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ECONOMIC OUTLOOK 2022

4th Quarter Outlook

An Indepth Forecast Of The Year 2022

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3rd Quarter Recap

The summer stock market rally that started on June 16, 2022 came to a screeching halt following Federal Reserve (Fed) Chairman Powell's Jackson Hole hawkish speech in August in which he declared: "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. These are the unfortunate costs of reducing inflation". The Fed is trying to lower the inflation rate by lowering aggregate demand through higher interest rates.

Chairman Powell's strong message was repeated in the Federal Open Market Committee (FOMC) September 21, 2022 meeting when it raised interest rates by 75 basis points (0.75%) for the third consecutive time and signaled significant additional increases ahead. The higher interest rates and lower equity prices that followed were the first down payment on "the pain" Powell talked about.

The strong bear market rally from June 16, 2022 to August 16, 2022 saw the tech-heavy NASDAQ Index jump by 23.2%, and the Russell 3000 Index, a broad measure of the stock market, increases by 18.5%. Since August 16, 2022, these indexes have dropped by 19.3% and 16.5%, respectively. The Russell 3000 Index ended the quarter with a loss of 4.5%. This is the first time since the 2008-09 financial crisis that this index had three consecutive quarters of negative returns.

INDEX NAME	CATEGORY	YEAR-TO-DATE RETURN (AS OF 9/30/2022)
S&P 500 Index	Large Cap Stocks	-23.88%
Russell 2000 Index	Small Cap Stocks	-25.11%
NASDAQ Composite Index	Technology Stocks	-31.99%
Bond Aggregate Index	General Bond Markets	-14.61%

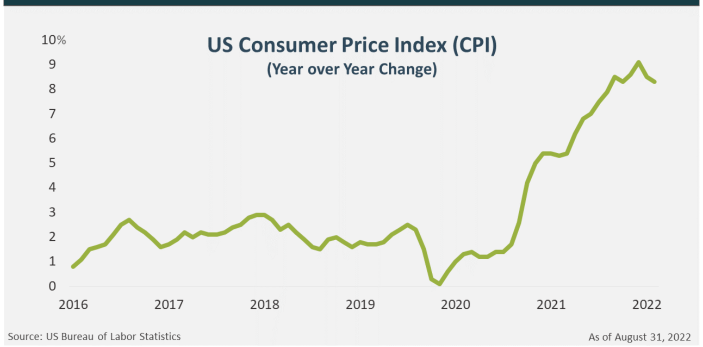
This rollercoaster-like market volatility is due to the uncertainty of the inflation trajectory and the likely hawkish Fed response. During the quarter, growth outperformed value as the Russell 3000 Growth Index lost 3.4%, while the Russell 3000 Value Index lost 5.6%. The small companies of the Russell 2000 index lost 2.2%, while the larger ones of the Russell 1000 Index lost 4.6%.

Only two sectors finished in positive territory: Consumer Discretionary (+3.8%) and Energy (+1.8%). The Real Estate sector was the laggard, losing 11.1%. All safe havens have gone down except the dollar (+6.1%), with gold (-7.9%), silver (-6.6%), and 10-year U.S. Treasury (-5.7%).

Inflation

Inflation continues to be a hot topic of discussion, not just in the United States but across the globe. Before 2020, inflation in the U.S. was almost non-existent. In fact, the Federal Reserve mentioned they wanted the inflation rate to be higher and would be willing to see it run a little hotter for some time, but not this high! Even today, the Fed is targeting inflation at around 2%, a huge gap from its current readings of 8.3%.

INFLATION TREND



Remnants of the Covid lockdown continue to linger and keep prices inflated. One such issue is the supply chain disruption that China's Zero Tolerance Policy towards Covid has caused. Entire cities are suddenly shut down due to a single positive case of Covid. This, in turn, closes manufacturing and shipping, essentially stopping the supply chain in its tracks. The semiconductor industry continued to have significant backlogs from these sudden and lasting shutdowns, impacting everything from autos to cell phones to watches. Companies are moving their production outside of China to ease some of the backlogs and prevent future overexposure to foreign economies. While this may create jobs in other countries, it does increase costs. The lack of cheap labor that China provided for decades adds to production costs which are being passed on to the end consumer. This decoupling from China is going to take time and it is highly inflationary as building costs and high labor costs will not ease soon.

