Q3 2022: Year of Extremes Continues

By Peak Trust Company's Chief Investment Officer, Lisa Russell, CFA. November | 2022

HIGHLIGHTS

- In the first half of the quarter, stocks and bonds rallied on the hopes of a Fed policy pivot, but a sharp reversal in the second half brought new highs for bond yields and new lows in stocks for the year.
- Investors reacted negatively to the Federal Reserve Chair Jerome Powell's August speech at the annual Jackson Hole Economic Symposium where he communicated the Fed's resolve to whack inflation back to levels consistent with its stable price mandate.
- The Fed's strong and explicit rhetoric throughout the quarter reinforced its continued obsession with lowering inflation, even at the expense of the broader economy and asset prices.
- The years of extremes in stock and bond returns and volatility continue.

Overview

The third quarter was defined by volatile economic data and markets and began with a furious bear market rally that resulted in the S&P 500 gaining 17% from June 16 to August 16. But the market eventually rolled over and hit new lows to close out the quarter by falling 17% from the mid-August high of the bear market rally that started in June.

The Bloomberg U.S. Aggregate Bond Index followed a similar path, gaining 5.6% from June 14 to August 1 before falling 8.1% and making new lows just before the end of the quarter on September 27.

The Fed

Perhaps more than anything, the event most responsible for the markets' reversals and declines to new lows was the Federal Reserve's Jackson Hole Economic Symposium, an annual conference that hosts central bankers, policymakers, academics, and economists from around the world to discuss economic issues, implications, and policy options.

Fed Chair Jerome Powell's topic this year was supposed to be "reassessing constraints on the economy and policy." His original speech addressed that topic. However, the rallying markets, easing of financial conditions, and increasing of inflation expectations for July and much of August provided the opposite result from what the Fed had been seeking.

So, Powell tore up his original speech and decided to be blunt. His 1,301-word speech on August 26 was by far the shortest by a Fed Chair at the Symposium since at least 2010. His point hit home: The Fed would not be pivoting on monetary policy anytime soon:

> *"The Federal Open Market Committee's overarching focus right now is to bring inflation back down to our 2% goal. Restoring price stability will take some time and requires using our tools forcefully to bring demand and supply into better balance. While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses."*

The final sentence from Powell's quote not only sums up the Fed's current no-win situation, but it is also starkly at odds with the calming voice that the markets are used to hearing from central banks during times of turmoil. That quote was absolutely necessary as the market rally was further jeopardizing the Fed's ability to return inflation back to its mandate and further risking its credibility.

The Fed is attacking inflation in three ways: raising interest rates, reversing quantitative easing (selling bonds it acquired during its years of quantitative easing), and using its words intentionally. Taken together, these tools are designed to depress asset prices—stocks, bonds, and housing—to create a negative wealth effect, curtail demand, and, hopefully, bring inflation down. Year-to-date results show that U.S. stocks are down 24%, and U.S. bonds are down 15%, which marked their worst year ever after posting their fourth worst year in 2021. Foreign stocks and bonds are in even worse shape as global central banks are almost all pursuing similar policies.

A question that clients have been asking me all year when I discuss the high risk of a recession happening in the near future is, "Aren't we already in one?" If the traditional definition of two consecutive quarters of a decline in the gross domestic product (GDP) was applied, then the answer would be, "Yes, we are."

Just as everything else doesn't seem to have a clear-cut answer this year, this one also does not. The labor market is extremely tight, which both the government and the Fed have decided needed to ease before a recession could be declared. The Fed is still in a box. The backwards-looking labor market is tight, and the tools at its disposal are blunt because it can only impact demand. The Fed cannot print more workers, houses, or gasoline. It can only address inflation by reducing demand. In particular, the Fed is trying to bring labor supply and demand back into balance, according to Powell's comments in March:

> *"Well, if you take a look at today's labor market, what you have is 1.7 plus job openings for every unemployed person. So that's a very, very tight labor market tight to an unhealthy level, I would say."*

Signs indicate that the Fed may be making modest progress on beating the labor market. Last month, job openings decreased by 1.1 million. Moves of that size are not common. Since 2000, drops of more than 1.0 million job openings occurred only in March and April of 2020. However, given that the unemployment rate today is 3.5% and is barely off its historic lows, the Fed has more work to do.

