Market Performance Recap

It seems as though just yesterday we were ringing in the new year and now we are welcoming the start of the fourth quarter. The big story this quarter, similar to previous quarters, is the Federal Reserve continuing to increase its benchmark Fed Funds Rate. These increases have lifted Treasury rates across the curve. In each of the final nine weeks of the quarter Treasury yields were higher, an unprecedented run of higher interest rates. Treasuries are considered the risk-free rates from which all other rates in the US and across most of the world are derived. The interest you pay on your credit card, the yield required for a corporation to issue debt, and even your mortgage all are derived from Treasury yields.

One of the recent acronyms in the equity market was TINA (there is no alternative) which helped propel stock prices from the pandemic lows until November of 2021. It was a catch-phrase investors used to justify paying high price-to-earnings (P/E) multiples for equities. Now, there is an alternative and you can purchase short-term Treasuries with yields close to 4%. With yields rising, and no clear end in sight, selling across all risk assets has continued with US debt and equity markets down close to $17 trillion since the November 2021 highs. That is the largest decline of wealth on record.

With the opening preamble, you would expect equities to have had a negative quarter, which they did. But the ride down was not linear. When the quarter started in July, equities were well bid and traded up for the month. That rally continued into the opening weeks of August before reversing and selling off. Going into the end of September the sell-off gathered steam and finished the quarter on a low note. The S&P slid 9.2% for the month of September but only 4.9% for the quarter after the solid start (chart 1). Growth beat value across the market cap spectrum. Small cap equities in general fared better than large cap as the Russell 2000 returned -2.2% on the quarter and small cap growth (Russell 2000 Growth Index) managed to find a positive return, even though it was a modest 0.2%. Only two sectors in the S&P 500 Index were positive (chart 2), consumer discretionary which was up 4.4% and energy, up 2.3%. Communication services was the sector that fell the most, declining 12.7%, with the company formerly known as Facebook leading the way lower.

US fixed income fell in third quarter as the Fed raised rates. The Fed raised its benchmark Fed Funds rate 0.75% in July and then again in September for a total 1.5% increase in the rate. It probably would have raised rates in August but the Fed takes the month off to go to Jackson Hole, WY for some fly-fishing and reflection. Investment grade fixed income, measured by the Bloomberg US Aggregate Index, fell 4.8%, while municipal bonds fared better with the Bloomberg Municipal Bond Index falling only 3.5%. Despite a risk-off tone in the markets, the higher risk Bank of America High Yield Index fell only 0.7% on the quarter.

An additional impact from higher interest rates in the US is capital flowing in from abroad causing the US dollar to strengthen substantially against other developed currencies. In the waning days of September, the UK's currency reached an all-time low against the dollar. The Japanese Yen fell all the way back to the Asian Financial Crisis low of 1998. While this is good if you are traveling abroad any time soon, it presents challenges for international trade, especially in commodities which are priced in dollars. The stronger dollar detracted from non-US fixed income returns as the FTSE World

Government Bond Index slid 7.6%, driven in part by the currency translation back to USD.

The global economic headwinds and the languishing war in eastern Europe, combined with the stronger dollar, pushed non-US equities lower. Most of the decline came in September when there was a palpable risk-off tone in the markets and the dollar showed its strength. Developed market equities, as measured by the MSCI EAFE Index, fell 9.4% and the MSCI Emerging Markets Index fell by 11.6%.

Economy

Inflation is still the prevalent topic in economic discussions. In the US, inflation is hovering around 8.3% for the twelve-month period ending in August (chart 3). This is slightly lower than the highest point in the cycle, but still near 40-year highs. The Federal Reserve is likely to increase its benchmark Fed Funds Rate again in October and maybe several more times before it stops. The goal is to cool the economy without crashing it, something very hard to pull off since the effects of interest rate increases are lagged by 6-months or more. GDP has already dropped for two consecutive quarters in the US, though the declines have been modest. Another impact that has become evident is the seizing up of the housing market where interest rates on 30-year mortgages topped 7% at the end of the quarter, sellers cut prices (chart 4) and home sales slowed dramatically. Housing has a wealth effect on consumers- if home values decline consumers feel less wealthy and consume less. However, the US economy is still creating jobs with 526,000 new jobs in July, 315,000 new jobs in August and 263,000 in September. While the pace of new job creation is slowing, it is still strong and the unemployment rate fell back to the cycle low of 3.5%. On one hand, this is a great sign as more Americans are getting jobs and able to provide for their families. On the other hand, the Federal Reserve is working to weaken the economy and thus weaken employment, and so far its efforts have not been effective. A potential sign of weakening is that the number of jobs in excess of unemployed people has declined by one-third from six million to four million. This is still a strong employment market, but perhaps a little of the exuberance is starting to come out, which the Federal Reserve is hoping for.

The view outside of the US tends to be bleak in developed economies but some emerging economies are showing signs of resiliency. The UK and Europe are recessionary, driven in part by skyrocketing energy costs caused by the war in Ukraine. Energy typically prices in dollars on the international market, so the dollar strength further exacerbates that pain. European governments are scrambling to react and doing everything from tax cuts and stimulus money to restricting energy consumption and encouraging their populations to heat their homes with wood and coal this winter. The world's second largest economy is still struggling with covid lockdowns and a collapsing housing market, but after China confirms a third term for Xi Jinping this month there is likely to be positive change as he consolidates his power and effectively becomes an authoritarian leader for the rest of his life.