Geopolitical tensions, especially the Russia-Ukraine conflict, contributed to the high cost of goods. Europe's embargos on gas and oil coming out of Russia have increased costs throughout Europe and are not expected to ease any time soon. A potential long cold winter in Europe is quickly becoming a significant concern causing many investors to become short-term weather forecasters. The potential energy crisis will likely push the European economy into a recession. Since Europe is one of our major trading partners, any damage to the European economy will adversely affect the U.S. economy.

These sources of higher inflation are not the only factors we noticed. In the U.S., the most recent reading of the Consumer Price Index (CPI) shows widespread price increases throughout the economy and remain elevated. One of the leading contributors to this indicator's high reading was shelter (owners' equivalent rent of residences, rent of primary residence, lodging away from home, and tenants' and household insurance), which constitutes a third of the CPI. Work from home and the resulting migration out of the cities to the suburbs, along with the lifting of rent controls put in place during Covid in 2020 are the major contributors to the rise of this CPI component.

As we consider inflation and the factors that cause it to move up or down, we should dig into some of the components of CPI. One of the more volatile drivers of consumer prices is energy. As of late, gasoline prices have actually been declining. The price for a gallon of gasoline peaked around $5.00, not ironically around the same time the stock market bottomed in mid-June. As gas prices have fallen, consumer sentiment has risen, perhaps as consumers feel as they can spend a little more on goods and services rather than fuel to get around.

We would be remiss if we did not mention one of the 'stickier' drivers of inflation, wage growth. The most recent Atlanta Fed Wage Tracker reading showed that wages are increasing by around 6.7% on a year over year basis. It is important to note that typically once wages go up, they are difficult to bring back down.

FED

The Federal Reserve has been increasing rates at a feverish pace, up 75 basis points (bps) in the last three meetings and 3% year to date.

This is a substantial move considering their target was only 25 bps as recently as March. While the Fed has been given a dual mandate (stable prices and full employment), as of late, restraining inflation is by far at the top of their agenda.

They are now firmly emphasizing price stability regardless of its impacts on near-term economic growth or unemployment.

The members of the Federal Reserve say they believe they can engineer a 'soft landing' or bring down prices without putting the U.S. economy into a recession. This may, however, prove to be a challenging exercise. Gross Domestic Product(GDP) has taken a negative turn in the first half of the year, which may be a sign of a slowing economy. However, the Fed continues to beat the drum of a strong labor market. With the unemployment rate at 3.7%, there is a belief that ample unfilled jobs will keep the U.S. out of a recession. Should individuals be laid off from their current jobs, the excess number of available jobs could help those folks get back to work.

However, the Fed would like to see job openings lower to reduce upward wage pressures, and they want this to happen without the significant pain in the labor markets generally associated with job losses. The markets are telling us the prospects of this economic sleight of hand are not good.

The reality of the situation now is that the Fed historically ends up going "Too Far for Too Long." This often-repeated truism indicates the Federal Reserve could very well raise rates so high they push the U.S. economy into a recession, or what many call a hard landing. Perhaps this is why they are now "pumping the brakes" by raising rates quickly. They are using their tools now, knowing there is a three to six-month lag until those rate impacts are seen, and several Fed members have cautioned that the rate hikes will not be reversed soon.

In the most recent Fed meeting, the Fed's Dot Plot (a chart showing the Fed member projections of the Fed Funds rate in the future) has also indicated they are likely to raise the rate another 125 bps (1.25%) through the rest of 2022, 75 bps in November and 50 bps in December. Put another way, the Fed expects the near-term target rate to be around 4.25% at this year's end and rise again in early 2023. This is a steeper path to higher rates than many in the markets have expected. In fact, the Fed Funds rate is now at a level not seen since before the Banking Crisis in 2008.

With higher rates in the United States, we have witnessed an extremely strong U.S. dollar. For many in the US, this is of no significant consequence, but for large multinational companies with a high percentage of foreign sales, this could spell disaster. As they repatriate foreign currency back in the greenback, those higher rates essentially reduce earnings stated in dollars and make the earnings comparisons more difficult. Of course, stocks rise on stronger earnings, not weaker earnings.

