LOOK AHEAD

Q4 2022

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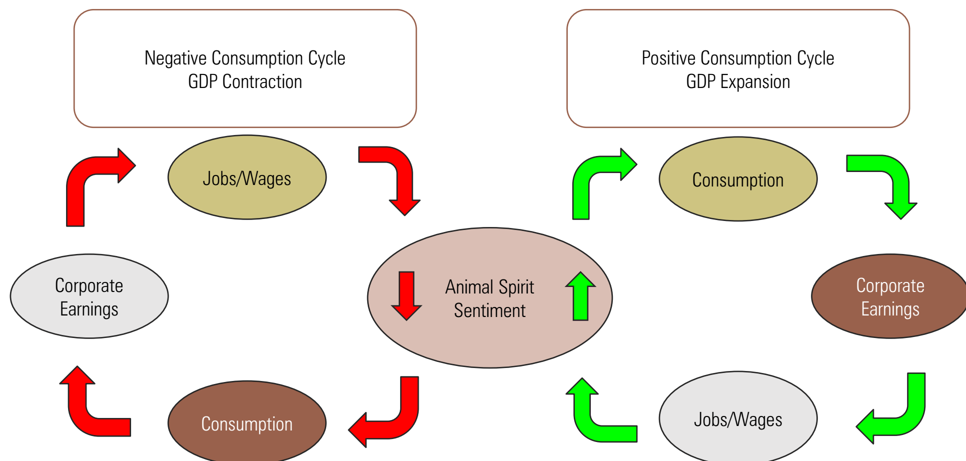
Growth Detour or Recession Kick Off?

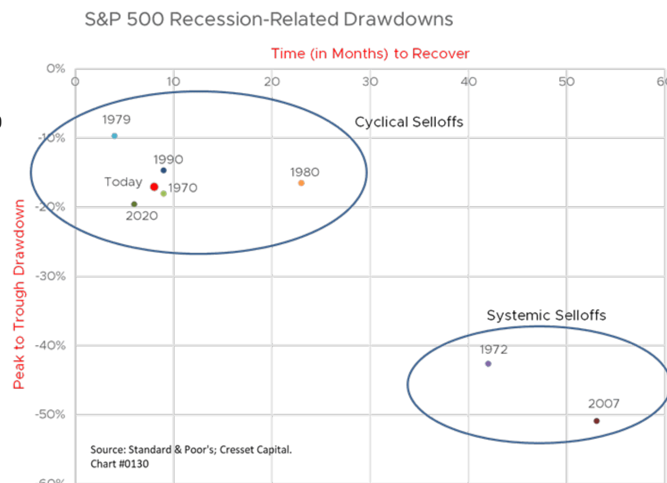
It's easy to lose track of where we are in the cycle when we are in the midst of massive drawdown.



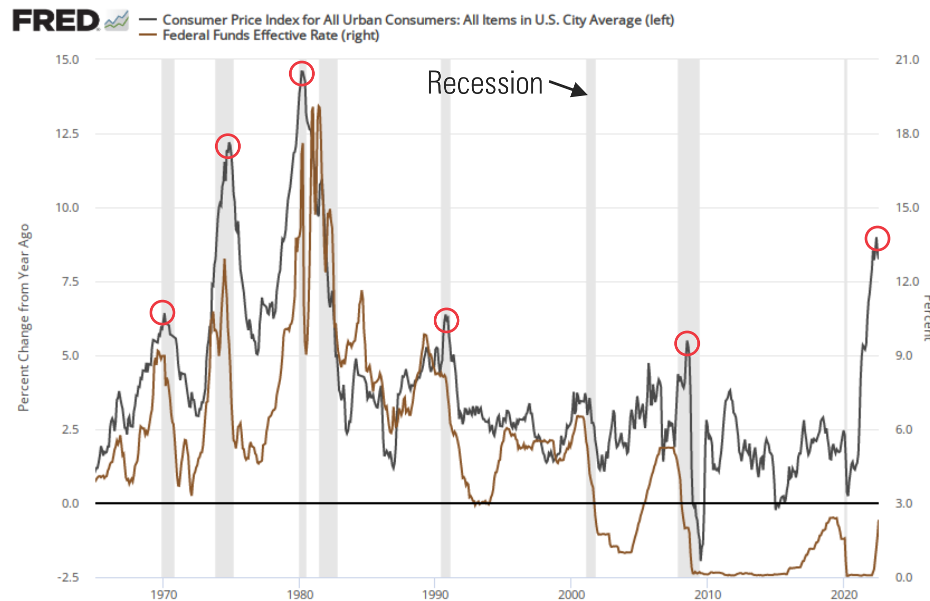
At this stage, its reasonable to question how long this will last.

Currently, we're nine months into the selloff with the S&P 500 down ~20%.

Based on history, we may be pretty well through what would be expected from a typical cyclical selloff.



The current environment – with high inflation leading to higher rates – generally precede recessions based on historical standards,



Typically, when the S&P 500 is down over 10% through the third quarter, the next four quarters end up much better.

The average recovery is nearly 14% and in midterm election years, that average accelerates to about 27%.

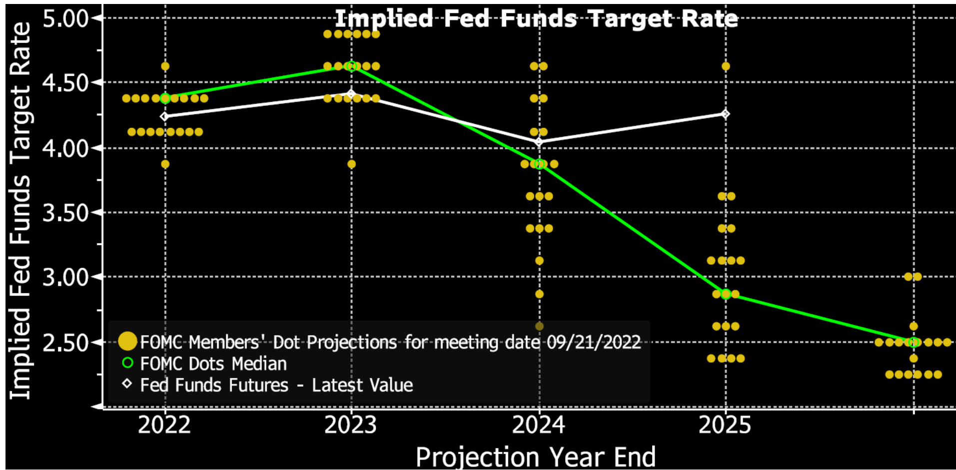
S&P 500 After 10%+ YTD Decline Thru Q3

	S&P 500 Performance (%)		
Year	**YTD Through Q3**	**In Q4**	**Next 4 Quarters**
1946	-13.82	2.27	1.00
1953	-12.12	6.25	38.37
1960	-10.64	8.58	24.68
1962	-21.36	12.14	27.42
1966	-17.17	4.92	26.32
1969	-10.34	-1.14	-9.57
1974	-34.86	7.90	32.00
1977	-10.17	-1.48	6.23
1981	-14.42	5.48	3.65
1990	-13.40	7.90	26.73
2001	-21.16	10.29	-21.68
2002	-28.99	7.92	22.16
2008	-20.57	-22.56	-9.37
2011	-10.04	11.15	27.33
2022	-19.36		
Average	-17.23	4.26	13.95
Median	-14.42	7.08	23.42
% Positive	0.0	78.6	78.6
All Years			
Average	4.66	4.08	8.73
Median	6.29	5.04	9.62
% Positive	69.2	79.2	72.7
Midterm Years			
Average	-22.52	8.16	26.93
Median	-20.36	7.90	26.73
% Positive	0.0	100.0	100.0
All Midterm Years			
Average	-1.17	6.38	19.46
Median	2.34	7.90	22.16
% Positive	52.6	84.2	89.5

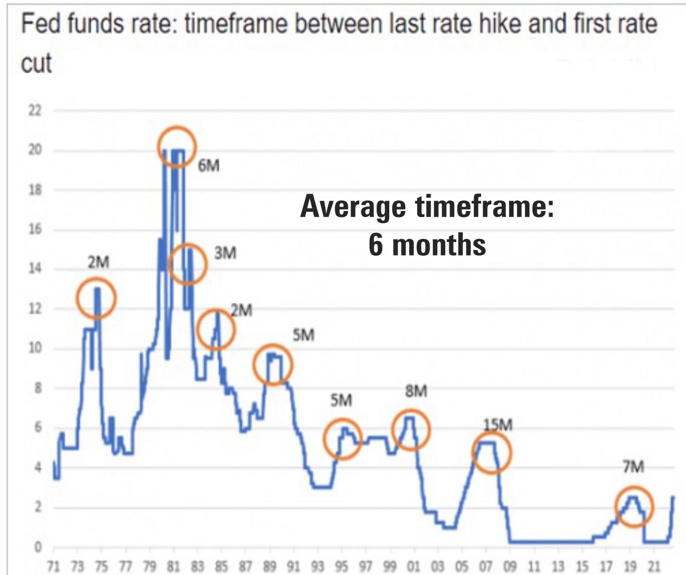
Data Sources: Federal Reserve Bank of St. Louis, Cresset Capital, Bespoke

Interest Rates – Dragging On

The Fed delivered a third 75bps rate hike, lifting the fed funds rate target range to 3%-3.25%.
The median dot plot projection now shows a rate midpoint of 4.375% at end-2022 and 4.625% at end-2023.



