EASTBAY INVESTMENT SOLUTIONS

Quarterly Investment Commentary – Q3 2022

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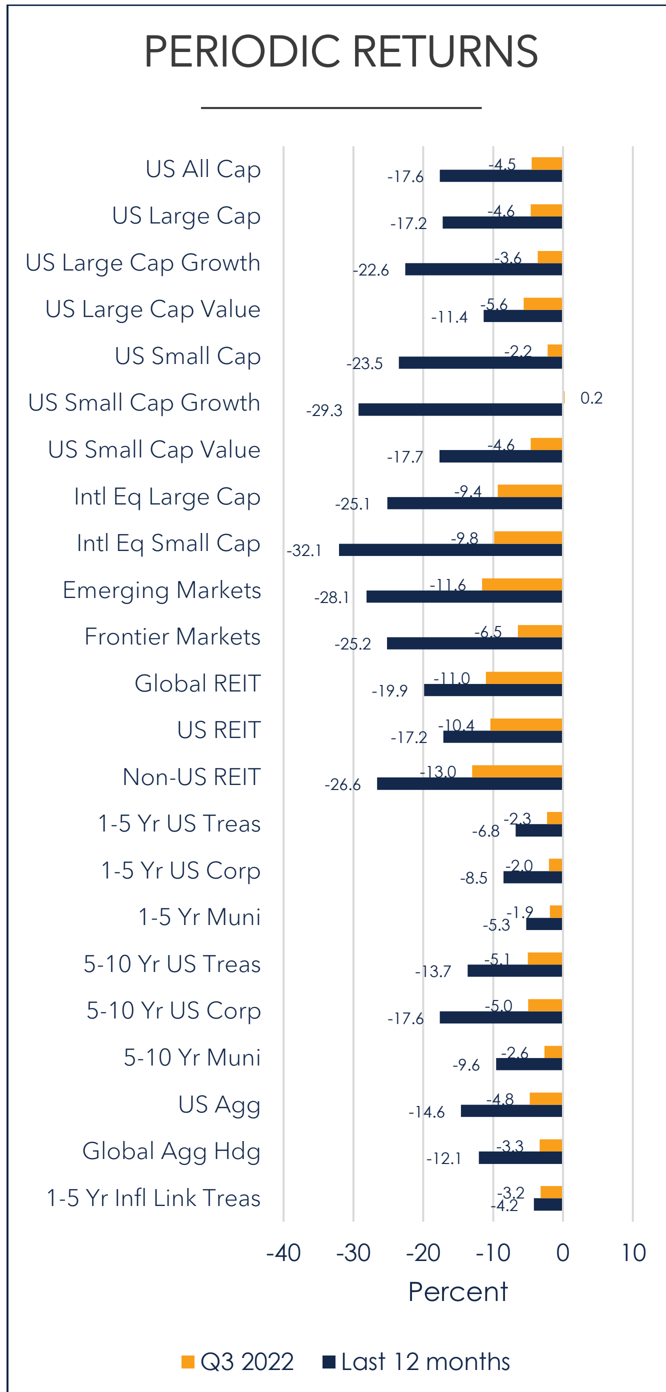


Source: Morningstar; Russell, MSCI, Dow Jones, Bloomberg, ICE BoA ML benchmarks shown; past performance is not indicative of future results

KEEPING A BALANCED APPROACH

Summary:

- **Global inflationary concerns persist**
- **US Dollar keeps climbing**
- **The bond market has experienced its worst run in history on a YTD basis**

Positive Signals:

- ✓ **Fixed income yields are the highest they have been in years**
- ✓ **CPI headline inflation in September (8.2%) has fallen since June highs (9.1%)**
- ✓ **Equity and fixed income valuations are much more attractive than they were at the start of the year**
- ✓ **A 3.5% unemployment rate is not consistent with economic downturns**

Reasons for concern:

- ? **There is no shortage of negative headlines including inflation that is still stubbornly too high, slowing economic growth, the war in Ukraine, energy challenges in Europe, or Covid-19 and continued lockdowns in China**
- ? **What if the Fed and other central banks raise rates too high and too fast?**
- ? **What does Russia do from here?**

Inflation running hot, but easing slightly

Inflation remains in the driver's seat as it runs hot across the globe. Forecasters were clearly wrong that the 8.5% headline inflation we saw in March was the peak, as we saw inflation increase to 9.1% in June. Fortunately, while inflation was still high in July (8.5%), August (8.3%), and September (8.2%) at least we saw it somewhat moderate.

