Third Quarter 2022

Quarterly Letter to Clients

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The third quarter opened with a solid rebound in stocks that was fueled by better-than-expected corporate earnings reports, declining bond yields, and high hopes that the Fed may end its aggressive interest rate policies earlier than markets expected. However, midway through the third quarter, it became evident that inflation wasn't waning, geopolitical tensions were escalating, and investors finally succumbed to the fact that a 'Fed pivot' wasn't in the cards.

International currency and bonds markets also added to the long list of concerns, after The United Kingdom announced an economic stimulus plan that included 45 billion pounds ($48 billion) of tax cuts and no spending reductions. The market feared the timing of this stimulus package would add to the already high inflation pressures. This caused the pound to drop to an all-time low vs. the dollar, which then required the Bank of England to step in and buy long-dated bonds to restore order in the country's bond market.

As a result, investors shifted away from risk assets by selling stocks and bonds in droves, sending both asset classes lower for a third consecutive quarter. This marked the worst decline in the first nine months of a year in over two decades, putting all three major U.S. indexes in bear market territory.

Economy

Inflation continued to dominate the news cycle throughout the third quarter. For the better part of a year, the inflation narrative from economists and policymakers has been that food and fuel were the main drivers of rising inflation. However, recent consumer price index (CPI) reports tested that narrative by reporting price increases that were more extensive than previously thought. The monthly headline CPI readings in July and August increased by 0.0% and 0.1%. However, core CPI, which excludes the volatile food and energy components, rose 0.6% in August after increasing 0.3% in July. On an annual basis, headline CPI decelerated to 8.5% in July and 8.3% in August, helped by a drop in energy prices. Of particular interest to the consumer was the "food at home" index, a good proxy for grocery prices, which increased 13.5% over the past year -- the largest increase since March 1979. Both headline and core CPI have increased for 27 consecutive months.

The Federal Open Market Committee (FOMC) delivered an unprecedented third consecutive 75 basis point hike in September and signaled that rates will continue to rise to levels higher than previously expected. The effective federal funds rate now stands in a range of 3.00% to 3.25%, its highest level since 2008. The so-called "dot plot" of Fed officials' forecasts showed an average expected rate of 4.4% by the year's end, a significant increase from an earlier projection of 3.4% released in June. The Committee also reiterated that they would continue raising rates if inflation remains inconsistent with the Fed's price stability mandate.

Gross domestic product (GDP), the broadest measure of goods and services produced across the country, decreased by 0.6% in the second quarter after falling 1.6% in the first quarter. The decrease in GDP reflected downturns in private inventory investment, residential fixed investment, and federal, state, and local government spending that were partially offset by increases in consumer spending and exports. The Conference Board forecasts that U.S. real GDP will rise by 0.3% in the third quarter of 2022.

Total nonfarm payroll employment increased by 528,000, 315,000, and 263,000 in July, August, and September, respectively. The increase in new jobs in September fell to a 17-month (April 2021) low due to labor shortages and waning demand for workers as talk of a recession grows. While still strong historically, the lower level of new jobs suggests a gradual cooling in the labor markets. Meanwhile, the unemployment rate dropped to 3.5% from 3.7%. That puts unemployment at a pre-pandemic low and marks one of the lowest rates since the late 1960s. The labor participation rate declined during the third quarter to 61.7% from 62.1%. Initial filings for unemployment claims fell to a five-month low totaling 193,000, another sign that the labor market is strengthening, despite the central bank's efforts to slow the labor market. Collectively, the data points to a tight labor market that may keep wage growth elevated and monetary policymakers on their aggressive rate hiking path.

According to the Census Bureau, retail sales declined by 0.4% in July, as falling fuel prices dampened gas station sales and consumers turned more heavily to online shopping. However, retail sales improved by 0.3% in August, boosted mainly by a big jump in motor sales and parts dealer receipts. When adjusted for inflation, retail sales rose by 0.1% in August.

Economic activity in the manufacturing sector expanded in September, but at a slower pace than in the prior two months. The September ISM manufacturing index fell by 1.9% to 50.9% during the quarter, falling to its lowest level since May 2020. Although the headline number is slightly above the 50% expansion level, two of the five subindexes fell into contraction territory. Manufacturing employment has contracted in four of the last five months, with the employment index posting its second-biggest monthly drop in the last decade. The factory sector may weaken further as challenging financial conditions and a strong U.S. dollar weigh on foreign demand (exports).

The highest mortgage rates in more than 20 years contributed to a steep drop in mortgage demand. According to the Mortgage Bankers Association, the average contract rate for 30-year fixed-rate mortgages with conforming loan balances (< $647,000) increased to 6.75% to end the third quarter. The current rate has more than doubled over the past year. Additionally, sales of previously owned homes retreated for the seventh consecutive month in August, as rising mortgage rates reduced affordability and reduced the number of would-be buyers from the market. Contract closings fell 0.4% in August from July. Existing home sales were 19.9% lower than in the year-ago period. However, sales of new single-family homes soared in August, increasing 28.8% from July's total but 0.1% below August 2021. However, the price of homes sold decreased in August, with an average sales price of $521,800, which was down from the prior reading of $556,700. It appears from the data that higher mortgage rates are beginning to impact the real estate market.

