MARKET REVIEW & OUTLOOK

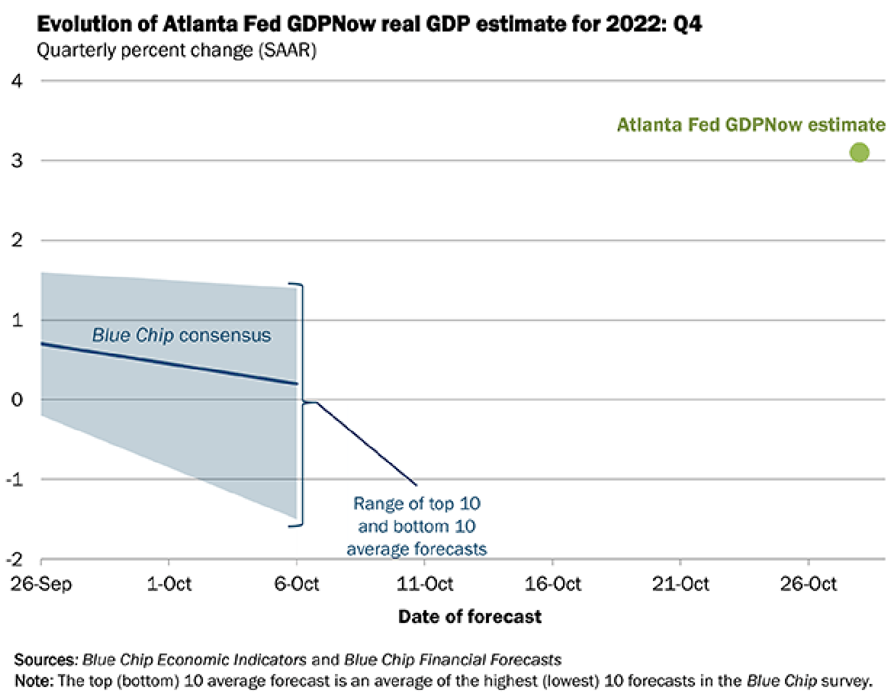
OCTOBER 2022

KEY TAKEAWAYS

- The relentless selling of September finally abated as we turned the calendar. In fact, the Dow Jones had its' biggest October rally ever!
- Interest rates continued moving higher, with a late month spike near 4.25% on the 10-year Treasury, but rates came down to finish closer to the middle of the range. The Fed is on deck Wednesday, with another interest rate decision.
- Oil still traded in a wide range but snuggled up with the $85 level as the month wore on.

The U.S. Economy

The first look at 3rd quarter was quite strong at 3.1%, though more fuel and weapons going to Europe and less imports from Russia accounted for 108% of the GDP growth. The first look at the 4th quarter estimate from the GDPNow estimate is a repeat of 3rd quarter at just over 3% while the Blue-Chip consensus is around +0%. So, does a "strong" GDP print keep the Fed continuing to increase interest rates?



Source: https://www.frbatlanta.org/cqer/research/gdpnow

Stocks and Bonds

Interest rates continued to head higher as economic data, remains resilient and inflationary data continues to reach new heights. The credit distress in the British Gilts backed off as the new PM quickly became the old PM and the PM candidate that lost was named the new PM, wow British politics are complicated. 😊 Anyhow, the market liked their second choice for PM and the British markets settled down. The Fed's concerns about inflation seem to be well founded as October's numbers again beat expectations. The markets are no longer clamoring for rate cuts, now they are just hoping for a pause in rate hikes. The Bank of Canada and the Reserve Bank of Australia both "flinched" and didn't raise rates as much as expected. Giving the U.S. markets hope that the Fed will soon "flinch" as well, Wednesday is the next Fed meeting. Expectations are firm that we see another 75bps hike and all ears will be listening for any clues that the December meeting won't be a repeat of November. The increase in yields continues to serve as a headwind, though not as strong as last month, for High Quality fixed income, which as measured by the iShares US Aggregate Bond ETF lost -1.30% for the month. The U.S. 10-year Treasury bond yield ended the month at 4.08% closing off the almost 4.25% high yields of the month, but still up meaningfully from September's close of 3.80%.