As a result, the Fed has been busy "keeping at it", which is a phrase that honors past Fed Chair Paul Volcker whose memoir is titled "Keeping at it." After the last few Fed meetings, the remarks by Chairman Powell have been relatively short and direct. He has made mention to the reality that there might be "some pain" brought to households and businesses and that "these are the unfortunate costs of reducing inflation." The costs he refers to are the continued increases in the Fed Funds rate, which impacts borrowing costs. In September, the Fed raised rates by 75 bps for the third consecutive meeting, bringing rate increases to 300 bps since 2022 started. How high will rates go? How fast will they rise?

Exhibit 1

Source: Bloomberg, 9/21/2022

Exhibit 1 shows the Fed dot plot, which maps out policymakers' expectations for where interest rates could be headed in the future, with an emphasis on "could be." We emphasize the "could be" because we know the Fed has been wrong before. It wasn't too long ago that the Fed assumed inflationary pressures were temporary and didn't think there would be much, if any, rate increases this year. The dot plot serves as a guide for financial markets and is considered forward guidance, as investors don't like surprises, especially when they come from the central bank. As you can see, there is relative consensus for 2022 and 2023 with rates settling around 4.25-4.50%, which is still 100-125 bps higher than we are at today. Looking past that into 2024, some Fed policymakers believe the Fed Funds rate will remain above 4.5% while one believes it will drop down closer to 2.5%.

As a reminder, the Fed has a dual mandate. One part of the mandate is to maintain stable prices, which means the Fed really wants to bring inflation down to their preferred level. Their other mandate is full employment, and with an unemployment rate of 3.5% in September, that isn't their major concern. In the past we have referenced the Fed can only control so much and that they have no control over supply chain problems, Covid-19 lockdowns in China, or commodity prices. While that remains true, the other challenge for the Fed is that it takes time for these rate hikes to work their way through the economic system; these rate hikes will not have an immediate impact on inflation reduction. Does the Fed push forward and continue to raise rates or take a pause? Based on Chairman Powell's recent comments, it certainly seems we are in for more rate increases in the near term.

Are we in a recession?

If we turn our attention to GDP, which we know is related to inflation, we know that GDP decreased in both the first and second quarters of this year (Q3 GDP won't be released until October 27, 2022). We also know that the financial media often defines two consecutive quarters of declining GDP as a recession, which is why we saw a 52,000% increase year over year in "recession" searches in Wikipedia when the last GDP numbers were released (source: Goldman Sachs Global Investment Research, Wikipedia, Goldman Sachs Asset Management, data as of 9/30/2022). Even though the NBER, the official arbiter of recessions, uses a more complex definition to determine recessions, it is clear investors are concerned we are either in a recession today or moving into one soon, and that that the Fed will raise

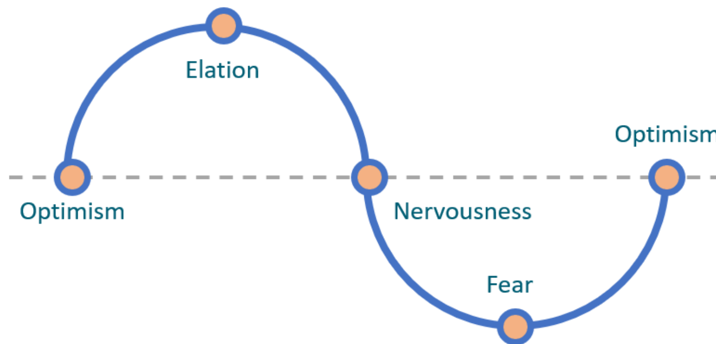
rates too high and/or too fast. As rates rise, borrowing becomes more expensive. In effect, by raising rates the Fed is trying to slow the economy, which in turn should reduce prices if demand slows. The problem is that if growth slows too much or even stalls, that can lead to a recession.

Frankly, though, the current environment lacks the typical imbalances we have seen in past recessions (e.g. fiscal, etc.). In particular, the current unemployment rate of 3.5% (September 2022) is historically low and is not consistent with economic downturns.

<u>Don't let emotions drive your investment strategy</u>

As we talk about recessions and read all the negative headlines, it is no wonder that many clients are in the "nervousness" or "fear" stages in the cycle of market emotions (Exhibit 2). But as we always tell investors, don't let emotions drive your investment strategy.

