TFC FINANCIAL
The Financial Counselors

COMMENTARY | Q3 2022
October 2022

OUR VIEW

Global equities, as represented by the MSCI All Country World Index, fell 6.8% during the third quarter, bringing the year-to-date loss to more than 25%.

Third Quarter Review

The short-lived summer market rally faded in September, with stocks and bonds finishing with negative returns for the quarter and returning to bear market territory for the year. Concerns that dominated the market outlook for much of the year – inflation, central bank policy, war in Ukraine –contributed to another poor quarter for capital markets. Rising recession risk in the U.S., the potential for a severe recession in Europe and slowing economic growth in China gave investors additional grounds for pessimism.

Global equities, as represented by the MSCI All Country World Index, fell 6.8% during the third quarter, bringing the year-to-date loss to more than 25%. The S&P 500 Index lost 4.9% during the quarter, for a year-to-date loss of nearly 24%. U.S. small company stocks lost 2.2%, bringing the year-to-date loss to approximately 25%. Developed international stocks, as measured by the MSCI EAFE Index, fell by 9.4% during the quarter and have a year-to-date loss of more than 27%. Emerging markets stocks also have a year-to-date loss of more than 27% after a decline of 11% during the quarter.

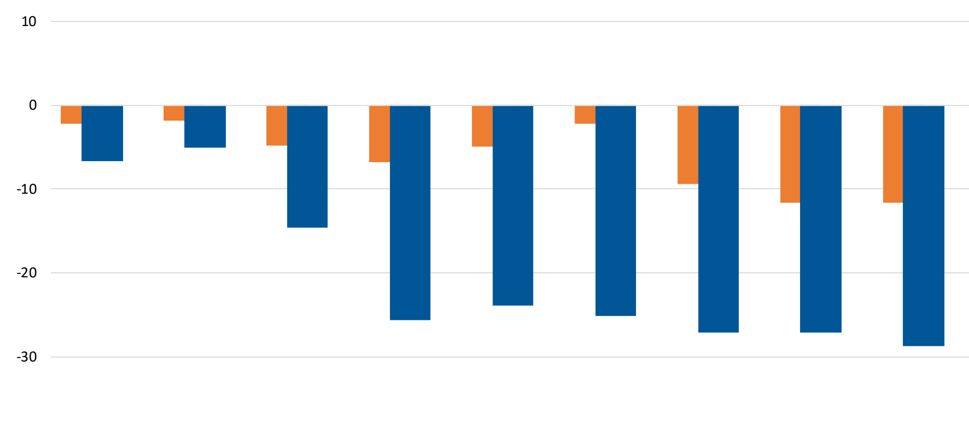
Value stocks lagged growth stocks during the third quarter, largely in response to growing fears of a U.S. recession. The Russell 1000 value index fell by 5.6%, in contrast to the loss of 3.6% for the Russell 1000 Growth Index. Consumer discretionary and energy were the only sectors in the S&P 500 Index with positive returns for the quarter; energy remains the only sector with positive returns for the year. The defensive utilities and consumer staples sectors lost less than the market year-to-date. Communications services and technology sectors were the worst performers year-to-date.

Fed policy remained a dark cloud over bond returns. The Bloomberg Barclays Aggregate Index lost 4.8%, bringing year-to-date losses to 14.6%. The Bloomberg Municipal Index fell by 3.5% during the quarter, with year-to-date losses of more than 12%. The shorter-duration Bloomberg 1-5 year Government/ Credit Index fell 2.2% for the quarter and 6.6% for the year-to-date period.

TFC client portfolios fell in absolute terms along with market indexes and were slightly behind client benchmarks during the quarter. TFC's shorter-duration fixed income holdings were bright spots during the quarter and year-to-date periods, as were insurance-linked and private real estate holdings. The U.S. and developed international growth holdings that were big gainers during the height of the pandemic were relative outperformers for the quarter but remain sharply down year-to-date. Intermediate-term bond holdings also detracted from performance.

Quarter To Date Returns

9/30/2022



	Short Term Bonds	Short Term Muni Bonds	Barclays Agg.	Global Equities	S&P 500	U.S. Small	Intl. Large Core	EM	Global Real Estate
QTD	-2.2	-1.9	-4.8	-6.8	-4.9	-2.2	-9.4	-11.6	-11.6
YTD	-6.6	-5.1	-14.6	-25.6	-23.9	-25.1	-27.1	-27.2	-28.7
Full Cycle*	-1.5	-1.0	-4.4	0.1	4.2	0.9	-4.9	-5.9	-8.1

* Full Cycle is the annualized return from February 12th 2020 peak to present.

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Market Outlook

There are a lot of reasons for investor pessimism entering the final three months of the year. Inflation remains stubbornly high, likely forcing the Fed into a “higher for longer” monetary policy stance. The energy shock caused by the war in Ukraine is a cost-of-living shock, particularly for European and U.K. consumers. Businesses forced to absorb higher costs or reduced availability of natural gas are also feeling the pain. The economic slowdown in China, largely caused by restrictive Covid policies, is another blow to a slowing global economy. China will likely gain from a modest reopening boost next year, but Chinese deleveraging will drag on growth for years to come. Elevated geopolitical risk factors include the continuing war in Ukraine, tensions between the U.S. and China, and concerns about the potential for China to attempt a forced reunification with Taiwan.

