PRIVATE CAPITAL MANAGEMENT

# Q3 2022 Commentary

**October 2022**

*"The dollar is our currency, but it's your problem"*
John Connally

## Q3 MARKET RECAP

Stocks and bonds declined for the quarter as markets continue to digest high inflation, continued monetary tightening, and slowing global growth. Nearly all major equity indices remain in a bear market. U.S. stocks outperformed international and emerging market stocks, growth outperformed value, and large caps outperformed small caps. Sharply rising interest rates resulted in negative returns for bonds with high yield outperforming investment grade bonds and municipal outperforming taxable bonds. For high income investors, municipal bonds now provide a significant tax equivalent yield advantage over investment grade bonds.

| Asset Class | Benchmark | September | Q3 2022 | YTD |
|---|---|---|---|---|
| U.S. Large Cap Stocks | S&P 500 TR USD | -9.21 | -4.88 | -23.87 |
| U.S. Small & Micro Cap | Russell 2000 TR USD | -9.58 | -2.19 | -25.10 |
| Intl Dev Stocks | MSCI EAFE NR USD | -9.35 | -9.36 | -27.09 |
| Emerging & Frontier Mkt Stocks | MSCI EM NR USD | -11.72 | -11.57 | -27.16 |
| Global Stocks | MSCI ACWI NR USD | -9.57 | -6.82 | -25.63 |
| U.S. Municipal Bonds | Bloomberg Municipal TR USD | -2.63 | -2.30 | -7.72 |
| U.S. Taxable Bonds | BBgBarc US Agg Bond TR USD | -4.32 | -4.75 | -14.61 |
| U.S. High Yield Bonds | BBgBarc US Corporate High Yield TR USD | -3.97 | -0.65 | -14.74 |
| Intl Dev Bonds | S&P International Sov Ex-US Bond TR USD | -6.63 | -10.00 | -26.86 |
| U.S. REITs | MSCI US REIT NR USD | -12.32 | -10.28 | -28.86 |
| Broad Commodity Futures | Bloomberg Commodity TR USD | -8.11 | -4.11 | 13.57 |
| Energy Partnerships | Alerian MLP TR USD | -7.62 | 8.05 | 18.90 |
| Gold | DJ Cmmdty Gold TR USD | -2.89 | -7.90 | -9.31 |

*Data from Morningstar as of 9/30/22*

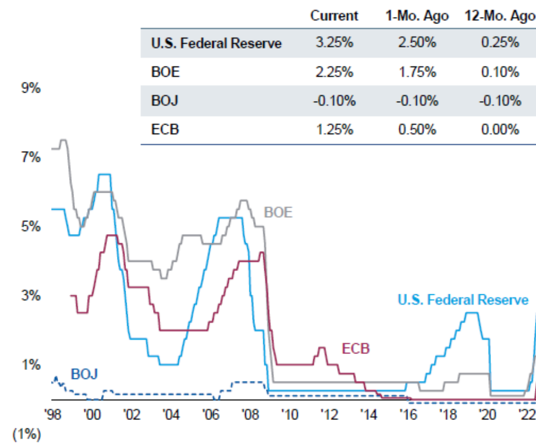
Macro and geopolitical concerns continue to weigh on investors' risk appetite. Many economists are calling for a recession in the Eurozone as soon as this quarter, due to exorbitant energy prices and sky-high inflation readings. Consumer confidence remains low as inflation is offsetting recent wage gains. Yet, investors see light at the end of the tunnel as 5-year inflation expectations continue to trend lower. The U.S. dollar has risen an impressive 16.8% relative to global currencies which helps our inflation problem domestically but exacerbates the issue for those outside the U.S. when transacting in USD. [1] Third quarter earnings season should provide much needed insight into consumer demand, corporate profits, the US dollar's impact, inflation, and general economic momentum.

