TrustPoint

MarketPoint

An Economic & Market Commentary from Trust Point

Third Quarter 2022 | Issue No. 39

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An Economic and Market Update from Trust Point

The third quarter of 2022 was another difficult period for both stocks and bonds. Economic growth concerns remained prevalent in the face of very hawkish efforts from central banks determined to kill the hot inflationary backdrop. We are clearly in a more difficult phase of the business and market cycle, and as a result, markets are likely to remain volatile. This is not the time to be aggressive, so we continue to position portfolios with defense in mind.

KEY ECONOMIC DATA

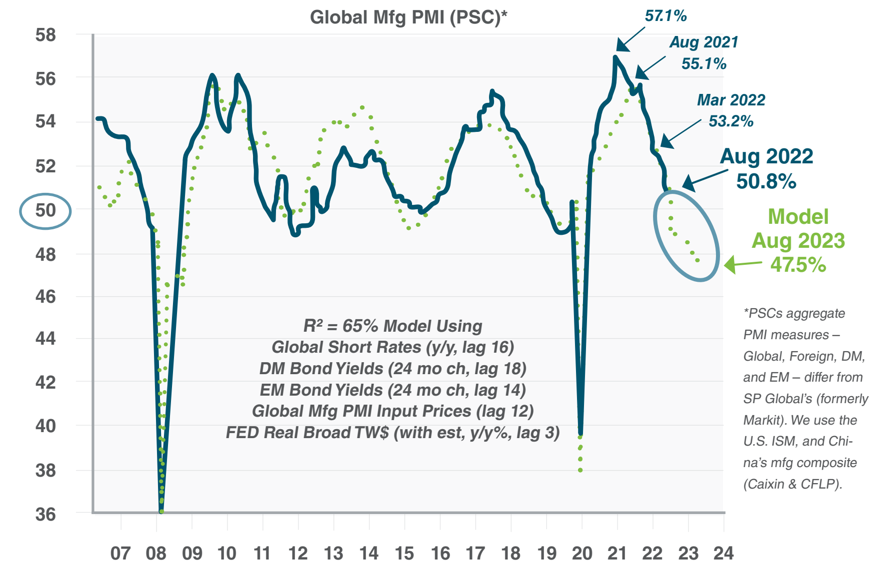
	As of	Actual	3 Mos. Ago	1 Year Ago
Dollar Index Level	Sept	112.1	104.7	94.2
US Economic Activity				
ISM Manufacturing (>50 = Expansion)	Sept	50.9	53.0	60.5
ISM Non-Manufacturing (>50 = Expansion)	Sept	56.7	55.3	62.6
Non-Farm Payrolls	Sept	263k	293k	424k
Unemployment Rate	Sept	3.5%	3.6%	4.7%
CPI Ex-Food & Energy (yoy)	Aug	6.3%	6.0%	4.0%
Global Economic Activity				
JP Morgan Global Manufacturing Index (>50 = Expansion)	Sept	49.8	52.2	54.1
JP Morgan Global Services Index (>50 = Expansion)	Sept	50.0	53.9	53.8

Source: Bloomberg

Global Recession is Very Likely

Our analysis shows that economic growth should slow well into 2023 (Chart 1). A rise in short-term and long-term interest rates remains the primary factor contributing to an anticipated slowdown ahead. With the cost of money for consumers, businesses and governments going up, economic growth has and will continue to slow. The U.S. remains the most insulated economy, given a still-healthy labor market, large excess savings, a strong U.S. dollar and the trend toward "onshoring", "reshoring" or "nearshoring" (Chart 2). This is the notion of bringing operations/businesses back to America for political, national security, regulatory, competitiveness, or logistical reasons. However, our economy is not immune to a global recession and the likelihood that the U.S. economy completely avoids a recession has clearly diminished. Outside the U.S., Europe and the UK are in a very difficult situation due to the crisis in Ukraine and the resulting surge in energy bills driven by Russia's increased willingness to use energy as a weapon. The equity market is telling us that a global recession is likely, and we think the market is largely correct in its assessment.

Chart 1: Slower Economic Growth Ahead



Source: Piper Sandler & Co.

