Market Commentary

As of September 30, 2022

Economy & Market Review

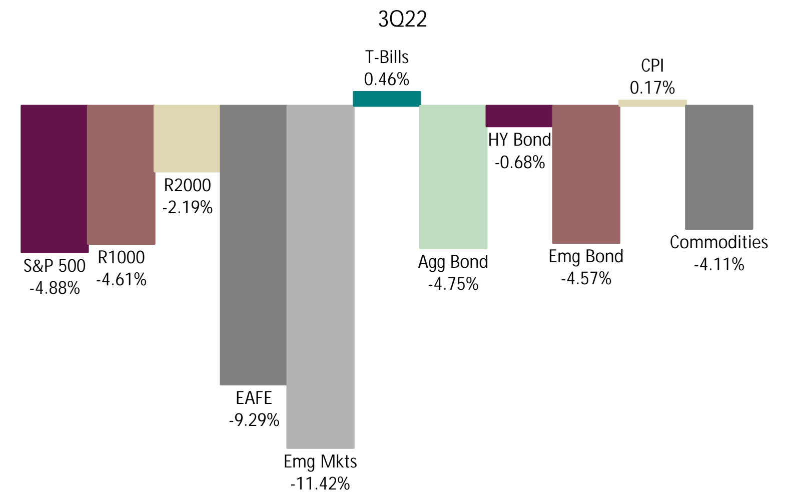
Third Quarter 2022

In an effort to quash the inflation that the Federal Reserve (Fed) helped cause (and sought), they have been raising interest rates sharply at each Federal Open Market Committee (FOMC) meeting. This action has provided a challenge for both the stock and bond markets. Historically, equity markets have experienced three negative quarters in a row and likewise the bond market has been down three quarters in a row, but not until this year have both the stock and bond markets fallen together for three consecutive quarters. During the quarter, US large cap stocks dropped another 4.9%, US small caps fell 2.2%, developed non-US stocks were down 9.3% and emerging market equities tumbled 11.4%. After plummeting 5.9% and 4.7% in the first two quarters of the year, bonds fell another 4.8% during the quarter. As the Fed verbally prepares the markets for further rate increases, a reduction in its balance sheet and slower economic growth, globally, other central banks are anxious. For instance, the Bank of England which previously had a restrictive economic policy to lessen inflation, pivoted to an easier monetary policy due to issues in the foreign exchange markets. The foreign exchange market pressures are due to a surging US dollar. Each Fed rate increase and additional dollar strength puts enormous pressure on developed and particularly emerging markets.

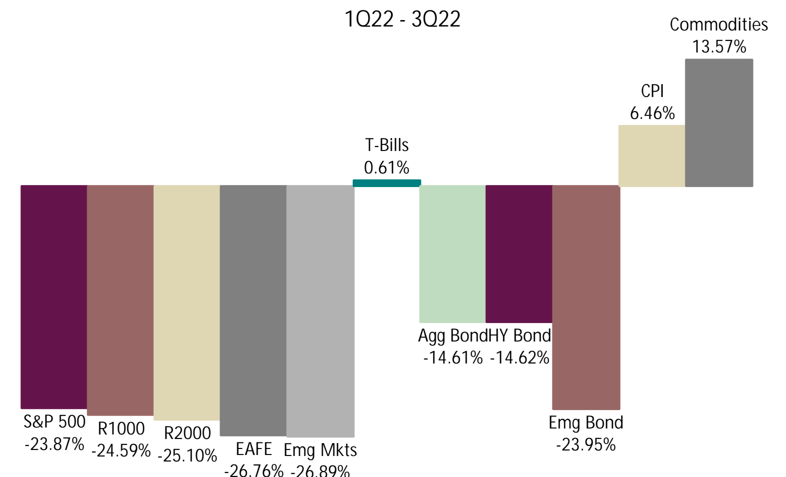
To limit inflation, the US Central Bank is trying to slow consumer consumption and therefore the economy, but so far the economy has been fairly resilient. Only recently have some metrics started to slow. Both the ISM manufacturing index and factory orders came in below estimates. From an employment perspective, the JOLTS (Job Openings and Labor Turnover Survey) decreased to 10.1 million through August. This compares to an estimate of 10.8 million and a previous number of 11.2 million. Unemployment remains low at 3.5%. Other areas of the economy, housing in particular, are feeling the impact of quickly rising interest rates. Pending Home sales are down both month-over-month and year-over-year with prices likely to decline as 30 year mortgage rates have moved from 2.73% at year-end to roughly 7% currently, altering affordability. The Fed actions are reminiscent of the 1990's movie, “Thelma and Louise” in which after creating chaos they decide the only way out is to drive off the edge of the Grand Canyon. Let's hope the Fed doesn't drive the economy off the cliff.

