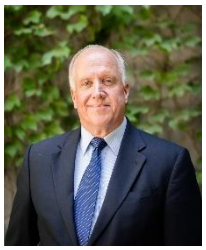
2022 – 3nd Quarter Review & Outlook

Economic and Investment Review



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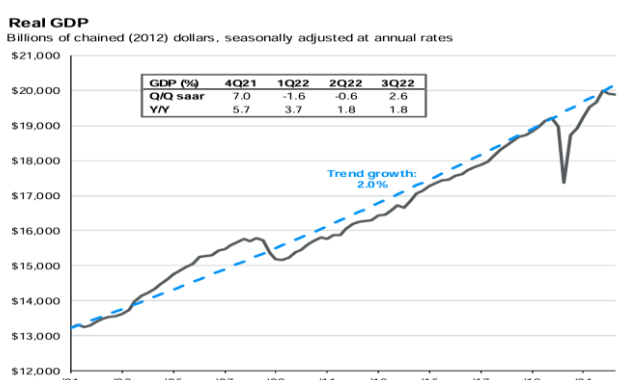
Economic Growth: The U.S. economy met the classic definition of recession of two quarters of negative GDP in the Q1-Q2 time period. However, there are other variables that go into making the recession claim official. The National Bureau of Economic Research - NBER is relied upon to make that determination and defines a recession as a significant decline in economic activity that is spread across the economy and that last for more than a few months. Other variables that are taken into account include real personal income, nonfarm payroll employment, real consumer spending, real wholesale-retail sales, and industrial production. All of those variables except for real wholesale-retail sales remained in positive territory over the past six months.

The U.S. economy reemerged from contraction to expansion in Q3. Q3 GDP exceeded consensus



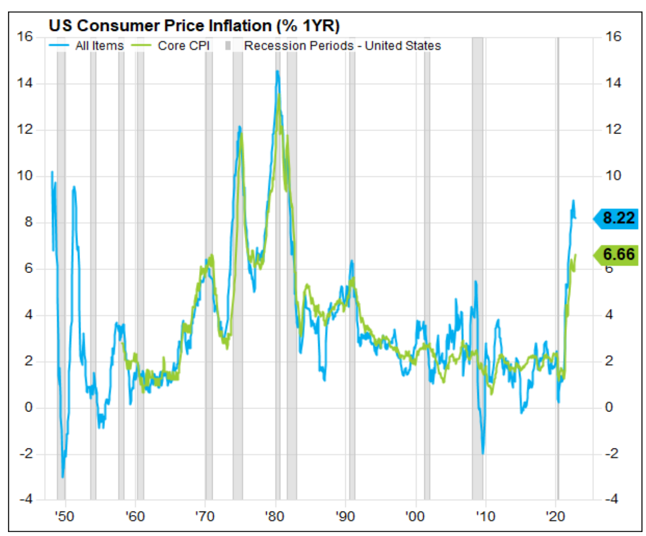
Source: BEA, FactSet, J.P. Morgan Asset Management

expectations with a reported annualized growth rate of 2.6%. However, the rate would have been slightly negative if not for a surge in energy related exports. The slow-down in new home construction was a significant drag, but the consumer continued to spend. Personal consumption has been slowing but still grew by 1.4% due to an increase in spending for services. The services sector has been in recovery mode after two years of COVID restrictions.

The consensus estimate for Q4 GDP is 0.6%. The consensus estimates for the first half of 2023 go negative once again to -0.3% for Q1 and -0.4% for Q2 before returning to slow positive growth in the second half. Raymond James forecasts negative GDP for the first three quarters. Goldman Sachs forecasts slow growth but no negative quarters in 2023.

GDP increased by 0.2% in the Euro area in the third quarter. Goldman Sachs forecasts that the Euro area will enter recession in Q4 and will see negative GDP growth for the next three quarters.

Inflation: Inflation has ticked down from peak levels but remains near the highest levels since the 1980's.



