MARKET OVERVIEW
Third Quarter 2022

OPAL WEALTH ADVISORS

Economic Overview

Inflation stickiness, the labor market, and the aggressiveness of the Federal Reserve's response took center stage in financial markets in the third quarter. The surprisingly strong August CPI report (8.3% headline; 6.3% core year over year vs. expectations of 8% and 6%, respectively) indicated that inflation is likely more structural than previously anticipated. Low unemployment (3.5% in September—matching pre-pandemic historic lows) accompanied by wage increases has given the Fed little room to ease up on its aggressive rate hiking. The Fed raised interest rates by 75 basis points twice during the quarter, bringing the federal funds rate up to a range of 3.0% - 3.25%, the highest it has been since early 2008. Fed officials signaled their intention of continuing to raise rates to 4.6% in 2023 with no rate cuts expected until 2024. Projections suggest the Fed expects to raise rates by at least 1.25% in its two remaining meetings this year. The Fed now expects GDP growth to slow to 0.2% for 2022, a dramatic decline from its forecast from June of 1.7%. The number of unemployed people per job opening is the lowest in decades. It appears that retirees leaving the workforce permanently, reduced immigration and the lingering impact of long Covid have led to structural changes in labor participation. All the above factors resulted in an extraordinarily strong U.S. dollar. The strength of the U.S. dollar has negative consequences for companies booking sales overseas or exporting products. Company earnings will likely be negatively impacted by currency translation. Higher yields are slowing economic activity but there remain areas of strength domestically, and supply chain recovery could support growth in some industries.

The impact of the Russian/Ukraine war on European energy prices makes a recession in that region likely. European governments are subsidizing energy in various forms, and the fiscal impact of these policies remains to be seen. Damage to the Nord Stream pipeline recently only makes the outlook for this winter worse across continental Europe. The likelihood of the U.S. dipping into recession remains heavily debated. The Fed's projection of a higher unemployment rate of 4.4% by the end of 2023 and a higher federal funds rate of 4.6% suggests a soft landing is unlikely, and at least a mild recession is the price to be paid to tame inflation. Inflationary pressures have been easing recently among commodity markets. Crude oil prices dropped 25% to close the quarter just below $80 per barrel. Supply chain pressures appear to be easing, providing deflationary tailwinds to food and transportation costs. Consumer sentiment ticked up to a five-month high in September, according to the final estimate from the University of Michigan's consumer survey. U.S. corporate earnings broadly held up well in the quarter, while forward-looking guidance reflects considerable uncertainty and consensus earnings estimates have begun to decline. Pending home sales have fallen as interest rates have risen, although the supply of new and existing home inventory has been rising from historically low levels, and homebuilders are beginning to cut prices.

Constructive Observations

- Consumer balance sheets are healthy and consumer confidence is stabilizing.
- High levels of bearish sentiment (4th worst AAII reading since 1987) serves as a contrarian bullish indicator (relief rallies).
- Strong labor market dynamics are supportive of consumer incomes and spending.
- Long-term inflation expectations suggest the market anticipates the Fed will be successful in bringing inflation down.

Cautious Observations

- Global and domestic growth is likely to slow with the likelihood of a recession increasing.
- Geopolitical risks are high with tensions rising between China and Taiwan and from the ongoing war in Ukraine as Russia moved to annex territory.
- Corporate profit margins and earnings are likely to contract.
- With higher debt servicing costs, a credit cycle downturn becomes more likely.

Macro Overview

The Federal Reserve's current rate hike cycle has been the fastest in modern history (five increases thus far in 2022 amounting to a 3.00% increase in the federal funds rate). There are market concerns that tightening financial conditions will push the U.S. economy into a recession. The outlook for employment and home prices is clouded by higher interest rates. Many companies face a challenging combination of higher input prices, weaker demand, and tighter credit markets. Geopolitical tensions have also weighed on the market.

