FINANCIAL PARTNERS

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QUARTERLY MARKET INSIGHT
3RD QUARTER 2022

SPOTLIGHT

MIDTERM ELECTIONS

With the U.S. midterm congressional elections fast approaching and control of Congress up for grabs, investors will likely begin paying closer attention to polls and financial media coverage attempting to link the election results with stock prices, bond yields, commodity prices, etc. Most analysts expect Democrats to lose control of slim majorities in one or both chambers of Congress. The party of the sitting president tends to lose congressional seats in midterm elections. This is especially true when the president suffers from a low approval rating, as is currently the case with President Biden. Over the past 22 midterm elections, the president's party has lost an average of 28 seats in the House of Representatives and four in the Senate. Only twice has the president's party gained seats in both chambers. Most recently, this occurred in 2018 when Democrats flipped 41 House seats to take control of the lower chamber of Congress heading into the third year of the Trump administration. In 2010, Republicans won back 63 House seats in the middle of President Obama's first term, marking the largest net gain for one party since the 1948 elections. A divided government in which the GOP takes back control of at least one chamber of Congress would almost certainly mean a two-year period of policy gridlock. Financial markets tend to favor the type of certainty gridlock produces due to a lack of new policies. Yet, midterm election results tend to quickly shrink in terms of market relevance compared to trends in economic data, monetary policy, and corporate earnings.

LAY OF THE LAND

Most polls suggest the Republicans will take back the House of Representatives and have close to even odds to win a narrow Senate majority. The Cook Political Report (CPR), a non-partisan newsletter, projects the GOP will regain control of the House, but not by as wide of a margin as many analysts predicted earlier this year. According to the CPR, there are 30 toss-up House races with Democrats defending 20 and Republicans 10. In the Senate, there are four toss-up seats, with Democrats defending two (Georgia, Nevada), Republicans defending one (Wisconsin), and a battle for Pennsylvania's open seat following Republican Senator Pat Toomey's retirement. Data from recent polling aggregators, including FiveThirtyEight, suggests the Democrats have a slightly better-than-average chance of holding on to the Senate either 50-50, or perhaps 51-49. A split Congress or Republican control of both chambers of Congress would likely be moderately market-friendly, as it would probably set the stage for policy gridlock over the next two years. Potential areas for bipartisan compromise are probably limited to a narrow set of items including cybersecurity and China policy. Although unlikely, the midterm outcome with the most potential to move markets over a short-term period would be Democrats' unexpected retention or expansion of their House majority, and an increase in their Senate seats. This could mean that centrist Democratic senators would be less able to dilute or block some of the more expansive legislation and spending championed by some of their party's most high-profile progressive members.

MARKETS IN MIDTERM YEARS

The general equity market pattern in midterm election years is weaker-than-average returns in the first three quarters of the year followed by volatile, but typically strong, fourth quarter returns. Since 1950, the S&P 500's median return in the first three quarters of midterm election years is 0.9% compared to 9.6% for all other years. Over the same period, the S&P 500's median fourth quarter return in midterm election years is 7.6% compared to 4.5% for all other years. This relationship does not change meaningfully based on the party in power or the composition of the government following the midterm election. According to analysis by Capital Group, since 1950, the average twelve-month return following a midterm election was 15%. That is more than double the return of all other non-midterm years during a similar period. This dynamic partly reflects markets' general preference for policy clarity (especially clarity on forthcoming gridlock) as opposed to uncertainty. So far, 2022 has been another example of a midterm election year with weak equity market returns. Of course, the impact of national politics this year has been overshadowed by inflation, rising interest rates, and the war in Ukraine.

CONCLUSION

As is typically the case for parties not in control of the presidency, Republicans are likely to win back one or both chambers of Congress in the 2022 midterm elections. This will almost certainly set the stage for a two-year policy stalemate as Democrats are unlikely to convince enough moderate Republicans to join their side to pass bills, and President Biden's veto will counter most Republican-sponsored legislation. Stock markets tend to perform better once the midterm elections are over irrespective of the party that wins ground. This suggests that midterm elections are mostly a noisy sideshow for what really matters for the trajectory of financial markets: monetary policy, economic fundamentals, and corporate profit trends.

THE FED'S TOUGH JOB

The Federal Reserve is attempting to achieve a “soft landing” for the domestic economy as policymakers aggressively hike rates in an attempt to quell inflation without causing a recession. According to the median forecast of the Federal Open Market Committee’s (FOMC) September Summary of Economic Projections, the unemployment rate is projected to increase 0.9% to a 4.4% rate by the end of 2023. FOMC participants expect the U.S. economy will achieve a lackluster economic growth rate of 1.2% for all of 2023. One potential problem with these forecasts lies in the non-linear nature of trends in the unemployment rate, as it tends to barely move or shift sharply in either direction. In a 2019 paper for the Brookings Institute, economist Claudia Sahm observed that every instance where the 3-month average unemployment rate increased by 0.5% above the rolling 12-month low, the U.S. economy entered a recession (see Chart 1).

