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2022 | Q3 Market Brief

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I – DOMESTIC MARKETS OVERVIEW

U.S. Equities Enter Bear Market

Losses Accelerate in Third Quarter Amidst Weak Economic Outlook

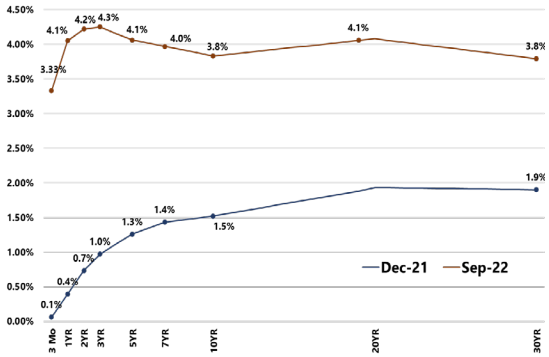
Market uncertainty carried through the third quarter of the year, as U.S. equities entered a bear market. Trends that have persisted through the balance of 2022 – a worsening economic outlook, the ongoing war in Ukraine, and persistently high inflation – continued to weigh on investor sentiment and appetite for risk assets. After a positive start to the quarter, U.S. large cap stocks retreated (S&P 500 **-4.9%**), with volatility increasing towards the end of September (Exhibit A). Most sectors declined, with the market pullback led by losses from otherwise disparate areas (S&P 500 Communication Services **-12.7%**; S&P 500 Consumer Staples **-6.6%**; S&P 500 Real Estate **-11.0%**). Energy stocks continued to be a bright spot (S&P 500 Energy **+2.3%**), while consumer companies bucked overall market sentiment (S&P 500 Consumer Discretionary **+4.4%**). Perhaps surprisingly, smaller capitalization companies outperformed on a relative basis during the third quarter (Russell 2000 **-2.2%**), as returns were aided by strong performance from energy and healthcare constituents. While corporate earnings have remained relatively resilient over the first nine months of the year, continued margin compression and concerns over the outlook for consumer spending are weighing on investors' prospects for the remainder of the year and into 2023.

Exhibit A: Trailing Asset Class Returns (Select Indices; through 9/30/2022) *Source: Morningstar*

Index	3-Month	YTD	12-Month	3-Year	5-Year
Capital Preservation (US 3-Month T-Bill Index)	0.69	1.07	1.08	0.63	1.19
U.S. Fixed Income (Barclays US Agg Bond Index)	(4.75)	(14.61)	(14.60)	(3.26)	(0.27)
U.S. Large Cap Equity (S&P 500 Index)	(4.88)	(23.87)	(15.47)	8.16	9.24
U.S. Small Cap Equity (Russell 2000 Index)	(2.19)	(25.10)	(23.50)	4.29	3.55
International Equity (MSCI ACWI Ex USA Index)	(9.91)	(26.50)	(25.17)	(1.52)	(0.81)
Global Real Estate (FTSE EPRA/NAREIT Developed	(11.58)	(29.89)	(22.77)	(6.47)	(0.85)

Bond Market Pain Continues with Fed Aggressively Fighting Inflationary Pressures

Exhibit B: Treasury Yield Curve (December 2021 → September 2022) *Source: FRED*



Fixed income markets continued to suffer over the past three months, as rising Treasury yields led to a third straight quarterly selloff (Bloomberg Barclays U.S. Aggregate Bond Index **-4.8%**). Treasury yields continued to rise as the U.S. Federal Reserve (Fed) accelerated the pace of interest rate increases to combat persistently high inflation (Exhibit B). The yield curve remains inverted, given uncertainty over the macroeconomic outlook. Despite that uncertainty, investment grade credit spreads were relatively unchanged over the quarter, while spreads for high yield bonds narrowed, leading the sector to outperform the broader fixed income market (ICE BofA US High Yield Index **-0.7%**). As Treasury yields increased across maturities, longer-dated bonds were disproportionally impacted, given their increased sensitivity to changes in yields. Government-backed mortgages underperformed, while international bonds, particularly those denominated in local currencies, underperformed as the U.S. dollar strengthened against most major currencies. Fixed income sectors with less interest rate sensitivity (e.g. bank loans, convertible bonds) generally outperformed over the past three months.

I – DOMESTIC MARKETS OVERVIEW (Cont.)

Fed Quickens Pace of Interest Rate Tightening

High Inflation, Low Unemployment Supportive of Hawkish Policy Stance

In September, the U.S. Federal Reserve progressed with its interest rate tightening cycle. The Fed increased its key Federal Funds Rate to **3.00-3.25%** and cautioned that rate increases will continue throughout the remainder of the year. The Fed expects to increase rates another 5 times over the final quarter of 2022 and currently anticipates additional rate increases in 2023, as well. Coupled with the interest rate increases, the central bank continued to reduce the size of its balance sheet to help dampen inflationary pressures. As inflation has remained high in recent months, the Fed has been under pressure to act even more aggressively in rate markets to slow aggregate demand. Relatively strong labor markets have, thus far, provided cover for the bank to purse this tightening cycle.

