DANN ASSET ADVISORS, LLC

Third Quarter 2022 Update

October 11, 2022

3Q22 Highlights

- Stocks register third straight quarterly decline despite a mid-quarter rebound
- Bonds have an even worse quarter as inflation stays high and interest rates rise substantially
- Fed aggressively raises rates and confirms that reducing inflation is its overriding goal
- Recession seems an increasingly likely by-product of current Fed policy

The table below summarizes the performance of some key indices during the third quarter and year to date:

Market Performance		
Index	% Ch. 3Q22	% Ch. YTD
S&P 500	(4.9)	(23.9)
S&P Mid Cap 400	(2.5)	(21.5)
Russell 2000 (small cap)	(2.2)	(25.1)
MSCI All Country World ex US	(9.9)	(26.5)
US Aggregate Bond	(4.8)	(14.6)
High Yield Corp. Bond	(0.7)	(14.4)

Source: Morningstar, iShares

<u>Equities</u>. The S&P 500 index of large-company U.S. stocks rose nearly 14% through the first half of August before declining 17% into quarter end. Stock prices seemed to be driven by interest rate expectations. They rose early in the quarter as investors believed the Fed would be done raising rates by late 2022. Prices then fell as inflation numbers came in higher than expected and the Fed stated that it would accept significant economic slowing as it raised rates to bring inflation down.

Growth stocks modestly outperformed value, with the Russell 1000 Growth index of large company stocks returning -3.6% compared with -5.6% for the Russell 1000 Value index. The same occurred in the small stock space, with the Russell 2000 Growth index returning 0.2% vs. -4.6% for the comparable value index. However, these comparisons mask the significant volatility of the quarter. After substantial underperformance relative to value over the first half of the year, growth stocks bounced back very strongly early in the quarter but gave much of that outperformance back over the quarter's second half as interest rates rose. Putting aside the growth/value distinction, overall it was a difficult quarter given the magnitude of the decline from the mid-August highs.

International stocks fared worse than the U.S as relatively higher energy prices in Europe, in particular, put additional pressure on many countries' economies. The strength of the U.S. dollar also has been a negative for international stocks.

<u>Fixed income</u>. It was a volatile and ultimately another poor quarter for fixed income. The 10-year treasury yield began the quarter at 2.97% and fell as low as 2.61% on August 1 as investors anticipated less aggressive Fed policies. But as inflation remained high and the Fed telegraphed that rates would rise higher and for longer than expected, the yield on the 10-year rose to a peak

of 3.96% before ending the quarter at 3.80%. Yields on two-year treasuries rose from 2.93% to as high as 4.32% and ended the quarter at 4.21%. We note that 10- and two-year treasury yields began 2022 at 1.51% and 0.73%, respectively, and are now at levels last seen just before the financial crisis in 2008. The rise in two-year yields was the largest increase through the first three quarters of a year since 1981[(1)].

As yields rise, the prices of existing bonds fall. Given the magnitude of the third quarter's increase in yields, bonds had a very difficult quarter. The Bloomberg US Aggregate Bond index (benchmark for U.S. investment grade bonds) returned a negative 4.8% for the quarter and is down 14.6% year to date. The iShares 20+ Year Treasury Bond exchange traded fund (ETF), a proxy for long-term U.S. treasury bonds, returned -29.9% through September 30, as rising rates have an even greater impact on longer-dated bonds. Although credit yield spreads have widened substantially in 2022[(2)], high yield bonds' (as measured by the iShares High Yield Corporate Bond ETF) total return was essentially in line with the Bloomberg investment grade index through September 30.

Market sectors[(3)]. The three best performing sectors were consumer discretionary, energy, and financial stocks, with returns of 4%, 3%, and -3%, respectively. These sectors typically do well in a recovering or strong economy. Their relatively strong performance may imply that investors are willing to look through the economic downturn that seems to be coming. Or it could be due to factors unique to each sector. Consumer discretionary was helped by a combined 38% weight in Amazon and Tesla – both these stocks had terrible first halves but bounced back strongly in the third quarter. Even though energy prices fell during the quarter, many of the stocks can continue to do well as the companies still generate strong earnings at current lower commodity price levels. And it's possible that the financial sector benefitted from the perception that higher rates would aid their earnings.