History suggests that a 0.6% rise in the unemployment rate will likely be followed by another 2.0% increase or more. This phenomenon tends to be driven by a self-reinforcing cycle in which consumers pare back discretionary purchases, and companies trim staff to protect profits. The loop typically continues until consumers feel they have built a sufficient cushion of precautionary savings to increase spending. Of course, this time could be different given the substantial savings most Americans, outside of the lowest income cohorts, built up from March 2020 through April 2021.

At the Jackson Hole Symposium meeting in late August, Fed Chairman Jerome Powell delivered unambiguously hawkish comments that disappointed many market participants. Powell and his FOMC colleagues stood by those comments at their September 20-21 meeting, where the committee voted to implement a third consecutive 0.75% rate increase, taking the federal funds rate to a range of 3.00% to 3.25%. Policymakers' message is increasingly that they are committed to bringing inflation back down to the FOMC's 2% target, even if economic growth is sacrificed. They still have plenty of work to do considering August consumer price index (CPI) data came in hotter than expected at a year-over-year rate of 8.3%. Core CPI, which excludes food and energy, accelerated to a rate of 6.3% over the same period. Finally, the Fed’s

ECONOMIC INDICATORS	LATEST	3MO PRIOR	CHANGE*
REAL GDP (QoQ ANNUALIZED)	-0.6%	-1.6%	▲
TRADE BALANCE	-67.4	-85.9	▲
UNEMPLOYMENT RATE	3.5%	3.6%	▲
NON-FARM PAYROLLS	263K	293K	▼
ISM MANUFACTURING	50.9	53.0	▼
ISM NON-MANUFACTURING	56.7	55.3	▲
RETAIL SALES (LESS AUTOS)	0.3%	0.9%	▼
INDUSTRIAL PRODUCTION	-0.2%	-0.1%	▼
HOUSING STARTS	1575M	1562M	▲
CONSUMER PRICE INDEX (YoY)	8.2%	9.1%	▲
CONSUMER CONFIDENCE	108.0	98.4	▲
EXISTING HOME SALES	4.8M	5.41M	▼
CONSUMER CREDIT	32.24B	26.93B	▲
CRUDE OIL PRICE	$ 79.49	$105.76	▲

Source: Bloomberg. Data as of 9/30/22. Past performance does not guarantee future results. *The change arrow is indicative of a positive or negative change in the economic nature of the data series. For example, a downward-pointing change arrow assigned to the crude oil price field will correspond with an increase in the actual price of crude oil over the last three months. This is because a short-term increase in the price of crude oil has historically been detrimental to aggregate U.S. consumer spending.

preferred inflation measure, the core personal consumption expenditures (PCE) index, was up 4.9% over the previous twelve months.

The U.S. economy is expected to grow at an annualized rate of 1.4% in the third quarter according to a recent Bloomberg survey of 60 economic forecasters. This follows contractions of 1.6% and 0.6% in the first two quarters of the year driven by weaker exports and a large drawdown in inventories. Although the negative effect of bloated inventories is likely to reverse in coming quarters, wavering consumer spending in the face of generationally high inflation is likely to constrain U.S. GDP growth for the foreseeable future.

EMPLOYMENT AND MANUFACTURING

U.S. labor market growth slowed from August with September's nonfarm payrolls increasing by 263,000 versus 315,000 in August. The September gain was the lowest monthly increase since April 2021. The unemployment rate declined to 3.5% in September from 3.7% in August. The U.S. labor force participation rate (the share of the U.S. population that is working or looking for work) stands at 62.3% in September but remains 1.1% below its pre-pandemic high of 63.4%. Average hourly wages climbed 0.3% in September from August and have risen 5.0% from a year ago.

Economic activity in the manufacturing sector continued to decelerate and grew at a slower rate in September, from August, according to the Institute for Supply Management (ISM). The latest ISM Manufacturing Purchasing Managers' Index (PMI) slipped to 50.9% in September from a 52.8% reading in August. Although this was the lowest reading since May 2020, the index posted its 28th consecutive month of expansion. A PMI reading above 50% indicates the manufacturing economy is expanding. Manufacturing activity has slowed as companies adjust to the increased uncertainty of near-term demand amid the Fed's interest rate increases.