While rate hikes cause some pretty significant pain for investors, the duration of time rates stay at elevated levels is pretty short-lived.
This is primarily driven by changes in consumer behavior. When consumers pull back on consumption, they create a deflationary cycle.



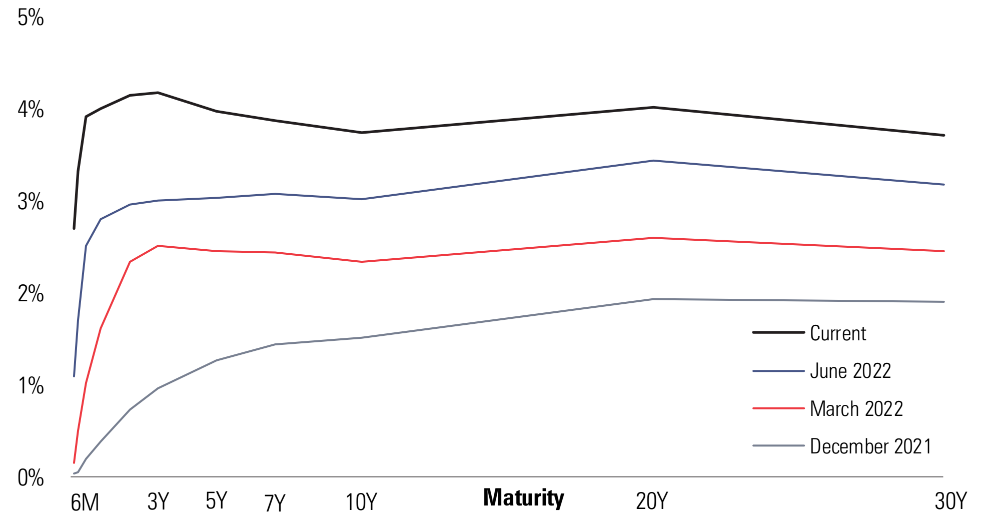
Wall Street expectations see the Fed most likely to have a 4.00% target for interest rates at its December meeting.
But by the March 2023 meeting, Wall Street sees the pace of rate hikes beginning to slow, now expecting rates to reach 4.25% at the midpoint.

	End of 2022		Q1 2023		Q2 2023		End of 2023	
	Hike/Cut	Implied Rate (%)	Hike/Cut	Implied Rate (%)	Hike/Cut	Implied Rate (%)	Hike/Cut	Implied Rate (%)
Bank of America	+75 bps	4.00%	+25 bps	4.25%	0 bps	4.25%	-25 bps	4.00%
Barclays	+75 bps	4.00%	0 bps	4.00%	-50 bps	3.50%	0 bps	3.50%
Deutsche Bank	+125 bps	4.50%	+50 bps	5.00%	0 bps	5.00%	-100 bps	4.00%
Goldman Sachs	+125 bps	4.50%	+25 bps	4.75%	0 bps	4.75%	0 bps	4.75%
JPMorgan	+50 bps	3.75%	0 bps	3.75%	0 bps	3.75%	0 bps	3.75%
Moody's Economy	+50 bps	3.75%	0 bps	3.75%	0 bps	3.75%	0 bps	3.75%
Morgan Stanley	+75 bps	4.00%	0 bps	4.00%	0 bps	4.00%	0 bps	4.00%
UBS	+100 bps	4.25%	0 bps	4.25%	-50 bps	3.75%	0 bps	3.75%
Wells Fargo	+125 bps	4.50%	+50 bps	5.00%	0 bps	5.00%	-50 bps	4.50%

High	+125 bps	4.50%	+50 bps	5.00%	0 bps	5.00%	0 bps	4.75%
Low	+50 bps	3.75%	0 bps	3.75%	-50 bps	3.50%	-100 bps	3.50%
Median	+75 bps	4.00%	0 bps	4.25%	0 bps	4.00%	0 bps	4.00%

In the bond market, short-term interest rates are meaningfully above long-term interest rates, which is known as an inverted yield curve, and is historically an indicator of a possible recession.

U.S. Treasury Yield Curve



Data Sources: Bloomberg, Daily Shot

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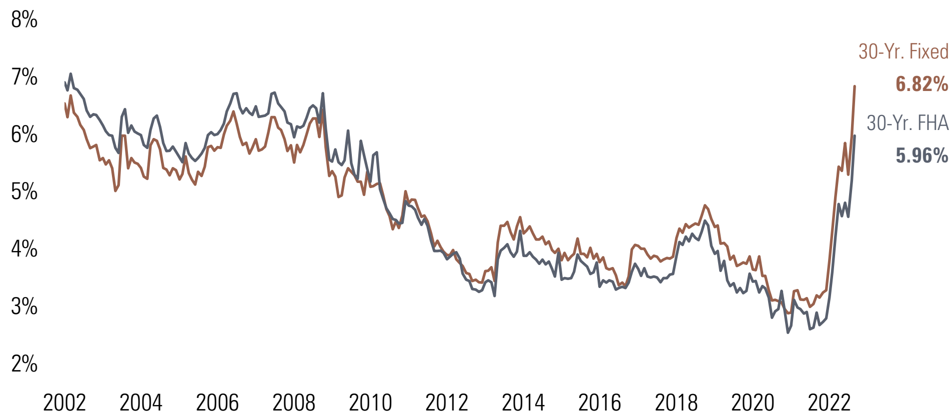
Federal Reserve in Demand Destruction Cycle

Interest Rate Pain

Mortgage rates in the U.S. continue to soar, surpassing 6% in mid-September and more than doubling from the record low in January 2021.

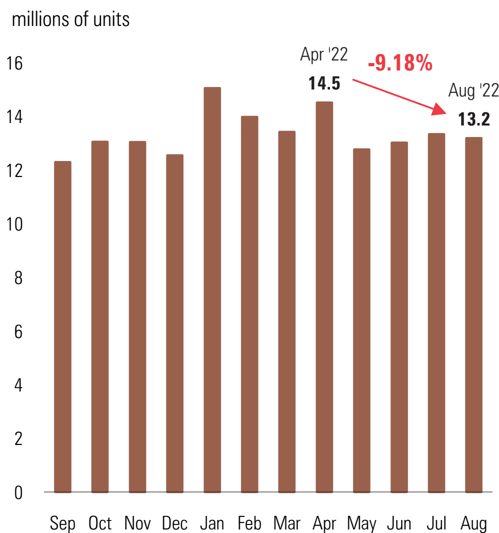
U.S. Mortgage Rates 2002 to 2022



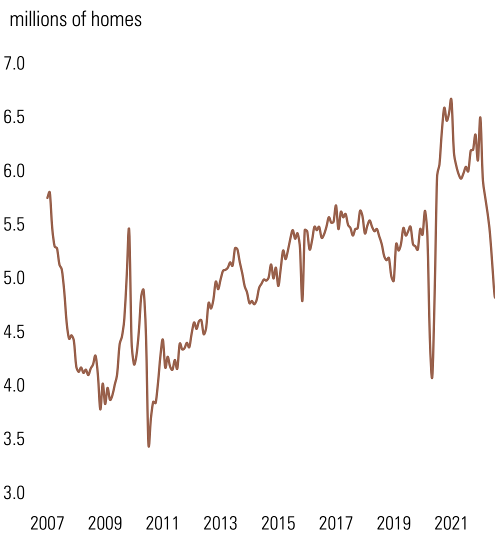
Rising interest rates can squash demand for housing, rents, recreation, appliances, clothing, and a whole host of other consumables. Take a look at what a 2% increase in the Fed Funds rate did to auto sales and housing.

