October 2022

Economic Update

A Review of Third Quarter 2022

Inflation may have peaked in June, but it remains stubbornly high at 8.3% year-over-year as of August. Both stock market and bond market volatility over the last few months are likely primarily attributable to the Federal Reserve's measures to combat this inflation. The Fed has consistently raised rates throughout the year. These raises are not helpful to either stock or bond valuation both because they slow down the economy and because they make current holdings less valuable as compared to alternative safe assets such as treasury bills.

Predicting that recent lower inflation readings might cause the Fed to adjust their plans to raise rates, markets rebounded during the first half of the third quarter, but then subsequently fell back down over the last six weeks as the reality that the Fed was not yet going to adjust course began to set in. The bond market has followed suit, seeing significant losses year-to-date.

The Fed rate now stands at a range of 3.0 to 3.25% while their target rate for year end is 4.4%.

U.S. Economy

The Fed has explicitly targeted 2% as the desired inflation rate over the long run. Expect rate increases to continue until they are confident that inflation is on a path that will bring it much closer to that 2% target.

Consumers are already noticing at least some inflation relief. The most recent Consumer Sentiment Survey reading conducted by the University of Michigan for August was 58.2. This is a poor reading by historical standards, but it is up from the lowest result ever seen in May. 44% of consumers now cite inflation's harmful effects on their living standards, which is down from 49% in the prior month.

Many economists expect a recession at some point during the next twelve months. Regardless of whether we do get an official recession, economic growth will almost certainly continue to be poor. In their September update to The OECD Economic Report, the group calls for 1.5% total U.S. GDP growth during 2022 and only 0.5% U.S. GDP growth during 2023.

Higher Fed rates have hurt home sales as of late. Existing home sales continue to trend down as the 30-year mortgage rate has more than doubled since the beginning of this year. Per the National Association of Realtors, homes were sold at a 4.8 million seasonally adjusted annual rate during August, which is the lowest annualized rate since May 2020.

On a positive note, jobs growth remains strong. Per the Bureau of Labor Statistics, the U.S. economy added 537,000 jobs during July, 315,000 in August and 263,000 in September. The total number of unemployed persons is now 5.8 million and the unemployment rate is 3.5%. This is roughly equivalent to pre-pandemic levels of 5.7 million and 3.5% respectively.

Jobs growth would likely be higher if we weren't seeing such a significant labor shortage. Per the Bureau of Labor Statistics, current job openings are still 10.1 million nationally, nearly double the total number of unemployed persons.

International Economy

The world economy continues to be impacted by Russia's ongoing war against Ukraine. Global energy and food prices have skyrocketed as a result. This has led inflation in many economies to be higher than it has been at any time since the 1980s. Looking forward, the upcoming winter in Europe could prove to be difficult as the OECD predicts, absent at least a 10% cut in usage, shortages of natural gas to occur by early February based on currently available supplies. A harsher-than-average winter would result in even more strain on supplies.

Euro area annual inflation is expected to be 10.0% in September, based on a flash estimate from Eurostat, which is the statistical office of the European Union. Much like the U.S., increased wages brought about by tight labor conditions are contributing to this inflation. Unemployment rates are close to 20-year lows in many countries.

Central banks throughout the world have generally been slower to respond to inflation as compared to the U.S. Federal Reserve. As a result, the dollar strengthened dramatically against most global currencies during the third quarter. As of this writing, the euro is worth exactly one dollar, which hadn't been the case since December 2002.

The OECD Economic Report predicts continued sluggish global growth for the near future. They now forecast total global GDP growth of 2.8% during 2022 and a mere 2.2% during 2023.

