OXFORD | HARRIMAN & COMPANY

Third Quarter 2022 Commentary

An Oxford Harriman & Company Market Commentary

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Third Quarter Recap

2022's stock and bond market volatility continued during the third quarter. Once again, the stock market's trend changed intra-quarter as investors reacted to economic data and speculation. The S&P 500 declined 4.9%, while the 2-year Treasury yield reached levels not seen since 2007.

Inflation & Fed Policy Continued to Dominate Headlines

Markets received fresh inflation data and updated Federal Reserve commentary during the third quarter. Data showed inflation pressures, as measured by the year-over-year (y/y) growth rate of the Consumer Price Index (CPI), eased for a second consecutive month during August. This decline occurred against a backdrop of falling energy prices, with AAA reporting the average price of a gallon of gasoline down 27% since peaking at $5.01 in early June. Markets reacted positively to the two consecutive monthly inflation declines, hoping June's 9% y/y inflation rate marked the peak.

Easing inflation pressures are a welcome development, but underlying data indicates inflation remains persistent across a broad range of categories. Unlike the headline CPI reading, the core CPI reading, which excludes the volatile food and energy categories, was higher during August at +6.3% y/y relative to June and July readings of +5.9% for each month. This divergence, with core CPI rising and headline CPI falling, grabbed the market's attention and gave further conviction to the Fed to continue its tightening efforts to prevent inflation from becoming entrenched.

Prior to the third quarter, the Fed had just raised interest rates 0.75% at their June meeting, bringing the year-to-date rate hike total to 1.5%. This was the first 0.75% increase since 1994. The Fed followed June's large interest rate increase with additional 0.75% increases at both the July and September meetings. The Fed also updated its Summary of Economic Projections at the September meeting for the first time since June. The Fed now projects the benchmark federal funds rate will end 2022 at 4.40%, which implies another 1.25% of interest rate increases by year-end. For comparison, in June the Fed's year-end projection was 3.40%.

A Recession Was Technically Confirmed

The path of the U.S. economy was uncertain entering the third quarter. Data showed the U.S. economy shrank 0.6% on an annualized basis during the second quarter. The negative reading followed the first quarter's 1.6% annualized decline and meets the technical definition of a recession, which is defined as two consecutive quarters of negative GDP growth. These data confirmed the U.S. economy is slowing after a period of robust growth during the pandemic recovery. As we mentioned in previous commentaries, the 2/10 yield curve inversion has been an accurate predictor of past recessions. As of this writing the 2/10 curve is inverted by more than 40 basis points. When this inversion surpassed 50 basis points in late September this represented the most inverted the curve has been since the early 1980's.

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While the prospect of slower growth and a longer recession are concerning, there are a few important points to remember. First, no two recessions are alike. We believe the current recession is even more unique due to the nature of the global pandemic, the impact of multiple rounds of fiscal and monetary stimulus, and inflation readings at a 40-year high. Second, it is still too early to determine the degree of the current slowdown or how long it will last. We will be monitoring labor market data, industrial activity, and housing data in the coming months to gain a better understanding of the U.S. economy's trajectory.

Upcoming Corporate Earnings Season

Corporate earnings were also an unknown entering the third quarter. Companies benefited from sharp demand increases during the pandemic recovery thanks to low interest rates and the reopening of the economy. Also, pricing power allowed companies to pass through their increased costs, which led to higher profit margins. S&P 500 earnings per share grew 6.3% y/y during the second quarter, a slowdown from the first quarter's 9.3% y/y growth rate. We are monitoring corporate earnings entering the fourth quarter to determine if companies can continue to grow earnings as higher interest rates slow economic activity, and employees demand higher wages.

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Third quarter earnings season won't officially kick off until mid-October, but companies are already providing updates. For example, one of the world's largest overnight delivery firms released a downbeat business update ahead of its September earnings release. The company disclosed its quarterly results were negatively impacted by soft global package volumes and the economic uncertainty prompted management to withdraw its previous fiscal year 2023 guidance.

Conversely, companies in other industries, such as packaged food, have reported strong demand even amidst higher food prices. This has led these companies to increase revenue and earnings guidance. Even some casino operators reported all-time records at their Las Vegas properties during the second quarter. There are obvious differences in the companies' end markets and cyclicality, but the guidance updates and management commentary are another conflicting signal for investors to digest.

Equity Market Recap – Yet Another Volatile Quarter

The third quarter was another volatile quarter in the equity market. Stocks dropped to new 2022 lows on the final day of the third quarter, due to a perceived deterioration in macroeconomic conditions. Global macro uncertainty increased between the Truss spending plan in the U.K., rising bond yields, and the annexation of Ukrainian territory by Russia. Earnings warnings also continued to increase. The Fed isn't getting any less hawkish as they have reiterated their commitment to hiking rates to combat inflation.