Economic Output Declines While Labor Markets Remain Resilient

The U.S. economy declined for a second consecutive quarter during Q2:2022. After an unexpected drop in economic activity in the first quarter, second quarter GDP was estimated to have declined -0.6% on an annualized basis. Further decreases in inventories, coupled with reduced government spending and residential and nonresidential investment, all contributed to the fall in economic activity. Consumer spending remained positive despite the inflationary environment. Although the Fed anticipates economic activity to pick up over the remainder of the year (Exhibit C), most economists believe the U.S. will enter a recession over the coming twelve to eighteen months.

Despite the macroeconomic outlook, labor markets have continued to support consumer activity. Headline unemployment has stayed low in recent months (September Unemployment Rate: 3.5%), while broader measures of unemployment (September U-6 Rate: 6.7%) remain at record low levels. Employment gains have continued to fuel rising wages, as employers fight to find and retain workers. While wage growth has remained stable over the course of the year (5-6% annualized growth), it has trailed overall levels of inflation. Prices increased 8.2% year-over-year in August, and questions remain over how quickly the Fed can dampen price levels. With the Fed working to combat inflationary pressures, concerns over the impact to consumer spending have increased. Although consumer sentiment improved in the third quarter, sentiment levels remain well below 2021 and pre-pandemic periods, as households grapple with higher food costs, mortgage rates, and declining savings. Within the housing market specifically, affordability remains low, with mortgage rates further increasing over the third quarter of the year.

Exhibit C: **FOMC Economic Projections (September 2022)** *Source: U.S. Federal Reserve*

		Median FOMC Projection			
Indicators	**Current**	**2022**	**2023**	**2024**	**Longer Run**
Change in Real GDP (%)	-0.6	0.2	1.2	1.7	1.8
Change from Prior Meeting	n/a	*-1.5*	*-0.5*	*-0.2*	*+0.0*
Unemployment Rate (%)	3.5	3.8	4.4	4.4	4.0
Change from Prior Meeting	n/a	*+0.1*	*+0.5*	*+0.3*	*+0.0*
Inflation (%)	8.2	5.4	2.8	2.3	2.0
Change from Prior Meeting	n/a	*+0.2*	*+0.2*	*+0.1*	*+0.0*
Federal Funds Rate (%)	3.00-3.25	4.4	4.6	3.9	2.5

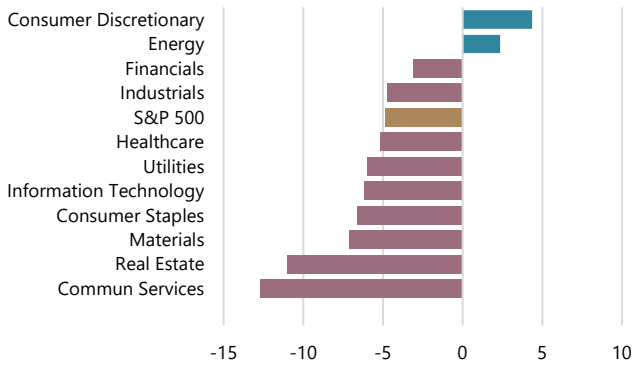
I – DOMESTIC MARKETS OVERVIEW (Cont.)

Market Contributors

Consumer Discretionary Stocks Bounce Back While Energy Continues to Outperform

After rising through the first half of the quarter, the S&P 500 index resumed its decline in mid-August as recession-wary investors worried the Federal Reserve would need to further tighten monetary policy to bring inflation in line with its mandate. The index ended down 4.9% for the quarter, bringing its return to -23.9% for the year. Most sectors declined, with only two industries ending the quarter in positive territory. Counterintuitively, given the concerns about economic growth, the consumer discretionary sector was the top performer, followed by the energy sector.

Exhibit D: **S&P 500 Sector Returns Q3:22** *Source: Morningstar*

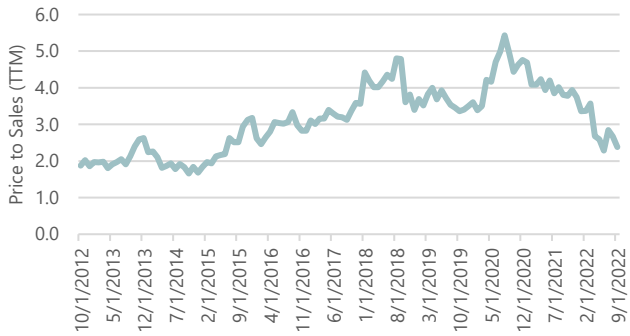


While the consumer discretionary sector was the worst performing sector over the first half of the year, some of the top performing stocks in the sector rebounded in the third quarter as results were better than feared, or valuations were relatively more compelling. Mega-cap companies Tesla and Amazon were bright spots. Despite founder and CEO Elon Musk selling nearly $7 billion in shares to pay for his potential purchase of Twitter, the stock rose over 18% after the company reported better than expected earnings and expressed confidence in growing vehicle deliveries. Amazon shares jumped following its announcement of a second Prime Day event in time for the holiday shopping season. Investors also found the company more appealing as it traded at valuations not seen in years (Exhibit E).