Stay Focused on the Long Term

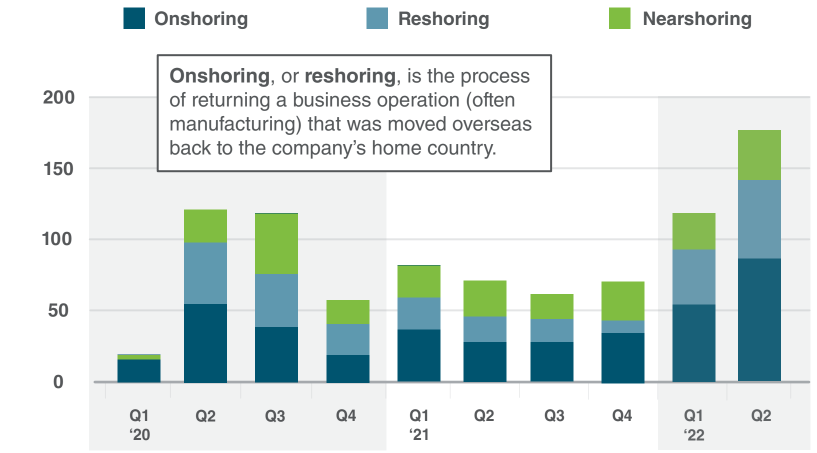
Yes, recession is a scary word but a recession doesn't mean the investing world is coming to an end. It is always interesting to hear people talk about prior recessions (and the associated downturn in asset prices) as past opportunities. Certainly, a recession can get ugly at times but remember that over the last 40 years, we have spent only 6% of that time in a recessionary window; the other 94% of the time, things were quite good and comfortable (Chart 3). That is quite remarkable given all the things we have endured over the past several decades: natural disasters, political failures, terrorist attacks, wars, pandemics, deflation or inflation scares, several recessions, etc. People and businesses have the ability to overcome, fix, learn, adjust, pivot, etc. This is why 94% of the time, our economy is growing and asset markets follow suit. Lower equity and bond prices have never made anyone feel good and we understand that. But as someone once told me, flowers take both rainy days and sunny days to grow, and the stock and bond markets are no different. This time around will be no different either.

Defense First

As we encourage our clients to stay the course and stick with their long-term plan, we also continue to urge for broad diversification across asset classes and geographies to improve portfolio resilience and help guard against a broader range of potentially negative outcomes. With that in mind, it is also our responsibility to tactically anticipate and adjust portfolios to changing macro conditions. All year, we have been active and have made a number of changes to improve the risk/return trade-off within our clients' portfolios. At multiple times throughout the year, we have taken advantage of short-term rallies in markets to reduce exposure to equities, credit, cyclical and international stocks, using the proceeds to increase exposure to higher quality bonds, value defensive, and domestic stocks. Tactically, we are pleased with the changes made. Strategically, we encourage our clients to stay focused, patient, and disciplined and consider the recent market decline as a long-term opportunity, not a threat. When everything gets cheaper and more attractive such as it has year-to-date, long-term future expected returns go up (not down).

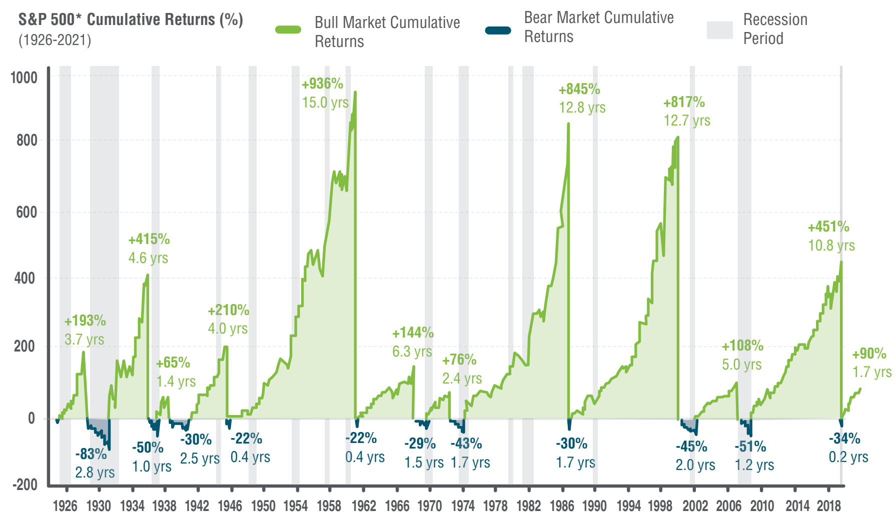
Chart 2: Bring It Home

Mentions of onshoring buzzwords in earnings calls and presentations of U.S. public companies