HOUSING

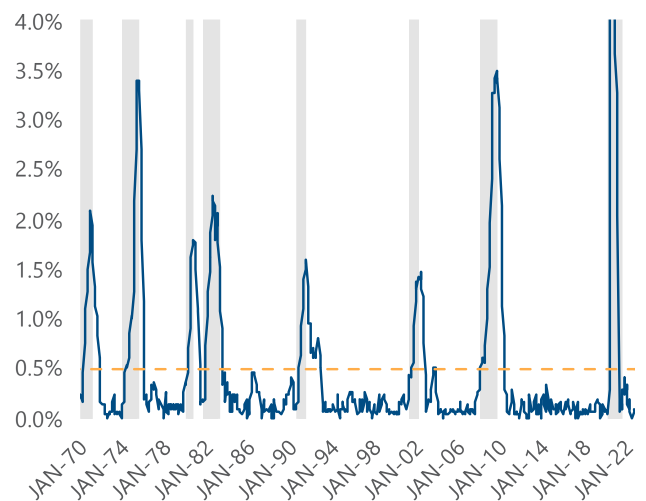
Higher mortgage rates and low inventory levels led to a seventh consecutive monthly decline in existing home sales in August. Existing home sales fell 0.4% from July and were down 19.9% year over year. The median price for existing homes sold last month was $389,500, down 5.9% from June's record high of $413,900 but still up 7.7% from a year ago.

The S&P CoreLogic Case-Shiller Home Price Index showed that home price growth in the U.S. slowed for a third consecutive month in July with a decline of 0.8% from June, the first monthly decline since 2019. The housing component of inflation tends to lag home price growth by a little more than a year. This historical relationship suggests housing inflation might rise further in the coming months before slowing sometime next year. Housing accounts for around a third of most inflation indexes so it is a critical component for overall inflation.

CHART 1

SOFT LANDING IS NO SMALL TASK

U.S. UNEMPLOYMENT RATE: 3M AVG LESS PRIOR 12M LOW



Source: Bloomberg. Data as of 9/30/22. Past performance does not guarantee future results. Grey bars indicate recessions. April 2020 through October 2020 is truncated at 4% for scaling purposes.

EQUITY

SUMMER RALLY FADES

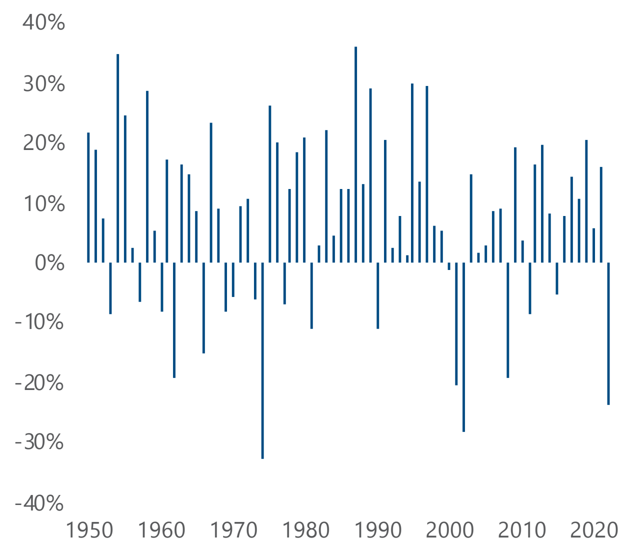
The tug of war over investors' expectations for inflation and Federal Reserve rate hikes led to a turbulent quarter for equities. The stock market advance that began in mid-June continued through the first half of the third quarter, underpinned by hopes for a less aggressive Fed rate hike cycle and better-than-feared second quarter earnings. The S&P 500 gained 17.41% from June 16 through August 16 and recaptured over half of its year-to-date loss. Equities' recovery ended abruptly in mid-August after Fed Chairman Powell reaffirmed the central bank's commitment to tightening monetary policy to combat inflation. The S&P 500 quickly reversed course, giving back all its recent gains and fell to a new low for the year by quarter end. The S&P 500 finished the quarter with a 4.90% loss and was down 23.87% year to date through September 30. As seen in Chart 2, S&P 500 experienced its worst performance through the first three quarters of the year since 2002 and its third worst performance since 1950. The technology-heavy Nasdaq index held up slightly better in the quarter with a 3.91% loss, but it has fared worse this year with a 32.00% decline. The small capitalization Russell 2000 index declined 2.19% in the third quarter and is down 29.28% this year.

The communications sector was the largest detractor in the S&P 500 with a quarterly loss of 12.72%, dragged lower by Facebook's parent company Meta (META) and Google's parent company Alphabet (GOOGL). Shares of both firms fell by double digits in the quarter amid concerns about weaker corporate spending on advertising. Real estate was the second worst performing major S&P 500 group in the quarter as higher interest rates posed challenges for the sector including a less attractive dividend yield relative to bond yields and higher financing costs.

Consumer discretionary and energy stood out as the only S&P 500 sectors with positive performance in the quarter. Surprisingly resilient consumer spending helped several consumer discretionary stocks in the retail and automotive industries post positive returns in the period. Better-than-expected second quarter earnings and an improved near-term outlook supported energy stocks' rise in the quarter despite the price of West Texas Intermediate (WTI) crude oil falling 24.84%. Energy was the only sector that saw analysts raise their third quarter earnings estimates in recent months as higher year-over-year oil prices drove upward earnings revisions. The price of WTI oil averaged $91.65 per barrel in the third quarter of 2022 which was 29.89% higher than the $70.56 average oil price in the third quarter of 2021.

