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***Q3 2022 Market Memo: The Hangover***

**Economic Update**

In our last update, we declared that the decade-long party of low rates and quantitative easing was officially over. Spooked by inflation that proved to be anything but transitory, the Federal Reserve began raising interest rates in March and began reducing its balance sheet in earnest in the late summer. Following the Fed's lead, global central banks have scrambled to keep up the pace despite facing significant economic and geopolitical challenges, tightening global financial conditions dramatically and slowing growth with a lagged effect. The bar is closed and the hangover is just beginning.

The biggest economic headache so far has been uncertainty. The impacts of exceptionally hawkish monetary policy combined with a sharp reduction in fiscal stimulus are still mostly unknown. There's no question there will be unintended consequences given the pace of tightening and our complex and interconnected financial system, but we still don't know what they will be, when they will appear, and how policy makers will respond. It can take months for the effect of higher rates to filter through the economy, although some cracks have started to appear.

The most concerning outcome thus far has been the strength of the US dollar relative to nearly every other global currency. Through 9/30, the DXY dollar index (which tracks the value of the dollar against a basket of major currencies) has risen over 17% year-to-date and gained over 6% in the third quarter alone[i]. The resulting weakness in the yen forced the Bank of Japan to intervene in their currency markets for the first time since 1998[ii]. The situation in the UK has been even more dramatic. In late September, following the Fed's decision to hike rates by 75 basis points and the release of a mini budget in the UK deemed to be inflationary, the pound dropped over 5% against the dollar in just a few days, sparking a liquidity crisis in the UK bond market. The Bank of England has stabilized the situation for now by purchasing gilts, but it is a solution that risks worsening the problem in the long run.[iii]

Why is the dollar so strong? Because the dollar is the world's global reserve currency, other countries need dollars for reserves to stabilize their own currencies, participate in global trade, and pay their USD-denominated debt. Among global central banks, the Fed was the first mover in tightening and has had the luxury of fighting inflation more aggressively since the US is more insulated from the geopolitical challenges and energy crisis faced by Europe. This has had the effect of removing more dollars from the system than other currencies, making the dollar more scarce and therefore more valuable for those who have no choice but to buy dollars. It is akin to a slow squeeze that looks likely to continue until the Fed changes course.

Why is a strong dollar a bad thing? After all, a strong dollar should help us fight inflation by reducing the cost of imports. Unfortunately, the benefits of cheaper imports are outweighed by the costs. The US economy is part of the global economy and can't be viewed in isolation. As exports become more expensive, they make American businesses less competitive globally. Slowdowns in the economies of our major trading partners caused by currency weakness and responses to it will have ripple effects that slow growth globally. In a worst-case scenario, a dollar that is too strong could trigger debt crises in both emerging and developed markets.

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For now, the Fed has not signaled that they will back off tightening in response to the strong dollar. But, like the drunk at the bar begging for "just one more" after last call, hope springs eternal. Equities sharply rallied over the summer on the narrative of a Fed pivot and then sold off in September when the pivot failed to materialize. We still don't see any evidence in the labor market or inflation data to support a change in the Fed's trajectory. Job openings fell slightly in September but there are still 1.7 jobs for every jobseeker and the unemployment rate fell to 3.5%, the lowest level since 1968[iv]. We think they will keep tightening until something breaks and they are forced to switch gears and support market functioning.

We are not at the "something breaks" point yet, but we are getting closer, and it is not just the dollar we need to worry about. Mortgage rates continued their relentless move upward and ended the quarter at 6.9%.[v] Housing prices have not dropped by nearly enough to offset higher rates, pushing affordability to extremely low levels. Office vacancies are high and rising as workers are rejecting demands to return to the office and companies look to pare costs ahead of a slowdown, which has the potential to ripple through the Commercial Mortgage-Backed Security (CMBS) market. The financial services sector is beginning to look vulnerable. Credit Default Swap (CDS) spreads on Credit Suisse, which measure the cost to insure their bonds against default, spiked in late September to levels worse than 2008.[vi] CDS spreads also widened for other European and even US banks, implying rising default risk at many global strategically important financial institutions.

Any of the above could be the catalyst for the Fed to pause or pivot, even against the backdrop of a strong labor market and high inflation, bringing back a risk-on environment. Before that happens, though, we would expect to see even more pain in markets. Our portfolios will remain positioned defensively until it becomes clear that the Fed cannot continue.

## Market Update

Stock and bond market performance in Q3 continued to be challenging for investors, driven by the effects of decades-high inflation, aggressive central bank interest rate hikes, and the rising risk of recession. The inflation outlook remains very uncertain due to Russia's continued war in Ukraine, strict Chinese Covid policies, and a still very robust US labor market. All eyes remained on the Fed this quarter as it continued its quantitative tightening measures (QT) by reducing its balance sheet and raising interest rates. The two components of QT are now in full effect with $60 billion worth of Treasury bonds and $35 billion worth of MBS rolling of its balance sheet each month and an increase of the federal funds rate by a total of 3% so far this year with signaling for continued hikes. Meanwhile recession fears have increased. Evercore ISI surveyed a swath of institutional investor on Oct. 3rd and 100% of respondents expects the U.S. will fall into a recession, 89% seeing it in 2023 and 11% in 2022.

