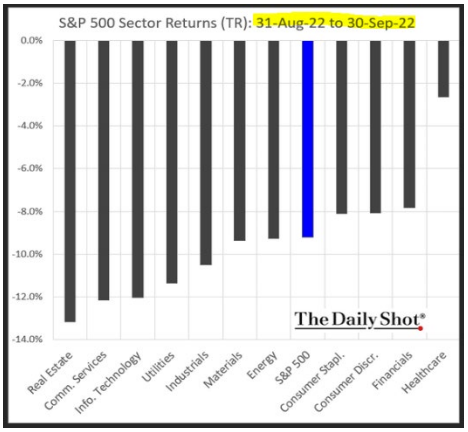
EQUITY MARKET UPDATE

As of 09/30/22 | Volume 11, Issue 9 | FFTAM.com

Stocks were crushed in September. Many of the major indexes ended the quarter at their lowest levels for the year. Markets continue to react to persistent inflation and rising interest rates from the Federal Reserve. Economic data shows the US economy remains on firm footing although momentum is slipping in some areas. The combination of high prices from inflation mixed with rising interest rates from central banks worldwide have investors worried about a possible recession in 2023.

US Stocks Drop on Hot Inflation Reading and Tough Talking Fed



The S&P 500 fell 9.22% in September. Conditions deteriorated after interest rates spiked on a hotter than expected CPI report and a Fed meeting that indicated many more interest rate hikes are on the horizon. Losses were widespread with real estate trusts (-13.15%), communications (-12.15%), and technology (-12.01%) seeing the sharpest declines. All sectors fell during the month. In fact, only one industry—pharmaceuticals—experienced a positive return. In 2022, the S&P 500 is down 23.88% with energy (+34.49%) being the only positive area.

The Dow Jones Industrial Average dropped 8.76% for the month. A higher allocation to healthcare, financials, and staples aided results versus the S&P 500. The Dow also has a lower allocation to technology. Year-to-date, the Dow is down 19.72%.

The NASDAQ plunged another 10.44% in September. The index was decimated as investors continue to flee from companies that are unprofitable and poorly capitalized. The index has fallen every month so far in 2022 except for March and July. Year-to-date, the NASDAQ is the worst performing major index with a total return of -31.99% as investors shy away from high valuation companies as interest rates rise. The index has also been hurt by disappointing earnings announcements from Meta Platforms, Netflix, PayPal, Alphabet, Amazon, and NVIDIA.

Middle-to-small-sized companies fared about the same as the large cap indexes last month with the S&P 400 Mid Cap Index falling 9.19%, while the S&P 600 Small Cap Index was down 9.88%. So far in 2022, this area has slightly beaten its large cap peers with the S&P 400 Mid Cap Index dropping 21.54%, while the S&P 600 Small Cap Index is down 23.19%.

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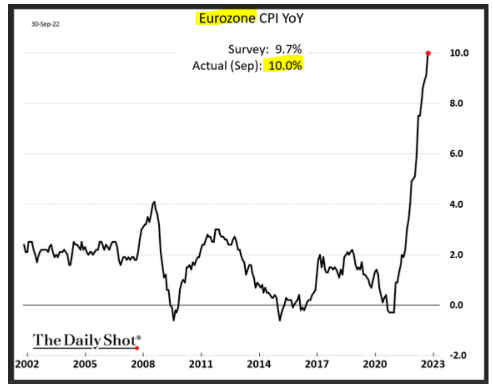
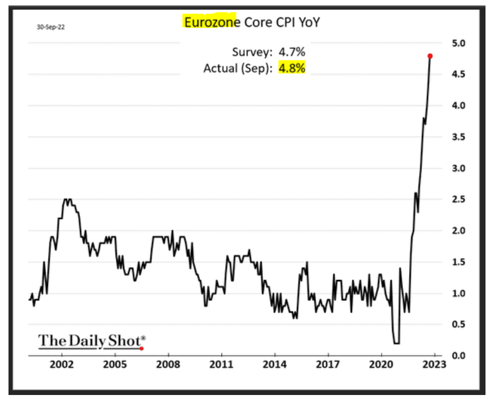
Europe on the Brink of Recession while China Remains Weak



The war in Ukraine continues to be the major source of price spikes in Europe. Inflation in the Eurozone reached a new record high of 10%. The acceleration came from large increases in the price of energy and food. Core inflation that removes the effects of food and energy was 4.8%. Businesses are unable to pass along the full extent of inflation, so profits are being squeezed. For example, Eurozone producer price inflation was 29.7%, a new record high. Obviously, consumer prices cannot rise that quickly without crushing demand. The inflation is pressuring economic growth. Eurozone Manufacturing PMI slipped for a seventh straight month to 48.4, while Services PMI decelerated for a fifth month to 48.9. Both readings signal Europe's economy is teetering on the brink of recession.

