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Market Newsletter
September 30, 2022

EXECUTIVE SUMMARY

- Stocks and bonds sold off in the third quarter of 2022 because of sticky inflation and aggressive interest rate hikes by the Federal Reserve.

- There are signs that inflation is moderating – for example supply chain constraints are easing, commodity prices and home prices are falling.

- The Federal Reserve looks at the backward-looking Consumer Price Index (CPI) to make decisions about interest rate hikes and is expected to continue its course.

- The economy is showing signs of slowing down and the probability of a recession has increased. However, the employment situation is strong, and the cyclical portions of the economy are not elevated which points to a mild recession if one were to happen.

- Corporate earnings growth is moderating but stocks are cheaper than their historical average. However, if earnings estimates get slashed further there could be further decline in equity prices.

- Historically, stocks have done well after recessions when investor sentiment is low. This supports the view that recessions are an opportunity to invest.

Table 1: Market indices

(Returns include dividends)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	-4.88%	-23.87%	-15.47%	8.16%	9.24%
S&P Mid Cap 400	-2.46%	-21.52%	-15.25%	6.01%	5.82%
S&P Small Cap 600	-5.20%	-23.16%	-18.83%	5.48%	4.84%
MSCI Emerging Markets	-11.42%	-26.89%	-27.80%	-1.71%	-1.44%
MSCI EAFE	-9.29%	-26.76%	-24.75%	-1.38%	-0.36%
Vanguard Total Bond Market Index (VBMFX)	-4.68%	-14.65	-14.75%	-3.37%	-0.35%
Investment Grade Credit (C0A0)	-5.11%	-18.33%	-18.19%	-3.70%	0.06%
Non-Investment Grade Credit (H0A0)	-0.68%	-14.60%	-14.10%	-0.70%	1.4%
Bloomberg Commodity Index Total Return	-4.11%	13.57%	11.80%	13.45%	6.96%
Dollar Index (DXY)	7.10%	17.19%	18.98%	4.10%	3.79%
10 Yr Rate	3.80% 09/30/2022	1.51% 12/31/2021	1.53%% 09/30/2021	1.68% 09/30/2019	2.33% 09/30/2017

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg, Yahoo Finance

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 10/07/2022			
	Latest Release	Recent Trend	Notes
Non-Farm Employment	263,000	Negative	The number of non-farm jobs added in the economy have been decelerating in recent months but still reflect a healthy job market. The unemployment number ticked down to 3.5% and average hourly earnings is still strong at 5%.
Weekly Claims for Unemployment Insurance	219,000	Positive	Unemployment claims rose recently but, it is still at a historically low level.
ISM Manufacturing Index (over 50 indicates growth)	50.9	Negative	In September, US manufacturing grew at its slowest pace in 2.5 year. New orders and manufacturing employment fell, a possible fallout of aggressive interest rate hikes by the Federal Reserve.
ISM Non Manufacturing Index (Over 50 indicates growth)	56.7	Negative	The services sector is still showing healthy growth, although the rate of growth has been falling since the beginning of this year. The sector is being supported by a shift from spending on goods.

