Retirement Market RECAP Q3 2022

HANYS Benefit Services

Hawkish Fed behavior, declining asset prices disrupt the global economic outlook

After a historically volatile first half of 2022, investors entered Q3 optimistic that inflation would subside and markets would begin to calm. However, when June's surprise 9.1% inflation report was released just two weeks into the quarter, it became clear Q3 would continue the tumultuous year. With the Federal Reserve's (the Fed) aggressively restrictive monetary policy, elevated inflation and geopolitical tensions in the Eurozone and Asia, investors are still grappling with uncertainty in today's macroeconomic environment.

U.S. markets saw a choppy third quarter driven by three of the highest inflation reports in 40 years. The S&P 500 experienced a loss of 4.88%. Small cap stocks, represented by the Russell 2000 Index, outperformed their large counterparts, seeing a loss of 2.19% in Q3. Sentiment within the broader market appears to be overwhelmingly bearish, with estimated earnings growth for the S&P 500 of 3.5% — the lowest projected growth rate since Q3 2020 (-5.7%).[1] While current earnings estimates appear poor, future earnings guidance is even more alarming. Earnings guidance provides key information about how a company is predicted to perform in the future, and it has been negative for Q3. According to FactSet, "65 S&P companies have issued negative EPS (earnings per share) guidance and 40 S&P 500 companies have issued positive EPS guidance."[2]

While U.S. markets have had another difficult quarter in 2022, non-U.S. counterparts experienced even greater headwinds. The MSCI EAFE Index, which focuses primarily on non-U.S. stocks in developed economies like Europe, experienced a loss of 9.36% in Q3, underperforming the S&P 500 by (4.48%). The Eurozone is facing several major headwinds, making investment in mainland Europe increasingly bleak. The Eurozone continues to see record inflation while concerns over Russian gas supplies have led to recession fears leading into winter, with "Benchmark gas in the region, trading six times its historical average."[3] The MSCI Emerging Market Index also underperformed the S&P 500 with a loss of 11.57%, driven by continued COVID-19 concerns in Asia, geopolitical uncertainty over Taiwan and the Russia-Ukraine War.

Fixed income remained a constrained asset class, with the Bloomberg U.S. Aggregate Bond Index experiencing a 4.75% loss in the third quarter. Long-term treasuries fared the worst, mirroring previous quarters. The effect of inflation and hawkish monetary policy employed by the Fed continue to dampen the income-generating effects of bonds, especially those of longer maturities. High-yield bonds performed relatively well, seeing a loss of .65% during the third quarter. It is important to note that high-yield bonds tend to exhibit lower correlation to other fixed income products and are generally less sensitive to interest rate risk than their counterparts. This has allowed high-yield bonds to be relatively protected during the rate-hiking cycle employed by the Fed, leading to relative outperformance. However, high-yield bonds tend to carry a higher default risk than other fixed income securities given the sub-investment grade credit ratings associated with their issuers.

Inflation, and the Central Bank's response to it, continues to be the key driver of capital market performance. To counter June's high Consumer Price Index (CPI) reading, the Fed raised the Fed Funds rate by 75 basis points at their July meeting. While July's report slipped to an 8.5% reading driven by lower gas prices,[4] August's report was surprisingly high, coming in at 8.3%, mirroring a

[1] https://www.factset.com/earningsinsight

[2] Ibid.

[3] https://www.bloomberg.com/news/articles/2022-09-20/traders-price-in-two-three-quarter-point-boe-hikes-by-year-end

[4] https://www.bls.gov/cpi/

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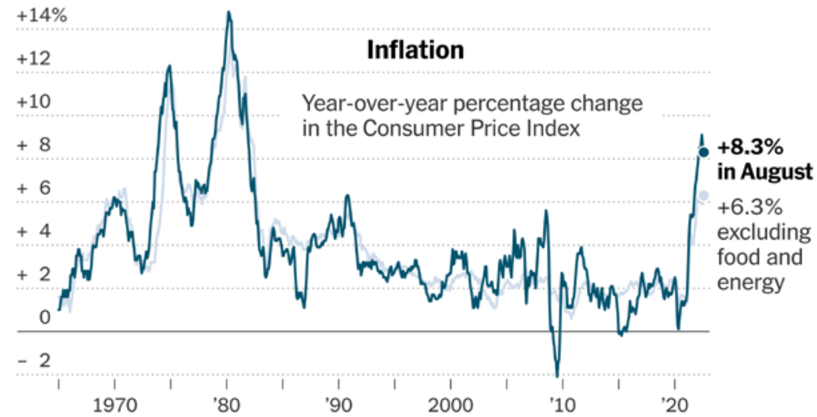
period of inflation not seen since the 1980's according to the Bureau of Labor Statistics (Figure 1).[5] This number was above estimates, with core CPI doubling its gain seen in July. On Sept. 13, stocks sold off upon news of the report, with the Dow Jones experiencing its worst day since June 2020.