Source: FactSet

Supply chain disruptions have moderated but continue to be impacted by ongoing COVID lockdowns in China. Reduced consumer demand and an improved transportation situation have taken some of the pressure off of supply chains. However, due to the desire to have less dependence on China for products, moving manufacturing to other geographies in Asia and North America will at least initially lead to increased costs. US manufacturing imports have declined for China and have increased for other areas of Asia.

Source: Department of Commerce, Goldman Sachs

The reshoring of manufacturing to the United States has been primarily limited to semiconductors. Any related increase in the price of semiconductors should have minimal impact on the price of final goods due to its small percentage of total input costs.

Inventories were depleted during COVID but have been improving recently. Gaps in the inventory-to-sales ratio have closed significantly since the pandemic. The biggest remaining gaps are in autos.

The number of job openings relative to the number of job seekers has been declining but still remains at a historically high level. Average hourly earnings growth has slowed in recent months. Demand for labor coming out of the pandemic was extremely strong. However, the supply of labor was constrained by a wave of early retirements, fewer immigrant visas and more women taking on additional child care duties. Labor supply has improved somewhat due to the incentive of higher wages and due to the need for more household income to offset the higher cost of living.

Housing related inflation is expected to slow due to a surge in multifamily construction and due to the drag on single-family home sales caused by higher mortgage rates.

Despite some expectations for inflation to begin trending lower, inflation will likely continue to be agonizingly high for longer than we would prefer. In response, the Fed raised the Fed Funds rate by 0.75% on November 2nd to a range of 3.75-4.00%. The possibility of a recession grows with each increase in interest rates by the Federal Reserve. Fed Chairman Powell stated that rates may need to move higher than anticipated and that it would be very premature to think about pausing. He stated that “we think we have a ways to go—we have some ground to cover with interest rates.” It is expected that the Fed Funds rate will reach 4.5-5.0% before any pause takes place.

If we do have a recession, it is likely to be relatively short and shallow given the good relative strength of corporate balance sheets and strength of the consumer. However, consumer strength may be challenged as savings decline and credit card balances increase.

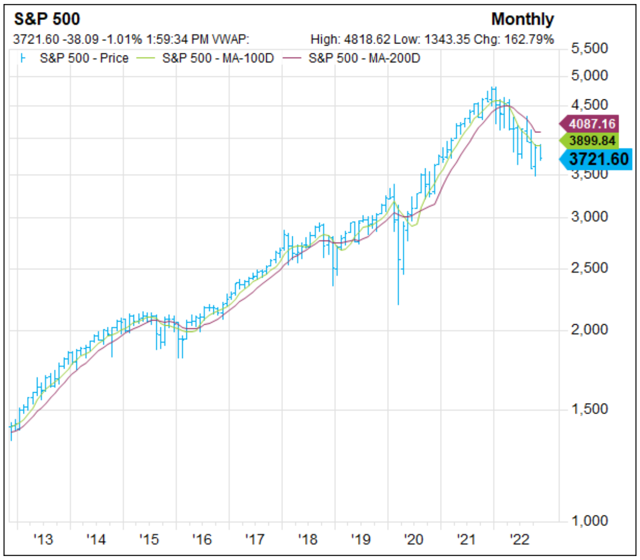
Unemployment increased from 3.5% in September to 3.7% in October. Unemployment will likely tick up as interest rates are increased and economic growth slows. Employment may not be impacted as negatively as it could be so long as job openings remain high.

Industrial Production increased two of the last three months and manufacturing was up each of the last three months. However, the ISM report indicates that manufacturing is trending towards contraction. The September report was just above water at 50.2.

The midterm elections are imminent. Polls indicate that the prospect for a divided government looks highly likely. Any significant spending program or tax increases will be more difficult to pass in the future.

