Market Commentary

Q3 — 2022

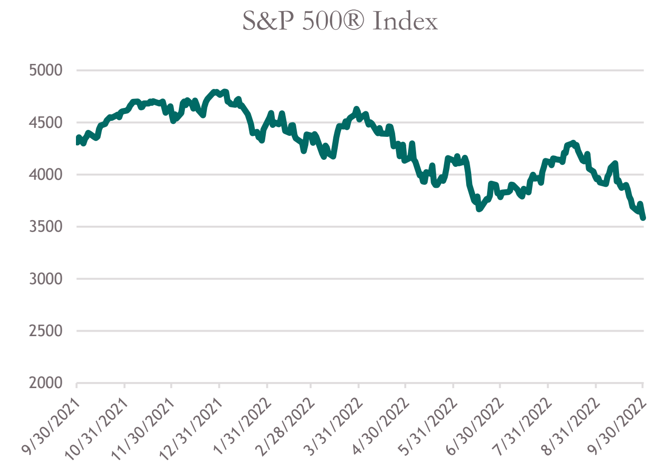
U.S. Equities Market

Channeling One's Inner Volcker

Markets accelerated their decline in the third quarter and virtually no asset class was spared, save the U.S. Dollar, which is reaching multi-decade highs against competing currencies. The S&P 500® Index ended the quarter down 4.9%, while the smaller-cap Russell 2000® Index ended down 2.2%. Growth outperformed Value as the global economy weakened and commodity prices fell, though both ended the quarter in the red. Consumer Discretionary stocks finished strongly positive as continued re-openings post-COVID helped the sector rebound from a dismal second quarter. Energy stocks also posted positive returns, though inflation worries and higher interest rates caused Real Estate and Communication Services stocks to finish deeply lower.

In Jackson Hole, Wyoming in August, and again at the most recent Federal Reserve meeting in September, Fed Chair Jerome Powell began talking tougher on inflation than markets expected. Akin to Paul Volcker, Fed Chair in the early 1980s, Mr. Powell and the rest of the FOMC are raising interest rates aggressively, stating they will continue to do so until inflation is tamed. Unlike Mr. Volcker, however, who very much was cleaning up after others, Powell and Co. are attempting to right the wrongs of their own loose-money policies these past few years. Post the Great Financial Crisis, easy money was necessary to support the beleaguered financial system, but post-Pandemic, when fiscal stimulus reached the heights of helicopter money, the Fed kept its proverbial foot on the gas and now is faced with the highest inflation in four decades. One must wonder now, however, is if the Fed is being too hawkish in the face of a weakening economy? In the not-too-distant-past, accelerating global growth was a cause for economic optimism, but such optimism now has been replaced with fears of global recession. The Fed has made it clear they are in it to fight inflation to the end regardless of the cost, but how much can the U.S. economy take before it, and the world, slide into an uneasy state of low growth amidst high food and energy costs?

Market pessimism aside, not all is amiss. The average U.S. consumer is exhibiting surprising confidence, is employed, has money in the bank, and, if a homeowner, a mortgage locked in at a low rate. U.S. company profits have remained resilient and profit margins are healthy. The U.S. remains the best house in a weakening neighborhood, with the U.S. Dollar as a strong, global reserve currency and relative food and energy self-sufficiency. With their weaker domestic markets, how the rest of the world evolves is a very open-ended question. Will China re-open or continue its strict Zero-COVID policy that has hampered its own economic growth and supply chains worldwide? Will Europe continue to face down Russian aggression, or will it succumb to the need for Russian energy to heat homes, run factories, and combat high inflation? Unlike the recent past, there are now alternatives to risk assets, with the one-year U.S. Treasury Bill yielding nearly 4%. The U.S. equity market has re-priced in the face of higher interest rates, but a weakening economy could impact company earnings and, perhaps, expose a market where equities may not be as inexpensive as they seem at first glance.