The Dow Jones Industrial Average soared +13.95%, the S&P 500 rallied +7.99%, and the small cap Russell 2000 jumped +10.94%. The international markets traded in a more muted to negative fashion relative to the U.S. The MSCI EAFE iShares Core International Developed Markets ETF Index gained +5.72%, and the MSCI Emerging Markets iShares Core ETF Index lost -3.59%.

October was very green and largely reversed September's losses.

The best performers were…

- Energy: +24.97%
- Industrials: +13.89%
- Financials: +11.92%

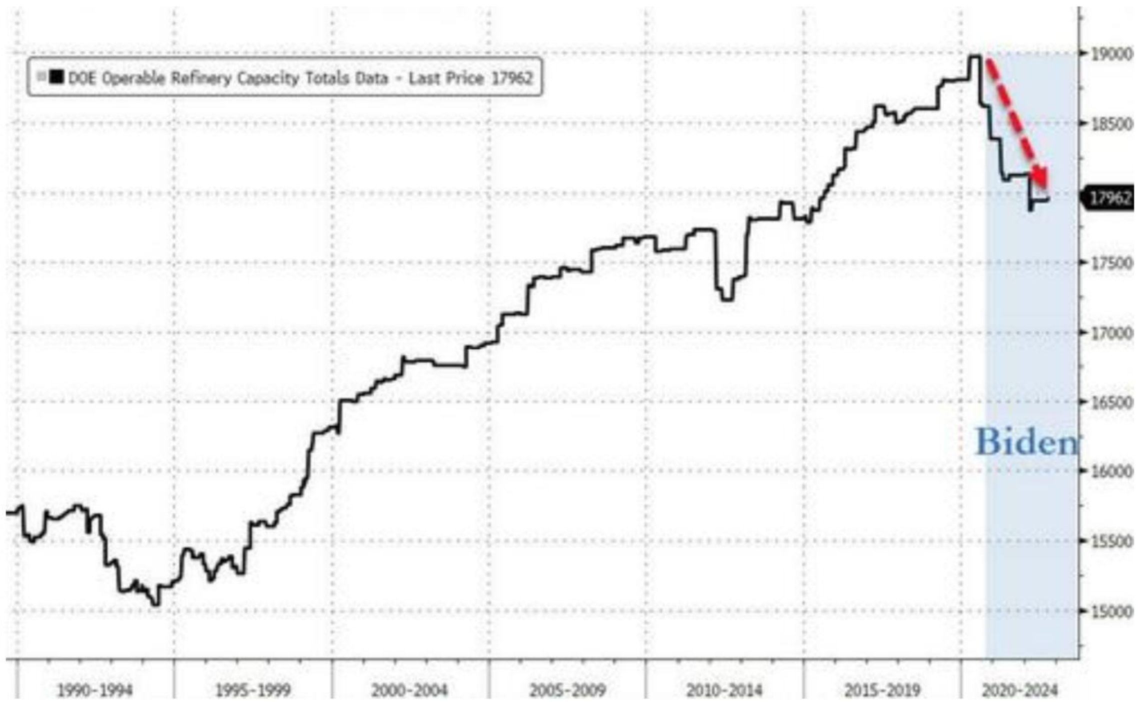
The worst performers were…

- Consumer Discretionary: -3.69%
- Communication Services: +0.67%
- Utilities: +1.94%

Source: https://www.sectorspdr.com/sectorspdr/tools/sector-tracker

Oil Report

The oil market rallied sharply to start the month as OPEC+ announced larger than expected supply cuts. The bulk of the rally held, but the rationale for the cuts was the expectation of a weaker economy, which took some of the bloom off the rose. There continues to be no progress in the Ukraine/Russia conflict and the U.S. continues to draw down the strategic oil reserve, but as the chart below shows, that may not be addressing the correct issue. The refining capacity in the U.S. is over 5% lower than the pre-Covid levels and goes a long way to explain high gas prices and near record low diesel reserves.



