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MARKET VIEW QUARTERLY

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A few months ago, we learned that real GDP contracted for the second straight quarter. Why does that matter? The last 10 times we have seen consecutive quarters of negative economic growth, the US was indeed in a recession. Could this time be different? We think so, and there are a few reasons why. For one, the labor market continues to shine as employment has now surpassed pre-pandemic levels. Pundits may argue that a rise in the unemployment rate to 3.7% from 3.5% from July to August is a concerning sign, however, this increase was only due to the fact that 786,000 new workers joined the work force.[1] With nearly twice as many job openings as there were unemployed workers to fill them, increased eagerness for employment should lead to increased economic activity. Similarly, consumers continue to spend. For confirmation of this, we can look behind the headline numbers and into the weeds of the data. The National Retail Federation (NRF) is projecting total Halloween spending to reach a record $10.6 billion, exceeding last year's record of $10.1 billion. Similarly, back-to-school and back-to-college spending exceeded 2021's record highs of $37 billion and $71 billion, respectively. [2] Lastly, sharp declines in shipping costs and prices paid signal that supply chains are improving, which should help inflation pressures ease down the road. A record 109 ships were documented by the Marine Exchange of Southern California & Vessel Traffic Service in Los Angeles in January 2022. As of August 2022, that ship count sat at eight, an all-time low.[3] For these reasons, we feel that economic growth will remain on solid footing and GDP will return to positive territory for the second half of the year.

DOMESTIC EQUITIES

There is no arguing that the first three quarters of the year were fraught with volatility. The S&P 500 was down -4.88% for the third quarter and is down -23.87% year to date through the end of September.[4] Meanwhile, the Dow Jones Industrial Average Index was down more than -6.17%[4] during the third quarter and -19.72%[4] year to date, and the tech-heavy NASDAQ Composite Index was down -3.91%[4] and -32.00%[4] for the third quarter and year to date, respectively. From an investment style perspective, mature, dividend-paying companies were out of favor for investors during the third quarter. As a result, the Russell 1000 Value index returned -5.62%[4] for the third quarter versus -3.60%[4] for the Russell 1000 Growth index. Coming off a record negative first half during what appears to be a late stage of the bear market, investors piled into small caps during the third quarter, as they tried to get ahead of a possible market recovery. As a result, small cap stocks have outperformed their large cap peers. Small caps returned -2.19% for the third quarter versus -3.44% for mid-caps and -4.61% for large cap equities.[4] We acknowledge that if inflation surprises persist, or a sizable shift in Fed policy occurs, equity markets could see a further pullback. However, we want to continue to stress that the fundamentals of the economy remain on solid footing. For all of the rhetoric surrounding a recession, positive guidance for earnings growth estimates is actually higher than the first and second quarters of 2022. Strong earnings have historically translated to solid stock market growth. With earnings growth expected to remain squarely positive into 2023, a turnaround in equities should come sooner rather than later.

INTERNATIONAL EQUITIES

We believe it's important for portfolios to be diversified across asset class, strategy, and geography, however, lower performance in international stock markets in recent years has made it more attractive to continue investing primarily in the U.S. The strength of the dollar has significantly weakened the performance of international stocks this year and investors who own international equities are currently getting punished because they're not receiving the benefits of a local market. For example, the MSCI EAFE Index, a benchmark of developed foreign country stocks, has lost more than -27.09% through the end of September.[4] Conversely, a version of the index that strips out the effects of currency fluctuations has only lost -7.5%.[5] Another headwind for the international and emerging market equity space is that geopolitical risks are still rising after Russia's full-on invasion of Ukraine in late February. Emerging markets may be fraught with even more risk, with the MSCI Emerging Markets Index down more -27.16% through the end of the third quarter.[4] This is mainly due to the fact that China has been and will continue to be the main driver of emerging market performance. China's zero-Covid approach has turned into a source of economic distress and as a result, household employment and income expectations have sunk to decade lows, according to the People's Bank of China urban depositor survey. China's crackdown on technology sectors created its own strain, with companies like Alibaba, Tencent, and JD.com laying off as much as 15% of their workers, according to Rhodium Group. Roughly one in five 16- to 24-year-olds were out of a job in July, with unemployment nearing 20%.[6] For decades, China has been synonymous with growth, however, this may no longer be the case. Due to the aforementioned, we continue to prefer a domestic bias in our equity exposure.