Fixed Income

Why is the Fed so focused on raising rates now, after generating easy money for so long? After fearing deflation for over a decade, the first signs of inflation were welcomed by all central bankers around the globe. Higher than generally acceptable inflation rates were seen as "transitory," and deflation concerns persisted. Eventually, the consensus grew, at the Fed and elsewhere, that the age of deflation was over and the inflation, initially caused by Covid-related bottlenecks and the Russian war on Ukraine, was serious and growing. The cost of capital, as measured in any manner, was far below the inflation rate. The Fed was still stimulating the economy while inflation was running amok, the unemployment rate was at inflationary levels, and there was nothing transitory about it. Hence, the abrupt about-face by the Fed and other central bankers and the drastic rate increases.

Most of the time, bond yields are negatively correlated to stock prices. If the stock market tumbles, as in a recession, bond prices rise because the central bank will lower interest rates to stimulate economic growth. Not so this time. The Fed is raising rates to fight inflation, which will most likely create strong headwinds for corporations, leading to lower earnings and, thus, lower stock prices. That is why stocks and bonds are both deep in the red this year.

Fixed income investors know higher rates mean lower prices for their bond portfolios. For this reason, we have held and advocated for a lower duration in our fixed income holdings. Shorter term notes and bills do not exhibit the price volatility longer bonds show.

With these higher yields, investors can now earn over 4% on high-quality U.S. Treasury notes with maturities of three years or less when that return was below 1% just last year.

There are plenty of calls projecting a deep recession for the U.S. economy. If these pundits are correct, or even if the economy escapes with just a shallow recession, history has shown that higher-quality bonds are a safer option, although there is no guarantee. For those reasons, we continue to favor shorter-term U.S. Treasury issues and perhaps some very high-quality corporate bonds.

Additionally, the risk/reward for longer-term bonds will look more attractive as we head into a slower economic environment, providing the Fed is successful in taming inflation. Due to relatively tight spread levels between higher-yielding bonds and U.S. Government bonds, high-yield bonds still appear expensive in this environment. To be sure, as long as the Fed does not see a convincing downtrend in inflation, they will continue tightening, but most likely in smaller increments. Under this scenario, we expect the yield curve to become even more inverted as recession fears intensify.

Business Cycle

Last quarter our data suggested we were mid-cycle, but we also noted there were indications we might be further along within the business cycle. As the quarter progressed, we continued to see economic reports deteriorate as the Fed continued to tighten. Looking back at the third quarter and deeper into the fourth quarter of 2022, we see several indicators typical of a late-cycle economy. Banks are tightening credit, economic growth is moderating (and GDP did turn negative for the last two quarters), yield curves are inverted, earnings and margins are under pressure from higher costs, and inventories are rising as sales growth slows. Additionally, the Fed continues to warn of significant additional increases in the Fed Funds rate even as financial conditions deteriorate; recession fears are rising.

Economy

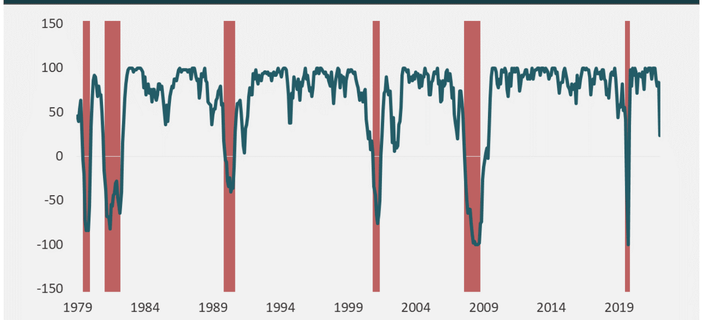
The strong labor market is one area of the economy which remains resilient. The increase in new jobs remains robust; the U.S. has averaged 438k jobs per month in 2022. The unemployment rate remains low and near decade lows. Job openings remain over eleven million and provide flexibility to workers looking for higher wages. There have been reports of companies cutting jobs, especially from companies that benefited during the height of the pandemic. However, if layoffs extend to other areas of the economy and wage-increase pressures drop, the labor sector would change from major support to a significant headwind for economic growth.

