Asset Strategy Consultants

MARKET REVIEW

Third Quarter 2022

We are pleased to present *Market Review*, featuring a discussion of the Capital Markets during the Third Quarter 2022 and a summary of historical performance for the major asset style passive indices for the period ending September 30, 2022. We hope you find the information useful and helpful in your investment considerations.

We welcome your comments.

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Founded in 1991, Asset Strategy Consultants provides investment consulting services to institutional clients representing $7 billion under advisement. Asset Strategy Consultants is headquartered in Baltimore, with a consulting office in Harrisburg, PA.

THE MACROECONOMIC ENVIRONMENT

Global Challenges Wreak Havoc on Markets

There were few places for investors to hide (again) this quarter as a mostly familiar slate of worries fueled sharp declines in global stocks and bonds. Sticky and uncomfortably high inflation led to aggressive Fed rate hikes and increasingly hawkish rhetoric, raising concerns over the ultimate impact of sharply higher rates on the U.S. economy.

The effort to combat inflation has been global; roughly 90 central banks around the world have raised rates in 2022, and more than 40 have hiked by at least 75 bps. As a result, the prospect of a global recession has emerged. China's woes and fears of recession in Europe further contributed to dismal sentiment. And the war in Ukraine, which has driven up energy and food prices, showed no signs of ending. Add to this mix the late-quarter "mini-budget" fiasco in the U.K., which put further pressure on bond markets and buoyed an already strong U.S. dollar.

While headline inflation in the U.S. moderated over the summer as gas prices declined, core inflation climbed, mostly due to increased shelter costs. The Consumer Price Index (CPI) jumped 8.3% in August (year-over-year) and Core CPI (which excludes food and energy) rose 6.3%. The Personal Consumption Expenditures (PCE) Index gained 6.2% and Core PCE increased 4.9% (YOY), well above the Federal Reserve's long-run inflation rate objective of 2% for the Core PCE Index.

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The Federal Reserve has been explicit in its intent to aggressively fight inflation and is willing to see the economy slow and unemployment rise to bring it down. Following the June 75 bps hike, the FOMC again raised the Fed Funds target by 75 bps in July and in September, the first time for three consecutive 75 bps rate hikes. The Fed Funds target is now 3.0 – 3.25%, the highest since 2008. The median projection from the Fed for the rate at year-end is 4.4%; in June the year-end projection was 3.4%. More significantly, the Fed's outlook for 2023 unemployment was revised up from its June forecast of 3.9% to 4.4%, up sharply from the current 3.7% unemployment rate. At the same time, the real GDP projection for 2022 fell to just 0.2%, down from 1.7% in June. Notably, both the markets and the Fed expect inflation to fall over longer periods. The Fed's 2025 projection is 2.0%. Five-year breakeven spreads, which reflect the market's expectations for inflation over the next five years, were 2.1%, down from 2.6% at the end of 2Q.

Shelter costs have been one of the key contributors to core inflation. As mortgage rates have risen sharply, approaching 7% as of quarter-end, there have been signs of market cooling. Housing starts have moderated, mortgage applications have dropped, and permits for homebuilding have fallen to the lowest level since 2020. Housing prices have begun to decline in some areas. The median house price, which hit a record high of $413,800 in June, fell to $389,500 in August (according to the National Association of Realtors) but is still nearly 8% higher than one year ago. Higher mortgage rates have not helped with affordability, which remains at the lowest level since 2006.

Unemployment ticked up to 3.7% but job gains were robust and the ratio of job openings to job seekers also stayed elevated, with roughly twice as many openings as seekers at the end of August.

The U.S. dollar is at a two-decade high, as measured by a basket of currencies of major trading partners. The dollar has benefited from relatively high interest rates in the U.S. as well as its perceived safe haven status. The euro is at its lowest since 2002 vs. the dollar. The Bank of Japan was forced to intervene in currency markets for the first time since 1998 to bolster its currency. The yen lost nearly 11% vs. the dollar in 3Q and is down more than 18% over the last 12 months. While a strong dollar helps to temper inflation in the U.S., it is bad for U.S. exports and hard on other economies, especially those in emerging markets that may issue debt in U.S. dollars.

The labor market remained strong through the quarter. Unemployment ticked up to 3.7% but job gains were robust and the ratio of job openings to job seekers also stayed elevated, with roughly twice as many openings as seekers at the end of August. Most expect the job market to cool as inflation and higher rates take a toll on profits.

