HIGHTOWER
Westchester

Market Commentary Q3 2022

Good riddance to the third quarter! This was the third consecutive quarterly decline for U.S. equities (S&P 500 -5.28%) and there were few places to hide with every domestic size and style box losing value. Global equities fell, bond prices got hit and commodities sank.[1] The quarter started with proverbial "Federal Reserve ("Fed") Pivot" optimism and ended with the reality that inflation is going to be harder to tame than most originally thought.

Leading US Indices (Total Return)	1Q'21	2Q'21	3Q'21	4Q'21	2021	2Q'22	3Q'22 (sorted)	YTD
Russell 2000	12.7%	4.3%	-4.4%	2.1%	14.8%	-17.2%	-2.2%	-25.1%
S&P 400 Mid-Cap	13.5%	3.6%	-1.8%	8.0%	24.8%	-15.4%	-2.5%	-21.5%
S&P/Citigroup Growth	2.1%	11.9%	1.9%	13.4%	32.0%	-20.8%	-3.9%	-30.4%
Nasdaq	3.0%	9.7%	-0.2%	8.4%	22.2%	-22.3%	-3.9%	-32.0%
Dow Jones Wilshire 5000	5.8%	8.1%	-0.6%	8.1%	22.8%	-17.6%	-4.6%	-26.1%
S&P 500 Total Return	**6.2%**	**8.5%**	**0.6%**	**11.0%**	**28.7%**	**-16.1%**	**-4.9%**	**-23.9%**
S&P 600 Small-Cap	18.2%	4.5%	-2.8%	5.6%	26.8%	-14.1%	-5.2%	-23.2%
S&P 100 Mega-Cap	5.1%	9.4%	1.0%	11.3%	29.4%	-16.9%	-5.4%	-25.1%
S&P/Citigroup Value	10.8%	5.0%	-0.8%	8.3%	24.9%	-11.3%	-5.8%	-16.6%
Russell 2000	12.7%	4.3%	-4.4%	2.1%	14.8%	-17.2%	-2.2%	-25.1%

S&P 500 Sectors (Total Return)	1Q'21	2Q'21	3Q'21	4Q'21	2021	2Q'22	3Q'22 (sorted)	YTD
Discretionary	3.1%	6.9%	0.0%	12.8%	24.4%	-26.2%	4.4%	-29.9%
Energy	30.9%	11.3%	-1.7%	8.0%	54.6%	-5.2%	2.3%	34.9%
Financials	16.0%	8.4%	2.7%	4.6%	35.0%	-17.5%	-3.1%	-21.2%
Industrials	11.4%	4.5%	-4.2%	8.6%	21.1%	-14.8%	-4.7%	-20.7%
S&P 500 Total Return	**6.2%**	**8.5%**	**0.6%**	**11.0%**	**28.7%**	**-16.1%**	**-4.9%**	**-23.9%**
Health Care	3.2%	8.4%	1.4%	11.2%	26.1%	-5.9%	-5.2%	-13.1%
Utilities	2.8%	-0.4%	1.8%	12.9%	17.7%	-5.1%	-6.0%	-6.5%
Technology	2.0%	11.6%	1.3%	16.7%	34.5%	-20.2%	-6.2%	-31.4%
Staples	1.1%	3.8%	-0.3%	13.3%	18.6%	-4.6%	-6.6%	-11.8%
Materials	9.1%	5.0%	-3.5%	15.2%	27.3%	-15.9%	-7.1%	-23.7%
Real Estate	9.0%	13.1%	0.9%	17.5%	46.2%	-14.7%	-11.0%	-28.8%
Communication Services	8.1%	10.7%	1.6%	0.0%	21.6%	-20.7%	-12.7%	-39.0%

Source – Strategas Securities, LLC – 10/3/2022

September certainly lived up to its horrid reputation, with the S&P down nearly -10% from start to finish to close the month below June's important 3,637 low.[1] It marked the S&P 500s ninth worst September on record and the lowest September return since 2008.[1] We don't need to tell you how short-term oversold this market is by any traditional measure, but the message of an oversold market that can't seem to rally is the more important takeaway.

Fed Chair Powell has said that he would "keep at it" until the job is done and there is breathing room in the U.S. economy so they can tighten further. There is also a willingness to tolerate below-trend growth and even a recession if necessary. The FOMC still looks set for another rate hike of 0.75% on November 2nd and 0.50% on December 14th.