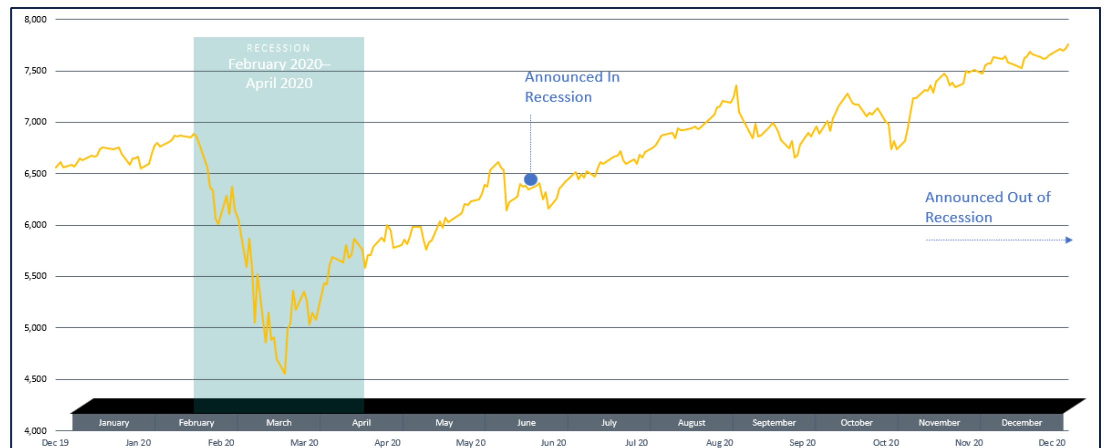
Exhibit 2



The idea behind investing is to buy low and sell high. Yet, by following an emotional investment cycle, reactive decisions may bring the opposite effect: buying at higher prices and selling at lower prices. It is also extremely difficult to accurately time the market on a consistent basis. We know that staying disciplined through rising and falling markets can be a challenge, but it increases the chances for long term success. And remember, all of the negative news we have discussed and know about is already priced into the market.

Another helpful reminder is that the markets and the economy are different. Exhibit 3 shows us this important concept. As the graph shows, there was an official recession from February 2020 – April 2020 (the blue bar). However, it was not announced by the NBER that we were actually in a recession until June 2020 (two months after the recession ended) and it wasn't officially announced the recession ended until July 2021. Just look at the returns you would have missed out on if you unsuccessfully tried to time the markets based on the economic headlines.

Exhibit 3



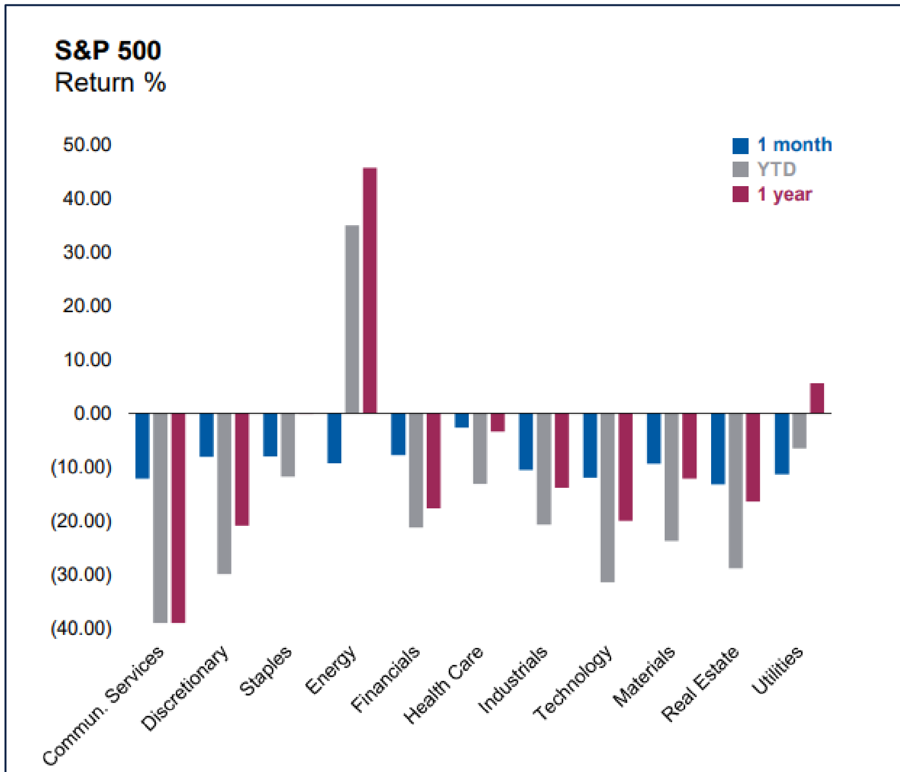
Source: S&P 500 Total Return daily index performance, January 2020-December 2020, Performance data represents past performance and does not predict future performance. Performance does not reflect the expenses associated with the management of an actual portfolio. S&P data © 2022 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. Indices not available for direct investment therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

