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Market Review
Third Quarter 2022

The third quarter of 2022 was dispiriting, as stocks and sentiment shifted from one extreme to the other.

More specifically, a strong summer rally that began in mid-June and extended into August was wiped out by a sell-off in the second half of the period. During the span, the major stock indices plummeted in six out of seven weeks. The S&P 500 and Russell 2000 indices ended the quarter down 4.88% and 2.19%, respectively, relinquishing the summer hope and gains into a “bear market bounce”. The large- and small-cap benchmarks are now down 23.87% and 25.10% for the year; the decline marks the worst first nine months for the Russell 2000 Index on record.

There were two main drivers behind the optimism that pushed the summer advance. First, after increasing the federal funds rate by 75 basis points in July, Chairman Powell clumsily commented that the large rate hikes upfront meant smaller increases in the future, which investors latched onto as a “dovish pivot”. Then, declining commodity prices (finally) manifested in a benign July CPI report that registered 0% month-on-month growth. The combination lent support to the growing “peak inflation, peak Fed” narrative. It also turned a tentative bounce in the S&P 500 into a 17.41% advance from the June lows.

The problem, however, was that the Federal Reserve did not agree with the market’s conclusion.

While investors went bargain shopping, official after official cautioned that the celebration in the fight against inflation was premature. It wasn’t until the Federal Reserve communicated a new “raise and hold” strategy at its Jackson Hole Symposium that the hawkish message hit home. After a surprisingly hot August CPI report, the central bank increased the federal funds rate by another 75 basis points in September. The median policymaker projection is now for rates to end 2022 at 4.4%, up from 1.9% in March.

As policy became more restrictive, there were also more signs of flagging growth. While most interest rate sensitive indicators – like housing – had long rolled over, the deterioration extended into the manufacturing and retail economic data. There was also a spate of disappointing business updates from high-profile corporates in late September, including a huge increase in inventory at Nike as well as the first (negative) earnings preannouncement from FedEx in nine years.

The combination of intense policy and waning growth devastated sentiment. By the end of September, stock indices were testing June lows, the yield curve was massively inverted, and the dollar index was at a 20-year high. Furthermore, the more stocks fell, the more investors fretted that there was another shoe to drop – the consequence of too much tightening too fast. Sadly, the headlines from Ukraine also confounded as recent Russian military struggles have made their threats and tact much more dire.

While pessimism abounds, we thought there were several positive developments hidden in the wreckage. We were encouraged that the Federal Reserve seemed to find the right message for the markets with its “raise and hold” tact. It feels appropriate, which increases the central bank’s credibility, and enables businesses and investors to make informed decisions. It is also clear that policy is working. In the September ISM Manufacturing Survey, new orders contracted, prices paid normalized, delivery times accelerated, and hiring slowed. These trends are both indicative of lessening supply chain constraints, and are consistent with the central bank’s stated objective. Lastly, there continues to be a compelling investment case for small cap stocks, which have corrected more sharply than the large cap indices, and are trading at a 12.4x trailing price to earnings, excluding loss-making companies.

The bottom line is that it is never going to be a good year for stocks when policy authorities’ interest rate forecasts increase by over 3% in nine months. The good of the bad is that through this painful process, the Federal Reserve has reestablished control of the narrative. It is also unlikely that there will be as much (financial) confusion going forward, which is key to more stable markets. We believe that our profitability-focused, conservative growth process will help us to weather the lingering uncertainty while we strive to capitalize on attractive valuations to position for better days ahead.

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Sources: *FactSet, GICS Sector Classification, Furey Research Partners, U.S. Bureau of Labor Statistics, Federal Reserve Summary of Economic Projections, Steven DeSanctis*

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S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market, this world-renowned index includes 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. S&P 500 is part of a series of S&P U.S. indices that can be used as building blocks for portfolio construction.

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Index Definition Sources: *Standard & Poor's, FTSE Russell*

Investment Statistic Definition Sources: *Investopedia*