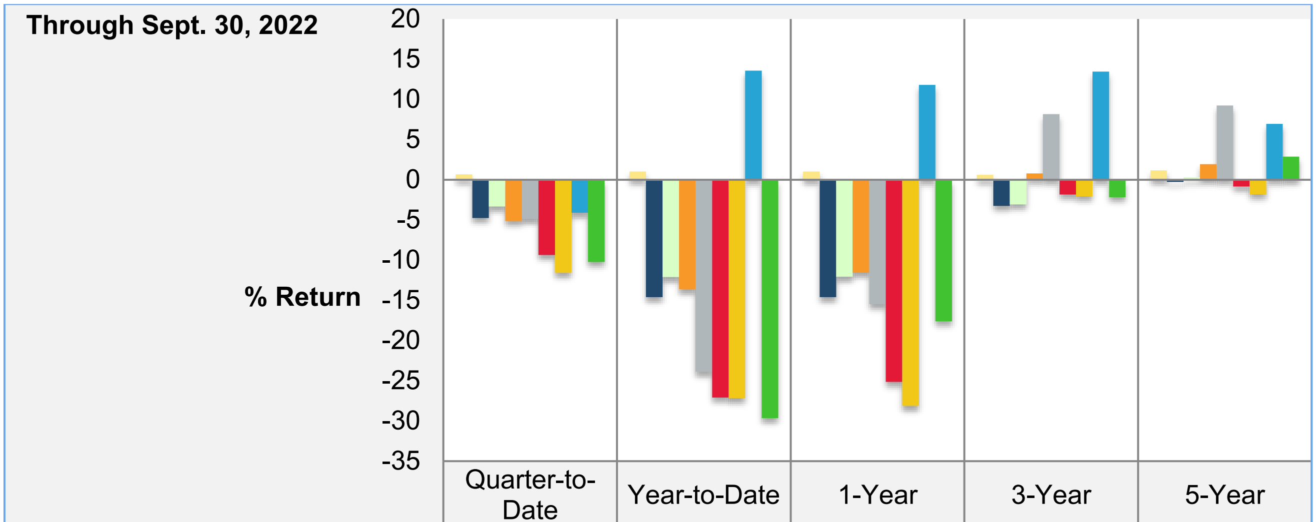
China's zero-Covid policy has made it impossible to achieve their 5.5% GDP growth target in 2022. The OECD predicts 3.2% growth from the country this year. Ongoing trade tensions between China and other major economies such as the U.S. have also contributed to this slower growth. Foreign investment has been stagnating as state-owned companies seem to be gaining more favor from the Chinese government. Berkshire Hathaway recently sold its stake in electric vehicle maker BYD and Tencent has had more than $7 billion in foreign investment withdrawn during the third quarter alone.

Markets

Developed equity markets experienced another poor quarter for returns due to the economic uncertainty throughout the world today. U.S. large-cap equities, as represented by the S&P 500 Index, lost 4.88% during the period. Developed international equity markets, as represented by the MSCI EAFE Index, finished the quarter down 9.36%. Real estate also continued to struggle as well. The Wilshire REIT Index lost 10.23% during the quarter.

Bond indexes had another quarter of relatively large losses, given what is typical for the category. Interest rates, which heavily influence bond prices, continued to climb during the quarter. The Barclays U.S. Aggregate Bond Index and the Barclays Global Aggregate Bond Index lost 4.75% and 3.34% respectively during the quarter. Even the Barclays U.S. Inflation-Linked Bond Index was not immune, also losing 5.14% for the period.

Emerging markets were down even more than developed markets. The MSCI Emerging Markets Index finished the quarter down 11.57%. Commodities were also not immune to losses this quarter. The Dow Jones UBS Commodity Index lost 4.11% during the third quarter of 2022.



	Quarter-to-Date	Year-to-Date	1-Year	3-Year	5-Year
T-Bills	0.67	1.02	1.04	0.61	1.16
Bloomberg US Agg Bond Index	-4.75	-14.61	-14.60	-3.26	-0.27
Bloomberg Global Agg Bond Index	-3.34	-12.09	-12.05	-3.07	0.32
Bloomberg US Infl Linked Bond Index	-5.14	-13.61	-11.57	0.79	1.95
S&P 500 Index	-4.88	-23.87	-15.47	8.16	9.24
MSCI EAFE Index	-9.36	-27.09	-25.13	-1.83	-0.84
MSCI Emerging Markets Index	-11.57	-27.16	-28.11	-2.07	-1.81
Bloomberg Commodity Index	-4.11	13.57	11.80	13.45	6.96
Wilshire REIT Index	-10.23	-29.66	-17.60	-2.17	2.88

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Outlook

The Federal Reserve System operates under a dual mandate of maximum employment and price stability. With the employment component of that mandate still looking relatively strong, expect the Fed to continue to focus on price stability, meaning that they will keep taking whatever actions that they feel are needed to fight inflation. Even more so because they were specifically called out by many economists for not recognizing the onset of this inflationary period quickly enough in the first place.