Source: Bloomberg

Chart 3: Expansions Are Much More Common Than Recessions



As of December 31, 2021, S&P 500* (gross dividends reinvested) in USD. Bear markets represented peak-to-trough price declines of 20% or more in the S&P 500* Index. Bull markets reflect all other periods. Monthly returns are shown for S&P 500* Index, except for the COVID-19 Crisis, which is daily. Past performance is no guarantee of future results.

Source: FactSet and NBER

An Equity Market Update from Trust Point

In Q3, the S&P 500 index declined 5.0% while the MSCI ACWI ex-US index fell 9.9% (USD). As has been the theme all year, central banks' continued aggressive actions to raise interest rates to fight inflation have led to worries about slowing economic growth and a possible recession. The result has been a further drawdown in equity markets.

The 4th Bear Market Rally Flips to Another Drawdown. What now?

In mid-June, global and U.S. equities, measured by the MSCI ACWI Index and S&P 500, respectively, reached their lowest levels to date since the market drawdown began in early January … but then rallied approximately 13% over the next two months. Investors were latching onto falling oil prices and hopes of less hawkish monetary policy. Investor optimism soon ran out as central bankers doubled down on their commitment to get inflation under control. In the last six weeks of the quarter, global markets fell another 15% to hit year-to-date lows that are down over 25%. Putting a bear market cycle in perspective is helpful in times of big market moves. During the bear market of 2008-09, the market experienced several mid-cycle rallies (Chart 4). Prior bear markets also highlight the fact that markets don't go down in a straight line. So far this cycle, the index has experienced four rallies, suggesting another rally may still be a possibility. But, if the next rally represents the fifth in the cadence, that may imply yet another leg down before ultimately bottoming. Our research also shows that during Fed-led recessions, which we believe is the current scenario, the S&P 500 has had a median 28% maximum drawdown, perhaps suggesting the worst may already be behind us. On the other hand, we are likely not out of the woods yet as declines in corporate earnings do not look to be fully priced into the market at this point, as we discuss below. Encouragingly, however, equity prices now represent a better entry point for long-term investors, even with the possibility of more short-term volatility.

EQUITY BENCHMARK TABLE

US Economic Activity	Quarter-End	3 Mos. Ago	1 Year Ago	3 Years Ago	5 Years Ago
S&P 500	3,586	3,785	4,308	2,977	2,519
Dow Jones Industrial Average	28,726	30,775	33,844	26,917	22,405
NASDAQ	10,576	11,029	14,449	7,999	6,496

Equity Returns (%)	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Large Cap Growth	-3.6%	-30.7%	-22.6%	10.7%	12.2%
US Large Cap Value	-5.6%	-17.8%	-11.4%	4.4%	5.3%
US Mid Cap Growth	-0.7%	-31.5%	-29.5%	4.3%	7.6%
US Mid Cap Value	-4.9%	-20.4%	-13.6%	4.5%	4.8%
US Small Cap Growth	0.2%	-29.3%	-29.3%	2.9%	3.6%
US Small Cap Value	-4.6%	-21.1%	-17.7%	4.7%	2.9%
International Large Cap Developed (US Dollar)	-9.4%	-27.1%	-25.1%	-1.8%	-0.8%
International Small/Mid Cap Developed (US Dollar)	-9.8%	-32.1%	-32.1%	-2.2%	-1.8%
Emerging Market (US Dollar)	-11.6%	-27.2%	-28.1%	-2.1%	-1.8%