Most asset classes across fixed income and equity are down double-digits this year, except for a few bright spots. Every S&P sector except energy (which was up 31% through 9/30) is deeply in the red year-to-date.[vii] US stocks have fared better due to a relatively better economic backdrop than the rest of the world, allowing the Fed to combat inflation and hike interest rates more aggressively without putting undue pressure on the economy. US equities also benefitted from dollar strength despite the future potential impact on corporate earnings.

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| Name | QTD | YTD |
|---|---|---|
| MSCI ACWI NR USD | -6.82 | -25.63 |
| S&P 500 TR USD | -4.88 | -23.87 |
| Russell 1000 Value TR USD | -5.62 | -17.75 |
| Russell 1000 Growth TR USD | -3.60 | -30.66 |
| Russell Mid Cap Growth TR USD | -0.65 | -31.45 |
| Russell Mid Cap Value TR USD | -4.93 | -20.36 |
| Russell 2000 Growth TR USD | 0.24 | -29.28 |
| Russell 2000 Value TR USD | -4.61 | -21.12 |
| MSCI US REIT Diversified NR USD | -9.44 | -21.72 |
| MSCI EAFE NR USD | -9.36 | -27.09 |
| MSCI EM NR USD | -11.57 | -27.16 |
| MSCI China NR USD | -22.50 | -31.23 |
| Morningstar Turkey NR USD | 17.73 | 23.06 |
| Morningstar Brazil NR USD | 8.38 | 8.96 |
| Morningstar India NR USD | 7.53 | -9.69 |
| Bloomberg US Agg Bond TR USD | -4.75 | -14.61 |
| Bloomberg US Credit TR USD | -4.95 | -18.07 |
| Bloomberg US Government TR USD | -4.30 | -12.95 |
| Bloomberg Municipal TR USD | -3.46 | -12.13 |
| Invesco DB US Dollar Bullish | 7.88 | 17.66 |
| S&P GSCI Wheat TR USD | 2.63 | 14.90 |

- Global Indices
- US Indices
- International Indices
- Fixed Income Indices
- Misc. indices

Source: Morningstar Direct as of 9/30/2022

The MSCI EAFE Index, which tracks international developed markets, has lost 27.09% year-to-date, lagging the S&P 500, which was down 23.87%.[viii] Energy and food inflation continues to hit hardest outside of the US with countries like Turkey and Argentina experiencing roughly 80% inflation. The average inflation across the EU is currently about 10% and is expected to reach 14% by year end due to Europe's reliance on imported goods, energy, and food.[ix] Comparatively the US is supposed to have already hit peak headline inflation of 9.1% in July[x].

At the start of the year the key policy rates of the ECB and the Bank of England were at -0.50% and +0.25% respectively. Today they have risen to 0.75% and 2.25% respectively and they are both set to move higher in the months ahead even if the region slumps into recession. Developed Europe will bear the brunt of the economic and market volatility from the Russia-Ukraine War, especially as we enter the winter months and energy demand increases. The strong dollar has undermined international equities for US investors and will continue to make international investing for dollar investors difficult. European manufacturing and services PMI readings have also been in decline leading to a slump in consumer confidence and spending. Adding to the instability, the UK government's plan to cut taxes was received negatively by market participants worried about the U.K.'s ability to take on such high levels of new debt, leading to spiking government bond yields and a sinking currency.

The MSCI Emerging Markets has performed the worst this year, losing 27.16% on a total return basis.[xi] A majority of the underperformance can be attributed to China where growth has been slow due to the knock-on effects of the

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Ukraine war, last year's reforms, attempts to rein in a housing bubble, and an aggressive zero-Covid policy. Unlike most other central banks, the People's Bank of China (PBOC) has cut rates and remained accommodative. A few EM countries bucked the negative trend with Turkey, Brazil, and India returning 17.7%, 8.4%, and 7.5% respectively due to interest rate cuts and increasing commodity prices.

Economically sensitive market segments, particularly value stocks and REITs, were among those with the biggest losses. This has been a reversal of trend from the rest of the year where growth companies were under siege from rising rates and stunted growth, but it appears that investors have lost faith that the Fed can engineer a soft landing and have shifted to a more recession friendly investment approach. Energy and Consumer Discretionary were the only sectors with positive performance in the third quarter, driven by strong earnings.[xii]

Against this backdrop, most types of bonds posted steep losses and longer duration assets, which are typically a hedge against equity declines, have suffered as rates rose. Among Morningstar's fixed-income indexes, core bonds, global Treasuries, and long-term U.S. Treasuries all saw their worst market performance this year since the start of performance history in 1999. The only silver lining in fixed income has been higher yields with the 10-Yr US Treasury yielding 3.83% and the 2-Yr US Treasury yielding 4.23%.