Source: https://www.zerohedge.com/energy/energy-execs-tell-granholm-shuttered-us-oil-refineries-wont-restart

The current NYMEX WTI Crude Oil futures settled at $86.53 and posted a gain of almost 9% from the prior month close of $79.74 a barrel. The strength in oil carried over to RBOB gasoline, which gained almost 7% vs September's close. As mentioned last month, though prices are significantly off June's high, prices seem to have bottomed, and are starting to move up again. Hurricane season seems to have come and gone quickly, sparing the oil and gas infrastructure in the Gulf of Mexico. Now we turn our attention back to the economic data.

The Rest of the Data

The September ISM Manufacturing Index decreased to 50.9 from August's reading of 52.8. Additionally, the ISM Services Index decreased modestly to 56.7 in September from August's print of 56.9. The prices paid component for Services dropped modestly, but prices remained at high and elevated levels. Any reading above 50 generally indicates improving conditions. Consumer confidence decreased to 102.5 in October, which compares to a downwardly revised figure of 107.8 in September. The unemployment rate dropped to 3.5%, and the economy added a solid 263,000 jobs in September, which again edged expectations of 255,000 jobs. The Consumer Price Index for All Urban Consumers (CPI-U) increased at

+0.4% in September, on a seasonally adjusted basis. Over the last 12 months, the All-Items Index eased modestly, now to +8.2% on a non-seasonally adjusted basis. The CPI ex Food and Energy, rose to 6.6% over the last year. The market keeps hoping to stuff the inflation genie back into the bottle, but the data continues to say not so fast. The above data still indicates the economy is generally on good footing, despite continued rhetoric to the contrary. The data is also why the Fed continues to argue for higher interest rates even though the equity markets keep trying to price in/hope for a "pivot". The markets have tried to test the meddle of the Fed's conviction, but so far, the data hasn't gotten really even weak, let alone bad. The equity markets are now rallying on the hopes of a Fed pause, at this point anything that isn't continual 75bps rate hikes seems will fit the bill. We will continue to monitor economic activity in concert with inflation reports and how that may impact Fed policy.

Summary

The equity markets staged a large rally in hopes that the Fed is nearing a point of "pause" in the vicious rate hiking we have seen the last several months. Interestingly, the Fed is concerned about Financial Conditions easing, which would help spur additional inflation. The large rally causes an easing of financial conditions, so the more the markets rally, the more the Fed is inclined to continue hiking interest rates. The tug of war between the equity markets and the Fed doesn't appear to be ending anytime soon. The Fixed Income markets continue to price in additional interest rate hikes and the longer end of the Treasury curve seems to be starting to get comfortable with the level of interest rates in relation to projected inflation and economic activity over a longer period. The Fed likely raises rates 75 bps Wednesday and barring anything dramatic probably does the same in December. Inflation and economic activity remain stubbornly high. At some point the rate hikes should curtail economic activity, but so far, we really aren't seeing it in the data. Perhaps another result of the distortions from the pandemic. For now, we will continue to stay the course.

As always, the markets can be emotional, so we retain our focus on what we can control, which is the amount of equity risk that is taken in a clients' portfolio in concert with the clients' risk tolerance and long-term goals. The markets will always face different "worries", today it is inflation/war vs. waning growth expectations, tomorrow it will be something else. We have built our asset allocation models with dynamic features and quarterly rebalancing, both in fixed income and equities. If the markets continue to decline, we will reallocate the overweight that occurs in Fixed Income back into equities. The decline in equity markets has triggered the rules-based defense mechanisms to reduce the risk of the portfolio via the dynamic investment vehicles that have been deployed. Additionally, the recent strategic asset allocation changes, have insulated some of the fixed income allocation from continued Fed rate hikes. Further, if the equity markets get too extended on the downside, some of the vehicles will reallocate some capital back into their respective equity exposures.

These dynamic tools have been engaged, a couple of times during the increase in volatility. At month end a portion of equity has shifted to Treasury Bills for U.S. Large and Mid Cap, as well as Developed International. The tactical allocation is currently allocated in Floating Rate Treasuries.

If you have specific questions about your portfolio or financial situation, we are here to help. Long-term financial planning is designed to deal with uncertainty like those we discussed above. Our portfolio management process is to design a prudent allocation across many asset classes. Equities are for long-term growth and several vehicles that we utilize offer defensive mechanisms to mitigate equity market declines.

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