Markets Overview

Equities

The third quarter began with an equity market rally fueled by optimism that inflation would moderate, requiring fewer rate increases by the Fed. This sentiment faded after the Fed reiterated its priority was to tame inflation, potentially at the expense of economic growth. The third quarter marked the U.S. equity market's third consecutive quarter of negative returns. September was one of the worst-performing months for the S&P 500 since 2008 (-9.2%), and that index ended the quarter (-4.9%) at a new low for the year (-23.9%). Every sector of the S&P 500, except for Energy (up 35%), has declined year to date.

U.S. value stocks outperformed growth stocks by 12.9% year to date. While the valuation disparity between value and growth stocks has compressed, it remains wide: the Russell 1000 Value trades at 12.6 times forward earnings compared to 20.8 times for the Russell 1000 Growth Index. The valuation spread between stocks benefiting from and those hindered by low interest rates continues to be very wide.

International equity markets continued to retreat in the third quarter, with every sector and country in the MSCI EAFE posting negative returns amid geopolitical and economic uncertainty. Recession fears heightened as many central banks increased interest rates to combat inflation. The U.S. Federal Reserve's aggressive interest rate hikes contributed to the U.S. dollar's rapid appreciation—another headwind for U.S. dollar-based investors exposed to international equities. Year to date, the MSCI EAFE is down 14.1% in local currency, but down 27.1% in U.S. dollars. The MSCI Emerging Markets Index had a total return of -11.4% for the quarter and -26.9% for the year to date.

China continues to struggle with ongoing real estate problems, regulatory intervention, and an economic slowdown. Chinese stocks declined 22.4% this quarter, down 31.1% for the year. Stocks in Taiwan have fallen over 35% this year; Korea has declined 40%.