The three worst performing groups were communications services, real estate investment trusts, and materials, with returns of -12%, -11%, and -7%, respectively. Communications services (Alphabet, Meta Platforms, Disney, and Verizon are significant components) have been hurt by concerns over the strength of advertising, the profitability of streaming services, and disappointing broadband subscriber growth. We believe real estate investment trusts were affected by higher rates, which often reduce investors' interest in higher dividend paying sectors. Finally, materials stocks usually do relatively well when energy and financials are doing well, so we don't have a good explanation for their lagging in the quarter.

Portfolio Positioning

We made no significant changes to fixed income portfolios, which for most clients remain 90% or more in investment grade mutual funds and 75% to 80% in short duration (which we define as three years or less) funds. We are interested in adding a bit more intermediate term exposure given the big increase in rates thus far in 2022, but believe it makes sense to wait for signs of stability in the bond market before doing so. On equities, we purchased a U.S. banks ETF, believing that many of the underlying stocks should benefit from higher rates so long as the economy doesn't fall into a severe recession.

Analysis and near-term outlook. We were somewhat surprised by the magnitude of the stock market's rise and ensuing fall during the third quarter but our outlook for the economy and market hasn't changed. Inflation remains the key issue, in our opinion, as its level and duration will determine Fed actions, how high interest rates rise, and the severity of an increasingly likely recession.

We note that the stock market initially bottomed in mid-June when the 10-year treasury yield hit 3.48%. From there, the market rose 17% as the 10-year yield dipped to 2.61% by early August in response to investors believing inflation would moderate and the Fed become substantially less aggressive in 2023. From that point, rates again began rising, causing stocks to roll over. And the whole process accelerated for the worse with the release of a higher than anticipated consumer price index number (+8.3% year over year) in mid-September.

We try not to get too wrapped up in stock prices' monthly fluctuations or a single economic indicator like the CPI. But we went through the foregoing recap to illustrate how tightly stock prices are currently correlated to inflation expectations and interest rates. We expect this correlation to continue for the near term.

In the question-and-answer session following the Fed's September 21 rate announcement, Chair Powell emphasized that reducing inflation is the Fed's top priority and acknowledged that its interest rate increases could cause a recession(4). Even though the unemployment rate remains near historically low levels, we believe the combination of inflation in necessities like food and energy (reduces consumers' spending on more discretionary items) and the amount and pace at which rates have risen (increases borrowing costs) make a recession highly likely.

Part of the market's decline in 2022 is due to higher rates, which reduces the multiple of earnings that investors are willing to pay for stocks. Part also likely stems from investors now anticipating recession and the resulting decrease in earnings that usually comes with a downturn. Assuming rates are close to a peak (as we believe), the issue for stock valuations becomes how far earnings decline and the extent to which investors are willing to look beyond that decline and ahead to an eventual recovery in earnings (and the market).

We don't know the answer to those questions but note that Morgan Stanley and Goldman Sachs' equity strategists recently framed base (mild recession at worst) and downside (more severe downturn) ranges for the S&P 500 at 3400 to 3000(5) and 3600 to 3150(6), respectively, compared with a price of 3583 at the September 30, 2022, market close. Goldman's current forecast was a response to the recent increase in rates and represented a 16% decline from their prior forecast.

While the strategists' price ranges seem reasonable, like us they don't really know what the market will do over the nearer term. As noted in our second-quarter update, we believe we're still in a pandemic-induced period of compressed and accelerated economic changes. Our best guess is that the magnitude and rapidity of Fed rate increases will cause the economy to contract more quickly than many expect, and that this will lead to a deceleration in inflation, a faster than expected pause in the Fed's tightening policies, and an opportunity for stocks to rebound. While getting from here to there might be unpleasant, we're expecting a potentially significant upturn in the markets by the second quarter of next year, if not sooner.

(1) Wall Street Journal, *Battered Investors Now Find Thrills in T-Bills*, October 2, 2022.
(2) ICE BofA US High Yield Index Option-Adjusted Spread, Federal Reserve Economic Data from Federal Reserve Bank of St. Louis.
(3) Market sector performance numbers based on Vanguard sector ETFs.
(4) Federal Reserve Bank transcript of Chair Powell's September 21, 2022, press conference.
(5) Morgan Stanley September 19, 2022, US Equity Strategy piece.
(6) Bloomberg, September 22, 2022, citing Goldman Sachs research report.

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