## Monetary Policy

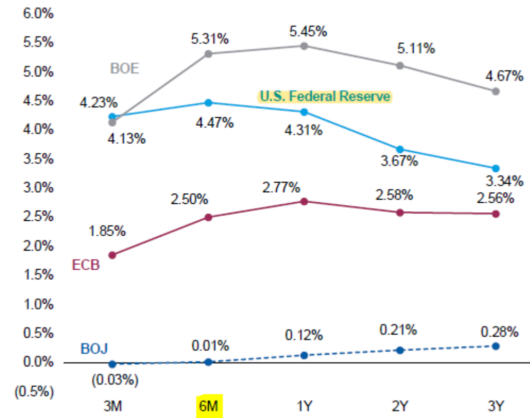
Facing stubbornly high inflation, the Federal Reserve raised the Fed Funds rate by 0.75% at September's FOMC meeting to a range of 3-3.25% and indicated they will continue be dependent on new economic data when adjusting rate policy. Fed members reduced real GDP growth estimates for next year and increased unemployment rate forecasts, Fed Funds rate expectations, and core inflation forecasts.[2] This combination sent equity markets lower, bond yields higher, and further strengthened the US dollar relative to foreign currencies.

[1] Data from MarketWatch as of 9/30/2022.
[2] https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20220921.pdf, accessed 10/5/2022.

Since the September FOMC meeting, market expectations for the peak Fed Funds rate sits around 4.5% in the next 6 months. Drilling down, market participants expect two sizable rate hikes this year followed by a small rate hike in January. Absent future inflation surprises forcing more hawkish rate policy, the Fed has done its heavy lifting and future rate hikes are largely priced into current market prices.




| | Current | 1-Mo. Ago | 12-Mo. Ago |
|---|---|---|---|
| U.S. Federal Reserve | 3.25% | 2.50% | 0.25% |
| BOE | 2.25% | 1.75% | 0.10% |
| BOJ | -0.10% | -0.10% | -0.10% |
| ECB | 1.25% | 0.50% | 0.00% |

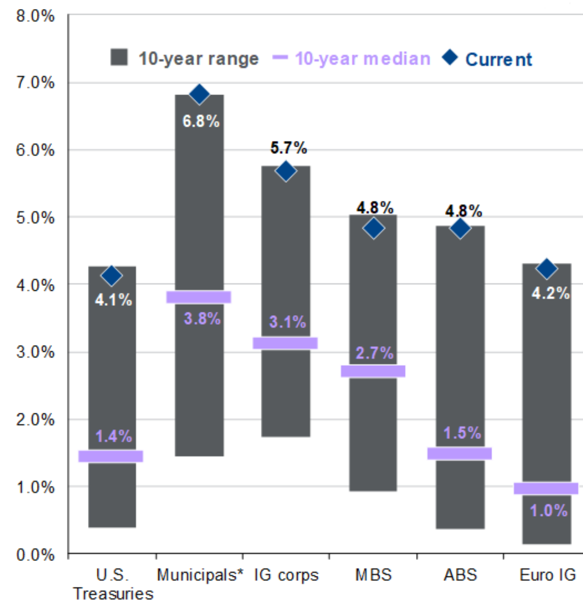



Source: Bloomberg, Factset as of 9/30/22. Data provided is for informational use only. See end of report for important additional information.

Tighter financial conditions influence interest rates, credit spreads, equity prices, and currencies; together these should slow demand and ease inflation. Judging by increased volatility in capital markets, investors appear increasingly concerned about Fed overshooting its rate hikes and sending the economy into a hard landing recession scenario.

## Opportunity in Fixed Income

Fed Chairman Powell wants lower growth and inflation and the transmission mechanism for that is going to be asset prices. The 10-year Treasury is up to 3.63% and the 2-year is up to 4.1%[3], which is almost 4% higher than this time last year. The sharp increase in rates has resulted in a severe drawdown for fixed income. At quarter end, investment grade bonds delivered their worst year-to-date return (-14.6%) in the last 90 years.[4] Following the stunning increase in rates, the yield curve remains inverted (2-year Treasury yield is higher than the 10-year Treasury yield), suggesting market participants are anticipating an economic slowdown in the coming years. Despite rising recession risks, credit spreads are well below recession levels with lower-than-average default rates and higher recovery rates.[5] Bond yields are becoming increasingly compelling relative to other risk assets (see chart to the right). Expected returns from bonds are higher now than we have seen at any point over the past 10 years, except during the market panic in March 2020 which proved to be a buying opportunity.




