April may be the cruelest month, but October is surely the weirdest – at least for stock market investors. The tenth month has a well-deserved reputation for crashes, rallies, and wild volatility. This year has been no exception, as bad news vied with good news for our attention. Look at a stock chart for just the past four weeks, and you’ll see four distinct rallies and four distinct losing streaks, each one of sufficient amplitude to leave many investors gasping for breath. Even intraday volatility has been unusually high, with swings of as much as 5.5% in a single session.

Throughout the month, we have patiently stood off to the side, watching the market’s gyrations; we know that this is typical behavior for markets during a bottoming process, and it’s typical of October, too. Our attitude is not passive or dissociated; we are actively engaged in evaluating the flood of incoming data, ready to shift our clients’ portfolios as needed. So as the calendar turns from colorful and scary October to gray and grateful November, it’s worth pausing to consider what we’ve learned so far.

Three factors have been driving the stock market this month, giving investors many treats but also playing a few nasty tricks: The economy, the Federal Reserve, and corporate earnings. Herewith, a brief review of each.

The U.S. economy contracted during the first two quarters of 2022, leading many economists to assert that we had entered a recession despite a robust jobs market. Data released last week pointed the other way, as gross domestic product expanded at an annualized rate of 2.6% in the September quarter. All three of the quarterly numbers were skewed by international trade fluctuations caused by events overseas and by the dollar’s strength. Setting these factors aside, the GDP data suggest that the economy is, at best, muddling along unimpressively.
Growth is still positive, but it’s much slower than it was a year ago. Several important sectors of the economy are now seeing worrisome trends. Housing starts and new home sales, for example, have been deteriorating for months (Chart 1), a trend which casts ripples through many other sectors of the economy as well. The Leading Economic Indicators index (Chart 2) likewise shows a broad slowdown in the economy in recent months. A recession seems likely.

![Chart 2: Index of Leading Indicators](chart2.png)

The labor market also bears scrutiny. Layoffs tend to be a lagging indicator, but job openings tend to move coincident with the broader economy. Chart 3 shows that openings have shrunk markedly in the past few months, but they still exceed the number of job seekers by a wide margin. Companies have been reluctant to part with workers when they still have so many openings, so layoffs remain near record lows. The seller’s market for labor has kept wages high and still rising quickly. With annualized hourly wage gains persistently above 5%, the Federal Reserve clearly wants to alter the supply-demand dynamic by squashing job openings. It’s made progress, but it has a long way to go.

![Chart 3: Job Openings & Wage Growth](chart3.png)
The Federal Reserve is walking a tightrope as it examines the broad sweep of data at its disposal. Most output indicators match the housing market data, showing deceleration bordering on contraction. But most price indicators match the wage numbers, as inflation remains stubbornly high. The September CPI report was mixed, as shown in Chart 4: Overall consumer price inflation dipped a bit, but “core” inflation (excluding food and energy) accelerated as earlier increases in commodity prices have finally filtered into the goods and services that consumers actually purchase. In this respect, the wage inflation shown in Chart 3 is troubling, as it suggests that workers are beginning to expect higher raises and higher long-term inflation.

Stock and bond markets are locked in a wrestling match with the Fed. Investors’ expectations for future inflation rates can be derived from the prices of futures contracts on government debt; Chart 5 suggests that investors expect inflation to come down sooner and more sharply than the Fed does; the market’s collective guess is that CPI down the road will drift down to 2%, in stark contrast to the Fed’s more gloomy outlook.
The conflict between the Fed and the markets is also evident in the Fed’s most recent “dot plot,” shown in Chart 6.¹ As inferred from the Treasury yield curve, investors currently expect the Fed to raise overnight interest rates by 75 basis points (0.75%) this week, followed by another 50 basis points in December and perhaps another 50 to 100 bps early next year; but after that, the yield curve suggests that investors expect the Fed to pivot quickly and start cutting rates to avert recession. Yet the dot plot shows that the Fed expects to raise rates perhaps 75 bps further in 2023, and not to begin cutting rates until sometime in 2024. The wide disparity of dots in the 2024 column suggests that opinions within the Federal Open Market Committee members are widely divergent. The Fed evidently has no collective idea when it will start cutting rates, but it appears that it won’t be until sometime in 2024 – at least a year later than the markets believe.

If the dot plot prevails, investors will suffer because the Fed will keep rates higher than expected and for longer than expected, accepting that a recession is the probable side effect of fighting inflation. Conversely, if the markets are right, the Fed will cave, switching its focus from prices to employment. Our bet is on the Fed here, as Chair Jerome Powell is acutely aware that the Fed was faced with a similar situation in the early 1970s; back then, the Fed prematurely declared victory over inflation, resulting in the nightmare of 1979-80.² We may get a better sense of the Fed’s intentions later this week, but we think the Fed is more likely to err on the side of excessive rate hikes. In any event, we won’t see a fresh dot plot until mid-December.

¹ If you’re not familiar with the dot plot, each dot represents the forecast for the overnight fed funds rate by one of the 19 members of the Federal Open Market Committee, for each of the four time periods shown.

² Back in the early 1970s, President Ford was ridiculed for his toothless “Whip Inflation Now” buttons. Today, Mr. Powell and his colleagues are taking what might be called the Devonian line of attack, backing their anti-inflation talk with blunt instruments like interest rate policy and quantitative tightening: When a problem comes along / You must whip it / When something’s going wrong / You must whip it / It’s not too late / to whip it, whip it good.
Corporate earnings reports, meanwhile, have been giving trick-or-treating investors mixed signals about the health of the economy – some candy but also some bitter fruit. A little more than half of S&P 500 companies have reported their third-quarter earnings so far, averaging about 2.2% growth from a year ago. That represents a clear slowdown from earlier this year. The reasons are well known, and corporate CFOs have had plenty of practice rehearsing them on conference calls with investors: The strong dollar has hurt export competitiveness; commodity price inflation earlier this year is squeezing profit margins; Covid-related shutdowns in China have interrupted supplies of key inputs; distribution and logistics operations remain scrambled; and a nationwide labor shortage is forcing many companies to forego potential business opportunities. The FANMAG stocks, Apple excluded, all showed the effects of a slowing advertising market and slowing consumer demand; their stock prices nosedived as investors came to realize that these formerly invincible companies are now subject to the same macroeconomic trends as everyone else.

But it hasn’t been all bad news. Consumer spending has been surprisingly resilient in some areas even as it has been disappointing in others. Airlines and some retailers have posted robust results for the quarter, and Visa and MasterCard reported very strong credit card transaction volumes. Others, such as Pepsi, topped forecasts because price hikes offset weaker unit volumes. Strong industrial and enterprise demand has boosted companies as diverse as Honeywell, Caterpillar, Raytheon, Service Now, and others; yet other firms such as 3M and General Electric posted results badly short of estimates. Direct competitors such as FedEx and UPS went in opposite directions, depending on how well their management teams adapted to an economy that is clearly in flux.

On balance, investors fretted their way through September, driving stock prices down on fears that the economy is slowing, the Fed would overreach, and third-quarter earnings would be dismal. In October, the prevailing sentiment reversed, after several fits and starts: Investors piled back into stocks on hopes that the economy won’t slow too much, that the Fed may pivot sooner rather than later, and earnings turned out to be less bad than feared. We’re not quite ready to get excited about stocks yet, but the Fed’s commentary later this week may force us to change our outlook.

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