Global Market Performance

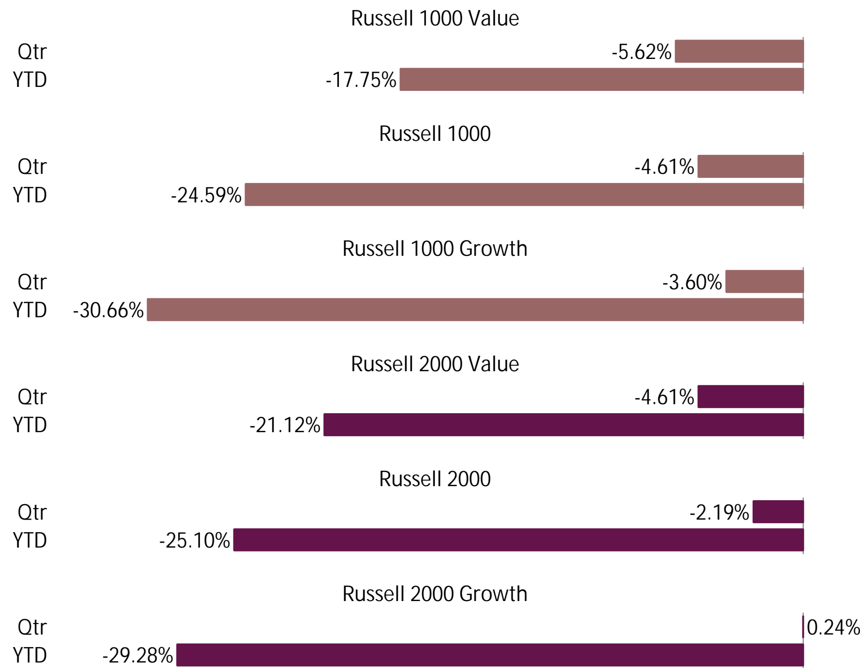
Quarter Performance



Year To Date Performance



U.S. Equity Markets

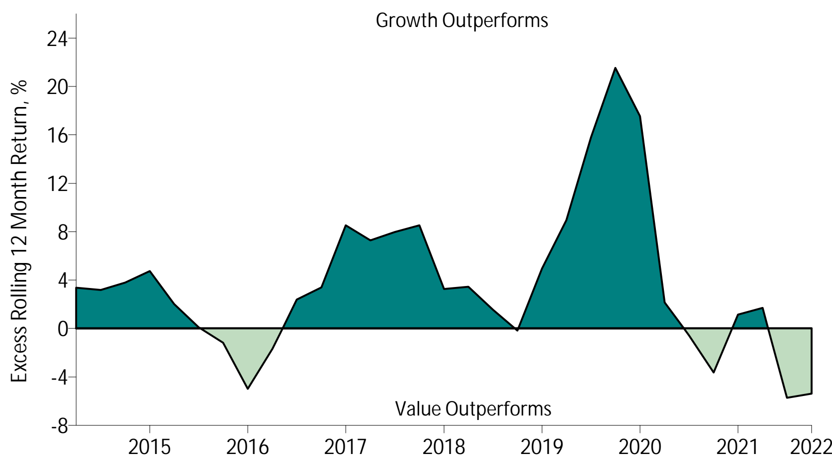


As rates rise, slowing growth and likely earnings, equity markets continue to sell-off. The Russell 1000 Index of large cap stocks decreased 4.6% during the quarter and 17.2% for the year. Small cap stocks as measured by the Russell 2000 Index fell 2.2% for the quarter and 23.5% for the year. US stock valuations, although lower with the continued market performance, still don't appear cheap. The current Price-to-Earnings ratio (P/E) of 15.2x is only slightly lower than the 25 year average of 16.8x, and many other valuation metrics still register above their respective 25 year averages.