Japan deserves its own paragraph in this letter because you can look at it from many perspectives. One viewpoint would be the meltdown in their currency, at multi-decade lows similar to the pound and euro, must mean things are getting bad. But there is another lens to view Japan through because unlike Europe, Japan is not experiencing runaway inflation and the Japanese economy is growing. Inflation still has not exceeded 2% while GDP growth rates have been remarkably

consistent around 1.7% per year and the International Monetary Fund (IMF) projects that to continue this year and next. With a declining population, any growth rate is impressive. While Japan is dependent on others for energy imports, the rest of the economy is largely self-reliant. Corporate reforms have unlocked value for shareholders and the currency is making exporters more attractive.

Emerging market countries have seen their currencies weaken in the face of the strong dollar, but their growth rates remain more attractive than the developed world. This is especially prevalent in Asia where the IMF expects India to grow 7.4% this year and other ASEAN countries to grow on average by 5% (chart 5). Compared to a shrinking Europe and possibly even the US, these are attractive growth rates. The currency weakness has effectively put these assets on sale at discounted prices, setting up the potential for outsized gains when the market rebounds and currencies normalize.

Consumers

Consumers drive economies in the developed world, especially here in the US. The consumer has been under pressure from multiple angles this year. Inflation has eroded purchasing power, yet consumers have continued to maintain their lifestyle by using their accumulated savings and financing additional spend on their credit cards (chart 6). That trend is not sustainable. Additionally, consumers are the primary investors in (or at least beneficiaries of) stocks (chart 7), bonds and they own real estate. All of these are experiencing significant declines making the consumers feel worse about their financial health. Yet there are still four million more jobs in the US than there are people seeking employment. That demand for employees should help people who are feeling the financial pressure to find new and more lucrative opportunities. As long as demand for labor outstrips supply, labor will have the advantage and can demand greater compensation and benefits.

Moving Forward

The last two recessions were far more severe than average with GDP falling by more than 3% during the first year of the covid pandemic and during the financial crisis in 2008-9. These recessions have conditioned people to expect the worst when they hear that term. Looking further back, most recessions have been milder and reduced GDP by 1.5% or less (chart 9). That milder recessionary environment is a likely outcome for the US going forward. We will have a few periods of negative GDP growth in the US, possibly interspersed with some positive quarters. The third quarter is looking positive after two negative quarters, with the Atlanta Federal Reserve forecasting 2.9% growth for Q3 (chart 8). Unemployment is likely to rise over the coming quarters, but not to levels anywhere near what was experienced during the previous two recessions.

The next move for the equity markets is likely lower too, but this time instead of driven by fear and higher interest rates, it will be driven by fundamentals. This is fairly common in a recessionary bear market, where you have some initial legs down driven primarily by sentiment with some sharp rallies along the way. Then sentiment settles out and the markets start to trade on fundamentals. Earnings expectations are still bullish and have not come down meaningfully during this period of volatility. The current expectation is for earnings growth next year (chart 10). For some companies, particularly higher growth technology, communications and consumer discretionary ones, those expectations are too high. As those expectations come

more in line with reality over the coming quarters those stocks will sell-off. However, other companies may benefit; value-oriented companies with strong and stable cash flow may see their equity prices stabilize and perhaps even appreciate as fundamentals drive the next leg of the market (chart 11). Our current positioning remains underweight equities in favor of uncorrelated assets and hedge funds. We continue to be patient and look for opportunities to add back equity risk when the sentiment turns more favorable.

Fixed income is likely to remain under pressure as long as the Federal Reserve continues to increase interest rates. The Fed is getting caught between slowing inflation in this country and damaging the finances of other countries with such a strong dollar. For now, inflation is the primary focus. Over time, the international outcry will get louder for the Fed to stop raising rates. It is only a matter of time before it pivots and stops its restrictive monetary policy.

If you wish to discuss any part of this in greater detail, please reach out.

Dennis Santos
Chief Investment Officer

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Chart 1 – Market Performance