Total U.S. auto sales have declined 9.18% since April 2022, while existing home sales are down almost 20%. year-over-year.

Total U.S. Auto Sales (SAAR)
millions of units



Existing Home Sales (SAAR)
millions of homes



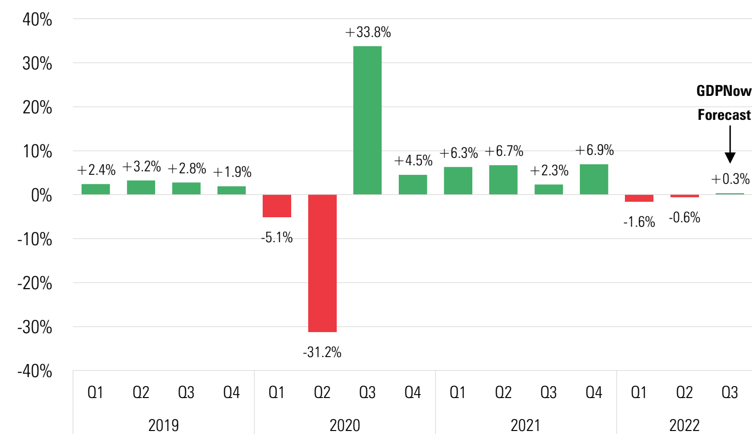
A record $16.32 trillion of wealth has been destroyed in stocks and bonds this year.

Add to that the ~$1.25 trillion in wealth that has been destroyed in crypto assets, and it brings total wealth destruction to $17.58 trillion, or 71% of GDP.

U.S. Equity & U.S. Bonds Year-to-Date Market Value Drawdown

The U.S. economy posted its second consecutive quarter of negative GDP growth in Q2, putting the economy in the recessionary territory as defined by the National Bureau of Economic Research.

Real GDP, QoQ SAAR
2019 to 2022



Data Sources: Optimal Blue, Bloomberg

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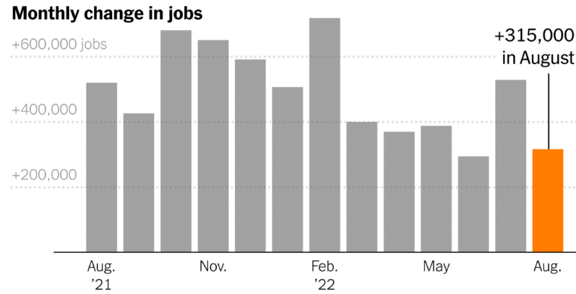
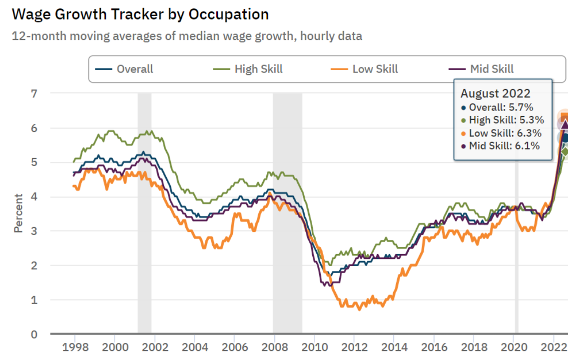
Consumer Strength – Not Weak Enough

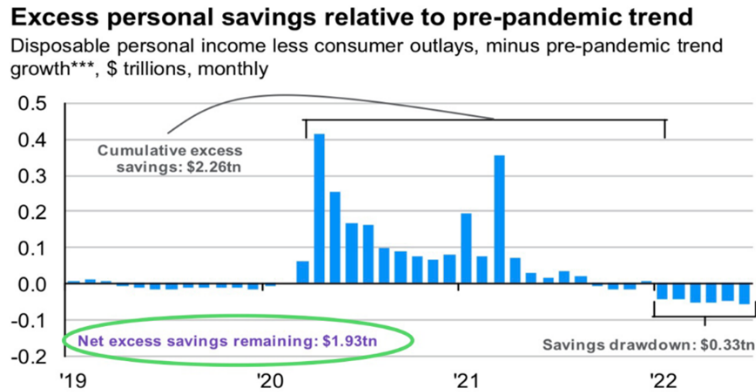
Jobs are abundant with the U.S. economy adding another 315k people to the workforce in August, with an average of 489k jobs being added per month over the last year.



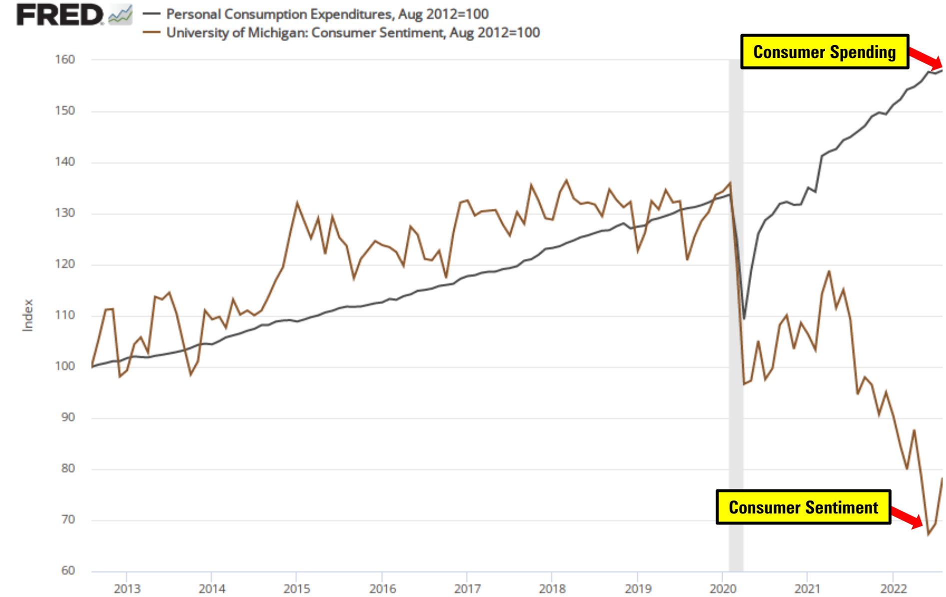
Beyond the jobs that are plentiful, wages are incredibly strong.
Notably, wages for the lowest skilled workers are growing at the fastest rate across cohorts at 6.3%.



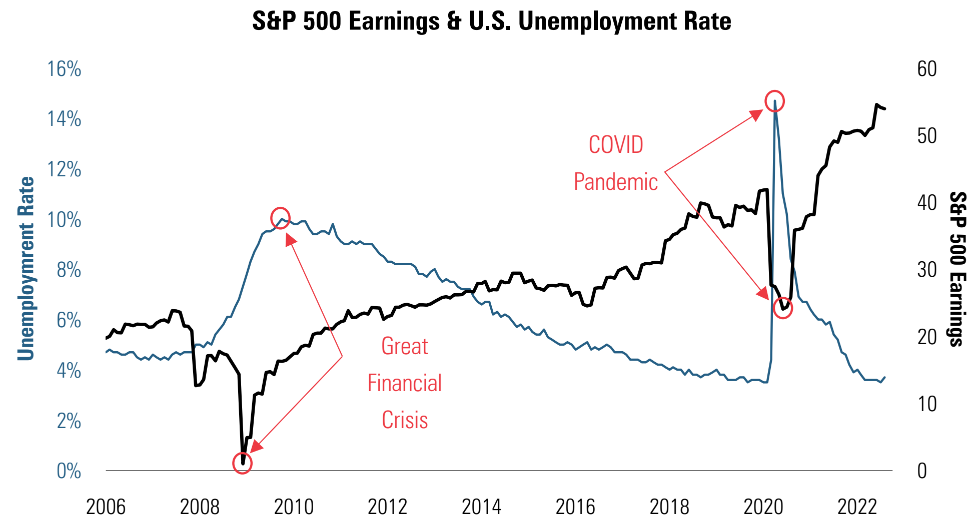
While the consumer is spending down their savings from the pandemic, they are still sitting on $1.93 trillion in excess savings according to J.P. Morgan. That's equivalent to ~8% of annual GDP.