The Conference Board Consumer Confidence Index increased in September for a second consecutive month. The Index rose to 108.0, up from 103.6 in August. The survey indicated that the improvement was supported by jobs, wages, and declining gas prices. However, purchasing intentions were mixed, with higher intentions to buy automobiles and big-ticket appliances, while

home purchasing intentions fell. Looking ahead, the improvement in confidence may bode well for consumer spending, but rising interest rates and inflation will likely remain strong headwinds as we enter the final quarter of 2022.

Stocks

S&P 500 earnings for the second quarter were better than expected. Despite the challenging backdrop, most earnings reports beat estimates, which showed investors that earnings were holding up better than expected. Hope for a less-aggressive Fed paired with better-than-expected earnings and 'peak' inflation fueled a 9.2% gain in the S&P 500 in July. Stocks continued to climb higher during the first half of August, propelled by the July CPI report (released in August), which showed annualized inflation falling to 8.5% from 9.1% in June. Investors welcomed the news as 'confirmation' of peak inflation, which, combined with the possibility of a "Fed pivot," boosted the S&P 500 to a four-month high by mid-August. But ultimately, investors grew increasingly worried that the economy was headed toward a recession and stock prices trended lower.

Those looking for relief in the stock market did not find it during the third quarter, thanks to persistent inflation and higher interest rates. The S&P 500, Dow Jones Industrial Average (DJIA), and the Nasdaq Composite shed roughly 5.3%, 6.6%, and 4.1% during the quarter, respectively. The DJIA is down 21% in 2022, the S&P 500 is off 25%, and the tech-heavy Nasdaq Composite has plunged 32%, which marked the worst first nine months of performance since 2002. All three indexes closed at their lowest levels since 2020. The summer rally turned out to be a "Bear Market Rally."

From an investment style standpoint, value and growth registered quarterly losses. But, unlike the first half of 2022, growth outperformed value in the third quarter. Growth rebounded early in the quarter as markets rallied on the hope of peak inflation and a Fed pivot. However, that growth outperformance dwindled late in the quarter as inflation remained high and the Fed signaled there would be no imminent end to the rate hiking cycle.

Market Performance % Barometer				
U.S. Equity Indexes	**Q3 2022**	**Q2 2022**	**Q1 2022**	**2022 YTD**
U.S. Market	-4.58%	-16.85%	-5.30%	-24.88%
Value	-6.60%	-9.44%	2.40%	-13.43%
Growth	-3.84%	-25.30%	-12.00%	-36.79%
Developed Markets - ex-U.S.	-9.17%	-14.90%	-5.20%	-26.70%
Emerging Markets	-9.81%	-11.59%	-5.90%	-24.98%
Source: Morningstar Direct, Morningstar Index, Data as of September 30, 2022 in Total Return USD				

Bond Market

Yields in the bond market have risen precipitously over the last few quarters. The U.S. Treasury 10-year yield climbed to 3.97% on September 27, its highest level since 2010. It ended the quarter marginally lower at 3.83%. The 2-year Treasury yield soared to 4.22%, up from 2.84% three months earlier. A year ago, the 2-year Treasury yield stood at just 0.27%. With short-term Treasury yields higher than long-term yields, the yield curve is now inverted by the most since the summer of 2000. An inverted yield curve is a commonly cited indicator of an impending recession.

Against this backdrop, it was a historically challenging quarter for the already-bloodied bond market. Bonds of all types and duration posted losses in the third quarter, extending the losses from the year's first half. The Morningstar Long Term Core Bond Index (10+ years) plunged by 9.5% during the quarter, bringing the year-to-date loss to 29.5%. The Morningstar Short-Term 1-5 Year Core Bond Index fell 2.2%. However, the Morningstar High Yield Index lost just 0.7%, thanks to corporate earnings, which kept default risk generally low during the quarter.

Market Performance % Barometer				
Broad Market	**Q3 2022**	**Q2 2022**	**Q1 2022**	**2022 YTD**
Core Plus Bond (US 5-10 Year Treasury)	-4.8%	-4.5%	-4.5%	-14.6%
Sector				
U.S. Treasuries	-4.5%	-3.7%	-5.5%	-13.1%
Corporate	-5.2%	-6.9%	-7.9%	-18.7%
High Yield	-0.7%	-9.9%	-4.5%	-14.6%
Mortgage	-5.4%	-4.0%	-5.0%	-13.7%
Maturity				
Short-Term Core	-2.2%	-1.2%	-3.6%	-6.8%
Intermediate Core	-5.2%	-4.2%	6.0%	-14.7%
Long-Term Core	-9.5%	-12.1%	-11.3%	-29.5%
Inflation Protected				
TIPS	-5.6%	-6.3%	-2.4%	-13.6%
Source: Morningstar Direct, Morningstar Index, Data as of September 30, 2022				

Thank you for your continued confidence and trust in us. If you have any questions or comments, please do not hesitate to contact us.