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Market Overview

All major indices continued to decline in the 3rd quarter, driven by increased hawkish rhetoric from the Federal Reserve, an unexpected increase in the Consumer Price Index (CPI) data, and increasing interest rates. Although the S&P 500 index[1] rallied from mid-July into mid-August, it was followed by a steep sell off into the end of the quarter. The S&P 500 index fell (4.9%) during Q3 2022, the NASDAQ[2] was down (3.9%), while the Dow Jones Industrial Average[3] (DJIA) led the decline dropping (6.2%).

In the third quarter, the consumer discretionary sector was the top performing sector, followed by the energy sector. However, while these sectors were the best performing ,the consumer discretionary sector is down (30.3%) year-to-date, while energy is up 29.7%.

The Federal Reserve (the "Fed") continued to hike interest rates in July and again in September in both months by 75bps, bringing the Federal funds rate now to a range of 3.0% to 3.25%. It is expected that the Fed will lift interest rates by another 125bps throughout the remainder of the year. This would bring the forecasted rate to 4.25% to 4.50%. These interest rate hikes have continued to put pressure on the U.S. economy and have led companies to reduce their earnings expectations for the next few quarters. Finally, commodity prices have continued a correction throughout the quarter. WTI Crude opened the quarter at $105 a barrel and declined all the way down to $76.

Ten-year Treasury bond yields climbed higher during the third quarter from 2.9% to 3.8% with a peak during the quarter of 4% on September 30th. Interest rate volatility continued its big swings during the quarter, met with equally large movements in stock price volatility, putting downward pressure on both equity and bond prices.

International and emerging markets continued to decline in the 3rd quarter as the US dollar marched higher finishing up 7.8% for the quarter and 17.6% year-to-date. This led major foreign central banks to intervene in the foreign exchange market, to stem their currency's continued depreciation by selling dollars and buying their own.

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U.S. Equity Returns Table
Source: Tamarac

Index	Q3 2022 Returns	2022 Returns
Dow Jones	-6.17%	-19.72%
S&P 500	-4.88%	-23.87%
NASDAQ	-3.91%	-32.00%
Russell 2000	-2.19%	-25.10%
MSCI World	-6.71%	-25.34%

U.S. Treasury Yield Table
Source: Treasury

	09/2022	09/2021	09/2020
3 month	3.33%	0.04%	0.10%
2 year	4.22%	0.28%	0.13%
5 year	4.06%	0.98%	0.28%
10 year	3.83%	1.52%	0.69%
30 year	3.79%	2.08%	1.46%

Other Indices Table
Source: Morningstar

	Q3 2022 Returns	2022 Returns
Gold (GLD)	-8.19%	-9.53%
Brent Oil (BNO)	-16.55%	30.66%
U.S. Dollar Index (UUP)	7.83%	17.64%
Int'l Equity Markets (EFA)	-10.37%	-27.20%
Emerging Equity Markets (EEM)	-13.02%	-27.98%

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Falling Inflation May Outrun the Fed

September has historically been the poorest performing month of the year for the stock market, and this year's version didn't disappoint. Last month posted the worst decline since 2008.The market's fear of ever higher interest rates leading to recession, has driven the major market averages back into bear-market territory.

The S&P 500 index has now declined for three consecutive quarters, which is its longest losing streak since 2009. Fed officials have been out in force telling anyone who will listen that, no matter what, they are determined to raise interest rates high enough to reduce inflation to its 2% target. In doing so, they see short-term rates rising as high as 4½%-5% this year, with no expectations of rate cuts next year. If that forecast comes to fruition, it is highly likely that it would result in a classical, broad-based recession. But the Fed's history for economic projections is extremely poor, and this time may be no different.

There are already signs set for a decline in inflation in the coming months. Oil, gasoline, and most other commodity prices have been moving lower since June. Ocean freight rates are back to pre-crisis levels, while trucking rates are well off their May peak. The Purchasing Managers Index for both the service and manufacturing sectors shows prices paid for inputs are below their peaks and falling. Most importantly, home prices have clearly peaked with the Case-Shiller Housing Price Index showing a year-to-year decline for the first time in a decade.

Economic growth has downshifted. Consumer spending has weakened but is still positive. One factor holding up household spending is the more than $2 trillion in savings accumulated from the fiscal stimulus measures that followed the pandemic. Consumers still have approximately $1.3 trillion left to support spending in a period of elevated prices.[4]

There has been a shift in consumer preferences for services spending relative to spending on goods as the Covid lockdowns have ended. This has been reflected in business service output activity posting stronger (and positive) growth relative to goods production. This shift has elevated inflation rates as service prices are more sticky. That spending rotation may have largely run its course. Capital spending continues to rise especially in technology and transportation. So far there are few signs as yet of a broad-based decline in economic activity.

This environment is still likely to create corporate earnings shortfalls for the next few quarters as right sizing businesses for an environment of slowing demand and still-elevated input costs is likely to squeeze margins. Most analysts are yet to seriously mark down estimates of earnings for this year and 2023. Next week's third quarter earnings reports should shine more light on what is ahead for next year. Several large companies have pre-announced earnings shortfalls over the past few weeks, so Wall Street is expecting disappointing reports.

While the stock market appears to have priced in a recession for the coming year, the bond market has given little indication that one is on the horizon. The yield difference between 2- and 10-year Treasury bonds is only a negative (.4%), which is not constraining financial transactions. And yield spreads between corporate bonds and U.S. Treasuries are nowhere near the highs seen during recessions in the past. This is partly due to stronger balance sheets built up over the pre-pandemic years of high profitability and a lower rate of debt financed acquisition activity.

The good news in all of this, is that declining inflation is likely to run ahead of the Fed's overly aggressive attempts to bring it to heel and may prevent them from making another serious error of overstaying a restrictive policy. That is our current expectation. If so, the resulting mild recession would be consistent historically with the length and decline in the stock market that we have experienced this year.

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Sources & Disclosures

1. The S&P 500 is designed to be a leading indicator of U.S. equities and is commonly used as a proxy for the U.S. stock market.
2. The Nasdaq Composite is a stock market index that includes almost all stocks listed on the Nasdaq stock market and is heavily weighted towards companies in the information technology sector.
3. The Dow Jones Industrial Average (DJIA) is a price-weighted measurement stock market index of 30 prominent companies listed on stock exchanges in the United States.
4. Source: JP Morgan Guide to the Markets. Data as of September 30, 2022.

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