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Q4 2022 Newsletter | Jeff Griggs, CFA

Due to the wide range of risk tolerances of our clients, some topics or asset classes may have more, less, or no importance to your portfolio. For a detailed analysis, give us a call, or request a detailed performance review.

Big Picture

Equities continued their downward march in the third quarter with inflation and the labor market remaining stubbornly problematic. The Fed has doubled down on its tightening policy raising the target rate by 3% so far this year. China's strict COVID policy, Russia's invasion of Ukraine, and the tight US labor market continue to weigh heavily on the global economy and the prospects for risk assets.

I had expected a natural slowing of the labor market as more "voluntarily unemployed" re-entered the job market after sitting out during the pandemic, and a natural easing of inflation as pandemic related supply chain issues sorted themselves out. It now appears that these expectations were misguided and becomes increasingly apparent that the only way to rein in inflation will be for the Fed to manufacture a recession and put the bargaining power back in employer's hands by forcing lay-offs and increasing the unemployment rate. A recession appears unavoidable at this time, and even the so-called Fed Put is being called into question. So far, everything but risk assets have largely shrugged off the aggressive tightening the Fed has thus far conducted, I believe policy makers are surprised by the resilience we are seeing in labor markets, economic activity, and subsequently inflation. Which makes me wary to assume they will act aggressively to drop the target rate and prop up the economy in the face of the recession they are currently hoping for.

On the Fridge

Floating Rate Bonds

Once again floating rate bonds were the best performing asset class that we track, returning just 0.6% in the quarter, narrowly beating cash at 0.5%.

Consumer Discretionary

The consumer discretionary was the best performer in the quarter, rising 4.4% and it was one of only two sectors that finished in the black with Energy taking second place at 2.3%.

In the Dog House

Emerging Markets

With global recession fears and many developed economies propping up their currencies with interest rate hikes, emerging market stocks fell –11.4% in the quarter, good for last place.

Communication Services

The communication services sector was the worst performer in the third quarter, falling –12.7%. Netflix (+35%) and Twitter (+17%) were the only two companies in the sector that posted a positive return in the quarter.

Looking Ahead

2022 has seen a clear transition from the optimism to the despair phase of the economic cycle. The despair phase can be defined as the period where the market moves from peak to trough, this is the phase usually associated with bear markets, recessions, P/E multiple contraction and deteriorating macroeconomics. The question now becomes when will we transition to the next hope (recovery) phase, and the answer lies largely with Fed policy. The hope phase of an economic cycle is historically the shortest, yet strongest, phase of the cycle accounting for about 2/3 of bull market returns.

Timing the transition from despair to hope is exceedingly difficult. The hope phase nearly always starts during a recession when the economy is weak, and corporate earnings are still deteriorating. Most bear markets trough 6 to 9 months before a recovery in corporate earnings. Price recovery occurs in anticipation of, not in response to, profit recovery. While a shift in Fed policy could lead to a sustained transition into the hope phase, I believe the Fed has been surprised and disappointed with the lack of effectiveness of their rate hikes and will remain convicted to their hawkish strategy well into 2023. Although, a significant reduction in inflation expectations could change that prognosis quickly and would likely trigger a lasting market recovery. The fourth quarter will be defined by volatility as market participants attempt to foretell whether the latest inflation print is indicative of a robust trend, or simply an anomaly. In the mean time, valuations are not yet consistent with historical market troughs.

Links and Articles

Now Comes the Hard Part
A sobering commentary from famed economist, fund manager and long-time bear John Hussman.

Where are the Workers?
John Mauldin explains some of the curiosities we are seeing in the labor market.

Tempted to Time the Market?
This short Bloomberg article highlights several charts that show the risk of getting out of the market.

Different Strings Similar Story
Liz Ann Sonders of Charles Schwab speculates on recession through the lens of leading indicators.