The S&P 500's 8.0% earnings growth in the second quarter was nearly double the 4.1% growth that analysts projected at

CHART 2
THIRD WORST FIRST NINE MONTHS SINCE 1950

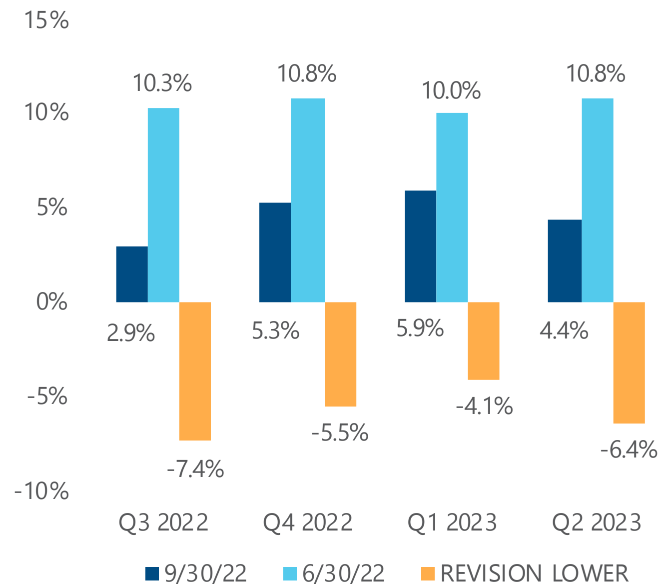


Source: Morningstar. S&P 500 performance through first nine months. Data as of 9/30/22. Past performance does not guarantee future results.

the start of the earnings reporting season. The earnings beat was driven by a small group of sectors including energy, health care, real estate, and utilities. The energy sector's earnings growth of 260.7% was the largest contributor to S&P 500 earnings growth. Excluding energy, S&P 500 earnings were down 1.9%. Negative earnings growth in the financials, communications, consumer discretionary, and technology sectors pulled the index's overall earnings lower. The slower economy led analysts to lower their projections for year-over-year S&P 500 third quarter earnings growth to 2.9% at the end of September, compared to 10.3% at the end of June. Earnings growth projections for the fourth quarter and first two quarters of next year were also revised lower from around 10% growth to mid-single-digit percent growth in each quarter.

The stronger U.S. dollar caused foreign developed equities to fall by about twice the S&P 500's loss during the quarter. The dollar's rise detracted 5.77% from MSCI EAFE's third quarter performance, resulting in a 9.29% loss in U.S. dollar terms. MSCI EAFE's performance in local currency, which excludes the dollar's impact, was 3.52%. Emerging market stocks fared the worst among major equity asset classes in the quarter, with the MSCI Emerging Markets index down 11.42%. The dollar also weighed on emerging market performance, but it had less of an impact compared to its effect on foreign developed stocks. MSCI China's 22.44% quarterly loss was the largest source of weakness in the emerging market index. Excluding China, emerging markets were down 5.38%. Investor sentiment toward China remains challenged as the country continues to pursue a zero-COVID policy with sporadic lockdowns in large population centers. South Korea and Taiwan were also notable emerging market detractors as major equity indexes in both countries fell over 10% during the period. The weaker outlook for global growth weighed on stocks in these countries since their stock markets are heavily concentrated in multinational technology companies (i.e. Samsung Electronics and Taiwan Semiconductor Manufacturing Company) that get the majority of their sales from the U.S. and Europe.

CHART 3
S&P 500 EARNINGS ESTIMATES REVISED LOWER



Source: Bloomberg. Data as of 9/30/22. Past performance does not guarantee future results.

FIXED INCOME

PRIORITIZING PRICE STABILITY

The third quarter brought a continuation of several major developments across fixed income markets from the first half of 2022. The Fed persisted in aggressively tightening policy by hiking its benchmark rate by 0.75% at both its July and September meetings amid the refusal of broad-based inflation readings to roll over. Bond volatility remained very elevated, as the ICE BofA MOVE Index, a measure of implied volatility across a range of one-month U.S. Treasury option contracts, approached its highest level since March 2020. The U.S. Treasury curve continued its bear-flattening trend, with large parts moving deeper into inversion territory. As seen in Chart 4, yields on the 2-year U.S. Treasury note climbed 1.33% to 4.28% during the quarter, while yields on the 10-year maturity increased 0.81% to 3.83%. The last time the two-year note outyielded its 10-year counterpart by more than 0.4% was in 2000. An inverted yield curve is atypical and frequently precedes periods of slowing economic growth.