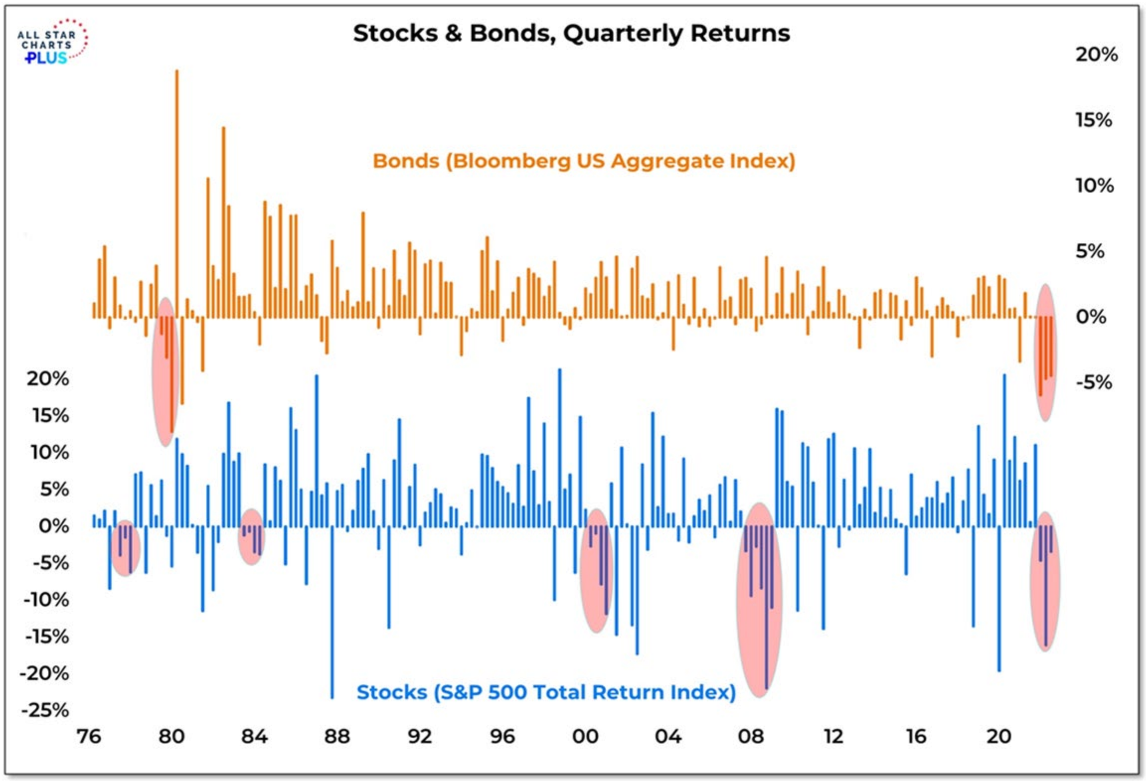
Fixed Income

U.S. Treasury yields continued to surge in the third quarter as the Federal Reserve took an even more aggressive stance to combat stubbornly high inflation, implementing two 75-basis point hikes (one in July and one in September). Chair Jerome Powell messaged the Fed's intent to aggressively hike rates until policymakers see "clear and convincing evidence" that inflation is moving towards its 2% target. As of September 30, the futures market was pricing in 116 basis points of incremental rate increases by the end of 2022. Meanwhile, the yield curve flattened as investors grew increasingly concerned that further monetary policy tightening could tip the economy into a recession. The U.S. Treasury yield curve is quite steep on the short end, but extremely flat/inverted for longer maturities. The 3-month Treasury is yielding 3.23% and the 2-year is almost a full percentage point higher at 4.20%. For maturities exceeding 3 years, the U.S. Treasury yield curve currently has a negative slope with 3-year Treasury yields (4.21%) exceeding the 5-year yield (4.04%), which in turn exceeds the 10-year yield (3.80%) which is higher than the 30-year yield (3.77%). As higher yields drove down bond prices, the broad U.S. investment-grade fixed income market returned -4.8% in the third quarter, bringing year to date returns to -10.8%, the worst year for bonds in modern history. With mortgage rates at their highest level since 2007, home refinancing activity has plummeted. High yield bond spreads declined from 5.9% in late June to 4.21% in early August, finishing the quarter at 5.43%.