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Performance

Both stocks and bonds continued their retreat in the third quarter, with bonds falling -6.9% and stocks falling -6.7%. International bonds fared the worst of the fixed income subclasses, losing -8.8% in the face of dollar strength. Corporates lost 5.1% while Treasuries lost 4.3%. International equities underperformed the US market with developed markets falling 9.1% and emerging markets down 11.4%. Year-to-date that brings bonds down 20% and stocks down 25% for an absolutely devasting year for diversified portfolios so far this year. In fact, 2022 may go down as the worst year ever for a diversified 60/40 portfolio.

	Benchmark Index	2022 Q3	YTD	LTM	3yr	5yr	10yr
Cash	**Bloomberg US Treasury Bill 1-3 M TR USD**	0.5%	0.6%	0.6%	0.6%	1.1%	0.6%
Fixed Income	**Bloomberg Global Aggregate TR USD**	-6.9%	-19.9%	-20.4%	-5.7%	-2.3%	-0.9%
Fixed Income Blend	Bloomberg Global Aggregate TR USD	-6.9%	-19.9%	-20.4%	-5.7%	-2.3%	-0.9%
Government	Bloomberg US Government TR USD	-4.3%	-12.9%	-12.8%	-3.1%	-0.2%	0.5%
Inflation Protected	Bloomberg US Treasury US TIPS TR USD	-5.1%	-13.6%	-11.6%	0.8%	2.0%	1.0%
Municipal	Bloomberg Municipal TR USD	-3.5%	-12.1%	-11.5%	-1.9%	0.6%	1.8%
Floating Rate	Bloomberg US Trsy Floating Rate TR USD	0.6%	1.1%	1.1%	0.8%	1.3%	0.0%
Corporate	Bloomberg US Corp Bond TR USD	-5.1%	-18.7%	-18.5%	-3.7%	0.0%	1.7%
High Yield	Bloomberg US Corporate High Yield TR USD	-0.6%	-14.7%	-14.1%	-0.5%	1.6%	3.9%
International Bond	Bloomberg Gbl Agg Ex USD TR USD	-8.8%	-23.9%	-24.8%	-7.8%	-4.0%	-2.4%
Equity	**MSCI ACWI GR USD**	-6.7%	-25.3%	-20.3%	4.2%	5.0%	7.8%
Equity Blend	MSCI ACWI GR USD	-6.7%	-25.3%	-20.3%	4.2%	5.0%	7.8%
US Equity	MSCI USA GR USD	-4.7%	-24.8%	-17.2%	8.1%	9.2%	11.7%
Developed Markets	MSCI World ex USA GR USD	-9.1%	-25.9%	-23.5%	-0.7%	0.1%	4.1%
Emerging/Frontier	MSCI EM GR USD	-11.4%	-26.9%	-27.8%	-1.7%	-1.4%	1.4%
Alternatives	**Wilshire Liquid Alternative TR USD**	-1.9%	-7.3%	-6.7%	0.6%	0.8%	1.2%
Alternatives Blend	Wilshire Liquid Alternative TR USD	-1.9%	-7.3%	-6.7%	0.6%	0.8%	1.2%

Sector	2022 Q3	6mo	YTD	1yr	3yr	5yr	10yr
Information Technology	-6.2%	-25.2%	-31.4%	-20.0%	14.9%	16.7%	17.1%
Financials	-3.1%	-20.1%	-21.2%	-17.7%	4.9%	5.5%	11.4%
Health Care	-5.2%	-10.8%	-13.1%	-3.4%	12.5%	10.2%	13.7%
Consumer Discretionary	4.4%	-22.9%	-29.9%	-20.9%	6.7%	10.5%	13.2%
Consumer Staples	-6.6%	-10.9%	-11.8%	-0.1%	6.2%	7.6%	9.5%
Industrials	-4.7%	-18.8%	-20.7%	-13.9%	4.0%	4.9%	10.4%
Energy	2.3%	-2.9%	34.9%	45.7%	13.4%	6.1%	3.5%
Utilities	-6.0%	-10.8%	-6.5%	5.6%	3.7%	7.8%	9.9%
Materials	-7.1%	-21.9%	-23.7%	-12.2%	7.6%	5.9%	8.6%
Communication Services	-12.7%	-30.8%	-39.0%	-39.1%	-0.1%	2.0%	3.8%
Real Estate	-11.0%	-24.1%	-28.8%	-16.4%	0.4%	5.8%	7.8%

Source: Morningstar; The 1,3,5, and 10 year performance is annualized.