U.S. demand also looks to be slowing, which is a key sign of restrictive monetary policy. Housing, which is an interest rate sensitive sector and leading indicator, is also weakening (weekly mortgage applications are declining). From a rate of change standpoint, we haven't seen a move like this in 30-year fixed rate mortgages since the early 1980's. Early cracks in the housing market are starting to reflect the new paradigm in borrowing costs. Consumer expectations remain low and credit card borrowing has spiked. Meanwhile, U.S. manufacturing PMI orders dipped back into contraction territory in September and M2, a measure of U.S. money stock, growth has slowed. The 2yr/10yr yield curve remains inverted.

The Fed continues to watch employment closely as it relates to their ability to stay hawkish. U.S. nonfarm payrolls rose a solid +263,000 m/m in September, with small revisions.[1] The unemployment rate declined to 3.5% (the cycle low) as the labor force participation rate fell back down to 62.3%.[1] The U-6 under-employment rate declined to 6.7%.[1] Wage gains were stable: average hourly earnings rose +0.3% m/m and 5.0% y/y. [1] The FOMC can't pivot on this package of readings, it still looks too much like a labor market that's overheating.

Yet the FOMC wants to avoid the "stop-and-go" monetary policy of the 1970s. The plan remains destroying job openings (which remain plentiful) before the economy destroys jobs. Even though it's well known that policy acts with a lag, it's unlikely the committee will be satisfied without seeing more domestic economic weakness, and the effects should reverberate abroad. It's a slow dance into a potential recession, which is very different than 2008-2009.

Despite its recent pullback, we expect the dollar strength to remain elevated, supported by the unfolding global slowdown, rising economic/geopolitical uncertainty, and a relatively strong U.S. economy. In each month during the 3rd quarter, the year-over-year change in the DXY was greater than 15%.[1] With reporting season set to begin in a few weeks, we expect to hear large multinational companies cite the dollar as a reason for missing earnings. Longer term, the stronger dollar will help cool commodities and inflation.

Historically, U.S. recessions have always been accompanied by declines in corporate profits. This downside risk is still ahead of us, in our estimation. Multinational corporations will also feel the global impact of slowing growth. A U.S. recession should bring down current inflation considerably. This result comes at the expense of company earnings, however.

After several weeks of price declines, oil is back on the rise after the OPEC+ alliance agreed to the biggest production cut since 2020.[1] While higher energy prices stoke inflation, markets appear to be seizing on the thought that they will end up limiting demand, hit company earnings and slow economic growth. For U.S. officials, who spent the past few days in a frantic lobbying effort to persuade Saudi Arabia and others in the group to change course, the implication is clear: in the increasingly hostile energy war between Russia and the West, Saudi Arabia is willing to help Russia and snub the U.S.

The S&P GSCI Index recorded a negative performance in the third quarter, driven lower by weaker prices for energy, industrial metals, and precious metals. Energy was the worst-performing component of the index in the quarter, with sharply lower prices for crude oil, Brent crude and unleaded gasoline offsetting higher prices for natural gas. Within the precious metals component, the price of both gold and silver declined in the quarter.

Shifting to the fixed world, where we experienced continued negative performance. The Bloomberg Aggregate Bond Index was down almost -15% through quarter end. Of the 187 quarters since 1976, there has never been a period that has seen negative quarterly returns for both stocks and bonds three quarters in a row until now![1] As normally expected, higher credit quality and shorter duration assets performed well, in relative terms, but the best performing sectors of fixed income have still experienced mid-to-high single digit declines in market value year-to-date. An outlier, although experiencing negative double-digit returns year-to-date, was the taxable high yield sector which performed well against peer sectors during the quarter in relative terms.

With mixed data signals, little clarity of outlook, and real interest rates (the rate of return after inflation) still in negative territory, our position within fixed income allocations remains cautious. We continue to recommend shorter duration and higher credit quality in fixed income portfolios combined with a healthy amount of cash, cash management strategies, or "dry powder" available to be deployed opportunistically.

