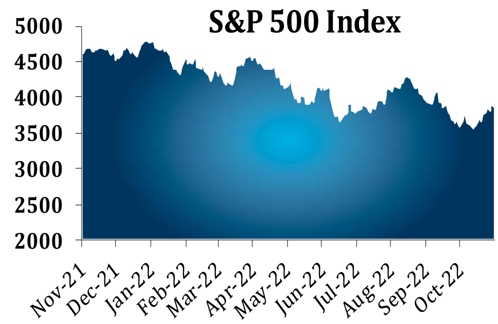
Public

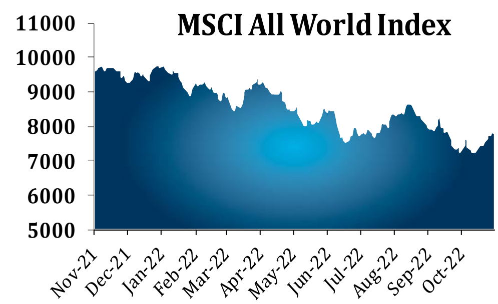
This Month in the Markets

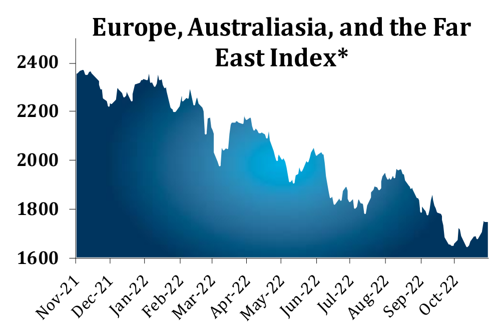
October 2022

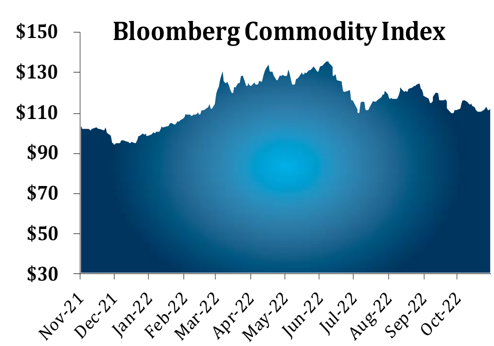
Equity Commentary

The News Was Not Great, But the Market was Up









*MSCI EAFE Index

"Interest rates are to asset prices like gravity is to the apple. They power everything in the economic universe." -Warren Buffett

"If it is in the news, it's in the price." -Bill Miller

Hope for a Federal Reserve pivot, and solid quarterly earnings helped propel stocks positively in October. The MSCI ACWI Net Total Return Index posted a gain of 6% for the month. The MSCI World Value Index jumped 9.7% compared to the gain of 4.6% in the MSCI World Growth Index. The S&P 500 rose 8.1%, while the MSCI EAFE Net Total Return Index climbed 5.4%. The MSCI ACWI Energy Sector index was once again the top performer, posting a strong 18% gain on the back of solid energy company earnings, increasing shareholder returns, and firming crude oil prices. The MSCI ACWI Communications Service Sector was the under-performer, with a fall of 0.9% in part due to weakness in social media stocks like Meta Platforms Inc. (Facebook) and Snap Inc., which collapsed after weak earnings reports.

We have touched on inflation previously, and it remains a key determinant of near-term trajectories for interest rates and pricing on a host of risk assets, including equities. Buffett's quote above notes the valuation drag that rapidly rising rates can have on asset prices due to rising discount rates. We suspect, however, that upon evidence of interest rates peaking and the rate of change of increase decelerating, risk assets should begin the recovery. The timing, of course, is not possible with certainty. Given this, there may be some more general considerations one may ponder in times like these:

1. You are unlikely to get back or reclaim losses from bonds or stocks by holding cash. To make back a loss in either, you have higher odds by owning them to make a recovery. Getting "defensive" after significant drawdowns can be extremely counterproductive to longer-term returns.

2. We are programmed to fight or flee from fear or danger even though we know it's better to buy low and sell high. It is extremely hard to act constructively when times are bad and easy to be brave when conditions are jubilant. Right now, the focus tends to be on "how low will we go," not "how much higher markets can go." Valleys are always beside peaks.

3. We believe markets currently are pricing high levels of negativity and pessimism. The AAII US Investors Sentiment Bearish reading recently hit levels not seen since the Great Financial Crisis, for example. This doesn't mean things can't get worse, but it does suggest that future disappointments will need to be increasingly more negative than known. See Bill Miller's quote above.

4. Losses in profitless, "story" stocks with questionable business attributes are likely to be permanent. Profitable companies with strong competitive positions and solid secular business prospects are likely to recover and even thrive as the market conditions turn more favorable.

Crown Holdings Inc ("CCK") was the largest underperformer in the portfolio for the month, and we sold off the position after a weak earnings report that suggested an unexpected slowdown in North American beverage can demand coupled with inflationary pressures on margins that may persist for several future quarters. The top performer in the month was Devon Energy Corp., up ~29%, which rallied with the strength in the energy sector for the month.

Public

Fixed Income Commentary

Winds of Change or More of the Same?