Among the sectors, Consumer Discretionary performed the best rising 4.4% while energy extended its dominance on the year rising 2.3% in the quarter, to put it up 35% year-to-date. Energy remains the only sector that has provided a positive return on the year, with the second-best being utilities at -6.5%. Factor-wise, growth actually outperformed value a bit in the quarter, falling 3.6% vs. 5.9% for the value factor. While it may only be temporary it is a marked reversal from the year-to-date relative performance which has value (-17.8%) outperforming growth (-32.4%) by nearly 15%. The worst performing factor this quarter was high yield which fell 7.7% but remains the top performing factor on the year down just 16.3%.

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Asset Class	Benchmark	Description
Cash	Bloomberg US Treasury Bill 1-3 M TR USD	Measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.
Fixed Income	Bloomberg Global Aggregate TR USD	The Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers.
Government Bonds	Bloomberg US Government TR USD	The Bloomberg US Government Bond Index comprises the US Treasury and US Agency indices. The index includes US Dollar-denominated, fixed-rate, nominal US Treasuries and US agency debentures (securities issued by US government owned or government sponsored entities, and debt explicitly guaranteed by the US government).
Inflation Protected	Bloomberg US Treasury US TIPS TR USD	The Bloomberg US Treasury Inflation-Linked Bond Index (Series-L) measures the performance of the US Treasury Inflation Protected Securities (TIPS) market.
Municipal	Bloomberg Municipal TR USD	The Bloomberg U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.
Floating Rate	Bloomberg US Trsy Floating Rate TR USD	The Bloomberg US Treasury Floating Rate Index measures the performance of floating rate bonds issued by the US Treasury.
Corporate Bonds	Bloomberg US Corp Bond TR USD	The Bloomberg US Corporate Bond index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.
High Yield Bonds	Bloomberg US Corporate High Yield TR USD	The Bloomberg 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.
International Bonds	Bloomberg Gbl Agg Ex USD TR USD	The Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers. This version excludes USD-denominated debt.
Equity	MSCI ACWI GR USD	The MSCI ACWI captures large and mid cap representation across 23 Developed Markets and 23 Emerging Markets countries. With 2,477 constituents, the index covers approximately 85% of the global investable equity opportunity set.
US Equity	MSCI USA GR USD	Captures broad US equity coverage. The index includes 3,108 constituents across large, mid, small, and micro capitalizations, representing about 99% of the US equity universe.
Developed Market Equity	MSCI World ex USA GR USD	Captures large and mid cap representation across 22 of 23 Developed Market countries, excluding the United States. With 1,023 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Emerging Market Equity	MSCI EM GR USD	The MSCI Emerging Markets Index captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 829 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Alternatives	Wilshire Liquid Alternatives TR USD	Measures the collective performance of the five Wilshire Liquid Alternative strategies that make up the Wilshire Liquid Alternative Universe, including the Wilshire Liquid Alternative Equity Hedge, Global Macro, Relative Value, Multi-Strategy, and Event Driven indices. This index is meant to provide a representative baseline for how the liquid alternative investment category performed as a whole. Constituents comprised of '40 Act mutual funds.
US Large Cap Equity	S&P 500	Widely regarded as the best gauge of large-cap US Equities. The S&P 500 is a market-weighted index that includes 500 leading companies and captures approximately 80% coverage of available market capitalization.