US Yields	1Q'21	2Q'21	3Q'21	4Q'21	2Q'22	3Q'22	Q/Q Chg (bps)	Y/Y Chg (bps)
Fed Funds Target Rate	0.25	0.25	0.25	0.25	1.75	3.25	150	300
3-Month T-Bill	0.01	0.05	0.04	0.05	1.65	3.33	168	329
2-Year Note	0.11	0.25	0.28	0.73	2.92	4.22	130	397
5-Year Note	0.74	0.69	0.74	1.07	3.00	4.06	106	337
10-Year Bond	1.70	1.40	1.46	1.44	2.98	3.86	88	246
30-Year Bond	2.42	2.07	2.09	1.89	3.12	3.76	64	170

Source – Strategas Securities, LLC – 10/3/2022

Against a backdrop of aggressive Fed tightening and liquidity being quickly drained from the financial system, virtually any asset with a price was punished during the quarter. Municipal bonds were no exception, as directionally, tax-exempt yields tracked the direction of those in the U.S. Treasury bond market. With most of the drubbing taking place in September, for the quarter, the broad market as measured by the Merrill Lynch Municipal Bond Index, posted a return of -3.46%.[1] The severe price declines further exacerbated the year-to-date "bear market" returns, which totaled -12.13%.[1]

Despite the amount of bonds that needed to be sold by mutual fund portfolio managers to meet shareholder redemptions, the liquidity in the tax-free arena has been relatively strong.

Eurozone shares experienced further sharp falls in the quarter amid the ongoing energy crisis, rising inflation, and consequent fears about the outlook for economic growth. The European Central Bank raised interest rates in July and September, taking the deposit rate to 0.75% and refinancing rate to 1.25%.[1] Annual inflation for the eurozone was estimated at 10.0% in September, up from 9.1% in August.[1]

Energy costs continued to be the largest contributor to inflation. Nord Stream 1, the main pipeline supplying gas to Europe from Russia, was closed for maintenance in July. It came back onstream temporarily before Russia shut it down again in early September. This put further pressure on power generators, many of whom need to buy natural gas from higher cost sources, and intensified worries over potential energy shortages this winter. The news also sent the Euro to a 20-year low versus the U.S. dollar.

GDP figures showed the eurozone economy grew by 0.7% quarter-on-quarter in Q2.[1] However, forward-looking indicators signaled a weakening economy. The flash composite purchasing managers' index (PMI) for September came in at 48.2, representing a third consecutive month below 50 (a reading below 50 indicates contraction, while above 50 signals expansion).[1]

UK equities fell in the third quarter. A key event in the quarter was the election of Liz Truss as new Conservative Party leader and hence as prime minister. The new government announced a fiscal package in September which was poorly received by markets and sent sterling to an all-time low versus the U.S. dollar.

Emerging market equities also posted negative returns in Q3, against a backdrop of slowing global growth, heightened inflationary pressure and rising interest rates. China underperformed by a significant margin. They not only have a slump in the property market that weighed on investor sentiment, but the imposition of Covid-related lockdowns in various major cities has had a negative impact on domestic demand.

Growth-sensitive north Asian markets, such as South Korea and Taiwan, suffered as the outlook for global trade deteriorated. Colombia also performed poorly as commodity prices fell, while the Philippines and South Africa, where concerns about the power situation weighed on sentiment, also lagged the index.

India and Indonesia posted positive returns which were ahead of the broader index. Brazil performed well as investors took comfort from a narrowing in opinion polls ahead of October's presidential election, and as growth and inflation improved.