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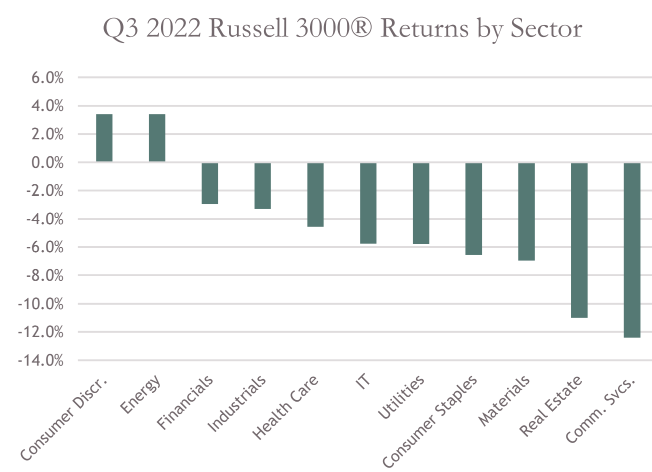

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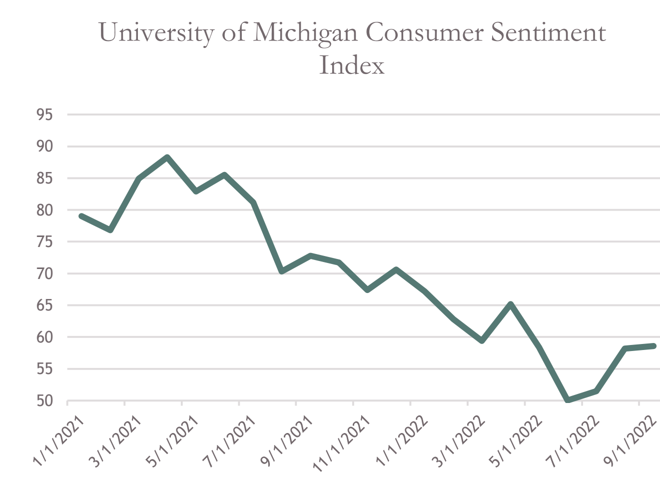

Source: Bloomberg

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U.S. Taxable Fixed Income Market

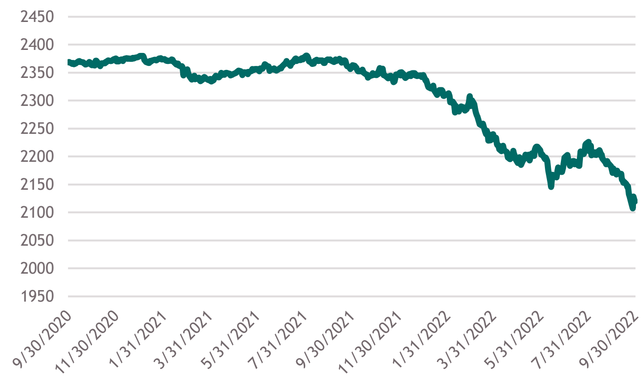
FAIT Accompli

The Bloomberg Barclays Intermediate Government/Credit Index lost 3.1% in the third quarter of 2022, continuing losses suffered in the first half and bringing year-to-date losses to 9.6%. Rising rates continued to weigh on Treasury performance, but credit received at least some reprieve early in the quarter before fears of something "breaking" came back to the fore.

The Fed has already admitted they were behind the curve in raising rates. They would likely challenge the notion that Flexible Average Inflation Targeting (FAIT) played any role in the inflation America has experienced over the last year, but that policy almost certainly doomed the economy to rapid and dramatic price increases from the outset. We got high prices then, because the Fed was purposely behind the curve, will they now fail to assess the damage they are doing to the U.S. economy in a timely manner? Their recent comments and focus on what are generally lagging indicators do not offer much comfort. The Fed wants to raise rates to ensure inflation comes down, but the year-over-year increase in the Consumer Price Index often peaks only once a recession has already begun, on average 4 months into a recession. It would be better to focus on leading indicators that are already flashing signs of an impending recession. This dynamic can be seen in the chart to the right that shows the year-over-year percentage change in The Conference Board Leading Economic Index (LEI) and recessions. Since 1960, this measure has never fallen to -1%, its current level, without a recession occurring within, at most, 13 months. On average, a recession starts within 4 months of this mark being reached.