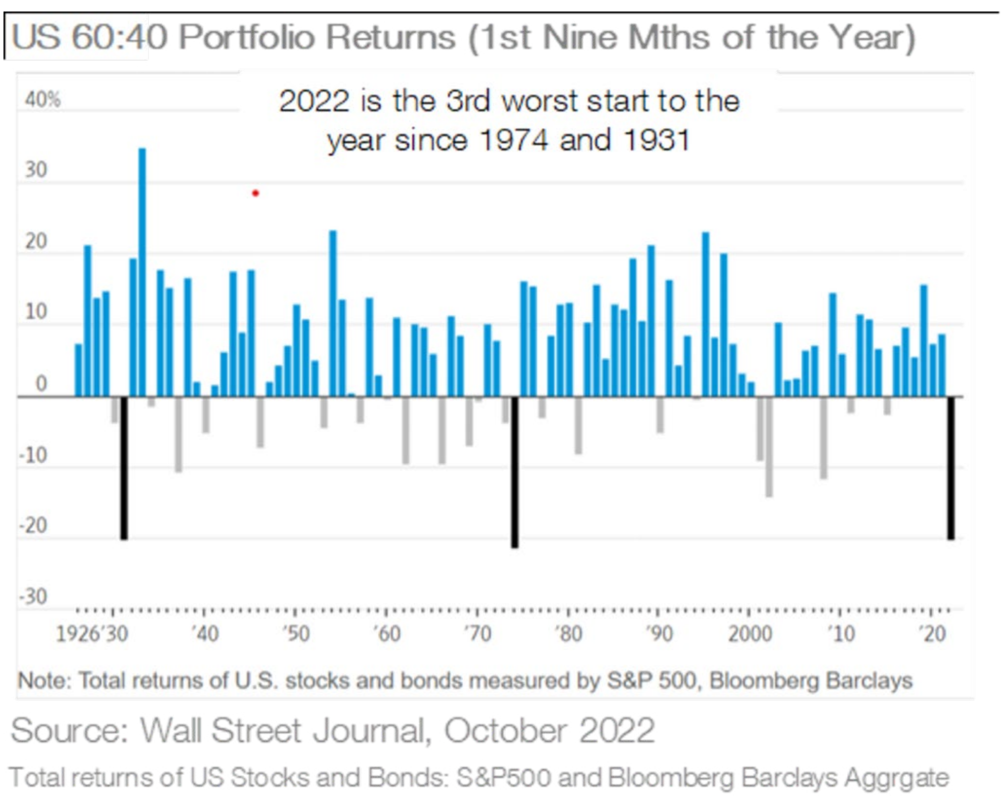
Real Assets

Most commodities declined in the third quarter as the outlook for global growth weakened. Crude oil pulled back dramatically (WTI down 21%) in the third quarter). In recognition of Europe's likely gas shortage this coming winter, natural gas prices increased over 25% this quarter, up a remarkable 87% for the year. Industrial and precious metals all fell in the third quarter, with most down double-digits year to date (aluminum and copper are both down over 20% this year). Despite declines this quarter, most broad commodity indices (reflecting the strength of energy markets) are still positive year to date: one of the few asset classes that can make that claim (Bloomberg Commodity +14% and S&P GSCI +22% year to date).