*Source: JP Morgan Guide to the Markets – U.S. Data are as of 9/30/22*

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[3] Data from CNBC as of 10/03/2022

[4] Data from Morningstar Advisor Workstation as of 9/30/2022. IA SBBI US T Gov TR benchmark 1/01/1926 - 12/31/1980, Bloomberg US Aggregate Bond TR thereafter.

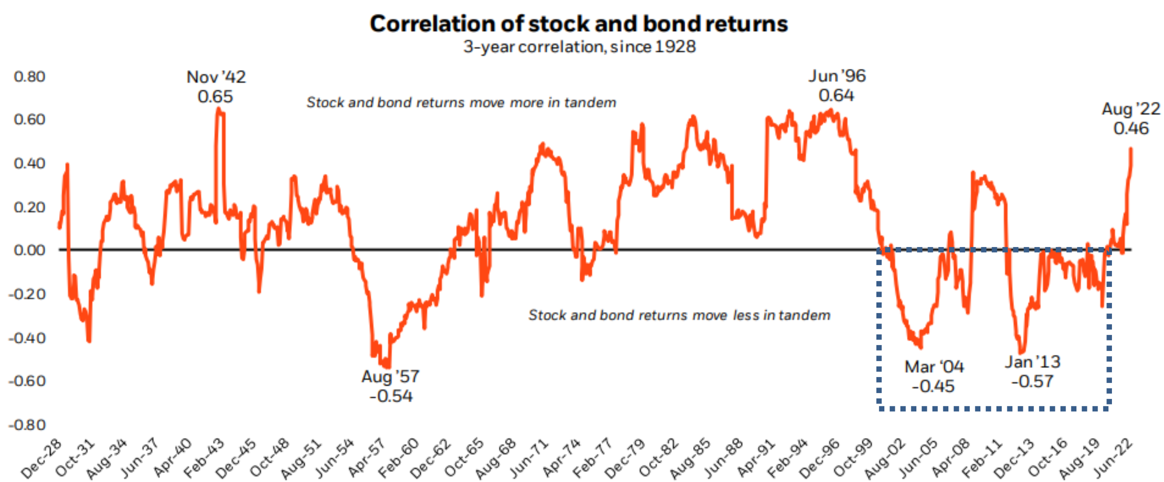
[5] Data from Eaton Vance as of 9/30/2022. Investment grade corporate bond spread of 1.59% and high yield of 5.43%

## Economic Update

Recession risks in the U.S. are rising, yet key parts of the economy have positive momentum. American consumers are well capitalized and continue to shift spending from goods to services. Corporations delivered solid earnings growth in the 2nd quarter despite inflationary and growth headwinds. Both the ISM Manufacturing and ISM Services indices grew in September, although manufacturing expanded at the slowest rate since the pandemic recovery began.[6] The labor market remains robust with an estimated 1.7 job vacancies available per job seeker. That said, major corporations have announced job cuts and are rethinking hiring plans. Job vacancies fell by 1.1 million in August down to 10.1 million.[7] The lowest paid workers continue to see strong wage increases and job switchers are being rewarded with double digit pay raises.[8] Housing strength is quickly losing momentum with average 30-year mortgage rates approaching 7%, more than doubling over the past year.[9] Home builder confidence has fallen in tandem as builders are also getting pinched by the rising cost of goods and wage inflation. However, single and multifamily housing demand remains strong which should support home prices.

## Revisiting Asset Allocation

For traditional 60/40 portfolios, the current drawdown is the second worst ever year-to-date return in modern history[10]. Part of this can be explained by rising correlations between stocks and bonds. Except for the Global Financial Crisis, stocks and bonds have moved in different directions, on average, for the last 20 years. This trend has been upended in the current inflationary and rising interest rate environment. Bonds have not provided the same diversification benefit to which we've grown accustomed. If inflation stays elevated, it is possible that positive stock / bond correlations continue. In this scenario, investors may want to consider alternative investments that have historically delivered returns with lower correlation to public assets, often with lower volatility.



