Key Takeaways

After a very difficult first half of the year, equity markets rebounded in July and August …but tumbled to fresh lows in late September amid further aggressive central bank rate hikes and statements of further tightening to come.

Core investment-grade bonds didn't avoid the Q3 carnage. The 10-year Treasury yield hit a decade high of 3.97%, causing the Bloomberg U.S. Aggregate Bond Index (the "Agg") to drop 4.75%.

The economic backdrop for the U.S. and global economy deteriorated further in the third quarter. Stubbornly high Inflation remains the key economic indicator.

While headline CPI inflation (which includes food and energy) seems to have peaked, core inflation measures have continued to rise and are far above the Fed's 2% target.

The good news is that many of these supply-chain disruptions are dissipating as the pandemic recedes globally.

While I weigh the evidence as leaning strongly towards a U.S. recession, there are still some positives supporting the economy that may mitigate the *severity* of a recession if/when it happens: a strong labor market, rising wages, and a strong US consumer.

At current valuation levels, stocks may not be adequately discounting the potential for further earnings declines.

The sharp increase in interest rates this year has driven bond yields up to more attractive levels – more attractive than they have been in about a decade.

On a relative basis, core investment-grade bonds now look much better versus stocks than at the start of the year.

Market Recap

After a very difficult first half of the year, equity markets rebounded in July and August on investor hopes inflation easing and a Fed pivot or pause on interest rate increases. The reprieve was short-lived however, as stocks tumbled to fresh lows in late September amid further aggressive central bank rate hikes and statements of further tightening to come.

Global stocks (MSCI ACWI Index) fell 6.82% for the quarter and are down 25.63% for the year. The S&P 500 dropped 4.88% for the quarter and is down 23.87% for the year. Developed international markets (MSCI EAFE Index) fell 9.36% for the quarter and 27.09% YTD. Emerging Market stocks (MSCI Emerging Markets Index) dropped 11.57% for the quarter, and down 27.16% YTD.

Foreign stock market returns were negatively impacted by the sharp appreciation of the dollar. The U.S. Dollar Index was up 7.1% for the quarter and a stunning 17.3% on the year, hitting a 20-year high (for US based investors, a stronger US dollar is a headwind to foreign equity returns). What this means is that if you are an American investor holding securities denominated in a foreign currency, then even if those securities defied the markets and maintained their value since the beginning of the year, you would still have lost 17.3% to currency changes when translating the value of your investment back into U.S. dollars.

Core investment-grade bonds didn't avoid the Q3 carnage. The 10-year Treasury yield hit a decade high of 3.97%, causing the Bloomberg U.S. Aggregate Bond Index (the "Agg") to drop 4.75%. This puts the "safe-haven" Agg down an incredible 14.61% since the start of the year. In other segments of the fixed-income markets, high-yield bonds (ICE B of A Merrill Lynch U.S. High Yield Index) dropped 0.69% and floating rate loans (Morningstar LSTA Leveraged Loan index) gained 1.37% for the quarter. For the year to date, floating rate loans have been one of the best performers, down just 3.25%.

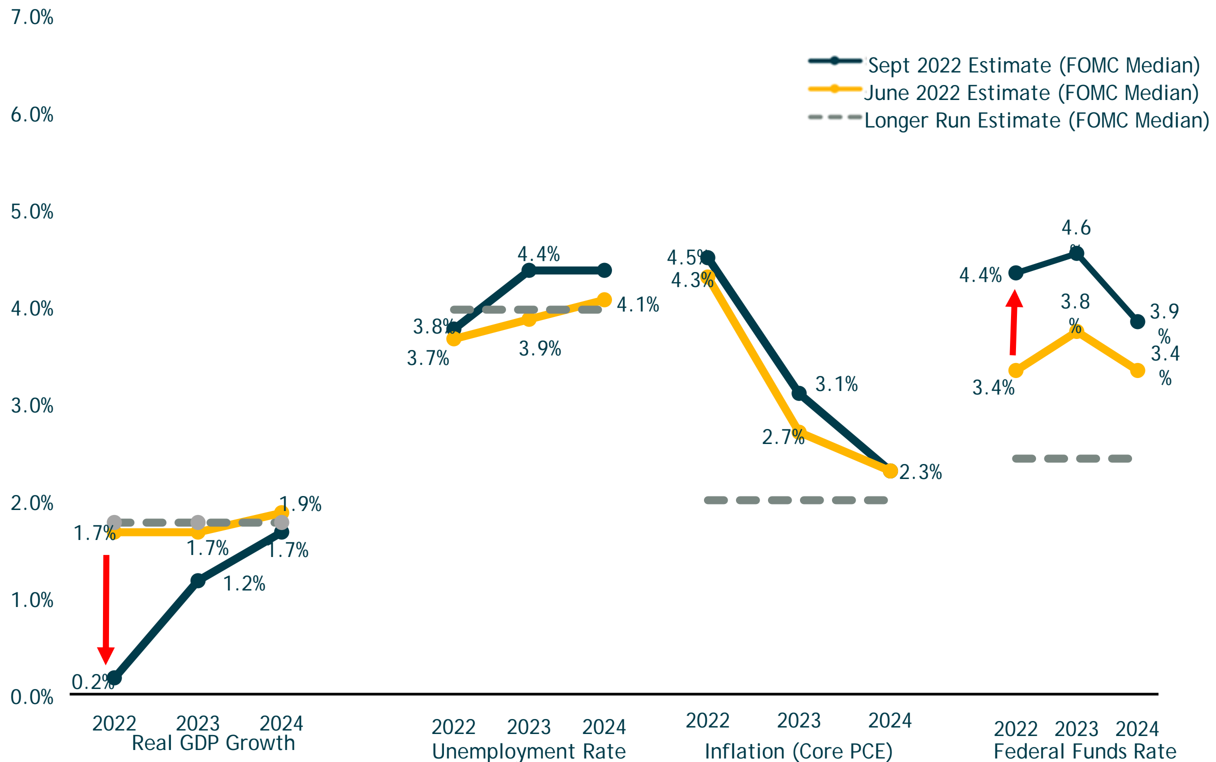
Our trend-following managed futures fund, the PIMCO TRENDS Managed Futures Strategy, which we're using as a bond-alternative in our portfolios, was one of few bright spots, earning 2.83% for the quarter. A feature of managed futures funds is that they have the potential to generate positive returns in both positive and negative equity or bond environments. This past quarter showed why this fund can function as an attractive diversifier to both stocks and bonds. In a 12-month period that saw the S&P 500 index fall more than 15%, and the Barclays Aggregate Bond index decline more than 14%, this fund generated a positive 22.51% return.