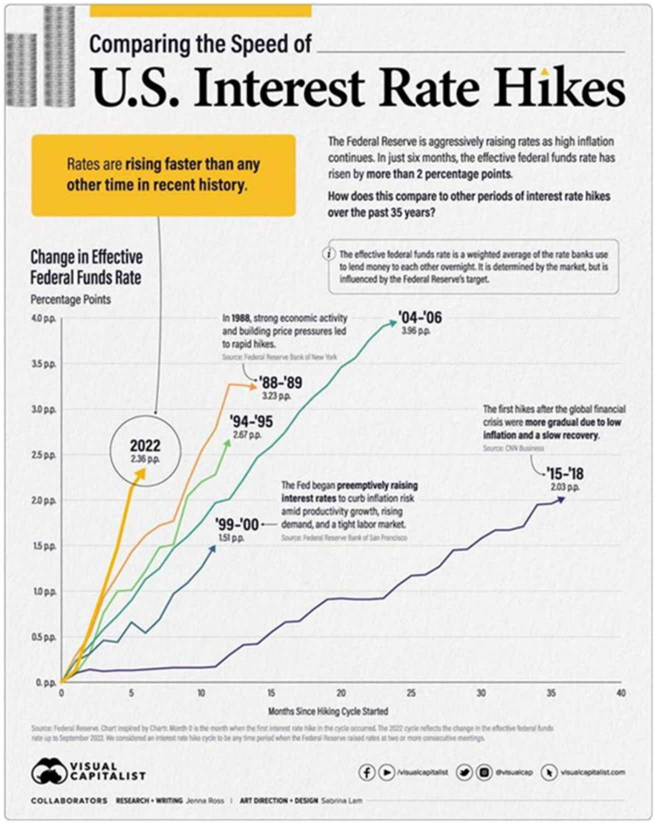
Charts of the Quarter



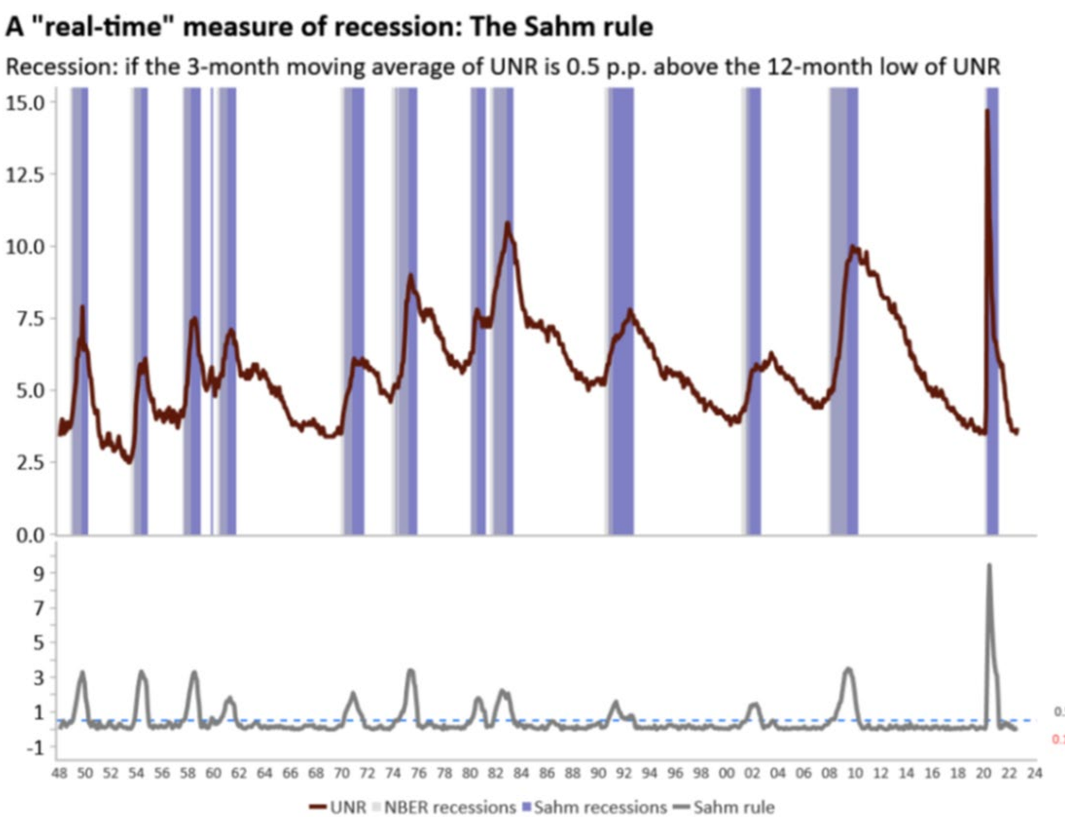
Source: All Star Charts.



Source: WSJ.

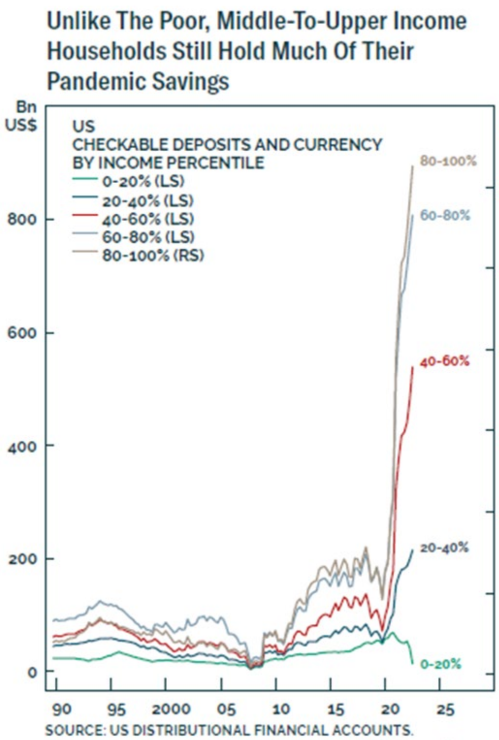


Source: Visual Capitalist.