Markets were volatile in the third quarter because of investors have been trying to successfully guess when the Fed will decide that inflation is finally under control and pivot in a new direction. We expect this volatility to continue for the near future, at least until the Fed actually does pivot because they are convinced that our current bout of inflation has been put to rest.

While the current choppiness might continue for the near future, we still believe in the market over the long run. As always, we recommend a diversified portfolio containing a reasonable amount of equity exposure for any investor with a long enough time horizon.

Bloomberg US Aggregate Bond Index: The Aggregate Bond Index is a broad-based benchmark that measures the investment grade, dollar-denominated, fixed-rate taxable-bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS. The Aggregate rolls up into other Bloomberg flagship indices such as the multi-currency Global Aggregate Index and the Universal Index, which includes high-yield and emerging markets debt. The Aggregate Index was created in 1986, with index history backfilled to Jan. 1, 1976.

Bloomberg Global Aggregate Bond Index: The Global Aggregate Index provides a broad-based measure of the global investment grade fixed-rate debt markets. The Global Aggregate Index contains three major components: the Aggregate (USD 300mn), the Pan-European Aggregate (EUR 300mn) and the Asian-Pacific Aggregate Index (JPY 35bn). In addition to securities from these three benchmarks (94.0% of the overall Global Aggregate market value as of Dec. 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar (USD 300mn), Euro-Yen (JPY 25bn), Canadian (USD 300mn equivalent) and Investment Grade 144A (USD 300mn) index-eligible securities not already in the three regional aggregate indices. The Global Aggregate Index family includes a wide range of standard and customized sub-indices by liquidity constraint, sector, quality and maturity. A component of the Multiverse Index, the Global Aggregate Index was created in 1999, with index history backfilled to Jan. 1, 1990.

Bloomberg Global Inflation-Linked Index: The Global Inflation-Linked Index (Series-L) includes securities that offer the potential for protection against inflation as their cash flows are linked to an underlying inflation index. All securities included in the index have to be issued by an investment-grade-rated sovereign in its local currency. The list of eligible currencies is the same set of currencies eligible for inclusion in the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) represents a stand-alone multi-currency index exposed to the real yield curve for each relevant currency. As such, the index does not contribute to the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) was created on Oct. 31, 1997.

S&P 500® Index: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. It measures the movement of the largest issues. Standard & Poor's chooses the member companies for the 500 based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. The returns presented for the S&P 500 are total returns, including the reinvestment of dividends each month.

MSCI EAFE Index: The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed-market equity performance, excluding the U.S. and Canada. As of April 2002, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index: The MSCI EMF (Emerging Markets Free) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of April 2002, the MSCI EMF Index consisted of the following 26 emerging-market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

Bloomberg Commodity Index: Bloomberg Commodity Index℠ and Bloomberg Commodity Index Total Return℠ the DJ-UBSCI℠ family includes both the BSCI℠, which is calculated on an excess-return basis, and the BSCITR℠, a total return index based on the BSCI℠. The former reflects the return of underlying commodity futures price movements only, while the latter reflects the return on fully collateralized positions in the underlying commodity futures.

Wilshire US REIT Index: Introduced in 1991, the Wilshire REIT index is intended as a broad measure of the performance of publicly traded real estate equity securities. The index is market-capitalization weighted of publicly traded real estate securities, such as Real Estate Investment Trusts (REIT), Real Estate Operating Companies (REOC) and partnerships. The index is composed of companies whose charters are the equity ownership and operation of commercial real estate.

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