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Third Quarter Review & Outlook: All Eyes on the Fed

The third quarter saw a reversal of the equity market recovery that began in June. Fears over the magnitude of Fed tightening triggered a selloff in August that has pushed equity prices to a new low for the year. Interest rates have risen dramatically across the yield curve, and inflation, despite signs indicating a decline, has been stickier than expected. Risk in Ukraine has escalated, adding uncertainty to the geopolitical landscape.

Capital Markets Review

The third quarter saw continued declines across all major asset classes. International stocks bore the brunt of the decline, with both developed and emerging markets down 9.4% and 11.6% respectively, bringing year-to-date declines of over -27%. U.S. equities fared a bit better during the quarter, but still posted declines of -4.9% for large cap stocks and -2.2% for small caps. As interest rates continued to rise during the quarter, the Bloomberg Barclays Aggregate Bond Index dropped -4.8, bringing the total decline for the year to -14.6%, currently the worst year for bonds in history dating back to 1927 (Source: Blackrock). Liquid alternative investments ("Absolute Return") fared better, posting a -0.5% return for the quarter and down 4.6% on the year. Our ongoing underweight to bonds and overweight to liquid alternatives shielded client portfolios from the full impact of bond losses.

Asset Class Returns

Asset Class	Index	September 2022	Q3 2022	YTD
U.S. Large Cap	S&P 500	-9.2	-4.9	-23.9
U.S. Small Cap	Russell 2000	-9.6	-2.2	-25.1
International Developed	MSCI EAFE	-9.4	-9.4	-27.1
Emerging Markets	MSCI EM	-11.7	-11.6	-27.2
U.S. Investment Grade	Barclays U.S. Aggregate Bond	-4.3	-4.8	-14.6
U.S. Inflation-Indexed	Barclays U.S. TIPS	-6.6	-5.1	-13.6
U.S. High Yield	BBgBarc U.S. Corp High Yield	-4.0	-0.6	-14.7
EM U.S. $ Debt	JPM EMBI Global	-6.4	-4.6	-23.9
Absolute Return	HFRX Global Hedge Fund	-1.0	-0.5	-4.6%

Source: Morningstar
As of 9/30/2022

Sector Review

Looking at U.S. equity sectors, losses were widespread during the third quarter, with consumer discretionary (+4.4%) and energy (+2.4%) the only sectors to post positive returns. Energy remains the only equity sector with a positive return on the year, up 34.9%.

Sector Returns: Q3 and 2022

Sector	Index	September 2022	Q3 2022	YTD
Energy	S&P 500/Energy	-9.3	2.4	34.9
Utilities	S&P 500/Utilities	-11.3	-6.0	-6.5
Consumer Staples	S&P 500/Cons Staples	-8.0	-6.6	-11.8
Health Care	S&P 500/Health Care	-2.6	-5.2	-13.1
Industrials	S&P 500/Industrials	-10.5	-4.7	-20.7
Financials	S&P 500/Financials	-7.8	-3.1	-21.3
Materials	S&P 500/Materials	-9.4	-7.1	-23.7
Real Estate	S&P 500/Real Estate	-13.2	-11.0	-28.9
Consumer Disc	S&P 500/Cons Disc	-8.1	4.4	-29.9
Info Technology	S&P 500/Information Technology	-12.0	-6.2	-31.4
Comm Services	S&P 500/Commun Services	-12.2	-12.7	-39.0