The headline Consumer Price Index (CPI) remains above 8% and the Fed’s preferred inflation measure, the core Personal Consumption Expenditure (PCE) index, is far above the Fed’s 2% long-term target. With inflation staying stubbornly above the Fed’s targets, we expect the Fed to continue raising rates at least through the end of the year.

Despite a lot of bad news regarding inflation, we think recent inflation data does not fully reflect the impact that rising rates are having on economic growth and inflation. For example, although rising interest rates are clearly taking the exuberance out of the housing market, the shelter component of inflation takes a long time to catch up with real-time measures of leasing activity. Shelter inflation accounts for 42% of the core CPI basket and 57% of core services. Although the U.S. housing market is probably already in a recession, the shelter component of CPI jumped 0.7% month over month in September. Landlords cannot raise rents for existing tenants to the same level as they are charging new tenants in real time; they must wait for leases to renew. This process is likely now peaking, given the softness starting to show up in market-based measures of lease activity. It may be early to mid-2023 before the slowdown in the rental market is reflected in CPI measures.

The job market remains very tight, despite job openings falling by 10% in August. There are still 1.7 openings for every unemployed worker. Although the Fed does not seem concerned about the likelihood of the U.S. returning to the "wage-price" inflation spirals of the 1970s, the Fed is worried about the potential for inflation expectations to become "un-anchored." Consequently, the Fed is focused on easing the tightness in the labor market and is paying more attention to headline measures of inflation than would normally be the case. For the time being, U.S. long-term inflation expectations remain well anchored. The TIPS market suggests that inflation will fall to 2.5% by the end of 2023, then decline to near 2%. The University of Michigan survey indicates that median inflation expectations 5-to-10 years are still below 3%, roughly in line with mid-1990s levels.

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The Fed isn't likely to "blink" to pause its tightening cycle with headline inflation above 8% and unemployment below 4%. We expect their strategy to change if unemployment rises toward 5%. The Fed is likely to tighten until something breaks, which raises the potential for a financial accident. The disruption of the U.K. government bond market that destabilized U.K. pension funds and forced the Bank of England to intervene via asset purchases could be a preview of similar disruptions elsewhere.

Amidst so much bad news, we think that investors may be underestimating the resilience of the U.S. economy and the degree to which much of the bad news may already be priced into markets. Most American households have the resources and the willingness to consume at a rate sufficient to keep the economy from falling into a steep recession.

Outside the U.S. skyrocketing energy costs and the slowing Chinese economy are pushing Europe toward a recession that is likely to be more severe than the potential recession in the U.S. Although imports of Russian gas have collapsed, Europe has been able to rebuild gas inventories to more than 90% of capacity, providing hope that if winter is mild the economic impact may be less than feared. Germany, the country whose economy is most exposed to the energy crisis, is implementing a fiscal response worth more than 5% of GDP to cap gas and electricity prices for a pre-set level of basic consumption. Germany's targeted approach provides a safety net for the most vulnerable households and firms without weakening incentives to cut energy demand. The major drawback of the German plan is that it is a unilateral move, which likely reduces of an EU-sponsored fiscal stimulus package to ease the pain of rising energy costs. Countries such as Italy have less fiscal room for a stimulus package and face considerably higher borrowing costs than Germany.

In contrast to Germany, the U.K. government decided to subsidize everyone's energy consumption, capping energy prices regardless of whether they live in a one-bedroom apartment or a ten-bedroom mansion. The U.K. is less exposed than the EU to slowing growth in China but faces woes of its own with Brexit's impact still a drag for economic growth.

Portfolio Positioning

The market's decline in the third quarter brought year-to-date losses in range of prior median and average bear market declines. The median post World War II decline in the U.S. market was 24%; the average decline was 30%. Excluding the Global Financial Crisis, the median decline was 22% and average decline 27%. If worst case scenarios are avoided, such as a severe U.S. recession or major geopolitical event such as nuclear escalation by Russia or invasion of Taiwan by China, the markets may be close to bottoming. Importantly, equity markets typically bottom while the economy is still getting worse.

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We think the U.S. will enter recession next year, but that a mild recession is the most likely scenario. Equity valuations in the U.S., particularly outside the handful of high-profile technology and communication stocks, arguably have a lot of bad news priced into the market. The range of possible outcomes outside the U.S. is wider, with recession potentially more severe in Europe than in the U.S. The economy and stock market often diverge from one another, however, so we try to separate our view of the economic outlook from the stock market outlook.

Although we share the negative consensus outlook towards the European (and Chinese) economies, there continue to be compelling investment opportunities outside the U.S. over both the near and long-term time horizons. However, amidst the challenging economic outlook outside the U.S., there may be big winners and big losers in the months and years to come, which has implications for the size and nature of our non-U.S. allocations.

Amidst continuing uncertainty about the short-term outlook for inflation, rates, and geopolitical events, we are seeing long-term changes in the economy and political realm that will have a lasting impact on capital markets. As we have shared in prior letters and webinars, we expect inflation to be a more persistent challenge than deflation over the next decade. The need for more resilient supply chains has significant implications for corporate profits, employment, and trading relationships. The war in Ukraine highlights the importance of food and energy security and is a wake-up call regarding the complexity and uncomfortable trade-offs associated with the climate transition. We have made portfolio changes that reflect our near-term and long-term outlook, including the shortening of bond duration and the addition of more "real assets" to portfolios. We will make further changes as needed.

Our next webinar will be on November 1 at noon. Dan will share his insights after his recent 10-day trip to the U.K.

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As always, we welcome your comments and questions.

Sincerely,

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