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FINANCIAL PARTNERS

Q3 2022

MARKET REVIEW

A brief recovery rally in July fizzled out as policymakers signaled their determined intent to bring inflation back under control, pulling markets down in the process.

3Q2022 Quarterly Review

LEEWARD FINANCIAL PARTNERS

Containing inflation is painful

Markets bounced in July, recovering from oversold levels and encouraged by better-than-expected corporate earnings. By August the rally fizzled, cut short by hawkish comments from Federal Reserve Bank (Fed) Chair Powell and stubbornly hot inflationary data. The downward trend continued in September, as the Fed announced a 3rd consecutive 0.75% rate hike and raised its forecast for the terminal rate (the rate at which the Fed will stop raising rates) up 0.5% to 4.5% from 4.0%. The net result has been a third consecutive quarter of negative returns for both equity and fixed-income markets.

While weakness this year has been painful, it has not been unexpected. The lingering uncertainty of risks stemming from global energy markets, the Russia/Ukraine war, the housing market in China, and the mid-term elections stateside have produced a turbulent downward-biased market. Continued inflationary pressure throughout the global economy has not brightened the picture, but in fact, has stiffened the resolve of policymakers to pump the brakes on the economy to bring prices under control, at the expense of financial markets.

What has been surprising is the increased aggressiveness of the Federal Reserve Bank in the current environment. At the September Federal Reserve meeting, Chairman Powell acknowledged that raising rates higher for longer would be painful and that policy is not going to get more accommodative for markets until there is evidence that inflation is falling, and the labor market is cooling.

The upward revisions for expected interest rates, along with the shift in tone in the commentary suggest higher interest rates will be with us for some time, and in a vacuum, rising interest rates mean falling stock and bond prices. Inflation is at levels we've not seen since the early 1980s, and bonds are on course to post their worst year of performance on record.

So, where does that leave us?

This year has been tough. The S&P 500 Index declined another 5.3% in Q3, bringing year-to-date performance to -24.8%. Small-caps (-25.1%) and tech companies (-32.4%) underperformed, and strength in the U.S. dollar presented massive headwinds for investors in foreign equities. Bonds, which normally provide protection in period of equity market stress, have also declined precipitously as interest rates have risen. The U.S. bond market has delivered a total return of -14.4% over the year-to-date. To put that figure in perspective, the second worst year for bonds over the last 50 year was 1994, when the bond market fell around 3%. REITs (-27.9%) have also performed poorly, as they tend to correlate with equity returns, particularly during periods of market turbulence.

Currently, we are six months into a 'reset' period, where rates are rising, corporate earnings are being cut, and valuations are moderating. This period will continue in the near term with volatility remaining the name of the game – in other words, we are likely to continue to see recovery rallies, followed by pullbacks. Opportunities will emerge for tactical repositioning, but by and large, our goal is to remain conservative until we gain confidence that positive upward momentum is building.

What's keeping us up at night?

Fortunately, nothing economically structural. Unlike the case during the Global Financial Crisis, we haven't seen signs of major systemic issues which may portend a longer, more severe economic and market downturn. While rising interest rates will eventually make it more difficult for companies to refinance their debt, we're not yet seeing any material increase in loan payment delinquencies or bankruptcies, meaning that companies are still able to access the capital they need to finance their operations. While the housing market is turning over, it's doing so after a period where low mortgage rates pushed up home values past where they probably should have been, and Covid-related supply and labor disruptions curtailed new housing development, creating a near-term supply shortage.

This is a completely different environment than the Global Financial Crisis, where we saw the popping of a speculative bubble in the housing market, and a surge in corporate credit spreads (higher interest rates for corporate loans) which cut off the circulation of capital to companies all over the world, paving the way for a high number of bankruptcies and later, layoffs.

To put it plainly, there are plenty of things to point at that are negative: leading economic indicators don't look great, sentiment is depressed, inflation is high, retail sales are low, and housing prices are falling. The economy is starting to run a little cooler, and for people around the world, the impact of this slowdown as well as higher prices in general, are being amplified by the weakness in foreign currencies relative to the dollar, which is eroding their purchasing power. Geopolitical risks remain elevated and are always a wildcard – it's rare that the negative geopolitical event of note ends up being the one that everyone was talking about in the preceding weeks and months. All these pieces of the puzzle warrant continued monitoring and vigilance, but we believe things are more likely to start improving incrementally rather than deteriorating quickly. Given that markets are forward-looking, we want to make sure portfolios are positioned for the rebound when it occurs.

