ECONOMIC & INVESTMENT PERSPECTIVES

OCTOBER: STRONG RALLY FOR STOCKS
POSITIVE GDP GROWTH, BUT THE ECONOMY IS SLOWING

Figure 1: 10/31/2022 Returns (source: Bloomberg)
Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	YTD	1YR	vs. 52-wk High	vs. 52-wk Low
US Aggregate Fixed Income	AGG	-1.3%	-15.5%	-15.6%	-17.8%	1.8%
Investment Grade Corp Bonds	LQD	-0.8%	-21.8%	-22.0%	-25.1%	3.0%
U.S. Treasury Bonds	GOVT	-1.3%	-15.0%	-14.2%	-16.3%	1.3%
U.S. 20+ YR Treasuries	TLT	-6.0%	-34.1%	-33.6%	-38.0%	4.6%
Muni Bonds	MUB	-0.8%	-11.4%	-10.8%	-13.0%	0.2%
High Yield	HYG	3.4%	-12.4%	-11.5%	-16.2%	4.3%
Non-US Corp Bonds	IBND	1.4%	-26.3%	-27.4%	-28.5%	5.1%
Emerging Markets Bond LC	EMLC	-0.1%	-17.5%	-18.8%	-23.7%	1.3%
Global Equity						
ACWI Global Equity	ACWI	6.3%	-21.0%	-19.8%	-23.0%	9.3%
United States	VTI	8.1%	-18.7%	-16.9%	-20.5%	11.0%
International Developed	EFA	5.9%	-22.9%	-23.2%	-27.7%	8.6%
Emerging Markets	EEM	-2.0%	-29.4%	-31.2%	-34.4%	2.1%
Global Equity by Region						
United States	VTI	8.1%	-18.7%	-16.9%	-20.5%	11.0%
Europe	IEUR	8.5%	-24.5%	-24.4%	-28.6%	11.3%
Asia ex-Japan	AAXJ	-5.2%	-32.6%	-34.2%	-37.1%	2.1%
China	MCHI	-16.4%	-43.0%	-47.9%	-49.9%	1.6%
Japan	BBJP	2.2%	-24.2%	-25.0%	-29.0%	4.7%
Latin America	ILF	9.2%	15.1%	15.2%	-17.1%	24.8%
US Equity						
US S&P 500	IVV	8.1%	-17.7%	-14.6%	-19.6%	10.9%
NASDAQ 100 QQQ	QQQ	4.0%	-29.8%	-27.6%	-32.0%	9.3%
US Large Growth	IWF	5.8%	-26.7%	-24.8%	-28.6%	10.2%
US Large Value	IWD	10.1%	-9.5%	-7.2%	-12.6%	11.7%
US Eqwt S&P 500	RSP	9.6%	-13.0%	-10.0%	-15.4%	11.7%
US Mid Cap	IJH	10.6%	-13.2%	-11.6%	-17.0%	11.6%
US Small Cap	VTWO	11.2%	-16.8%	-18.5%	-25.0%	12.8%

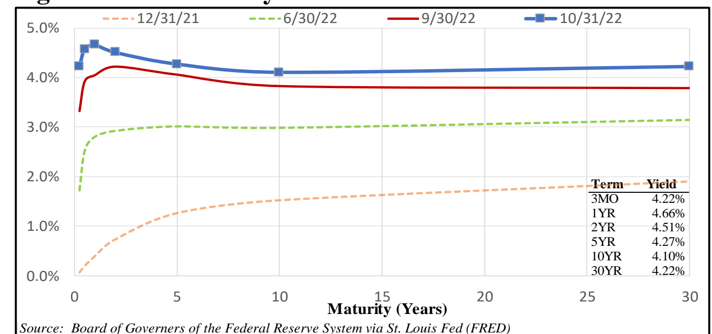
Global markets rebounded strongly in October, especially in the U.S., as solid quarterly corporate earnings reports and hope that the Fed is nearing the end of its tightening cycle buoyed markets. Whether these gains are sustainable or just another bear market rally (like July) remains to be seen. Performance highlights for the month and year-to-date (YTD) are below.