Source: Morningstar
As of 9/30/2022

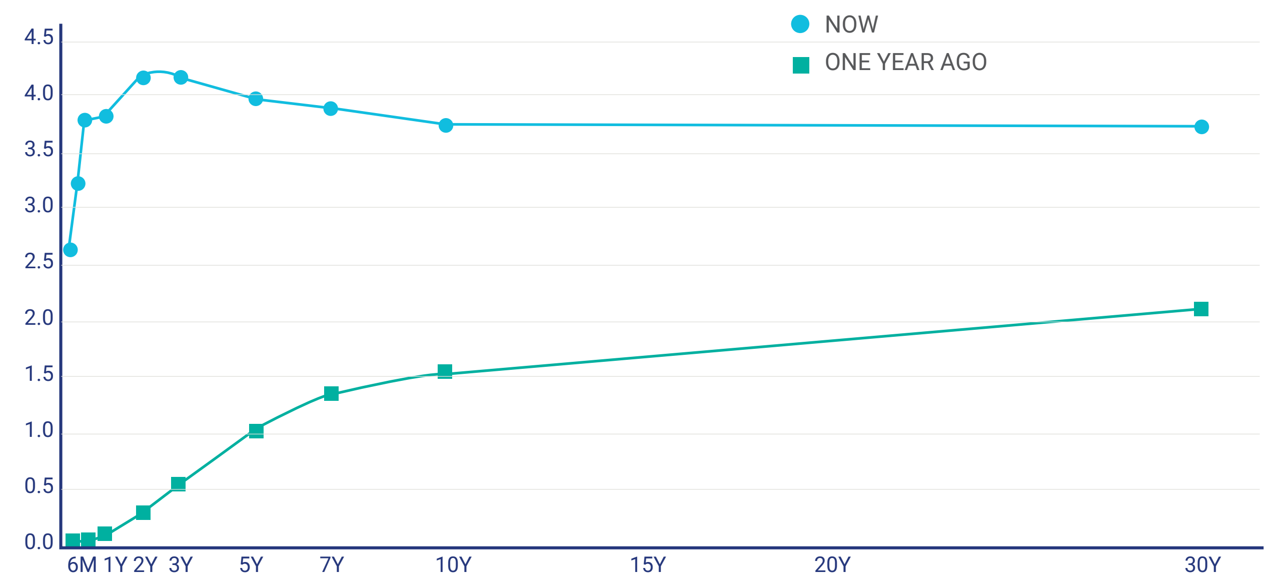
Review of Themes

At the start of the year, we identified three themes that we felt would drive global markets: 1. COVID would slow, and the U.S. economy would be able to fully reopen as a result; 2. the Federal Reserve would begin to tighten monetary policy in a measured fashion; and 3. staying overweight stocks was appropriate in such an environment. At the end of the third quarter, the first two themes have been mostly accurate – COVID is largely behind us, with the global economy largely open for business. Secondly, the Fed has tightened monetary policy more aggressively than initially forecast due to extremely persistent inflation. Our third theme, overweight equities, has not been correct thus far, as inflation/recession fears continue to drive stock prices lower.

Is it the right time to sell?

With June's equity rally fading in August, investors everywhere are asking if now is the right time to sell equities and wait for an economic recovery. These concerns are valid, given that the Fed is raising rates faster than any previous period in history. The 10-year treasury started the year at 1.51% and closed the 3rd quarter at 3.80%. With the Fed's "Dot Plot" or estimate of future rate movements predicting a 4.4% Fed Funds rate by year end, that's a lot for the economy to absorb. The risk of recession is real, given the persistence of inflation in the face of an aggressive Fed.

U.S. Treasury Yield Curve



Source: FactSet
As of 9/30/2022

Maturity	9/30/2022 YIELD	One Year Ago YIELD	Change in YIELD
1M	2.63	0.05	2.58
3M	3.23	0.04	3.19
6M	3.79	0.05	3.74
1Y	3.83	0.08	3.75
2Y	4.16	0.29	3.87
3Y	4.17	0.54	3.63
5Y	3.99	1.01	2.98
7Y	3.89	1.34	2.55
10Y	3.75	1.54	2.21
30Y	3.73	2.09	1.64