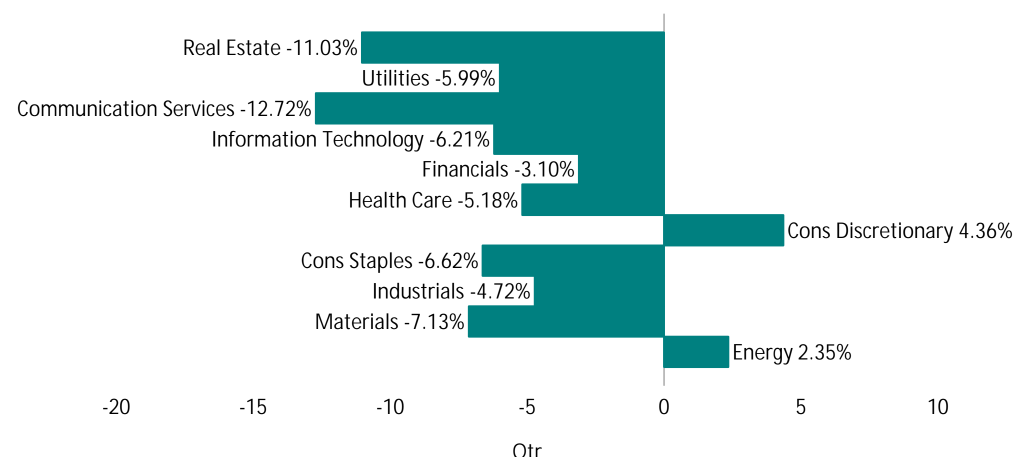
Breaking a recent trend, growth stocks outperformed value stocks during the quarter. Small cap growth was actually counter-trend for the quarter providing a slightly positive return. Last quarter's commentary highlighted that small growth had the most reasonable valuation relative to historic metrics in recent memory. Based upon a comparison of current P/E to 20-year average P/E, all valuations by style except large growth trade at discounts, but only small cap is meaningfully below average.

Even with the additional negative equity market returns, two sectors provided positive results, Consumer Discretionary and Energy. Energy markets have some external forces impacting performance. Communication Services, Real Estate, and Materials sectors were the worst performers as economic growth becomes a major concern.

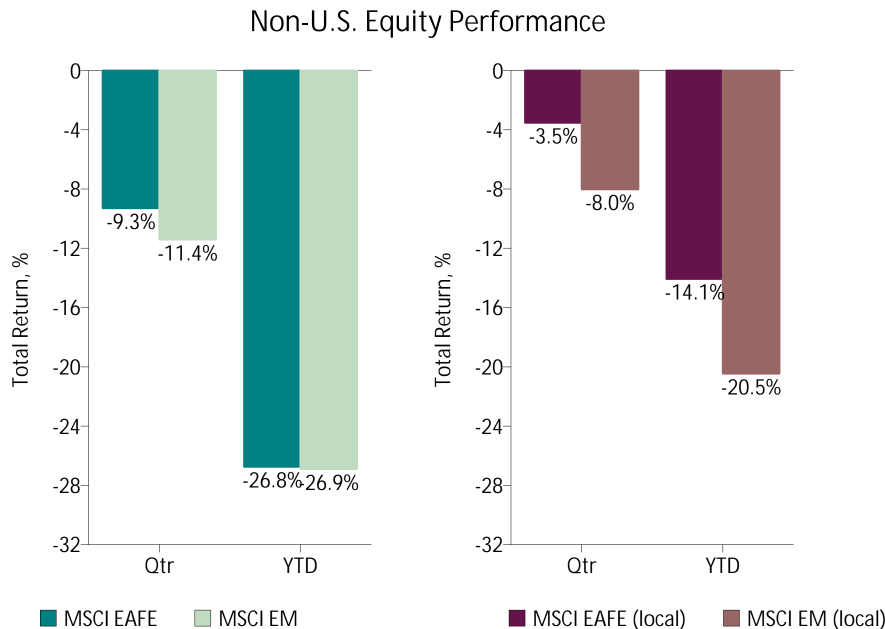
Growth Relative to Value (Russell 1000)



