ECONOMIC & INVESTMENT PERSPECTIVES

MARKETS DETERIORATE FURTHER IN SEPTEMBER

Figure 1: 9/30/2022 Returns (source: Bloomberg)
Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	Q3	YTD	1YR	vs. 52-wk High	vs. 52-wk Low
US Aggregate Fixed Income	AGG	-4.1%	-4.7%	-14.4%	-14.5%	-16.6%	1.0%
Investment Grade Corp Bonds	LQD	-6.0%	-6.2%	-21.2%	-20.9%	-24.3%	1.0%
U.S. Treasury Bonds	GOVT	-3.4%	-4.4%	-13.9%	-13.1%	-15.0%	0.8%
U.S. 20+ YR Treasuries	TLT	-8.2%	-10.3%	-29.9%	-27.7%	-34.0%	1.5%
Muni Bonds	MUB	-2.8%	-3.0%	-10.6%	-10.0%	-12.1%	0.4%
High Yield	HYG	-3.7%	-1.7%	-15.3%	-14.6%	-18.5%	0.7%
Non-US Corp Bonds	IBND	-5.8%	-10.5%	-27.3%	-28.7%	-29.5%	3.8%
Emerging Markets Bond LC	EMLC	-4.9%	-5.5%	-17.4%	-19.8%	-24.2%	0.1%
Global Equity							
ACWI Global Equity	ACWI	-9.4%	-7.2%	-25.7%	-20.5%	-27.6%	0.1%
United States	VTI	-9.2%	-4.4%	-24.8%	-18.0%	-26.5%	0.1%
International Developed	EFA	-9.2%	-10.4%	-27.2%	-25.1%	-31.7%	1.4%
Emerging Markets	EEM	-11.5%	-13.0%	-28.0%	-29.1%	-33.7%	0.5%
Global Equity by Region							
United States	VTI	-9.2%	-4.4%	-24.8%	-18.0%	-26.5%	0.1%
Europe	IEUR	-9.6%	-12.1%	-30.4%	-26.8%	-34.2%	2.3%
Asia ex-Japan	AAXJ	-12.6%	-15.4%	-28.9%	-29.5%	-34.1%	0.1%
China	MCHI	-14.3%	-23.7%	-31.8%	-36.1%	-41.9%	0.5%
Japan	BBJP	-8.8%	-7.4%	-25.9%	-28.5%	-30.5%	0.4%
Latin America	ILF	-2.4%	5.2%	5.5%	-0.3%	-24.1%	14.3%
US Equity							
US S&P 500	IVV	-9.2%	-4.9%	-23.9%	-15.5%	-25.6%	0.0%
NASDAQ 100 QQQ	QQQ	-10.5%	-4.5%	-32.5%	-24.9%	-34.6%	0.1%
US Large Growth	IWF	-9.7%	-3.5%	-30.7%	-22.7%	-32.6%	1.2%
US Large Value	IWD	-8.7%	-5.6%	-17.8%	-11.4%	-20.7%	0.2%
US Eqwt S&P 500	RSP	-9.2%	-4.7%	-20.7%	-13.6%	-22.8%	0.2%
US Mid Cap	IJH	-9.2%	-2.5%	-21.6%	-15.3%	-24.9%	0.9%
US Small Cap	VTWO	-9.6%	-2.1%	-25.2%	-23.6%	-32.5%	1.2%

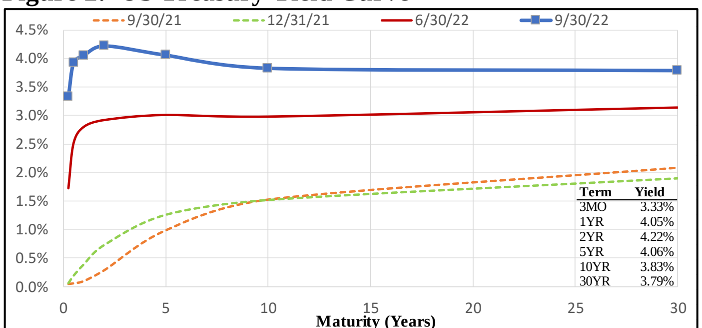
Pressure on the global markets intensified in September amid the persistent headwinds of inflation, rising interest rates, recession risk, and the war in Ukraine. Global stock markets reached new 52-week lows, and bonds continued their historical slump as interest rates rose sharply. Performance highlights for the month and the third quarter (Q3) are summarized below.