Equity Markets

Equity markets continued to struggle in the face of slower economic growth, higher interest rates and geopolitical tensions. The S&P 500 closed at 3585 on September 30, down -23.87% YTD and down -4.88% for Q3. The S&P 500 has rallied about 5% since the end of September into early November, but the question remains—is this yet another bear market rally? The S&P 500 did not fall into bear market territory (-20%) until June, but the market has been trending down since the beginning of the year. During that time there have been seven bear market rallies. Rallies have been based on the premature optimism for renewed economic growth, easing inflation, and a Fed pivot. It's like the old Yogi Berra saying—"It's deja vu all over again."



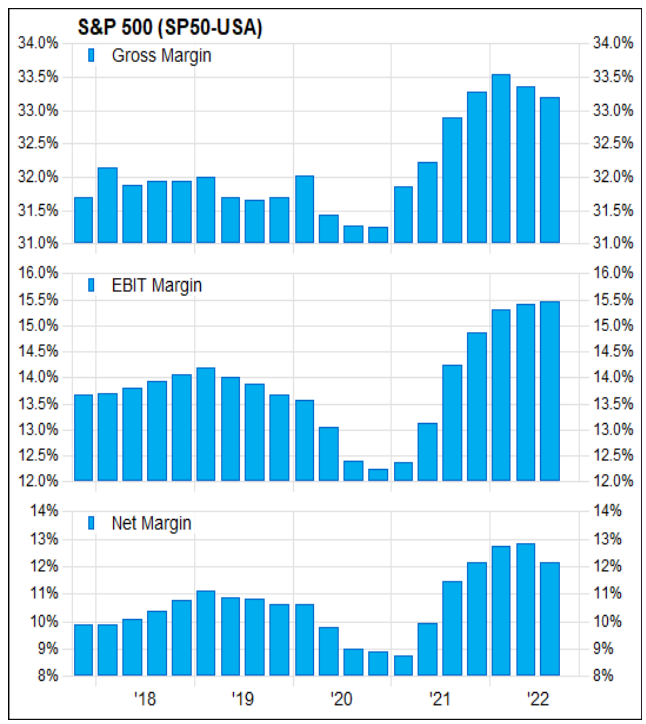
Source: FactSet

So, when will we get a rally that is not just a bear market rally? We will likely have to see sustained, meaningful improvement in the Fed's "hot" items. Seeing job openings decline to be more in line with the number of job seekers and wage growth leveling out combined with declining inflation would certainly encourage the Fed to be less hawkish.

David M. Lebovitz – JPMorgan Asset Management - Global Market Strategist states in a 10/21/22 publication (When will earnings estimates begin to decline?) that "Investors can decompose equity markets returns into three variables – changes in earnings expectations, changes in valuations (forward P/E ratio), and dividends.

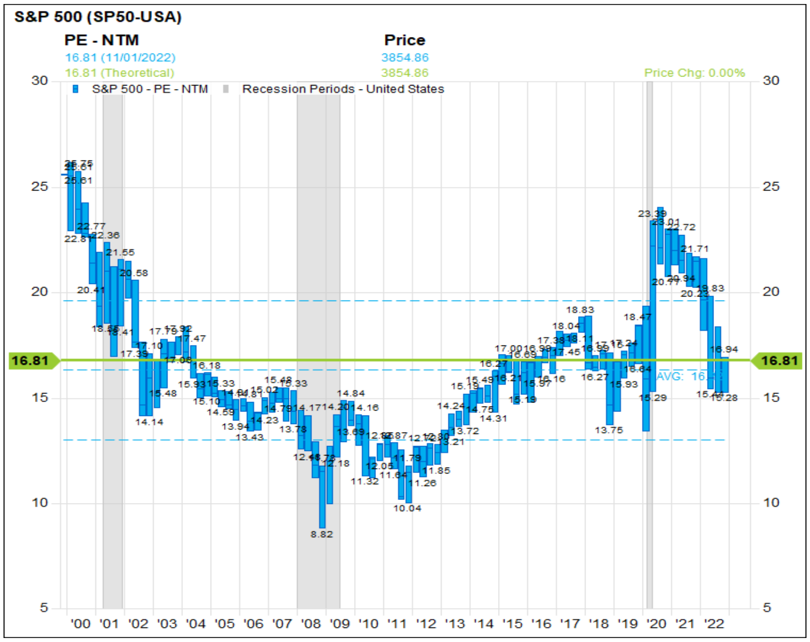
Earnings growth expectations for 2023 peaked at about 14% in June and have come down to about 6% currently. Expectations will likely decline further as the economy slows and the Fed continues to increase rates.