U.S. Equity Sector Performance (S&P 500)

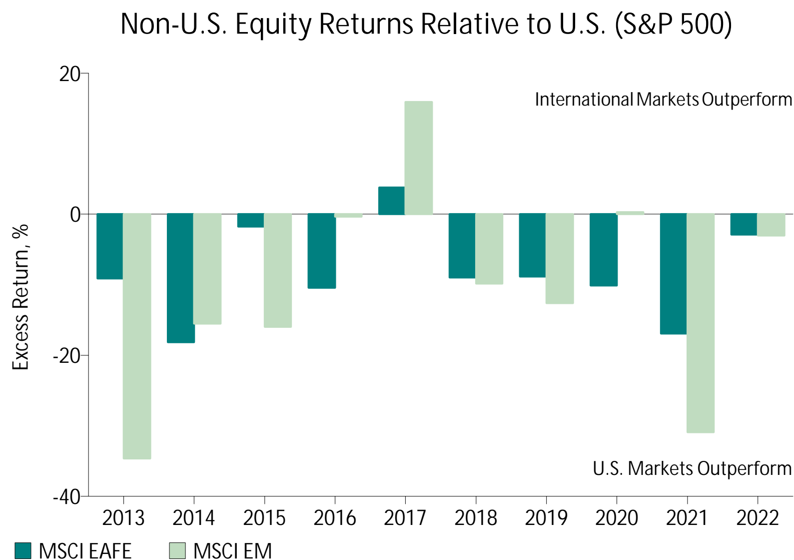


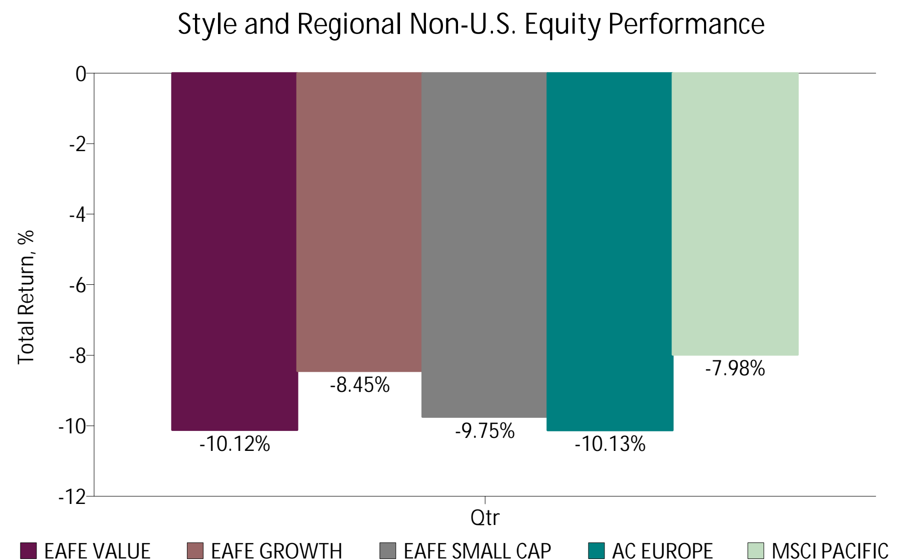
International Equity Markets



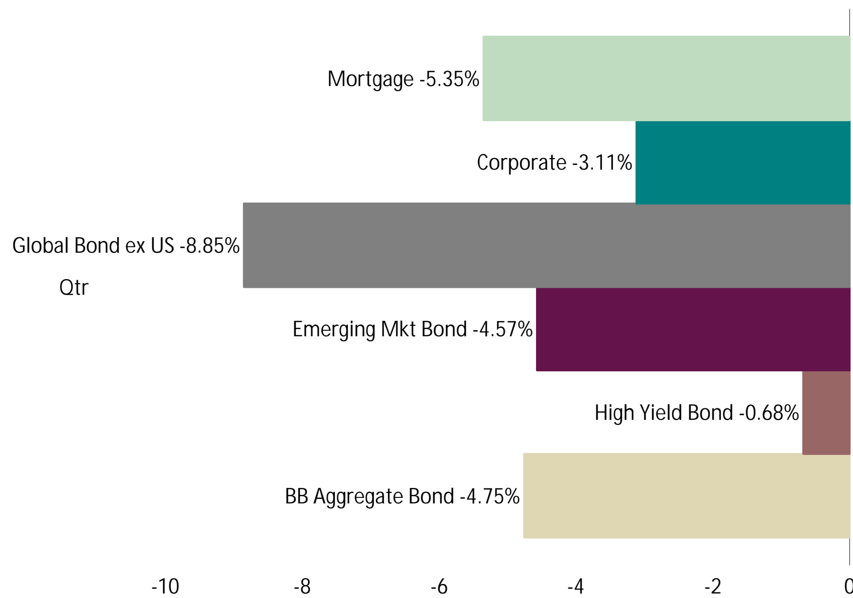
As mentioned above, US dollar strength is really causing difficulties for both international economies and their investment markets. For instance, during the quarter the EAFE Index was down 3.5% in local currency, but down a whopping 9.3% in US dollar terms. Although the Fed's hawkish monetary policy is a major reason for the dollar strength, the US economy is still looking much better than other advanced economies adding to international pressure. A currency isn't strong or weak on its own; it can only be so compared to another currency. At this point, it isn't apparent whether it's a strong dollar or incredibly weak fiat currencies around the globe. Historically, the US dollar has been a safe haven in volatile times.

Developed markets, Europe in particular, continue to deal with extremely high energy costs and rapidly slowing economies. The MSCI EAFE Index, a proxy for large international developed equity markets, was down 9.3% during the quarter and 24.7% over the last year easily underperforming the US markets. Emerging markets (EM) relative returns were even worse for the respective time periods down 11.4% and 27.8%. Whether due to COVID or simply for control purposes, China's continued market underperformance continues to weigh on emerging markets as China is about one-third of the emerging market index.