While oil prices declined on concerns about global growth, the energy sector and energy related companies also gained value over the quarter. Natural gas prices in Europe have trebled over the year due constricting deliveries of natural gas supplies from Russia. Analysts also expect that Europe will ration gas this winter. This has been supportive to traditional oil and gas companies like ConocoPhillips and Occidental Petroleum. However, alternative energy companies also posted strong gains, benefiting from higher energy prices and the passage of the Inflation Reduction Act, which will provide federal support for non-carbon energy sources. Constellation Energy, a leading nuclear power plant operator, and Enphase Energy, a solar and battery company, were the two best performing stocks in the S&P 500 index.

Interest rates again rose across the yield curve, leading short duration fixed income, like cash, asset-backed securities, and other short-term bonds to outperform. Bank loans and below investment grade bonds also had better returns as high yield credit spreads tightened.

Exhibit E: **Amazon Price to Sales (TTM)** *Source: Morningstar*

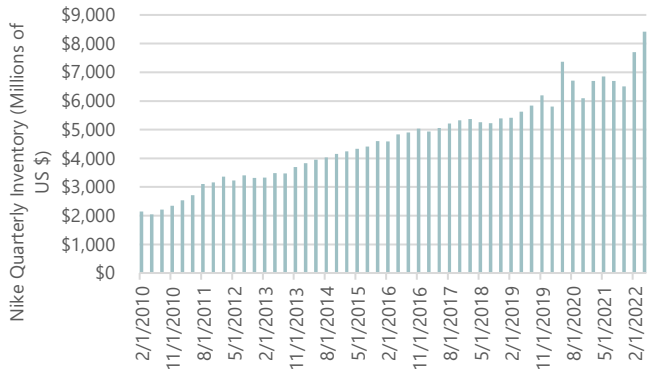


I – DOMESTIC MARKETS OVERVIEW (Cont.)

Market Detractors

Global Growth and Consumer Spending Concerns Weigh on Companies Across Most Sectors

Exhibit F: **Nike Quarterly Inventory Levels** *Source: Macrotrends*



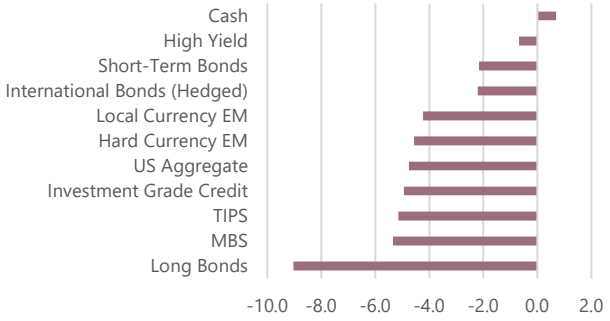
Companies vulnerable to global growth concerns, sustained elevated inflation, and increased competition were some of the worst performers over the quarter. The communication services sector again led the market lower. Alphabet contributed the most to the S&P 500's decline. The company generates over 80% of its revenue from advertisements, and companies tend to spend less on marketing during periods of economic uncertainty. Meta – also reliant on advertising revenues – continued its slide. Additionally, investors were concerned about increased competition for advertising revenues from other social media companies and other technology giants, like Apple, Amazon, and Microsoft. Charter Communications and Comcast Corp also suffered steep losses. While investors value the cable industry's dominance in high-speed broadband, fixed wireless providers Verizon and T-Mobile have poached customers.

After announcing disappointing quarterly earnings guidance, FedEx shares suffered their worst day on record. Management cited a global macroeconomic slowdown and an inflation induced reduction in consumer spending as the causes of its disappointing results. Additionally, after a pandemic related surge in spending on goods, consumers have switched to purchasing travel and entertainment. This change in consumption weighed on stocks such as Nike and VF Corp (owner of the North Face and Timberland brands). Both companies suffered from elevated inventory levels (Exhibit F). Nike also struggled with decreased demand from China and a strong U.S. dollar.

The current macroeconomic environment has also walloped chip makers like NVDIA and Intel. NVDIA especially faces headwinds. Many of its chips are used in mining cryptocurrency, and in addition to the selloff seen in those assets this year, Ethereum's moves from "proof of work" to "proof of stake" will drastically reduce the need for semiconductors from its mining process. The U.S. government also announced a ban on exports of NVIDIA chips used for artificial intelligence to China. The real estate sector was another low spot this quarter, as rising mortgage rates have negatively impacted the heavily indebted industry.

For the third quarter in a row, rising interest rates across the curve resulted in underperformance for duration sensitive fixed income securities, like long-dated Treasuries and corporate bonds. Mortgage-backed securities also underperformed, as starting in September the Federal Reserve began to allow up to $35 billion of its holdings of the securities to mature each month.