Rates rose broadly outside of the U.S. as central banks embarked on an unusually synchronized global effort to fight inflation. The European Central Bank hiked rates by 50 bps in July, emerging out of negative territory, and 75 bps in September. It increased its forecast for 2022 inflation in the euro zone from 6.8% (in June) to 8.1% given high energy and food costs as well as supply shortages. Its growth forecast for 3Q22 is 0.1% and -0.1% in 4Q as rising prices hurt consumer spending and confidence, and uncertainty over gas supply reductions and rising rates constrain activity. Full-year growth is expected to be a tepid 0.9% in 2023. The economic effects of the Russian invasion of Ukraine have been especially painful in Europe, which has relied heavily on Russia for its energy needs. Annual inflation in the euro zone was 10.0% in September, up from 9.1% in August and ahead of expectations. The Bank of England raised rates by 50 bps in September from 1.75% to 2.25%, the largest increase in nearly 30 years, to combat inflation. In Britain, the CPI rose 9.9% in August from one year earlier.

China continued to languish in relative terms due largely to its policies to combat COVID (mass lockdowns) but also a falling yuan and a collapsing property sector that accounts for about 30% of economic activity. Weakness among its trading partners has also played a role. The World Bank expects growth in China to be 2.8% in 2022, sharply lower than its 8.1% in 2021 and slower than developing countries for the first time in 30 years. As the second-largest economy in the world, China's slowdown weighs heavily on the prospects for global growth.

In the U.K., a late-September announcement from Chancellor Kwasi Kwarteng of a "mini-budget" that included the largest tax cuts in 50 years (with no offsetting revenue) spurred a sharp sell-off in government bonds and caused the pound to plummet. Versus the U.S. dollar, the pound fell to an all-time low. Ten-year government bond yields climbed 100 bps on the news, and ultimately the Bank of England had to intervene with a temporary bond-purchase program to help stabilize markets. The International Monetary Fund issued a critical rebuke, warning that the suggested tax cuts would likely fuel inflation and heighten inequality, and Moody's warned the unfunded tax cuts would be a "credit negative" event. The "mini-budget" has since been modified to reverse the planned cuts to the highest tax rates, and the plan is currently undergoing further analysis by the U.K.'s Office for Budget Responsibility. ■

GLOBAL EQUITIES

The S&P 500 Index sank 4.9% in 3Q and is down 23.9% year-to-date (YTD). Returns were quite mixed across sectors with Energy (+2.3%) and Consumer Discretionary (+4.4%) posting positive results and Communication Services (-12.7%) and Real Estate (-11.0%) delivering the lowest returns. Somewhat counterintuitively, value underperformed growth (Russell 1000 Value: -5.6%; Russell 1000 Growth: -3.6%) but value remains ahead on a YTD basis (Russell 1000 Value: -17.8%; Russell 1000 Growth: -30.7%).

Global ex-U.S. markets fared worse, driven mostly by U.S. dollar strength. The MSCI ACWI ex USA Index fell 9.9% (Local: -4.9%), bringing its YTD loss to 26.5% (Local: -16.2%). The U.S. dollar continued to strengthen, benefiting from its "safe haven" status as well as attractive interest rates relative to other developed markets. The yen and euro lost 6% versus the greenback and the British pound fell 8%. Across developed market countries, losses were broad-based with several posting double-digit declines. As in the U.S., value (MSCI ACWI ex USA Value: -10.4%) underperformed growth (MSCI ACWI ex USA Growth: -9.4%). Unlike the U.S., no sectors delivered a positive return in 3Q.

Emerging markets (MSCI Emerging Markets: -11.6%; Local: -8.2%) underperformed developed markets for the quarter but returns were mixed across countries. China (MSCI China: -22.5%) was one of the worst performers while several countries posted positive returns; two of the best were India (+6.5%) and Brazil (+8.5%). Returns were also mixed across regions: Latin America (+3.6%), Emerging Europe (-12.4%), and Emerging Asia (-14.0%). ■

GLOBAL FIXED INCOME

The 10-year U.S. Treasury briefly touched an intra-quarter high of 4.0% in late September, the highest since 2008, before closing the quarter at 3.83%. At quarter-end, the yield curve was inverted by about 40 bps with the 10-year at 3.8% and the 2-year at 4.2%. The Bloomberg US Aggregate Bond Index fell 4.8% in 3Q, bringing its YTD return to a startling -14.6%, a historical worst for the first nine months of a year. Notably, the sharp sell-off has eroded gains over the past 10 years; the Aggregate's 10-year annualized gain is now a muted 0.9%. Mortgages and corporates underperformed U.S. Treasuries, with mortgage-backed securities doing especially poorly, underperforming like-duration U.S. Treasuries by 160 bps on poor technicals and rising rates. The yield-to-worst of the Aggregate Index climbed to 4.75%, up sharply from 1.75% at the beginning of the year. TIPS (Bloomberg TIPS: -5.1%; -13.6% YTD) were not immune from the sell-off. High yield corporates (Bloomberg High Yield: -0.6%) fared better, but the Index is down a similar 14.7% YTD. The yield-to-worst was 9.7% as of quarter-end.