- Bonds: The U.S. Aggregate index (AGG) fell 1.3% (-15.5% YTD) as interest rates rose. Corporate bonds (LQD) lost 0.8% (-21.8% YTD), but high yield (HYG) rose 3.4% (-12.4% YTD) as credit spreads narrowed. Non-U.S. corporate bonds (IBND) were up, but emerging markets credit (EMLC) was flat; each has under-performed YTD due to a strong U.S. dollar.
- Global equity (ACWI): +6.3% in October (-21.0% YTD).
- U.S. Equity: The broad market (VTI) rose 8.1% (-18.7% YTD); the S&P 500 (IVV) also gained 8.1% (-17.7% YTD). Large growth stocks (QQQ and IWF) were up but continued to under-perform due to rising interest rates and disappointing earnings reports (TSLA, AMZN). Small stocks (VTWO) rose 11.2% (-16.8% YTD). All sectors posted gains for the month, led by energy stocks as oil surged back above $86 per barrel.
- Non-U.S. Equity: Developed market stocks (EFA) rose 5.9% (-22.9% YTD), led by Europe (IEUR). Emerging markets (EEM) lost 2.0% (-29.4% YTD); Brazilian stocks (EWZ) surged as elections were finalized, but China (MCHI) fell 16.4% (-43.0% YTD) amid hardline government rhetoric.

Interest Rates and the Economy

The yield curve (Figure 2) plots the yields (Y-axis) for various maturities (X-axis) of U.S. Treasuries. Yields are now over 4% across the curve, indicating expectations for more interest rate hikes. The Fed is expected to announced another 0.75% rate hike this week in the on-going effort to tame inflation, potentially raising the Fed Funds target range to 3.75%-4.00% from the current range of 3.00-3.25%. The curve remains inverted (short-term yields higher than long-term yields), signaling growth and recession concerns. The 10-year Treasury bond now yields 4.10%.

Figure 2: US Treasury Yield Curve

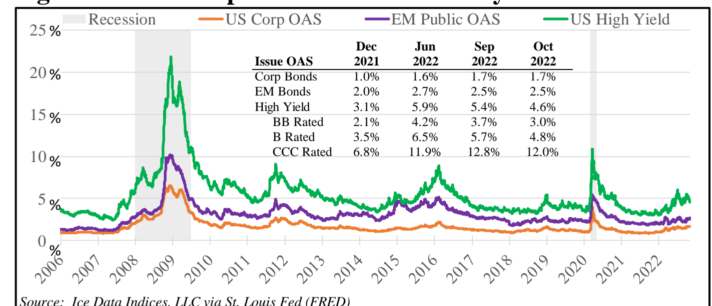


Source: Board of Governers of the Federal Reserve System via St. Louis Fed (FRED)

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, but high yield spreads narrowed notably this month.

- Investment grade corporate bond spreads stabilized at +1.7% but are significantly above the +1.0% spreads at year-end 2021.
- High yield (non-investment grade) spreads narrowed to +4.6% but are well above year-end spreads of +3.1%. The riskiest bonds (rated CCC & below) narrowed to +12.0% over Treasuries, significantly wider than 2021 year-end spreads of +6.8%.
- Emerging market credit spreads were steady at +2.5% this month. Despite stable 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

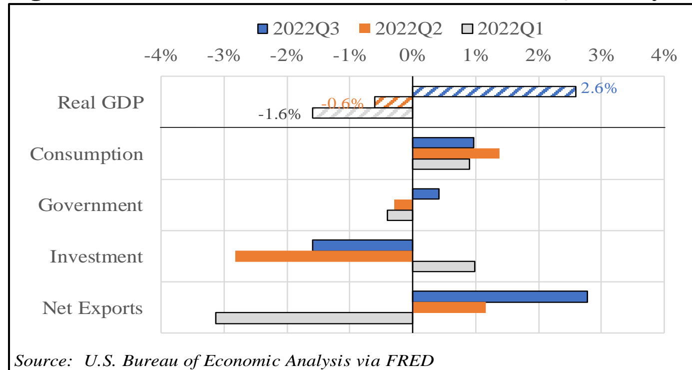


Source: Ice Data Indices, LLC via St. Louis Fed (FRED)

Growth & Inflation

The Bureau of Economic Analysis (BEA) reported that U.S. real GDP grew at an annualized rate of +2.6% in Q3 after two consecutive quarterly contractions. (Note: Real GDP stands for Gross Domestic Product, the value of all final goods and services produced in the U.S., adjusted for inflation.) Figure 4 plots the growth contributions of the four primary GDP sub-components.