Exhibit G: **Fixed Income Returns Q3:2022 (%)** *Source: Morningstar*



II – INTERNATIONAL MARKETS OVERVIEW

World View

Global Market Volatility Persists Amid Recession and Geopolitical Fears

Global markets declined for the third consecutive quarter as inflation remained near multi-decade highs and market volatility persisted (Exhibit H; MSCI World Index Q3: **-6.2%**). Global central banks continued to implement aggressive monetary policy measures to combat inflation and to help stabilize local currency prices adding to market volatility in the third quarter. Local currencies have faced tremendous headwinds against the U.S. dollar year-to-date amidst rising interest rates in the United States and a flight to safe-haven assets. In Europe, the resulting energy crisis from the Russia-Ukraine war continued to put downward pressure on the region's economy. High energy prices and supply shortages fueled the region's inflation during the quarter which reached 10% in September. The region has not seen double-digit inflation since World War II. Economic activity in the United Kingdom lost momentum due to the energy crisis and a weaker Sterling (MSCI United Kingdom Index Q3: **-10.8%**). Additionally, consumer confidence in the country fell to an all-time low in September as the death of Queen Elizabeth II, the election of a new Conservative Party leader, and the Russia-Ukraine war weighed on consumers and investor sentiment. Asian markets followed global markets lower during the quarter. Fresh concerns over the stability and trajectory of China's economy weighed on investors as Covid-19 cases rose and geopolitical tensions with the U.S. remained high.

Exhibit H: **Global Equity Returns (%)**

Select Countries and Regions, Q3:2022. Source: Morningstar. Currency: USD and local.

Global Equity Returns				
Region/Country	3Q22		1-Year	
	USD	Local	USD	Local
MSCI Australia	-6.7%	-0.3%	-16.4%	-6.1%
MSCI Canada	-7.9%	-1.9%	-13.1%	-5.7%
MSCI China	-22.5%	-21.7%	-35.4%	-33.9%
MSCI France	-8.9%	-2.8%	-24.0%	-10.1%
MSCI Germany	-12.6%	-6.7%	-37.1%	-25.6%
MSCI Italy	-8.5%	-2.4%	-28.5%	-15.4%
MSCI Japan	-7.7%	-1.6%	-29.3%	-8.3%
MSCI United Kingdom	-10.8%	-2.9%	-14.1%	3.8%
MSCI USA	-4.8%	-4.8%	-17.6%	-17.6%
MSCI ACWI Ex USA	-9.9%	-4.9%	-25.2%	-13.9%
MSCI EAFE	-9.4%	-3.6%	-25.1%	-11.1%
MSCI EM	-11.6%	-8.2%	-28.1%	-21.5%
MSCI AC Asia Ex Japan	-13.8%	-10.7%	-28.7%	-22.9%
MSCI AC Asia Pacific	-11.2%	-6.8%	-27.7%	-16.8%
MSCI Europe	-10.1%	-4.1%	-24.8%	-11.8%
MSCI North America	-5.0%	-4.7%	-17.4%	-17.1%
MSCI World	-6.2%	-4.4%	-19.6%	-15.5%

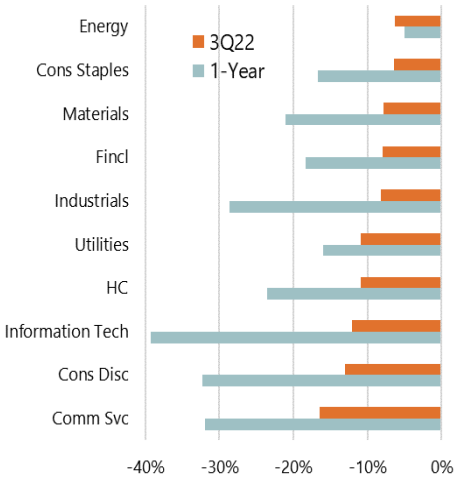
International equity markets underperformed domestic markets in the third quarter (MSCI ACWI ex USA Index Q3: **-9.9%**; MSCI USA Index Q3: **-4.8%**). This was largely attributable to the outperformance of U.S. dollar over the quarter. In general, all major international equity markets ended the third quarter in negative territory. In a reverse from last quarter, China was the worst performing market over the third quarter (MSCI China Index Q3: **-22.5%**). This was largely attributable to the country's zero Covid-19 policy, fears of a global recession, and ongoing U.S.-China angst as investor's priced in the economic impact to the country. European markets continued their broad selloff during the quarter as the ongoing war in Ukraine continued to negatively impact the region (MSCI Europe Index Q3: **-10.1%**). German markets continued to underperform broader European markets (and international markets) as its heavy industrial economy relies meaningfully on gas supplies (MSCI Germany Index Q3: **-12.6%**). Outside of the United States, Australia was the best performing market during the quarter (MSCI Australia Index Q3: **-6.7%**). The country is a large exporter of natural gas, coal, and wheat and benefited from higher export prices during the quarter because of the aforementioned geopolitical issues and conflicts.

II – INTERNATIONAL MARKETS OVERVIEW (cont.)

World View (Cont.)