Mr. Lebovitz goes on to say that "earnings estimates remain too high, and will decline – as they should – as we work our way through the current earnings season. However, given the unique nature of this cycle, it may be inappropriate to simply assume any decline will align with what has been seen on average during recessions over the past seventy years." He argues that increased share repurchases and the ability of companies to limit margin compression could help to support earnings growth. Margins have moved slightly lower but remain elevated on a historical basis.



Source: FactSet

Valuations have declined considerably but remain near a 20+ year average. Investors are generally



Source: FactSet

willing to assign higher multiples in lower interest rate - higher earnings growth environments and will assign lower multiples during periods of higher/rising interest rates – lower earnings growth.

The S&P 500 is currently trading at 16.2X the 2023 earnings estimate of 232.34. Reducing the earnings growth rate from 5.9% to 4.4% for 2023 and from 8.9% to 8.4% for 2024 results in a 3-6 month weighted forecast of 3700 and a 9-12 month weighted forecast of 3900. The forecasts assume multiples of 15.5X for 2023 and 16.5X for 2024. Goldman Sachs forecasts 3600 for 3-6 months and 4000 for 12 months.

FactSet reports that at the mid-point of the earnings season for the third quarter, the percentage of S&P 500 companies reporting a positive earnings surprise and the aggregate (percentage) difference between actual earnings and estimated earnings are below their 5-year and 10-year averages. On a year-over-year basis, the S&P 500 is reporting its lowest earnings growth since Q3 2020.

Overall, 52% of the companies in the S&P 500 have reported actual results for Q3 2022 to date. Of these companies, 71% have reported actual EPS above estimates, which is below the 5-year average of 77% and below the 10-year average of 73%. In aggregate, companies are reporting earnings that are 2.2% above estimates, which is below the 5-year average of 8.7% and below the 10-year average of 6.5%. If 2.2% is the final percentage for the quarter, it will mark the second lowest surprise percentage reporting by the index in the past nine years.

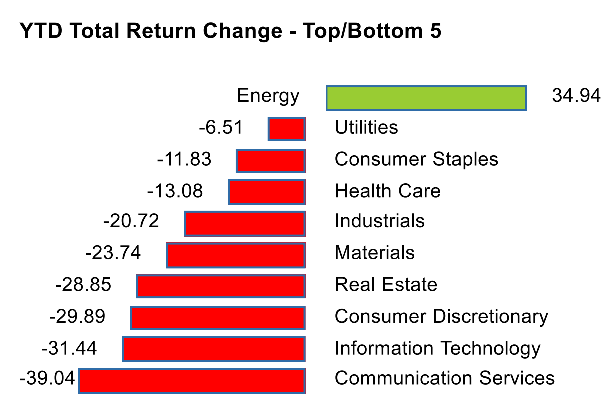
The blended (combines actual results for companies that have reported and estimated results for companies that have yet to report) earnings growth rate for the third quarter is 2.2% today. If 2.2% is the actual growth rate for the quarter, it will mark the lowest earnings growth rate reported by the index since Q3 2020 (-5.7%).

International stocks were the worst laggards in Q3 and for 1 and 3 years. Growth stocks were the biggest losers on a year-to-date basis but remained the leader for 3 years.