Interest rates also rose overseas and the U.S. dollar continued to strengthen, hurting unhedged fixed income returns.

The Bloomberg Municipal Bond Index fell 3.5% for the quarter and is down 12.1% YTD. The shorter duration 1-10 Year Blend fell 2.3% for the quarter and 7.7% YTD. The ratio of AAA Municipal yields to the 10-year U.S. Treasury fell to 86%, down from 92% at the end of 2Q. The 4.0% yield-to-worst of the Bloomberg Municipal Bond Index is the highest since 2009.

Interest rates also rose overseas and the U.S. dollar continued to strengthen, hurting unhedged fixed income returns. The Bloomberg Global Aggregate ex USD fell 8.8% (hedged: -2.2%). The YTD differential for hedged and unhedged investors is nearly 14 percentage points (unhedged: -23.9%; hedged: -9.9%). Losses were broad-based but the U.K. fell the most sharply; 13.2% in local currency terms and 20.2% in US$ in response to announced plans for massive fiscal stimulus in the form of unfunded tax cuts. Emerging markets performed similarly, with the JPM EMBI Global Diversified down 4.6% and the local currency JPM GBI-EM Global Diversified off 4.7%. ■

REAL ASSETS

Real assets as a group posted negative returns in 3Q. Commodity prices, especially metals and oil, declined on concerns over slowing global growth; the S&P GSCI Index fell 10.3%. WTI Crude closed the quarter at $79/barrel, down more than 20% from 2Q. Gold (S&P Gold Spot Price Index: -7.5%), listed infrastructure (DJB Global Infrastructure: -1.1%), REITs (MSCI US REIT: -10.0%), and TIPS (Bloomberg TIPS: -5.1%) declined. ■

CLOSING THOUGHTS

Markets have been both punishing and humbling in 2022 and the ability of central banks to dampen high and widespread inflation without causing recessions remains a key question for investors. The war in Ukraine and its ultimate implications also weighs heavily. Stock and bond markets have undergone significant corrections, and both represent much better forward-looking opportunities than we have seen in some time, but we expect volatility to continue to be a key theme given significant tail risks. As always, ASC continues to advise adherence to a disciplined investment process that includes a well-defined long-term asset allocation policy. ■