	Total Return (%)						
				Annualized Returns as of 9/30/22			
	Month to Date	Third Quarter	Year to Date	1 Year	3 Year	5 Year	10 Year
FIXED INCOME INDICES							
FTSE (3 M) Treasury Bill	0.2	0.4	0.6	0.6	0.6	1.1	0.7
FTSE 5-Year Treasury Benchmark	-2.9	-4.0	-10.7	-11.5	-2.5	-0.2	0.3
FTSE 10-Year Treasury Benchmark	-5.0	-6.1	-16.8	-16.2	-4.6	-0.8	0.1
FTSE WGBI (USD)	-5.1	-7.6	-21.3	-22.1	-7.0	-3.1	-1.8
Bloomberg US Aggregate	-4.3	-4.8	-14.6	-14.6	-3.3	-0.3	0.9
Bloomberg Global Aggregate	-5.1	-6.9	-19.9	-20.4	-5.7	-2.3	-0.9
Bloomberg Municipal Bond	-3.8	-3.5	-12.1	-11.5	-1.9	0.6	1.8
ICE BofA US High Yield	-4.0	-0.7	-14.6	-14.1	-0.7	1.4	3.9
EQUITY INDICES							
S&P 500	-9.2	-4.9	-23.9	-15.5	8.2	9.2	11.7
Russell 3000	-9.3	-4.5	-24.6	-17.6	7.7	8.6	11.4
Russell 3000 Growth	-9.7	-3.4	-30.6	-23.0	10.2	11.6	13.4
Russell 3000 Value	-8.9	-5.6	-18.0	-11.8	4.4	5.1	9.1
Russell 1000	-9.3	-4.6	-24.6	-17.2	7.9	9.0	11.6
Russell 1000 Growth	-9.7	-3.6	-30.7	-22.6	10.7	12.2	13.7
Russell 1000 Value	-8.8	-5.6	-17.8	-11.4	4.4	5.3	9.2
Russell 2000	-9.6	-2.2	-25.1	-23.5	4.3	3.6	8.6
Russell 2000 Growth	-9.0	0.2	-29.3	-29.3	2.9	3.6	8.8
Russell 2000 Value	-10.2	-4.6	-21.1	-17.7	4.7	2.9	7.9
MSCI All Country World	-9.6	-6.8	-25.6	-20.7	3.7	4.4	7.3
MSCI All Country World ex-U.S.	-10.0	-9.9	-26.5	-25.2	-1.5	-0.8	3.0
MSCI EAFE	-9.4	-9.4	-27.1	-25.1	-1.8	-0.8	3.7
MSCI Emerging Markets	-11.7	-11.6	-27.2	-28.1	-2.1	-1.8	1.0
ALTERNATIVE INDICES							
Credit Suisse AllHedge Index (USD)	-2.0	-2.3	-3.6	-3.6	2.8	2.6	2.0
Bloomberg Commodity Index	-8.1	-4.1	13.6	11.8	13.5	7.0	-2.1
S&P Goldman Sachs Commodity Index	-7.8	-10.3	21.8	23.6	12.2	7.8	-3.9
FTSE NAREIT (Real Estate) Index	-12.7	-10.8	-27.9	-16.3	-1.1	4.1	7.0
S&P Global Property Index	-12.6	-11.8	-29.2	-23.3	-6.5	-1.6	2.8
Consumer Price Index - Unadjusted	0.2	0.2	6.5	8.2	5.0	3.8	2.5