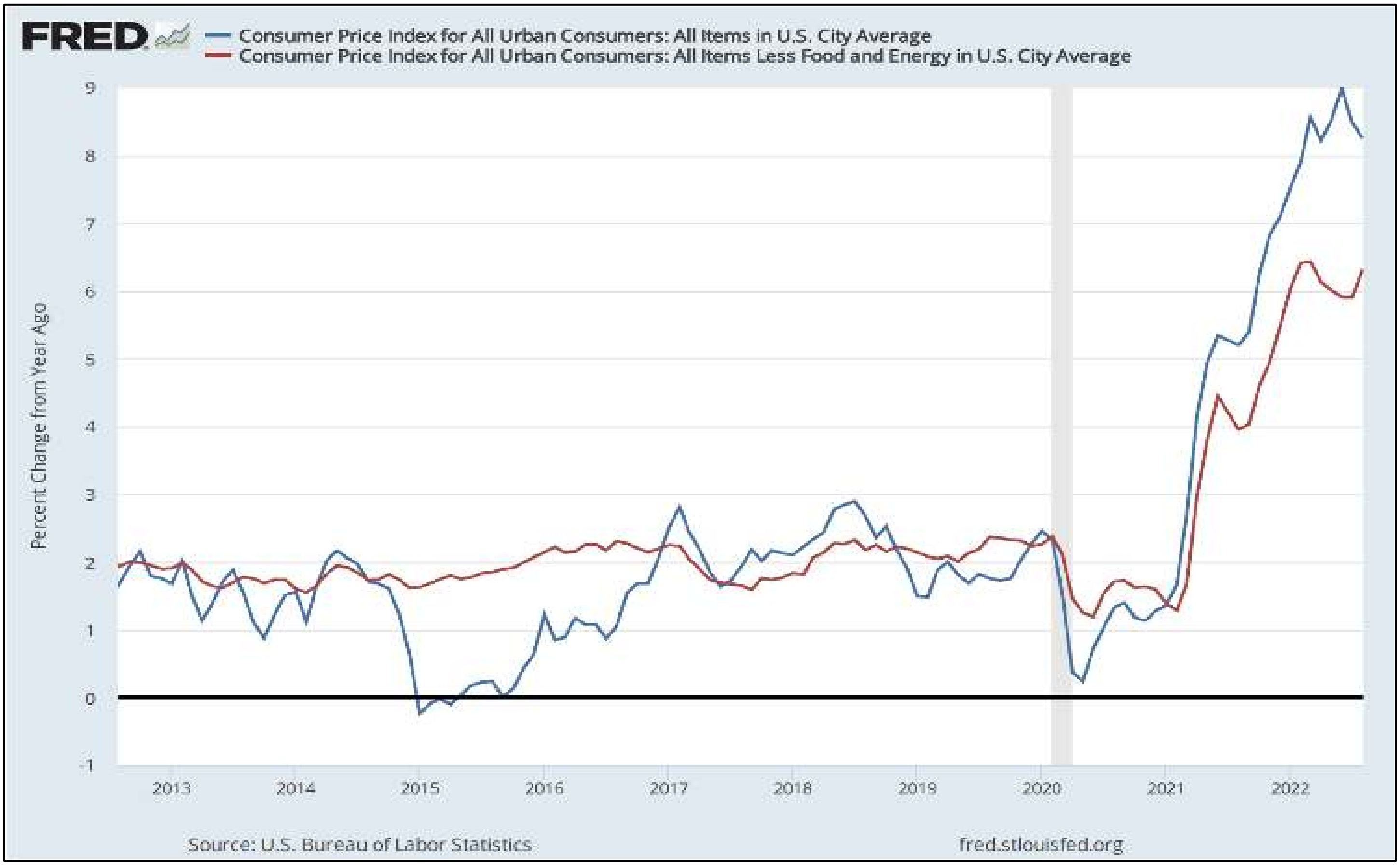
	Latest Release	Recent Trend	Notes
Consumer Prices (Month over month change)	0.1%	Positive	Year over year consumer prices are increasing at a slower pace, however core inflation which excludes food and energy increased sharply as compared to previous months. Shelter cost was a major factor.
Producer Prices (Month over month change)	-0.1%	Positive	Producer prices fell for the second consecutive month, somewhat allaying fears of long lasting inflation. Improvement in supply chain bottlenecks and a shift in spending to the service sector helped.
Retail Sales (Month over month change)	0.3%	Negative	Lower gas prices contributed to an unexpected spike in retail sales in August but previous month's number was revised downward.
Consumer Confidence (Conference Board)	108	Positive	Falling gas prices and a healthy jobs market bolstered consumer confidence, which rose for the second straight month.
Durable Goods Orders (Month over month change)	-0.2%	Negative	Durable good orders fell, but core capital good which excludes defense and aircraft sales improved by 1.3% showing some resilience in corporate investments.
Industrial Production (Month over month change)	-0.2%	Negative	Industrial production fell but manufacturing output increased in August. Utilities fell and mining was unchanged.
Capacity Utilization	79.6%	Positive	Capacity utilization has been inching up from it's pandemic low and is now above it's long run average.
Housing Starts	1.575 million	Negative	New home construction rose in August but is down from a year ago. Other indicators such as building permits show that high mortgage rates are impacting the housing market.
Home Prices (Case-Shiller Home Price Index- Year over Year)	16.7%	Negative	In July, home prices fell at the fastest rate since this index was started in February 2012. However, home prices in the 20 largest cities are still up 16.7% from a year ago.
GDP (Real, Annualized)	-0.6%	Negative	The economy shrank in the second quarter of 2022 following a decline in the first quarter. Consumer spending was stronger than expected, but trade deficit and a sharp decline in business spending hurt.

Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ism.ws, www.nahb.org

Global stocks and bonds continued to sell off in the third quarter as sticky inflation and an aggressive Federal Reserve (Fed) raised fears of a recession in the economy. Stocks are decisively in a bear market now and bonds are having one of their worst performances in decades. Even commodities, which had been having a good year sold off with recession fears (Which will reduce the demand for commodities) and a stronger dollar (Since commodities are usually priced in dollars). The US dollar is now at a 20 year high against a basket of major currencies.

Inflation continued to be of concern this quarter- The yearly change in the US Consumer Price Index peaked at 9.1% in June and has been steadily falling, primarily due to a decline in oil prices. However, core inflation, which strips out food and energy inflation, unexpectedly jumped in August 2022. (Fig 1) To curtail inflation the Fed increased interest rates by 75 basis points (100 basis points is 1%) in each of its last three meetings. The Fed has now raised rates by a steep 3% since March and has indicated it will raise it to 4.4% by the end of this year. Fed Chairman Jerome Powell has indicated he is committed to bringing inflation back to 2%, a level considered tolerable, even at the risk of an economic slowdown.

Fig 1: Inflation: All items and core (less food and energy)

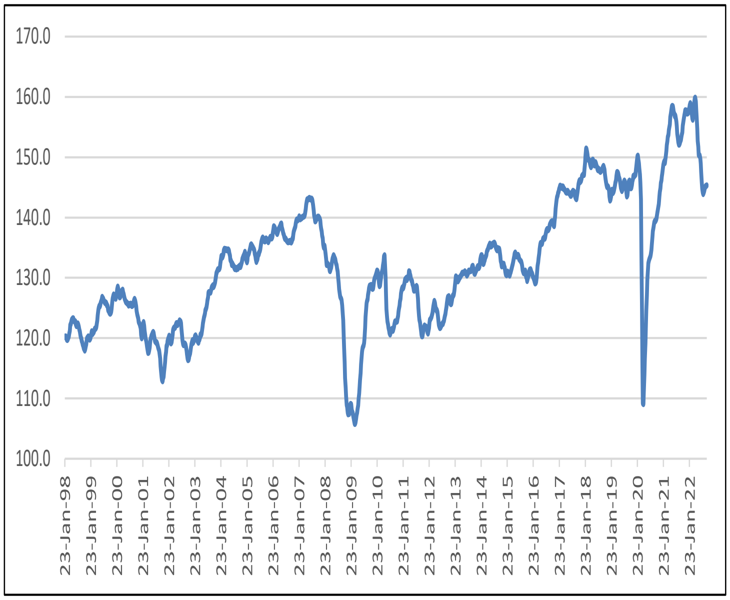


Source: Federal Reserve Bank of St Louis

There are signs that inflation is moderating- for example global supply chain conditions have improved as countries lift lockdowns and companies adjust their supply chains; commodity prices have fallen taking the pressure off raw materials used by companies; and home prices are declining. Rents have also peaked suggesting shelter prices, a key input in the calculation of inflation numbers, could subside. Consumers, bond market investors and professional forecasters are expecting inflation to drop to a range of 2.5% to 3% over the next 5 years. The decline in inflation is likely to be gradual and the concern is that the Fed, which monitors the backward-looking inflation numbers, may err on the side of hiking interest rates more than required.

The economy is showing signs of slowing down as seen in forward looking indicators such as the ECRI Weekly Leading Index (Fig 2) and there could be a recession sometime next year. The steep hike in interest rates has led to the yield curve inverting between the 2-year and 10-year levels (Fig 3)- usually a harbinger of a recession.