International Indices (Price Chg)	1Q'21	2Q'21	3Q'21	4Q'21	2021	2Q'22	3Q'22 (sorted)	YTD
Bovespa (Brazil)	-2.0%	8.7%	-12.5%	-5.5%	-11.9%	-17.9%	11.7%	5.0%
Sensex (India)	3.7%	6.0%	12.7%	-1.5%	22.0%	-9.5%	8.3%	-1.4%
All Ordinaries (Australia)	2.4%	8.1%	0.6%	2.0%	13.6%	-13.4%	-1.0%	-14.1%
Nikkei 225 (Japan)	6.3%	-1.3%	2.3%	-2.2%	4.9%	-5.1%	-1.7%	-9.9%
S&P/TSX (Canada)	7.3%	7.8%	-0.5%	5.7%	21.7%	-13.8%	-2.2%	-13.1%
OMX Stockholm 30 (Sweden)	17.0%	3.2%	-0.2%	7.1%	29.1%	-10.6%	-2.3%	-24.4%
CAC 40 (France)	9.3%	7.3%	0.2%	9.7%	28.9%	-11.1%	-2.7%	-19.4%
FTSE 100 (UK)	3.9%	4.8%	0.7%	4.2%	14.3%	-4.6%	-3.8%	-6.6%
MSCI EAFE	**6.9%**	**4.0%**	**0.7%**	**3.6%**	**16.1%**	**-8.8%**	**-4.3%**	**-16.5%**
Swiss Market Index	3.2%	8.1%	-2.5%	10.6%	20.3%	-11.7%	-4.4%	-20.3%
DAX (Germany)	9.1%	1.5%	-1.8%	4.1%	13.0%	-13.8%	-5.3%	-26.2%
MSCI AC World	**5.5%**	**6.6%**	**-0.8%**	**6.7%**	**19.1%**	**-14.1%**	**-5.3%**	**-22.9%**
Bolsa (Mexico)	7.2%	6.4%	2.2%	3.7%	20.9%	-15.9%	-6.1%	-16.2%
Kospi (South Korea)	6.5%	7.7%	-6.9%	-3.0%	3.6%	-15.4%	-7.6%	-27.6%
IBEX 35 (Spain)	6.3%	2.8%	-0.3%	-0.9%	7.9%	-4.1%	-9.0%	-15.5%

Source – Strategas Securities, LLC – 10/3/2022

Further, historical seasonality trends indicate that markets tend to sell-off into the midterms. This year's midterm elections have significant macro implications. Implications stem from not only potential fiscal policy, but also from the heightened geopolitical risk environment and deglobalization themes that appear largely bipartisan in their support. Again, pricing higher risk into longer term valuations.

This all contributes to what could be a new era of normal, requiring us to pull back our historical reference-point beyond the growth rally that drove the better part of the past decade. While sentiment is low and equities have already discounted significant risk, this extended overhang of higher rates, higher risk and higher cost may present a lower price-to-earnings ("P/E") environment for a while longer.

We expect to have more clarity on forward guidance upon earnings season in a couple weeks. Remember, Q2 earnings were "better-than-feared", and low sentiment led to a strong July rally. We're entering a seasonally strong part of the year, as a seasonally weak September is now behind us. We continue to believe the U.S. is in a better economic situation, compared to non-U.S. markets: supported by the U.S. consumer, a strong currency, better energy security and greater financial stability.

Areas of the U.S. economy are slowing, particularly around housing, and earnings expectations are being revised lower for most industries. We are seeing signs of slowing with hiring freezes across big tech and soft macro data around shipping volumes, as examples.

Bottom line is we are increasingly confident that central banks will bring inflation down. The question is, at what cost? A recession should tame inflation (even in the 1970s this was true). With more and more discussions of a financial crisis or significant event occurring like a bank failure, we thought it might be helpful to show this table which on average shows significant events are often buying opportunities for equities. Naturally it doesn't feel right in the moment but on average one year after said event, the S&P 500 is up on average 5.2%.[1] It's worth noting that an event such as those listed in the table has not occurred yet.