2022 Q3 Returns				
		YTD	1 Year	3 Years
EQUITY	Q3 2022	9.30.22	9.30.22	Annualized
S&P 500	-4.88	-23.87	-15.47	8.16
S&P 500 Value	-5.82	-16.56	-9.63	5.11
S&P 500 Growth	-3.86	-30.41	-21.11	9.92
Dow Jones Ind Avg	-6.17	-19.72	-13.40	4.36
S&P Mid Cap 400	-3.44	-24.27	-19.39	5.19
S&P Small Cap 600	-5.20	-23.16	-18.83	5.48
MSCI EAFE	-9.36	-27.09	-25.13	-1.83
MSCI Emerging Mkts	-11.57	-27.16	-28.11	-2.07

Source: FactSet

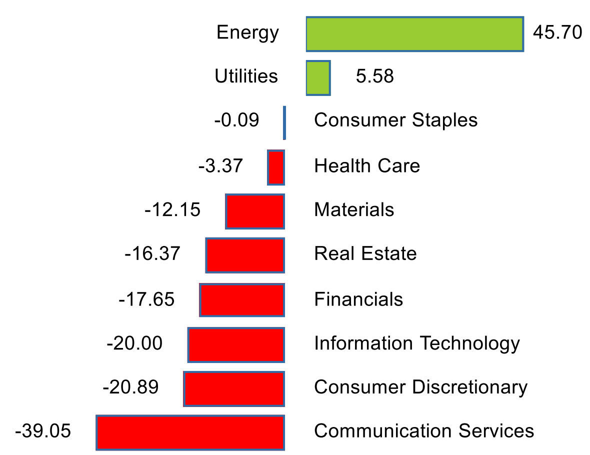
Energy is the only sector with a positive return YTD.



Source: FactSet

The Energy sector was up 45.7% and Utilities sector was up 5.6% for one year ending September 30. All the other sectors were down. Communication Services was the worst performer.

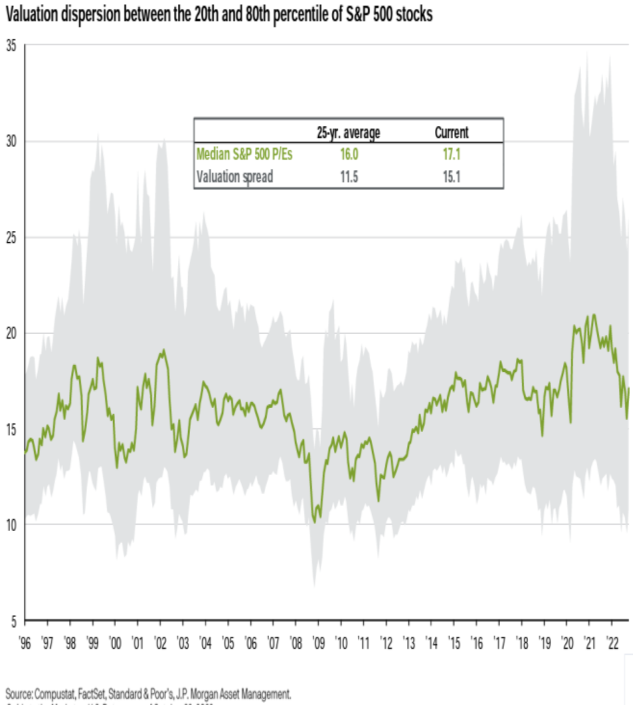
1 Year Total Return Change - Top/Bottom 5



Source: FactSet

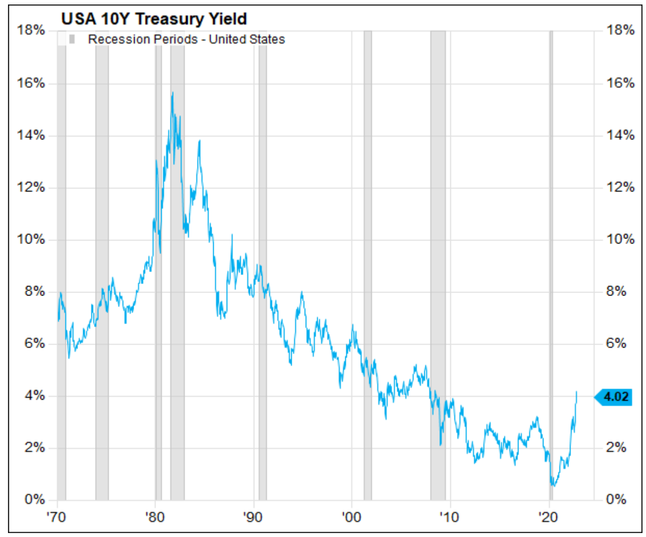
It should be noted that the spread of price-to-earnings multiples is much wider than historical averages. Lower multiple stocks are near long-term lows while high multiple stocks have declined from elevated levels.