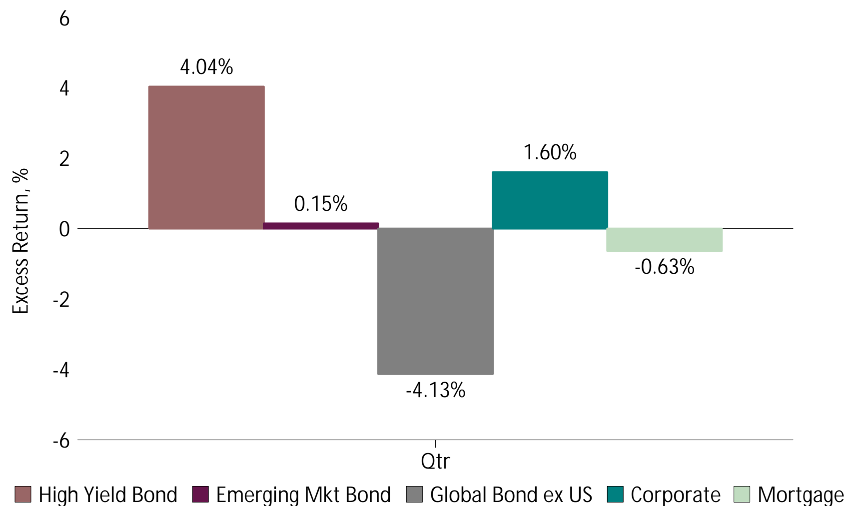


Fixed-Income Markets



Cash and cash-like investments are finally yielding a return. The yield still is less than inflation, but improving nonetheless. During the ultra-low interest rate environment of the last decade, a saying developed called TINA (There Is No Alternative) to risk assets. Now there is an alternative and the bond market is feeling the squeeze. As interest rates rise, bond prices fall producing negative returns, but at some point bonds and bond funds reflect those increased yields too. The time may be approaching that bonds present value we haven't seen in a while. As the Fed continues to drive short rates higher, longer-dated maturities have been impacted, but not to the same extent. The resulting inverted yield curve has the 10 Year – 2 Year spread as negative as it has been since March of 2000. The US 10 Year yield started the quarter at 2.98% escalating quickly to the current 3.89%.

Internationally, the strong dollar and rising global interest rates placed an exceptional strain on global bonds. As a result, the Global Bond Ex-US Index was down almost 9% for the quarter. Similar to last quarter, this was much worse than the Bloomberg Barclays Aggregate Index, a proxy for the US market, which was down 4.8%. Corporate credit and high yield continue to hold up reasonably well in light of much higher rates and a slowing economy. Since high yield has still experienced low default rates, the High Yield Bond Index was only down less than 1% during the quarter.