Source: Bloomberg, Morningstar

Chart 4: Equities Average About Five Rallies Per Bear Market

Source: Bloomberg

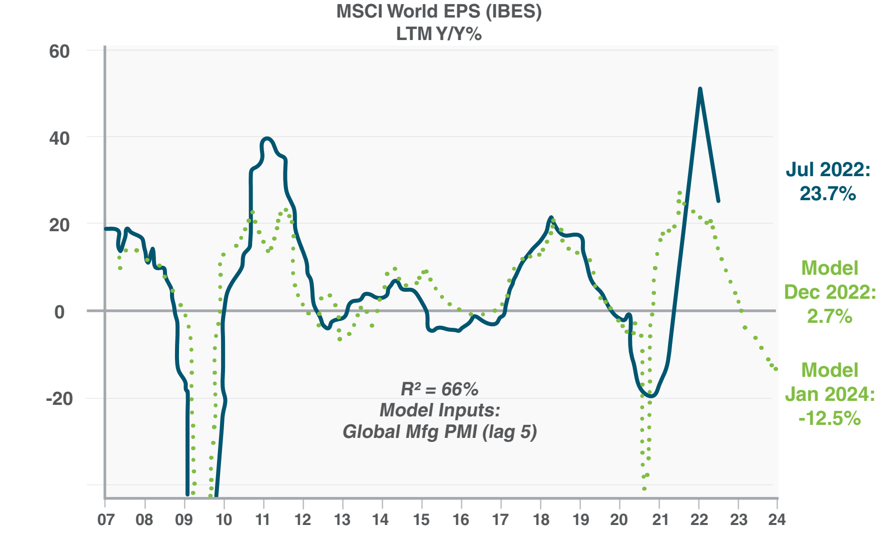
Earnings Growth Expectations Contracting As Expected

The economic activity models we follow forecast an economic slowdown ahead, and so do the models for earnings growth. One such model (Chart 5) is now predicting that by January 2024, the last 12 months global earnings ("LTM"), which is to look back over calendar year 2023, will have fallen 12.5% from 2022 levels. The 2023 forecasted earnings are currently expected to increase 6.6% year-over-year. That is a 19.1% point difference! So, why is the model for earnings growth so pessimistic compared to current expectations in the marketplace? Although corporate profit margins hit a multi-decade high last quarter, both revenue and costs continue to be more vulnerable by the day. A slowdown in demand and economic activity puts corporate revenues at risk while labor costs, typically a company's biggest expense, are likely to increase as long as the labor market remains as tight as it is today. Further, widely-followed CEO confidence surveys have historically been a good proxy for profit-margin growth, and confidence has eroded considerably since the beginning of this year and is now at recessionary levels. Thus, while profit margins continued to rise last quarter, we see a path toward lower margins and lower earnings over the next several months.

Equity Positioning, TINA, and TARA

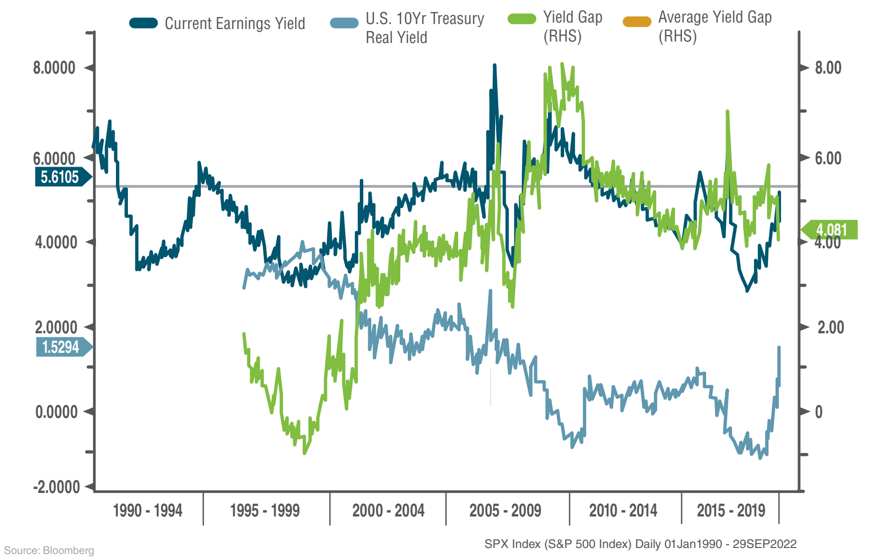
Throughout the year we have been proactive in reducing risk exposure in portfolios to now having, relative to the benchmark, an underweight position to equities and an overweight position to fixed income. These changes highlight the shift from "there is no alternative" or TINA, a period earlier this year that referred to stocks being relatively attractive to other asset classes despite expensive valuations, to "there are reasonable alternatives" or TARA, today, a term recently coined by Goldman Sachs. While U.S. stock valuations have fallen dramatically this year, U.S. bond valuations have fallen even more, embodied by the highest yields in over a decade. This, in turn, makes high-quality bonds look attractive compared to stocks, given bonds' greater downside protection profile and stocks' lower equity risk premium (the extra returns investors should expect for investing in stocks relative to bonds, Chart 6). This provides investors with less incentive to take on risk and consider allocating to equities. Furthermore, within equities, we have taken a considerable defensive approach by allocating more to quality and low-volatility factors and increasing exposure to sectors that tend to provide more downside protection, such as consumer staples, health care, and utilities.

