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Investment Insights Quarterly

From The Desk of Bill Hornbarger, Chief Investment Officer October 2022

Is It a Recession Yet?

This has been one of the most difficult years in modern history for investors. The U.S. broad equity indices are in bear markets and bonds are on track to have the worst year (by a wide margin) on record for core fixed income. Through the end of the third quarter, the S&P 500 and Bloomberg Barclays Aggregate Bond Index were down 23.9% and 14.6% respectively, with both markets deteriorating further in the early part of the fourth quarter. There have been very few asset classes or sectors that have provided investors with positive returns this year, with commodity prices generally – and the energy sector in particular – leading the way, despite both declining during the third quarter.

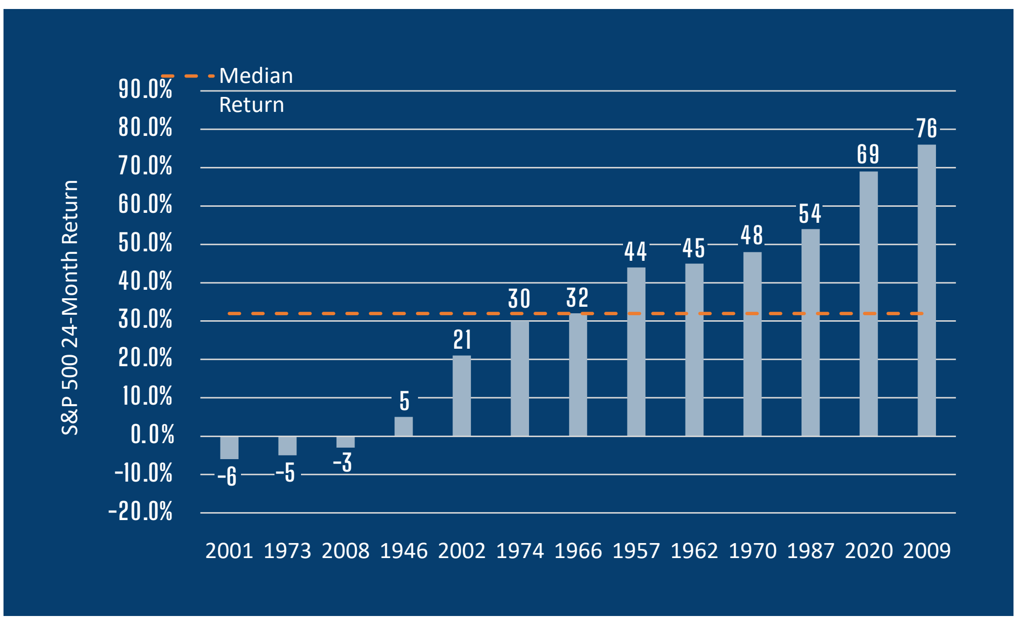
The majority of economists that we follow believe the economy is currently either in recession or will be in the near future. The index of leading economic indicators has been down for seven consecutive months and this has generally been a very reliable recession indicator. On the positive side, the unemployment rate remains at historically low levels (last at 3.5%). There are signs that the labor market is softening at the edges, with job openings coming down from their peak and average hourly earnings falling in recent months coupled with negative real wage growth. Other measures of economic activity, such as the Institute for Supply Management manufacturing and service surveys and industrial production, show the economy growing at a moderate pace. The The Federal Reserve Bank of Atlanta's latest GDPNow forecast is currently forecasting third quarter growth at 2.9% after real GDP was negative in the first two quarters of 2022. The Fed, in this environment, has aggressively raised rates and provided guidance that rates will continue to climb as we close the year and head into 2023.

We believe the third quarter earnings season will be an important waypoint for the equity markets for several reasons. The S&P 500 is expected to see earnings growth of approximately 4% although when eliminating the energy sector, that turns negative. Equally as important will be comments and forward guidance from corporate CEOs about general business conditions, the impacts of inflation, and any additional shortages and supply chain issues. Bloomberg shows trailing earnings for the S&P 500 at $203.82 with the next twelve months forecast at $231.93, up 13.8%. The composite price to operating earnings ratio of the S&P 500 has dropped from 30.7 in December 2020 to 21.5 in January to 17.2 at the end of Q3.

Fixed income investors will remain at the mercy of Fed policy and inflation. The bond market seems to be sending mixed messages with the inverted yield curve and the short part of the yield curve indicating more Fed tightening to come and the potential for a recession. Credit spreads (investment grade and high yield) have widened this year, reflective of equity weakness and the mixed economic performance/outlook, but not to levels that suggest panic. The implied five- and ten-year spot inflation rate has declined in recent months and is one of the reasons the Fed has opined that inflation expectations remain well anchored. Finally, while yields have generally moved higher across the globe this year, most developed market yields remain below the U.S. with ten-year sovereign bonds from countries such as Japan, Germany, Switzerland, France, and the U.K. yielding less than domestic Treasuries. A strong dollar and high relative yields make the U.S. attractive to foreign buyers.

After opening their third quarter statements, most investors are likely pretty glum and recent volatility and weakness has resulted in some of the fear indicators increasing noticeably. While the future is unknown, much damage has already been done (and we won't be surprised by new lows), but we would advise against selling and sitting in cash at this point. This is because equity returns in 12-24 months following bear markets have historically been above average. In fact, the median equity gain of the S&P 500 in the year following past bear markets was 23%, while extending that period to 24-months resulted in a higher 32% gain.

S&P 500 Return 24 Months after 20%+ Pullback in a Calendar Year



Source: Goldman Sachs

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We still believe the biggest risk to the financial markets is a policy mistake by the Fed. We hope that they will soon pause and look at the cumulative effects of the tightening to date, which tend to operate with a lag of two to three quarters before results are seen. At times like these, we remind ourselves that the decline in equity prices and valuations increases the prospects for forward returns for patient investors and the increase in bond yields also bodes well for the future return prospects of that asset class (the best predictor for bond returns is starting yields, which are significantly higher than any time in the past decade).

We are also mindful that recessions are dated after the fact, often long after markets have bottomed. The National Bureau of Economic Research (NBER) dated the trough in April 2020, 15 months after that date, and earlier determinations took anywhere from four to 21 months. We would also point out that, since World War II (with the exception of 2001), stocks have bottomed during a recession. Research also suggests that the current decline in the S&P 500 is the largest that has been seen prior to a recession. In other words, the markets are forward looking and have currently already priced in significant bad news at current levels. As we have mentioned previously, bear markets also feature violent bounces, making attempts to time the market difficult or even impossible.

Finally, we would be remiss if we didn't mention that the prospects for the oft maligned 60/40 (equity/fixed income) portfolio have improved dramatically. After the recent repricing of bond yields, and in the wake of a decade plus of extraordinary monetary policy and low bond yields (and low returns), the 40 portion of the 60/40 portfolio now offers the prospect of attractive current yields and a buffer against additional equity volatility. The Bank of America/Merrill Lynch Corporate Bond Master Index Yield has increased from 2.33% at the beginning of the year to 5.22% at the end of the third quarter. For much of the last decade, bonds offered risk with little return. They are now at the point where their more traditional portfolio roles of current yield, equity market risk mitigation, and liquidity are attractive.

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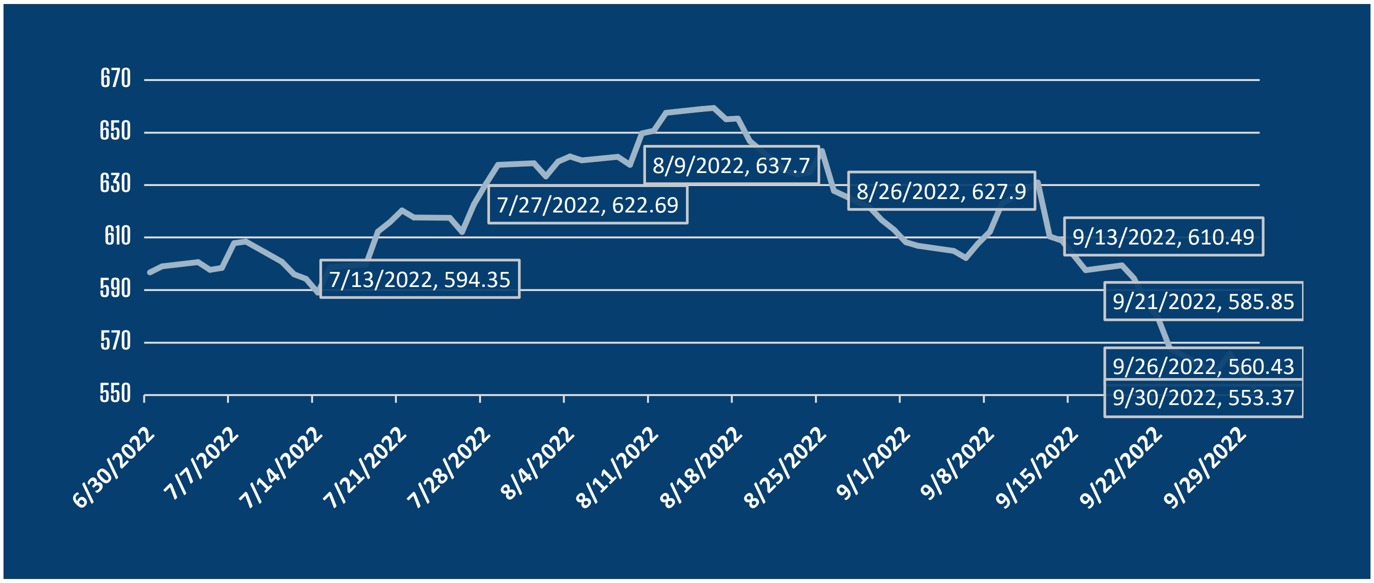
Key Q3 Dates

- July 13 – June CPI is released and is 9.1%, the highest in over 40 years.
- July 27 – FOMC raises rates 75 basis points.
- August 9 – Treasury yield curve inversion accelerates.
- August 26 – Fed Chairman Jerome Powell gives very hawkish speech at the Jackson Hole symposium.
- September 13 – The S&P 500 is down 4.32%, the largest percentage loss of the year.
- September 21 – FOMC raises rates 75 bps.
- September 26 – The British pound falls to the lowest level vs. the U.S. dollar since 1985.
- September 30 – The S&P 500 closes at the lowest level of the year, 3,585.62. This is the third consecutive quarterly loss, the first time this has happened since 2009.

Global Stock Market
MSCI ACWI in USD

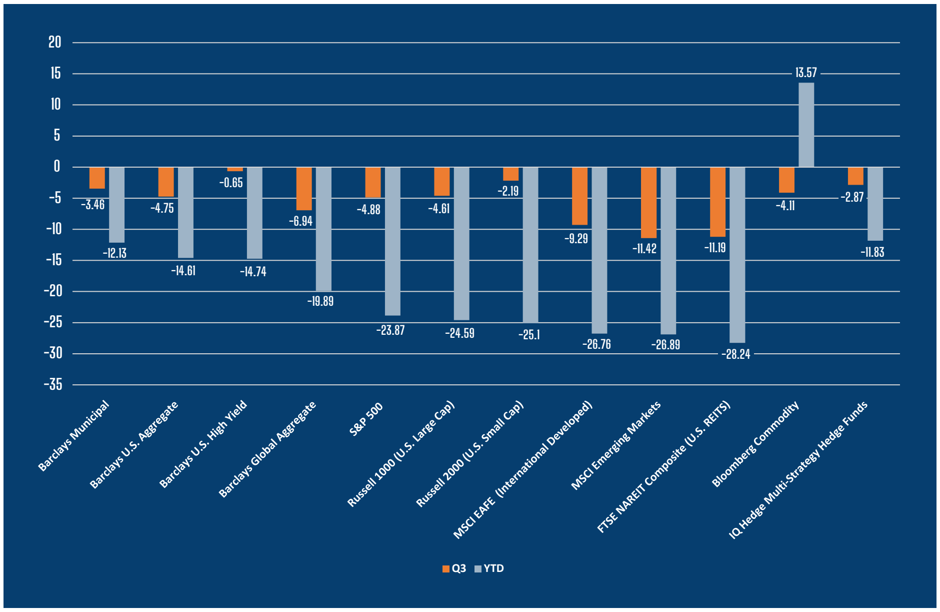


Source: Bloomberg

ASSET CLASS PERFORMANCE

Asset Class Returns

Q3 2022



Source: Conway

Fixed Income

- Treasuries and other sovereign debt yields continued their surge higher in September, leading to sharp losses in core fixed income and municipal bonds.
- Credit spreads widened last month on the growing risk-off trade. Levered loans provided some relative outperformance.
- Bonds outside the U.S. were hit particularly hard by higher yields and the strong U.S. dollar.

Equities

- September was a rough month for risk assets including U.S. equities. The S&P 500 fell 9.2% while the Russell 2000 dropped 9.6%.
- Large cap tech and growth stocks were the hardest hit in September.
- Value led growth in large caps last month, but growth beat value across small caps.
- Non-U.S. developed market equities outperformed the U.S. in local terms but lagged when factoring in the strong U.S. dollar.
- Value beat growth within the EAFE (international developed) and emerging market indices.
- Small caps beat large caps in emerging markets, but they lagged in developed markets.

Alternatives

- Real estate was one of the worst performing sectors in Q3, hurt by higher interest rates, broader market weakness, and a weaker economy.
- Commodities were weak during the quarter on the slowing economy and stronger dollar. Industrial metals and lumber were noticeably weaker.

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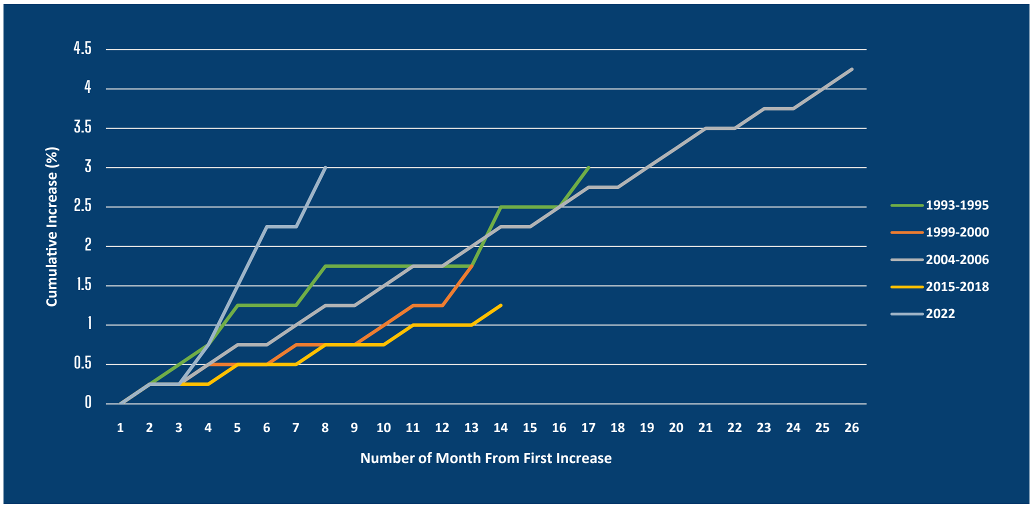
Fiscal and Monetary Policy Highlights

The Fed Has Moved Fast This Cycle

Last Five Tightening Cycles



Source: Benjamin F. Edwards

- The Fed raised rates at both meetings by 75 bps in Q3.
- To date, this has been one of the fastest tightening cycles on record with the Fed having increased rates a total of 3% in just nine months.
- The Fed's rhetoric remains hawkish, with the summary of economic projections released in September indicating the Fed sees the Fed funds rate rising to 4.50% to 4.75% in 2023.

Global Inflation

Country/Region	Headline Inflation	Target	Policy Rate
United States	8.3%	2.0%	3.25%
Euro Area	10.0%	<2.0%	1.25%
Japan	3.0%	2.0%	-0.10%
United Kingdom	9.9%	2.0%	2.25%
Canada	7.0%	2.0% (+/- 1%)	3.25%
Australia	6.1%	2.0%-3.0%	2.60%
New Zealand	7.3%	1.0%-3.0%	3.50%
Switzerland	3.3%	<2.0%	0.50%
Denmark	8.9%	-	0.65%
Norway	6.5%	2.0%	2.25%
Sweden	9.8%	2.0%	1.75%

Source: Bloomberg, Danmarks Nationalbank

- Inflation is elevated across developed economies.
- Global central banks have generally responded by raising interest rates and tightening monetary policy.

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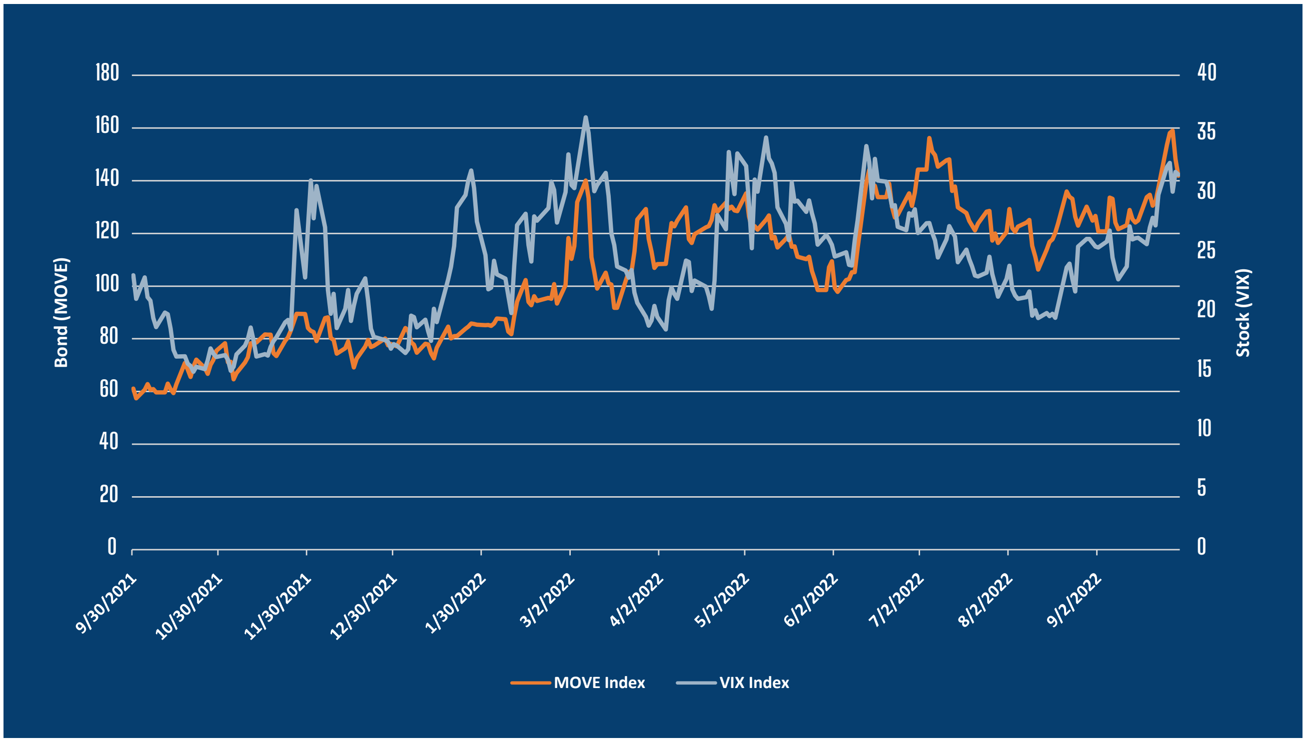
Volatility

Stock (VIX) and Bond (MOVE) Volatility



Source: Bloomberg

- The VIX (stock) and MOVE (bond) are options-based indices that are a measure of volatility. Higher readings typically are a coincident indicator of fear and volatility.
- Both indicators have increased this year but remain below levels typically associated with non-functioning markets.
- No bear market in recent times has bottomed without the VIX hitting 45. This market cycle has not achieved that level to date.

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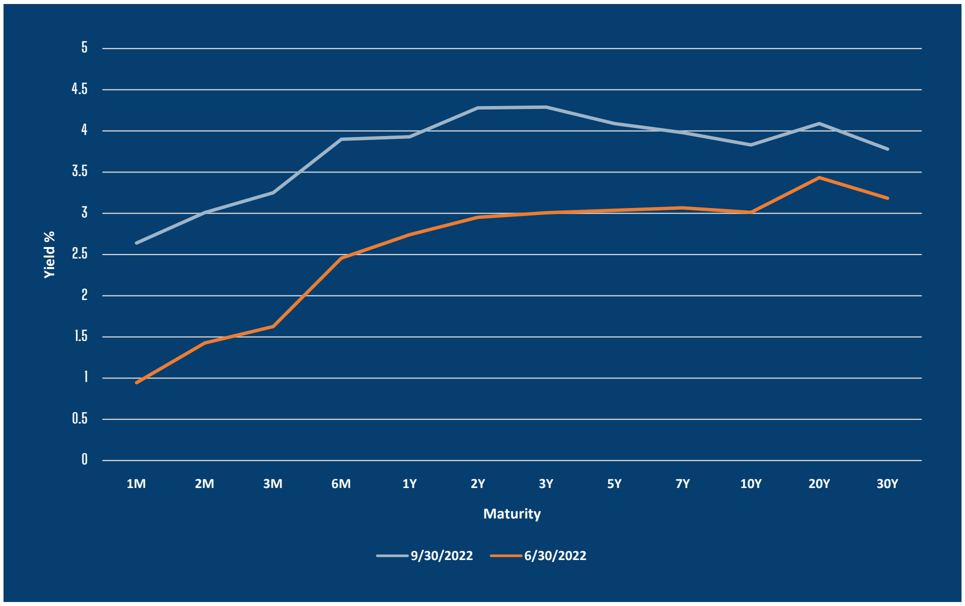
U.S. Treasury Curve

Treasury yields continued to rise during the quarter in response to Fed activity and higher inflation readings. Bonds in general are suffering through one of the worst years on record.

Treasury Yield Curve



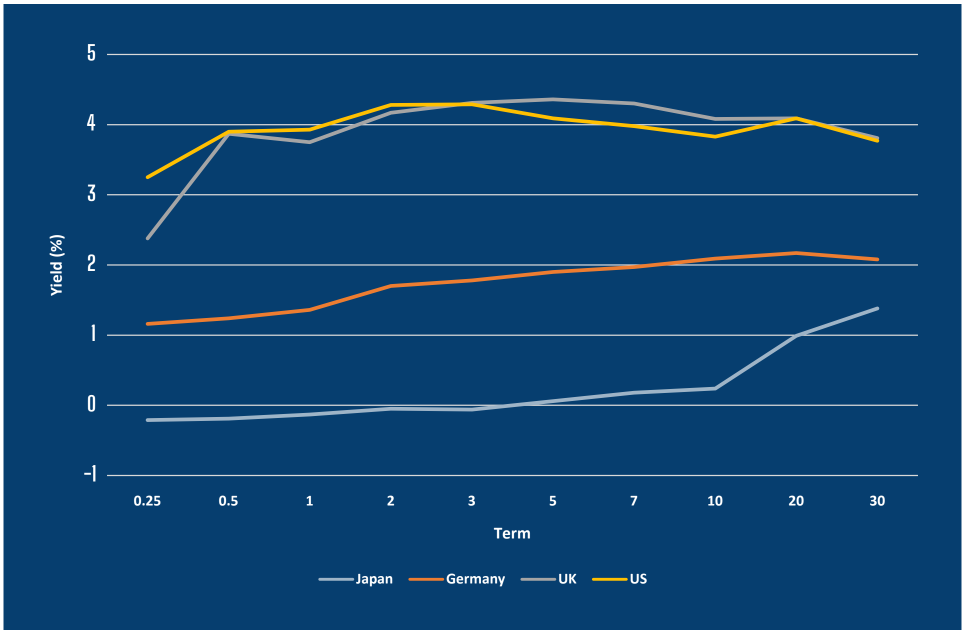
Source: Bloomberg

Government Bond Curves

Global yield moved higher during the quarter as inflation and central bank activity pressured the fixed income markets. U.S. and U.K yields remain high relative to most other developed markets.

Government Bond Yield Curves

End of Q3 2022



Source: Bloomberg

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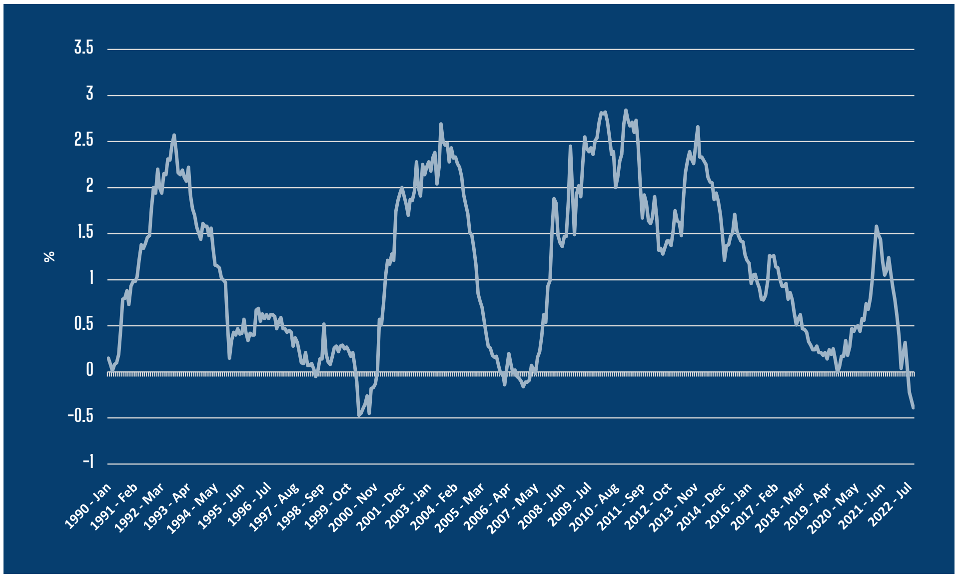
Yield Curve

The yield curve (10-year Treasury less 2-year Treasury) has inverted with short-term yields higher than long term yields. This is a relatively rare state, and an indication that investors expect the economy to slow. An inverted yield curve often happens prior to/during a recession.

The Yield Curve

10-Year Treasury less 2-Year Treasury



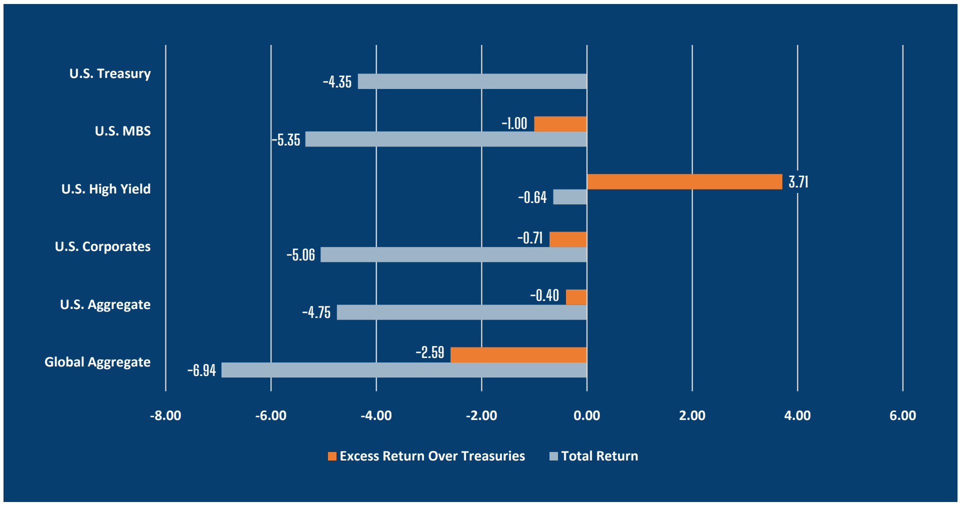
Source: Bloomberg

Fixed Income Performance (Q3)

Fixed income as an asset class was under extreme pressure again in Q3 with all major sectors of the market posting negative returns. Rising benchmark Treasury rates were a heavy headwind. Global bonds were hardest hit with the strong U.S. dollar adding to negative performance.

Fixed Income Performance

Q3 2022



Source: Bloomberg

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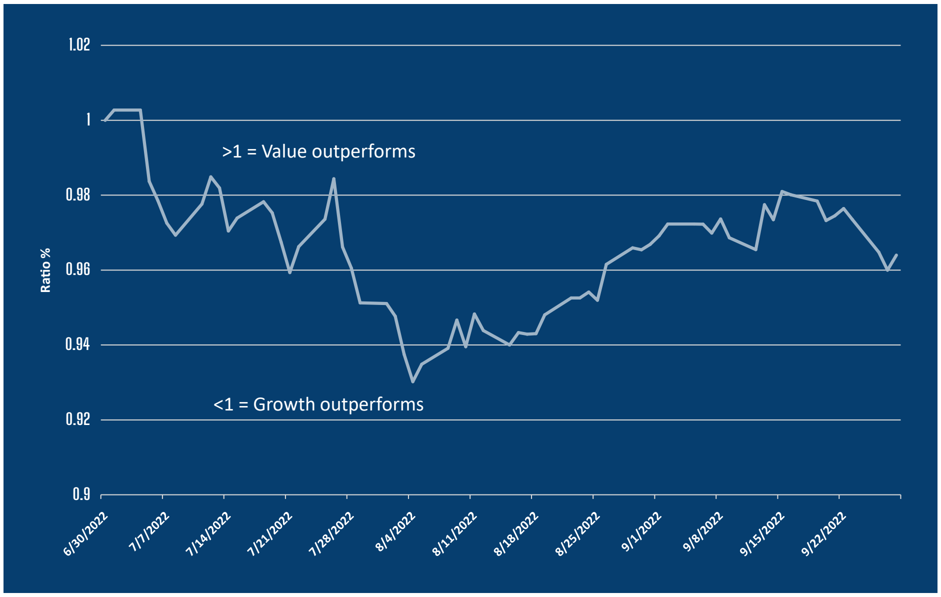
Equity – Value vs. Growth

Growth outperformed value during Q3.

Large Cap Value/Large Cap Growth – Q3 2022

Russell 1000 Value/Russell 1000 Growth



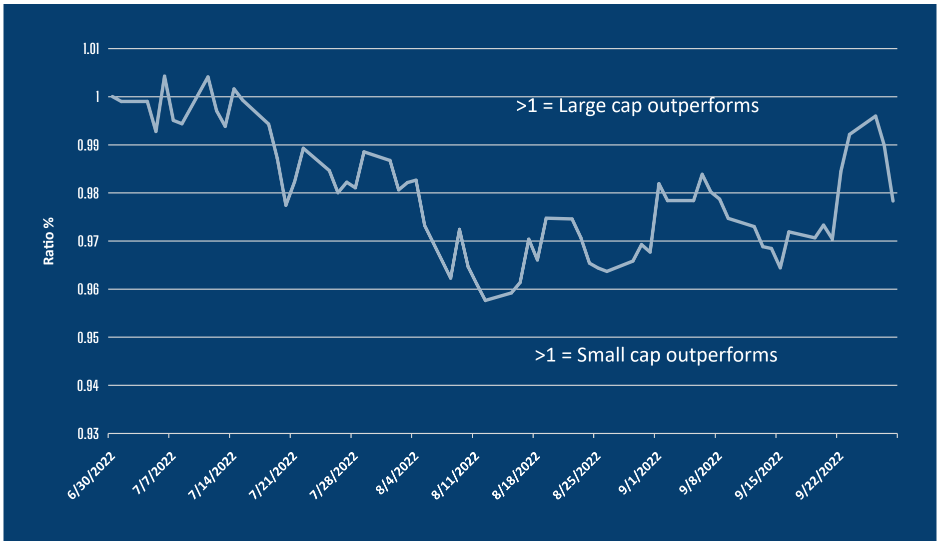
Source: Bloomberg

Equity – Large vs. Small

Large cap slightly outperformed small cap during Q3 despite a late September swoon.

Large Cap/Small Cap – Q3 2022

S&P 500/Russell 2000



Source: Bloomberg

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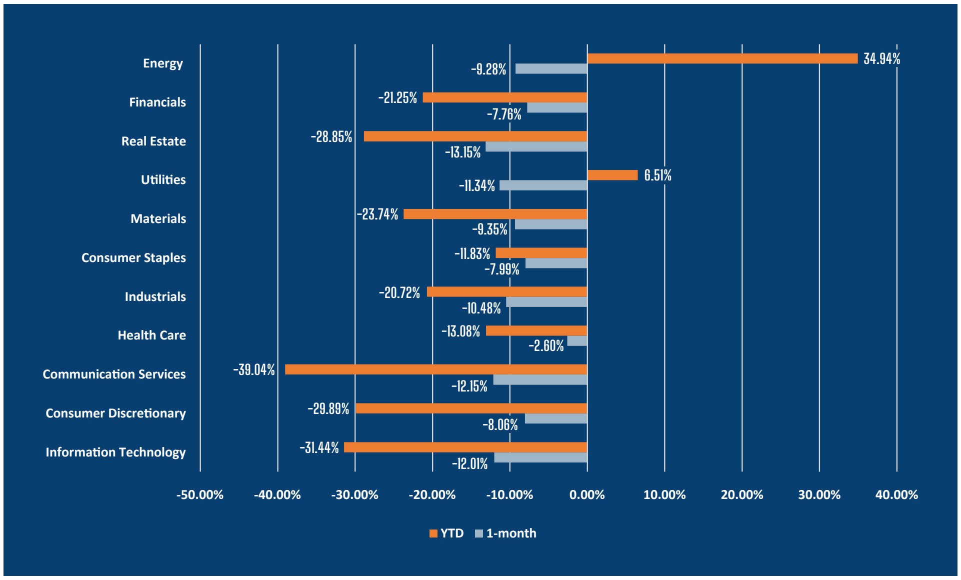
U.S. Equities – Return by Sector

A difficult quarter for the broad market with all sectors lower. YTD, energy has been the best performer, with utilities the only other sector positive in 2022.

S&P 500 Sector Returns

Q3 2022



Source: Conway

Country Total Returns (%) – 10 Largest Economies

Global equities generally fell in Q3 as inflation surged, bond yields rose, and fears of a global recession increased. U.S. investors in foreign markets were also hurt by the strong U.S. currency.

Country Total Equity Market Returns

Source: Bloomberg

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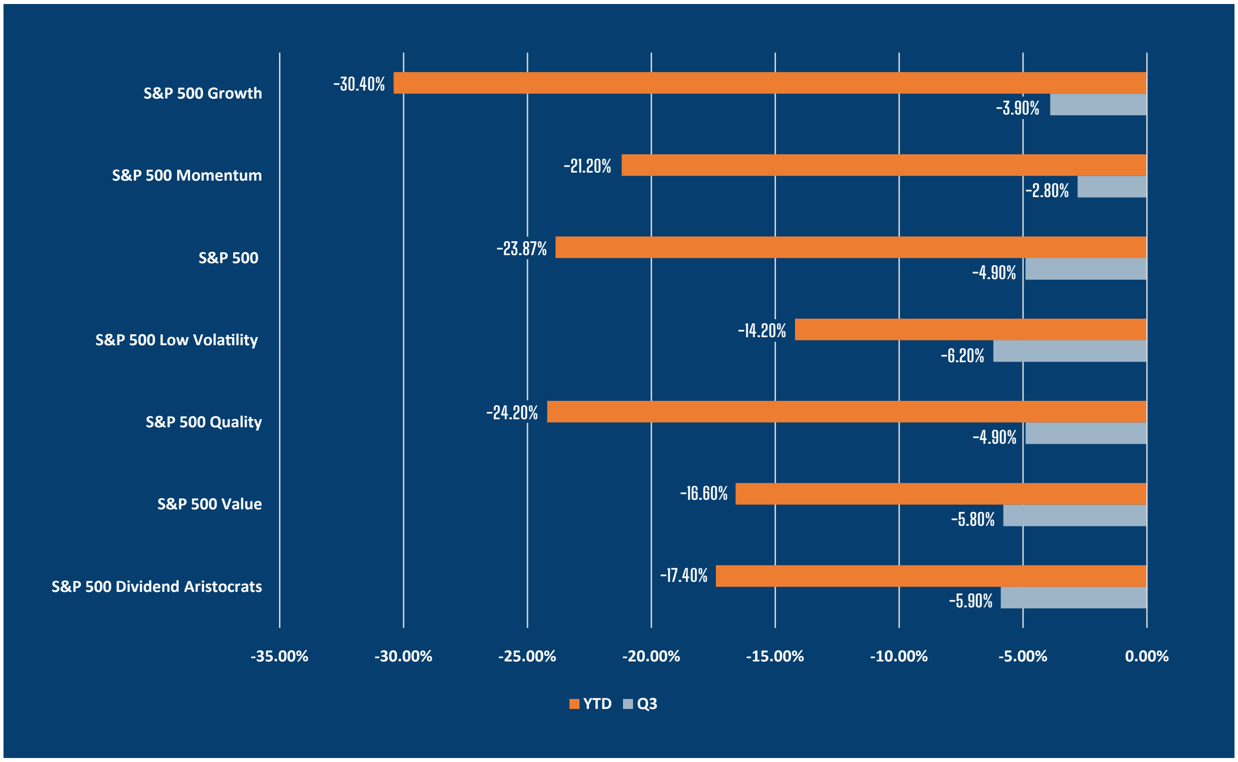
U.S. Equity Factors – Total Return Q3

All the core factors were lower for the quarter deepening the losses for the year. There was some rotation from Q2 with growth and momentum turning in the best performances.

Total Return: Core Factors
Q3 2022



Source: S&P

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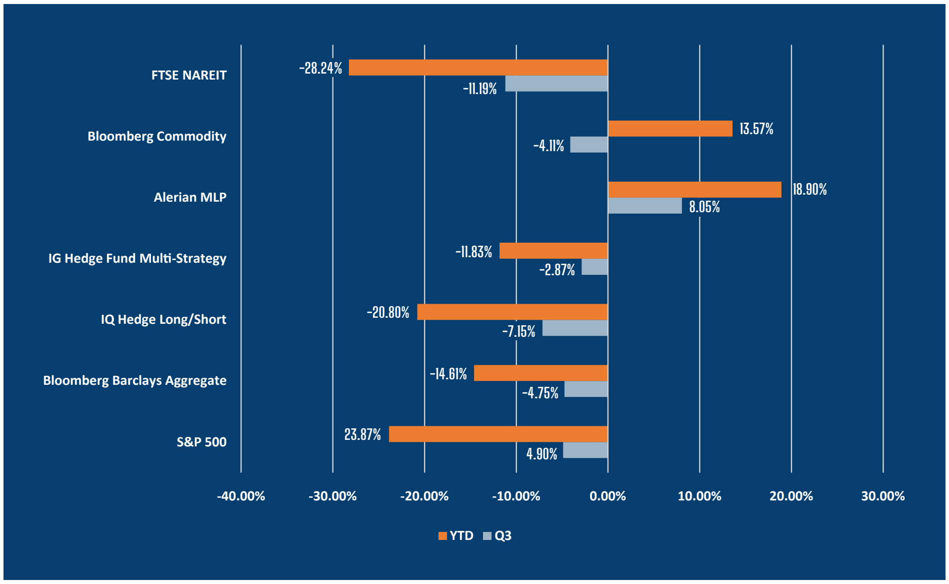
Alternative Returns

Alternative strategies and asset classes were generally weaker in Q3.

Alternative Returns
Q3 YTD

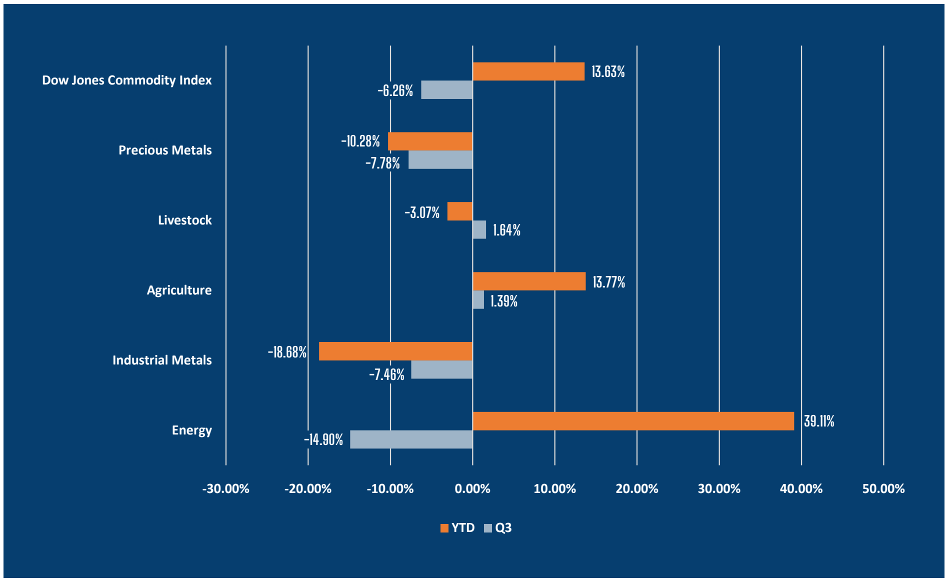


Source: Conway

Commodities

Commodities were mixed in Q3 and are mixed YTD.

Commodity Performance
YTD 2022



Source: S&P

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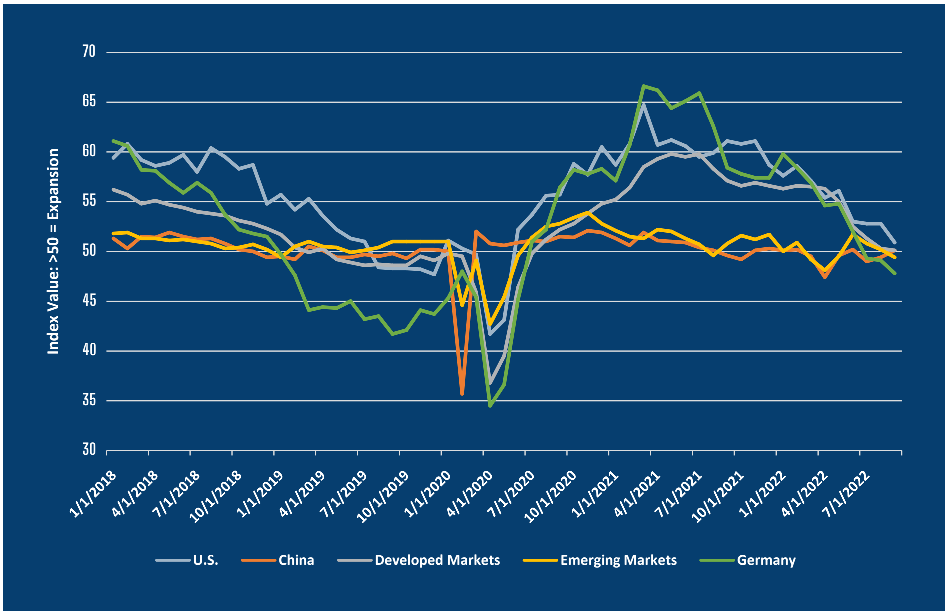
PMI Composites

The Purchasing Managers Index (PMI) is a survey-based measure of the prevailing direction of trends in the manufacturing sector. Readings >50 equal expansion and <50 contraction. By this measure, the global economy generally and broadly softened in Q3.

Global Manufacturing Surveys

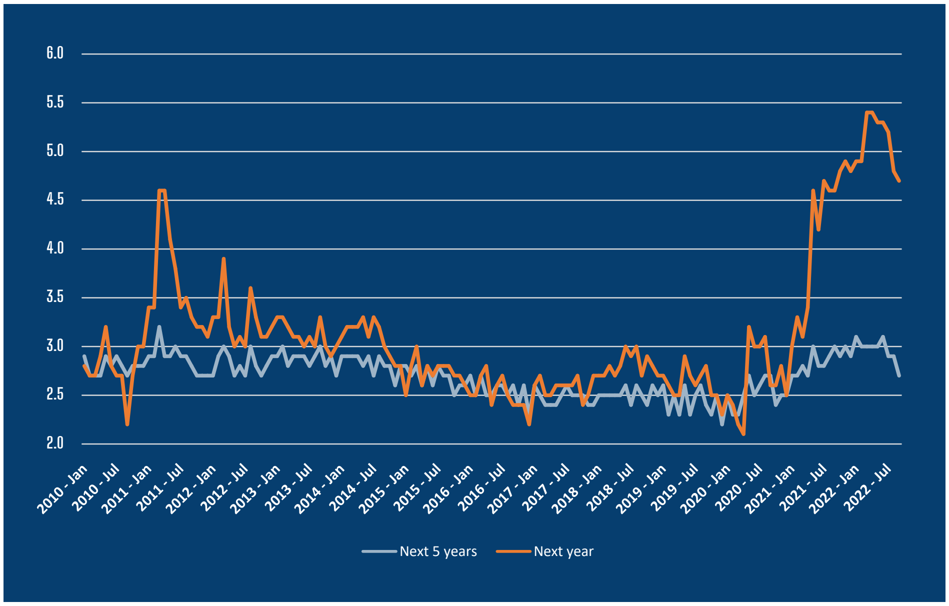


Source: Bloomberg, Haver

Inflation

Despite current elevated rates of inflation, both survey (shown) and market-based measures show inflation expectations remain "well anchored." The Fed watches this closely as a leading indicator for consumer activity.

University of Michigan: Expected Inflation Rate (%)



Source: Haver

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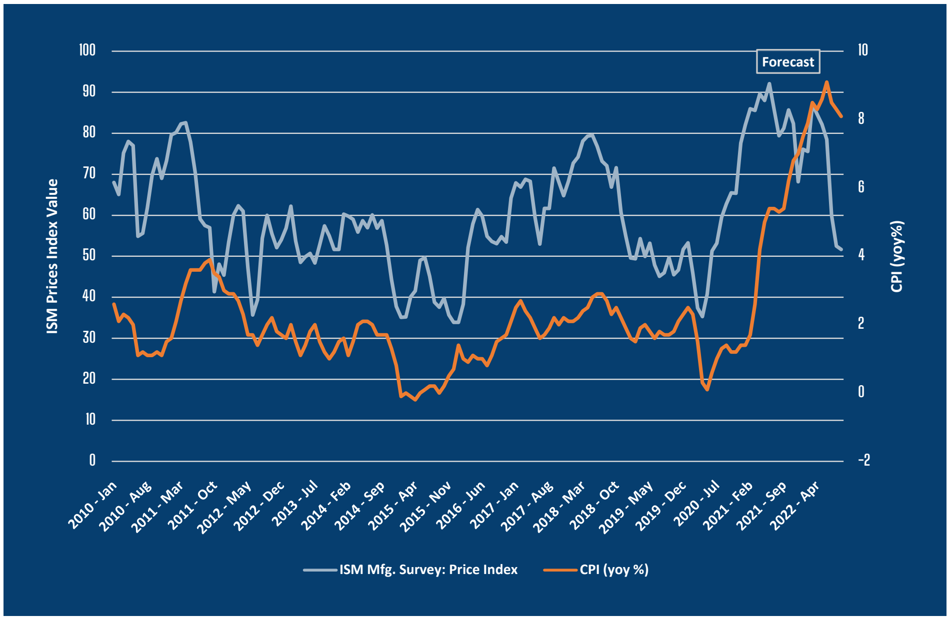
Inflation

There are emerging signs that inflation has peaked including the ISM manufacturing survey price index.

CPI vs. ISM Survey Price Index

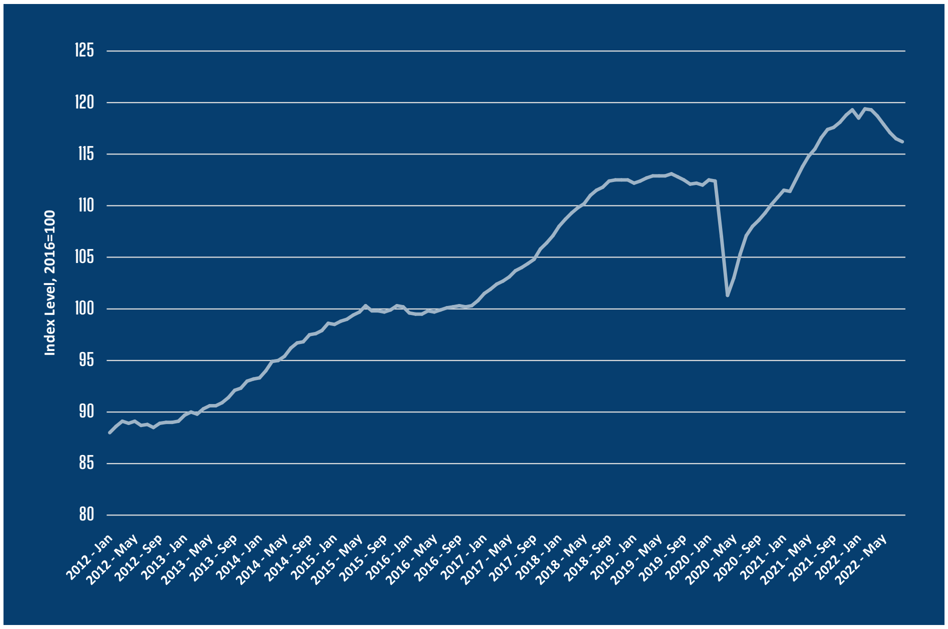


Source: Haver

Leading Economic Indicators

The leading economic indicator index has fallen six consecutive months through May. This has signaled a recession with 100% accuracy since 1959.

Leading Economic Indicators



Source: Haver

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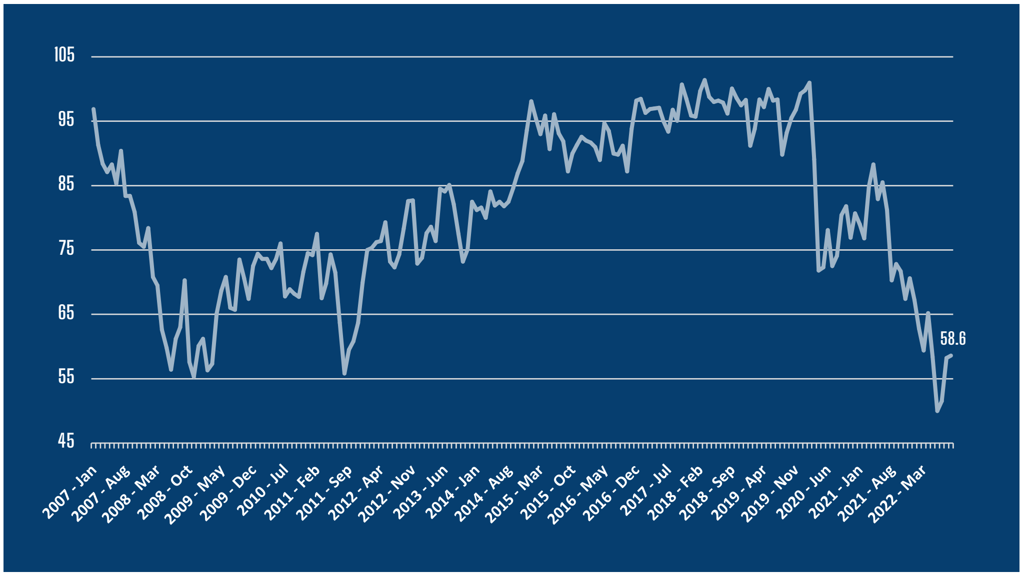
Consumer Sentiment

Consumer sentiment remains depressed from a long-term perspective but did move higher during Q3. Lower gas prices and a low unemployment rate offset the weakness in the equity markets.

University of Michigan: Consumer Sentiment
NSA, Q1-66=100

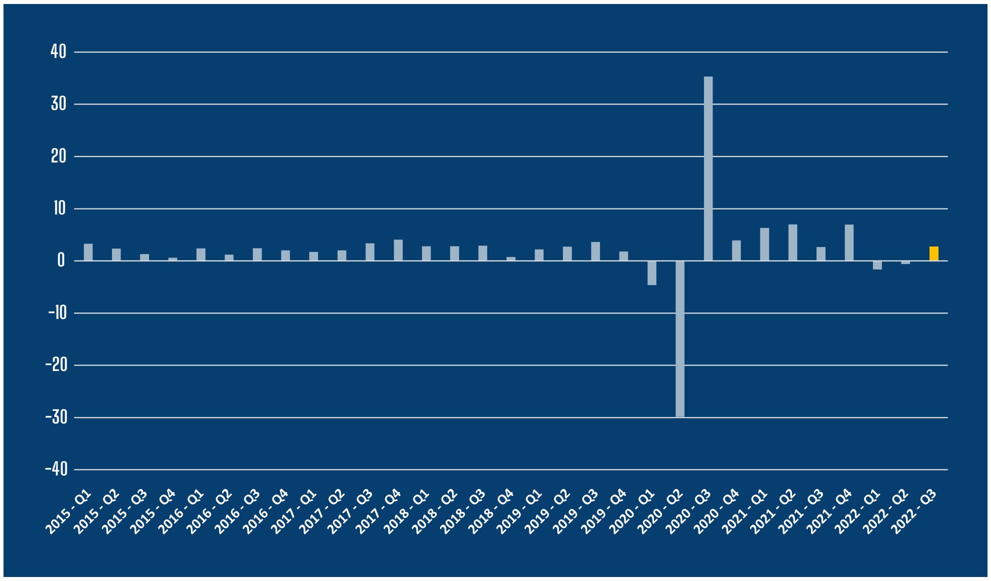


Source: Haver

Gross Domestic Product

GDP was negative in the first two quarters of 2022 but is forecast to rebound in Q3. Two consecutive negative GDP quarters has historically been a recession indicator.

Gross Domestic Product
% Change - Annual Rate



Source: Haver, Atlanta Fed

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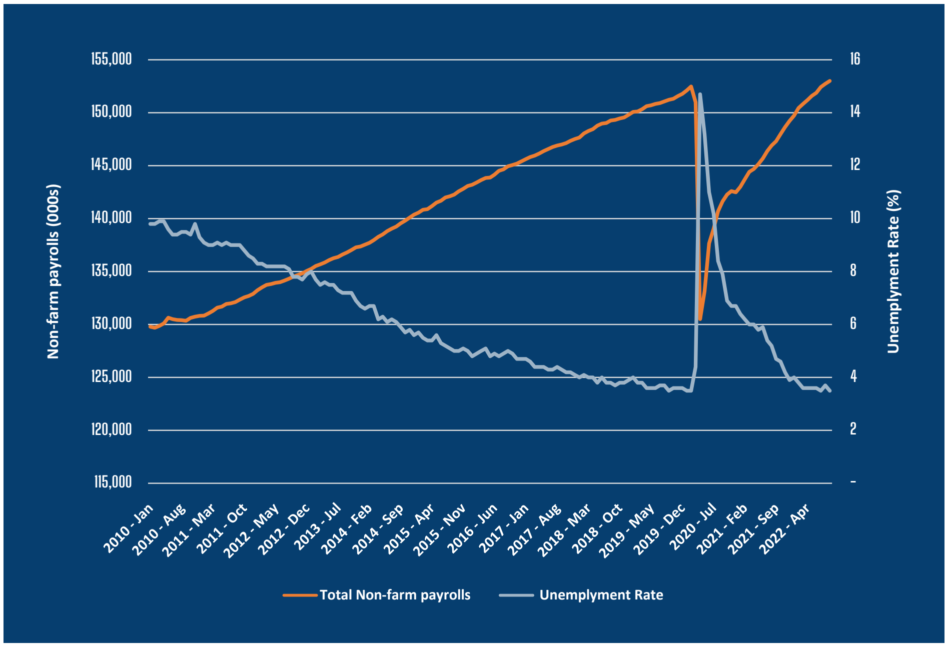
Employment

Employment has been one of the few bright spots in 2022. During Q3 (August) the total number of workers on non-farm payrolls eclipsed the previous pre-Covid-19 high and the unemployment rate fell to 3.5% at the end of Q3, tying for the lowest since 1969.

Employment



Source: Haver

Supply Chain

Global shipping costs have collapsed hitting new cycle lows in Q3.

World Consumer Index Freight Container Cost

$ Per 40 Foot Container
Shanghai to Los Angeles

Source: Bloomberg

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September 30, 2022	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Barclays U.S. Treasury Bill 1-3 Month	0.20%	0.47%	0.63%	0.64%	0.55%	1.10%	0.64%
Barclays Municipal	-3.84%	-3.46%	-12.13%	-11.50%	-1.85%	0.59%	1.79%
BBgBarc U.S. Govt/Credit Intermediate	-1.22%	-1.48%	-4.54%	-5.07%	-0.41%	0.70%	0.81%
Barclays U.S. Aggregate	-4.32%	-4.75%	-14.61%	-14.60%	-3.26%	-0.27%	0.89%
Barclays U.S. High Yield	-3.97%	-0.65%	-14.74%	-14.14%	-0.45%	1.57%	3.94%
S&P/LSTA Leveraged Loan	0.04%	0.04%	-3.22%	-2.51%	2.28%	2.98%	3.53%
Barclays Global Aggregate	-5.14%	-6.94%	-19.89%	-20.43%	-5.74%	-2.32%	-0.93%
JPM GBI EM Global Diversified	-4.87%	-4.73%	-18.57%	-20.63%	-7.06%	-3.92%	-2.43%
U.S. Equity Indices							
DJ Industrial Average	-8.76%	-6.17%	-19.72%	-13.40%	4.36%	7.42%	10.45%
S&P 500	-9.21%	-4.88%	-23.87%	-15.47%	8.16%	9.24%	11.70%
NASDAQ Composite (Price)	-10.50%	-4.11%	-32.40%	-26.81%	9.75%	10.24%	13.00%
Russell 1000	-9.25%	-4.61%	-24.59%	-17.22%	7.95%	9.00%	11.60%
Russell 1000 Growth	-9.72%	-3.60%	-30.66%	-22.59%	10.67%	12.17%	13.70%
Russell 1000 Value	-8.77%	-5.62%	-17.75%	-11.36%	4.36%	5.29%	9.17%
Russell Mid Cap	-9.27%	-3.44%	-24.27%	-19.39%	5.19%	6.48%	10.30%
Russell 2500	-9.53%	-2.82%	-24.01%	-21.11%	5.36%	5.45%	9.58%
Russell 2000	-9.58%	-2.19%	-25.10%	-23.50%	4.29%	3.55%	8.55%
Russell 2000 Growth	-9.00%	0.24%	-29.28%	-29.27%	2.94%	3.60%	8.81%
Russell 2000 Value	-10.19%	-4.61%	-21.12%	-17.69%	4.72%	2.87%	7.94%
Non-U.S. Equity Indices							
MSCI World	-9.26%	-6.08%	-25.13%	-19.25%	5.06%	5.84%	8.69%
MSCI ACWI	-9.53%	-6.71%	-25.34%	-20.29%	4.23%	4.96%	7.84%
MSCI ACWI Ex-U.S.	-9.94%	-9.80%	-26.18%	-24.79%	-1.07%	-0.34%	3.48%
MSCI EAFE	-9.31%	-9.29%	-26.76%	-24.75%	-1.38%	-0.36%	4.15%
MSCI EAFE Growth	-9.70%	-8.45%	-32.82%	-30.06%	-1.18%	1.03%	5.08%
MSCI EAFE Value	-8.91%	-10.12%	-20.61%	-19.62%	-2.20%	-2.14%	2.98%
MSCI Europe	-8.68%	-10.11%	-28.42%	-24.33%	-1.16%	-0.65%	4.05%
MSCI Japan	-10.22%	-7.52%	-26.11%	-29.02%	-2.29%	-0.26%	5.18%
MSCI AC Asia	-11.84%	-11.58%	-27.09%	-28.70%	-1.62%	-0.66%	4.16%
MSCI EAFE Small Cap	-11.45%	-9.75%	-31.82%	-31.74%	-1.78%	-1.41%	5.66%
MSCI ACWI Ex-U.S. Small Cap	-10.99%	-8.25%	-29.07%	-28.57%	0.80%	-0.16%	4.83%
MSCI Emerging Markets	-11.67%	-11.42%	-26.89%	-27.80%	-1.71%	-1.44%	1.42%
MSCI EM Asia	-13.18%	-13.87%	-28.56%	-29.21%	-0.47%	-0.73%	3.43%
MSCI China	-14.54%	-22.44%	-31.12%	-35.29%	-7.06%	-5.42%	2.56%
MSCI EM Eastern Europe	-13.27%	-21.88%	-87.05%	-88.02%	-46.12%	-28.44%	-15.47%
MSCI EM Latin America	-3.24%	3.72%	3.36%	0.80%	-3.02%	-2.28%	-1.96%
MSCI EM Small Cap	-9.99%	-5.03%	-23.88%	-22.76%	6.01%	1.67%	3.28%
MSCI Frontier Markets	-9.24%	-6.34%	-25.49%	-24.94%	-1.01%	-0.97%	3.97%
Hedge Fund Indices							
IQ Hedge Long/Short	-6.66%	-7.15%	-20.80%	-19.23%	-0.15%	0.72%	--
IQ Hedge Multi-Strategy	-3.85%	-2.87%	-11.83%	-11.74%	-1.02%	0.26%	1.75%
Real Assets Indices							
FTSE NAREIT Composite	-13.21%	-11.19%	-28.24%	-17.24%	-1.68%	3.55%	6.55%
Alerian MLP	-7.62%	8.05%	18.90%	19.56%	4.46%	1.90%	0.66%
Bloomberg Commodity	-8.11%	-4.11%	13.57%	11.80%	13.45%	6.96%	-2.14%
S&P Global Infrastructure	-11.78%	-9.64%	-10.09%	-5.98%	-0.13%	2.10%	5.66%
Other							
Oil Price Brent Crude	-8.84%	-23.39%	13.09%	12.02%	13.11%	8.86%	-2.42%
CBOE Market Volitility (VIX)	22.23%	10.14%	83.62%	36.65%	24.87%	27.16%	7.23%

Source: Morningstar

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