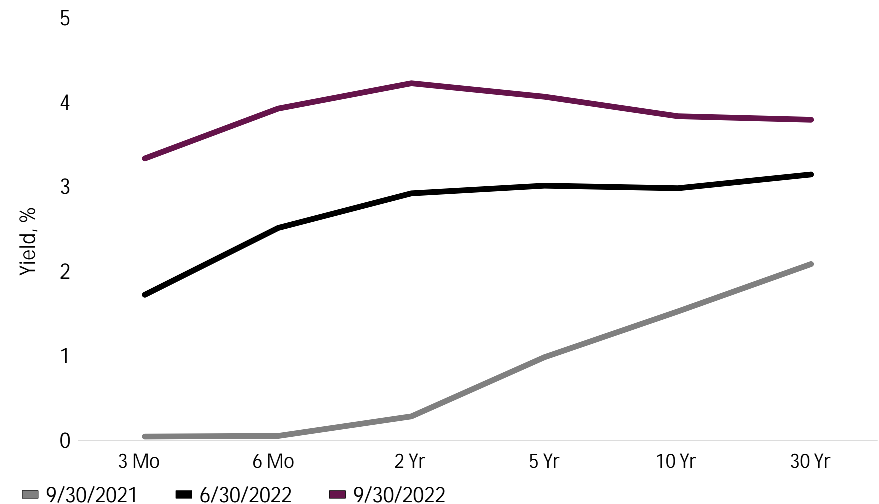
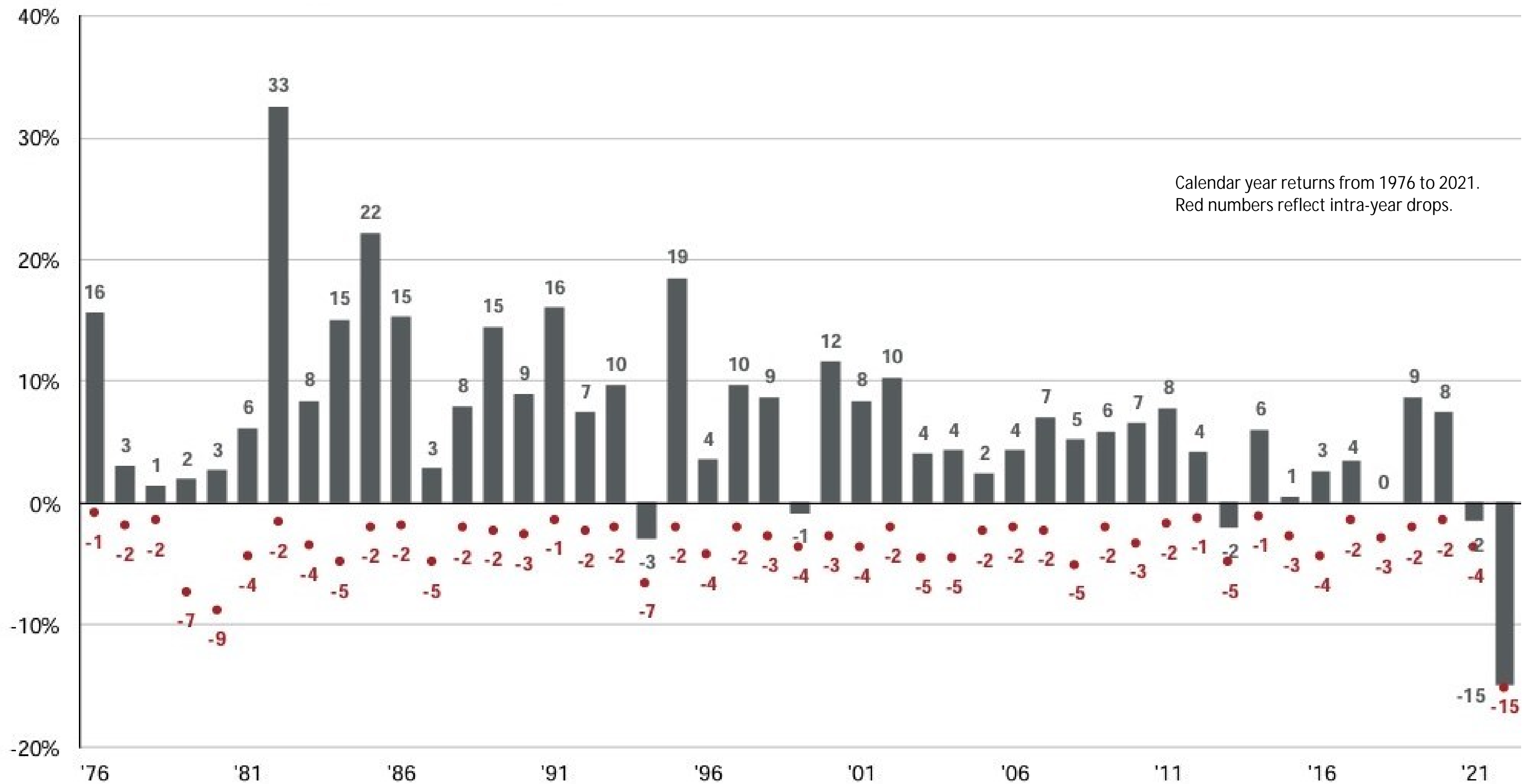


Chart of the Quarter

Bloomberg US Aggregate Bond Index



The above chart illustrates the significant impact of Fed interest rate policy in 2022. As you will see reflected in the graph, a normal intra-year drop (red) is around 3% in any one year. Bond markets historically have provided positive annual returns in 42 of 46 years going back to 1976. Nothing could have prepared investors for the 15% downdraft in bond returns we are seeing in 2022. The real tragedy is that normally bonds provide a hedge to volatile stocks. 2022 will go down as the year investment modeling based on historical returns and risk characteristics goes out the window. We deceive ourselves when we believe that past stock or bond market patterns provide the framework by which we can predict the future.