From here our outlooks hinges heavily on the pace at which inflation begins to abate and how closely the Fed follows through with its QT plans. "Don't Fight the Fed" is often the sole basis for investors to chase bull markets when the Fed employs easy monetary policy. Unfortunately, some investors forget the phrase is equally meaningful when the Fed is not friendly to markets. We are currently underweight equities and overweight short duration fixed income and cash, a positioning we have been working into since last summer as our outlook turned bearish. We continue to like water, infrastructure, short-dated US treasuries, and cash. We are currently wary of international equities, China, and low-quality long duration assets. On the other side of this bear market (which could be a while), we will be looking for opportunities to reposition into areas of the market that may provide more upside potential and/or downside protection. Small and mid-cap equities, which have underperformed large caps for years in both rallies and selloffs, are one such area. The US dollar is also well above its long-term fair value, hitting parity with the Euro for the first time ever in July. Any reversion to the mean would be a tailwind for international equities.

**Climate and ESG Update**

As we speed towards the end of this year, and in a sea of otherwise dreary economic and market realities, the GAM team can't help but get excited about the future of the sustainable investment space. It is our belief, based on the direction of asset flows, new research being published, and recent bold legislative victories, that the capital markets are on the precipice of an increase in the impact of corporate environmental, social and governance (ESG) performance on security prices. There has always been a material link from sustainability factors to performance, but we see that correlation increasing. The sustainable market infrastructure that has been built up over the past several decades is having a real impact on transparency and capital flows today. Below are some examples of this market infrastructure:

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*ESG Data Disclosure*

Carbon emissions, human rights violations, climate change, diversity and product liability are just a few of the adverse external impact's companies can have on the world. Market infrastructure is necessary to create transparency into these issues and provide sufficient detail to be able to use the information in investment decisions. Markets are in the final stage of development of a regulatory framework across markets in the US, EU and UK that will increase the amount and quality of information about externalities related to carbon and methane emissions. Government regulations that require companies to disclose their performance on material environmental factors related to climate change will allow investors to better quantify and price these externalities, which is the market mechanism that sends signals to innovators and entrepreneurs about opportunities to develop new products and strategies. This global coalescing of frameworks and disclosure mandates has been a long coming and is a vital step in realizing the success of sustainable investing.

*Capital Deployment Mechanisms*

A big part of the legislative victories of the EU Green Deal, Bipartisan Infrastructure Plan, and the Inflation Reduction Act are their ability to deploy capital into nascent industries and technologies. For instance, The IRA created a new $5.8 billion Advanced Industrial Facilities Deployment Program under the Department of Energy's Office of Clean Energy Demonstrations to invest in projects aimed at reducing greenhouse gas emissions from energy-intensive industries. The IRA also grants $3 billion to the Environmental Protection Agency to award rebates and grants to port authorities, other local governing bodies and private entities to acquire green equipment and develop climate action plans. All together the IRA alone is set to inject $800 billion in federal spending to incentivize investment into solutions over its lifetime. We have already seen the development of new industries (renewable energy, electric vehicles, etc.) and companies prior to this infrastructure and government action. We now expect to see an increase in capital formation and a real acceleration in real-world solutions.

*Product Proliferation*

There are thousands of asset management products and funds that use this transparent ESG data and benefit from the newly established capital deployment mechanisms. Many new entrants are doing excellent work and pushing the mainstream in the process. Institutional investors and retail investors indicate that they plan to invest more heavily into responsible and ESG strategies. As this market expands, we are seeing waves of product innovation in our industry already, and we are just getting started.

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[i] Source: Bloomberg, DXY Index
[ii] https://www.reuters.com/markets/asia/boj-keep-ultra-low-rates-remain-global-outlier-despite-weak-yen-2022-09-21/
[iii] https://www.theguardian.com/business/2022/oct/11/bank-of-england-bond-buying-pension-funds-kwasi-kwarteng
[iv] Source: Bloomberg, JOLTS Survey, September 2022
[v] Source: Bloomberg, Bankrate 30 Year Mortgage Rate
[vi] Source: Bloomberg, Credit Suisse 1Y and 5Y CDS
[vii] Source: Bloomberg, S&P Economic Sectors YTD Performance
[viii] Source: Bloomberg, Total Return, as of September 30, 2022
[ix] https://www.centralbanking.com/central-banks/monetary-policy/monetary-policy-decisions/7951706/boe-accelerates-tightening-as-inflation-expected-to-hit-13
[x] Source: Bloomberg, CPI Year-Over-Year
[xi] Source: Bloomberg, Total Return, as of September 30, 2022
[xii] Source: Bloomberg, S&P Economic Sectors YTD Performance