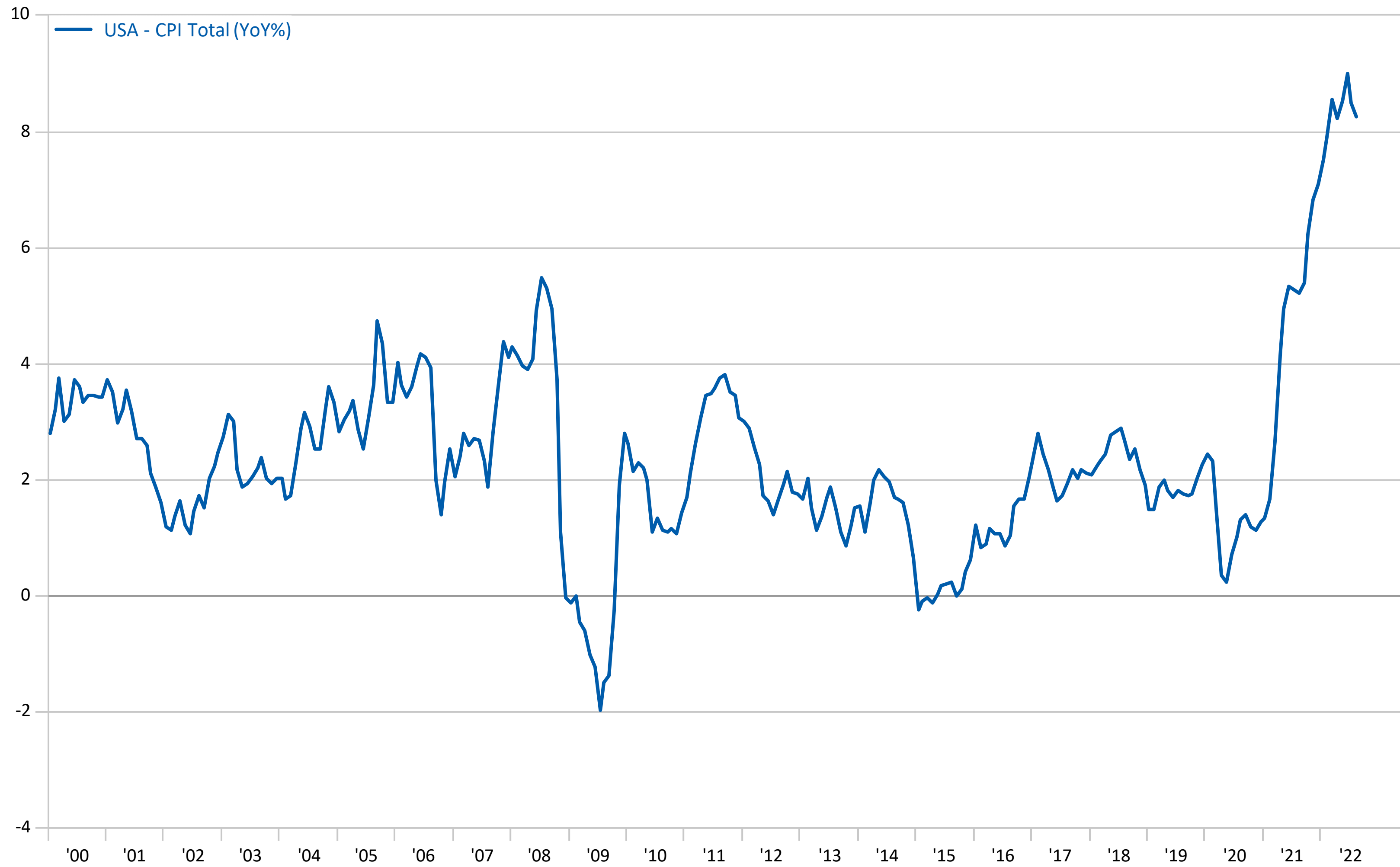
Source: FactSet, September 30, 2022

Chart 2 – Sector Performance of the S&P 500 Index

	Energy	Materials	Financials	Industrials	Cons. Disc.	Tech.	Comm. Services*	Real Estate	Health Care	Cons. Staples	Utilities	S&P 500 Index	
S&P weight	**4.5%**	**2.5%**	**11.0%**	**7.9%**	**11.7%**	**26.4%**	**8.1%**	**2.8%**	**15.1%**	**6.9%**	**3.1%**	**100.0%**	**Weight**
Russell Growth weight	1.6%	1.4%	3.0%	7.2%	17.1%	42.9%	7.4%	1.6%	12.2%	5.7%	0.0%	100.0%	
Russell Value weight	7.8%	4.1%	20.0%	10.0%	6.0%	8.8%	8.0%	4.8%	17.3%	7.2%	6.0%	100.0%	
Russell 2000 weight	6.1%	4.0%	17.3%	14.8%	10.2%	12.8%	2.7%	6.4%	18.9%	3.4%	3.4%	100.0%	
QTD	2.3	-7.1	-3.1	-4.7	4.4	-6.2	-12.7	-11.0	-5.2	-6.6	-6.0	-4.9	**Return (%)**
YTD	34.9	-23.7	-21.2	-20.7	-29.9	-31.4	-39.0	-28.8	-13.1	-11.8	-6.5	-23.9	
Since market peak (February 2020)	52.0	19.0	3.4	3.3	9.3	18.4	-14.0	-4.5	21.8	12.9	1.8	10.4	
Since market low (March 2020)	244.7	86.1	81.1	77.1	60.1	72.0	20.4	53.3	69.0	48.7	58.2	66.8	

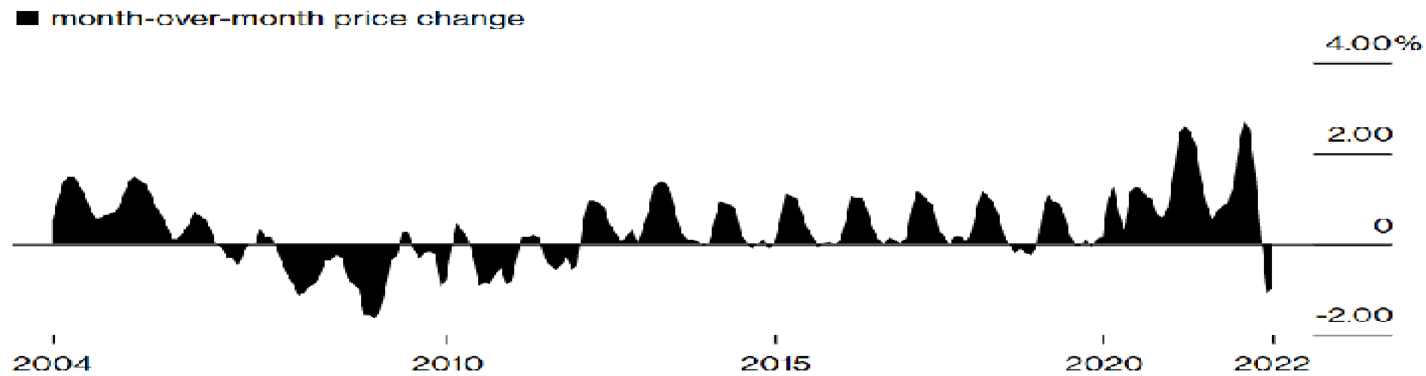
Source: JP Morgan, Guide to the Markets, September 30, 2022. Russell Growth and Russell Value are short forms of the Russell 1000 Growth Index and Russell 1000 Value Index.

Chart 3 – US CPI Inflation Rate



Source: Federal Reserve Board, January 1, 2000 – August 31, 2022

Chart 4 – 30-Yr Fixed Rate Mortgages & Home Price Changes (Month over Month)