The manufacturing sector of late has slowed after a strong start at the beginning of the year. Industrial Production, an indicator with a strong correlation to GDP growth, advanced by 2.5% in the year's first four months. However, in the following four months, Industrial Production slowed substantially and only increased by 0.3%. Furthermore, New Orders Reports from the Institute for Supply Management (ISM) have shown weakness, dropping from their highs just a few months ago. New orders are seen as a leading indicator for future economic growth and now suggest modest near-term growth,

Furthermore, many regional Federal Reserve surveys are painting a similar picture, with new orders falling and overall manufacturing weakening. One index from the Federal Reserve Bank of Philadelphia analyzes economic activity across all 50 states, comparing those that are stable to those declining.

The August report of this diffusion index shows a substantial decline from just six months ago. The August reading of 24 is the lowest reading since the start of the pandemic in 2020, and well off the reading of 100 in the first quarter of this year. Since 1979, levels below zero augured a recession. This report highlights how fast economic growth has slowed since the start of the year.

DIFFUSION INDEX VS. US RECESSION



Source: Federal Reserve Bank of Philadelphia

As of August 31, 2022

Covid-related supply chain pressures and bottlenecks have been a key driver of shortages for many businesses over the past couple of years. Fortunately, we are seeing some signs of these pressures easing. Trucking tonnage growth through the year's first half is up 8.0%, back above pre-pandemic levels. The New York Fed also reports that the Global Supply Chain Pressure Index is starting to decline, and the declines appear to be broad-based. Delivery times and backlogs are improving and could provide relief to inflationary pressures throughout the economy.

Consumer

Consumer sentiment remains persistently low and near pandemic levels as fears of a recession increase. Additionally, high inflation impacts sentiment as higher costs continue to hurt consumer pocketbooks. The latest data from the University of Michigan indicate consumer sentiment is bouncing near 10-year lows, and it does not look to be moving higher anytime soon. The Conference Board Consumer Confidence Index is also weak but is still well-off pre-pandemic levels. Both numbers suggest a bearish tone for the market and the economy and suggest the odds of a recession are rising as we end 2022 and look ahead to 2023.

Despite the dismal readings from consumer sentiment indexes, consumer spending has been resilient and has been holding up economic growth. Consumer makes up two-thirds of U.S. GDP, which is especially important to economic growth. Thus far in 2022, consumer buying of services has been the key driver of growth, even though the total GDP numbers were negative for the year's first half.

However, consumers are feeling pain elsewhere as interest rates continue to rise. The housing and auto industries are highly sensitive to moves in interest rates. The higher borrowing costs have slowed overall demand and continue to be a significant headwind for the two industries. Thirty-year fixed mortgage rates are now around 7%, resulting in a major decline in home purchases and home building. Many Americans are now priced out of the housing market due to high home prices and higher mortgage rates. Further, the Fed tightening, which began earlier this year, is reflected in tighter financial conditions making it more difficult for some people to get a mortgage or other types of loans. Unfortunately, the Fed is still talking about higher rates, and consumers should expect borrowing costs to continue to rise through the rest of 2022 and into 2023. The tighter conditions will cut demand more and push us even closer to a recession.

Dollar

The U.S. dollar continued to strengthen versus a basket of major currencies in the third quarter. Higher interest rates in the U.S. have contributed to the surge in the U.S. dollar from abroad. Unfortunately, the strong dollar has also been a significant obstacle for many multinational corporations. The conversion of foreign revenue back to U.S. dollars has negatively impacted companies that export by making their goods/services less competitive and reducing their earnings once translated into the stronger home currency. We expect the U.S. dollar to continue to strengthen through the rest of the year as the Fed persists in its rate hikes. Companies with significant exposure overseas will continue to see their bottom lines negatively impacted. This is an additional headwind for the stock market.

Equity Market

In the third quarter, the market continued its downward trajectory as it did in the year's first half. During the early summer months, there was a rally based on Fed pivot hopes, that is, hope that inflation was peaking and would roll over hard. Consequently, the Fed is turning less hawkish and may even cut rates in 2023. Those hopes contributed to a nearly 20% stock market rally that turned out to be a premature bear market rally. Instead, inflation remains stubbornly high and far from the Fed's 2% target even though it may have peaked.

What now for the equity market? Again, to answer this question, it helps to think in a probabilistic framework with Bull, Base, and Bear cases to map the stock market's trajectory in the months ahead.

