Q3 2022 Market Update

THE QUARTER IN BRIEF

Equity markets tried to bottom out in June and bounced higher in July and August as inflationary and economic headwinds appeared to abate. However, this reprieve was short-lived as higher-than expected inflation and weaker economic metrics in September sent markets back down to new lows. The third quarter proved difficult to navigate for traditionally allocated portfolios, with both stocks and bonds showing losses as markets digested a myriad of concerns.

Name	3 Month	Year to Date	1 Year	3 Year	5 Year
S&P 500 Total Return	-6.97%	-23.26%	-16.46%	29.13%	54.76%
S&P GSCI Total Return - Commodity Index	-1.06%	32.78%	30.16%	54.24%	58.88%
Russell 2000 Total Return	-4.04%	-23.86%	-23.24%	18.21%	19.65%
Russell 1000 Value Total Return	-5.67%	-16.46%	-12.19%	17.86%	29.82%
Russell 1000 Growth Total Return	-7.83%	-30.53%	-23.50%	36.46%	75.42%
MSCI World Ex USA Total Return	-8.74%	-25.39%	-22.97%	-0.07%	0.38%
MSCI Emerging Markets Total Return	-10.67%	-26.13%	-27.29%	-3.68%	-8.66%
Dow Jones US Real Estate Index Total Return	-15.42%	-31.58%	-22.28%	-9.09%	13.38%
Bloomberg US Treasury	-4.65%	-13.47%	-13.05%	-10.15%	-1.34%
Bloomberg US Aggregate	-5.07%	-14.83%	-14.58%	-10.20%	-1.44%
Bloomberg Municipal Bond	-3.77%	-11.40%	-10.69%	-5.24%	3.81%

 Returns through 10/11/2022

DOMESTIC MARKETS

Even though the US economy has already recorded two consecutive quarters of negative economic growth this year and the university of Michigan's consumer confidence survey has dropped close to its lowest levels in 50 years, most economic data published in the third quarter continued to highlight the resilience of the US economy.

This resilience is particularly true for the US labor market, with the latest employment and JOLTS (Job Openings and Labor Turnover Survey) reports showing plenty of momentum in the US jobs market as 315,000 payroll jobs were added across the economy in August and job openings are hovering around 11 million.

The tight labor market is also generating substantial household income gains, with wage and salary income rising by USD 1.04 trillion (or 10.0%) in the year ending in July, reflecting a 5.2% increase in average hourly earnings and a 4.1% rise in payroll jobs.

On the inflation front, consumer prices were flat in July and rose just 0.1% in August, with the year- over-year inflation rate falling to 8.2%. Markets nevertheless reacted badly to August's consumer price index (CPI) print, as the modest 0.1% increase for the month was almost entirely explained by a 10.5% decline in gasoline prices, while there were plenty of hotspots elsewhere, such as shelter costs, which rose by 0.7%. Overall, inflation is still expected to moderate in the coming months, but core inflation is expected to remain above the Fed's target.

That said, the Fed's tighter monetary policy is already cooling down some parts of the economy, such as the housing market, as 30-year fixed mortgage rates have risen to well above 6%, their highest level since 2007.

Consequently, housing activity data, such as existing home sales or the NAHB (National Association of Home Builders) homebuilder survey, have remained on a downward trend. This weakness has raised some fears of a repeat of the 2008 housing-led financial crisis. However, the housing market fundamentals are now much stronger as 95% of mortgages have long-term fixed rates while the percentage of subprime mortgages has dropped from 14% in 2008 to 2.3% today. Therefore, while we expect a continued slowdown in housing activity and economic growth, we don't expect a financial crisis.

ECONOMY

Central banks backed up their tough talk with policy rate hikes totaling 1.5% from the Fed, 1.25% from the European Central Bank and +1% from the Bank of England. Markets also moved to price in a much more aggressive path of future rate hikes, with rates now expected to rise to 4.5%, 3.5% and 5.75% by next year in the US, Europe, and UK respectively.

On the economic growth front, the data published over the third quarter, continued to point to a global growth slowdown. The J.P. Morgan Global Composite Purchasing Managers' Index (PMI) business survey entered contractionary territory in August for the first time since June 2020. Moreover, the local surveys showed that Europe, the UK, and the US are all already teetering on the verge of recession.

One positive, though, is that against a backdrop characterized by elevated inflation and slowing growth, global equity market valuations have now generally fallen below their 25-year averages. Even in the US, the market is currently trading on a price-to-earnings (P/E) ratio of 15.6 vs. a long- term average of 16.6. However, these valuations are based on current consensus analyst forecasts for earnings growth, which are gradually being revised down. Therefore, we could still potentially see further declines in equities.

LOOKING FORWARD

As we enter the fourth quarter, the global economy should continue to slow while some economies could enter recession. The magnitude of this potential recession will partly depend on the effectiveness of measures deployed by policymakers to reduce the impact of the energy crisis on households and businesses. Central banks, confronted with the biggest inflation shock since the 1970s, will most likely continue to prioritize the fight against inflation over supporting growth.

Overall, while the growth outlook remains challenging, many stocks are now already pricing in a relatively high probability of at least a moderate recession. Government bonds are now also pricing in a significant amount of further tightening. So, after a very difficult year so far for both stocks and bonds valuations now look more attractive for both.

CoreSat Model Update

Core Allocation

Adjust equity overweight to focus on quality companies both domestic and foreign as inflation potentially peaks but recession odds tick higher.

- In-light of increased volatility and the potential for recession, we are adjusting our US and foreign equity exposure to increase our overweight to quality companies with low valuations.
- As the US Dollar continues to march higher, we are adding currency hedging to our foreign equity exposure.
- Increasing our exposure to adjustable-rate, and actively managed fixed income strategies.

Satellite Allocation - Tactical

With the increase in volatility and equity markets rolling over during the quarter we removed our hedge exposure to increase the cash allocation. In times of heightened volatility, with no other place to hide, cash is a viable alternative. The satellite allocation is currently comprised of multi-asset strategies that provide dynamic exposure to global markets using complimentary trend-following methodologies designed to identify short and long-term momentum shifts. These strategies will invest both long and short in commodities, currencies, equities, and fixed income. The goal of these adaptive allocation strategies is to provide differentiated return streams, essentially stacking returns from non-correlated markets and strategies with the goal of reducing risk and providing better risk adjusted returns. The combination of core and satellite allocations are designed to provide a robust approach that diversifies across geographic regions, asset classes, and investment styles.

Drew Corradetti, CMT
Chief Investment Officer

CITATIONS: Morningstar Direct, JP Morgan Asset Management, www.blackrock.com/advisor insights, YCharts, Bloomberg

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