

# Economic and Market Outlook – Third Quarter 2022

## Clouded, Uncertain, and Facing Multiple Risks

The world faces multiple and unsettling unknowns: substantial geopolitical risks with the ability to reorder societies, economies, and markets; economic policy risks; and the risks attendant upon making decisions in a rapidly changing economic and market system. After the risk of nuclear war had seemed to recede for several decades, it once again seems possible in the context of Russia's invasion of Ukraine. Russia has weaponized oil and gas supplies, amplifying shocks to commodity supply chains already shocked by the Covid pandemic. The apparent sabotage of the Nord Stream gas pipeline not only threatens further fuel disruptions, but also generated the largest single release into the atmosphere ever recorded of the extremely potent greenhouse gas methane.<sup>1</sup> China and Taiwan are rattling sabers. A change in government in the U.K., accompanied by an abrupt and unexpected return to Thatcher-era supply side policy, roiled the Gilt market, with the yield on the 10-year Gilt approaching emerging-market levels of volatility. The Supreme Court opened a new term, loading its docket with cases on voting rights, affirmative action, and partisan gerrymandering. Central Banks, with the notable exception of the Bank of Japan, have substantially tightened monetary policies and financial conditions, raised interest rates, and rocked currency markets. As interest rates rise and economic activity slows, the probability of recession rises.

## How far will the Fed go?

Since the Great Financial Crisis, the phrase "Don't fight the Fed," attributed to Martin Zweig's 1986 book, *Winning on Wall Street*, has suggested a risk-on posture: As long as the Fed was providing plenty of liquidity, high price-to-earnings ratios were nothing to fear. Low interest rates could plausibly be followed by even lower interest rates, and the market could rely upon "the Fed put" to bail out investors in a downturn. Today's market calls for a revision of that mantra to: "Believe the Fed." We do believe the Fed when the Chair and the members of the Federal Reserve Board of Governors assert that they will do "whatever it takes" to tame inflation. The Fed's increases in the Federal Funds rate in this cycle have been breathtakingly aggressive: 3% in just six months, with an additional 1.5% anticipated in the next six months. Compare this with the three years it took from December 2015 to December 2018 to raise rates by just 2.375%; or the two years it took from mid-2004 to mid-2006 to raise rates by 4.3%. Further, the current Fed rate hikes have been from an extremely low level of rates, leading to a massive -14.61% drawdown for the Bloomberg US Aggregate Bond Index.

Unfortunately, no one knows exactly how much tightening is needed to control inflation, as the degree to which consumers and businesses have embedded inflationary expectations is unknown and only partially observable. Currently, the Fed's Dot Plot implies the Federal Funds rate reaching 4.625% in 2023, approximately what the market is now predicting. The Fed's actions are intended to decrease aggregate demand. The risk is overtightening, especially with as steep a path of interest rate increases as this one. Consumers and businesses make their own decisions about spending and investing based on the information that they have. That information now includes the knowledge that the Fed is determined to raise interest rates to a restrictive level, that the Fed views the risks to economic growth as skewed to the downside, and that the Fed has lowered its projections for 2023 economic growth by a full percentage point, to just 1.2%.

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<sup>1</sup> Jared Gans, "UN: Nord Stream pipeline rupture largest single release of methane recorded", The Hill, 10/02/22



Changes in the 10-Year Treasury yield typically lead the purchasing managers index by 18 months; so the 2% increase in 10-year rates that we have seen since March of 2022 will likely not have its full effect on economic activity until September of 2023. We expect the interest rate hikes to continue until the data show several consecutive readings of much softer core inflation, much softer growth in unit labor costs and average hourly earnings, and a much narrower gap between job openings and unemployment. While the Fed and other Central Banks wait for the data to show a clear deceleration, financial restriction raises the overall level of risk. Where exactly those risks will manifest is unknown; but past hiking cycles have led to corporate inability to float new bond issues, liquidity crunches in sovereign bond markets, currency crises, and coordinated antagonistic sovereign political actions.

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### Third Quarter Performance

Stock and bond markets dropped for a third consecutive quarter. Despite a two-month, 17% rally between June 16 and August 16, the S&P 500 returned -4.88% for the quarter, extending the disappointing returns already seen in 2022, and bringing the year-to-date loss for the S&P 500 to -23.87%. For the year-to-date, estimated forward earnings have risen by 6.5%, while valuation compression, as measured by Price-to-earnings ratios (P/E), reduced S&P 500 returns by -29.4%. During the quarter, equity market declines were relatively insensitive to either capitalization or geography, with the S&P Small Cap Index returning -5.22%, the S&P Mid Cap index returning -2.46%, and the MSCI ACWI Net and the MSCI ACWI ex-US Net returning -6.82% and -9.91% respectively. As recession fears supplanted inflation fears, Growth stocks outperformed Value stocks, with the Russell 3000 Growth Index returning -3.37% and the Russell 3000 Value Index

