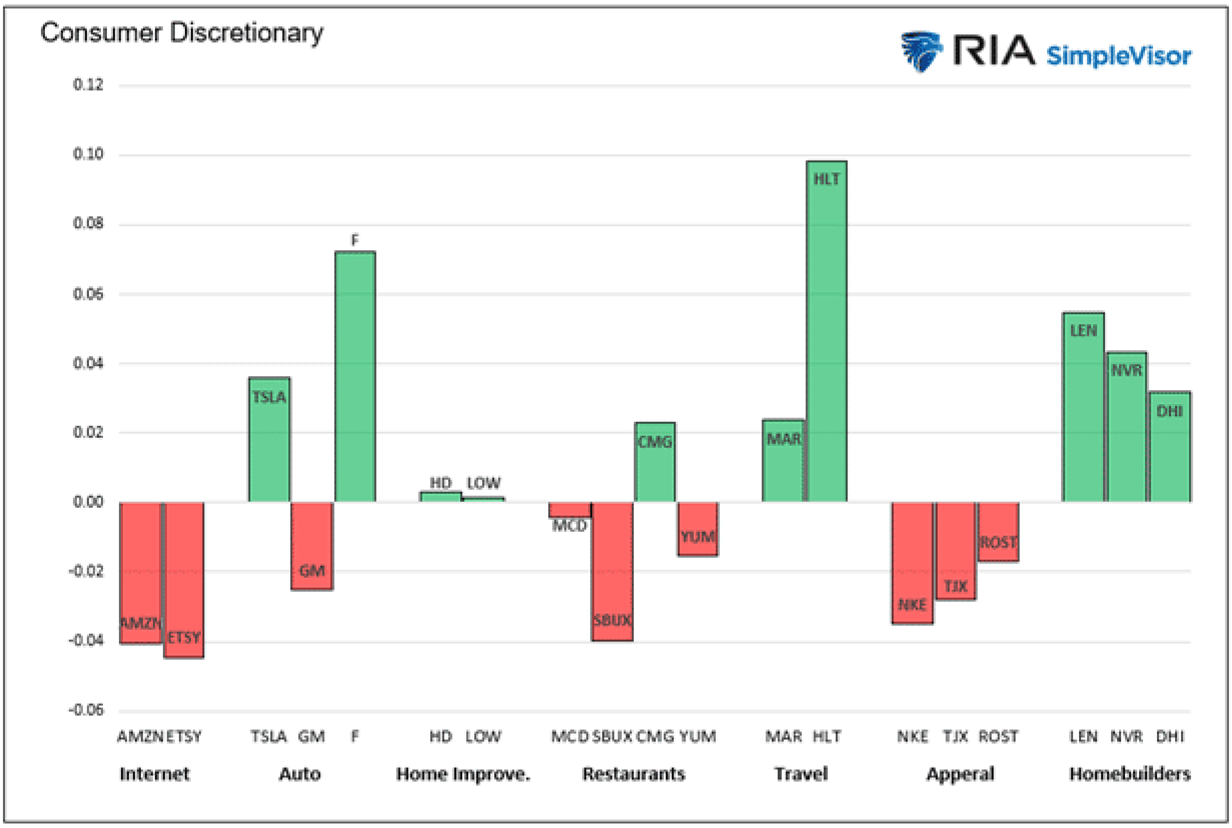




Earnings on Deck

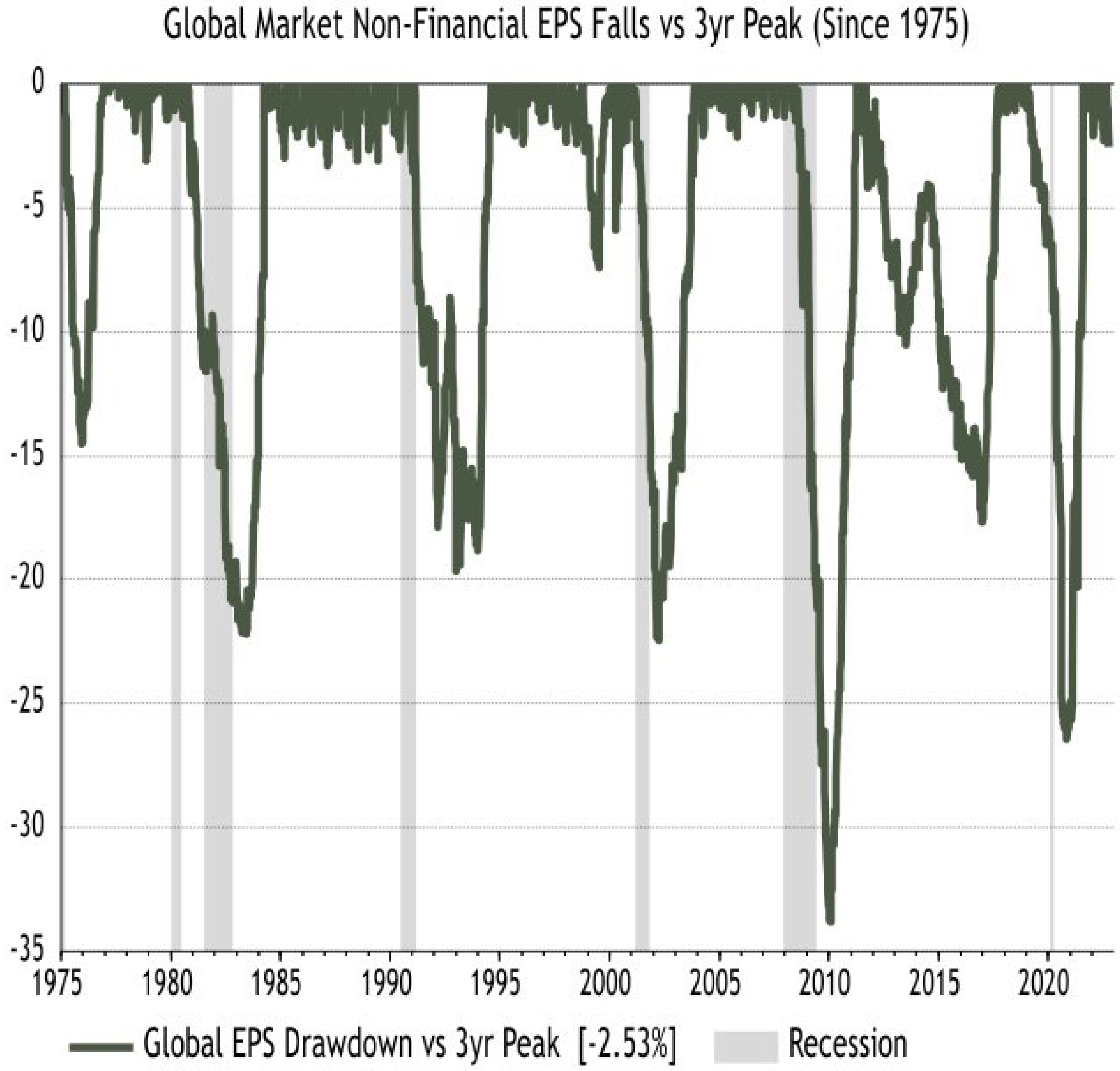
As we embark on another earnings season, considering the current inflationary environment and the increasing likelihood of a recession is worth considering. Thus far, many companies have successfully passed on higher prices to consumers. Discretionary stocks, for example, as we wrote about in [Consumer Staples versus Discretionary](), saw the operating margins of its top companies increase by 0.73% last quarter. On the other hand, the top Staples companies saw a decline in margins. Wealthier consumers, able to better withstand higher inflation, helped discretionary companies. Looking ahead, however, lingering inflation may catch up with many of those consumers and, ultimately, the operating margins of discretionary stocks. Per the article:

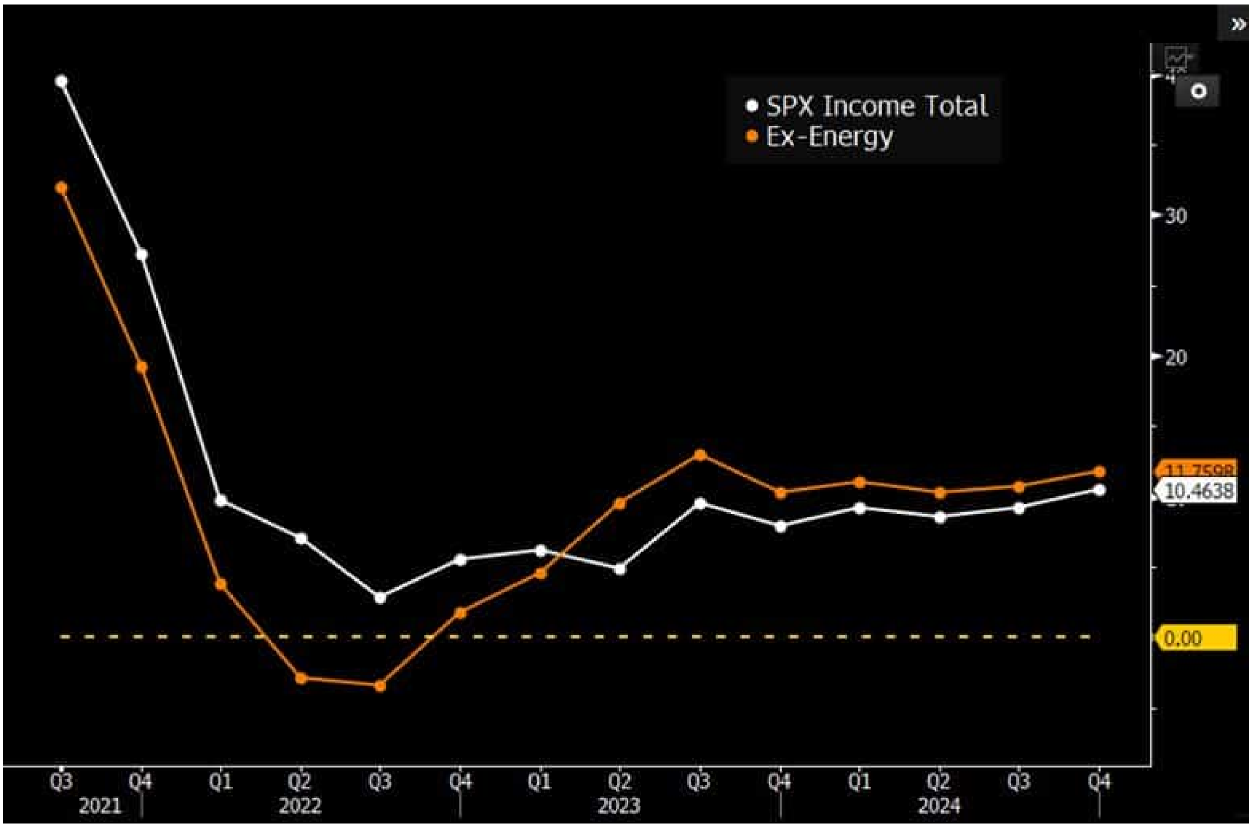
> *It's likely consumers are going to have to make some tough decisions. Consumers are more likely to forgo purchases of discretionary items to help afford needed staples. If that proves true, margins and sales will likely hold up better for staples than discretionary stocks.*



History teaches us that as inflation lingers, it becomes harder for companies that weathered the first wave of higher inflation to continue to pass on higher prices. Further, if we are indeed heading for a recession, earnings expectations need to be revised lower. The graph below shows a 20-30% decline in earnings commensurate with prior recessions. The second graph shows that S&P earnings growth is expected to remain slightly positive for the third quarter. It appears the market is off-side in its earnings expectations unless a recession does not occur.