Chart 5: Model Predicting Double-Digit Global Earnings Declines in 2023



Source: Piper Sandler & Co.

Chart 6: Equity Earnings Yields Becoming Less Attractive Compared to Real Bond Yields



Source: Bloomberg

A Fixed Income Market Update from Trust Point

Global interest rates have continued to rise as soaring inflation has caused central banks around the world to hike policy rates in unison. In the U.S., the Federal Reserve has made it clear that reducing inflation is a priority and the Fed is willing to sacrifice growth to attain that objective, even if it brings pain to households and businesses. Given this recent hawkish messaging from central banks, we may be approaching peak yields as interest rates continue to price in higher terminal policy rates while ignoring recession concerns building up.

FIXED INCOME BENCHMARK TABLE

US Yields (%)	Quarter-End	3 Mos. Ago	1 Year Ago	3 Years Ago	5 Years Ago
3 Month T-Bill	3.3%	1.6%	0.0%	1.8%	1.0%
2 Yr US Treasury	4.3%	3.0%	0.3%	1.6%	1.5%
10 Yr US Treasury	3.8%	3.0%	1.5%	1.7%	2.3%

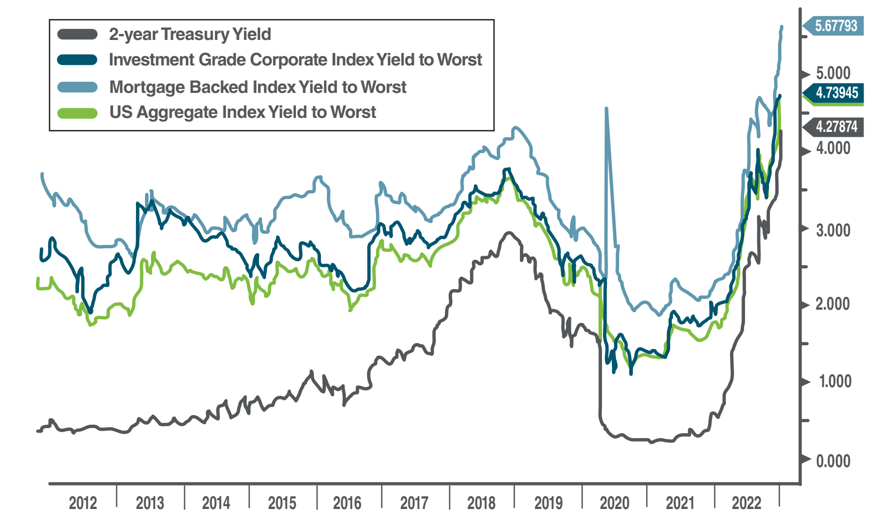
Global Economic Activity	3 Month	YTD	1 Year	3 Year (Ann)	5 Year (Ann)
US Intermediate Treasuries	-4.9%	-13.6%	-13.8%	-3.2%	-0.2%
US Treasury Inflation Protected Sec.	-5.1%	-13.6%	-11.6%	0.8%	2.0%
US Mortgages	-5.4%	-13.7%	-14.0%	-3.7%	-0.9%
US Short-Intermediate T/E Munis	-2.6%	-8.2%	-8.1%	-1.1%	0.4%
US Investment Grade Corporates	-5.1%	-18.7%	-18.5%	-3.7%	0.0%
US Senior Bank Loans	1.4%	-3.3%	-2.5%	2.2%	3.0%
US High Yield	-0.7%	-14.6%	-14.1%	-0.7%	1.4%
Int'l Bonds Ex-US (Hedged)	-3.3%	-11.5%	-11.3%	-3.9%	0.5%
Int'l Bonds (Unhedged)	-6.9%	-19.9%	-20.4%	-5.7%	-2.3%
Emerging Market Debt (US Dollar)	-4.2%	-22.2%	-22.2%	-6.1%	-2.3%

Source: Bloomberg, Morningstar

Bonds Are No Longer Boring!