<u>U.S. Equity</u>

Just like the two quarters before this in 2022, it was another poor showing for US equities. The quarter started out very strong in July as the S&P 500 returned 9.2% for the month. Unfortunately, that was followed by declines of -4.1% in August and -9.2% in September. For the quarter, small cap growth was the only US equity asset class with a positive return, eking out only +20 bps of return. Most US equity asset classes are in bear market territory, having fallen more than 20% with large cap core having fallen "only" -17.8%.

If you look more closely at the S&P (see Exhibit 4), the negative returns are fairly broad as the energy sector is the only one with positive returns on both a YTD basis and over the last 12 months.

Exhibit 4



Source: Eaton Vance Monthly Market Monitor, Morningstar as of 9/30/22. Data provided is for informational use only. Past performance is not a reliable indicator of future results.

Keeping with the S&P 500, it last reached a peak of 4,797 in January 2022 (S&P 500 was 3,586 as of September 30, 2022). What would returns look like in order to get back to the peak? Well, if we got back to the peak in one year, the S&P would need to return 35.7%. If it takes 5 years to get back to peak, the S&P 500 would need to return an annualized 7.9%. Would you be disappointed with a 7.9% S&P 500 return over the next five years?

Non-U.S. Equity

Similar to US equities and similar to the last two quarters, all of the international equity indexes we track had negative returns for the third quarter with international developed stocks (MSCI EAFE USD) falling -9.4% and international developed small cap stocks (MSCI EAFE Small Cap USD) dropping -9.8%. Similar to the last two quarters, at least some of non-U.S. equities' underperformance versus their U.S. counterparts can be attributed to the dollar's strength over the quarter, as we know a stronger dollar hurts international equity returns. To put some numbers behind it, if we looked at the MSCI EAFE in local currency, it returned -3.6% for the quarter, a difference of 580 bps from currency alone.

From a country perspective, no major developed country in the MSCI World All Country IMI index outperformed the US during the quarter. For reference, Japan declined -7.1%, France fell -9.3%, UK dropped -11.6% and Germany tumbled -13.2%. In the emerging markets, China remains the largest country exposure by far, at roughly one-third of the entire index. China had the second worst return of all countries within the MSCI World All Country IMI index, declining -22.6%. Source: Dimensional Fund Advisors, Country returns are the country component indices of the MSCI All Country World IMI index

Global REITs

Like global equities, global REITs, as represented by the Dow Jones Global Select REIT, declined by -12.4% over the quarter. U.S. REITs were slightly better (-12.2%) vs. non-US REITs (-13.0%) for the quarter.

Diving deeper into the YTD sector returns for the FTSE NAREIT US index (a REIT index that provides sector returns publicly), all of the sectors show negative returns with the specialty REIT sector performing the best (examples of specialty REITS may include movie theaters and casinos), declining -12.0%, while office REITS were the worst performing REIT sector, dropping -36.7%. Source: NAREIT

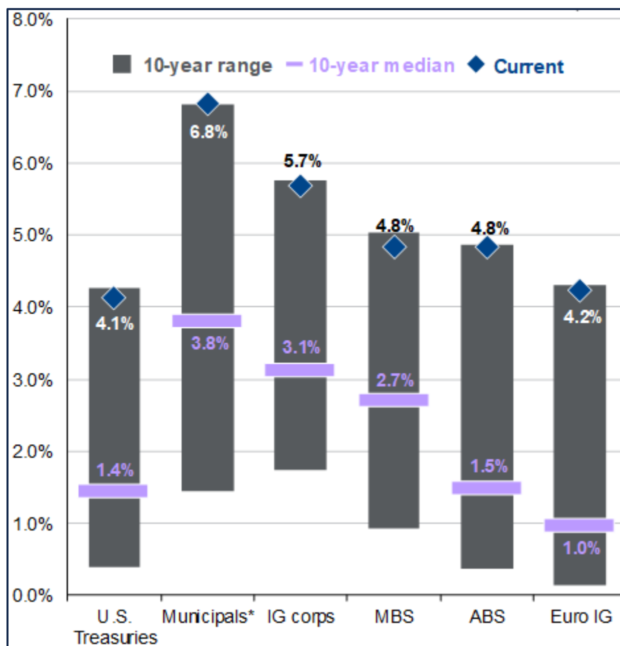
Global Fixed Income

As interest rates continued to push higher over the quarter, the fixed income indices we follow were all negative for the third quarter and are negative, too, for YTD and the last 12 months. Even the 1-5 Year Inflation Linked Treasury index turned negative for the last twelve months (it was positive last quarter). As a reminder, as bond yields increase, bond prices decrease. The sheer magnitude of the yield increases is the main driver behind the negative returns we are currently experiencing in fixed income.