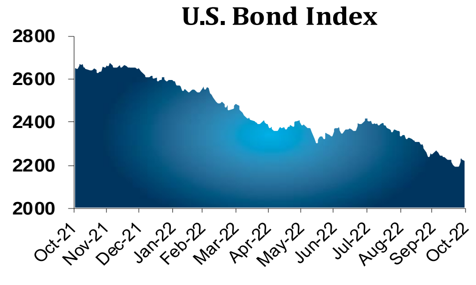
Interest rate volatility and yield curve flattening (or inversion) have been consistent bond market themes in 2022. Both continued through October. The 10-year treasury traded in a huge 0.69% range, reaching an intra-day peak of 4.32% on the 21st before declining into month-end. Overall, the 10-year treasury rate rose +0.22% to end the month at 4.05%. The highly watched 3-month to 10-year portion of the treasury yield curve inverted for the first time in this interest rate hiking cycle during the month. This is a metric watched by the Fed as it has a reliable track record as an indicator of a recession within 18 months of inverting. It's not surprising the 3-month to 10-year slope has inverted. The Federal Open Market Committee (FOMC) raised the fed funds rate (upper bound) by 0.75% to 3.25% in September. It has raised it another 0.75% at the November 2nd meeting which brought the upper bound to 4%. Markets are currently split between a 0.50% and 0.75% hike in the December meeting.

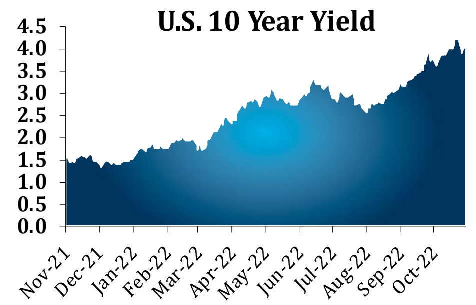
Investment grade credit spreads (compensation for taking on corporate credit risk), were largely stable in October, while high yield credit spreads rallied. Within the high yield market, B-rated and BB-rated credit outperformed, while CCC-rated credits remained very much unloved. The CCC-rated companies have the highest risk of default. With the Fed on its aggressive hiking cycle these companies have been shunned by investors. On the other end of the spectrum, BB-rated credits are the highest quality companies in the high yield universe. This cohort has seen strong demand by investors and the recent rally is evidence of the 'up in quality' trade within high yield.

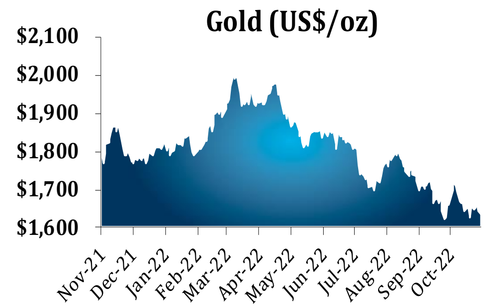
The rally in corporate credit spreads in October was certainly aided by hopes of a Fed pivot. This was driven by a few factors:

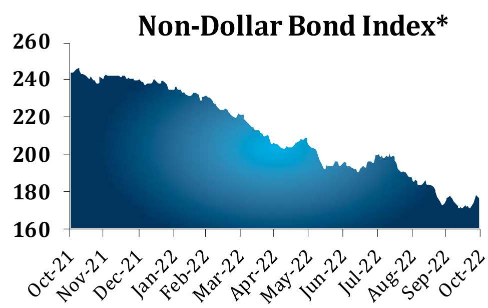
- Fed regional reserve bank presidents less hawkish rhetoric: In reference to the pace of rate hikes, Federal Reserve Bank of San Francisco President Mary Daly, commented that "the time is now to start talking about stepping down. The time is now to start planning for stepping down." Mary Daly is not a FOMC voting member until 2024. James Bullard, St. Louis Federal Reserve Bank President, and outspoken hawk is a 2022 voting member. In late October he said, "You've come off zero. You've gone to this much higher level of the policy rate. But once you're at the right level, then you can just make minor adjustments at that point – maybe to stay where you are, maybe to go a little bit higher, based on incoming data." The Fed's own dot plot shows the magnitude and pace of rate hikes abating before pausing, so it doesn't really seem like a pivot per say, rather than the passing of peak hawkishness. Nonetheless, on the margin more clarity and fewer hikes should be positive for risk assets.

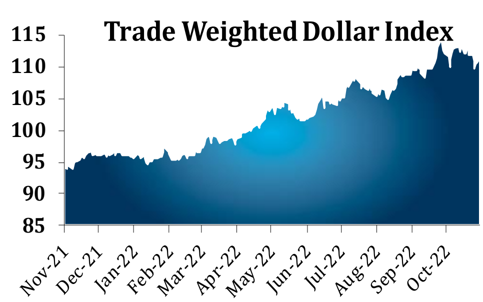
- Other central banks actions/rhetoric: In October, the Bank of Canada hiked its policy rate by 0.50%, lower than the 0.75% expected by the market. The Bank of Australia was the first bank to tone down rate hikes by surprising to the downside. In early October it hiked by 0.25% when the market had been expecting a 0.50% hike. In October, the European Central Bank (ECB) hiked rates by 0.75%. Nonetheless, European sovereign bond yields declined on the day as the hike was deemed to come with a more dovish hint. In ECB President Lagarde's statement, language that suggested rate hikes would continue "over the next several meetings" was dropped. It should be noted that Canada and Australia are somewhat hamstrung with the extent of their rate hiking ability given the sensitivity of their (expensively highly valued) housing markets to rising interest rates. Meanwhile the ECB has very real financial stability concerns concerning sovereign funding costs (Italy), and banking fragility (Credit Suisse). It remains to be seen how much we can extrapolate to the Fed from other central bank actions/rhetoric.











*Merrill Lynch Global Broad Market, Ex US Dollar Index

Disclaimer