Markets

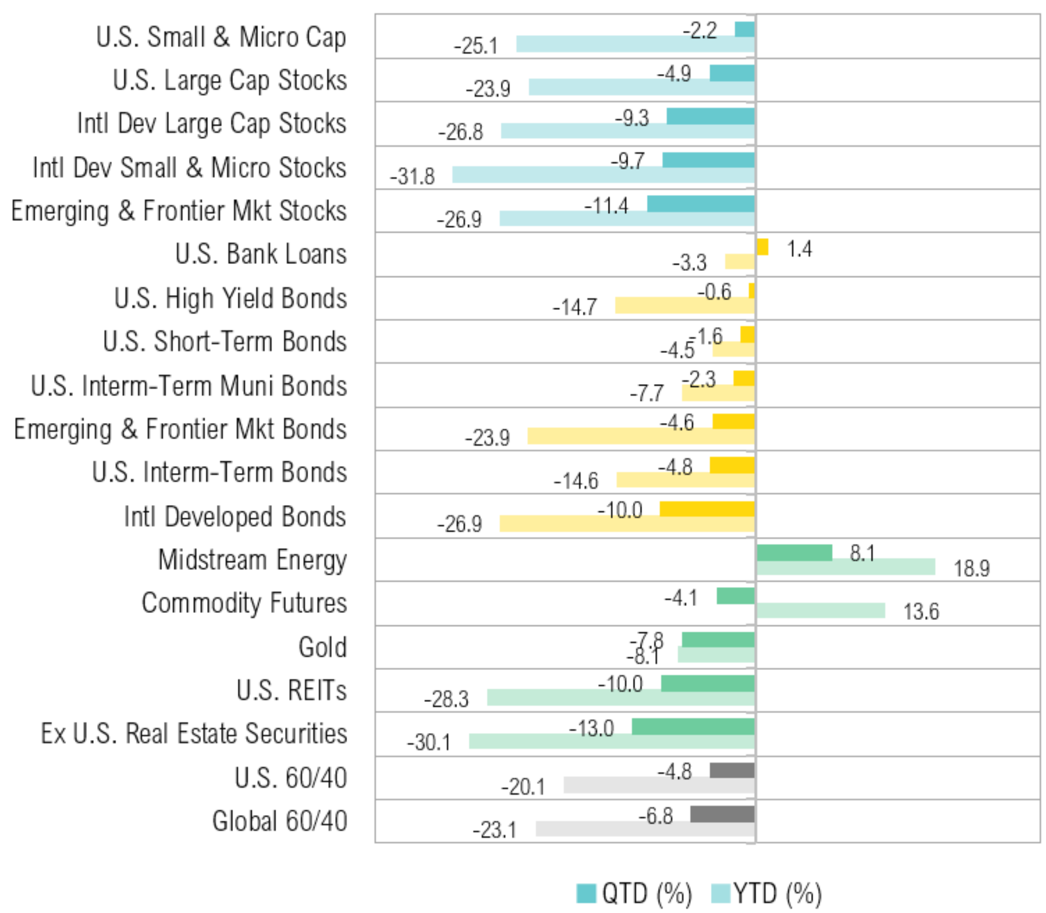
The S&P 500 Index fell 4.9% in the third quarter, sending the index back into bear market territory. From a style perspective, large-cap value stocks outperformed large-cap growth stocks, as the Russell 1000 Value Index fell 3.6%, while the Russell 1000 Growth Index fell 5.6%. Small caps outperformed large caps, with the Russell 2000 returning -2.2%, largely driven by small-cap growth outperforming small-cap value at +0.2% versus -4.6%.

From a sector perspective, energy was among the only bright spots, returning 2.3%, despite West Texas Intermediate Crude oil falling from $108 to $79 per barrel over the quarter. Real estate continued to struggle in the rising interest rate environment, losing 11% over the quarter. Communication services was the only sector to perform worse, down 12.7%. Despite this dramatic market sell-off, valuations for the S&P 500 are still not cheap compared to history. The Shiller Price/Earnings Ratio, a commonly referenced measure of valuation, measured 28.5 at the end of September, which is at the 74th percentile over the past 20 years and above the 20-year median of 25.9.