Just how bad has fixed income been this year? Well, when we say 2022 has been a year like no other for fixed income investors, we really mean it. Specifically, through September 23, 2022, the losses for the Bloomberg US Aggregate index (-13.8%) are over four times more than the previous worst calendar year in percentage terms (1994: -2.5%).

But there is a bright side to all of this. Looking at Exhibit 5, the gray bars show the range of yields for various fixed income asset classes over the last 10 years with the purple line showing the median. The blue diamond shows the current yield to worst as of 9/30/22 and as you can see, it is on the top end of the range in every asset class. This is positive for a few reasons. For one, fixed income investors are finally able to earn some attractive yields. Plus, if we continue to see an increase in yields, there is more coupon income to offset any price depreciation. Also, we know that these yields are a good predictor of forward-looking fixed income returns, so this bodes well for the near-term future of fixed income.

Exhibit 5

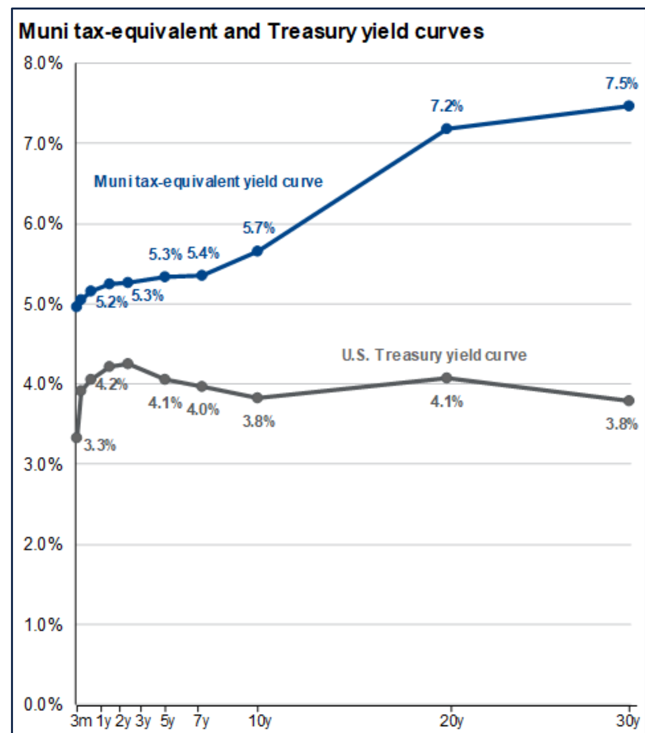


Source: Bloomberg, FactSet, JP Morgan Credit Research , JP Morgan Asset Management, Indices used are Bloomberg. Yield to worst is the lowest possible yield to worst assuming a top income tax bracket of 37% plus a Medicare tax rate of 3.8%. Data as of September 30, 2022

Similarly, we think having a non-US fixed income allocation can also help diversify away from solely having US interest rate risk and exposure. Yields outside the US are higher now too, and once you include the USD hedge, total returns for non-US fixed income look even more attractive.

Municipal bond performance was also negative for the quarter across the municipal yield curve. However, as Exhibit 6 shows, the municipal tax equivalent yield (the blue line) is quite attractive relative to US Treasuries (the gray line) across the entire yield curve and is not inverted like the US Treasury curve, which simply means you are being compensated more for taking on some duration risk.

Exhibit 6



Source: J.P. Morgan Asset Management, Bloomberg, FactSet, Federal Reserve. Municipal tax-equivalent yield assumes a top-income tax bracket rate of 37% plus a Medicare tax rate of 3.8% for a total tax rate of 40.8%. *Guide to the Markets – U.S.* Data are as of September 30, 2022.

We continue to view fixed income as a method of reducing overall portfolio risk (as measured by standard deviation), given that equities are expected to have much higher volatility. Our portfolio's focus will continue to be on high quality bonds with an emphasis on short to intermediate duration government and corporate bonds, where default risk has historically been relatively low.

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