Bull Case

As we highlighted in June, in our third quarter outlook, the Bull case is for inflation to be in a clear downward trend to the 2%-3% level in the months ahead, with declining month-over-month price growth. Easing supply chains and less consumer spending as the Fed enacted hikes start to lower aggregate demand, which in turn could lower services inflation. However, the Bull case is our least likely case to materialize as the labor market continues to be strong for services and goods inflation to slow down significantly.

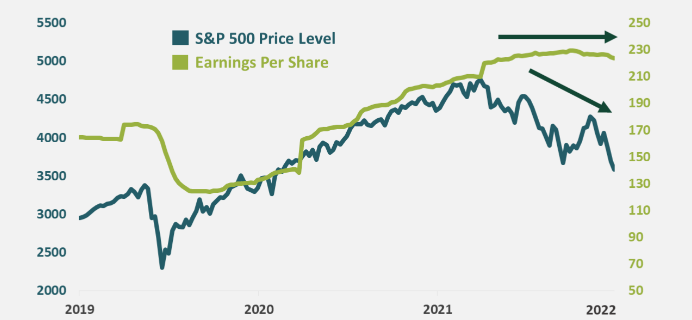
Base Case

Similar to what we outlined in our 3rd quarter outlook, our Base case is for inflation to come down but stay stubbornly high by year-end, surprising market participants and consumers to the upside. As highlighted in the inflation section above, rent and housing prices are feeding into the Consumer Price Index with a 6 to 12-month lag. This will keep upward pressures on the core inflation measure for the rest of the year as shelter inflation represent 30% of headline CPI, and 40% of Core CPI.

In the next two quarters, the deteriorating earnings picture may be the next significant risk to the equity market. The selloff since the beginning of the year has entirely resulted from a rising interest rate shock reflecting rising inflation. Rising interest rates put pressure on valuation multiples. For example, the next twelve-month price-to-earnings (PE) ratio for the S&P 500 has compressed by 27%. At the beginning of the year, it was at 22 times, and at the time of writing, it is 16 times.

Conversely, the following twelve-month earnings estimates remain positive and have grown 6.7% since the beginning of the year. This indicates that the move in stocks was entirely due to the interest rate shock. The next risk we are watching is the degree of earnings deterioration in the months ahead, as corporate profit estimates are still way too bullish given all the potential economic land mines.

EARNINGS ESTIMATES STILL TOO HIGH



Source: Bloomberg

As of September 30, 2022

Bear Case

Our Bear case is still a stagflation environment, where economic growth is stagnant, and inflation remains stubbornly high but no recession. We are assigning a lower probability to this than we did in our last quarter's outlook as leading indicators of inflation are showing signs of lower inflation ahead as the economy slows down. For example, prices paid indices in major Fed regional surveys are rolling over hard and establishing a steep downward trend.

Additionally, inflation expectations in the bond market are near the 2% level for 1-year, 2-, 5-, and 10-year timeframe. So, bond investors are expecting the hawkish Fed to get inflation under control within the next twelve months, but at what cost to the economy? That remains to be seen. We believe the cost will be severe as the Fed hikes are starting to bite and supply is not moving in their favor fast enough not to endure significant pains in the aggregate demand part of the equation.

Earnings

With the economy slowing down and high inflation widespread, it's natural to expect earnings to deteriorate. The debate is to what degree earnings will be reported in the next few quarters. Are we on the cusp of an earnings recession? Negative earnings growth in two consecutive quarters?

Probably not in the third quarter earnings season as worsening economic conditions, such as inventory building, contract renewals, and price increases, take time to go into effect. However, as we go into the fourth quarter and the first half of next year, the impact of the slowing economy will show significantly in earnings, in our view. The risk is to the downside as analysts have not meaningfully adjusted their estimates to reflect the deteriorating macro backdrop.

Risks To Our Outlook

There are significant risks and opportunities in the current global arena. China's zero-tolerance policy can push the global economy into recession as they react to new cases of Covid by shutting down entire cities. However, most analysts expect this policy to change after the October election of Xi Jinping to an unprecedented third term as leader of China. The Russian invasion of Ukraine and the resulting European sanctions on Russian gas and oil are likely to send Europe into recession. Without Russian natural gas, many European cities, especially Germany, will face a tough winter. We believe potential positive development in that conflict will bring a major rally in stocks. Also, we can't forget the U.S. mid-term elections in November. The make-up of the next Congress is likely to significantly impact energy regulations, and gridlock has historically been good for the stock market.