Figure 4: U.S. Real GDP Growth Contribution Quarterly



Source: U.S. Bureau of Economic Analysis via FRED

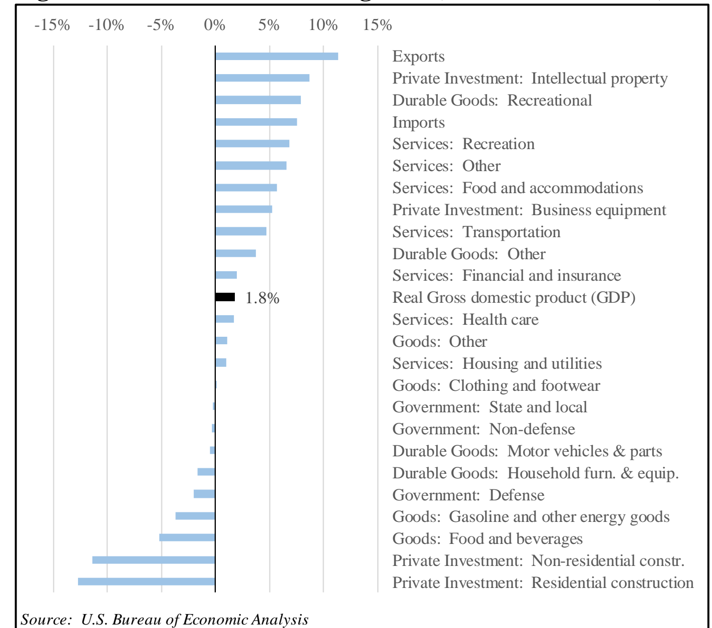
Strong consumer spending and a shrinking trade deficit drove economic growth in Q3. Highlights are summarized below.

- **Personal Consumption:** Aggregate consumer expenditures account for 68% of U.S. economic activity. Healthy consumer spending has been a consistently positive contributor to economic growth in each of the first three quarters of 2022.
- **Government expenditures:** 17% of GDP is driven by direct consumption of goods and services by federal, state and local governments. Government spending had a small positive impact on growth in Q3 after detracting in the first two quarters.
- **Private Investment:** 18% of U.S. economic output comes from the expenditures and investment activity of businesses, including construction, equipment, manufacturing and inventories. The Q3 contribution to real growth was negative primarily due to a sharp slowdown in residential construction.
- **Net Exports:** A trade deficit (the net value of U.S. exports minus imports) subtracts from economic growth, currently -4% of GDP, but the contribution to real growth was positive in Q3 as the U.S. trade deficit shrank for the second straight quarter.

Despite this return to positive growth, the economy is clearly slowing as the Fed fights decades-high inflation by aggressively raising interest rates and tightening financial conditions. Figure 5 offers a more granular view of the sources of economic growth over the past year rather than focusing on just the most recent quarter. The graph contains a list of economic categories tracked by the BEA, sorted from highest to lowest real growth to show the changing dynamics over the past year. Highlights include:

- The U.S. economy grew 1.8% after inflation over the past year (2022 Q3 vs. 2021 Q3). This is slightly below the 2.4% average growth rate for the five calendar years before the pandemic.
- Consumer spending on goods and services has shifted in favor of recreation, travel and leisure and away from areas hard hit by inflation (food/beverage, gas, cars and other durable goods).
- Government spending has declined marginally.
- Business spending (private investment) on intellectual property (software, etc.) and equipment is robust, but construction activity has slowed dramatically; residential construction is down 13% compared to this time last year, and non-residential construction is down 11%. Homebuilding is usually one of the first areas hit as the economy slows, especially in an environment of high inflation, rising interest and high mortgage rates.
- Trade with other countries for goods and services increased. Exports are up over 11% despite the stronger U.S. dollar. Imports are up significantly as well (which detracts from GDP). Net exports (exports minus imports) have had negligible economic impact, up just 0.5% in the past year after inflation.

Figure 5: U.S. Real GDP Categories (Year/Year Growth)



Source: U.S. Bureau of Economic Analysis

Bottom Line

Markets rallied strongly in October on mostly solid quarterly corporate earnings reports and hopes that we are close to the end of the Fed's interest rate-hiking cycle. Whether this is just another bear market rally or something more sustainable remains to be seen. A similar upward surge in equity markets in July was followed by sharp declines to new lows in August and September.

Anecdotal and technical data suggest that peak inflation may be behind us, but the Fed has given every indication that they remain steadfastly committed to the inflation fight. That means more hikes are coming, including another 0.75% increase expected this week. The economy is clearly slowing, evidenced by two consecutive quarters of negative real U.S. GDP growth (Q1 and Q2) and a sharp slowdown in homebuilding, but the labor market is still very strong. Weekly jobless claims and monthly employment reports have shown no signs of weakness, with unemployment at historic lows, robust jobs growth and plentiful job openings. Unfortunately, unemployment must rise in order to reduce the wage and price pressures that drive elevated inflation. As Fed Chair Powell said, this is going to be a painful process. Future employment data will likely need to be materially negative to tame inflation. The October jobs report is due out later this week.

Given the significant geopolitical (Russia-Ukraine War) and economic headwinds (inflation, rising interest rates, tighter monetary policy, slowing growth), recession remains likely in the U.S. and globally; diversification and a lower risk profile (global equity, bonds, cash and alternatives) make sense in this environment.

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