Fig 2: ECRI Weekly Leading Index (4 week average)

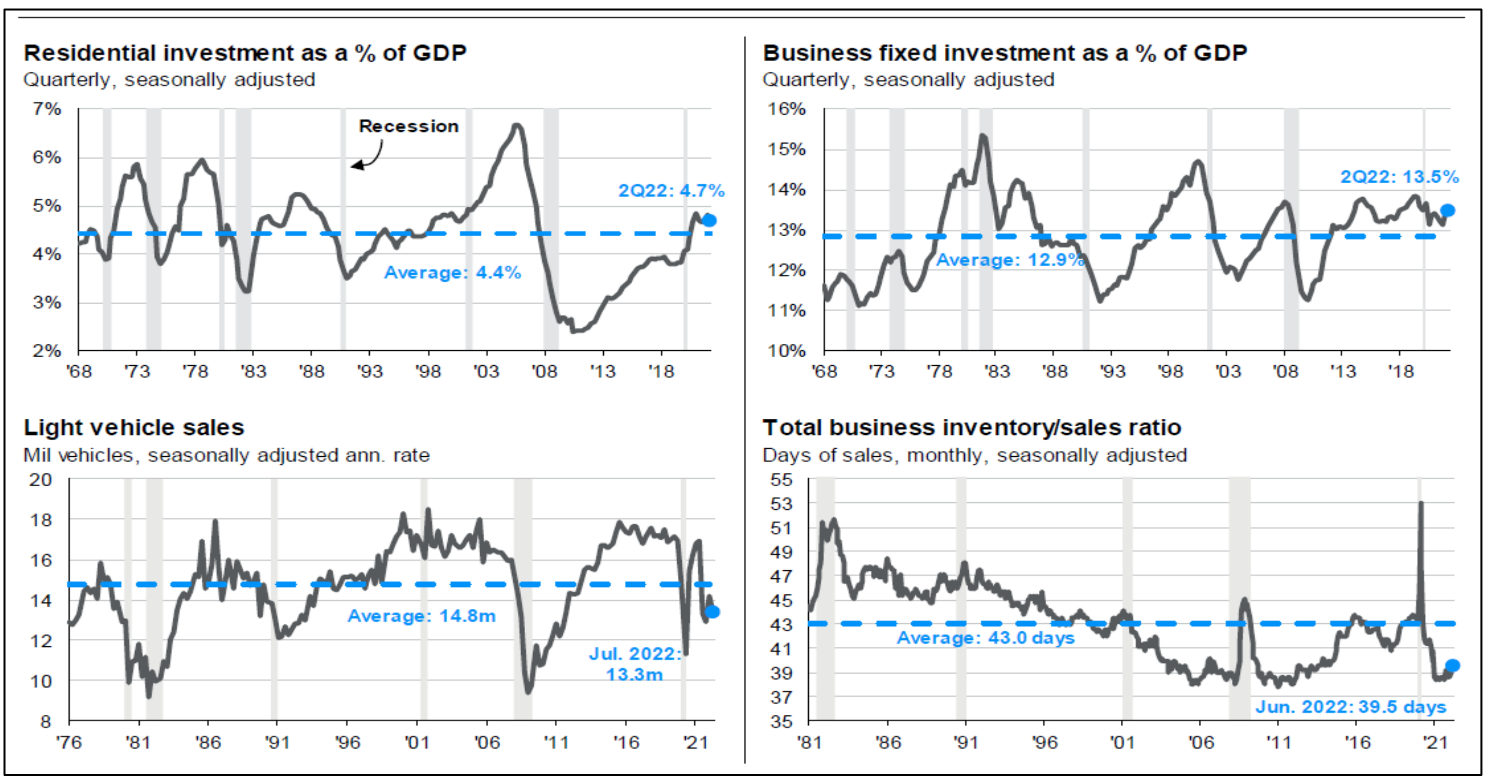


Source: ECRI

Fig 3: 10 year UST minus 2 year UST

Source: Federal Reserve of St Louis

Fig 4: Cyclical sectors of the economy

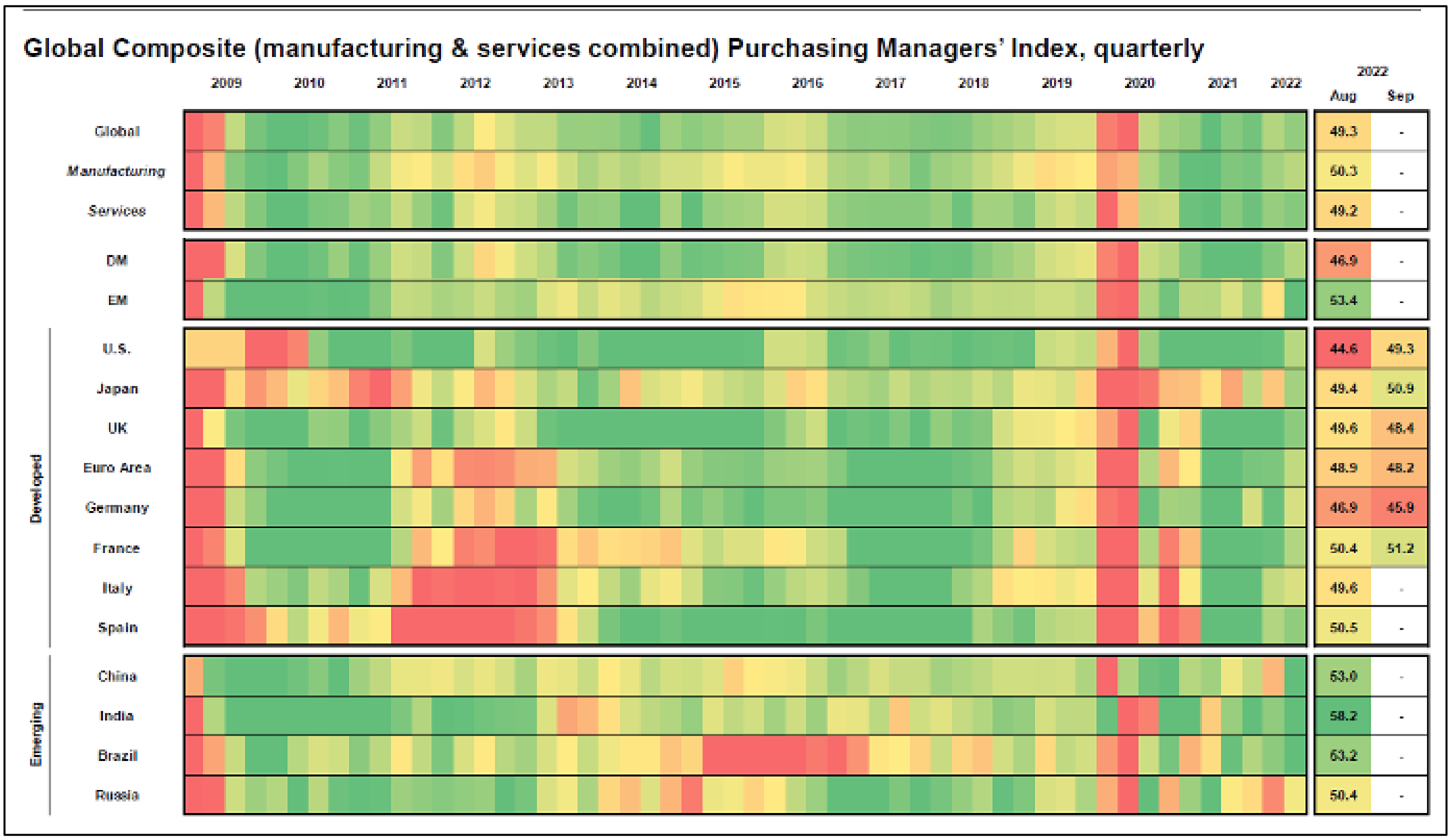


Source: JP Morgan

The one bright spot of the economy is employment, which is still strong with nearly two job openings for every unemployed person. This supply-demand mismatch has emboldened employees to demand higher salaries or move to higher paying jobs, which has kept wages growing at a relatively high annual rate of over 4%. The strong demand for workers means a recession could be relatively mild for the employment prospects of workers. There are also other signs that the severity of a recession, were it to arrive, would be relatively mild- the cyclical portions of the economy such as residential and business investments and inventory to sales ratio are not elevated. (Fig 4)