Source: Bianco Research, October 4, 2022

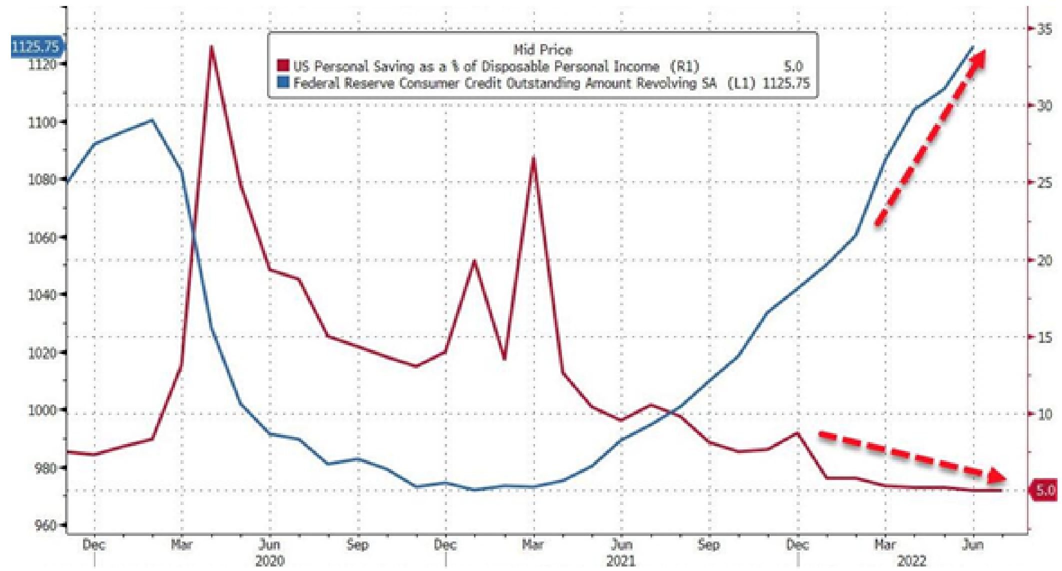
Chart 5 – GDP Growth Estimates from the IMF

Latest World Economic Outlook Growth Projections

(real GDP, annual percent change)	2021	PROJECTIONS 2022	PROJECTIONS 2023
World Output	6.1	3.2	2.9
Advanced Economies	5.2	2.5	1.4
United States	5.7	2.3	1.0
Euro Area	5.4	2.6	1.2
Germany	2.9	1.2	0.8
France	6.8	2.3	1.0
Italy	6.6	3.0	0.7
Spain	5.1	4.0	2.0
Japan	1.7	1.7	1.7
United Kingdom	7.4	3.2	0.5
Canada	4.5	3.4	1.8
Other Advanced Economies	5.1	2.9	2.7
Emerging Market and Developing Economies	6.8	3.6	3.9
Emerging and Developing Asia	7.3	4.6	5.0
China	8.1	3.3	4.6
India	8.7	7.4	6.1
ASEAN-5	3.4	5.3	5.1
Emerging and Developing Europe	6.7	-1.4	0.9
Russia	4.7	-6.0	-3.5
Latin America and the Caribbean	6.9	3.0	2.0
Brazil	4.6	1.7	1.1
Mexico	4.8	2.4	1.2
Middle East and Central Asia	5.8	4.8	3.5
Saudi Arabia	3.2	7.6	3.7
Sub-Saharan Africa	4.6	3.8	4.0
Nigeria	3.6	3.4	3.2
South Africa	4.9	2.3	1.4
Memorandum			
Emerging Market and Middle-Income Economies	7.0	3.5	3.8
Low-Income Developing Countries	4.5	5.0	5.2

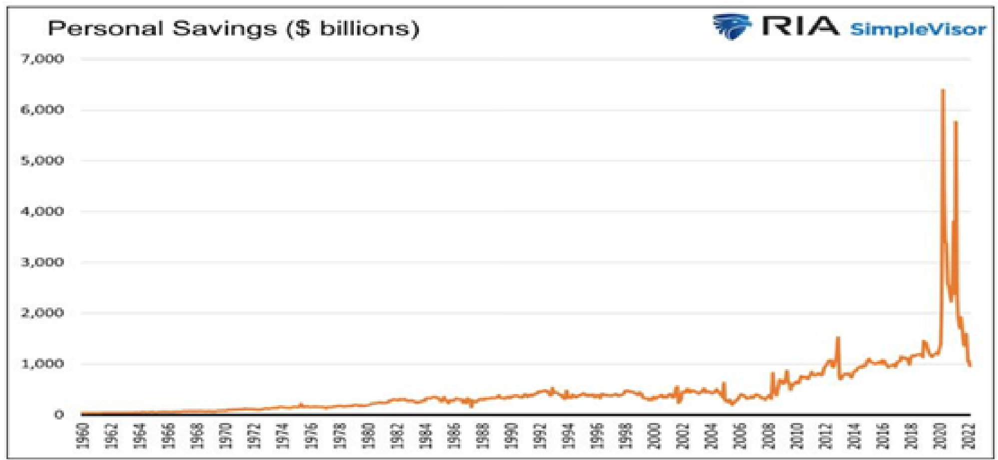
Source: IMF, *World Economic Outlook Update*, July 2022