Fixed income usually takes a back seat to equities as the bond market is mostly a low volatility, slow-moving asset class in which investors are happy collecting coupons while watching their bond prices move at a snail's pace. This narrative has been flipped upside down this year as the bond market has been the source of headlines and market volatility. The decade-long era of zero and even negative interest-rate policies across the globe has come to an end, as global central banks are now hiking policy rates in unison at a historically rapid pace. In the U.S., shorter-term Treasury yields have risen well above 4%, the highest levels since 2007. Higher yields are not just isolated to government bonds; multiple sectors of the fixed-income market, such as municipal, mortgage backed, and corporate bonds, are all trading with yields at the highest levels in over 10 years (Chart 7). With high-quality bond yields well over 4% and riskier segments of the market yielding anywhere from 7%-10%, a great deal of value has been restored across the bond market as forward-looking return assumptions have doubled in a very short period of time. In short, these days the boring bond market is looking a lot more compelling.

Chart 7: High Quality Bond Yields at 10-Year High – Pricing in a Rapid Rate Hike Cycle



Source: Bloomberg as of 9/30/2022

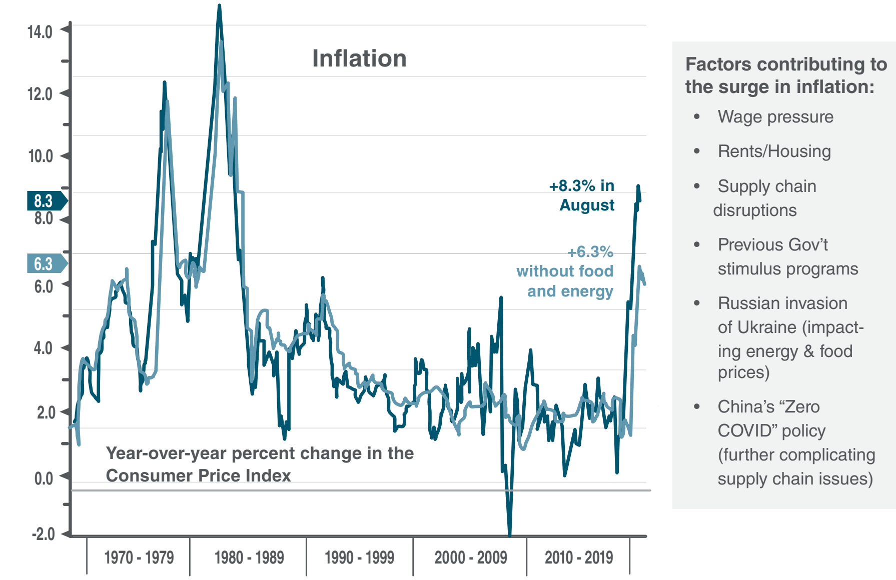
Will the Federal Reserve Be Successful in Reigning in Inflation?

Bond yields have soared in response to recent CPI (Consumer Price Index) readings, which have remained above expectations (Chart 8). The U.S. Fed and other global central banks are acting in response to surging inflation by raising policy rates at the quickest pace in 40 years. The goal is to ultimately slow economic activity, reduce consumer demand, and bring down inflation. We have seen the effect of higher policy rates as 30-year mortgage rates have soared to nearly 7%, up from 3% at the beginning of the year. Home prices are starting to come down, along with other measures of consumer confidence and demand. So far this year, the Fed has time and time again surprised markets with higher expectations of Fed Funds rate. The terminal rate, or expected maximum Fed Funds rate, has continued to increase and has now risen to 4.5% (Chart 9). This is up from 1.75% at the beginning of the year. We believe the Fed will ultimately achieve its goal of reigning in inflation because it is making it a priority. Expect CPI to continue to trend lower for the remainder of this year and throughout 2023.

