Third Quarter 2022

Figure 1 – S&P 500

Figure 2 – U.S. 10-Year Treasury Yield

Market Recap

Stocks rallied in July, but lost ground later in the quarter as inflation readings remained strong. The S&P 500 large cap index dropped 4.9% and is now -23.9% for the year. All major indices registered losses. Small and mid-cap stocks fell 2.2% and 3.4% respectively. International exchanges suffered the largest losses, hurt by continuing U.S. dollar strength. The MSCI Emerging Markets index lost 11.6% and developed countries outside the U.S. fell 9.4%. For the first time this year, growth (-3.9%) fared slightly better than value (-5.8%), which was hurt by profit-taking in the energy sector. Bond investors also felt the pain as interest rates resumed their rise (**Figure 2 – U.S. 10-Year Treasury Yield**). The Bloomberg U.S. Aggregate Bond Index dropped 4.8% in the quarter and is now -14.6% for the year.

Earnings reports in July brought some relief to stock investors with most companies faring better than feared. The technology-heavy Nasdaq rose as much as 20% as bellwethers including Apple, Amazon and Alphabet posted stronger than expected results. However, the world economy continued to struggle in the third quarter as the war between Russia and Ukraine dragged on. European energy prices rose at record rates raising fears for the coming winter. In August, the U.S. Consumer Price Index reading was surprisingly strong due to persistent core inflation. Stocks fell sharply on the news, eventually reaching new lows by the end of September, as it became clear that the Federal Reserve would continue increasing interest rates.

Corporate earnings in the second quarter rose 6.9%, while revenue increased 14%. Once again, these results were better than anticipated, as analysts had forecast an increase of 2.1%. However, the energy sector (+267.9%!) had an outsized impact. Without energy, aggregate earnings fell 3.3% from last year. Rising material and labor costs continue to pressure corporate profit margins and demand for many sectors has started to slow. The technology sector (-8.5%) in particular has been hard pressed to maintain the torrid growth of the last 3 years. Earnings growth forecast for the upcoming third quarter earnings season has dropped from +7.2% in July to only +1.0% today, or -5.7% ex-energy. Given the recent market declines, companies that meet or exceed expectations may see their stocks rebound, as we saw in July.

Economic Perspective

U.S. gross domestic product (GDP) fell 0.6% in the second quarter, slightly better than the -1.6% logged in the first quarter of the year. Exports fell again, and housing construction declined, offsetting increases in consumer spending and business investment. By one traditional measure, this 2nd consecutive quarter of negative indicates that the U.S. economy is in recession. However, the U.S. National Bureau of Economic Research considers other economic indicators, including employment and wage growth, before declaring an official recession. Recent estimates for third quarter GDP have risen slightly with consensus calling for growth to resume but slowing is

Index returns taken from Morningstar.com

evident in many sectors. Purchasing manager surveys in manufacturing still indicate slight growth, but the services sector, which had rebounded strongly with the post-COVID reopening, has registered contractionary readings for the past three months.

The employment picture remained strong with the economy adding jobs every month and an unemployment rate of 3.5% in September. Wages have also grown each month, most recently at a rate (+5.0%) that suggests continuing inflation. Wage growth has ticked down the past 3 months, possibly an early sign of peaking inflation. Job openings have also fallen from their all-time high in March, another gradual sign of cooling in the labor market. At this time, the labor market's strength is likely to lead to further interest rate increases by the Federal Reserve.

We have written in the past about the strength of the U.S. consumer, supported by low unemployment, wage gains and historically low debt levels. Debt payments remain near historic lows (**Figure 3 – Household Debt Service Payments as a Percent of Disposable Personal Income**). However, some signs of reduced spending have emerged, particularly for the biggest purchases. Home sale prices fell in August for the first time since 2020. In addition, auto retailer CarMax reported disappointing earnings and warned that consumers are struggling with affordability.