High inflation and increasing interest rates are a global phenomenon and is affecting economies around the world. The war in Ukraine is compounding the problem in Europe and the United Kingdom which are facing commodity shortages and high energy prices. In China, apart from the war, a zero-lockdown policy and a housing market collapse are causing headwinds to the economy. Fig 5 shows the composite Purchasing Manager's Index (Which measures the manufacturing and services sector's performance) around the word. As seen, the momentum in the economies has declined in 2022. (Yellow and red show weakness, green shows strength)

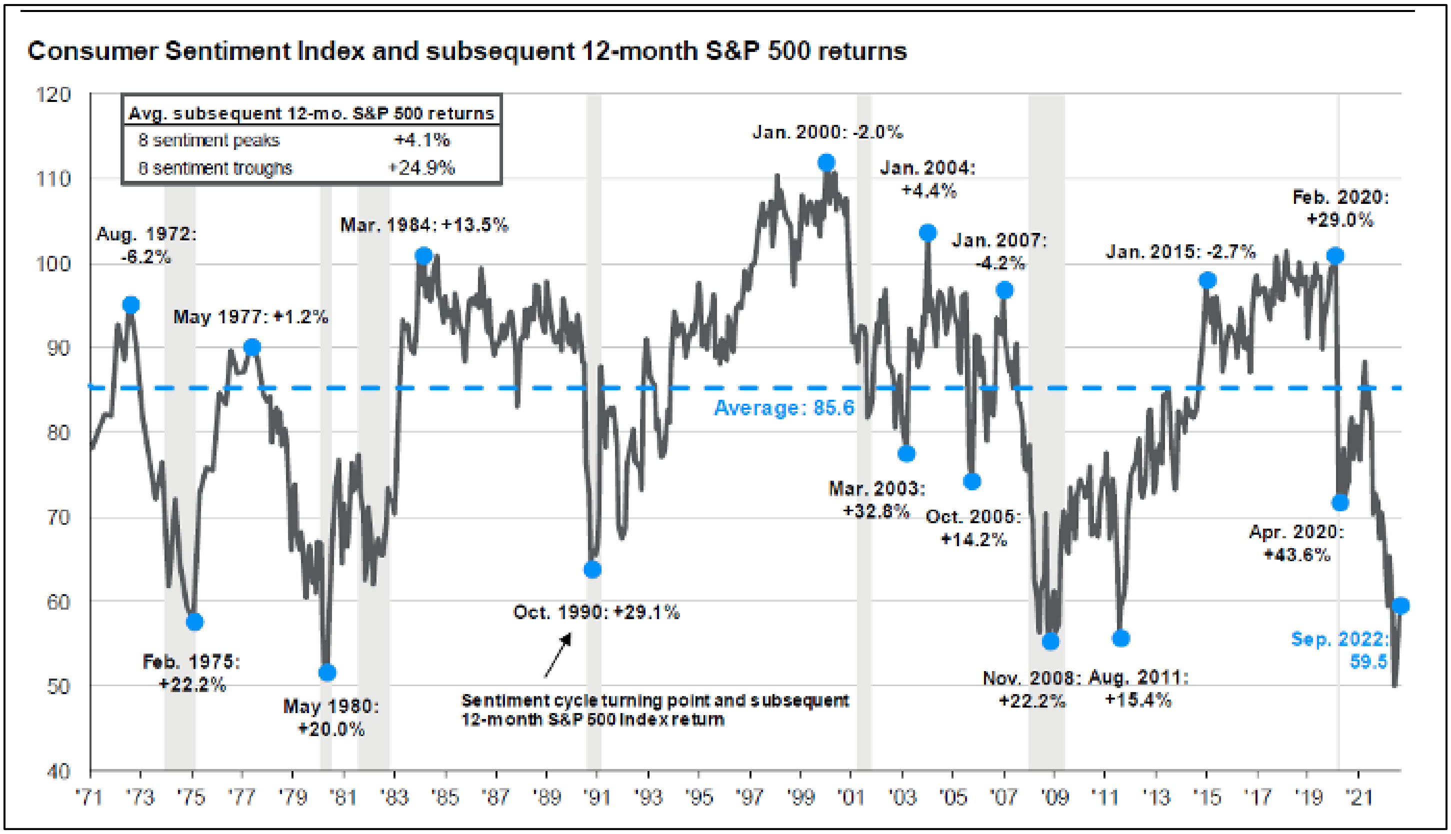
Fig 5: Composite Purchasing Manager's Index around the world