How Investors Should Think About Fixed Income Positioning

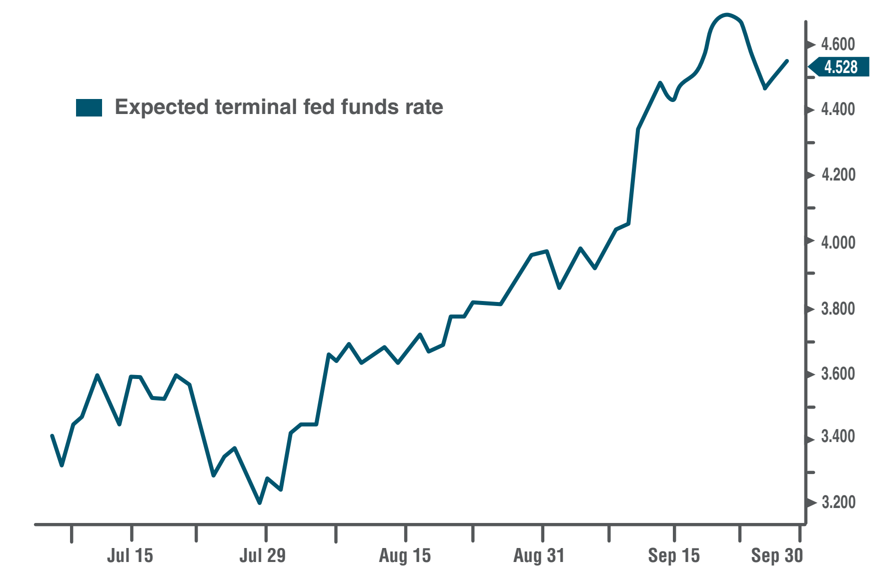
Interest rates have moved significantly higher. Given what has already been priced in, we conclude that the market is not far away from peak yields, as the market may be underestimating the lagged negative effect of higher rates on the economy and inflation. We see more value in the bond market now than at the beginning of the year. We especially like short-term bonds which provide a good risk/return trade-off in the current environment. Short-term rates have already moved higher in anticipation of additional rate hikes in the fourth quarter and in 2023. We have remained cautious on interest rate risk or duration, but think we may be given an opportunity to extend duration early next year as the rate hike cycle ages. In other areas of the market, we have reduced our inflation hedges, given the central banks' strong commitment to take inflation down. We have also remained cautious on corporate credit given the Fed's commitment to slow economic activity. Overall, while painful this year, a great deal of value has been restored and we are optimistic that the bond market is likely to experience more gains and less pain in the coming quarters.

Chart 8: U.S. Inflation Remains Near a 40-year High



Source: Bureau of Labor Statistics; Bloomberg

Chart 9: Peak Fed Funds Rate Has Continued to Rise



Source: Bloomberg as of 9/30/2022

Key Investment Themes

Macroeconomics

- Structurally, Debt, Demographics, and Deglobalization may influence global growth and inflation for years
- **Cyclically, global growth is moderating. Recession risks have increased**
- Structurally, healthier consumers & banks (vs the 2010 decade) should lead to good growth
- **Biggest wild cards: Inflation (and central banks' reaction to it) + Ukraine/Russia conflict**

Asset Allocation

- **Medium-term, the risk/reward outlook no longer favors equities**
- **Recent rise in bond yields & decline in equity valuations have improved the return outlook 3-5 yrs out**
- Global macro factors have important implications for various sub-asset classes/sectors
- Important to maintain a diversified approach and not let emotions dictate investment decisions