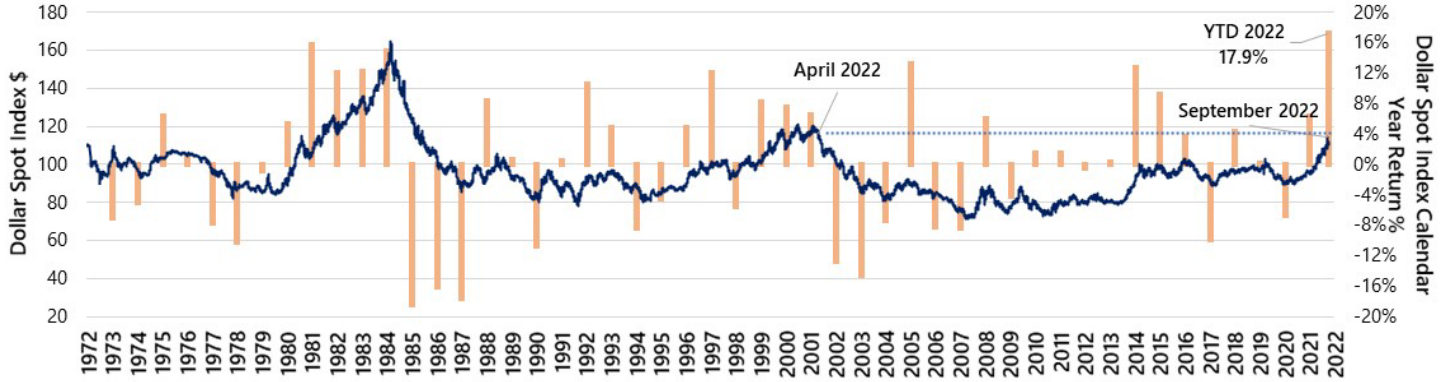
Despite global equity markets rallying in July, all ten equity sectors declined during the third quarter as high inflation persisted and global recession fears were reignited. More defensive areas of the market continued to outperform (MSCI World Defensive Sectors Index Q3: **-5.9%**; MSCI World Cyclical Sectors Index Q3: **-7.2%**). The communication services sector was the worst performing over the quarter (MSCI ACWI ex USA Communication Services Index Q3: **-16.5%**). This was largely attributable to the poor performance of Chinese communication company Tencent Holdings Ltd (Q3: **-24.6%**). The energy sector continued to be the best performing sector (MSCI ACWI ex USA Energy Index Q3: **-6.3%**) as global supply shortages and demand for natural gas aided the performance of energy companies. Consumer Staples was the second-best performing sector during the quarter (MSCI ACWI ex USA Consumer Staples Index Q3: **-6.4%**) as consumers preferred to shop at discount stores in an effort to cut household spending.

Exhibit I: **Global Equity Sector Returns (%)**
Select Sectors, Q3 2022. Source: Morningstar



Global fixed income markets struggled during the quarter as heightened market volatility persisted and central banks and investors continued to grapple with high inflation (Bloomberg Global Aggregate Bond Index Q3: **-6.9%**). Despite continued inflation concerns, global government and inflation-related bonds underperformed during the quarter (Bloomberg Global Aggregate Government Index Bloomberg Q3: **-7.4%**; Global Inflation Linked Index Q3: **-10.0%**). This was largely attributable to the longer relative duration of both asset classes. Despite investors general risk-off sentiment, high yield bonds outperformed during the quarter as credit spreads tightened across the curve (Bloomberg Global High Yield Bond Index Q3: **-2.7%**; Bloomberg Emerging High Yield Bond Index Q3: **-3.5%**). From a regional standpoint, European bonds significantly underperformed broader global fixed income markets (Bloomberg Euro Aggregate Bond Index Q3: **-10.6%**) as investors priced in signficant interest rate increases from the European Central Bank (ECB). The US dollar continued benefit from its safe-haven appeal and a more hawkish Federal Reserve (US Dollar Index Q3: **+7.1%**; YTD: **+17.2%**). The dollar is on pace to have its best annual return since the 1970s. Despite the US dollar's strong performance, emerging market bonds generally outperformed international bonds. (Bloomberg EM Hard Currency Agg Index Q3: **-4.8%**; Bloomberg EM Local Currency Aggregate Index Q3: **-3.1%**).

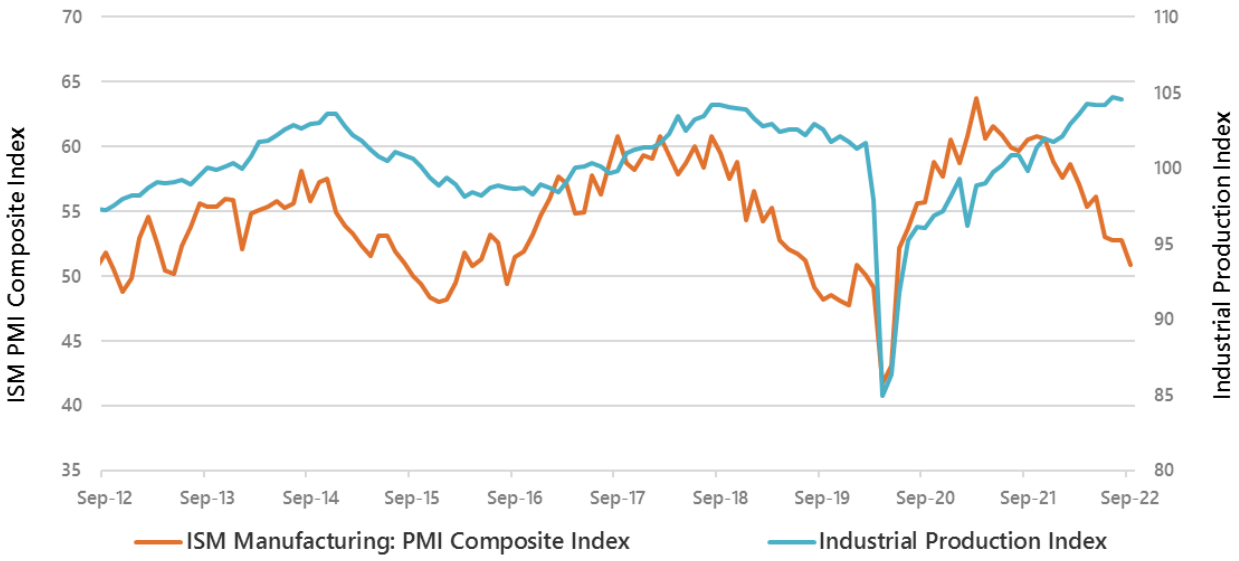
Exhibit J: **U.S. Dollar Spot Index Price and Calendar Year Returns (%)**
Data as of September 30, 2022. Source: Bloomberg.