Consumer and investor sentiment is dropping and that could lead to some drag on consumer spending. That consumer demand destruction has been pulling corporate earnings expectations lower.



Once we see corporate earnings begin to buckle, we should see jobs lost and a bump in unemployment.



Data Sources: U.S. Bureau of Labor Statistics, Atlanta Fed, JPMorgan, Federal Reserve Bank of St. Louis, Bloomberg

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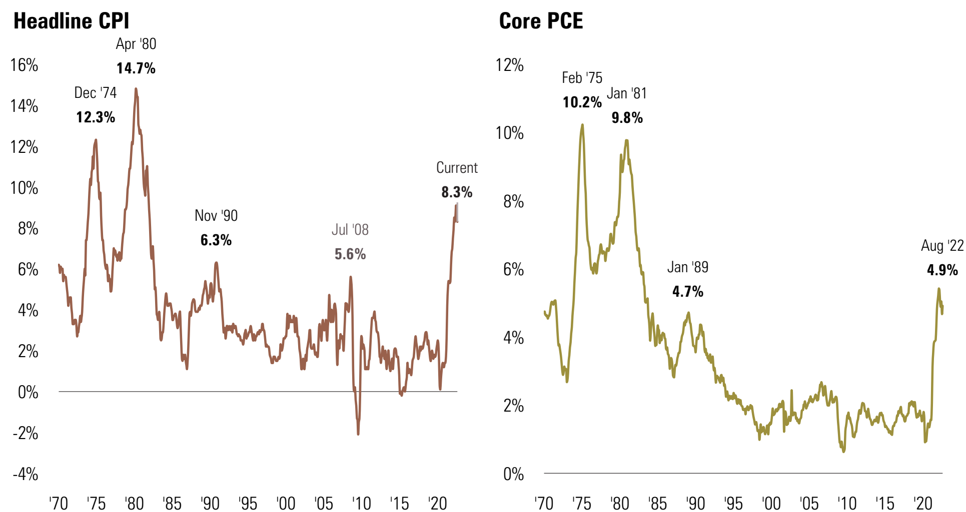
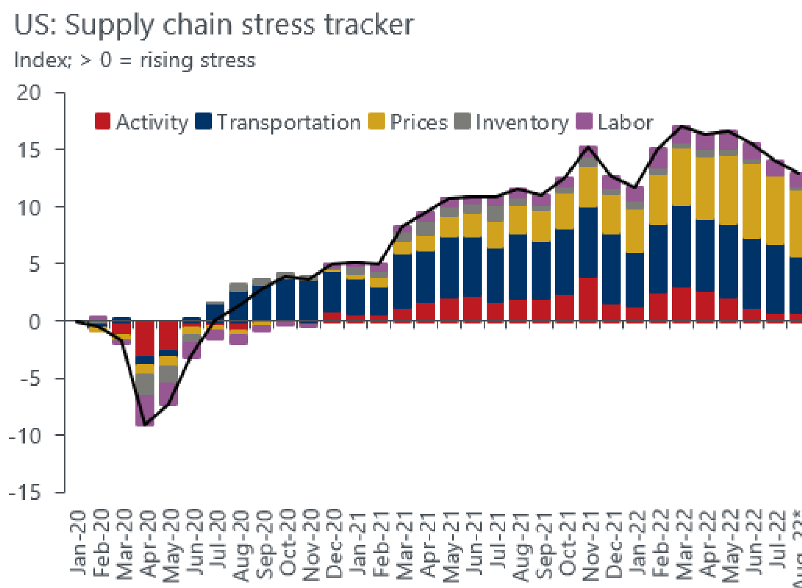
Inflation – Will It Ever Moderate?

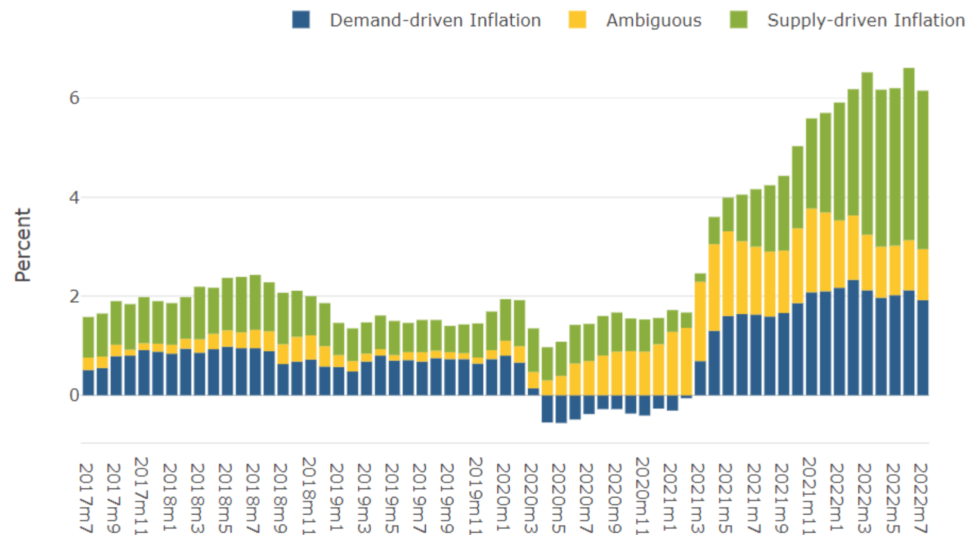
The consumer price index rose by 8.3% year-over-year in August, as food and energy prices continued to climb. Core CPI (ex-food and energy) was up 4.9%. Spending on rent, transportation, and healthcare increased strongly while goods spending declined.



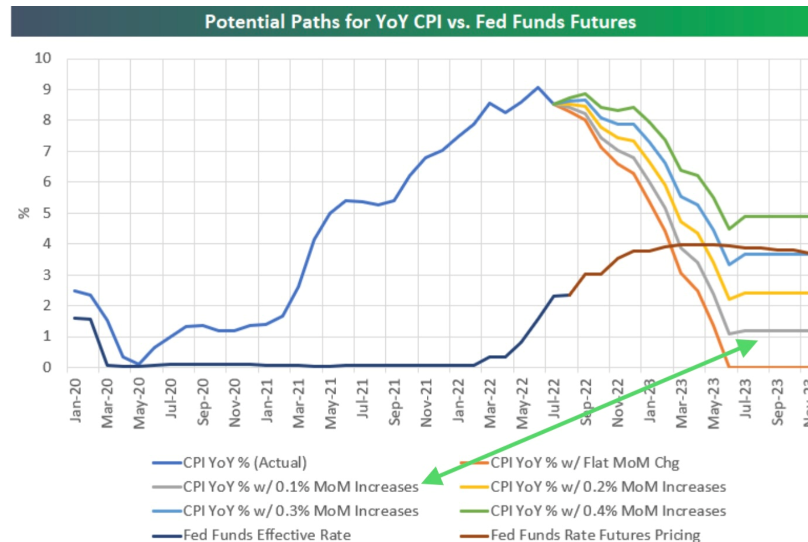
Supply-chain disruptions have shown signs of moderating recently.
Those improvements – helped by cooling consumer demand for goods – should slow price increases.



How much inflation is driven by supply and demand?
According to a recent Federal Reserve Board of San Francisco study the supply side remains a major driver.



The good news is the August print on inflation was a month-over-month increase of 0.1%. That puts us on the gray line and if that is the trend, then we should be well below the Fed's 2% inflation target by mid-2023.



Data Sources: U.S. Bureau of Labor Statistics, Federal Reserve Bank of San Francisco, Bespoke

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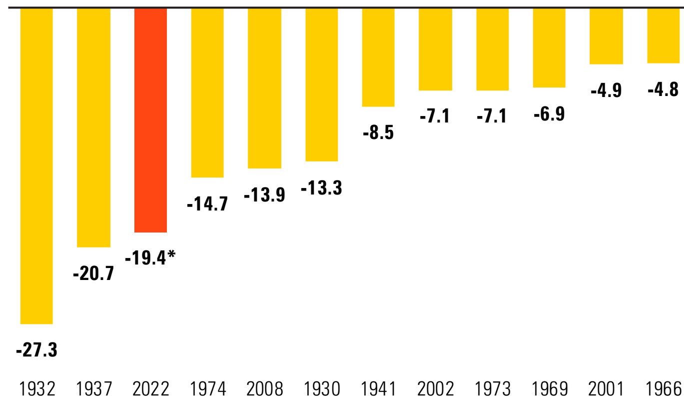
Fixed Income – Sitting on Cash

It's been a nasty year for portfolios, especially those traditionally considered conservative like the 60/40 stock/bond portfolio.