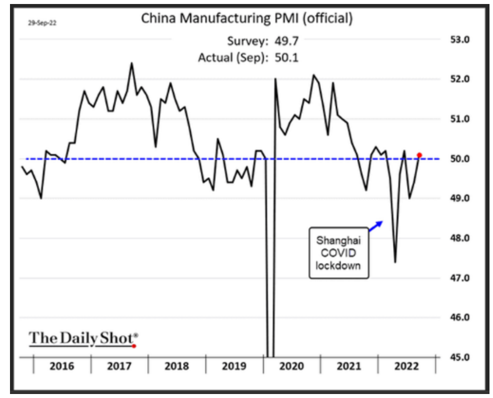


As I have discussed in the past, the European Union gets 35% of its total energy needs from Russia, so prices have skyrocketed as the region scrambles to find new sources. They have struck deals with the US, UAE, Qatar, and Canada. Unfortunately, none of these solutions provide an immediate fix, so Europeans face several years of elevated prices to wean itself off Russian energy. In the near term, Russia has discontinued natural gas flows to Germany for "maintenance" reasons. Engineers have discovered structural leaks in both the Nord Stream I and II pipelines. All signs point to sabotage. To make matters worse, Russia has annexed four parts of Ukraine, and Mr. Putin is threatening to use nuclear weapons if American and European leaders continue to aide Ukraine. With winter approaching, Germany is rationing the amount of energy citizens and businesses can use as they try to fill storage tanks for colder temperatures. This is causing Germany's economy to deteriorate at a pace not seen since 2008.

To protect citizens and small businesses from skyrocketing energy prices, both the UK and the European Union have announced plans to cap energy prices. The UK took an additional step by declaring unfunded tax cuts in hopes of stimulating business activity. That announcement backfired as investors sharply sold UK government bonds out of fear that inflation would accelerate. This caused the British pound to fall to its lowest level since 1985 versus the US dollar. To prevent a market meltdown, the Bank of England stepped in with a bond purchase program, and the UK Chancellor of Exchequer has dropped the proposed tax cuts. This is the clearest example of how the US economy has escaped the worst of inflation, but a rising dollar is punishing the rest of the world with few alternatives.

Persistently high inflation and a sinking euro has pressured the ECB to begin raising interest rates for the first time in over a decade. Despite the weak economic data, the ECB must continue to hike rates to tame inflation. They are proceeding much slower than the Fed, and the interest rate differential has caused the Euro to plunge below parity versus the US dollar. They must proceed with caution since interest rate spreads between Italian and German bonds have widened. Unlike the Fed, the ECB faces the unique challenge of rate hikes disproportionately hurting highly indebted countries in Southern Europe. ECB Chairwoman Christine Lagarde unveiled a proposal to invest the roll-off from their bond portfolio into government bonds from weaker countries to hold down spreads.

The Chinese economy continues to struggle from the effects of extreme drought, constant lockdowns to combat the spread of

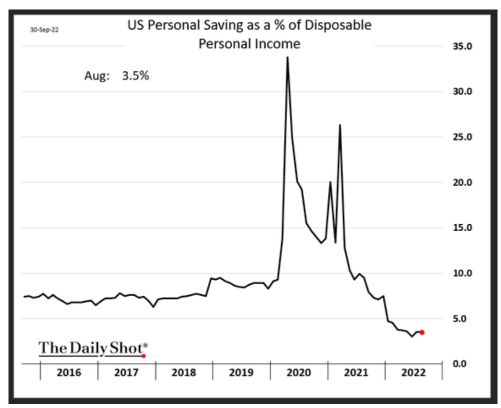


COVID-19, and a depreciating property market. As the month ended, 25% of the country's GDP remains under COVID related restrictions. Economic results are feeble. China's Manufacturing PMI edged higher to 50.1; however, data showed a sharp pullback in export orders with a reading of 47, the lowest level in four months. Meanwhile, service activity slipped back into contraction territory. Job growth remains a challenge with youth unemployment of 18.7%. That is very concerning considering China's shrinking workforce due to an aging population. Home sales fell for a 15th consecutive month despite recently announced stimulus measures. With the economy stumbling, officials have dropped their 5.5% GDP growth target, and analysts are now forecasting growth of 3%.