Valuation dispersion between the 20th and 80th percentile of S&P 500 stocks



Fixed Income Markets

Bond investors benefited from declining interest rates for nearly forty years through 2020. Yields for the 10-Year U.S. Treasury exceeded 15.0% in 1981 and trended down to below 1.0% in 2020.



Source: FactSet

There were some bumps in the road, but bonds generally filled their role as a tool to help manage volatility in diversified asset allocation strategies and in providing income. As yields declined to minimal levels, the total return that could be realized and the income that was being generated became less attractive to investors. As a result, the term – There Is No Alternative (TINA) came in to vogue for equities.

Investment grade bond returns turned negative in 2021. The Bloomberg Aggregate Bond Index was down -1.54% for the year. The index continued to

2022 Q3 Returns				
FIXED INCOME	Q3 2022	YTD 9.30.22	1 Year 9.30.22	3 Years Annualized
Bloomberg US Agg Bond	-4.75	-14.61	-14.60	-3.26
ICE AMT-Free Nat'l Muni	-3.17	-11.14	-10.44	-1.60
Markit iBoxx USD Liquid High Yield Index	-0.70	-14.43	-13.80	-1.30

Source: FactSet

decline -14.6% in 2022 through September as the Fed began their tightening cycle. Equity valuations adjusted down due to slower economic and earnings growth and higher interest rates. As a result, the increase in bond yields has once again begun to grab investor's attention. "A" rated corporate bonds with 2-5 year maturities that have yield-to-maturities greater than 5.0% suddenly looks appealing to many investors. The story is similar for "AA" rated municipal bonds offering rates greater than 3.5% for short maturities. High yield bond funds are yielding over 6.0%, although spreads have widened as the potential for a recession looms.

We continue to recommend focusing on high credit quality and shorter durations. We may look to extend duration or utilize more of a duration barbell approach as it becomes more apparent that the Fed is nearing the end of its current tightening cycle.

Real Assets

Some investors have held the illusion that real estate values never go down. Redfin reports that 55% of home sellers in Denver and 51.6% of home sellers in Salt Lake City have had to lower their asking prices to close deals. San Jose's home prices have dropped by 7.9% since the Fed began increasing rates. San Francisco had an even more significant drop of 10.5%. Elevated prices and high mortgage rates will undoubtedly keep more people in multifamily housing for longer. But even with this underlying support, average rents are beginning to drop in many markets due to an increase in new supply.

The Dow Jones U.S. Real Estate index is a benchmark for Real Estate Investment Trusts (REITs). Many REITs have a significant allocation to multi-family housing. The benchmark was down -10.4% in Q3, -28.3% YTD and -17.9% for 1 year.

2022 Q3 Returns				
Real Assets	Q3 2022	YTD 9.30.22	1 Year 9.30.22	3 Years Annualized
Dow Jones U.S. R/E	-10.41	-28.34	-17.87	-1.62
S&P GSCI	-10.31	21.80	23.64	12.19

Source: FactSet

Commodities have been one of the few bright spots in 2022, but even this asset class showed weakness in Q3. The S&P GSCI Commodity-Indexed Trust was down -10.3% in Q3. However, the index has moved up along with the price of oil since the end of the quarter.

Asset Allocation

60% equities/40% fixed has been the well-proven, go-to allocation mix for many investors over the years. The allocation failed investors in 2022 but should continue to be the basis for balanced accounts going forward, perhaps with some tweaks or modifications. We recommend increasing the quality of company stock and credit held and look to increase the use of less correlated alternative investments such as private credit and private REITs where appropriate.