Conclusion

The last quarter of 2022 will undoubtedly see a lot of volatility in both bond and stock markets. The rising geopolitical risks abroad and the Fed and other central banks raising interest rates to fight persistently high inflation will weigh on consumer and business confidence. The Fed will likely stay on its aggressive tightening course, having started too late, and probably will tighten too much. Supply chain issues appear to be declining but can quickly flair up again due to several potential global problems. With the economy in the late cycle phase and economic growth fear rising, the financial markets will face significant challenges. Earnings growth deterioration will have a major negative impact on stocks and rising interest rates are likely to be a headwind for the bond market.

The labor market remains strong, reinforcing rising wage inflation. Investors are bearish, and both stocks and bonds markets appear oversold. This is going to be a very volatile and risky quarter. We recommend staying with high-quality bonds and maintaining a low duration. For stocks, we continue to favor quality companies with strong balance sheets and favorable pricing power.

For Investors:

Economy

- Economic growth outlook continues to deteriorate
- Rising fear of an economic recession
- Resilient labor market is keeping the economy from a recession
- Fed tightening has worsened financial conditions
- Persistent and highly stubborn inflation and weaker consumer confidence
- Risk of global recession is on the rise, especially in Europe
- Interest-sensitive sectors like housing and auto are feeling the brunt of the Fed tightening
- U.S. manufacturing activity is weakening
- A strong dollar is hurting the bottom line of major exporting companies

Stocks

- Deteriorating earnings growth is the next headwind for stocks
  - Higher input costs will pressure margins
  - Analysts' earnings estimates may be too optimistic
- Rising interest rates to continue pressuring stock returns
- Market volatility to continue into fourth quarter
- High geopolitical risk weighs on financial markets
- Both retail and institutional investors' sentiment indicators show excessive pessimism
- Large Cap stocks have the potential to do better than Small Caps in rising interest environment
- Continue to favor defensive sectors and underweight cyclicals as the economy slows
- Favor strong balance sheet companies with pricing power
- Stick with your long-term plan and have realistic market expectations

Bonds

- Rising interest rates will be a major headwind for long-term bonds
- Economic growth worries and sticky inflation are opposing forces, keeping bond market volatility high
- In fourth quarter, favor shorter duration bonds over long-duration bonds
- Higher coupon rates are making bonds more attractive for income investors
- Investors should look to floating rate bonds as the Fed continues to raise rates
- Continue to favor high-quality bonds over high-yield bonds

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Disclosure

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Definitions

Large Cap: are defined as the group that account for the top 70% of the total market capitalization of the U.S. equity market.

Small Cap: are defined as the group that account for the bottom 10% of the total market capitalization of the U.S. equity market.

Growth Stock: A growth stock is any share in a company that is anticipated to grow at a rate significantly above the average growth for the market and have typically higher valuation multiples than the market.

Value Stock: is a stock with a price that appears low relative to the company's financial performance, as measured by such fundamentals as the company's revenue, dividends, yield, earnings and profit margins.

PE Ratio: Price/Earnings ratio is the stock price divided by the company's earnings per share for a designated period

Consumer Price Index (CPI): Measures the average change in prices over time that consumers pay for a basket of goods and services.

10-year U.S. Treasury Yield: used as a proxy for mortgage rates. It's also seen as a sign of investor sentiment about the economy.

*Russell 1000 Index: The Russell 1000® Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000® represents approximately 92% of the U.S. market.

*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 2,000 of the smallest securities based on a combination of their market cap and current index membership.

*Russell 3000 Index: The Russell 3000® Index measures the performance of the largest 3,000 US companies representing approximately 98% of the investable US equity market.

*S&P 500 Index: S&P (Standard & Poor's) 500 Index: a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies.

*The Bloomberg Barclays U.S. Aggregate Bond Index: a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States.

*NASDAQ: a global electronic marketplace for buying and selling securities on a computerized, speedy, and transparent system.

***Indexes are not managed. One cannot invest directly in an index.**

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