The Worst Years Ever for a 60/40 Portfolio



* 2022 return through 9/30/22

With bonds in a bear market and stocks hovering around their lowest since 2020, investors have $4.6 trillion in dry powder sitting in U.S. money-market mutual funds. Where does that money go?

Much of the portfolio headwind is being driven by raising rates and the Fed's policy to combat inflation. Bonds typically act as an anchor to falling stocks, but not during rising rate periods.

Hardest Hit Areas of Fixed Income This Year

Ticker	Name	Yield % Current	Return 2022 YTD	Duration (years)
EDV	Extended Duration Treasury Bonds	3.11%	−36.57%	24.00
TLT	20+ Year Treasury Bonds	2.74%	−29.24%	17.58
VCLT	Long-Term Corporate Bonds	4.62%	−28.50%	12.34
BLV	Long-Term Bonds	3.90%	−27.92%	14.07
TLH	10-20 Year Treasury Bonds	3.15%	−25.05%	14.18
CWB	Convertibles	2.71%	−22.39%	1.67
LQD	Investment Grade Corporate Bonds	3.54%	−20.69%	7.42
LEMB	Emerging Markets Bonds	4.72%	−17.64%	4.40
PFF	Preferred & Income Securities	5.70%	−16.92%	3.29
BOND	Active Bonds	3.59%	−15.94%	5.16
JNK	High Yield Bonds	6.78%	−15.66%	4.34
IEF	7-10 Year Treasury Bonds	2.23%	−15.22%	7.76
HYG	High Yield Corporate Bonds	6.11%	−14.60%	4.20
BIV	Intermediate-Term Bonds	2.40%	−14.48%	5.85
BND	Total Bond Market	2.61%	−14.10%	6.07
AGG	Core U.S. Aggregate Bonds	2.53%	−13.96%	6.00
TIP	TIPS Bonds	16.38%	−13.48%	6.73
MBB	MBS	2.56%	−12.97%	5.87
MUB	National Muni Bonds	2.32%	−10.67%	6.25
IEI	3-7 Year Treasury Bonds	1.59%	−10.18%	4.49

Tilting Towards a Pivot

If the Fed pivots and stops or slows the pace of rate increases, longer duration assets should rally but is the risk worth it?

Bloomberg US Aggregate Returns During Prior Rate Cut Cycles

	Total Returns by Maturity				
Rate Cut Cycle	**1-3 Year**	**3-5 Year**	**5-7 Year**	**7-10 Year**	**10+ Year**
7/5/1995 – 3/24/1997	10.23%	10.78%	11.41%	10.93%	10.11%
1/2/2001 – 6/29/2004	18.32%	21.34%	23.40%	27.24%	28.56%
9/17/2007 – 12/15/2008	6.70%	7.27%	5.76%	7.43%	6.90%
7/31/2019 – 3/17/2022	1.82%	1.75%	2.57%	3.74%	4.87%
Average	**9.27%**	**10.29%**	**10.79%**	**12.34%**	**12.61%**

Data Sources: Bloomberg

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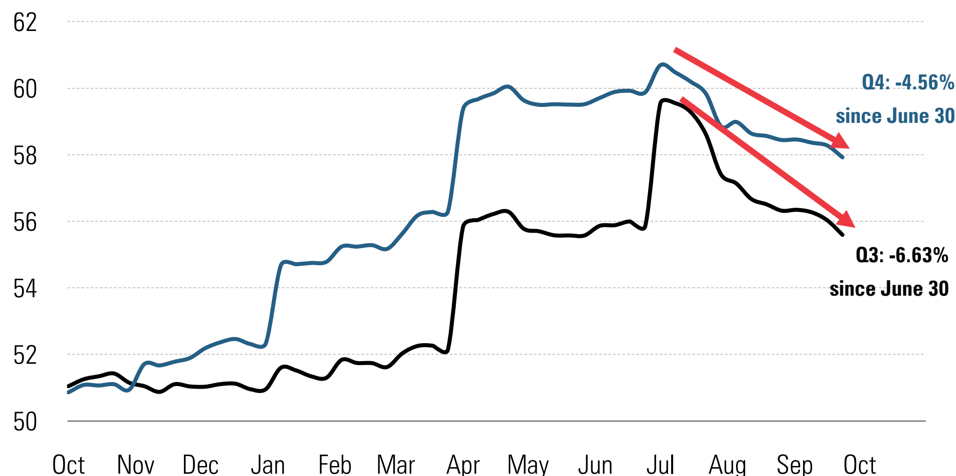
Earnings Still Matter

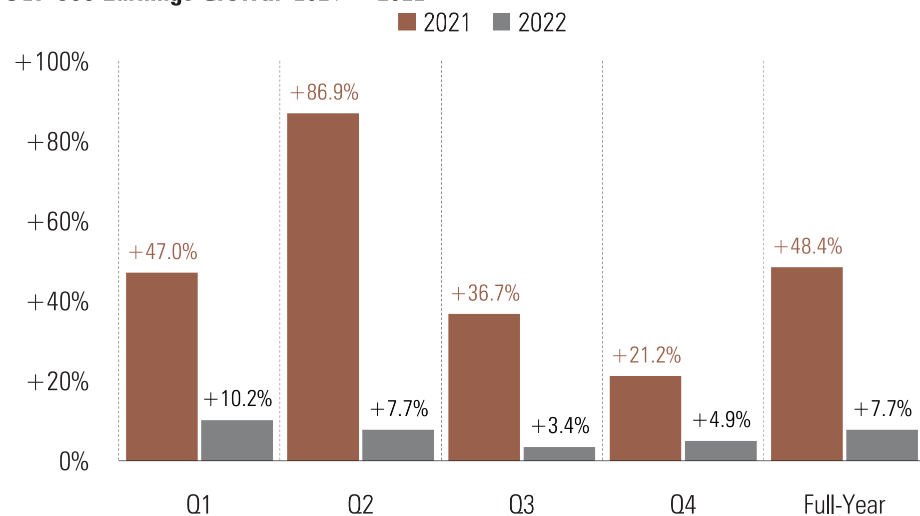
Consumer demand destruction has been pulling corporate earnings expectations lower for Q3 and Q4.

The estimated S&P 500 earnings growth rate for Q3 now stands at 3.4% compared to 9.8% at the end of Q2, which would mark the lowest growth rate reported for the index since Q3 2020.

S&P 500 Earnings Estimates Trend

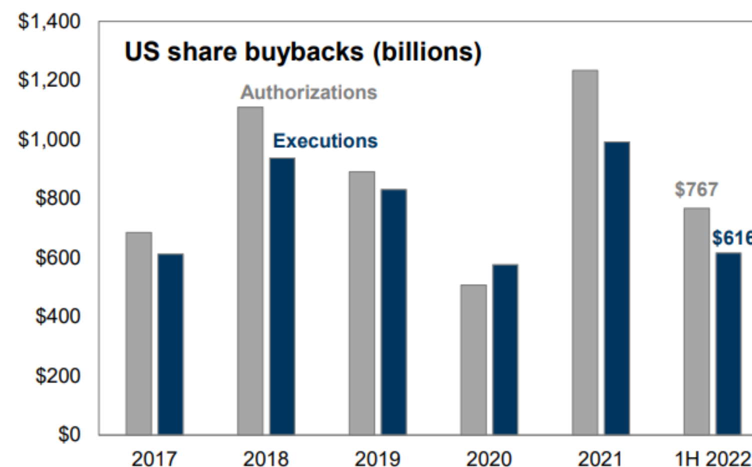


S&P 500 Earnings Growth 2021 – 2022



One tailwind to corporate earnings could be increased U.S. buyback authorizations which have YTD have jumped by 18% to $856 billion.

In addition, Goldman Sachs notes companies may pull forward planned buyback activity from 2023 to 2022 on a combination of low equity prices and the 1% buyback excise tax included in the Inflation Reduction Act.



The S&P 500 decline this year has been driven by rising interest rates.