Source: JP Morgan

Third quarter earnings for companies in the S&P 500 is expected to grow by 2.9% as per FactSet. This is significantly below the 9.8% growth analysts were expecting as late as June this year. It is likely companies will not meet even this modest estimate as depressed revenues, a stronger dollar (Which affects revenue from abroad) and higher labor costs are likely to adversely impact earnings. The price earnings multiple of the S&P 500 is currently 15X, which is below the 5-, 10- and 25-year average making stocks relatively cheap. However, if earnings estimates get slashed there could be further decline in equity prices.

Fig 6: Stock performance following various levels of consumer sentiment



Source: JP Morgan

<u>How stocks perform during a recession</u>

Since the chances of a recession have increased, it may be of interest to see how stocks perform during a recession. As detailed in a previous note, there have been 16 recessions in the last 100 years. CLICK HERE for an interactive chart on how the economy and the stock market performed during each of those recessions. What you will conclude from the chart is that the cause of any recession, its duration and how stocks perform during each recession are all very different, making it next to impossible to forecast one let alone make investment decisions based on the forecast. What you also see is that through all these recessions, the stock market has continued to reward patient investors.

More recently, since World War 2, there have been 12 recessions. The table below (Fig 7) shows each of these recessions and the stock market's (S&P 500) returns 6 months leading up to the recession, during the recession and then one, three, five years and ten years from the end of the recession. As seen, while stocks have performed very differently before and during recessions, over time they have recovered and performed well.

As seen in Fig 6, investor sentiment is usually very low before and during a recession and so it is currently. And when investor sentiment is very low, stocks have done well in the year ahead. This supports the view that historically, recessions have been an opportunity to invest.

Fig 7: Stocks before, during and after recessions since World War 2

Recession	6 Months Prior	During the Recession	One Year	Three Years	Five Years	Ten Years
Nov 1948 - Oct 1949	9.83%	4.12%	31.48%	87.98%	171.33%	497.04%
July 1953 - May 1954	-6.46%	27.57%	35.92%	83.74%	144.81%	294.38%
Aug 1957 - April 1958	9.28%	-6.51%	37.31%	66.35%	89.72%	211.33%
April 1960 - Feb 1961	-1.04%	18.40%	13.61%	35.06%	68.41%	111.33%
Dec 1969 - Nov 1970	-7.78%	-3.45%	11.24%	20.63%	25.16%	145.87%
Nov 1973 - Mar 1975	2.86%	-17.90%	28.32%	21.99%	55.33%	252.40%
Jan 1980 - July 1980	7.67%	16.14%	12.92%	55.89%	100.89%	345.64%
July 1981 - Nov 1982	-1.02%	14.66%	25.40%	67.24%	103.23%	350.51%
July 1990 - Mar 1991	3.09%	7.64%	11.04%	29.84%	98.21%	284.66%
Mar 2001 - Nov 2001	-17.84%	-7.18%	-16.51%	8.44%	34.33%	33.16%
Dec 2007 - June 2009	-2.33%	-35.46%	14.43%	57.70%	136.98%	294.17%
Mar 2020 - April 2020	1.92%	-1.12%	45.98%	???	???	???

Sources: NBER, Returns 2.0

Source: Ben Carlson- A wealth of common sense