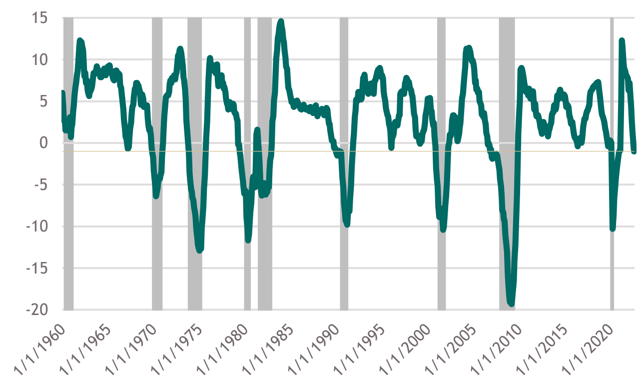
Complicating the Fed's task is the prospect of a "job full" recession – structural factors supporting worker shortages and therefore a stronger labor market than typical in a recession. This backdrop materially increases the probably the Fed pushes rates higher than the economy can endure. Were the Fed to continue to underweight leading indicators and overweight lagging indicators, credit spreads could widen further, with high yield needing to widen another 375 basis points and investment grade another 133 basis points just to reach their averages during the last three recessions. Much like inflation and unemployment, spreads often do not peak until after the recession has started. We continue to believe a recession in the U.S. is more likely than not.

Bloomberg Barclays Intermediate Gov/Credit Index



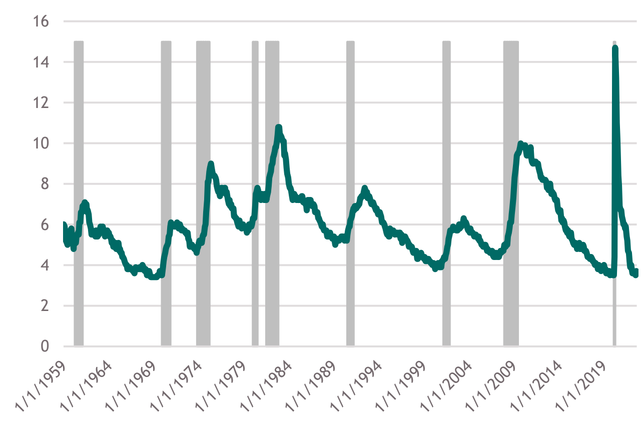
Source: Bloomberg

Conference Board Leading Economic Index (LEI)