S&P 500 Performance Following Significant Historical Events

Event	Date	-250-Days	-65-Days	Day Of	+65-Days	+250-Days
Germany Invades France	5/10/1940	7.4%	0.7%	-3.0%	-15.0%	-19.6%
Pearl Harbor	12/7/1941	-11.3%	-9.3%	-3.8%	-10.5%	3.7%
JFK Assassinated	11/22/1963	16.7%	0.3%	-2.8%	11.8%	23.9%
Penn Central Bankruptcy	6/21/1970	-20.8%	-11.9%	-0.5%	8.1%	31.1%
Oil Embargo	10/16/1973	2.0%	5.7%	0.1%	-13.3%	-35.4%
Pres. Nixon Resigns	8/9/1974	-21.3%	-10.8%	-0.9%	-7.1%	6.7%
Continental Illinois Bailout	5/9/1984	-2.3%	-0.2%	-0.3%	3.3%	12.4%
1987 Stock Market Crash	10/19/1987	19.8%	-9.6%	-20.5%	8.1%	22.4%
Iraq Invades Kuwait	8/2/1990	3.4%	7.5%	-1.1%	-11.3%	10.0%
Soros Breaks Bank of England	9/16/1992	8.3%	2.4%	0.0%	3.7%	10.0%
1st World Trade Center Bombing	2/26/1993	7.2%	3.7%	0.2%	2.4%	6.3%
Asian Financial Crisis	10/8/1997	41.5%	7.8%	-0.9%	-3.6%	1.1%
U.S.S Cole Yemen Bombing	10/12/2000	9.4%	-7.9%	-2.6%	0.0%	-17.5%
9/11 Terror Attacks	9/11/2001	-26.3%	-14.4%	-4.9%	10.0%	-14.3%
Iraq War	3/20/2003	-24.2%	-3.1%	0.2%	12.1%	28.3%
Bear Stearns Collapse	3/14/2008	-5.2%	-12.6%	-2.1%	4.9%	-41.7%
Lehman Brothers Collapse	9/15/2008	-15.2%	-6.3%	-4.7%	-23.4%	-12.6%
U.K. Votes to Leave EU (Brexit)	6/24/2016	0.6%	3.1%	-3.6%	6.0%	19.5%
NBA Shutdown (COVID)	3/11/2020	2.5%	-7.4%	-4.9%	10.9%	41.4%
Opposition to 2020 U.S. Election	1/6/2021	14.6%	10.2%	0.6%	10.1%	28.0%
Russia Invades Ukraine	2/24/2022	10.9%	-10.2%	1.5%	-3.0%	-
	Average	*0.8%*	*-3.0%*	*-2.6%*	*0.2%*	*5.2%*
	Median	*2.5%*	*-3.1%*	*-1.1%*	*3.3%*	*8.3%*

Source – Strategas Securities, LLC – 10/3/2022

This will remain a difficult market for both bulls and bears alike. We think it is important to remember that amid the 80% decline in the NASDAQ from March 2000 to October 2002, there were eight counter-trend rallies that ranged in magnitude from 13% to 44% and duration of 8 to 76 days.[1]

We, on the other hand, believe it makes more sense now to simply listen to the Fed tell you how it's going to proceed, regardless of whether one believes it to be right or wrong. As in Blackjack, the object of the money game isn't to get 21, it's to beat the dealer. With this in mind, we think it's unlikely that the Fed will make the mistake of staying too easy for too long twice in a row. Without hard data to support the idea that inflation is getting closer to its target, especially in the labor markets, the Fed is likely to continue to pursue more restrictive monetary policy.

While inflation has probably peaked, we are living in a supply constrained world, and we suspect inflation will be stickier than central bankers want. Importantly, the decade after the Global Financial Crisis ("GFC") was a time of excess supply, and central bankers around the world kept interest rates artificially low to stimulate demand. Investment strategies that worked well in the aftermath of the GFC seem less likely to work well in coming years and as we've seen so far in 2022, investment approaches that favor long duration (high P/E) growth stocks may fare poorly in a time of increasing interest rates. If, as I suspect, it takes more time than desired for inflation to fall to levels consistent with the Feds definition of price stability (2% inflation), then we may be living with structurally higher interest rates for years. Value stocks may do particularly well in this environment.

One thing is for certain, volatility will continue to persist heading into and throughout the midterms. For some context on how volatile the first nine months of the year were, we saw 88% of trading days had an intraday range greater than 1%.[1] This is the highest level since 2009 when 95% of the trading days saw ranges greater than 1%.[1] We see no reason for volatility to subside in the fourth quarter.

There is uncertainty around the elections, plus an element of volatility from “voter fraud” challenges, run-offs, and anything else unexpected that may happen in the modern-day election climate.

As long-term investors, we don’t turn and run just because a storm might come. Storms come and go, and over time, markets have continued to move higher. However, we do not believe that this is an appropriate time for risky investments or to pick the bottom. As we look out across the investment landscape and macro picture, we see more headwinds than tailwinds. At Hightower Westchester, we focus on capital preservation and diversification over the long-term. Currently we are holding extra cash and cash equivalents like Treasury bills (that actually produce some yield!).

Naturally, the optimal outcome for any central bank tightening monetary conditions would be a soft landing in which inflation eases without a recession Furthermore, we’ve lived through enough cycles to know that people sometimes panic when they hear a dire economic forecast. More importantly, however, we don’t believe the Fed would consider it to be a terrible outcome if the economy entered a mild recession if inflation was indeed vanquished in the end. For the time being, however, we believe discretion is the better part of valor.

To discuss this commentary further, please contact us at 914-825-8630.

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[1] *Strategas Securities, LLC – 10/7/2022*