Chart 6 – The State of the Consumer



Credit Card & Consumer Loan Balances Increasing Fast

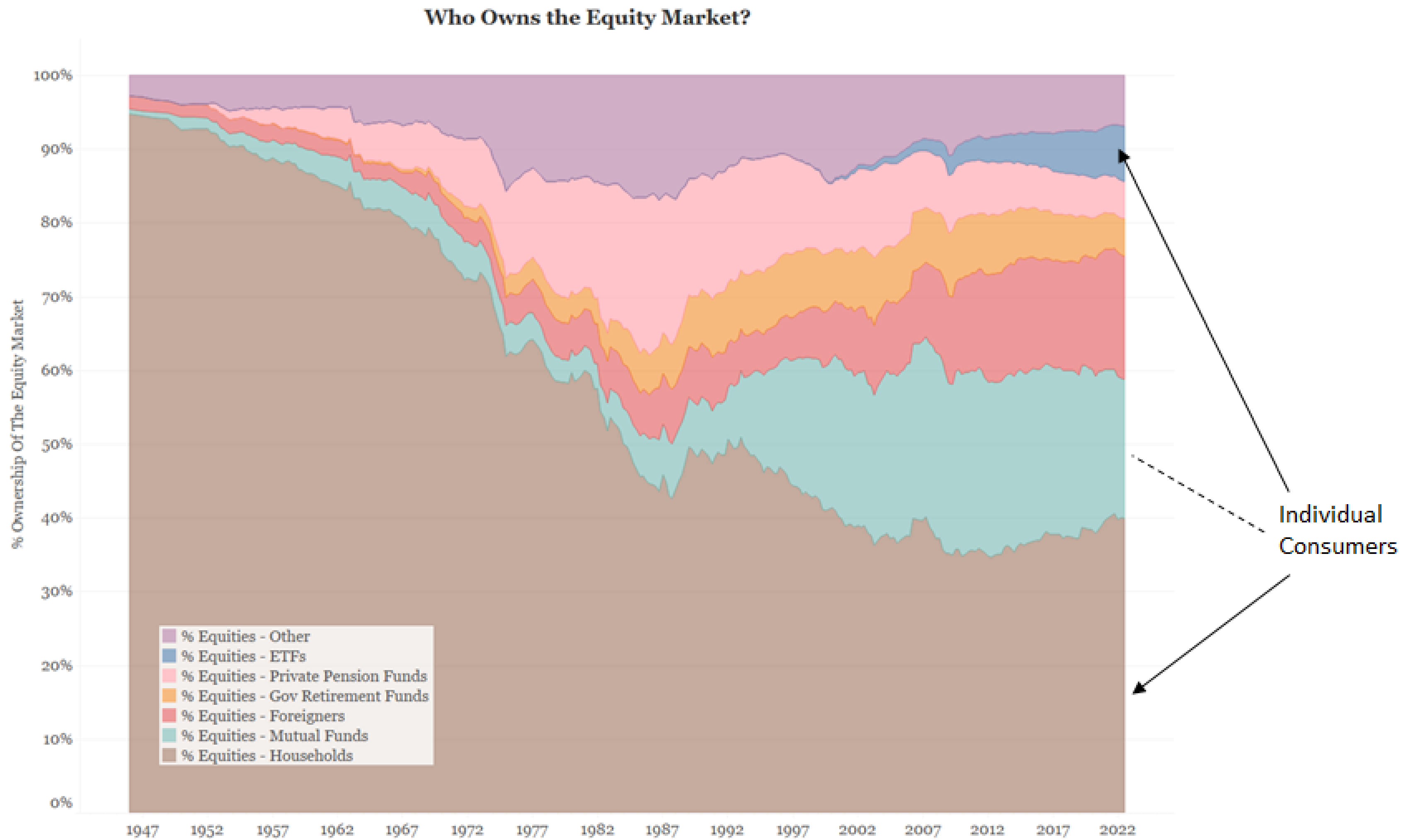
People Are Saving Less Than Pre-Pandemic



Total Savings Balances Are Below Pre-Pandemic Levels

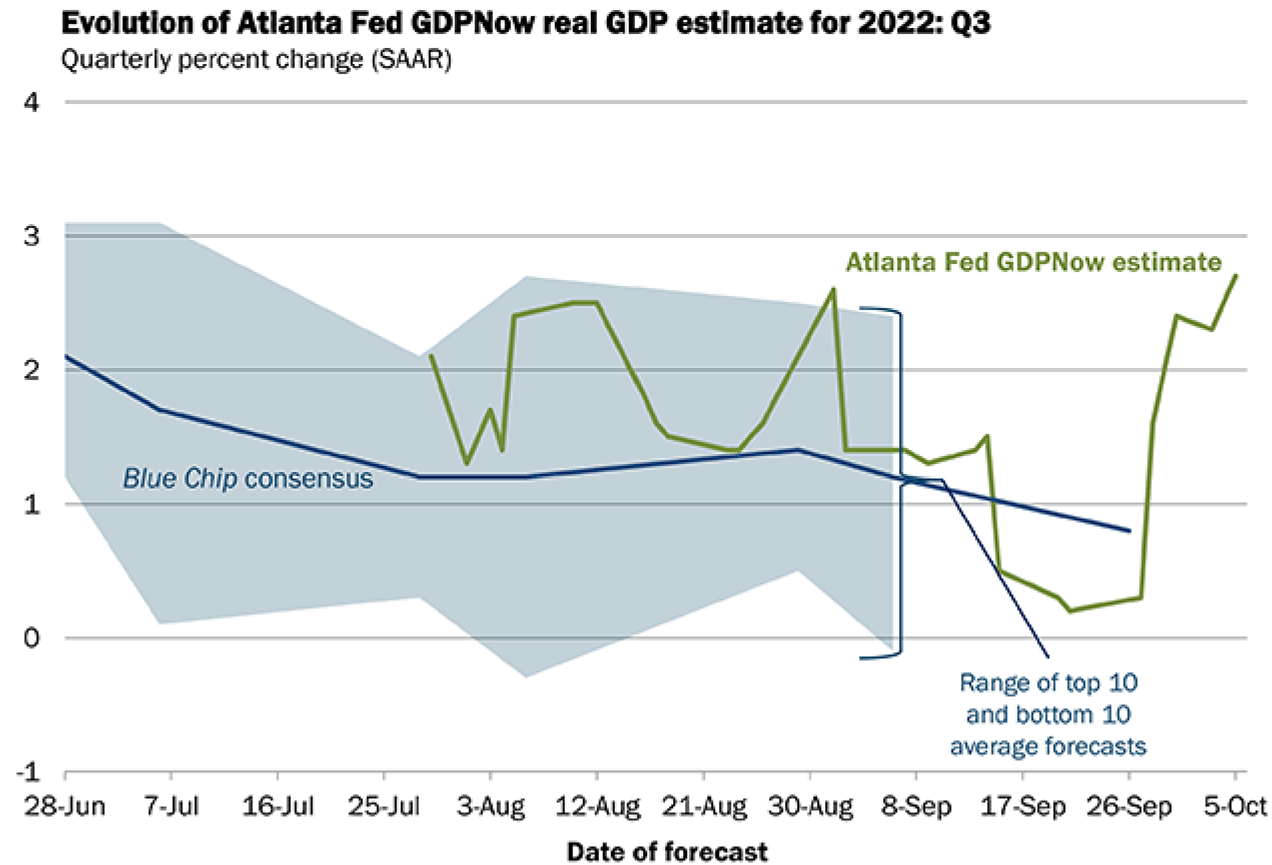
Source: ZeroHedge, The "Real" State of the Consumer, September 7, 2022