Investment Outlook and Portfolio Positioning

The economic backdrop for the U.S. and global economy deteriorated further in the third quarter. Stubbornly high Inflation remains the key economic indicator. The Fed's response to the sharp spike in inflation has been to aggressively raise interest rates – their primary means of bludgeoning economic activity to reduce aggregate demand and in turn bring inflation in line with their longer-term targets. This has been the catalyst for the steep declines in both stocks and bonds.

While headline CPI inflation (which includes food and energy) seems to have peaked, core inflation measures have continued to rise and are far above the Fed's 2% target. This indicates inflationary pressures have become more widespread throughout the economy, rather than driven by a few extreme outliers as in 2021.

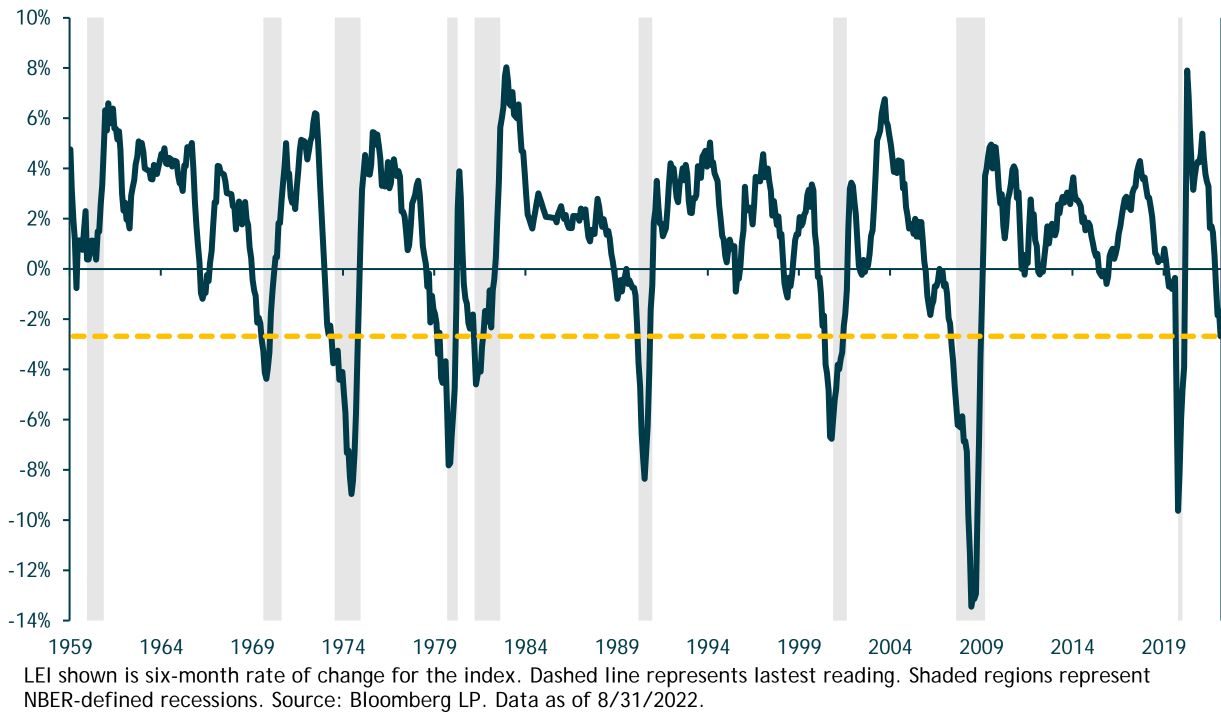
Some of this broad-based core inflation is still due to the initial "transitory" COVID-related supply-side disruptions and production/distribution bottlenecks, which central banks can't do anything about. The good news is that many of these supply-chain disruptions are dissipating as the pandemic recedes globally. However, the demand-side drivers of core inflation in the U.S. have not yet peaked, let alone demonstrated the consistent month-over-month declines that Fed Chair Jerome Powell says the Fed is looking for as "clear evidence" inflation is headed to their 2% target. As a result, the Fed has continued its path of aggressive rate increases and has signaled more to come (below):