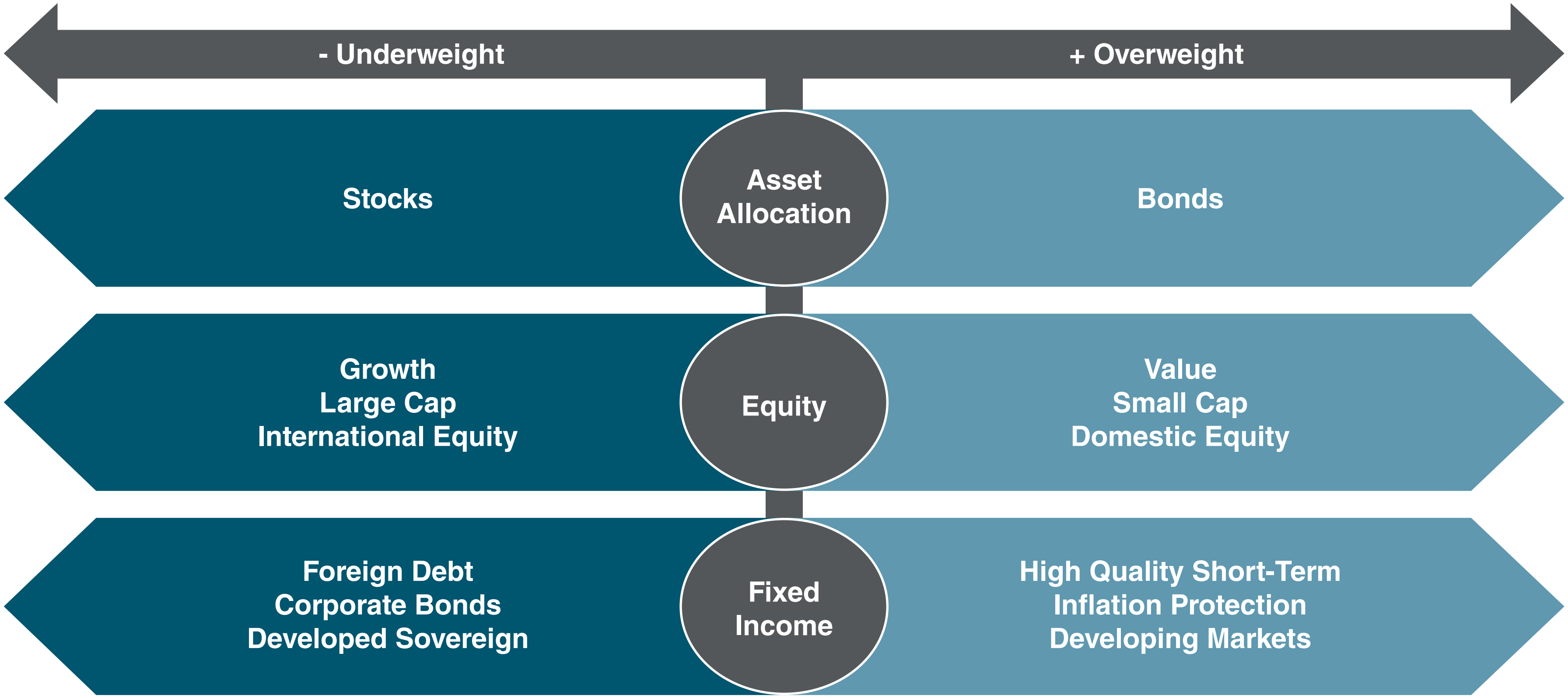
Fixed Income

- **Government bond yields have risen and have become increasingly attractive**
- Higher inflation is forcing central banks to normalize policies quickly
- Geopolitical uncertainty will allow the U.S. dollar to stay strong ST despite LT downward pressure
- **Healthy B/S and cashflows should allow defaults to stay relatively low. Favor credit from a structural standpoint**

Equities

- **Equities are no longer benefiting from the "lack of alternatives"**
- Volatility has returned as investors question central banks' intentions and assess the Ukraine/Russia situation
- 2022 & 2023 earnings estimates have been trending lower and remain at risk
- **Defensive stocks offer good relative value in the current environment**

Tactical Asset Allocation



Profile Summary

In the third quarter, we further de-risked portfolios on market strength as the medium-term outlook no longer favors equity, while the risk/reward outlook for high quality bonds has improved. The equity portion of portfolios has maintained a bias toward value stocks while continuing to favor defensive characteristics. We have taken advantage of higher yields, adding to short-term high quality bonds as the Federal Reserve has forced interest rates higher in attempts to reign in persistent inflation. A great deal of value has been restored in fixed income and equity markets long-term; we continue to position portfolios to ensure that we can provide the best risk-adjusted returns without taking unnecessary risks.

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Weekly Market Update

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MarketPoint

Market Point is a quarterly market commentary designed to provide you with an overview of economic conditions, as well as equity and fixed income market summaries for the quarter.

This commentary is offered by the Investment Management team. The individuals contributing to Market Point are pictured from left to right: Randy Van Rooyen, CFA®, Yan Arsenault, CFA®, CAIA®, Ryan Bergan, MBA, Steve Brudos, Brandon Hellenbrand, CFA®, Christine Doll and Nolan Gaffney. Please feel free to contact any team member with questions.







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