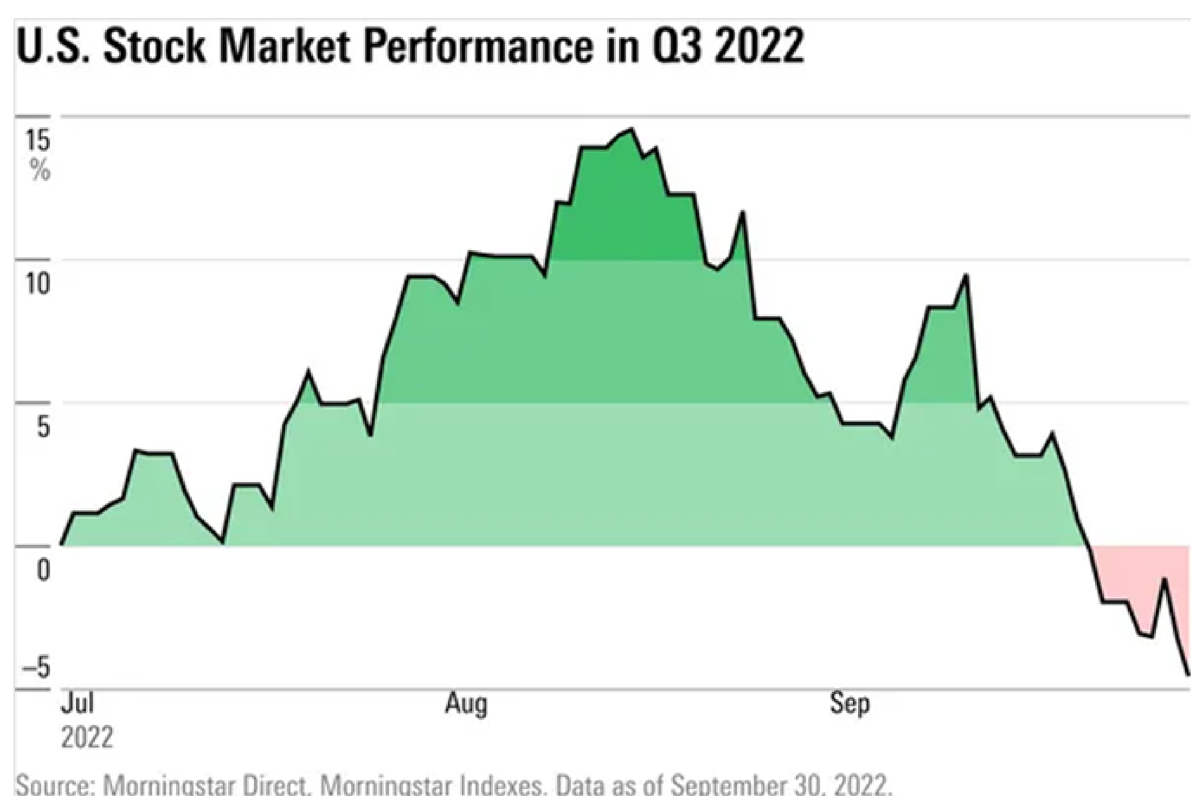
Market Commentary

The Quarter in Review – 3Q 2022

Performance

Equities fell sharply for a third straight quarter in 3Q 2022. The last instance of three consecutive negative quarters was in the aftermath of the Global Financial Crisis in 2009. The biggest fear factor for investors has been the pronounced tightening of financial conditions driven by expectations of a more aggressive global rate hike cycle. Stocks had managed to bounce nicely off their mid-June lows until inflation data in August came in hotter than expected. This closely watched report, coupled with a still tight labor market and the Fed reiterating that fighting inflation was their number one priority, was enough for market participants to fear "something will break" before their work is done. The Fed hiked short-term interest rates by an additional +0.75% in both July and September, prompting economists and market strategists to increase their odds for a recession in 2023. Equity declines have been widespread, and the Energy sector remains the only winner with an outlying +34.94% return for the year thus far. The DJIA "led" the major U.S. indexes with a decline of -6.17% for the quarter, while the S&P 500 and the tech-heavy NASDAQ fell -4.88% and -3.91%, respectively. Non-U.S. equities suffered far worse results amidst global currency debasement and turmoil overseas with the MSCI EAFE Index down -9.29% and the MSCI Emerging Markets Index losing -11.42%.



ABOUT THE FIRM

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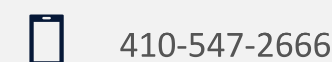
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When equity markets struggle, fixed income securities usually provide an anchor to windward. This has not been the case thus far in 2022. Bonds faced continued pressure in Q3 with the yield curve hitting its most inverted level this century. The 2-Year U.S. Treasury yield was up nearly +1.30% to just over 4.20% and 10-Year yields rose nearly +0.85% to just over 3.80%. As the ascent in yields continued, particularly on the short end of the yield curve, so did the move lower in bond prices. For the quarter, the Barclays Intermediate Government/Credit Bond Index and the Barclays 5-Year Municipal Bond Index declined -3.06% and -2.71%, respectively. This marks the third consecutive quarter of negative returns for both stocks and bonds. How rare is this? Looking at data going back to 1976, it has never happened. Analyzing the 187 quarters over the 46-year period, we found 21 quarters where both stock and bond returns were negative. Prior to 2022, the most recent quarter was 1Q 2018. There were just five instances of negative returns for two consecutive quarters, and until now, zero occurrences of three consecutive negative quarters for both asset classes.

Is All the Bad News Priced in Yet?

By quarter end, all three major U.S. equity indices, as well as the non-U.S. developed and emerging market barometers, were solidly in bear market territory. As mentioned, fixed income returns have also been historically tenuous. With such weak returns in response to global supply and demand shocks, tightening monetary policy, high inflation, and recession fears, at what point is all the bad news priced into the markets? The valuation of the market cap weighted S&P 500 Index, as measured by the forward 12-month Price/Earnings (P/E) multiple, has declined from 21.2x at the start of 2022 to 15.4x at the end of 3Q 2022. This pales in comparison to the five and ten-year average P/E of 18.6x and 17.1x, respectively. Put simply, the forward 12-month P/E is an indication of what investors are willing to pay today for a stock or index based on its expected future earnings. We are painfully aware of the 'P' (price) input of the equation and are very mindful of the significance of the 'E' (earnings) input. At the beginning of the year, 2023 earnings estimates for the S&P 500, based on data collected by FactSet, stood at $251. As of the end of September, that estimate declined to $241, a mere $10, or -4%, slide. So, with the S&P 500 Index down -24% year-to-date, -4% of that is attributable to a decline in earnings expectations, and the remainder is due to 'multiple compression' based on the impact of higher interest rates, higher inflation, and a generally less optimistic view of the future. Thus far, despite the turmoil, earnings expectations have held up surprisingly well. Earnings expectations for the full year 2022 remain at +7.4%, with revenue growth of +10.7%, unchanged from three months ago. Earnings expectations for the full year 2023 are currently +7.9%, with revenue growth of +4.4%. 3Q 2022 earnings season is about to begin and the results, 4Q 2022 guidance, and outlooks regarding profitability and the business environment for next year will be key to the market's path forward. A convincing case could be made now that if you were to look at the valuation for the "average" stock in the market, that stocks are fairly valued. For instance, the P/E for the equal-weighted S&P 500, counting every company equally as opposed to proportionally based on size, is currently 12.6x. In addition, based on our analysis, if you exclude the ten biggest names from the S&P 500 and look at the P/E of the remaining "S&P 490," the market trades at a P/E of only 12.8x. These levels do give us some comfort when considering recent bear market bottoms of 2002, 2009, and 2020 equated to P/E multiples bottoming out at an average of 12.2x.

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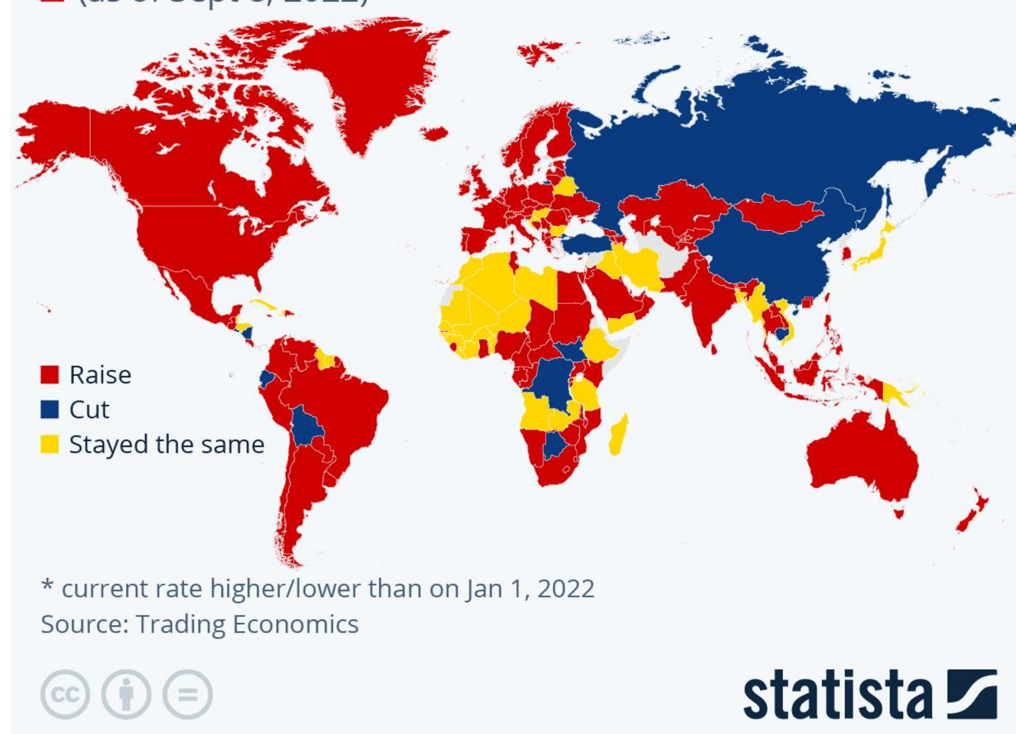
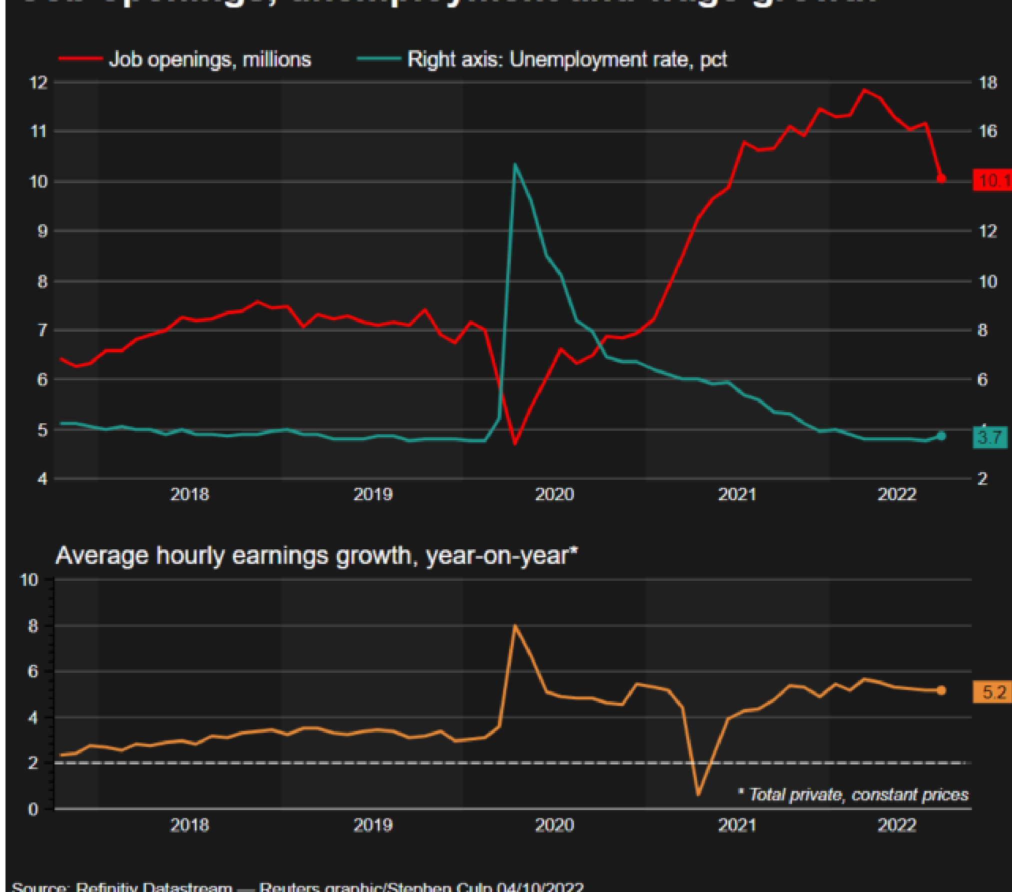
Has the FOMC Done Enough Already?

There is undoubtedly a lag effect on the economy via monetary policy. The great debate now, and the question that no one can answer, is just how high will the Fed raise rates in order to get inflation under control and will they go too far? The last time we had inflation this high was in the 1980s. That was also the last time monetary policy was broadly used as a tool for price stability. The Fed, and other central banks around the globe, have been lifting rates for seven months now and we are approaching restrictive territory. Global financial markets have taken notice. Economists have been ratcheting up their forecasts for how high they expect the Fed to hike short term interest rates before stopping, referred to as the terminal or "peak Fed Funds rate." At the end of the quarter, that level was expected to be 4.50% by April of 2023, a sharp increase from the 3.30% expectation as recently as the July FOMC meeting, and before the August CPI data release came in higher than anticipated. All eyes will be on the September CPI data release, which is expected in mid-October.

The Fed has been saying they want to kill job openings, not existing jobs. In August, according to the Bureau of Labor Statistics (BLS), job openings plunged by more than a million, from 11.1 to 10.05 million, providing some proof that the labor gap may be beginning to close and associated wage pressures could start to ease. With approximately 6 million unemployed, and an unemployment rate of 3.5%, the labor market has been historically tight with 2 job openings per person seeking employment. The new data suggests this ratio has narrowed to 1.67 to 1.



In addition, there are already some signs that parts of the economy are starting to slow. Although headline inflation figures remain stubbornly high, there are some examples of prices softening. Manufacturing activity, as measured by the Institute of Supply Management (ISM), grew at its slowest pace in nearly two and a half years in September. A recent report from the Commerce Department revealed that construction spending dropped -0.7% in August, its largest decline since February 2021, as single-family home building fell by -2.9%. On the inflation front, many commodity prices have fallen considerably from recent highs, and used vehicle prices have come down appreciably. The Bureau of Economic Analysis' (BEA) initial 3Q U.S. GDP estimate will not be released until October 27, but we know that GDP decreased at an annual rate of -1.6% in 1Q and -0.6% in 2Q. The consecutive GDP decline technically indicates that the U.S. may already be experiencing a recession. However, the GDP data will have several revisions and the National Bureau of Economic Research (NBER) will be the ultimate and official arbiter of such a classification. There is certainly no precedent or playbook for the global shocks that have combined of late: a pandemic, supply chain distortions, massive fiscal stimulus, inflation, and war. The majority of Americans are worried about the economy and so are the country's business leaders. According to a survey of 400 U.S. CEOs conducted by KPMG, 90% say they believe a recession will occur within the next year. More than half said they expected earnings to be impacted next year, but more than 80% said they were confident in their company's ability to weather an economic downturn.



Outlook

While much of this current market environment takes on a gloomy tone and this year has seen broadly negative performance across asset classes, there are some reasons to be optimistic. We will soon be entering the seasonally strong period for stocks. Since 1990, according to Fidelity Investments, the S&P 500 has gained an average of ~+2% from May through October, compared to an average of ~+7% from November through April. Interrelated, the fourth quarter of the calendar year is historically the strongest for equities. Since 1928, the S&P 500 Index has averaged a return of +2.7% in Q4, versus +1.6% in Q1, +2.2% in Q2, and +1.3% in Q3. Further, the upcoming midterm elections could be construed as a positive. Early voting may have already begun in some jurisdictions, but election day is November 8, and all 435 seats in the House of Representatives will be up for grabs as well as 34 of the 100 seats in the Senate. In the last 18 midterm elections, the S&P 500 has been positive every time in the 12 months following and has been up +15.1% on average.

In our opinion, this is not a matter of politics but rather psychology. The market simply does not like uncertainty. Once election results are in the rear-view mirror, regardless of the outcome, there will be more clarity regarding policy outlook from our nation's capitol. As always, and maybe now more than ever, we appreciate the continued confidence you have placed in us and encourage you to reach out with any questions or concerns you may have regarding planning or your portfolio(s) as we approach the end of another year.

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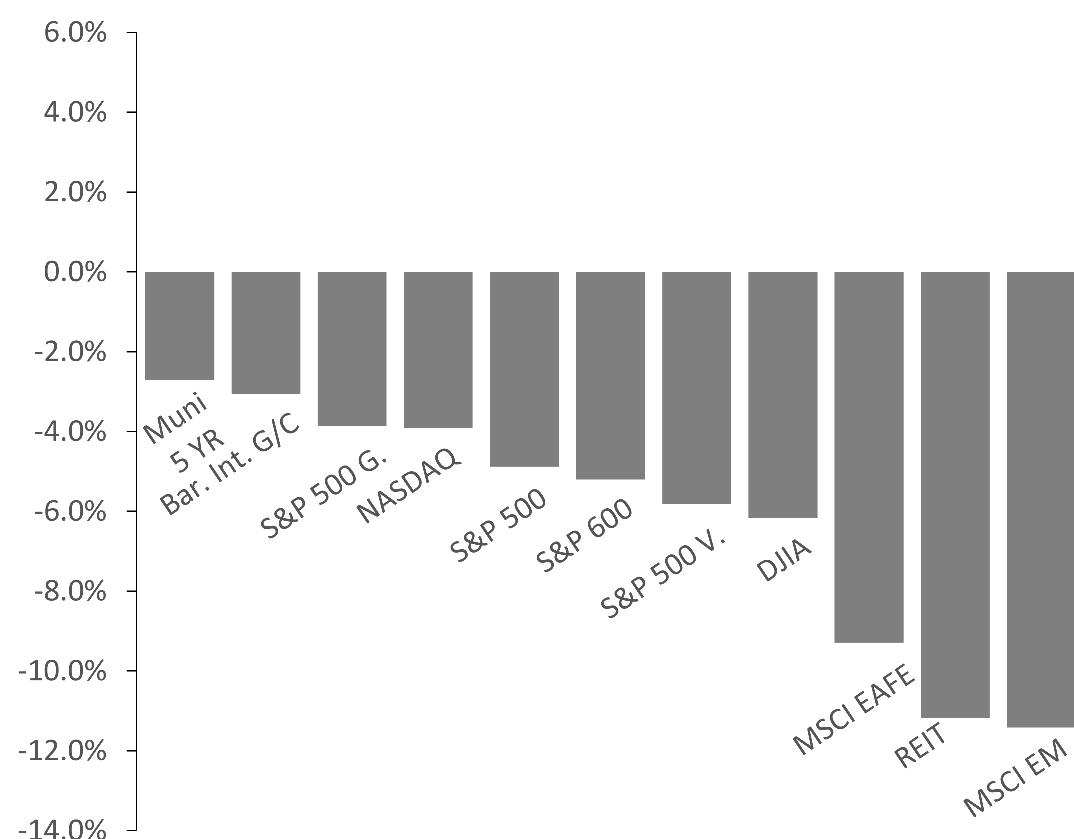
Ranked by 3Q 2022 Performance