Source: The Federal Open Market Committee, Summary of Economic Projections

The Fed's policy hammer of higher interest rates will eventually pound down GDP growth and increase unemployment. The odds of the Fed engineering an economic soft landing -- the U.S. economy slowing sufficiently to tame inflation but not falling into a deep recession with much higher unemployment – are increasingly slim. In fact, historically reliable indicators, including the Leading Economic Index (on the following page) and an inverted yield curve, **point strongly toward a recession, and that is now our base case scenario for the next 12 months.**

The U.S. Leading Economic Indicator (LEI) is Signaling Recession is Likely



LEI shown is six-month rate of change for the index. Dashed line represents lastest reading. Shaded regions represent NBER-defined recessions. Source: Bloomberg LP. Data as of 8/31/2022.

While I weigh the evidence as leaning strongly towards a U.S. recession, there are still some positives supporting the economy that may mitigate the *severity* of a recession if/when it happens: a strong labor market, rising wages, and a strong US consumer. Moreover, there doesn't appear to be any major, systemic economic/financial imbalances (e.g., unlike in 2007/2008).

My focus is on longer-term fundamentals and valuations, and I'm not in the business of making shorter term bets on the markets. However, the research I'm reading tells me that at current valuation levels, stocks may not be adequately discounting the potential for further earnings declines. This has led me to revise some of my underlying assumptions and reduce the return I expect from stocks over the next five-year time horizon.

At the same time, the sharp increase in interest rates this year has driven bond yields up to more attractive levels – more attractive than they have been in about a decade. On a relative basis, core investment-grade bonds now look much better versus stocks than at the start of the year. Further, core bonds provide good downside protection, which would be especially helpful if conditions turn out to be worse than currently anticipated.

For these reasons, I've considered a modest shift to our target allocations, which would increase core bonds and reduce equities (generally from 2% to 5% depending on the portfolio). However, I'm aware that it is also possible, given recent large percentage moves in the stock market, that stocks could quickly fall enough to make their valuations more attractive, even in a high-interest rate environment - it is this possibility that keeps me from making an allocation shift to bonds at this time. But what's informative to me is that for the first time in a while, I'm looking at bonds as a vehicle *to make money* and not just as a stock market hedge, and I suspect others are doing the same.

Updated Five-Year Expected Returns for Equity and Core Bonds					
	Current Level	Downside/Bear	Base Case Lower	Base Case Upper	Upside/Bull
US Stocks	3,586 USD	-3.6%	3.9%	10.1%	15.0%
Europe Stocks	1,565 LCL	-2.2%	3.0%	10.9%	20.7%
Emerging-Markets Stocks	54,180 LCL	0.6%	9.3%	16.3%	23.8%
US Core Bonds	4.75%	8.0%	5.3%		5.8%

US Stocks: S&P 500 Index, Europe Stocks: MSCI Europe Index, Emerging-Markets Stocks: MSCI EM, US Core Bonds: Bloomberg US Aggregate Bond Index. Europe and EM stocks return estimates in local currency—the US dollar will impact returns for dollar-based investors. Return estimates as of 9/30/2022.

Estimated returns are annualized. This table shows my five-year, annualized asset class return estimates across several broad macroeconomic scenarios I believe possible. Collectively, the scenarios encompass the range of outcomes I believe are reasonably possible and therefore worth considering in determining portfolio allocations. I make assumptions for various fundamental and valuation metrics I believe are consistent for each asset class within each macro scenario then incorporate current prices to generate an estimated return. The macroeconomic scenarios and estimated returns can change. Upon request, I'm happy to provide my "Estimated Returns Disclosure," which outlines in greater detail the framework used to arrive at my estimates.

Closing Thoughts

It's been a tough year, with most investors (myself included) braced for more to come. But all bear markets come to an end, and it is worth remembering that the bottom is, by definition, the point at which things collectively feel the worst. I think about the long term and remain confident in our ability to deliver the long-term returns required to meet financial objectives while balancing risk.

As always, I thank you for your trust and welcome questions you may have.

Best,
Kelly D. Kane, ChFC, CFP