returning -5.56%. Nine of the eleven S&P 500 sector indices fell, with only the Energy sector and the Consumer Discretionary sector managing positive returns of 2.16% and 4.36% respectively. Other sector returns ranged -3.10% for the Financials Sector to -12.71% for the Communications Services sector. Treasury yields continued their upward march, with the 10-Year Treasury yield increasing 0.65%, to 3.66% at quarter-end. Credit spreads widened, dragging the Bloomberg Barclays U.S. Government/Credit Intermediate Index returns to -3.06%, while the Bloomberg Intermediate 1-10 Year Municipal Bond Index returned -2.30%.

### Valuation and Positioning

By the end of the quarter, P/E compression brought the S&P 500 forward P/E ratio down to 15.15 times, half of a standard deviation under its 25-year average, and the cyclically adjusted price-to-earnings ratio (CAPE) to 27.2 times, -0.13% below its 25-year average. The earnings yield of the S&P 500 increased to 6.6% during the quarter, while 10-year Treasury Inflation-Protected Security yields increased to 1.68%, suggesting that stocks will return about 4.9% more than bonds over the next year. We continue to favor stocks over bonds for the next three to five years, recognizing that while stocks may have additional risk over the immediate horizon, the earnings growth capacity of stocks over the long term should ultimately support their valuation. In the near term, declining business confidence and consumer confidence will likely translate into reduced corporate earnings, which is likely to initiate another down leg for equity markets. We anticipate a recession including declines in corporate profits. Over the past 40 years, declines in forward twelve months earnings per share during recessions have ranged between -8% and -39%; while declines in trailing twelve-month earnings have ranged between -15% for the Covid recession and -45% for the Great Financial Crisis. At current prices, we do not see the glaring imbalances of either the 1999-2000 Technology bubble or the 2006-2008 housing market bubble. We have already experienced substantial price to earnings ratio compression as interest rates have risen, but additional compression is still possible.

Market recovery is unlikely to start until the Fed and other Central Banks begin to ease, which will not happen until Central Banks judge that inflation expectations are sufficiently low. This is likely to be several quarters into the future. We note that

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recovery from bear markets is generally sudden and sharp, so that attempts to time the market are usually unsuccessful. While we have become more cautious, we believe that we are appropriately positioned for more risk-off markets. As always, we will be carefully monitoring economic data and our positioning as these higher interest rates begin to affect economic activity. In a slowing growth environment, we expect that our focus on quality, lower-leverage, profitable companies with steadier earnings and revenues will be protective.

We continue to avoid positioning for extremes and acknowledge that an environment of high uncertainty means an increased likelihood of rapid rotation, while the combination of rapidly rising rates and extreme U.S. dollar strength raise the risk for currency, liquidity, and legitimacy crises worldwide. In such an environment, thoughtful analysis of company management, strategies, and prospects assumes added importance. We remain committed to our long-term focus and investment in high-quality and sustainability-centered companies seeking to meet the challenges of this year of recovery and transition, and beyond. In addition, we are seeking out companies that acknowledge the ongoing climate crisis and which are setting their own targets for greenhouse gas reduction.

### Where to from here?

In such challenging and difficult times as these, companies will be increasingly distinguished by the quality and integrity of their management, and by management's attention to evolving social and environmental considerations. This is all the more true as we see regulatory frameworks dismantled. The growing environmental, social, and

policy challenges facing the world make it increasingly imperative that we, as shareholders, engage our companies in creating the transition to a lower carbon economy and recognizing the human rights and dignity of their workers. We expect our companies to act with integrity and purpose, and to take leading roles in creating alternative mechanisms, through legislation or internal policies, to protect the needs and concerns of their employees, communities, and planet.

### About Trillium Asset Management

Trillium Asset Management, LLC (Trillium), with \$5.3B in assets under advisement (\$4.1B in assets under management and \$1.2B in assets under advisement as of 9/30/22), offers investment strategies and services that advance humankind towards a global sustainable economy, a just society, and a better world. For 40 years, the firm has been at the forefront of ESG thought leadership and draws from decades of experience focused exclusively on responsible investing. Trillium uses a holistic, fully integrated fundamental investment process to uncover compelling long-term investment opportunities. Devoted to aligning stakeholders' values and objectives, Trillium combines impactful investment solutions with active ownership. The firm delivers equity, fixed income, and alternative investments to institutions, intermediaries, high net worth individuals, and other charitable and non-profit organizations with the goal to provide positive impact, long-term value, and 'social dividends'.

#### Contact Information

[ContactUs@trilliuminvest.com](mailto:ContactUs@trilliuminvest.com)

800-548-5684

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