- Bonds: The U.S. Aggregate index (AGG) fell 4.1% (-4.7% Q3) as interest rates rose. Corporate bonds (LQD) were down 6.0% (-6.2% Q3), and high yield bonds (HYG) lost 3.7% (-1.7% Q3). Non-U.S. corporate bonds (IBND) underperformed as developed market currencies weakened versus the dollar, but emerging market debt (EMLC) was roughly in-line with U.S. bonds.
- Global equity (ACWI): -9.4% in September (-7.2% Q3).
- U.S. Equity: The broad market (VTI) fell 9.2% (-4.4% Q3), and the S&P 500 (IVV) lost 9.2% (-4.9% Q3). Large growth stocks (QQQ and IWF) are now more than 30% below all-time highs as rising interest rates erode the present value of future earnings. Small stocks (VTWO) fell 9.6% (-2.1% Q3) and are 32.5% below 52-week highs. Utility stocks (traditional outperformers during drawdowns) were down 11.3% in September.
- Non-U.S. Equity: Developed market stocks (EFA) were down 9.2% (-10.4% Q3); European stocks (IEUR) lost 9.6% (-12.1% in Q3) as recession appears inevitable. Emerging markets (EEM) lost 11.5% (-13.0% Q3); Latin American stocks (ILF) were actually up 5.2% in Q3 as Brazilian election uncertainty decreased, but China (MCHI) was down 23.7% as COVID lockdowns and global recession risk lowered growth forecasts.

Interest Rates and the Economy

The yield curve (Figure 2) plots the yields (Y-axis) for various maturities (X-axis) of U.S. Treasuries. The Fed announced another rate hike of 0.75%, lifting the Fed Funds target rate to a 3.00-3.25% range. One- and two-year Treasury yields are now over 4%, indicating expectations for more interest rate hikes as the Fed fights inflation. The curve remains inverted (short-term yields higher than long-term yields), signaling growth and recession concerns. The 10-year Treasury bond now yields 3.83%.

Figure 2: US Treasury Yield Curve

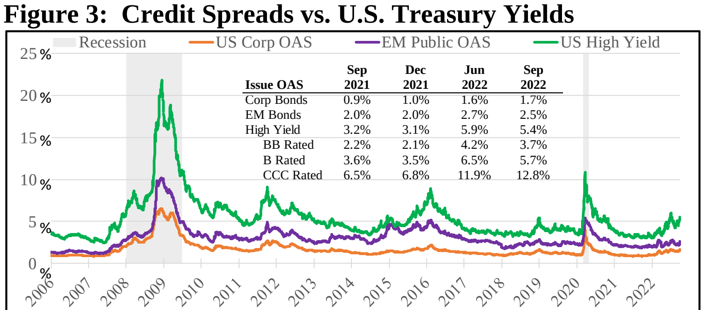


Source: Board of Governors of the Federal Reserve System via St. Louis Fed (FRED)

For bonds other than U.S. Treasuries, we track the option-adjusted yield spread (OAS) versus Treasuries of comparable maturities. Low or narrowing spreads signal optimism while high or widening spreads signal fear. Spreads have widened materially this year, confirming the "risk-off" tone of global markets.

- Investment grade corporate bond spreads widened to +1.7% in Q3, significantly higher than +1.0% spreads at year-end 2021.
- High yield (non-investment grade) spreads narrowed to +5.4% in Q3 but are well above year-end spreads of +3.1%. The riskiest bonds (rated CCC & below) spiked to +12.8% over Treasuries, significantly above 2021 year-end spreads of +6.8%.
- Emerging market bond spreads narrowed to +2.5% in Q3. Despite relatively stable credit spreads, emerging market debt has under-performed due to the strength of the U.S. dollar YTD.

Figure 3: Credit Spreads vs. U.S. Treasury Yields



Source: Ice Data Indices, LLC via St. Louis Fed (FRED)

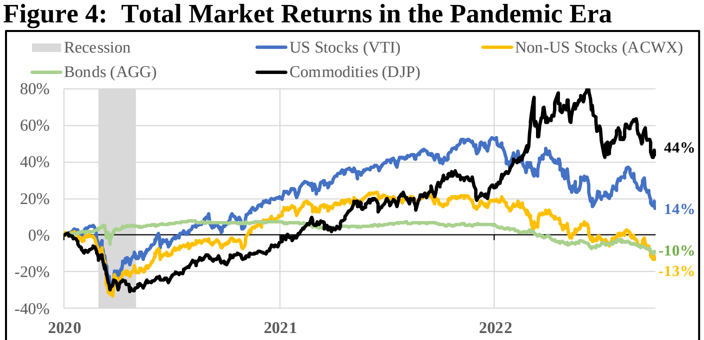
Uncertainty

Global stock and bond markets have been battered this year:

- U.S. stocks are down 25% (VTI) including dividends.
- Non-U.S. stocks are down 27% (ACWX). European (IEUR) and Chinese equities (MCHI) are down more than 30%.
- Bonds are down 14%, contributing to historically negative performance for balanced or diversified portfolios.
- Commodities are up 15% this year on average (led by energy) but remain volatile, evidenced by the 20% decline in the Bloomberg Commodity Index (DJP) since mid-June as oil prices dropped from over $122 per barrel to roughly $82 now.

It has been a painful year so far, but some perspective is helpful. In less than three years, we have been through a pandemic of historic scale, recession (but not a depression), unprecedented monetary and fiscal stimulus, rapid economic and financial market recovery, elections, war in eastern Europe, high inflation, aggressive tightening by global central banks, rising recession risks (again), and a second bear market! Figure 4 plots the cumulative returns of various assets since 12/31/2019.