III – LEADING ECONOMIC INDICATORS

Manufacturing and Industrial Output

Exhibit K: **Industrial Production and ISM PMI Indexes**
(Trailing 10-year)



ISM PMI Composite Index (U.S.) – The Institute for Supply Management (ISM) Purchasing Managers Index (PMI) combines five manufacturing indicators (new orders, production, employment, deliveries, and inventories) to create a composite view of national manufacturing activity. A PMI reading above 50 generally indicates manufacturing expansion.

Industrial Production Index (U.S.) – Calculated by the Federal Reserve, the Industrial Production Index measures real output for all facilities located in United States, including manufacturing, mining, electric utilities, and gas utilities.

Price Growth Slows as Demand Begins to Soften

The ISM PMI Composite Index showed continued growth in manufacturing through September 2022, registering its twenty-eighth consecutive month of expansionary readings spanning the global pandemic recovery. The Index has steadily declined, however, since reaching a high of 63.7 in March 2021. The September 2022 reading of 50.9 is only slightly expansionary and draws near to pre-pandemic readings last seen in early 2020. Slowing growth in the manufacturing sector is partly attributable to softening demand with the New Orders Index falling into contractionary territory. While supply chains remain far from normalized, survey responses indicate a degree of stabilization among commodities and other inputs. These factors, combined with growing concern of a global economic slowdown, have led to a steep decline in price growth over the past six months with the Prices Index falling from 87.1 in March 2022 to 51.7 in September 2022.

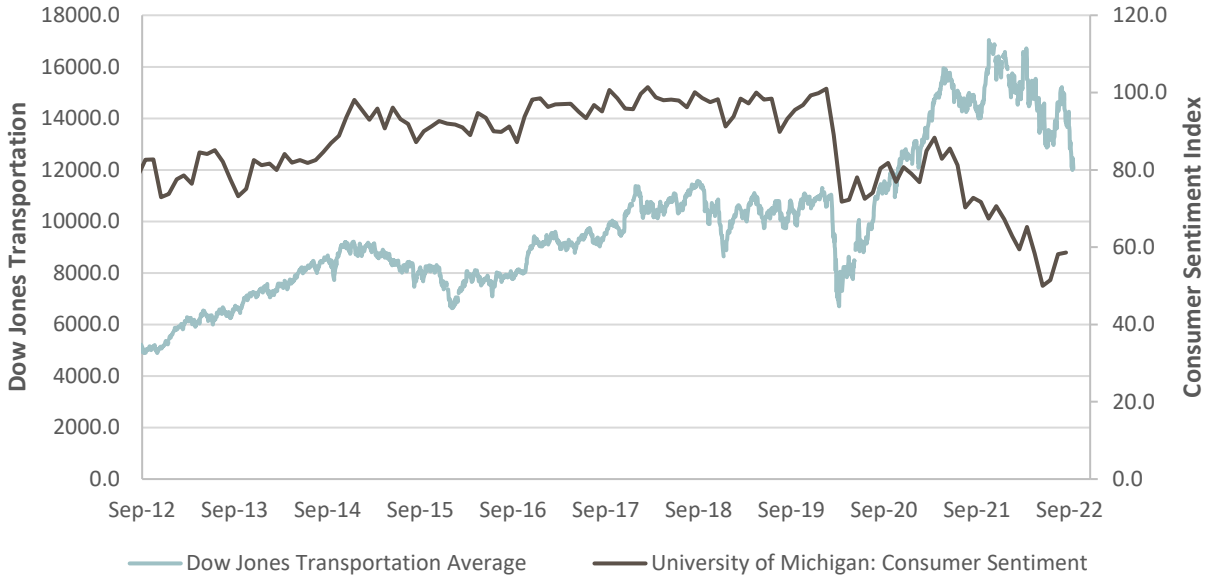
The Industrial Production Index declined slightly in August to a reading of 104.5. The Index has generally leveled over the past five months with market groups posting mixed results. Consumer goods, construction supplies, and materials declined slightly while the production of business equipment, business supplies, and defense and space equipment grew. The decline in consumer goods was primarily related to consumer energy products while the decline in materials was widespread.

