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The financial markets have been quite busy and have put in a significant rally since the lulls of late September / early October. Here are the returns of the major market indices, both for the month of November and for the two-month period since September 30 (QTD: Quarter-to-date):

	Nov	**QTD**
S&P 500 Index (U.S. Stocks)	5.60%	14.14%
MSCI ACWI ex-USA Index (Foreign Stocks)	11.80%	15.15%
Bloomberg U.S. Aggregate Bond Index (Bonds)	3.68%	2.33%

What is driving the recent gains? Many will argue that this is just another "bear market rally" that is bound to eventually fail. While that is always a possibility, we believe that the rally is justified given the vastly improved outlook for inflation. I do not need to remind you that inflation – and the Fed's response to it – is at the heart of the 2022 decline in financial markets. Heading into the last quarter of 2022, the general consensus amongst investors was the following:

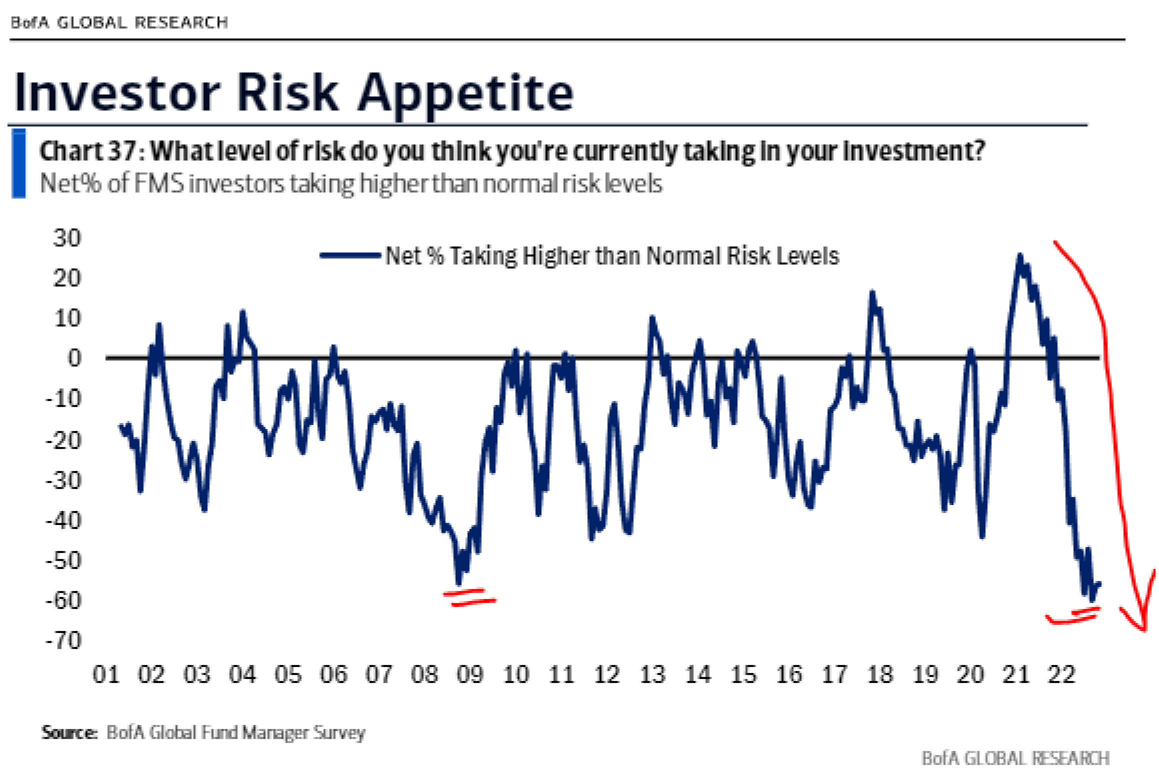
- Inflation is sticky and will remain elevated, and could take years to fall to the Fed's target
- Fed will not slow rate hikes until inflation nears 2% or until something breaks (like the economy)
- U.S. economy is tipping into a recession

Sum this all up and the takeaway is that investors are extremely bearish and see no reasons for stocks to sustain a meaningful recovery until AFTER a recession. But what if these "consensus" views begin to change or are, dare I say, wrong? Previous rally attempts this year have largely been based on hope – hope that inflation might eventually fall or hope that the Fed might pause their rate-hiking agenda and/or back off their tough talk. But when incoming inflation data and Fed commentary did not support these "hopes," those rallies eventually failed. Could this time be different? Consider the following:

- Inflation is already breaking to the downside and is now being reflected in the hard data; the October CPI print slowed to a 3-4% annualized inflation rate and the November print is expected to be similar

- The Fed has publicly acknowledged the softening inflation data, which could be sufficient for the Fed to slow the pace of rate hikes; December 2022 could very well be the last hike (0.50% increase expected)
- The labor market has slowed considerably, but without a commensurate rise in unemployment (Fed closely watches the labor market)
- The U.S. economy has been incredibly resilient as consumer spending remains robust and corporations have been able to absorb rising costs without much demand destruction (so far) or a major hit to earnings
- Long-term interest rates have fallen dramatically in just the past month, which is supportive of stocks (especially technology)

In just the past two months, the data driving the previous consensus views has significantly improved. But surprisingly enough, many investors maintain their more pessimistic stance and believe that the worst is yet to come. This is reflected in still extremely bearish investor sentiment surveys, fund flow data, and fund manager surveys. The chart below from the BofA fund manager survey shows that risk appetite is the lowest ever (yes I did say EVER)…



This is not all that surprising as recency bias is keeping investors bearish. But if the inflation outlook continues to improve and the Fed slows down their rate hike agenda, these pessimistic views will start to change. In fact, it may be happening already, albeit slowly, which is why the current market rally might be justified. And given the extreme bearishness amongst investors and "risk-off" positioning of fund managers, there is a lot of investment dollars that soon may be willing to take on more risk, adding fuel to the existing rally.

Most of 2022 has been a cascade of ever more troubling developments, from surging inflation, Russia-Ukraine war, Fed going all out, China issues, and multiple seismic events in the crypto markets. This has pushed interest rates higher, panicked policymakers and punished stocks and bonds around the globe. Still, markets have found some sort of footing and have risen substantially since early October. Or more specifically, since October 13, which was the day of the first CPI (inflation) release to show a slowdown in the pace of inflation. While we are not ready to give the “all-clear” signal, we do believe there is more reason for optimism than not.

Thank you for the trust that you have placed in us!