With inflation staying stubbornly elevated, the Federal Reserve's dual mandate of maintaining maximum employment and price stability looks increasingly onerous. In its most recent Summary of Economic Projections, the Federal Open Market Committee (FOMC) estimated the longer run, normal rate of unemployment consistent with its mandate is 4.0%. This is 0.5% higher than the current unemployment rate of 3.5%, which leaves some room for the labor market to soften. Meanwhile, year-over-year core PCE (Fed policymakers' preferred inflation gauge) sits at 4.9%. This is significantly higher than the Fed's stated target of an average annual rate of 2.0% over an economic cycle. As described in the Economy section, the growing fear is that the unemployment rate will need to move significantly above 4.0% for core inflation to fall anywhere near the Fed's 2.0% target.

Although Fed officials always closely monitor labor market trends, it has become very clear they plan to prioritize the "price stability" portion of their dual mandate until further notice. Federal Reserve Chairman Jerome Powell put it bluntly at the Jackson Hole Economic Symposium on August 26, stating "…(our) overarching focus right now is to bring inflation back down to our 2% goal." He continued, "…failure to restore price stability would mean far greater pain than some softening of labor market conditions." The message seems to be policymakers are willing to keep rates high even if unemployment ticks up moderately. Throughout the quarter, a growing number of bond market participants seemed to grudgingly accept Powell's hawkish interest rate narrative. As the third quarter progressed, market participants priced in an additional 1.0% of Fed rate hikes in late 2022 to early 2023. On September 30, fed funds futures markets projected the FOMC's

CHART 4
SELECTED U.S. TREASURY YIELDS

Source: Bloomberg. Data as of 9/30/22. Past performance does not guarantee future results.

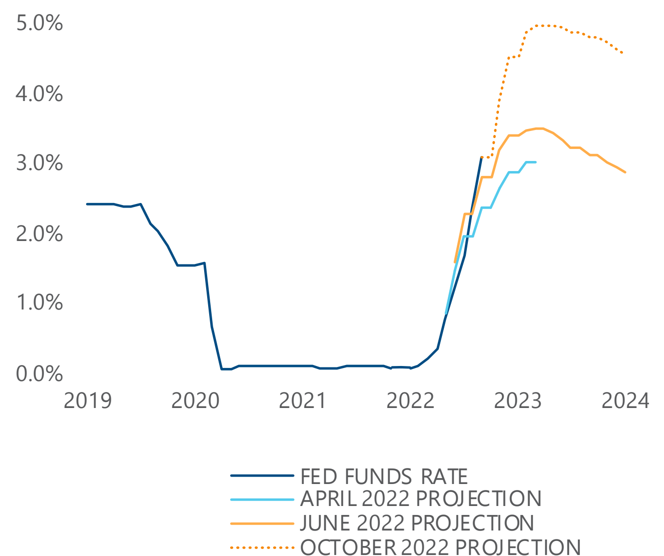
benchmark rate would climb to roughly 4.50% by March of 2023, compared to a projection of 3.49% on June 30 (see Chart 5). This implies policymakers will hike rates another 1.5% over their next four meetings.

Most major global central banks have moved in unison with the Fed by hiking rates to combat inflation in their local economies. The People's Bank of China and Bank of Japan are notable dovish exceptions to this trend. In September, the Bank of Canada raised rates 1.0% and the European Central Bank hiked by 0.75%. Both the Bank of England (BOE) and the Royal Bank of Australia lifted their policy rates by 0.5%. In the last week of September, BOE officials staged an emergency intervention in government bond markets to maintain financial market stability in the U.K. amid turmoil following a poorly received fiscal policy package unveiled by the new government. The BOE indicated it would buy long-dated U.K. government bonds "on whatever scale is necessary" to prevent a market crash. Some investors have questioned if this seemingly disjointed approach from the BOE of hiking rates to subdue inflation, while simultaneously engaging in tactical asset purchases to stabilize financial markets might be harbinger of things to come for other global central banks.

The Fed also began shrinking its balance sheet in June, which had ballooned from $4.2 trillion in February 2020 to nearly $9.0 trillion in March 2022. The central bank did not reinvest the proceeds of $47.5 billion of Treasury and Agency bonds in June, July, and August. This monthly pace accelerated to $95 billion in September. All other things equal, this so-called quantitative tightening process reduces the money supply and should put marginal pressure on longer term bond yields. Some observers are skeptical that Chair Powell and his colleagues can continue to aggressively hike the policy rate and wind down the $9 trillion balance sheet without creating significant stress in funding markets. In public markets, we would probably see funding problems first emerge in high yield debt and bank loans. If these fears materialize, we could see the Fed take a similar course to the BOE in attempting to fight inflation and stabilize a bond market rebellion at the same time.

Given the policy backdrop, we believe most fixed income portfolios should target a neutral duration relative to benchmark. The risks of an upside move in yields seem more balanced against a potential downside move than at most times over the last several years. Reductions in credit exposure should be considered after any period of considerable credit spread tightening. If market interest rates begin to overshoot realistic expectations for Federal Reserve rate hikes this year, it may make sense to selectively add duration exposure depending upon a portfolio's objective. Treasuries remain preferred over agencies given compressed spreads in the agency market. Treasuries also remain favored over corporates when purchasing maturities less than one year, given corporate illiquidity in this maturity range.