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The S&P 500 dropped by 4.9% during the third quarter, underperforming the Russell 2000 Index's -2.1% return. However, this decline hides the market's two extremes. The quarter started with the S&P 500 gaining approximately 14% through mid-August as expectations for a shorter tightening cycle and potential 2023 interest rate cut propelled stocks higher. However, this trend abruptly reversed, and the S&P 500 fell to a yearly low. The late third quarter sell-off was driven by an unwinding of investors' hopes for a shorter tightening cycle and 2023 interest rate cut. The August inflation report, which highlighted inflation's persistence, and updated Fed commentary brought to a halt the market's early quarter enthusiasm.

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After a challenging first half of 2022, Growth stocks started to find their footing during the third quarter. The Russell 1000 Growth Index traded down 3.5%, outperforming the Russell 1000 Value Index's 5.6% decline. Growth's outperformance may signal the start of a new investment regime. We believe that the first half 2022 sell-off was primarily driven by declining valuation multiples as interest rates moved higher. Growth's third quarter outperformance may suggest that investors are less concerned about the risk of lower valuation multiples and more concerned about slowing economic growth. Growth stocks are typically less cyclical in nature than Value stocks.

U.S. sector returns were varied with no clear performance trend during the third quarter. Despite soaring inflation and pressure on household budgets, Consumer Discretionary was the top performing S&P 500 sector. Energy was the only other sector to produce a positive return. The remaining sectors were mixed with no clear defensive or cyclical trend. Communication Services and Real Estate both traded down more than 11.0%. The middle of the pack sectors included three defensive sectors (Utilities, Health Care, and Consumer Staples), three cyclical sectors (Materials, Industrials, and Financials), and one Growth-style sector (Technology).

International markets underperformed the S&P 500 during the third quarter. The MSCI EAFE Index of developed market stocks declined 10.4% during the quarter, while the MSCI EM Index of emerging market stocks declined 13.0%. International markets faced a variety of headwinds during the quarter, including Europe's energy crisis and China's struggle to reopen and return to growth after its Covid-zero policy. In addition, a strong U.S. dollar, which produces currency translation losses when investments are translated back into USD, weighed on international stocks.

Bond Market Recap – Interest Rates Continue to Rise

Bonds continued to trade lower during the third quarter as Treasury yields rose to multi-decade highs in anticipation of a tighter Fed policy. The 2-year yield rose to the highest level since August 2007. To put this year's increase in bond yields into perspective, the 2-year yield was just 0.73% on 12/31/ and rose to over 4.2% during the third quarter. This dramatic move higher in Treasury yields is a result of the Fed's aggressive interest rate increases. Long-term bonds are experiencing their worst performance year on record because of the Fed's rate hikes. In fact, at one point this year, long-term bonds had lost more in percentage terms than the NASDAQ index.

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Fourth Quarter 2022 Outlook – Keeping an Eye on the Big Picture

As mentioned above, it's been a difficult year for both stock and bond returns. This year's sell-off is particularly challenging because bonds, which historically act as a portfolio hedge during times of market turmoil, have traded down with stocks. As a result, some balanced portfolios have experienced their worst quarterly returns since the 1970's.

During volatile market environments, it is helpful to take a step back and look at the bigger picture. We researched cumulative GDP growth during each economic expansion and recession period since 1950. The average recession lasted 13.3 months with a -2.3% cumulative U.S. GDP contraction. In contrast, the average expansion period lasted 57.2 months with a cumulative +21.5% U.S. GDP growth. While recessions are painful, the data show the subsequent expansion periods are meaningful.

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Volatility is the price of admission to investing in economic progress, technological innovation, increased productivity, and earnings growth. Markets experience both good times and bad, and the bad times can test even the most patient investor. It's easy to sell and go to cash to relieve near-term anxiety about your portfolio, but this often creates a bigger issue – when do you re-enter the market? And what happens when you miss the bottom, and you are holding cash as the market recovers and another economic expansion cycle begins? Refocusing on your long-term time horizon should help you realize the odds of obtaining your financial goals are likely much higher if you allow the economy (and the market) to expand despite the inevitable contractions, rather than attempt to time such inflection points.

As we consider the fourth quarter and beyond, we believe any sustained stock market rally will require better clarity on U.S. monetary policy and a more certain timeline towards an end to the Fed tightening. Greater visibility on the health of the U.S consumer along with a stable, or improving, geopolitical outlook will also help. A more moderate U.S. dollar, which has been a drag on earnings for domestic corporations, will also buffer equity prices.

We remain committed to monitoring the factors driving the markets, communicating our thoughts, and explaining how they impact your financial situation. We thank you for your continued trust.

Sincerely,

Dennis Barba
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Michael P. Finkelstein, CFA
Partner