Source: Bloomberg

U.S. Unemployment Rate and Recessions



Source: Bloomberg

U.S. Municipal Fixed Income Market

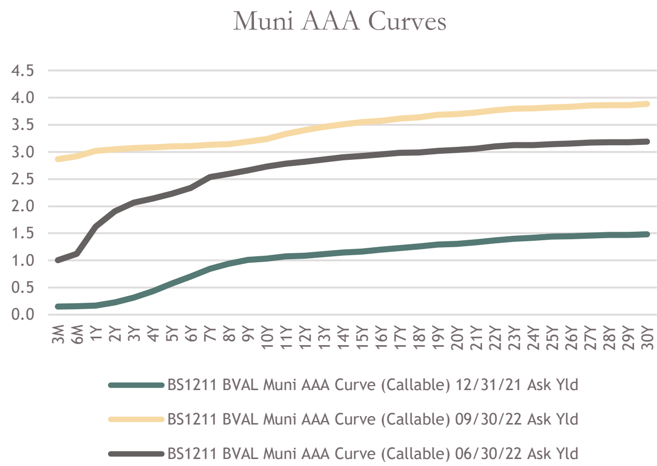
Munis in a World of Rising Rates

With some reluctance, municipal bonds yields rose in sympathy with Treasury yields over this past quarter, as the Fed continued to support its conviction that rates will rise until inflationary pressures ease. At the beginning of the third quarter, the muni curve was very steep. As the quarter progressed, the biggest moves have occurred in the sub-seven year range, which is where many defensive muni investors have positioned portfolios. The strong demand for short paper resulted in relatively low municipal yields and historically low ratios, as a percentage of Treasuries for short paper. But as the Fed continued their steady pace of rate hikes, the appeal of higher-yielding bonds further out the curve became irresistible. Past the seven year maturity mark, the Bloomberg AAA Callable Muni yield curve rose in a parallel fashion ranging from 50 to 69 basis points. Looking at the year so far, the rise in yields has again been fairly parallel, ranging from 218 to 285 basis points.

Although the muni market may look to the Treasury market for guidance, the volatility of muni yields tends to be lower than that of Treasury yields. This lower volatility can be attributed to the municipal underwriting / new issue market. If market yields move higher too quickly, the economics of funding new projects via muni debt may no longer pencil out. As of the end of the third quarter, municipal issuance was down approximately 15% year-to-date. Not surprisingly, we have seen a sharp decline in refunding activity as these highly interest rate-sensitive transactions no longer provide the necessary economic savings in our current rate environment. This removal of supply shifts support to existing secondary market inventory and less rate sensitive primary deals. This braking effect has resulted in municipal yields being less volatile than Treasury yields over the past year.

There is a relatively high level of credit quality in the municipal bond market currently; this can largely be attributed to the unprecedented level of federal stimulus programs, related to the pandemic, as well as local government budgeting practices (which tend to be risk averse.) However, there are certain sectors, such as assisted living and student housing, where we are cautious. Note that our managed portfolios typically have an average credit quality in the 'AA' range.

Strategically, we continue to remain defensive in the face of projected Fed rate hikes. As noted above, we are maintaining high credit quality and limiting our duration exposure. As some clarity has been reached regarding the Fed's conviction to fight inflation, we have cautiously been buying further out the curve, but still mostly less than 11 years. For now, replacing maturing or called bonds with bonds yielding north of 3% should provide value to long term bond holders as the Fed works to bring inflation back down to their 2% target.



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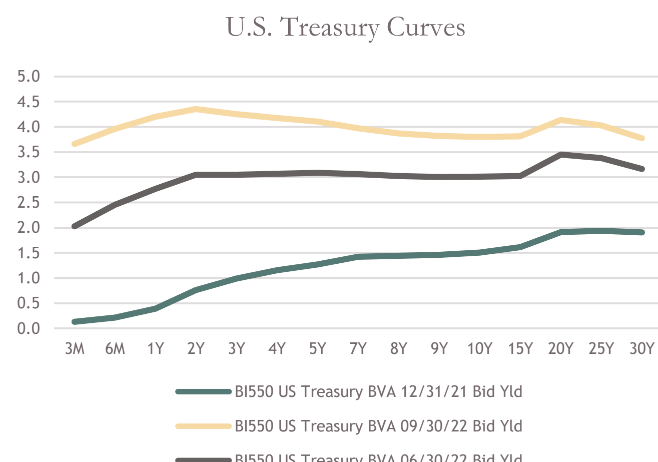

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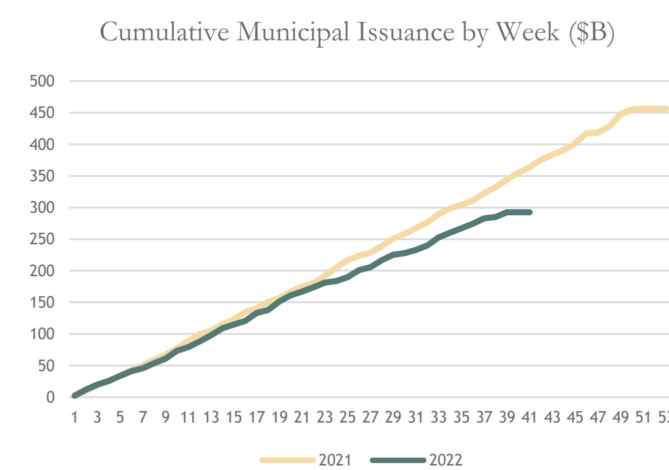