CHART 5
PROJECTED PATH OF FED RATE HIKES



Source: Bloomberg. Data as of 9/30/22. Past performance does not guarantee future results.

WILL CORPORATE EARNINGS HOLD UP?

Over the last six months, we focused our discussion in this section on the timing of a peak in domestic inflation and how much recession risk had been priced into the stock market. Of utmost importance to these two topics has been the Federal Reserve's policy reaction to the trajectory of inflation and labor market trends. The line of reasoning was fairly straightforward. If inflation did not show signs of cooling off, Fed policymakers would likely maintain an aggressive policy stance. More rate hikes coming at a faster pace would subsequently cause problems for equity market valuations, credit spreads, and potentially corporate earnings. How quickly and to what magnitude would sharply higher lending rates cause firms to start laying off workers was (and remains) the million-dollar question.

The third quarter revealed that certain measurements of inflation in the U.S. may have peaked, but the rate of change in consumer prices remains way too high for Fed policymakers. As seen in Chart 6, the year-over-year change in the core consumer price index (CPI) accelerated from 5.9% in July, to 6.3% in August, to 6.6% in September. This inflation measure excludes food and energy prices, implying that shelter and medical costs accelerated this summer. Fed Chairman Powell and his Federal Open Market Committee (FOMC) colleagues did not mince words in August and September in communicating that getting inflation under control was their number one priority (see Fixed Income section).

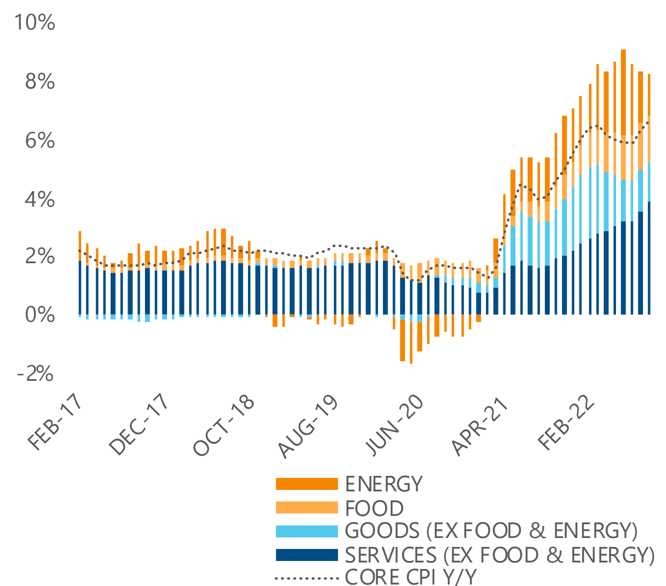
Bond markets finally got the hint. By the end of the quarter, fed funds futures markets were pricing in a terminal policy rate of roughly 4.50% in early 2023. This repricing in bond markets, which saw yields on the U.S. 10-year Treasury note surge from 2.57% on August 1 to 3.83% by September 30 helped end a powerful bear market rally in stocks. The S&P 500 surged 17.4% from June 16 through August due to a combination of acutely oversold conditions and hopes that lackluster economic data might cause Fed officials to ease or even halt their rate hike campaign. By mid-August, it became clear that this "bad news is good news" narrative was running out of steam as there were no clear signs of a deterioration in the labor market or consumer spending.

Consumer sentiment reached all-time lows and the pace of hiring was slowing. But U.S. employers still added a net 1.12 million workers to payrolls in the third quarter and the unemployment rate in September was 3.5%.

As described in the Equity section, second quarter corporate earnings held up better than expected despite growing fears of a collapse in profits driven by the twin scourges of high inflation and a hawkish Fed. Far from contracting, S&P 500 earnings per share (EPS) grew at an 8.0% year-over-year clip in the second quarter but were heavily reliant on record-setting energy sector profits. According to data aggregated by Bloomberg, expectations for full year 2022 S&P 500 EPS growth declined slightly to 9.6% in the last week of September from 9.8% in the beginning of the month. Expectations for 2023 S&P EPS growth are around 6.0%. Somewhat concerningly, several high-profile U.S. companies showed signs of operational challenges in September. These included bloated inventories at Nike (NKE), stubbornly high

CHART 6

COMPOSITION OF U.S. INFLATION



Source: Bloomberg. Data as of 9/30/22. Past performance does not guarantee future results.

OUTLOOK CONTINUED

transportation and packaging costs at FedEx (FDX), and Apple's (AAPL) reversal of a previous increase in expected iPhone demand in the second half of the year. Trends in inventories, costs and demand will need to be closely monitored at the industry-level and company-level for the foreseeable future.