The consensus forward P/E multiple has compressed by 28% since the start of 2022, from 22.05x to 15.80x.

S&P 500 Forward Price-to-Earnings

Data Sources: FactSet, Goldman Sachs, Bloomberg

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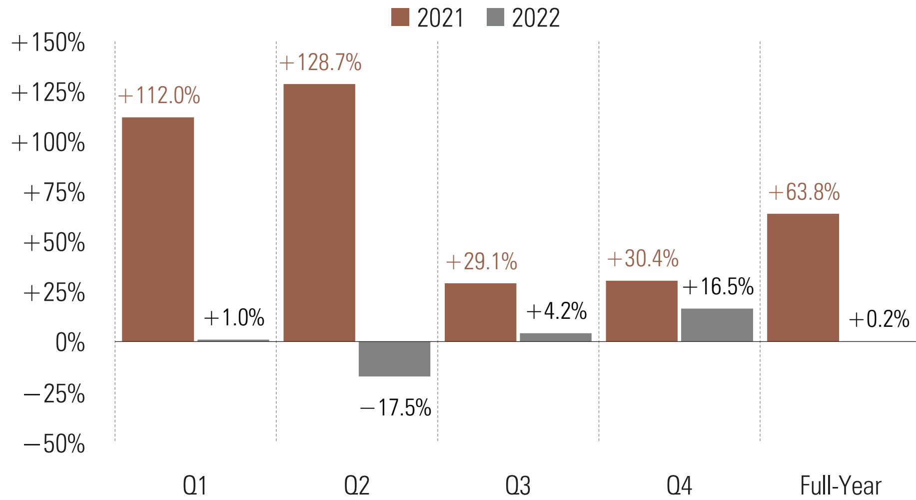
Developed Markets

After strong earnings growth in 2021, the invasion of Ukraine by Russian forces presents significant implications for both consumer demand and supply in the Euro area.

Sharply rising energy bills, weaker consumption, supply disruptions, shipping costs, and potential gas disruptions will weigh on both revenues and net income margins.

MSCI EAFE Earnings Growth: 2021 vs. 2022

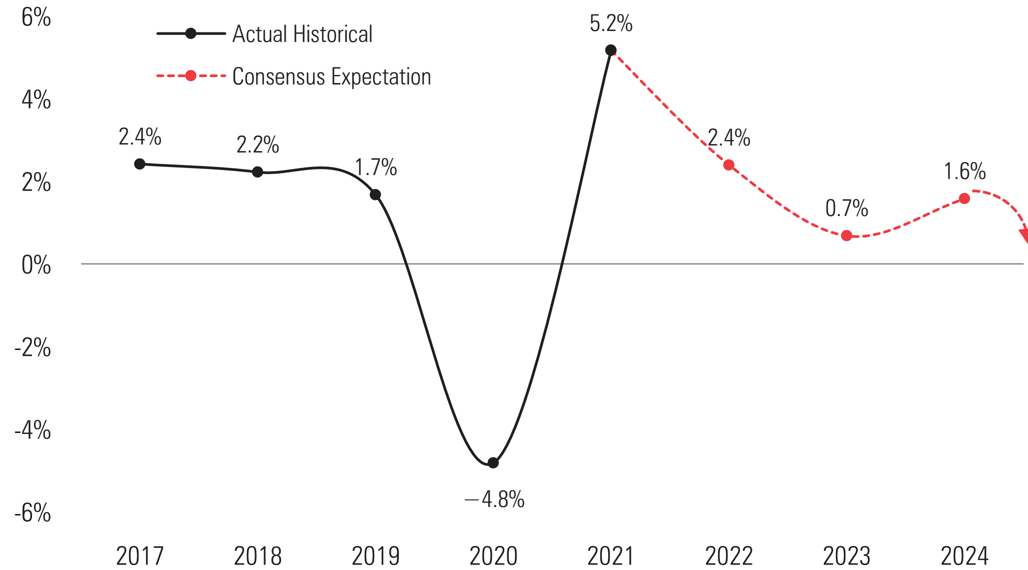


MSCI EAFE Forward Price-to-Earnings

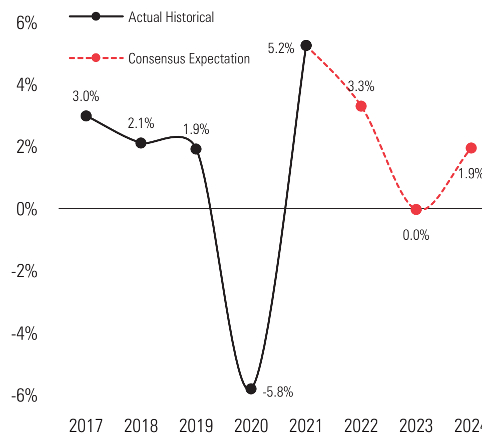
Developed markets growth could weaken substantially due to the spillovers from the Russia-Ukraine war, with full-year GDP growth of 2.4% (down from 4.1% before the war).

The uncertainty around the outlook, however, remains high. It would not be surprising to see zero growth in Developed Markets (Europe) and perhaps a recession in late 2022 or 2023.

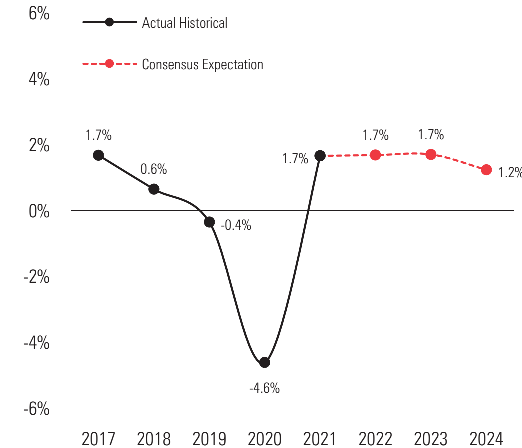
Developed Markets GDP Growth



Euro Area GDP Growth



Japan GDP Growth



Data Sources: Bloomberg

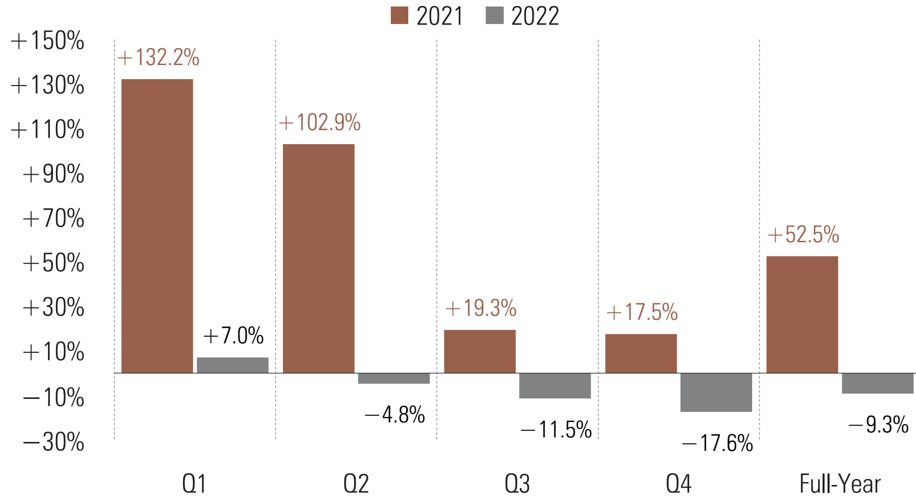
Emerging Markets

Over the past year, Emerging markets have grappled with higher real rates, a stronger dollar, and a slowdown in China growth.