With many challenges facing international markets, investors are proceeding with caution. The MSCI EAFE Index lost 9.30%, while the MSCI Emerging Markets Index fell 11.71%. Year-to-date, the two indexes are down 26.71% and 26.99%, respectively.

US Economy Grows, But Momentum is Slipping

The labor market remains strong. Last month, the economy added 263,000 jobs. The unemployment rate ticked down to 3.5% as labor force participating declined slightly. Average hourly wages grew 5.0% from one year ago, an amount that far exceeds pay raises seen pre-COVID. The JOLTS report showed there are 10 million jobs available but unfilled. That is a sharp decline from the previous month, but it still equates to 1.7 job openings for every unemployed person—near all-time high. The demand for labor is far outstripping supply in most industries which signals the tightness in the labor force and the competition to recruit and retain employees. This is something the Fed is paying very close attention to because wage inflation is the most durable and hardest to defeat type of inflation.



Consumer inflation was more than expected with prices jumping 8.3% from one year ago. Unlike Europe, US energy prices fell in September and was the largest detractor. Rising prices for homes and rent worsened. Core inflation that removes food and energy prices rose by 6.3%, also hotter than predicted. PCE data, the Fed's preferred measure of inflation, showed similar results with total prices climbing 6.2%, while prices ex-food and energy increased 4.9%. The data presents a major challenge for the Fed. It shows that despite the strong labor market and higher wages, consumers are struggling to keep pace. Inflation adjusted income has declined in 9 of the last 12 months, while the savings rate has plunged to 3.5%, a 14-year low. Credit card balances have returned to the levels seen pre-COVID. With more of their paychecks going towards everyday essentials (food, shelter, and energy), consumers are running out of discretionary income. Consumer spending, however, rose 0.4% last month as expenditures on services remained brisk. Spending on goods fell for the second straight month.

Business investment data is mixed. The ISM Manufacturing PMI slowed to 50.9, while new orders (47.1) contracted for the third time in four months. Prices paid remained high with the producer price index (PPI) jumping 8.7% on a 12-month basis. The ISM Service PMI (56.7) was a stronger than its manufacturing cousin. Finally, housing starts and mortgage applications fell as the 30-year mortgage rate has jumped to 7%.

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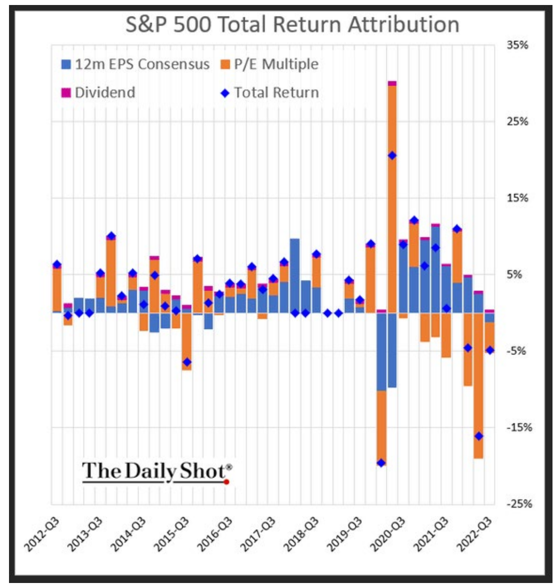
The Fed responded to the hot inflation data by raising interest rates by another 0.75%. The dot plots increased by another 100 basis points indicating the Fed believes further rate increases are needed. During the press conference, Chairman Jerome Powell stated the Fed is purposefully moving interest rates into restrictive territory and will leave them there for considerable time to ensure inflation is defeated. He reiterated that "pain" would likely be felt by households and businesses. He said the Fed would not waver until unemployment rose, wage inflation reverted, and housing corrected. Once again, this blew-up the market's hopes that the Fed would consider cutting interest rates next year, and it forced the bond market to align itself more with the Fed's dot plots that indicate interest rates will be over 4.5% by the end of next year. They are currently 3.25%. This is on top of their quantitative tightening program that involves shrinking the balance sheet by $95 billion each month.

Market Sell-Off Lowers Valuation

The recent sell-off has the S&P 500 trading at 15.52x 12-month estimated earnings. This is far below the 5-year and 10-year average multiple of 18.63x and 17.19x, respectively. It is also less than the pre-COVID PE ratio of 19.4x.



We are about to kick-off another earnings season. Analysts forecast third quarter profit growth of 2.9%, a sharp revision from the 9.8% increase they were expecting when the quarter started. They believe all sectors will report an earnings decline from one year ago, except energy. However, they see earnings growth reaccelerating in the fourth quarter and throughout 2023.

The market has finally gotten serious about the Fed and inflation by removing the premium valuation on stocks. Even though the current valuation appears attractive, it is based on profit growth estimates coming to fruition. The debate has intensified between economists that argue the economy is showing signs of heading towards recession, while company specific analysts forecast continued prosperity for at least the next two years, although they are less bullish than a few months ago given the Fed's tough stance on interest rates. This tells me three things. First, stocks are ripe for continued price volatility, especially among the higher valuation growth names. Second, the market has already priced-in the likelihood that several companies will miss upcoming earnings estimates and will guide their future numbers lower. Finally, the market is telling you if a recession occurs, it will likely be shallow and short-lived; therefore, interest rates will not return to 0%. This last point is important to keep in mind since it means we will not see PE ratios for the overall market expand back to the 20s; therefore, most of the future total return for stocks will come from earnings growth and dividends paid.

Our Outlook & Strategy

The biggest challenge for stocks is central banks navigating how to remove emergency stimulus policies needed during the depths of the pandemic without significantly slowing growth. Russia's invasion of Ukraine and global drought complicates matters by pushing energy and food inflation even higher. The prospect of higher interest rates raises the attractiveness of bonds, which reduces the PE multiples investors are willing to assign to stocks. This places outsized stress on stocks trading at lofty valuations, especially those that cannot clear the earnings growth hurdles analysts have forecasted.

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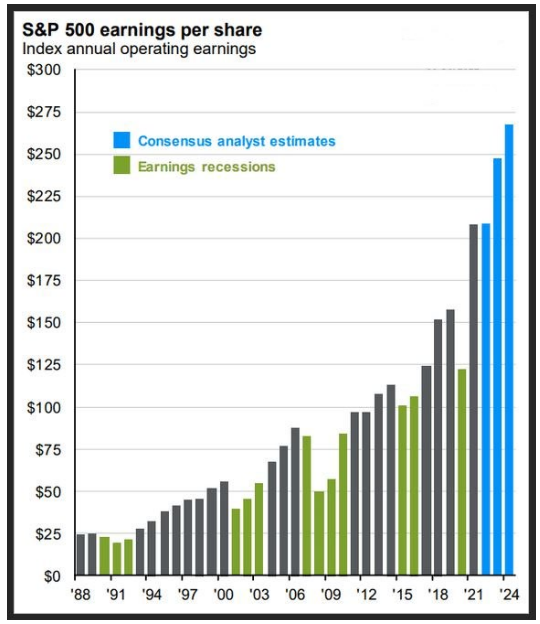

We believe the stock market has fully accounted for the competition being provided by higher interest rates. However, as we stated above, projections for future earnings growth may be too optimistic. We have seen recent examples when FedEx, Nike, and Carmax all slashed their profit forecasts citing a slowing global economy. In each of those instances, the stocks were punished with immediate double digit percent declines. It is naïve to believe those are the only companies experiencing hardship; therefore, we expect market volatility to remain high as we move through earnings season and the upcoming Fed meeting in early November.

We believe the recent decline presents some opportunities as overall indexes sit at oversold conditions. Several of the companies we follow now trade at valuations only seen in the depths of recession. This is most clear when looking at the difference in valuation between defensive and economically sensitive stocks. The current disparity indicates investors believe a Fed mistake and a soon coming recession is a certainty. We believe the Fed is right to raise interest rates quickly to address inflation; however, it appears the market is struggling to believe the higher rates can be left in-place for an extended period, especially given the recent financial turmoil in Europe. Historically, stocks have bottomed when the Fed pivots from tightening interest rates to holding steady or cutting. Any indication that the Fed will not need to raise rates as high as the dot plots forecast will be viewed as a dovish signal and result in a rally for stocks, especially among select cyclicals and technology. Therefore, we are using this sell-off to invest some of our excess cash. We continue to slowly trim our defensive holdings in consumer staples and utilities to boost select positions in industrials, financials, and real estate. We are also closely monitoring the energy sector as the pullback in oil prices have made select parts of the sector appear attractive as well.