Source: Asset Strategy Consultants and Callan Associates

PRELIMINARY RETURNS FOR VARIOUS PERIODS: 3Q22

		July	August	September	Last Quarter	Year to Date	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
EQUITY	1 Russell:3000 Index	9.38	(3.73)	(9.27)	(4.46)	(24.62)	(17.63)	7.70	8.62	11.39	7.92
	2 Russell:1000 Index	9.31	(3.84)	(9.25)	(4.61)	(24.59)	(17.22)	7.95	9.00	11.60	8.03
	3 Russell:1000 Growth	12.00	(4.66)	(9.72)	(3.60)	(30.66)	(22.59)	10.67	12.17	13.70	10.10
	4 Russell:1000 Value	6.63	(2.98)	(8.77)	(5.62)	(17.75)	(11.36)	4.36	5.29	9.17	5.71
	5 Russell:Midcap Index	9.87	(3.14)	(9.27)	(3.44)	(24.27)	(19.39)	5.19	6.48	10.30	7.55
	6 Russell:Midcap Growth	12.24	(3.28)	(8.49)	(0.65)	(31.45)	(29.50)	4.26	7.62	10.85	8.01
	7 Russell:Midcap Value	8.61	(3.06)	(9.70)	(4.93)	(20.36)	(13.56)	4.50	4.76	9.44	6.81
	8 Russell:2500 Index	10.35	(2.66)	(9.53)	(2.82)	(24.01)	(21.11)	5.36	5.45	9.58	7.27
	9 Russell:2500 Growth	11.41	(1.90)	(8.61)	(0.12)	(29.54)	(29.39)	4.76	6.30	10.30	7.90
	10 Russell:2500 Value	9.68	(3.14)	(10.11)	(4.50)	(20.41)	(15.35)	4.52	3.78	8.41	6.31
	11 Russell:2000 Index	10.44	(2.05)	(9.58)	(2.19)	(25.10)	(23.50)	4.29	3.55	8.55	6.40
	12 Russell:2000 Growth	11.20	(0.94)	(9.00)	0.24	(29.28)	(29.27)	2.94	3.60	8.81	6.82
	13 Russell:2000 Value	9.68	(3.16)	(10.19)	(4.61)	(21.12)	(17.69)	4.72	2.87	7.94	5.70
	14 S&P:500	9.22	(4.08)	(9.21)	(4.88)	(23.87)	(15.47)	8.16	9.24	11.70	8.03
	15 S&P:400 Mid Cap	10.85	(3.10)	(9.19)	(2.46)	(21.52)	(15.25)	6.01	5.82	10.04	7.93
	16 S&P:600 Small Cap	10.01	(4.39)	(9.88)	(5.20)	(23.16)	(18.83)	5.48	4.84	10.09	7.77
	17 MSCI:ACWI ex US	3.42	(3.22)	(9.99)	(9.91)	(26.50)	(25.17)	(1.52)	(0.81)	3.01	0.57
	18 MSCI:EAFE	4.98	(4.75)	(9.35)	(9.36)	(27.09)	(25.13)	(1.83)	(0.84)	3.67	0.61
	19 MSCI:EM	(0.25)	0.42	(11.72)	(11.57)	(27.16)	(28.11)	(2.07)	(1.80)	1.05	0.27
	20 MSCI:ACWI	6.98	(3.68)	(9.57)	(6.82)	(25.63)	(20.66)	3.75	4.44	7.28	4.07
FIXED INCOME	21 Blmbg:Aggregate	2.44	(2.83)	(4.32)	(4.75)	(14.61)	(14.60)	(3.26)	(0.27)	0.89	2.74
	22 Blmbg:Gov/Credit	2.16	(2.61)	(4.08)	(4.56)	(15.10)	(14.95)	(3.15)	(0.05)	1.02	2.86
	23 Blmbg:Credit	3.04	(2.83)	(5.07)	(4.95)	(18.07)	(17.89)	(3.61)	(0.05)	1.58	3.64
	24 Blmbg:Corporate High Yld	5.90	(2.30)	(3.97)	(0.65)	(14.74)	(14.14)	(0.45)	1.57	3.94	5.71
	25 Blmbg:Municipal Bond	2.64	(2.19)	(3.84)	(3.46)	(12.13)	(11.50)	(1.85)	0.59	1.79	3.19
	26 Blmbg:US TIPS	4.35	(2.66)	(6.62)	(5.14)	(13.61)	(11.57)	0.79	1.95	0.98	3.25
	27 Blmbg:Glob Agg ex USD	1.92	(4.99)	(5.87)	(8.85)	(23.88)	(24.77)	(7.78)	(4.03)	(2.39)	0.32
	28 S&P:LSTA Levg Loan	2.14	1.54	(2.27)	1.37	(3.25)	(2.53)	2.21	2.98	3.54	4.13
	29 ML:US Treasuries 1-3 Yrs	0.34	(0.72)	(1.18)	(1.56)	(4.35)	(4.86)	(0.48)	0.57	0.60	1.32
	30 LIBOR - 3 Month	0.24	0.27	0.31	0.82	1.41	1.45	0.90	1.45	0.98	1.07
	31 3 Month T-Bill	0.05	0.16	0.25	0.46	0.61	0.62	0.59	1.15	0.68	0.70
	33 S&P GSCI	(0.04)	(2.68)	(7.80)	(10.31)	21.80	23.64	12.19	7.75	(3.95)	(4.45)
	34 MSCI:US REIT Index	9.00	(5.99)	(12.14)	(9.96)	(28.26)	(16.56)	(2.00)	2.93	6.20	4.83
	35 Alerian:MLP Index	12.49	3.98	(7.62)	8.05	18.90	19.56	4.46	1.90	0.66	4.94
	36 DJB:Glbl Infrastructure	5.59	(3.71)	(12.56)	(11.10)	(14.78)	(8.40)	(0.40)	2.53	5.72	5.47
	37 US DOL:CPI All Urban Cons	(0.01)	(0.04)	–	–	–	–	–	–	–	–

Source: Callan Associates