Portfolio positioning

Portfolio positioning remains defensive and consistent with the last quarter. We remain underweight fixed income, emphasizing high-quality bonds in portfolios where we do have allocations. Our equity exposure is focused on domestic stocks, where we expect to add to our health care, staples, and utilities sectors as appropriate. We have stayed away from higher-risk asset classes, including real estate, smaller capitalization companies, cryptocurrency, and commodities in client portfolios.

There is potential to moderate our defensive positioning later in the fourth quarter. Any adjustments will depend on incremental data points and overall market levels. Over the next few weeks, we expect interest rates to increase, corporate earnings expectations to come down, and economic data to be lackluster. The outlook for safer, long-term bonds has improved markedly and we're considering adding exposure there over the next few months. First however, we'd like to get a few more months of inflation and labor market data, and hear what corporate management teams are experiencing in their businesses before making material portfolio adjustments.

So, where are the opportunities?

While the rise in interest rates has created some indigestion in financial markets, the higher level of current interest rates is starting to make the risk-reward trade-off for bonds more interesting. As of the end of the third quarter, the yield on the 30-year Treasury bond was 3.8%, meaning that if you were to buy a bond then and hold it to maturity in 30 years, you would earn 3.8% per year for 30 years in the "safe" or "bond" component of your portfolio. If inflation does start to fall and interest rates fall in tandem, bond portfolios will appreciate nicely, increasing the total return delivered above that 3.8% level. Longer-term, high-quality bonds are one of the areas of the market we're viewing most constructively.

In the stock market, we're leaning toward safer sectors such as Consumer Staples and Utilities, and we're monitoring smaller U.S. companies that may be best positioned to boom if a recovery gains some legs. The Energy sector may continue to perform well, and we may add further exposure there. From a global perspective, we remain overweight the U.S., and the U.S. dollar. Over the year-to-date, the United States has been the "cleanest dirty shirt" and given risks in Europe and China, this is likely to remain the case. Of course, to be early on these calls is to be wrong, and so we prefer a cautious approach – keeping portfolios close to long-term asset allocations designated in investment policy statements – until we get a clearer picture of what next year may bring.

Looking around the corner, earnings announcements over the next few weeks should provide a lot of insight into next year's earnings, and we're anticipating earnings expectations for next year will be cut 6-8%. It will be interesting to see how dire the energy situation gets in Europe as we approach the winter heating season. There is a risk that energy consumption caps prevent factories from operating at full capacity, though we believe some of the supply-side issues will moderate, preventing a surge in prices. Inflation is likely to fall considerably in the fourth quarter given recent disinflationary momentum. Favorable base effects as a result of the high inflation we experienced in Summer 2021 falling out of the trailing 12-month inflation calculation will be significant. It is important to note that falling inflation doesn't mean falling prices. If inflation were to fall to 0.0% in the next monthly reading that would mean that in aggregate, prices all stayed the same since last month. However, we think that it is possible that inflation does manage to fall from around 8% year-over-year to around 4% by the end of the first quarter of next year. If the Fed hikes rates to about 4.5% over the same time period as they're expected to, the setup for portfolios should be favorable as the Fed should feel more comfortable with loosening monetary policy if appropriate.

Conclusion

This year is shaping up to be the most challenging for investment portfolios in the last fifteen years. The rising rate environment has produced poor fixed-income returns, hitting conservative investors disproportionately hard. The economy is slowing and is likely already in a recession. Investors have reacted to the current environment by selling positions and pushing markets down throughout the year.

Despite these challenging market conditions, there is reason to be optimistic about year-end. A good deal of negative news flow has been priced in and we see a path emerging toward a more normal environment. Getting there is key. The fourth quarter has historically been the best period for market returns, and given the oversold level of markets at present, we believe the negative trajectory of the market may very well reverse sooner than later. Underpinning this view is our belief that markets are not structurally impaired. With time, asset values will recover and move higher. We are focused on positioning portfolios to be durable on the downside and to take advantage of opportunities to increase returns when recovery ultimately occurs. How quickly assets recover is always challenging to predict, but short of new, unforeseen exogenous events, we believe positive investment returns are closer rather than farther.

Thank you for your trust and partnership. Please reach out to us with questions and comments. We look forward to hearing from you.

Sincerely,

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