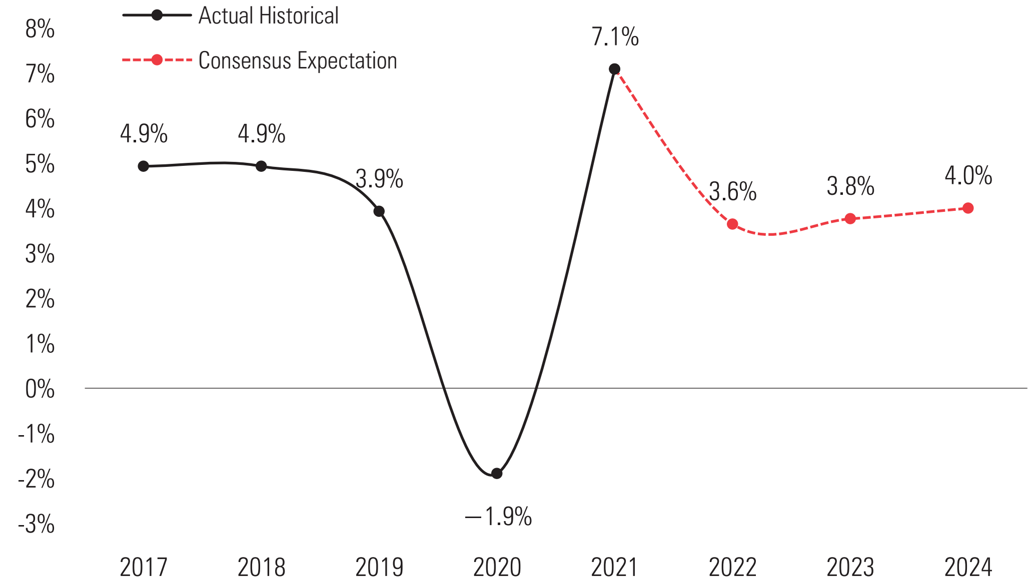
Dollar strength and rising U.S. rates may be a headwind to earnings for companies in Emerging economies that have U.S.-denominated debt, as interest payments and refinancings become more expensive.

While GDP growth in emerging markets could moderate around the 5% level, China and India should present stronger growth in 2022 and 2023.

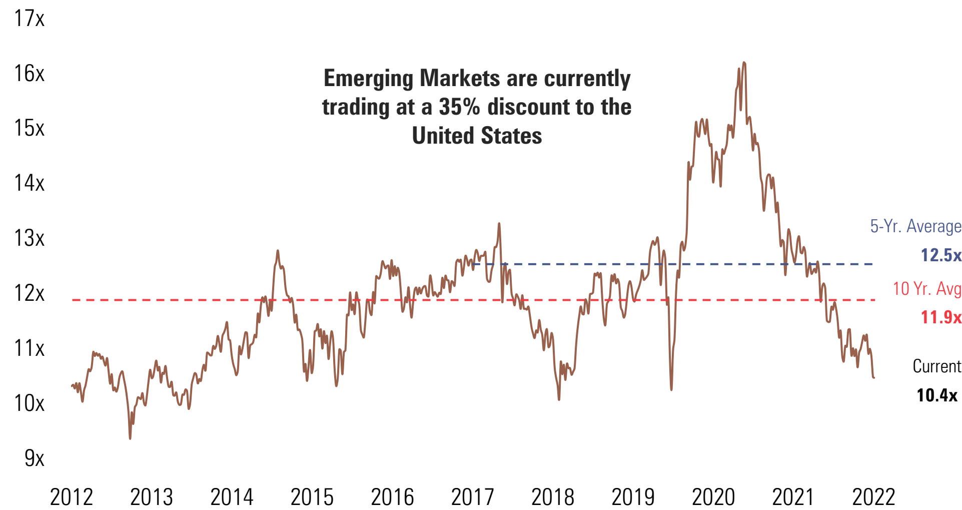
MSCI Emerging Markets Earnings Growth: 2021 vs. 2022

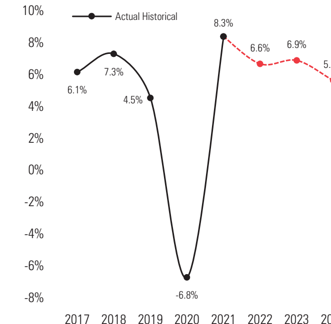


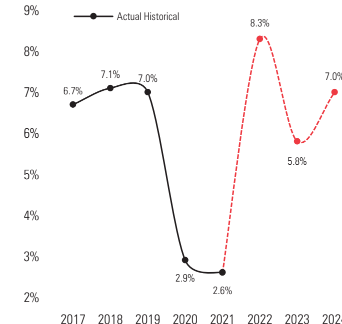
Emerging Markets GDP Growth



MSCI Emerging Markets Forward Price-to-Earnings







Data Sources: Bloomberg

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China

Resurgent COVID lockdowns and property market turmoil have weighed on Chinese stocks this year, with the CSI 300 down 22.5% for the year and almost 15% since the end of Q2.

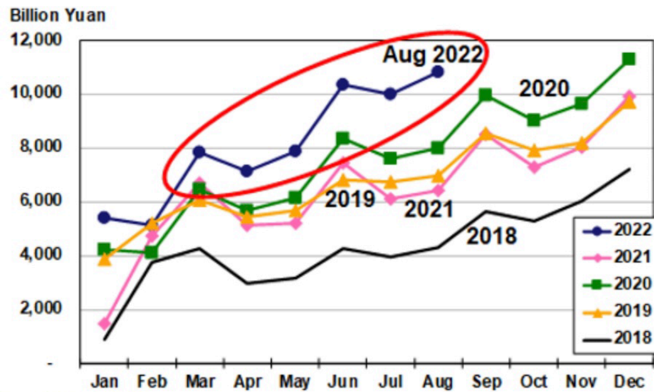
CSI 300 Market Performance Year-to-Date

Chinese households have been saving at a higher rate in 2022.

Year-to-date, households have added RMB 10.8 trillion ($1.54 trillion) in new bank savings compared to RMB 6.4 trillion ($913.2 billion) over the first eight months of 2021.

China Net Δ in Household Deposit

Year-to-date



Daily activity in China is beginning to return to pre-pandemic levels after fresh Covid lockdowns this year.

Intercity travel, road congestion, and subway traffic are tracking above 2019 levels while property sales and cinema revenue remain depressed.

China's yuan has fallen almost 12% this year as the U.S. dollar has rallied against other currencies.

A weaker currency is generally seen as a positive for Chinese exports, but its stability is considered even more important for the world's second biggest economy and the rest of the world through trade.

Onshore yuan falling to record lows

Data Sources: Bloomberg, Daily Shot, Evercore ISI

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How Long Will It Last?

When it comes to bear markets or recessions it's critical to realize "this too will pass." We entered a bear market on June 14th and the average days to end the 20% drawdown is 95 days.

Historically, the next year has had a market recovery of approximately 17.7%. Not too dissimilar to recessions and market recoveries.

Post-WW2 S&P 500 Bear Markets*

Start	-20%	Days to Bear	End	Days from -20% to End	% Chg from -20% to End	Full Bear % Chg	Full Bear # of Days	S&P 500 % Change Once -20% Threshold is Hit: Next Week	Next Month	Next 3 Mths	Next 6 Mths	Next Year
5/29/46	9/3/46	97	5/19/47	258	-8.20	-28.47	355	-2.73	-0.13	-3.40	2.73	2.20
6/15/48	6/13/49	363	6/13/49	0	0.00	-20.57	363	3.84	9.08	16.16	22.80	42.07
8/2/56	10/21/57	445	10/22/57	1	-0.43	-21.63	446	3.24	3.40	5.49	9.66	30.96
12/12/61	5/28/62	167	6/26/62	29	-5.73	-27.97	196	3.19	-1.96	5.93	11.93	26.14
2/9/66	8/29/66	201	10/7/66	39	-1.78	-22.18	240	3.88	2.39	7.90	16.44	24.62
11/29/68	1/29/70	426	5/26/70	117	-19.14	-36.06	543	0.25	4.45	-4.53	-8.93	11.89
1/11/73	11/27/73	320	10/3/74	310	-34.92	-48.20	630	-2.20	2.13	0.73	-7.44	-26.92
11/28/80	2/22/82	451	8/12/82	171	-8.22	-27.11	622	1.54	1.06	2.96	1.28	30.37
8/25/87	10/19/87	55	12/4/87	46	-0.41	-33.51	101	1.26	6.76	10.89	14.71	23.19
3/24/00	3/12/01	353	9/21/01	193	-18.16	-36.77	546	-0.79	0.28	6.41	-7.42	-1.24
1/4/02	7/10/02	187	7/23/02	13	-13.34	-31.97	200	-1.57	-1.29	-12.66	0.77	7.41
10/9/07	7/9/08	274	11/20/08	134	-39.55	-51.93	408	0.05	4.15	-26.90	-28.47	-29.08
1/6/09	2/23/09	48	3/9/09	14	-8.99	-27.62	62	-5.72	10.71	19.33	38.05	47.26
2/19/20	3/12/20	22	3/23/20	11	-9.81	-33.92	33	-2.87	12.46	22.60	34.68	58.96
1/3/22	?	161+	?	?	?	?	?	?	?	?	?	?
	Average	**244**		**95**	**-12.05**	**-31.99**	**339**	**0.10**	**3.82**	**3.64**	**7.20**	**17.70**
	Median	**238**		**43**	**-8.60**	**-30.22**	**359**	**0.15**	**2.89**	**5.71**	**6.19**	**23.90**
	% Positive	--		--	--	--	--	57.1	78.6	71.4	71.4	78.6
Avg. All Periods Since 1945								***0.30***	***1.01***	***2.42***	***4.88***	***9.89***