Source: FactSet
As of 9/30/2022

Portfolio Positioning

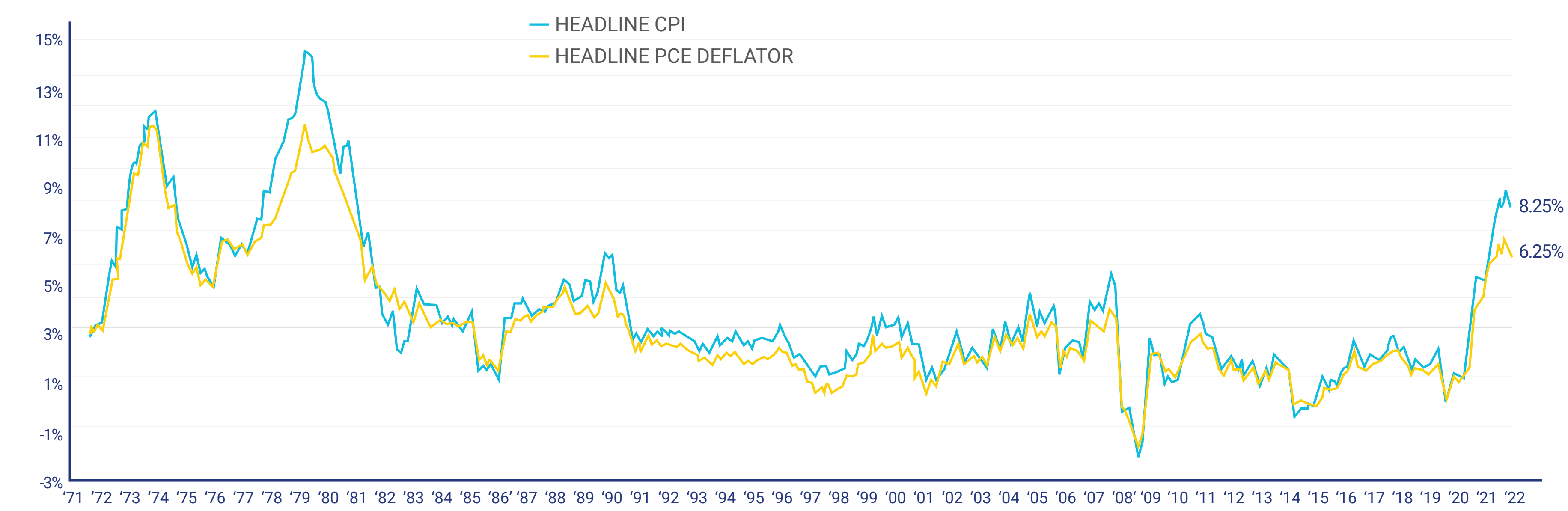
History of making a strong comeback

Our current view on equities is mixed. We do not feel that this is the time to sell out of equities. However, we are being more patient regarding additions to equities in existing portfolios. For new investors with cash earmarked for long-term growth, we feel that history will show this time period as a good opportunity to average into equities over the coming months. Returns in the first year after the five biggest market declines since 1929 ranged from 36.2% to 137.6% and averaged 71%. Over the longer term, the average value of an investment more than doubled over the five year following each of the market lows. (Source: Capital Group).

Heightened volatility remains

Markets tend to recover before the economy does. We are likely to experience heightened volatility for the coming months. When the market has confidence that inflation is on the decline, it will recover. We have seen signs of declining inflation, but inconsistently. Any data points that fail to show progress will continue to be met with market selloffs. For clients with short time horizons, reducing equities now may be a prudent strategy. However, for longer-term investors, figuring out when to get back in will be extremely difficult, and we would recommend staying invested. History shows that missing the best days in the market reduces returns substantially. According to a recent Natixis study, if you had missed just the best 10 days over the most recent 20-year period, you would have reduced your return by more than half. That's a heavy toll to pay. (Source: NATIXIS, 6/30/22).

Headline CPI and Headline PCE Inflation



Source: FactSet, FRED Economic Data, St. Louis FED
Data as of 8/31/2022

Recession and inflation add to uncertainty

As a result of equity market declines, we are close to our long-term target weights on equities. Currently we are not adding to equities meaningfully, recognizing that uncertainty over the dual threats of recession and inflation will prevent sustained progress in equity markets. Patience will be required over the next 6-12 months as data points both support and contradict the recovery narrative.

As always, please don't hesitate to reach out to your contacts at Webster Private Bank if you have any questions. It is a pleasure to serve you during these difficult times and we appreciate the trust you have placed in us.