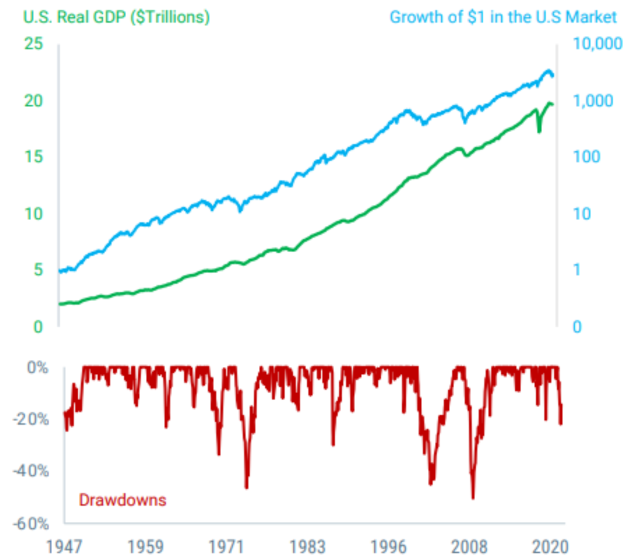

Source: Morningstar as of 8/31/22. U.S. bonds represented by the IA SBBI US Gov IT Index from 1/1/26 to 1/3/89 and the Bloomberg U.S. Agg Bond TR Index from 1/3/89 to 8/31/22. U.S. stocks are represented by the S&P 500 Index from 3/4/57 to 8/31/22 and the IA SBBI U.S. Lrg Stock Tr USD Index from 1/1/26 to 3/4/57, unmanaged indexes that are generally considered representative of the U.S. stock market during each given time period.. **Past performance does not guarantee or indicate future results**. Index performance is for illustrative purposes only. You cannot invest directly in the index.

Anticipating higher interest rates, investors feel the urge to sell bonds and take refuge in cash or money markets until there is more clarity on inflation trends. However, we advise against doing so, because re-entering the market will require a great deal of luck to get the timing correct. Additionally, high quality

[6] https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/, accessed 10/5/2022
[7] https://www.bls.gov/news.release/pdf/jolts.pdf, accessed 10/5/2022.
[8] https://www.atlantafed.org/chcs/wage-growth-tracker, accessed 10/5/2022.
[9] Freddie Mac, 30-Year Fixed Rate Mortgage Average in the United States [MORTGAGE30US], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MORTGAGE30US, October 6, 2022.
[10] Data from Morningstar Advisor Workstation as of 9/30/2022. Time period used is third quarter year-to-date each year.

bonds, notably US Treasuries, may provide a considerable diversification benefit relative to risk assets should the U.S. slip into a recession.

Equity investors are also anxious following this summer's bear market rally. Valuations are at or below 25-year averages for most equity sectors, implying go-forward returns are likely to revert to historical averages over time. U.S. equities have been one of the best asset classes for long-term wealth generation despite episodic and sometimes severe drawdowns. Our economy has been able to overcome many recessions and inflationary periods to drive real GDP growth and stock prices higher over time (as evidenced by the chart on the right).



*Source: Monthly ETF Field Guide, Avantis Investors September 2022*

## PARTING THOUGHTS

There is no shortage of pessimism in today's markets as the future looks increasingly uncertain. An entire generation of investors have lived in a falling interest rate, low inflation environment that has delivered impressive stock and bond returns. For many, our current environment is uncomfortable and uncharted territory. The good news? Our economy has endured high inflation and slowing growth before. Furthermore, our economy is more diversified than the 1970s/80s with much more economic diversification and energy independence. Higher risk-free rates should result in higher returns over time. Successful investors must remain patient, have trust in diversified portfolios, and make prudent decisions with investment dollars.

Meantime, we are actively tax loss harvesting client portfolios to reduce future tax bills, considering Roth IRA conversions for suitable clients, and reengaging clients with deferred financial planning needs.

Your PCM advisor is here to help you navigate these challenging times. Thank you for your continued trust.

Sincerely,
The Private Capital Management Team

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