III - LEADING ECONOMIC INDICATORS (Cont.)

Commercial Activity

Exhibit L: **Transportation Index and Consumer Sentiment**
(Trailing 10-year)

Source: Morningstar, Thomson Reuters/University of Michigan



The Dow Jones Transportation Index – The Dow Jones Transportation Index represents the stock price movement of 20 of the nation's largest transportation firms, including trucking, airlines, and railroads. It is commonly used as a forward indicator for future commercial and industrial activity.

Consumer Sentiment Index – Conducted by the Survey Research Center under direction from the University of Michigan, this index reflects the personal and overall economic outlook of respondents. The survey is widely used as a proxy for future consumer spending expectations.

Dow Jones Transportation Index Falls, Consumer Sentiment Rises from Lowest Level Ever.

The Dow Jones Transportation Index (DJT) dropped 8.4% over the third quarter after the Index plummeted 15.2% in the second quarter of 2022. The quarterly loss was driven in part by FedEx, as they reported that a weakening global economy, particularly in Europe and Asia, is weighing on the company and the overall transportation industry. This caused the company's stock to drop 21% on missed earnings and led to ripple effects throughout the rest of the transportation sector. Global freight demand has also dropped significantly, close to levels seen at the beginning on the pandemic. With a recession possibly on the horizon, the transportation sector is expected to continue to face headwinds in the near term.

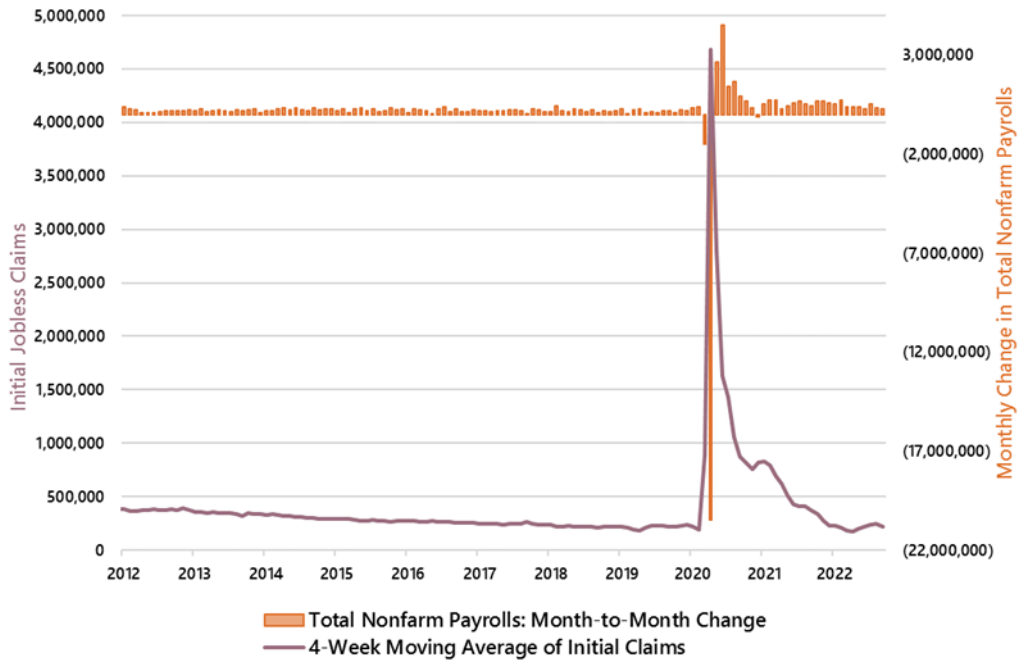
The Consumer Sentiment Index increased to 58.4 in the third quarter, rebounding from the all-time low of 50.0. Consumer Sentiment gained in the third quarter due to the long-term inflation outlook dropped below 2.9% annually for the first time since July 2021. However, Consumers are continuing to report the least favorable economic prospects in over a decade. Sentiment is still low due to around 40% of surveyed consumers believing that they or someone close to them will lose their job in the next six months.

III - LEADING ECONOMIC INDICATORS (Cont.)

Labor Markets

Exhibit M: **Initial Jobless Claims and Total Nonfarm Payroll**
(Monthly, seasonally adjusted, 2012-current)

Source: Federal Reserve Bank of St. Louis, BLS



Total U.S. Nonfarm Payrolls – U.S. Bureau of Labor Statistics statistical measure representing the total number of paid U.S. workers of any business, excluding government employees, private household employees, employees of some nonprofit organizations, and farm employees.

Initial Jobless Claims (4-week moving average) – Initial Jobless Claims readings are issued by the U.S. Department of Labor. This indicator measures the number of unemployed who are filing for initial unemployment benefits. To smooth volatility, a 4-week moving average is utilized.