Source: Bloomberg

International Equities Market

Taking FX Into (Current) Account

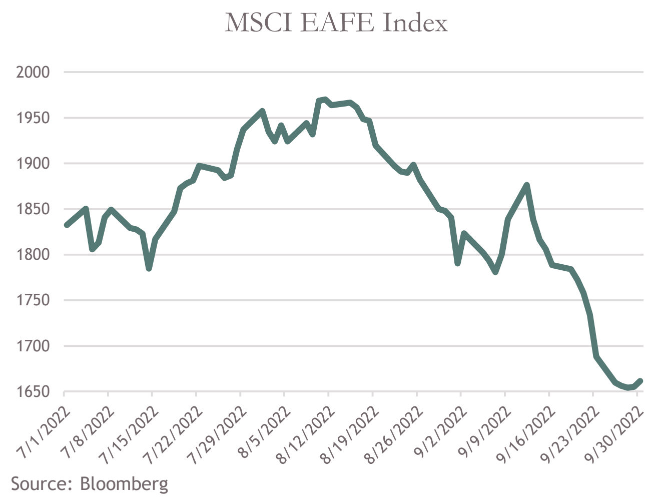
International equities recorded losses during the third quarter and underperformed domestic equities. The MSCI EAFE index recorded a loss of 9.4% whereas the MSCI Emerging Markets index recorded a loss of 11.6%. Currency continued to be a headwind to performance. The Bloomberg Dollar Spot Index, which tracks a basket of ten leading global currencies versus the U.S. Dollar, appreciated over 6% during the quarter – another strong performance.

Central Banks played a major role during quarter with most raising interest rates. During Chairman Powell's Jackson Hole speech, he reiterated the Federal Reserve's commitment to bring inflation down to its 2% goal and hinted that at their next meeting, they would raise interest rates higher than market expectations at the time. Consequently, interest rates climbed higher, as did the U.S. Dollar.

Changes in currency exchange rates are important drivers of international investment performance, assuming no hedging. As market stressors build globally, rising exchange rate volatility negatively impacts performance. There are several theories that try to explain changes in exchange rates – changes in relative prices, inflation rate differentials, interest rate differentials...and in practice, they overlap each other. Inflation reflects changes in prices, whereas interest rate changes reflect changes in inflation, and so forth. So, as the Federal Reserve raises rates in the U.S., the Dollar appreciates relative to other currencies, all else being equal. Currency depreciation is not necessarily a bad thing. If the country is a net exporter, the price of their goods to U.S. consumers gets cheaper, making their products more attractive. However, there may be a downside. If a country is a net importer of commodities - like energy - and those commodities are priced in Dollars, those countries experience commodity inflation because of their currency depreciation. If this increase in inflation is above their Central Bank's target, their Central Bank then will increase interest rates with the aim of bringing their inflation rate down. Add to that increased commodity volatility due to, let's say, a war, and you can see why exchange rate volatility would increase like it is today.

If these changes become large enough, there could be negative economic consequences. The chart to the right shows current account balances as a percentage of GDP. A country's current account primarily represents its imports and exports of goods & services. If the current account is positive, the country is a net exporter and if negative, a net importer. What's noteworthy is the dashed portion of the line, which represents economist forecasts through the end of 2023. Economists estimate the Eurozone will become a net importer at the end of this year and for 2023, which implies a major economic headwind. This outlook's biggest driver is the energy crisis Europe is experiencing due to the war. Resolutions to both these issues is critical in our opinion for the outlook to improve for this region. In fact, we consider both of these issues -- War in Ukraine and Energy Security -- as critical drivers when assessing future scenarios.