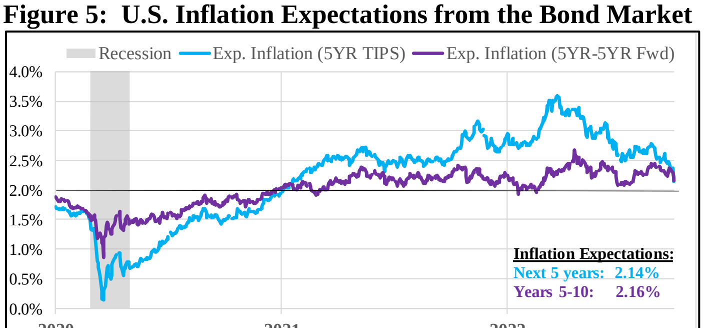
Figure 4: Total Market Returns in the Pandemic Era



Sources: Bloomberg, Yahoo! Finance, ACIMA

It is no surprise that commodities have had logged strong returns over this period, but it is interesting to note that U.S. stocks are still up 14%. Non-U.S. stocks have not fared nearly as well, down 13% over the period. Bonds were steady until inflation became entrenched, forcing global central banks to aggressively raise interest rates. Investors and markets continue to face significant uncertainty, but where markets go from here largely depends on how much damage will be inflicted on global economic growth in order to tame inflation. Interestingly, the consensus in the bond market is that inflation will ease rapidly. Figure 5 illustrates how inflation expectations embedded in bond prices peaked at 3.5% on average for the next five years (blue line) and have declined steadily since the Fed began hiking rates (March) to just over their 2% target, in-line with longer-term forecasts (purple line).

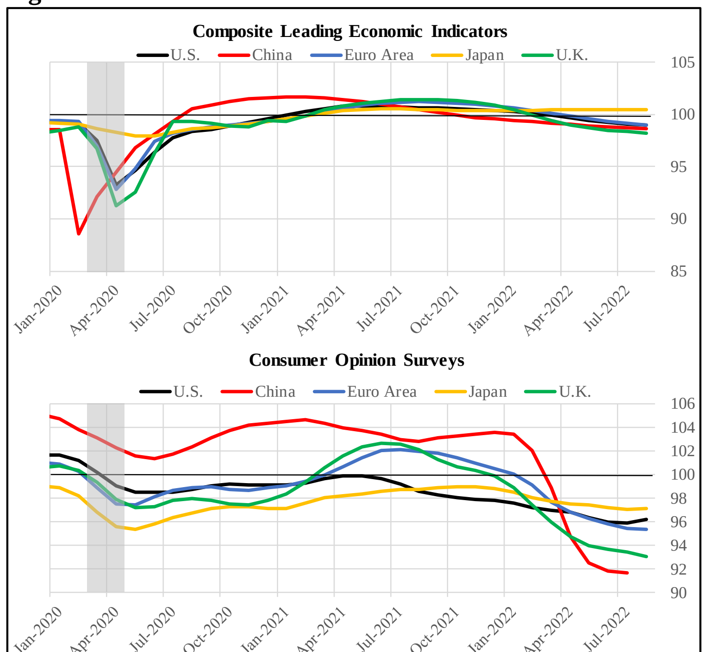
Figure 5: U.S. Inflation Expectations from the Bond Market



Source: Federal Reserve Bank of St. Louis via FRED

While inflation expectations have moderated significantly, the outlook for the world's largest economies has dimmed. Figure 6 summarizes the most recent (August) leading indicators tracked by the OECD for the U.S., China, Eurozone, Japan and U.K., which account for 68% of the global economy in aggregate. The Composite Leading Indicators (CLI) in the top panel have slipped below 100, indicating potential economic weakness ahead. CLI blends measures of interest rates, employment, manufacturing, construction, stock prices, business and consumer confidence, etc. While weak, the CLI are nowhere near the pessimistic levels observed at the onset of the pandemic. By contrast, consumer confidence around the world (bottom panel in Figure 6) has deteriorated far below pandemic levels, even below levels observed during the Global Financial Crisis more than a decade ago.

Figure 6: Global Economic Indicators



Source: Organization for Economic Co-operation and Development (OECD) via St. Louis Fed (FRED)

Bottom Line

The cumulative impact of the pandemic, war in Europe, decades-high inflation and rising interest rates has driven global stock and bond markets into the second bear market in less than three years. While investors and markets seem to believe that the Fed (and global central banks) will successfully bring inflation back down, the mood is decidedly pessimistic. While leading economic indicators point to a mild slowdown in global growth (so far), consumer confidence around the world is historically low. This is critical because personal consumption is the key driver of economic activity (68% of U.S. GDP).

Meanwhile, employment remains strong; unemployment is historically low and wages are rising. The Fed has pledged to do "whatever it takes" to slow the economy in order to bring supply and demand back into balance. Unfortunately, this means unemployment must rise in order to reduce inflationary pressures. Recession is likely in the U.S. and globally, but how deep the downturn will be is uncertain. We continue to monitor employment and corporate earnings for clues. Global markets are likely to remain volatile; diversification (global equity, bonds, alternative investments, and cash) and a lower risk profile are appropriate.

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