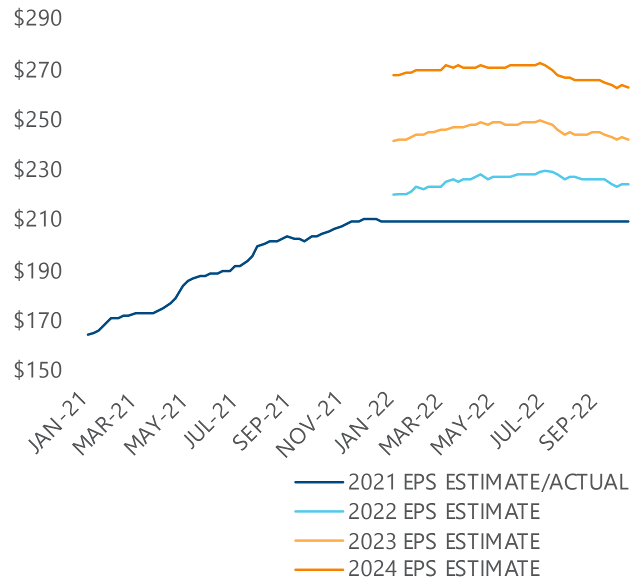
We think investors should pay particularly close attention to trends in wage growth as compensation expense tends to be one of the most important components in the profit margin calculation of S&P 500 companies. If wage growth does not dramatically accelerate, and U.S. companies can pass through most of their total input costs, the S&P 500 will likely avoid the 10% to 20% contraction that typically occurs during recessions. Thus far, we have not seen compelling evidence of an imminent inflation-driven contraction in corporate earnings. The longer underlying inflation remains sticky, and the U.S. dollar stays strong, however, the more likely an S&P 500 earnings recession is to materialize. As such, we believe gradually increasing exposure to defensive equity sectors with less demand elasticity (healthcare) and cyclical sectors that can benefit from higher commodity prices (energy, materials) is a prudent course of action.

In the last week of August, following the sharp run-up in stocks, we recommended moderately reducing equity risk and credit risk in client portfolios by selling hedged equity and trimming intermediate-term core bonds. We recommended that the proceeds be used to establish a position in short-term U.S. Treasuries and increase cash targets. This was driven by our expectation that further monetary tightening would create a gradually more difficult environment for equities and credit. Over the next three to six months, we would not be surprised if consumer spending and corporate earnings prove more resilient than many expect. Thus, we remain reluctant to reduce risk more aggressively at current equity market levels. Over a longer timeframe, however, we believe a sharply higher Fed policy rate will begin to weigh on economic activity and corporate earnings.

We continue to expect elevated volatility in both stock and bond markets for the remainder of the year as investors assess the most likely path of Fed policy. Areas of the equity market with strong pricing power and earnings visibility should continue to outperform. Fixed income portfolios should target a benchmark duration as the rapid back-up in yields to close the quarter creates a more balanced set of return outcomes. Once the U.S. midterm elections are in the rearview mirror (see Spotlight section), however, a period of equity market strength could emerge into the holiday season. The chances of a late-year rally would most likely be boosted by lower-than-expected CPI prints for October (November 10) and November (December 13).

CHART 7

S&P 500 EPS ESTIMATES: 2022, 2023, 2024

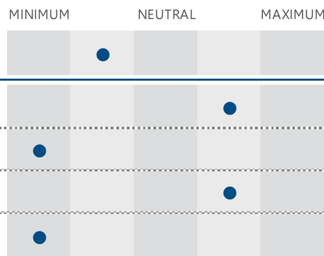


Source: Bloomberg. Data as of 9/30/22. Past performance does not guarantee future results.

ECONOMIC OUTLOOK AND INVESTMENT POLICY

ECONOMIC FACTORS	CURRENT OUTLOOK
U.S. GDP Growth	The median estimate for 2022 U.S. real GDP growth in a Bloomberg survey of forecasters from early October declined to 1.6% from 2.5% three months prior.
Federal Funds Rate	Fed funds futures markets currently project Fed officials will increase the policy rate to roughly 5.0% by May 2023 followed by several 0.25% rate cuts later in the year.
Inflation	Market-based expectations for average annual inflation over the next two years declined sharply from over 4.0% in June to 2.5% in the first week of October.
Employment	According to NFIB survey data, the net percentage of U.S. small businesses with plans to hire increased in each of the last four months but remains below year-ago levels.
Consumer Confidence	U.S. consumer sentiment has improved modestly in recent months from forty-year lows boosted by a welcomed decline in gasoline prices.
Oil	OPEC and its allies' October 5 announcement of a 2 million barrel-per-day cut in production quotas could put a floor under WTI crude oil prices around $75 per barrel.
Housing	Limited supply of existing homes and elevated prices could partially offset the trend of strong housing demand, which has been in place since the summer of 2020.
International Economies	Real GDP is expected to grow in 2022 by 3.0% in the euro zone, 3.5% in the U.K., 3.3% in China, and by 1.6% in Japan based on a recent Bloomberg survey of forecasters.