Stocks outside of the U.S. trailed their U.S. counterparts during the quarter, primarily because of the strong U.S. dollar, which gained 7.1% over the quarter. Foreign developed market equity returns, as measured by the MSCI EAFE Index, fell 9.7% in U.S. dollar terms. The MSCI Emerging Markets Index fared even worse, down 11.4% in U.S. dollar terms.

Within fixed income, U.S. taxable bonds—as proxied by the Bloomberg U.S. Aggregate Bond Index—again failed to offer meaningful diversification over the quarter after losing 4.8%. The 10-Year Treasury yield peaked at 3.95% on June 27, its highest yield since April 2010. A year-to-date return of -14.61% is by far the worst start of the year on record. Municipal bonds—as proxied by the Bloomberg Barclays Municipal Index—performed slightly better than taxable bonds losing 3.46% on the quarter and down 12.13% on the year.

Q3 2022 Key Market Total Returns



Source: Bloomberg

Looking Forward

This year continues to be one of extremes in both depressed prices and volatility across asset classes. Throughout this turmoil, one theme has remained dominant: Global inflation is much too high and has yet to show signs of meaningfully receding. It is important to remember the lag between monetary policy changes and their intended effects. As a result, inflation may, in fact, be on the decline, but it remains unclear how quickly it will recede and how low it will go. The answers to these questions will have dramatic implications for the markets. Outlooks must acknowledge a great deal of uncertainty.

While we remain cautious, we increasingly believe that attractive investment opportunities are potentially on the horizon. One year ago, the 10-year Treasury bond was yielding a paltry 1.5%, and today it is yielding over 4%. We are already seeing opportunities in the bond markets. Equity markets will most likely need a number of positive indicators to start a new bull market, but this will also happen, albeit eventually.

For now, we are patiently waiting for the much more desirable scenario in which the Fed declares victory over inflation, uncertainty regarding the Russian war with Ukraine subsides, and at least the U.S. enters a more stable environment. In the meantime, we will continue to take advantage of the opportunities in markets as we see fit, such as short-term fixed income.

About Lisa

Lisa Russell started with Peak Trust Company in 2003 and currently serves as Chief Investment Officer. Lisa brings over 25 years of investment experience to the Peak team. She specializes in designing unique investment programs for high-net-worth clients and trust accounts. She is highly attuned to the tax consequences of investment actions.

Lisa holds a Master of Business Administration in Finance from Emory University and a Bachelor of Science in Business Administration from the University of Southern California. Lisa holds the designation of Chartered Financial Analyst (CFA), and is a member of the CFA Institute and the CFA Society of Seattle.

LISA RUSSELL, CFA
Chief Investment Officer

IMPORTANT INFORMATION

PURPOSE OF THIS MATERIAL

This general market commentary is intended for informational purposes only. The views and opinions expressed represent the judgment of the author based on current market conditions, are subject to change without notice and may differ from those expressed by other departments or employees of Peak Trust Company. This material does not constitute Peak Trust Company research, nor should it be considered a recommendation of a particular investment or investment strategy or a solicitation for the purchase or sale of any security or other financial instrument. Investing involves market risk, including the potential for loss of principal. Past performance and any forward-looking statements are not guarantees of future results.

We believe the information contained in this material to be reliable and have sought to take reasonable care in its preparation; however, we do not represent or warrant its accuracy, reliability or completeness, or accept any liability for any loss or damage (whether direct or indirect) arising out of the use of all or any part of this material. Peak Trust Company does not provide legal, tax or accounting advice so you should seek professional guidance if you have such questions.

Peak Trust Company clients should rely on their custodial statements for the official investment activity records and should contact their custodian with any questions regarding monthly/quarterly receipt of those statements.

ABOUT PEAK TRUST COMPANY

"Peak Trust Company" is the brand for a group of affiliated federally and state chartered professional trust companies headquartered in Anchorage, Alaska. Peak Trust Company maintains separate state charters for operations in Alaska and Nevada as Peak Trust Company-AK and Peak Trust Company-NV. Peak Trust Company has established a federally chartered, non-depository trust company, "Peak Trust Company, NA", headquartered in Anchorage, with a branch office in Wilmington, Delaware. More information about Peak Trust Company, including our services, investment strategies, fees and objectives, are available upon request by calling (888) 544-6775, or visiting www.PeakTrust.com.

Talk to a Trust Expert

(888) 544-6775 expert@peaktrust.com