Chart 7 – Who Owns the Stock Market?



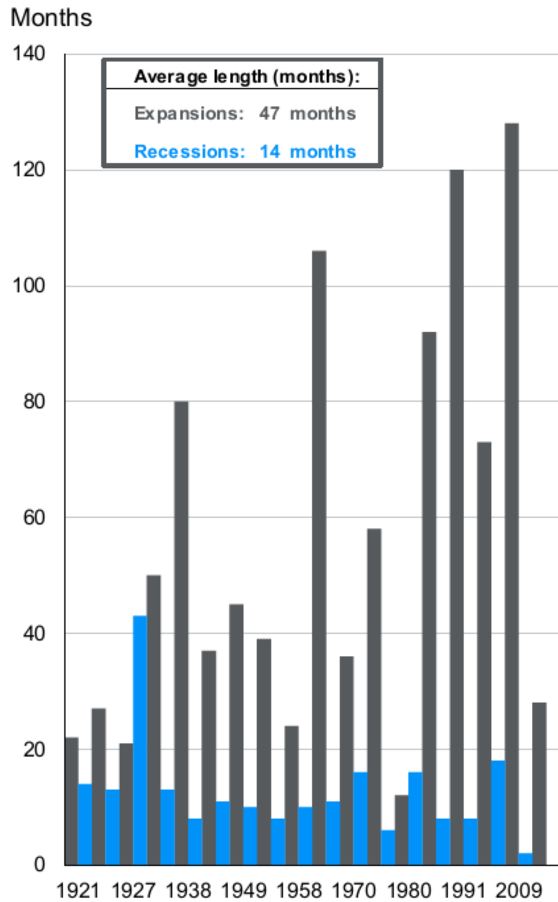
As of August 31, 2022

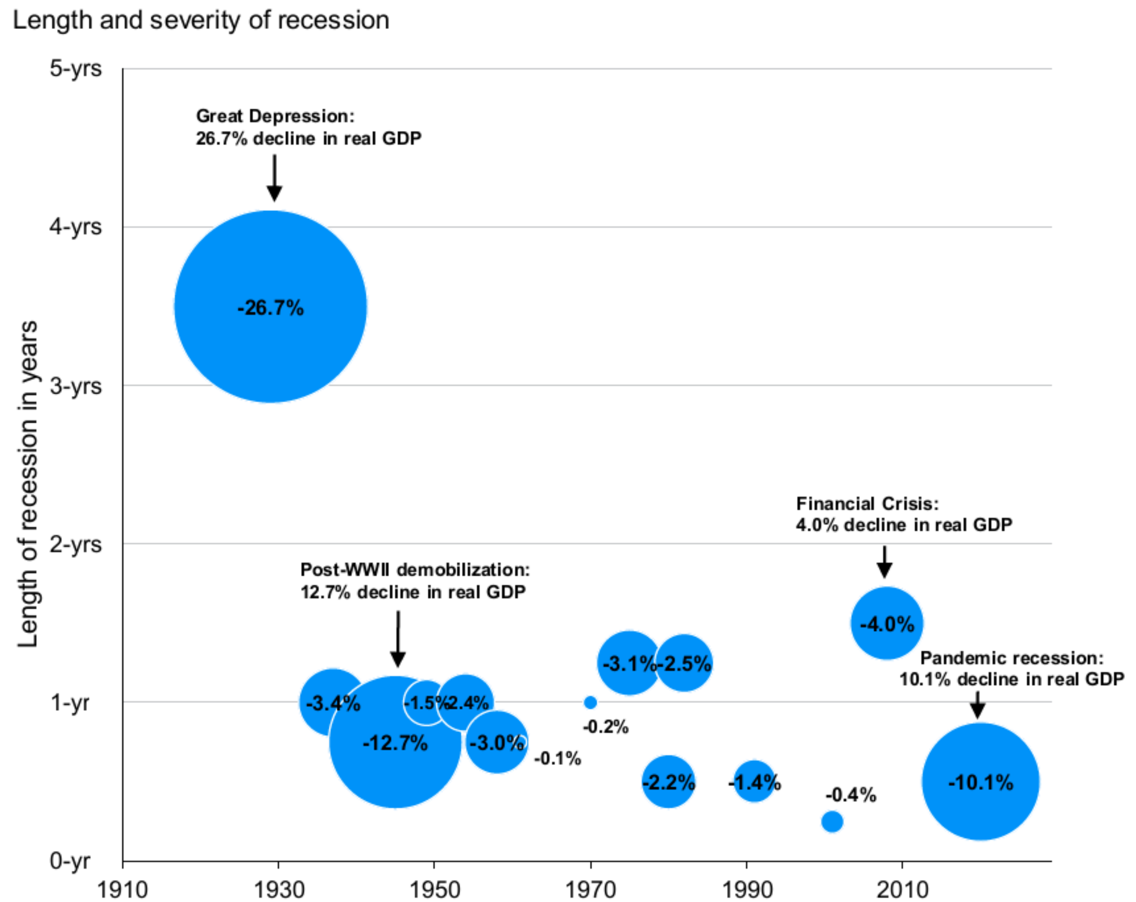
Chart 8 – Atlanta Federal Reserve GDPNow Estimate