Fig. 1



August's report — as well as the Fed's Chair Jerome Powell reiterating his rigid stance of monetary tightening at the annual Jackson Hole conference — led to yet another 75 basis point hike at the conclusion of the Federal Open Market Committee's (FOMC) third straight meeting in September. For investors, this solidified that the Fed is committed to its mandate of maintaining price stability with less regard for asset prices. While the Fed has been perceived as one of the most hawkish central banks, others have followed suit. The European Central Bank (ECB) raised rates 75 basis points in early September, and Sweden's Riksbank unexpectedly raised rates by 100 basis points, or 1%, on Sept. 20. It is clear that central banks have undertaken aggressive monetary policy to restore price stability in their respective regions, even with heightened recessionary risk.

Markets continue to be challenged moving into the final months of 2022, with all eyes on the effectiveness of the Fed's hiking cycle. While investors have an unshakeable fear of recession, it is important to separate from the daily news cycle and consider the broader economic landscape. The market's bumpy ride in 2022 has led to more attractive valuations, with the S&P 500 trading at a below-average forward 12-month Price to Earnings (P/E) ratio compared to both the five- and 10-year averages.[6] When viewing the market landscape through a longer lens, investors must not only consider their portfolio performance over the short-term, but remember the importance of remaining invested. This long-term view is crucial to avoiding the temptation to make market timing calls based on perceived economic conditions and missing out on potential rebounds.

[5] https://www.nytimes.com/live/2022/09/13/business/inflation-cpi-report

[6] https://www.factset.com/earningsinsight

EQUITY INDICES	3 MO	1 YR	3 YR	5 YR	10 YR
S&P 500 TR USD	-4.88%	-15.47%	8.16%	9.24%	11.70%
Russell 3000 TR USD (Broad Market)	-4.46%	-17.30%	7.70%	8.60%	11.39%
Russell 1000 TR USD (Large Cap)	-4.61%	-17.22%	7.95%	9.00%	11.60%
Russell Midcap TR USD	-3.44%	-19.39%	5.19%	6.48%	10.30%
Russell 2000 TR USD (Small Cap)	-2.19%	-23.50%	4.29%	3.55%	8.55%
MSCI EAFE NR USD (Int'l Equity)	-9.36%	-25.13%	-1.83%	-0.84%	3.67%
MSCI Emerging Markets NR USD (E.M. Equity)	-11.57%	-28.11%	-2.07%	-1.81%	1.05%
S&P United States REIT TR USD (Real Estate)	-28.15%	-16.36%	-1.94%	2.90%	6.10%
Morningstar Lifetime Mod. TR 2020	-6.01%	-18.89%	0.18%	2.47%	4.62%
Morningstar Lifetime Mod. TR 2040	-6.38%	-20.78%	1.78%	3.56%	6.79%

FIXED INCOME AND RETIREMENT INDICES	3 MO	1 YR	3 YR	5 YR	10 YR
ICE BofA 3M US Trsy Note TR USD	0.42%	0.59%	0.62%	1.18%	0.70%
ICE BofA 1-3YR US Trsy TR USD	-1.56%	-4.86%	-0.48%	0.57%	0.60%
BBgBarclays Long Term US Trsy TR USD	-9.63%	-26.65%	-8.51%	-1.62%	0.59%
BBgBarclays US Aggregate Bond TR USD	-4.75%	-14.60%	-3.26%	-0.27%	0.89%
BBgBarclays US Treasury US TIPS TR USD	-5.14%	-11.57%	0.79%	1.95%	0.98%
BBgBarclays High Yield Corp TR USD	-0.65%	-14.14%	-0.45%	1.57%	3.94%
BBgBarclays Global Aggregate TR USD (Global Bond)	-6.94%	-20.43%	-5.74%	-2.32%	-0.93%

ICE BofAML – Intercontinental Exchange Bank of America Merrill Lynch; BBgBarc – Bloomberg Barclays; S&P 500 – Standard & Poors; MSCI – Morgan Stanley Capital International
Sources: Morningstar as of Sept. 30, 2022

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