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Newsletter Highlights

Equities and bonds posted sharp declines in the third quarter as the Fed demonstrated resolve in fighting the highest rate of inflation in 40 years

- The S&P 500 ended the quarter at a fresh bear market low and 25% below the record high reached in early January
- Expectations for higher rates drove bond yields to the highest level in 15 years

The odds of a recession are rising as the economy adjusts to the most aggressive pace of policy tightening in 40 years

- After delivering a third consecutive 75-basis point rate hike in September, policymakers at the Fed expect to announce an additional 1% of rate increases in the fourth quarter
- Early signs of pressure are evident in the U.S. housing market, where a surge in borrowing costs recently contributed to the first monthly decline in home prices since 2012

We maintain a cautious view on equities due to various near-term headwinds

- Elevated inflation and the strong dollar are likely to drive downward earnings revisions in the months ahead
- For the first time in years, income-oriented investors have attractive options outside of equities when it comes to earning a reasonable level of yield

Now is not the time to second-guess one’s long-term strategy

- Equities are a leading indicator, and historical performance data suggests that stocks rebound several months before the economy exits a recession
- The highest bond yields in 15 years offer fixed income investors attractive forward returns
For months markets have anxiously awaited clarity around such events as the Russia-Ukraine conflict, ongoing lockdowns across China and monetary tightening by global central banks. Unfortunately, as the fog begins to lift on the economic outlook, investors do not like what they see.

As the war in Ukraine enters its eighth month, economic sanctions have done little to motivate Russian President Vladimir Putin to end a conflict that has already claimed thousands of lives and sparked an energy crisis in Europe. Meanwhile, manufacturing activity has fallen sharply in China as the world’s second largest economy remains unswervingly committed to its zero-COVID policy. Finally, after enjoying years of loose monetary policy, nearly 80% of the world’s major central banks are being forced to sharply reverse course in response to inflationary pressures.

Although recent economic data and corporate earnings have shown impressive resilience in the face of these headwinds, we expect the U.S. economy to undergo a transition over the next several quarters as the impacts of global events and aggressive policy tightening make their way into the real economy.

Markets often move ahead of the data, so it is important to invest based on where one thinks the economy is going rather than looking in the rear-view mirror. In anticipation of a more challenging investment environment, we have continued to cut risk across our strategies throughout the year by shifting to more defensive sectors of the market and reducing our broad exposure to equities.

In this quarterly update, we will discuss the evolution of our views as the economic landscape comes into focus. In addition, we will share data to put recent market performance into proper context. Ultimately, volatility can test the nerves of even the most seasoned investors, but it is important to remember that the market rewards discipline over the long-term.

**Powell Gives Investors a Reality Check in the Third Quarter**

Investors enjoyed a great start to the third quarter, as a better-than-expected earnings season and hopes of less aggressive Fed tightening drove the S&P 500 to a gain of nearly 14% through mid-August. It was not long before some analysts were claiming that the worst was over and a new bull market in stocks was underway. As we now know, the summer rally would prove short-lived.

We have all come to embrace the old Wall Street mantra: “Don’t fight the Fed.” In recent years, this meant that when the Fed was openly committed to providing monetary policy support, investors should take policymakers at their word and view it as a green light to engage in risk-seeking behavior. Unfortunately, those who got caught up in the recent equity market rebound failed to realize that not fighting the fed applies to both easing and tightening cycles. Although the Fed has been clear about its commitment to using aggressive rate hikes to combat the highest inflation in 40 years,
those who celebrated the summer rally chose to ignore the Fed’s message. Whether it was the result of a market that was in denial about the persistent threat of inflation or investors who were trying to call the Fed’s bluff, it was clear that investors and policymakers were not on the same page.

In his speech at the Jackson Hole Economic Symposium in late August, Fed Chair Jerome Powell was left with no choice but to regain control of the narrative. During less than ten minutes of prepared remarks, the Fed Chairman left little room for interpretation about the direction of monetary policy, and markets immediately responded by declining more than 3% before the close of that day’s trading session.

In the weeks that followed, equity prices would experience a sharp downward adjustment as investors resigned themselves to the fact that the Fed meant business. In fact, the S&P 500 made a 30% roundtrip from the start of the quarter to finish September at the lowest level since late 2020 and 25% below its all-time high.

Unfortunately, losses were not limited to the broader risk markets. The expectation of additional interest rate hikes drove bond yields to the highest levels in 15 years and resulted in a nearly five percent decline in the Bloomberg U.S. Aggregate Bond Index, bringing the year-to-date return of the asset class to -14%.