2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Annualized Return
				Small Cap Stocks 21.31%	Emerging Mkt Stocks 37.75%		Large Cap Stocks 31.43%				
Emerging Mkt Stocks 18.63%				High Yield 17.49%	International Stocks 27.77%		Small Cap Stocks 25.52%	Gold 24.61%			
International Stocks 17.39%				Large Cap Stocks 12.05%	Large Cap Stocks 21.69%		International Stocks 22.13%	Large Cap Stocks 20.96%			
Large Cap Stocks 16.42%		Large Cap Stocks 13.24%		Commodities 11.77%	Small Cap Stocks 14.65%		Emerging Mkt Stocks 18.90%	Small Cap Stocks 19.96%			
Small Cap Stocks 16.35%		Real Estate 12.49%		Emerging Mkt Stocks 11.60%	Gold 12.66%		Gold 18.43%	Emerging Mkt Stocks 18.69%	Commodities 27.11%		
High Yield 15.58%	Small Cap Stocks 38.82%	US Bonds 5.97%		Real Estate 8.76%	60/40 Blended Index 12.07%		60/40 Blended Index 16.50%	60/40 Blended Index 12.24%	Large Cap Stocks 26.45%		
60/40 Blended Index 11.09%	Large Cap Stocks 33.11%	60/40 Blended Index 5.51%		Gold 8.10%	Intl/EM Bonds 10.41%		High Yield 14.41%	International Stocks 11.13%	Real Estate 22.18%		
Real Estate 10.94%	International Stocks 15.78%	Small Cap Stocks 4.89%	Real Estate 15.01%	60/40 Blended Index 7.85%	Real Estate 7.62%		Intl/EM Bonds 9.98%	Intl/EM Bonds 7.90%	Small Cap Stocks 14.82%		
Intl/EM Bonds 10.60%	60/40 Blended Index 14.85%	High Yield 2.50%	Large Cap Stocks 0.92%	Intl/EM Bonds 5.77%	High Yield 7.48%		US Bonds 8.72%	US Bonds 7.51%	60/40 Blended Index 10.05%		
Gold 8.26%	Real Estate 13.94%	Intl/EM Bonds 2.08%	US Bonds 0.55%	International Stocks 5.01%	US Bonds 3.54%	Real Estate 8.35%	Commodities 7.69%	High Yield 6.17%	International Stocks 8.29%	Commodities 13.57%	-1.49
US Bonds 4.22%	High Yield 7.42%	Gold 0.12%	60/40 Blended Index 0.11%	US Bonds 2.65%	Commodities 1.70%	3-month T-Bills 1.87%	Real Estate 5.35%	Real Estate 1.17%	High Yield 5.36%	Real Estate 13.07%	10.94
3-month T-Bills 0.11%	3-month T-Bills 0.07%	3-month T-Bills 0.03%	3-month T-Bills 0.05%	3-month T-Bills 0.33%	3-month T-Bills 0.86%	US Bonds 0.01%	3-month T-Bills 2.28%	3-month T-Bills 0.67%	3-month T-Bills 0.05%	3-month T-Bills 0.61%	0.64
Commodities (1.06)%	US Bonds (2.02)%	Emerging Mkt Stocks (1.82)%	Intl/EM Bonds (2.42)%			Gold (0.93)%		Commodities (3.12)%	US Bonds (1.54)%	Gold (7.43)%	0.82
	Emerging Mkt Stocks (2.27)%	International Stocks (3.44)%	Small Cap Stocks (4.41)%			High Yield (2.26)%			Emerging Mkt Stocks (2.22)%	US Bonds (14.61)%	1.20
	Intl/EM Bonds (4.13)%	Commodities (17.01)%	High Yield (4.64)%			Intl/EM Bonds (3.17)%			Gold (4.33)%	High Yield (14.62)%	4.69
	Commodities (9.52)%		International Stocks (5.25)%			60/40 Blended Index (3.71)%			Intl/EM Bonds (4.44)%	60/40 Blended Index (15.80)%	6.15
	Gold (27.33)%		Gold (12.11)%			Large Cap Stocks (4.78)%				Intl/EM Bonds (23.85)%	0.29
			Emerging Mkt Stocks (14.60)%			Small Cap Stocks (11.01)%				Large Cap Stocks (24.59)%	12.32
			Commodities (24.66)%			Commodities (11.25)%				Small Cap Stocks (25.10)%	9.28
						International Stocks (13.78)%				International Stocks (26.18)%	4.23
						Emerging Mkt Stocks (14.25)%				Emerging Mkt Stocks (26.89)%	2.42