Source: Atlanta Fed GDP Now June 28, 2022 – October 5, 2022

Chart 9 – Putting Recessions in Perspective

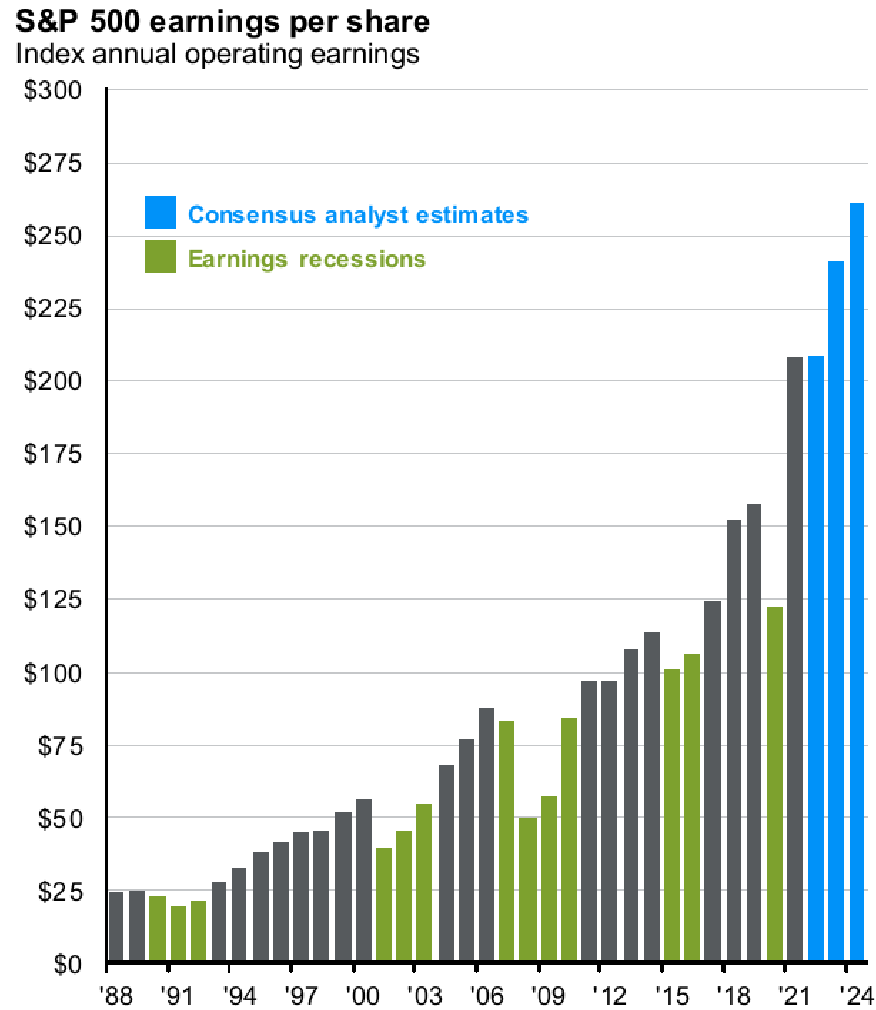




Source: BEA, NBER, J.P. Morgan Asset Management.

Source: JP Morgan, Guide to the Markets, September 30, 2022

Chart 10 – Earnings Estimates Are Still Bullish, Too Bullish?



Source: JP Morgan, Guide to the Markets, September 30, 2022

Chart 11 – Value is having a Renaissance, but has more room to grow

	Forward PE		Div. yield**	
Style	Current	Long-term avg.*	Current	Long-term avg.*
Value	12.09x	14.09x	2.60%	2.59%
Growth	20.38x	20.72x	1.15%	1.34%

Source: JP Morgan Guide to the Markets, July 1, 2022