Fed Prescribes Stronger Medicine

At its September policy meeting, the Federal Open Market Committee (FOMC) demonstrated its commitment to defeating inflation by delivering its third consecutive 75-basis point rate increase. In addition, despite the most aggressive tightening cycle in more than 40 years and the highest policy rates since 2008, updated FOMC policy projections signaled expectations for an additional 1% of rate hikes in the fourth quarter.
As monetary policy becomes more restrictive, investors are growing increasingly concerned that the Fed’s actions will lead to a recession in the U.S. After all, the central bank does not have a great track record when it comes to orchestrating a soft economic landing. It is well-known that monetary policy acts with a lag, and time will tell whether the Fed can maintain its resolve as the impact from aggressive tightening begins to show up in economic data.

For now, Chairman Powell and his colleagues are likely to argue that the cure is not as bad as the disease. Said another way, some economic pain is a reasonable price to pay to avoid the risk of inflation becoming entrenched in the economy.

Policymakers are no doubt haunted by the ghost of Arthur Burns, who served as Fed Chairman from 1970 to 1978 and is often remembered for prematurely loosening policy as inflationary pressures began to ease. As we know, inflation would eventually resurface with a vengeance before finally being subdued after Paul Volcker drove interest rates north of 20%.

With the central bank’s credibility already damaged after dismissing initial signs of inflation as “transitory,” Fed officials are highly aware of the need to get it right now. Therefore, they are likely to wait for signs that inflation is firmly anchored at more normal levels before considering their mission complete.
Risk of a Recession Is on the Rise

After experiencing back-to-back declines in activity in the first two quarters of 2022, the U.S. economy now meets the general definition of a recession. Although this rule of thumb has been a good predictor of economic downturns in the past, the National Bureau of Economic Research (NBER) gets the final word when it comes to identifying the beginning and end of a business cycle.

For their part, the economists at the NBER define a recession as a significant decline in economic activity that is spread across the economy and that lasts more than a few months. Although the odds of a future downturn have increased, it is likely too soon to label this an official recession.

Correction Underway in Housing Market

The clearest evidence of shifting economic tides is the U.S. housing market, where affordability issues recently drove home values to their first monthly decline since 2012. Although markets can vary by region, a quick look at the data suggests the housing correction is likely to continue at the national level.

For instance, the average rate on a 30-year mortgage recently topped 7%, nearly doubling the level available to borrowers three years ago. The issue around affordability is further complicated by the fact that home prices in the U.S. have increased by more than 40% since the start of the pandemic.

While discussions about weakness in the real estate market can bring back painful memories of the housing crisis, there are important differences between today’s environment and the events that reverberated across the U.S. economy roughly 15 years ago.

Thanks to the adoption of tighter lending standards, the majority of recent loans have been made to high quality buyers. Nearly 70% of new mortgage origination volume over the last two years has gone to borrowers with a credit score of 760 or higher, compared to just 25% in the years preceding the housing crisis.
In addition, research from Black Knight suggests that today’s homeowners are well positioned to withstand a readjustment in home values. Specifically, the data and analytics company found that the negative equity rate (i.e. those who are “underwater” on their homes) would rise to 0.9% and 1.9% if home prices declined by 5% and 10%, respectively. For context, during the height of the housing crisis, nearly 30% of homeowners owed more on their mortgage than their property was worth.

**U.S. Labor Market Remains Resilient**

Amid mounting evidence of economic headwinds, the strength of the current labor market is likely one reason the NBER remains reluctant to declare a recession. Over the last three months the U.S. had added more than 1.1 million jobs and currently boasts 11 million job openings (representing nearly 2 jobs for each unemployed worker).

In recent weeks, major technology companies including Google and Meta (formerly Facebook) have started to prepare for tougher times by announcing layoffs or hiring freezes. However, if the labor market is weakening it is not yet evident in the weekly data on initial jobless claims, which tracks the number of individuals claiming first-time unemployment benefits each week. In fact, this number is down nearly 30% from the level reached in mid-July, which speaks in part to the ease with which workers are finding new employment.

As we await the inevitable softening in the labor market as supply and demand come back into balance, it is important to acknowledge that the extremely tight labor market is hindering efforts of the Fed to rein in inflation. Due to the demand for labor, wages are up more than 5% over the past year, and companies are likely to share the burden of higher operating costs with their customers.
Equities Face a List of Headwinds

After seeing stocks decline 25% from their January peak, market valuations sit at the lowest level since early 2020. The forward price-to-earnings-ratio (which measures how much an investor is paying per unit of earnings over the next 12 months) of the S&P 500 recently fell to 15.2, below the 25-year average of 16.8.