Recession	Recession Length	Prior 6 Months	During Recession	Plus 1 Year	Plus 3 Years	Plus 5 Years
8/1929 - 3/1933	43 months	14.0%	-74.5%	92.0%	192.1%	84.8%
5/1937 - 6/1938	13 months	-2.4%	-24.2%	-1.8%	0.9%	44.3%
2/1945 - 10/1945	8 months	8.6%	27.7%	-7.3%	15.3%	57.8%
11/1948 - 10/1949	11 months	9.8%	4.1%	31.5%	88.0%	171.3%
7/1953 - 5/1954	10 months	-6.5%	27.6%	35.9%	83.7%	144.8%
8/1957 - 4/1958	8 months	9.3%	-6.5%	37.3%	66.4%	89.7%
4/1960 - 2/1961	10 months	-1.0%	18.4%	13.6%	35.1%	68.4%
12/1969 - 11/1970	11 months	-7.8%	-3.5%	11.2%	20.6%	25.2%
11/1973 - 3/1975	16 months	2.9%	-17.9%	28.3%	22.0%	55.3%
1/1980 - 7/1980	6 months	7.7%	16.1%	12.9%	55.9%	100.9%
7/1981 - 11/1982	16 months	-1.0%	14.7%	25.4%	67.2%	103.2%
7/1990 - 3/1991	8 months	3.1%	7.6%	11.0%	29.8%	98.2%
3/2001 - 11/2001	8 months	-17.8%	-7.2%	-16.5%	8.4%	34.3%
12/2007 - 6/2009	18 months	-2.3%	-35.5%	14.4%	57.7%	137.0%
2/2020 - 4/2020	2 months	18.4%	-13.7%	43.6%	—	—
AVERAGE	**13 months**	**2.3%**	**-4.4%**	**22.1%**	**53.1%**	**86.8%**

Regardless of if we are in a recession now or a soft landing, the Fed's tools are going to be truncated as growth continues to moderate and inflation abates.

Perhaps that's why in almost every case, two consecutive quarters of negative GDP growth has been followed by a median return of 31.55% on the S&P 500 one year later.

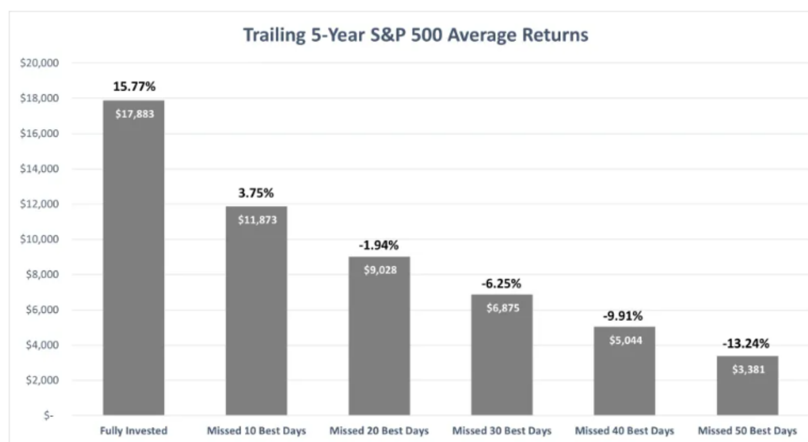
Back to Back Quarters of Negative GDP: 1950 - 2022

Second Quarter of Negative GDP	S&P 500 Performance (%): During 2 Down Qs	3 Months	Six Months	One Year
12/31/1953	2.78	8.59	17.73	45.02
3/31/1958	-0.75	7.46	18.91	31.69
3/31/1970	-3.75	-18.87	-6.05	11.92
12/31/1974	-20.28	21.59	38.84	31.55
9/30/1980	22.89	8.21	8.40	-7.40
3/31/1982	-3.63	-2.10	7.56	36.62
3/31/1991	22.60	-1.08	3.37	7.59
12/31/2008	-29.43	-11.67	1.78	23.45
6/30/2020	-4.04	8.47	21.15	38.62
6/30/2022	-20.58	4.22	4.22	
Median	**-3.63**	**7.46**	**8.40**	**31.55**

Markets move in brief bursts, miss just a few days and you lose all the advantage

Total Trading Days	1260				
Missed Days	10	20	30	40	50
% of Missed Days	0.79%	1.59%	2.38%	3.17%	3.97%

Source: Deep in the Trenches



Data Sources: Bespoke, Bloomberg, Capital Group, Bespoke

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Our View & Recommendations

Our View

- The current pace and trajectory of interest rate increases could induce a policy error-driven recession. Eroding consumer sentiment will pose a challenge to a straight-line Fed interest rate policy.
- The Federal Reserve will likely pause rate increases before Wall Street expectations are met, motivated by a weaker economic backdrop. A soft landing is still within the range of outcomes that can lift equity prices in the months to come.
- The U.S. consumer is still resilient, as strong jobs and wages provide a positive backdrop. However, expect an erosion in sentiment and a contraction in consumption.
- Europe too will be very close to a recession as they face higher food and energy prices as well as extreme consumer pessimism.
- A strong U.S. dollar is posing a threat to some emerging markets. However, Emerging Markets continue to offer strong growth-to-valuation opportunities.
- China will offer a counter-cyclical opportunity to the U.S. as it's in a stimulative economic posture. We expect Zero Covid policies to become watered down as the CCP grapples with a loss of confidence, weakening property sector and a renominating process in October.

Recommendations

- Reaffirm your investment strategy and maintain strategic liquidity to cover spending needs and provide opportunities for cost averaging.
- Underweight Developed Markets as the ground war in Europe poses a real risk to consumption habits and earnings growth.
- Maintain an overweight to Emerging Markets and China as they continue to represent reasonable earnings growth to valuation prospects.
- Capture shorter duration fixed income opportunities as a Fed pivot becomes more apparent.
- Continue to shift to Base Metals, Health Care, and U.S. Quality. Base metals offer a hedge against inflation and take advantage of a commodities super cycle. Health Care offers tremendous pricing power and a better corporate earnings outlook in an inflationary environment. Quality is a hedge against a prolonged rate increase cycle vs. growth.

What's On Our Mind?

ARE WE IN THE MIDST OF A SECULAR REGIME CHANGE FROM:	POSSIBLE ALLOCATION RESPONSES
Low Inflation → Enduring High Inflation Lower Interest Rates → Higher Rates for Longer	Cash now, duration on fixed income
Globalization & Importing Deflation → Deglobalization & Higher Costs Carbon Driven Energy → Carbonless Economies	Commodity exposure – minerals, energy, & oil
Uncorrelated Stock & Bond Movements → Correlated Stock & Bond Movements	Dividend & quality growth Non-correlated equity alternatives – illiquid, event-driven, hedge, China

Mean Reversion Dashboard

Style Forward P/E as a % of 20-Year Average

Size	Value	Blend	Growth
Large	89.6%	98.2%	112.6%
Mid	80.9%	85.4%	95.7%
Small	83.9%	78.3%	71.4%

Regions & Countries Forward P/E as a % of 20-Year Average

Regions

World	Developed Markets	Emerging Markets
91.7%	80.3%	92.3%

Countries

United States	Germany	United Kingdom	China	Brazil	India	Russia
100.0%	72.3%	65.7%	84.8%	61.0%	122.8%	—

Sector Forward P/E as a % of 20-Year Average

Sectors

Energy	Materials	Industrials	Consumer Discretionary	Consumer Staples	Health Care	Financials	Technology	Telecom	Utilities	Real Estate
36.2%	78.8%	95.1%	117.3%	111.1%	101.1%	88.6%	105.5%	85.8%	123.6%	73.3%

Data Source: Bloomberg

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THANK YOU

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