Labor Market Strength Wanes

The U.S. labor market added jobs in each month of the third quarter, bringing the total payroll growth year-to-date to 3.27 million. The unemployment rate dropped from 3.6% in June to 3.5% in September. The labor force participation rate also fell slightly. Although recent data illustrates decelerating employment growth, there is still broad-based strength in the labor despite rising interest rates and inflation. This is particularly the case with wages as employers continue to grapple with a relatively high number of openings and a desire to remain attractive.

In September, the largest monthly payroll gains were seen in education and health (+90,000), leisure and hospitality (+83,000), and professional and business services (+46,000). The largest monthly decreases in payroll were seen in government (-25,000), transportation and warehousing (-8,000), and financial activities (-8,000). The construction industry rallied to add +19,000 jobs in September, which was anticipated to fall given the declining housing market.

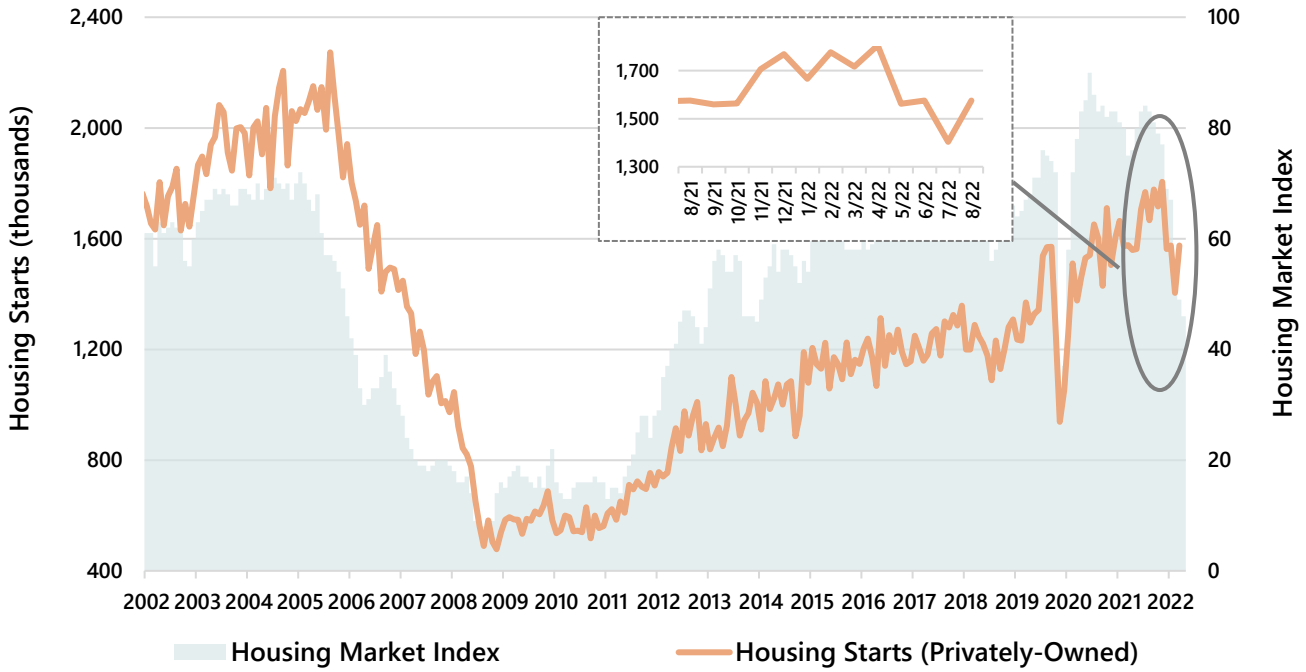
Wages increased by 0.30% in the month of September, which held steady from August, but failed to keep pace with price increases of goods and services over the same time period.

III - LEADING ECONOMIC INDICATORS (Cont.)

Housing

Exhibit O: **Housing Starts, Housing Market Index**
(2002 – current)

Source: Federal Reserve Bank of St. Louis, National Association of Home Builders, U.S. Department of Housing and Urban Development



Housing Market Index – Data compiled by National Association of Home Builders (NAHB) based on a monthly survey with a focus on single-family housing. The index is a weighted average of ratings from home builder surveys on market conditions for current and forecasted new home sales. The index ranges from 0 to 100, and a reading of 50 generally indicates positive sentiment in builders.

Builder Confidence Weakens with Decline in Demand for New Houses

After the NAHB Housing Market Index steadily declined in the first half of 2022, the Index fell significantly through September. The Index reported the largest month-over-month decline of the year, falling by 17.9% from June to July. The reading at the beginning of September was 46, which is below the historical average of 51, and indicates that there is negative sentiment amongst builders. Excluding March and April 2020, the Index has not fallen below 50 since 2014.

Privately-owned housing starts decreased 10.9% from 1,575,000 in June to 1,404,000 in July. However, starts increased in August, increasing back to 1,575,000. Building permits steadily declined – 1% from June to July and 8.5% in August. These declines indicate a possible slowdown in the housing market in the coming months. Since January, privately-owned housing starts have been impacted differently across types. Starts for single-family homes fell, indicating a decline in demand, while multi-family unit construction increased. In August, multi-family unit starts reached the highest level since 1986.

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