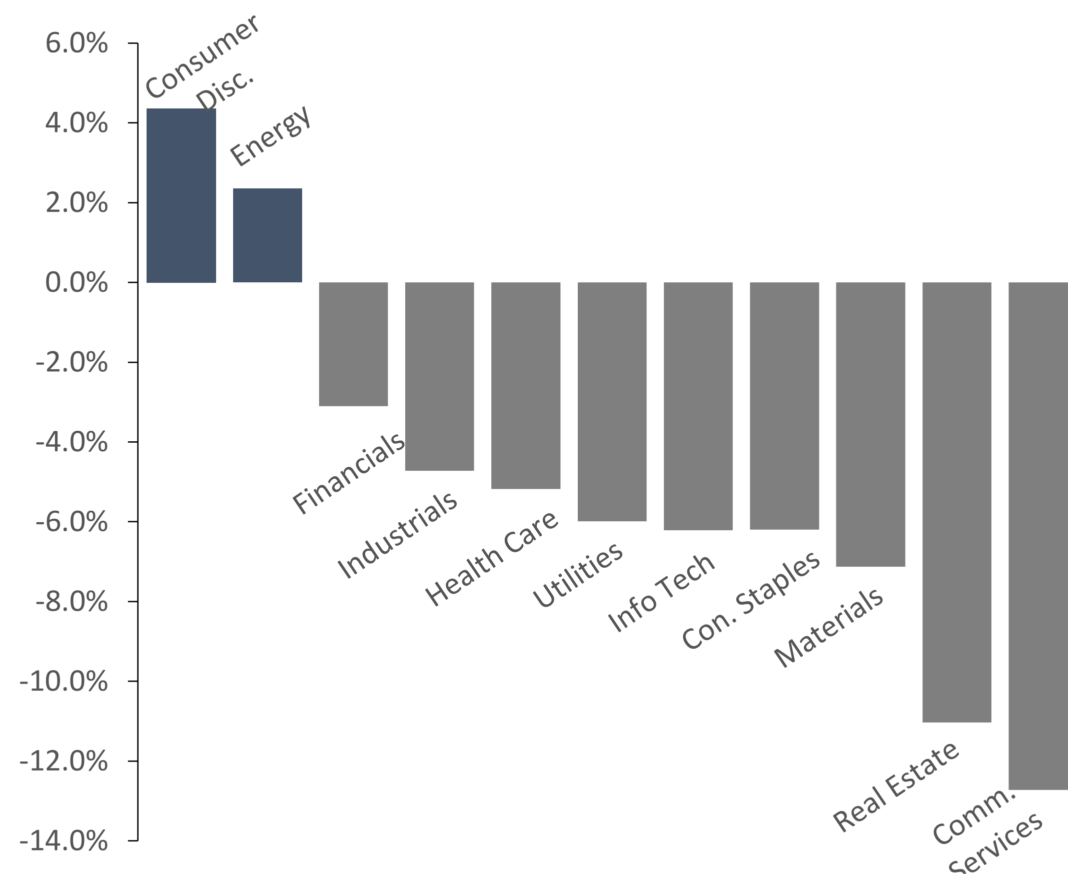
Major Market Indices	Jul	Aug	Sep	Qtr	YTD
Barclays Cap Muni Bond – 5 YR	1.82%	-1.69%	-2.80%	-2.71%	-8.06%
Barclays Int G/C (Bond Ind)	1.63%	-2.00%	-2.67%	-3.06%	-9.62%
S&P 500 Growth	12.82%	-5.34%	-9.98%	-3.86%	-30.41%
NASDAQ Composite	12.39%	-4.53%	-10.44%	-3.91%	-32.00%
S&P 500	9.22%	-4.08%	-9.21%	-4.88%	-23.87%
S&P 600 (Small Cap)	10.01%	-4.39%	-9.88%	-5.20%	-23.16%
S&P 500 Value	5.91%	-2.84%	-8.47%	-5.82%	-16.56%
DJIA	6.82%	-3.72%	-8.76%	-6.17%	-19.72%
MSCI EAFE (International)	4.99%	-4.74%	-9.31%	-9.29%	-26.76%
NAREIT All REIT	8.74%	-5.92%	-13.19%	-11.18%	-28.34%
MSCI Emerging Markets (EM)	-0.16%	0.45%	-11.67%	-11.42%	-26.89%

U.S. Industry Groups	Jul	Aug	Sep	Qtr	YTD
Consumer Discretionary	18.94%	-4.57%	-8.06%	4.36%	-29.89%
Energy	9.72%	2.83%	-9.28%	2.35%	34.94%
Financials	7.21%	-2.01%	-7.76%	-3.10%	-21.25%
Industrials	9.50%	-2.81%	-10.48%	-4.72%	-20.72%
Health Care	3.32%	-5.78%	.2.60%	-5.18%	-13.08%
Utilities	5.50%	0.51%	-11.34%	-5.99%	-6.51%
Information Technology	13.54%	-6.12%	-12.01%	-6.21%	-31.44%
Consumer Staples	3.30%	-1.75%	-7.99%	-6.62%	-11.83%
Materials	6.14%	-3.47%	-9.35%	-7.13%	-23.74%
Real Estate	8.54%	-5.61%	-13.15%	-11.03%	-28.85%
Communication Services	3.71%	-4.19%	-12.15%	-12.72%	-39.04%

3Q 2022 Index Returns



3Q 2022 Industry Group Returns



Source: FactSet

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