Global EPS Drawdown in US Recessions

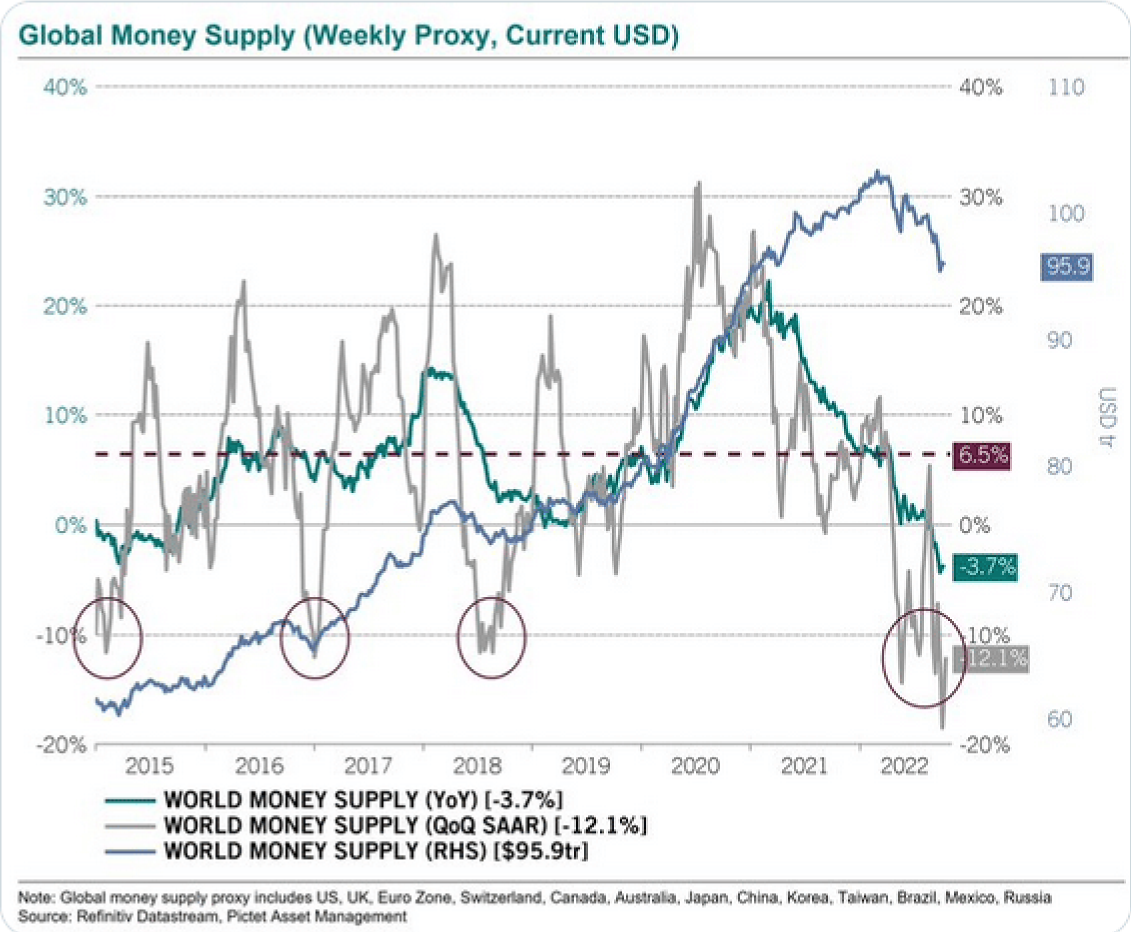




Tweet of the Day

Steve Donzé
@steve_donze

Monetary inflation update - Global money has been up $23tr from Mar20 and down $7tr since Mar22. How much more to reclaim pre-pandemic trends? Another $7tr.



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