FIXED INCOME

The Federal Reserve (Fed) decided to raise the Federal Funds Target Rate (fed funds) by 0.75%.[1] The target band now stands at 3.00 – 3.25%.[1] Like the July Fed meeting, this move had been largely anticipated, although following yet another stronger than expected August Consumer Price Index (CPI) release, some market participants leaned toward a 1.00% increase. The market now reflects a high probability of another 0.75% increase at the next meeting (November 2) and another 0.50% for the final Fed meeting of 2022 (December 14).[1] As a result of a more aggressive Fed, we have witnessed treasury yields climb throughout the quarter. The yield on the 10-year treasury currently sits at 3.82% and climbed above 4% for the first time in more than a decade during the last week of the quarter.[1] The yield on the 2-year Treasury is 4.27%, trading around levels not seen since 2007.[1] With such a rapid rise in yields, it should come as no surprise that the Bloomberg U.S. Aggregate Bond Index settled down -4.75% for the quarter and is currently down -14.61% for the year.[1] However, the continued repricing of rates makes fixed income not only more attractive, but over time, a better hedge for equity risk. At current levels, short maturity corporate bonds provide investors with superior yields without having to extend out maturities. With all but a guarantee that the Fed is set to hike rates into the first quarter of 2023, floating rate notes, specifically, should best insulate a portfolio. These securities have floating-rate coupons based on the prevailing interest rate environment and although floating rate bonds are down for the quarter with the Morningstar LSTA Leverage Loan Index up +1.37% for the quarter.[5] Ultimately, there should be better days ahead for the fixed Income market. On average, the higher the starting yield, the higher the future return, and vice versa. For example, at the end of October in 2008, the yield on investment grade bonds was 9.23%, a record high.[7] Over the next 10 years investment grade bonds would earn 8.1% per year. The market currently anticipates a fed funds range of 4.25% – 4.50% at year end, with the peak fed funds rate between 4.5% – 4.75% in early 2023.[1] This would mean 4.5% – 4.75% annual returns over the coming years.[7] Ultimately, we are slowly moving back into an environment where fixed income can provide uncorrelated returns to equity markets while offering attractive yields.

ALTERNATIVES

Alternative assets continued to climb in 2022 as investors weighed the effects of higher inflation expectations. Real assets often include direct or indirect links to inflation and thus have historically been better able to weather above average inflationary environments. Lower correlations relative to most equity and fixed income asset classes may also provide a cushion when markets suffer through volatility and uncertainty. Over the past 20 years (Jan. 2002 – June 2022) during inflationary environments, gold, real estate, and natural resources have provided average annual returns of 9.22%, 6.79%, and 5.58% respectively.[8] Within the alternative space we believe it's prudent to specifically focus on movements in the oil market as higher energy prices have been the bane of inflation readings for the majority of the year. WTI Crude prices had another volatile quarter as continued pressure and sanctions on Russian oil reared its head in broader energy markets. WTI crude oil prices started the quarter at $108.43 a barrel and retreated to $78.49 by quarter end.[1] Additionally, natural gas, historically one of the most volatile commodities, started the quarter at $5.73 and rose to $9.68 In early September before falling to $6.76 at the end of the quarter.[1]

REAL ESTATE

Homebuilder confidence declined for the ninth straight month in September as surging mortgage rates and steep prices pushed many buyers out of the market, according to the National Association of Home Builders. August 2022 existing-home sales were down -0.4% from July and -19.9% from one year ago.[1] However, we have seen data more recently that points to a softening in home prices and therefore a silver lining for affordability. Nationwide, 44.6% of home offers written by Redfin agents faced competition on a seasonally adjusted basis in August, the lowest bidding-war rate since the beginning of the pandemic when the housing market nearly ground to a halt. It's down from 63.5% a year earlier (Note: bidding war is defined as an offer with at least one competing bid).[9] Similarly, 7.8% of US homes for sale have now cut their asking price over the last 4 weeks, the highest percentage we've seen since Redfin started tracking the data in 2015. Owner's equivalent rent, which measures majority of the change in the shelter cost consumers experience makes up nearly 30% of CPI[1], so any relief in prices in the housing sector will be a very welcome sign for inflation readings in the coming months.

CONCLUSION

During bear markets and recessions, there's a tendency for correlations to rise, with many assets moving in the same direction: down. While it's tempting to abandon your diversified portfolio, that has not been a prudent strategy in the past. Markets move first, and they've already adjusted to increased volatility. The question looms, is the draw down seen in the first three quarters of the year significant enough to constitute a market bottom? While we do not have a crystal ball, what we do know is that we've seen recessions in the past where the S&P 500 has declined less (most recent example: 1990 – 91 recession) and some during which the S&P 500 has declined more (most recent example: 2020).10 A couple comforting thoughts to assuage the worried minds of long-term investors: 1) bear markets and recessions have always been significantly shorter than bull markets and expansion periods, and 2) all previous bear markets and recessions have ended in new expansions that led to new, all-time highs at some point in the future. Historically, if you stayed the course, you were eventually rewarded. With the Fed firmly on the brakes at a time when economic growth is already slowing, the macroeconomic backdrop remains challenging, which requires patience from investors. Markets could stay rangebound for a while but should recover once the Fed becomes less hawkish.

Economic Definitions

GDP: Gross domestic product (GDP) measures the final market value of all goods and services produced within a country. It is the most frequently used indicator of economic activity. The GDP by expenditure approach measures total final expenditures (at purchasers' prices), including exports less imports. This concept is adjusted for inflation.

Unemployment Rate: The unemployment rate tracks the number of unemployed persons as a percentage of the labor force (the total number of employed plus unemployed). These figures generally come from a household labor force survey.

CPI (headline and core): Consumer prices (CPI) are a measure of prices paid by consumers for a market basket of consumer goods and services. The yearly (or monthly) growth rates represent the inflation rate.

Housing Starts: Housing (or building) starts track the number of new housing units (or buildings) that have been started during the reference period.

Building Permits: This concept tracks the number of permits that have been issued for new construction, additions to pre-existing structures or major renovations. These statistics are based on the number of construction permits approved.

West Texas Intermediate (WTI): West Texas Intermediate (WTI) crude oil is a specific grade of crude oil and one of the main three benchmarks in oil pricing, along with Brent and Dubai Crude. WTI is known as a light sweet oil because it contains around 0.34% sulfur, making it "sweet," and has a low density (specific gravity), making it "light."

The Federal Reserve System: The central bank of the United States. It performs several general functions to promote the effective operation of the U.S. economy and, more generally, the public interest.

Index Definitions

S&P 500: The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

NASDAQ: The NASDAQ Composite Index is a broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market, and Capital Market. The index was developed with a base level of 100 as of February 5, 1971.

Dow Jones Industrial Average: The Dow Jones Industrial Average is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

Russell 1000 Value: Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The index was developed with a base value of 200 as of August 31, 1992.

Russell 1000 Growth: Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The index was developed with a base value of 200 as of August 31, 1992.

Russell Mid-Cap: Russell Midcap Index measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 25% of the total market capitalization of the Russell 1000 Index.

Russell 2000: The Russell 2000 Index is comprised of the smallest 2000 companies in the Russell 3000 Index, representing approximately 8% of the Russell 3000 total market capitalization. The real-time value is calculated with a base value of 135.00 as of December 31, 1986. The end-of-day value is calculated with a base value of 100.00 as of December 29, 1978.

MSCI EAFE: The MSCI EAFE Index is a free-float weighted equity index. The index was developed with a base value of 100 as of December 31, 1969. The MSCI EAFE region covers DM countries in Europe, Australasia, Israel, and the Far East.

MSCI EM: The MSCI EM (Emerging Markets) Index is a free-float weighted equity index that captures large and mid-cap representation across Emerging Markets (EM) countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

Bloomberg Barclays US Agg Bond: The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

Bloomberg Barclays High Yield Corp: The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

Morningstar® Diversified Alternative Index: The Morningstar® Diversified Alternatives Index is designed to provide diversified exposure to alternative asset classes in order to attempt to enhance risk-adjusted portfolio returns when combined with a range of traditional investments. The index consists of a diversified set of ProShares alternative exchange traded funds that employ alternative and nontraditional strategies such as long/short, market neutral, managed futures, hedge fund replication, private equity, infrastructure, or inflation-related investments.

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Investing involves risk, including the potential loss of principal. No investment strategy can guarantee a profit or protect again loss. In general, the bond market is volatile; bond prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed-income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. Vehicles that invest in lower-rated debt securities (commonly referred to as junk bonds or high-yield bonds) involve additional risks because of the lower credit quality of the securities in the portfolio. International investing involves special risks not present with U.S. investments due to factors such as increased volatility, currency fluctuation, and differences in auditing and other financial standards. These risks can be accentuated in emerging markets.

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1 Data obtained from Bloomberg as of 9/30/2022.
2 https://nrf.com/tag/consumer-spending.
3 https://www.bloomberg.com/news/articles/2022-08-30/flood-of-los-angeles-bound-container-ships-slows-to-a-trickle.
4 Data obtained from Morningstar as of 9/30/2022.
5 https://www.cnbc.com/2022/09/16/investment-strategist-why-a-strong-dollar-hurts-investors.html.
6 https://www.barrons.com/articles/china-stock-market-where-to-invest-now-51660863392.
7 Data Obtained from Bloomberg via ICE BofA US Corporate Index.
8 Franklin Templeton – "Combatting Inflation with Real Assets".
9 https://www.redfin.com/news/real-estate-bidding-wars-august-2022.
10 https://compoundadvisors.com/2022/how-to-think-about-investing-during-a-recession.

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