Source: Bloomberg



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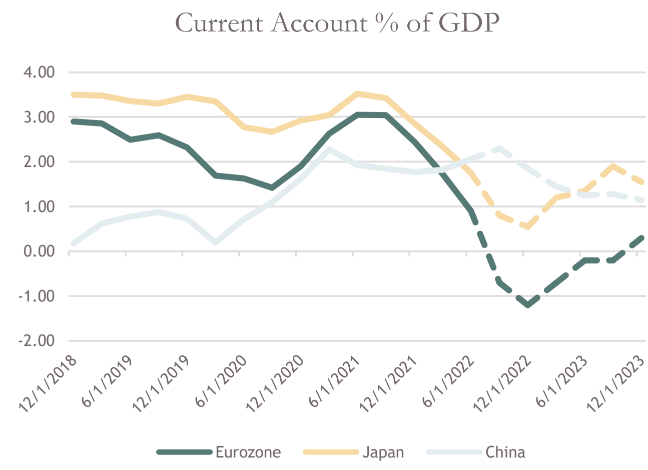

Source: Bloomberg

Disclosures

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The information on indices is presented for illustrative purposes only and is not intended to imply the potential performance of any fund or investment. Index performance assumes the reinvestment of all distributions, but does not assume any transaction costs, taxes, management fees, or other expenses. Indices are not available for direct investment.

The S&P 500® Index is a gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization

The Russell 3000® Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market. The Russell 3000 Index is constructed to provide a comprehensive, unbiased and stable barometer of the broad market and is completely reconstituted annually to ensure new and growing equities are reflected.

University of Michigan Consumer Sentiment is based on monthly surveys of consumers and is used to determine general sentiment and changes in willingness to buy as well as to predict subsequent discretionary expenditures

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set

The Bloomberg Barclays Intermediate Government/Credit Index measures the performance of U.S. Dollar-denominated U.S. Treasury bonds, government-related bonds (i.e., U.S. and non-U.S. agencies, sovereign, supranational and local authority debt) and investment-grade U.S. corporate bonds that have a remaining maturity of greater than or equal to one year and less than 10 years

Conference Board Leading Economic Indicators is a composite of economic variables that tend to move before changes in the overall economy and give a sense of the future economic state

Unemployment Rate tracks the number of unemployed people as a percentage of the total labor force (total employed plus unemployed)

The BVAL Muni AAA curve is the baseline curve for BVAL tax-exempt munis. It is populated with high quality U.S. municipal bonds with an average rating of AAA from Moody's and S&P. The yield curve is built using non-parametric fit of market data obtained from the Municipal Securities Rulemaking Board, new issues calendars and other proprietary contributed prices.

The U.S. Treasury BVAL curve is populated with USD denominated senior unsecured fixed rate bonds issued by the U.S. Treasury. The yield curve is built daily with bonds that have BVAL prices at the market close.

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The MSCI Emerging Markets Index is a free-float weighted equity index that captures large and mid-cap representation across Emerging Market countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI EAFE Index is broadly recognized as the pre-eminent benchmark for U.S. investors to measure international equity performance. It comprises the MSCI country indexes capturing large and mid-cap equities across developed markets in Europe, Australasia and the Far East, excluding the U.S. and Canada. Numerous exchange-traded funds are based on the MSCI EAFE Index, and the Chicago Mercantile Exchange, NYSE Liffe U.S. and the Bclear platform of Liffe are licensed to list futures contracts on this index as well.

The Bloomberg Dollar Spot Index tracks the performance of a basket of 10 leading global currencies versus the U.S. Dollar. It has a dynamically updated composition and represents a diverse set of currencies that are important from trade and liquidity perspectives.

A country's current account primarily represents its imports and exports of goods & services. If the current account is positive, the country is a net exporter and if negative, a net importer.