This valuation metric assumes the estimate for future earnings is accurate, and we question whether today’s earnings assumptions (which suggest profit growth of nearly 10% over the next 12 months) reflect our current economic reality. After bellwethers like FedEx and Nike recently warned about difficult operating conditions, we expect to see earnings projections decline in the months ahead.

In addition to the well-known inflationary pressures facing companies, many are likely to experience headwinds related to the strength of the U.S. dollar. After more than a decade of steady appreciation against major foreign currencies, the dollar has surged nearly 20% in 2022 (to the highest level in 20 years) as higher interest rates and increased geopolitical concerns have sparked global demand for the greenback.

As a net importer, a strong dollar is not only a source of pride but also benefits the economy because it makes our imports less expensive. However, it is not viewed as favorably by investors since it can hinder the performance of multinational companies by making their products more expensive in overseas markets. With foreign-sourced revenue accounting for nearly 40% of sales in the S&P 500 index, investors are no doubt mindful of the additional risks a rising dollar

Although investors may enjoy temporary relief rallies over the short-term like the one experienced during the summer, it will likely take time for the market to enjoy a durable rebound. Furthermore, the next bull market will likely have to rely on fundamentals instead of relative valuations for support.

In recent years, the market has enjoyed a unique tailwind thanks to unprecedented monetary policy moves that drove bond yields to historically low levels. This environment drove many would-be bond investors to stocks in hopes of earning a decent return to the point it became known simply as “TINA” – There Is No Alternative.
As we have seen, these accommodative actions were not without their costs, and policymakers are now taking aggressive steps to reverse course in hopes of restoring price stability. As a result, for the first time in more than a decade, equities will have to compete with a bond market that offers reasonable levels of income. After surging to 4.2% at the end of September, the 2-year Treasury note now offers a higher yield than nearly 90% of companies in the S&P 500.

The Case for Stocks and Bonds

As we turn the page to the fourth quarter, it appears highly likely that stocks and bonds will both finish the year in negative territory. Although most commentary focuses on investment returns over short-term periods, it is ultimately long-term performance that drives the success of one’s financial plan.

Despite the daunting headwinds facing both stock and bond investors in the current environment, there are a few important points for investors to keep in mind.

As we have observed, equities are a leading indicator and will generally decline sharply in anticipation of a recession. However, data suggests that the market has historically started to rebound several months before a recession is over as investors begin to see a light at the end of the tunnel. Therefore, if one is planning to sit on the sidelines while they wait for the “all clear” signal, they are likely to miss a large portion of the initial rally.

Meanwhile, there is no sugarcoating the recent weakness across fixed income, and many investors no doubt feel betrayed by the lack of support offered from their bond investments during this period of stock market volatility. However, it is important to remember why investors own bonds in the first place – for income. Income has historically accounted for more than 90% of bond returns, and with yields now at the highest level in 15 years, bonds can finally offer reasonable forward returns.
Although we have been active in reducing portfolio risk across our strategies since the beginning of the year, the risks we were seeking to protect against have changed. In recent months our concerns around inflation (which has now likely peaked) have been replaced by worries about an economic downturn driven in part by the Fed’s aggressive response towards high price levels.

In today’s environment, it is important to remain diversified and not give up on traditional asset classes that have exhibited short-term underperformance. While we often advise against significant deviations from one’s long-term strategy, we also believe that minor portfolio adjustments should be made to account for changing market conditions.

Within equities we have reduced our broad allocation to stocks and shifted towards more defensive sectors of the market. Meanwhile, thanks to the sharp rise in bond yields this year, one no longer has to rely on riskier sectors of the bond market as an additional source of return.

Therefore, we recently rebalanced towards higher quality bonds such as government and agency-backed debt. Finally, we continue to utilize uncorrelated investments (i.e. alternative investments) such as commodities to provide additional diversification to portfolios.
Time Is on Your Side

Although no one enjoys seeing losses in their portfolio, it is important to remember that bear markets are a normal part of an investment cycle and over the long-term the good times tend to far outweigh the bad. In fact, the average bear market has historically lasted just over one year and seen stocks decline by -35%, while historical bull markets have lasted for more than five years months and seen stocks rise by 192%.

In the weeks and months ahead, we will remain disciplined but nimble as we navigate the changing landscape. As always, any portfolio changes we make will be based on data and research rather than market noise and headlines.

If you have any concerns about your portfolio, we encourage you to review your financial plan with your advisor.

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