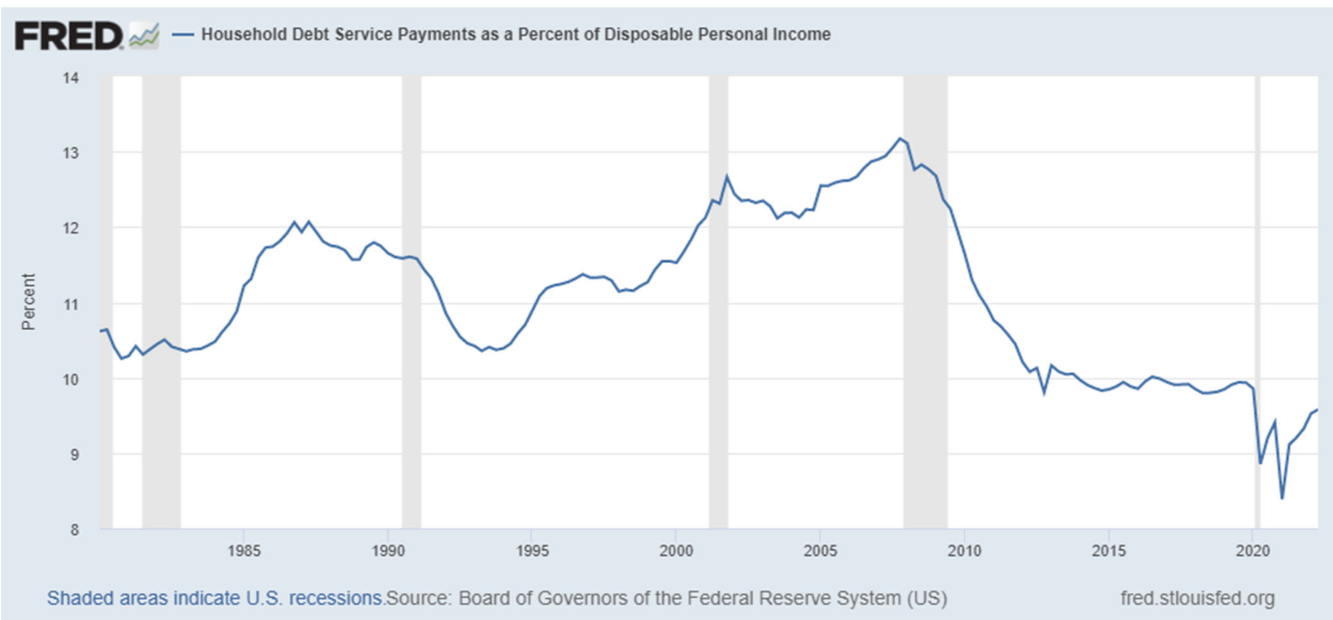

Figure 3 – Household Debt Service Payments as a Percent of Disposable Personal Income

The Federal Reserve raised interest rates twice in the quarter. The target federal funds rate now sits at 3.00 – 3.25%, a sharp increase from the target of 0.25 – 0.50% in March of this year. This has led to higher interest rates for borrowers across the economy and increased payments on fixed income investments. The 10 year Treasury bond yield is now 3.9%, and CDs are paying 4.0% or more. With these rates, many investors may be content to hold more short-term bonds or cash.

Figure 4 – Energy Select Sector Fund

Figure 5 – MSCI Europe, Far East & Australia

Looking Ahead

Stocks have continued their painful adjustment to higher interest rates, bringing valuations down. High inflation has persisted, but the economy is showing signs of slowing, which may allow the Federal Reserve to pause their interest rate hikes. Until that time, energy stocks (**Figure 4**) offer robust cash flows and market-leading dividends.

U.S. interest rate hikes and global uncertainty have led to the strongest U.S. dollar in 20 years. Foreign stocks are currently selling at substantial discounts to their U.S. peers. When the Fed does finally stop hiking, the U.S. dollar may decline, and foreign investments may become more attractive. At this time, we caution against trying to catch that falling knife (**Figure 5**) and would continue to underweight international stocks.

It was difficult in some ways writing this letter. Last quarter we shared that one year after the start of bear markets, U.S. stocks averaged 23.9% returns. 3 months later, stocks have fallen further, and the environment appears to be worsening in some ways. While we do believe that long-term financial success involves staying invested through good times and bad, there are very uncertain times, and it's impossible to predict when stocks will rally. Staying invested will, for most people, provide the best chance for portfolios to recover and resume growth. If this seems difficult today, we want to discuss this, and any other financial questions you have. We want to hear your concerns and help make good financial decisions in this challenging environment. We look forward to speaking with you.

Best regards,

Kenneth M. Bernard

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