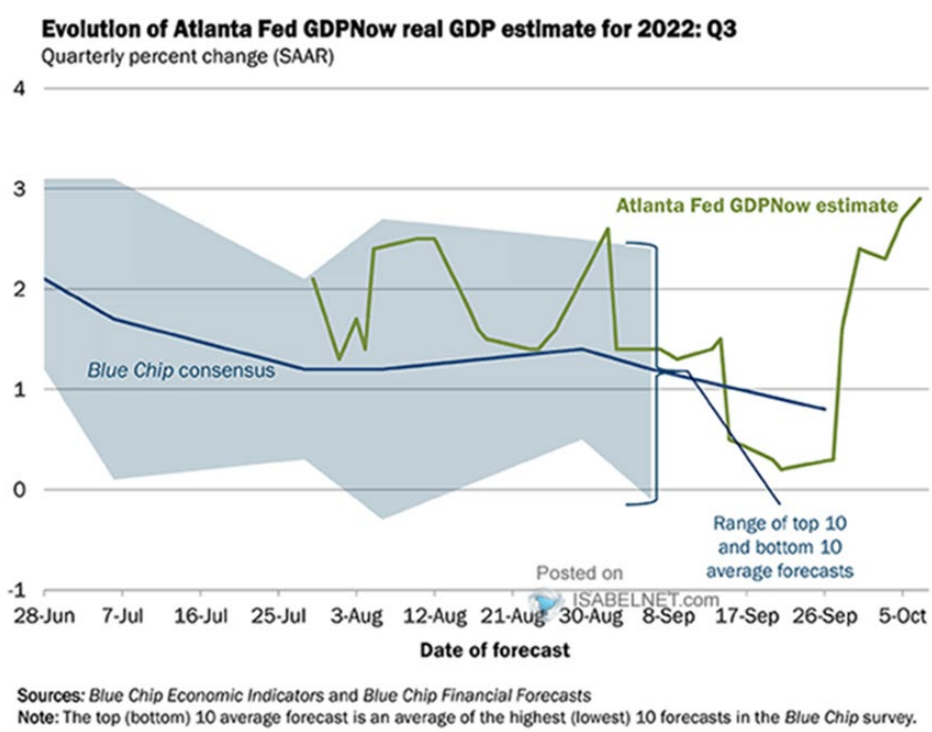


Source: Renaissance Macro.

Charts of the Quarter



Source: BCA Research.

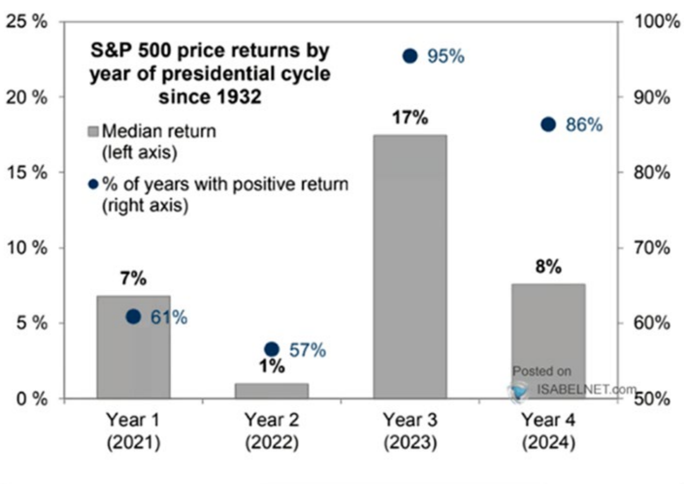


Source: Atlanta Federal Reserve.

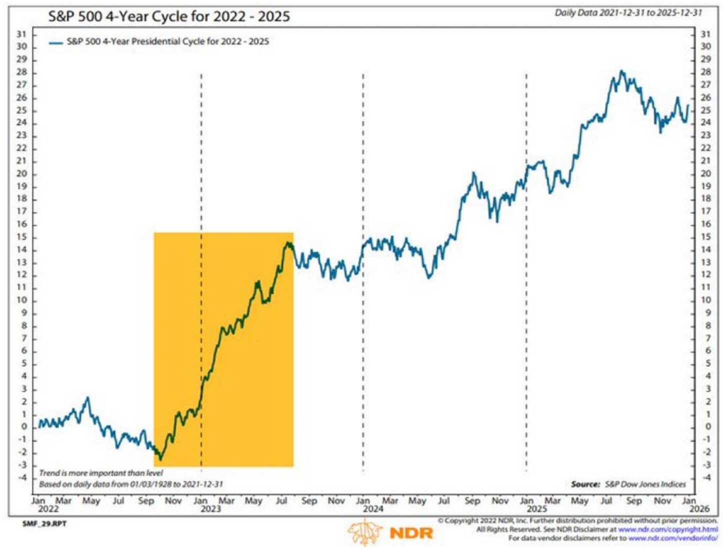
Charts of the Quarter

Exhibit 7: S&P 500 returns by year of presidential cycle

November to November



Source: Goldman Sachs Global Investment Research



Sources: Goldman Sachs/Ned Davis.

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