FIXED INCOME



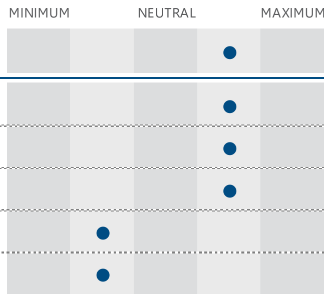
Core Bonds
TIPS
Non-Investment Grade
International

CURRENT OUTLOOK

In late August, we recommended a modest increase to fixed income and a shift in the composition of bond allocations in client portfolios. Short-term Treasury Inflation-Protected Securities (TIPS) were replaced with short-term Treasuries, credit exposure was trimmed, and duration was reduced. We still maintain an underweight to fixed income, although we are likely to consider increasing our recommended target weight if U.S. Treasury yields overshoot our projection of a reasonable federal funds rate-hike trajectory over the next 6 to 12 months. Signs of a substantial deterioration in U.S. labor market data or corporate profits would also most likely lead us to advocate for higher target weights to fixed income in client portfolios.

Given the monetary policy backdrop, we believe most fixed income portfolios should target a neutral duration relative to benchmark. The risks of a downside move in yields seem more balanced against further increases in yields than at most times over the last several years. Reductions in credit exposure should be considered after any period of considerable credit spread tightening. Depending on the path of Treasury yields, it may make sense to selectively add duration exposure depending upon a portfolio's objective. Treasuries remain preferred over agencies given compressed spreads in the agency market. Treasuries also remain favored over corporates when purchasing maturities less than one year, given corporate illiquidity in this maturity range.

EQUITIES



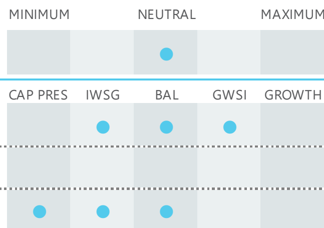
Large Cap
Mid Cap
Small Cap
Developed International
Emerging Markets

CURRENT OUTLOOK

We believe a moderate overweight to equity is still warranted at current valuations despite signs of a slowing global economy and the current Fed rate hike cycle. The nearly 30% contraction in the S&P 500 forward 12-month price-to-earnings ratio from 21.5 in the first week of January to 15.3 by the last week of September likely discounts most of the economic and profit damage associated with a typical recession. We continue to think relatively healthy aggregate corporate and consumer balance sheets and a resilient domestic labor market should provide a buffer against any demand destruction related to higher interest rates and elevated inflation over the next several quarters.

We expect elevated equity market volatility in the fourth quarter given uncertainty about the path of inflation and the Fed's subsequent reaction. We will most likely see a continuation of the "good news is bad news" paradigm in coming months in which strong economic data is greeted negatively by markets for fear that it could lead to a higher Fed policy rate target. We expect areas of the equity market that exhibit strong pricing power and better earnings to continue outperforming in the current environment. We will likely consider reducing our recommended equity target weight if we see an unjustifiably sharp expansion of equity market multiples, or signs emerge of a significant contraction in corporate earnings.

ALTERNATIVES*



Gold
Hedged Equity
Arbitrage

CURRENT OUTLOOK

In late August, we recommended that hedged equity allocations be sold in client portfolios and reallocated to a combination of short-term Treasuries and cash. The ultra-low interest rate world of the last 12 years appears to be shifting to one in which market interest rates establish trading ranges meaningfully higher than existed for most of 2009 through 2021. In this environment, we expect the risk-adjusted return benefits of most alternative strategies to subside especially compared to assets traditionally viewed as risk-free including cash and short-term U.S. Treasury notes. Our recommended allocation to merger-arbitrage strategies remains under review.

Although gold did not produce positive absolute returns in the first nine months of 2022, it did help limit the downside of diversified portfolios with exposure to sharp equity market drawdowns. We continue to believe a moderate allocation to gold should benefit portfolios given its low historical correlation with stock prices and its tendency to behave as a safe haven asset in periods of equity market stress. Our alternatives allocations, as seen in the table to the left, are designed to decrease the overall risk profile of our five investment objective-based portfolios (CAP PRES, IWSG, BAL, GWSI, and GROWTH).

The above minimum/neutral/maximum recommendations represent MainStreet Advisors' current positions relative to our Strategic Asset Allocation ranges. Views expressed have a 6-12 month horizon and are those of the MSA Investment Committee.

*Cap Pres: Capital Preservation, IWSG: Income with some growth, Bal: Balanced, GWSI: Growth with some income

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NOT A DEPOSIT	NOT FDIC INSURED	MAY LOSE VALUE	NOT BANK GUARANTEED
NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY			