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Q4 2022 Outlook

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Economic Outlook

- If anyone had any doubt that the Fed was serious about getting a handle on inflation, then they need only look at the aggressive increases in rates and comments from Chairman Powell during the 3rd quarter. Expectations for peak Fed Funds Rate went from 3.75% in June to 4.61% in September. At a speech during the annual Jackson Hole forum, Powell stated, "Restoring price stability will likely require maintaining a restrictive policy stance for some time. The historical record cautions strongly against prematurely loosening policy." He, along with other members of the board, have indicated their primary goal is to get inflation back down to a 2% target at the expense of a slower growing economy. Headline inflation came down slightly in September to 8.2%, while core inflation increased to 6.6%. Core inflation was driven by housing costs, which moves up with a lag compared to other components.
- Leading and lagging indicators are the focus around the debate on how high will rates go and if we will have a full-blown recession. Inflation is the focus of the Fed, but it has historically been a lagging indicator. This means that a recession is usually underway prior to inflation moving substantially lower. Leading indicators, such as new orders, building permits, and the S&P 500 index, have been trending down, but most importantly employment has held up. Unemployment moving higher by .3% to .5% would likely mark the beginning of a recession. The most likely timing on a recession looks to be sometime in the 1st or 2nd quarter of 2023.
- Employment has been strong and wages have moved higher, but after inflation wages have been declining. Households are in much better shape than they were going into the 2008 recession, but we will likely see wealth move substantially lower from the post-Covid peaks. With wages not keeping up with higher prices, many households have had to dip back into savings and take on more credit to support spending.

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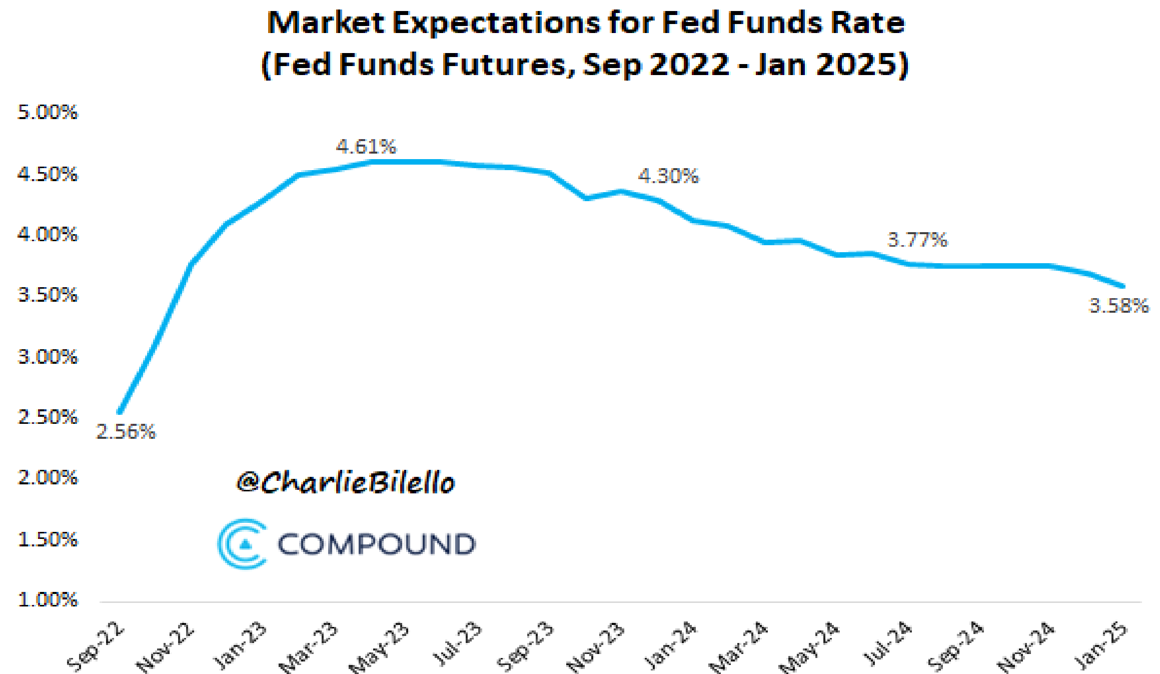
Rate Expectations Higher in September

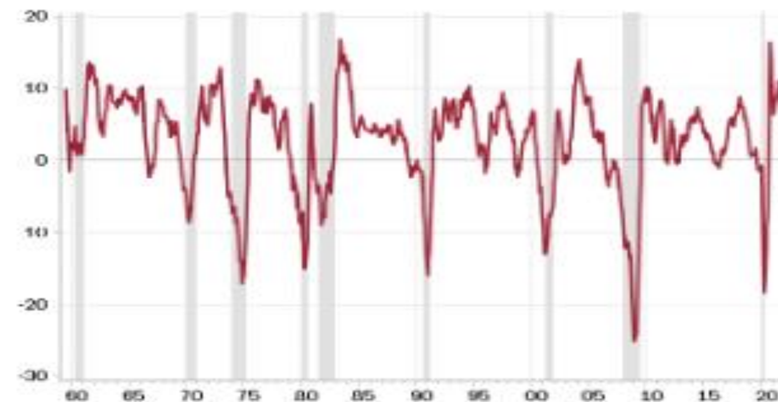
- Market expectations for Fed Funds reached a peak of 4.61% in September. Some Fed Governors see that rate getting as high as 5% before inflation moves back down to the 2% target.
- Yields on Bonds have moved significantly higher on these expectations. The yield on a 2-Year Treasury moved to over 4%.



Source: @CharlieBilello

Leading Indicators Have Turned Down

- Leading economic indicators have turned down and are at or near levels of prior recessions. Historically, there has been a 7-month lag between Leading Indicators turning negative and the start of a recession.
- Indicators making up the index include: initial jobless claims, mortgage applications, real Treasury yields, and stock prices in addition to a few others.



Coincident Indicators Have Not

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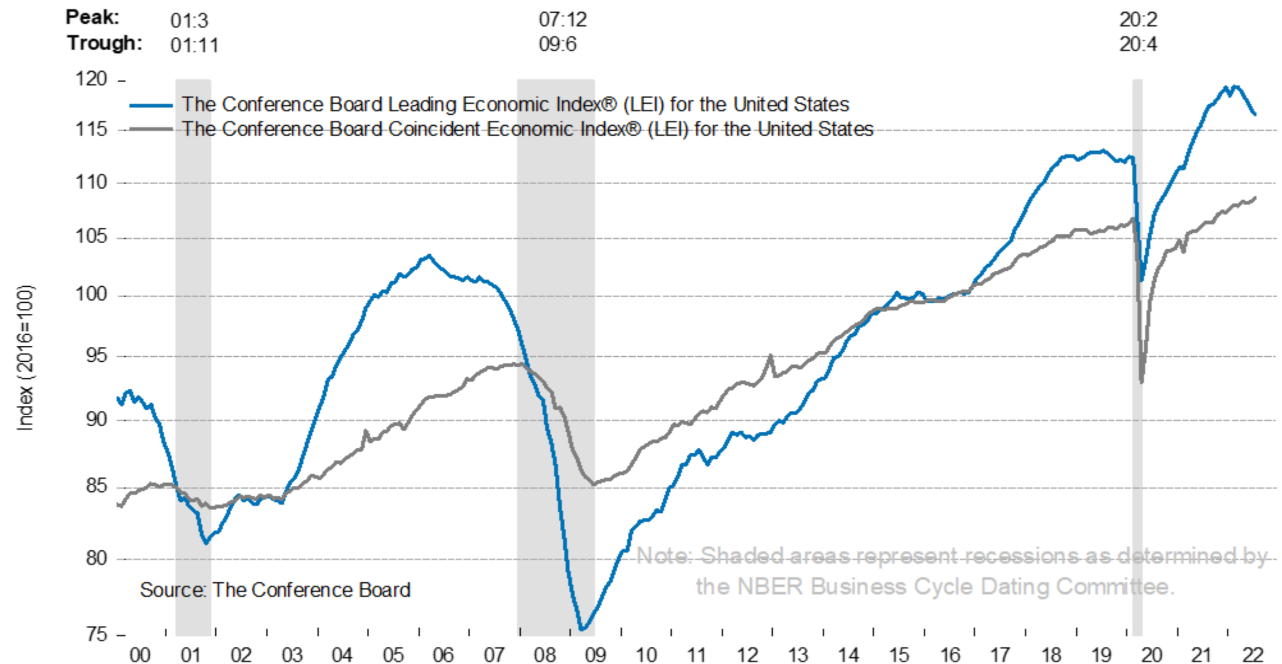
- Coincident indicators have historically turned down right at the beginning of a recession. They have not turned down yet.
- Coincident indicators include: Payroll Employment, Personal Income, and Industrial Production.



Fed Near-Term Forward Spread

- The Fed Near-Term Forward Spread is a measure of the expected 3mo. Treasury Bill rate 18 months from now, less the current 3mo. Treasury Bill.
- This indicator has been more accurate at predicting recessions than the 10yr Treasury minus the 2yr Treasury.
- The spread is still substantially positive and not flashing a warning of a recession yet.

Source: Bloomberg

Household Wealth and Debt

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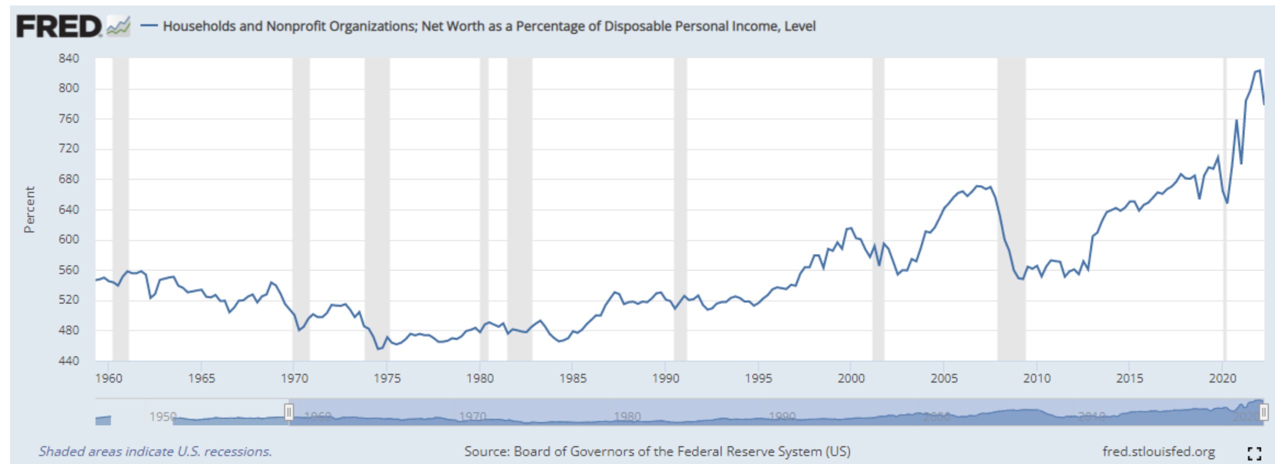
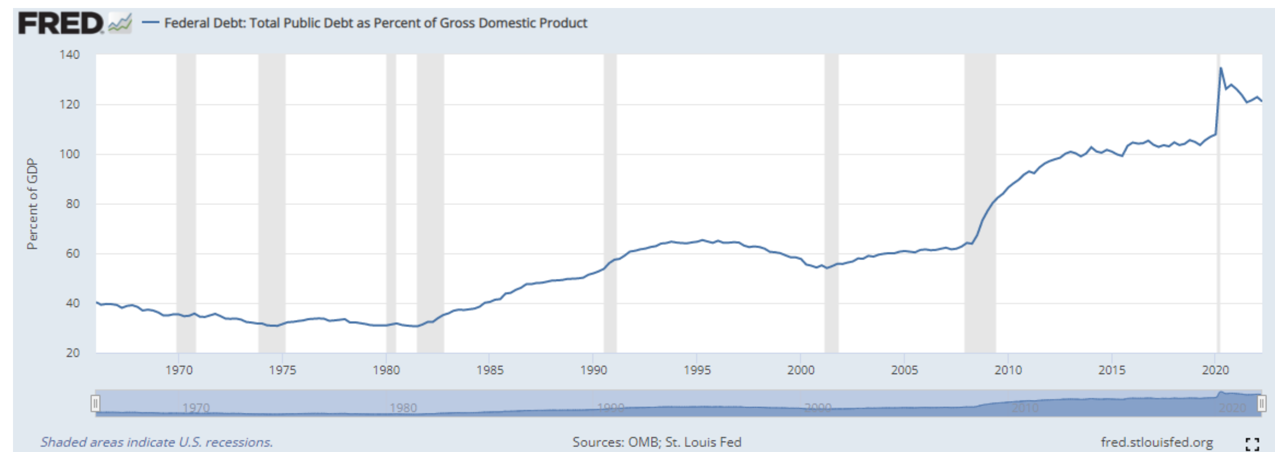
- Household Net Worth as a percentage of Disposable Income has peaked at historical highs. Equity holdings and home equity make up the bulk of net worth. Room to move down to pre-covid levels.
- U.S. Debt to GDP has risen substantially while Household Net Worth has increased. Likely not sustainable.





Timing of Recession

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- Recessions typically don't start until the Fed pauses on raising rates.
- Fed on pace to raise rates through the end of the year, which is why many strategists have moved projections for the start of a recession to early/mid 2023.
- The S&P 500 bottoms out after the Fed starts to cut rates, but before the end of a recession.

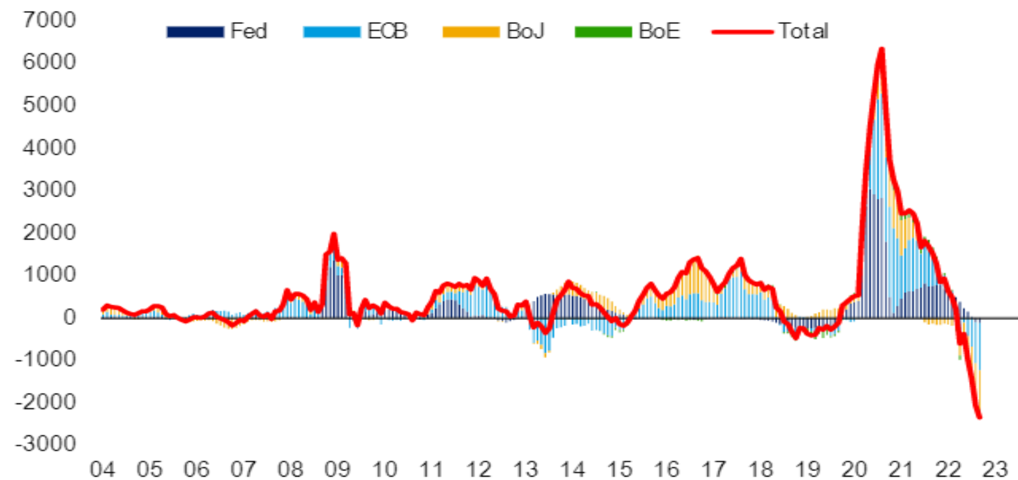
United States

Fed Pause	Start of Recession	First Fed Cut	S&P 500 Low
Jul 06	Dec 07	Sep 07	Mar 09
May 00	Mar 01	Jan 01	Oct 02
Nov 89	Jul 90	Dec 89	Oct 90
Jul 81	Jul 81	Jul 81	Aug 82
Dec 79	Jan 80	Jan 80	Mar 80
Jul 73	Nov 73	Nov 73	Oct 74
Aug 69	Dec 69	Oct 69	May 70

Source: Haver Analytics, Rosenberg Research

QT is Another Headwind

- Central banks, after years of Quantitative Easing, have begun Quantitative Tightening.
- The concern is that this will continue to put pressure on interest rates moving higher and staying higher.



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Higher Prices Hitting Consumers

- With higher prices, Consumers have had to dip into savings that they built up during Covid. The savings rate is back to 2008 levels.
- Many consumers have had to take on more credit to keep up their standard of living.

US Personal Savings Rate (%)

US Consumer Credit (YoY % Change)

Source: @CharlieBilello

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Performance For 60/40 Portfolio

- If the year ended on 09/30, it would be the worst yearly performance for a 60% S&P 500 and 40% US 10-Year Treasury portfolio since 1931.
- Historically, after this level of drawdown, performance over the next couple of years has been strong.

S&P 500, US 10-Year Treasury, and 60/40 Portfolio (Total Returns, 1928 - 2022)

Year	S&P	10-Yr	60/40	Year	S&P	10-Yr	60/40	Year	S&P	10-Yr	60/40	Year	S&P	10-Yr	60/40	Year	S&P	10-Yr	60/40
1928	43.8%	0.8%	26.6%	1947	5.2%	0.9%	3.5%	1966	-10.0%	2.9%	-4.8%	1985	31.2%	25.7%	29.0%	2004	10.9%	4.5%	8.2%
1929	-8.3%	4.2%	-3.3%	1948	5.7%	2.0%	4.2%	1967	23.8%	-1.6%	13.6%	1986	18.5%	24.3%	20.8%	2005	4.9%	2.9%	4.0%
1930	-25.1%	4.5%	-13.3%	1949	18.3%	4.7%	12.8%	1968	10.8%	3.3%	7.8%	1987	5.8%	-5.0%	1.5%	2006	15.8%	2.0%	10.2%
1931	-43.8%	-2.6%	-27.3%	1950	30.8%	0.4%	18.7%	1969	-8.2%	-5.0%	-7.0%	1988	16.6%	8.2%	13.2%	2007	5.5%	10.2%	7.4%
1932	-8.6%	8.8%	-1.7%	1951	23.7%	-0.3%	14.1%	1970	3.6%	16.8%	8.8%	1989	31.7%	17.7%	26.0%	2008	-37.0%	20.1%	-13.9%
1933	50.0%	1.9%	30.7%	1952	18.2%	2.3%	11.8%	1971	14.2%	9.8%	12.4%	1990	-3.1%	6.2%	0.7%	2009	26.5%	-11.1%	11.1%
1934	-1.2%	8.0%	2.5%	1953	-1.2%	4.1%	0.9%	1972	18.8%	2.8%	12.4%	1991	30.5%	15.0%	24.1%	2010	15.1%	8.5%	12.3%
1935	46.7%	4.5%	29.8%	1954	52.6%	3.3%	32.9%	1973	-14.3%	3.7%	-7.1%	1992	7.6%	9.4%	8.2%	2011	2.1%	16.0%	7.7%
1936	31.9%	5.0%	21.2%	1955	32.6%	-1.3%	19.0%	1974	-25.9%	2.0%	-14.7%	1993	10.1%	14.2%	11.7%	2012	16.0%	3.0%	10.7%
1937	-35.3%	1.4%	-20.7%	1956	7.4%	-2.3%	3.6%	1975	37.0%	3.6%	23.6%	1994	1.3%	-8.0%	-2.4%	2013	32.4%	-9.1%	15.6%
1938	29.3%	4.2%	19.3%	1957	-10.5%	6.8%	-3.6%	1976	23.8%	16.0%	20.7%	1995	37.6%	23.5%	31.7%	2014	13.7%	10.7%	12.4%
1939	-1.1%	4.4%	1.1%	1958	43.7%	-2.1%	25.4%	1977	-7.0%	1.3%	-3.7%	1996	23.0%	1.4%	14.2%	2015	1.4%	1.3%	1.3%
1940	-10.7%	5.4%	-4.2%	1959	12.1%	-2.6%	6.2%	1978	6.5%	-0.8%	3.6%	1997	33.4%	9.9%	23.8%	2016	12.0%	0.7%	7.3%
1941	-12.8%	-2.0%	-8.5%	1960	0.3%	11.6%	4.9%	1979	18.5%	0.7%	11.4%	1998	28.6%	14.9%	23.0%	2017	21.8%	2.8%	14.1%
1942	19.2%	2.3%	12.4%	1961	26.6%	2.1%	16.8%	1980	31.7%	-3.0%	17.8%	1999	21.0%	-8.3%	9.2%	2018	-4.4%	0.0%	-2.5%
1943	25.1%	2.5%	16.0%	1962	-8.8%	5.7%	-3.0%	1981	-4.7%	8.2%	0.5%	2000	-9.1%	16.7%	1.2%	2019	31.5%	9.6%	22.6%
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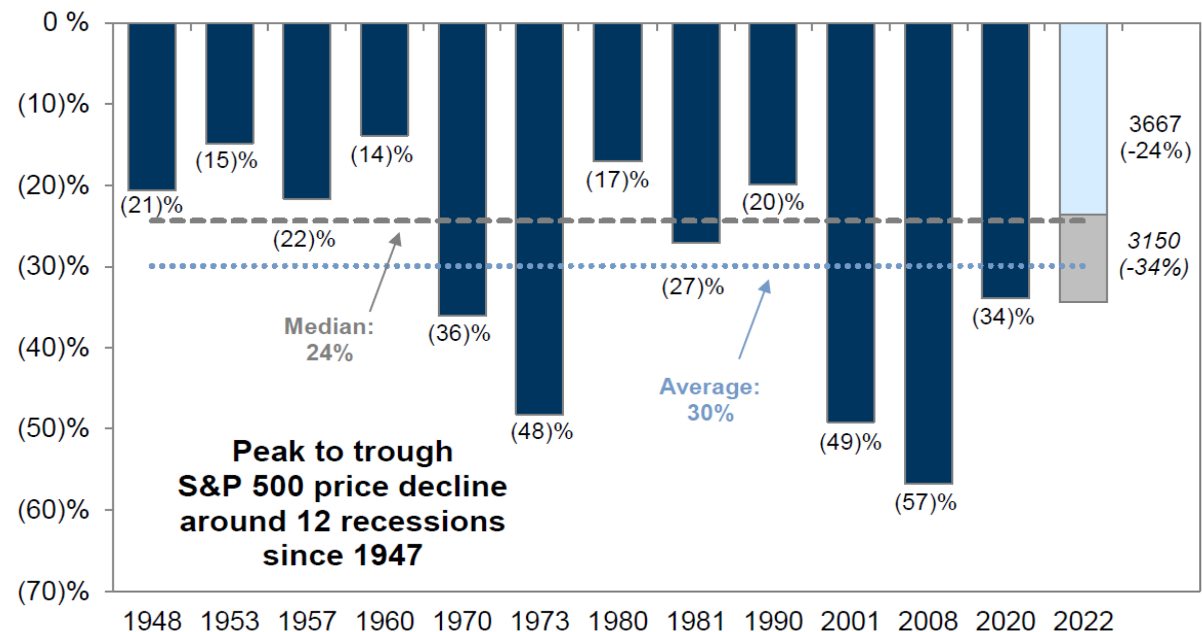
1945	35.8%	3.8%	23.0%	1964	16.4%	3.7%	11.3%	1983	22.3%	3.2%	14.7%	2002	-22.1%	15.1%	-7.1%	2021	28.7%	-4.4%	15.3%
1946	-8.4%	3.1%	-3.8%	1965	12.4%	0.7%	7.7%	1984	6.1%	13.7%	9.2%	2003	28.7%	0.4%	17.2%	2022*	-23.9%	-16.7%	-21.0%

COMPOUND @CharlieBilello *As of 9/30/22

Source: @CharlieBilello

S&P 500 Declines During Recessions

- Through the end of September, the S&P 500 was down roughly where the median decline has been during recessions going back to 1948.
- The average has been 30%, with larger drawdowns coming during some kind of financial crisis (1973, 2001, 2008).
- While we have seen the magnitude of decline of the median recession, we have not seen the duration.



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Market Positioning

- Our diversified approach has held up well in this environment. We have been concerned about a market where both equities and bonds sold off together. 2022 has been the perfect storm.
- We are slightly ahead of benchmark in Equity and Fixed Income allocations.
- We are significantly ahead in Absolute Return hedge funds (Positive through August). Private equity has held up well and is pretty much flat for the year.

- **Equity**: Overseas markets cheaper relative to U.S. With the geopolitical environment and government incentives, we are looking at the industrial sector (Materials, Automation/Robotics, *etc.*)
- **Fixed Income**: Looking to add exposure as rates have become attractive. We have mitigated drawdown by staying shorter in duration than benchmark. Likely to push duration out slightly.
- **Hedge Funds**: Increase exposure to Absolute Return strategies that can benefit from rising rates and provide diversification away from equity and fixed income risk.
- **Private Equity**: Focus on Small-Mid Buyout strategy, which is less frothy than Venture. Balance out smaller emerging managers with those that have persistent track records.

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Summary

The seriousness of the Fed's fight to lower inflation has been felt in both the equity and bond markets. Equity markets, as they typically do, discounted higher rates sooner than the bond market. While we have seen equities, especially technology companies, sell off we have seen bonds continue to sell off in a more dramatic fashion later in the quarter. For most of the past decade stocks were really the only major asset worth owning. Today with yields above 4% there are alternatives to equity to realize decent returns. While inflation is higher than bond yields currently, it is likely that real returns will be positive over a 5-10 year period. This year has been a year where diversification has made a difference in performance. For those that are only invested in equity and fixed income, it has been one of the worst years on record. Hedge fund strategies are up to slightly down and holding private equity has been a ballast to portfolios.

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