Q4 2022 MARKET OUTLOOK

Executive Summary

Although the US economy has been resilient, the probability it enters a recession in 2023 is increasing at a fast pace, as extremely tight labor market conditions collide with ultra-hawkish central bank policies. As the impact of rising interest rates flow through the real economy, we expect it will have a deleterious effect on economic growth and corporate profits, which will facilitate phase two of the current bear market. As a result, we believe the risk-reward relationship in risk-assets is unfavorable and a cautious investment strategy remains prudent.

Economic Data Check

The US economy remains resilient for now, but a 2023 recession appears increasingly likely.

- Domestic consumption is still strong while labor market conditions have continued to tighten. However, because the unemployment rate is at 3.5% (tied for a 50-year low), the US economy's potential to expand from here is limited.
- The Fed's hawkish policy should weigh on economic activity in the coming quarters; meanwhile, it is already creating stress in global currency markets, which presents a material risk to the global financial system. So far, it seems willing to push until something breaks.
- It is probable the US will enter a recession in 2023, whereas Europe and China are likely already in one.

Equities

Favor being underweight equities as growth slows and risk of recession increases.

- Global equities declined **-6.8%** in Q3 as the Fed grew increasingly hawkish, pushing interest rates higher and valuations lower. They're now down **-24.3%** in 2022.
- Until this point, data suggest this year's equity volatility has primarily been driven by higher interest rates. We expect market participants will transition their focus from rate risk to earnings risk as corporate fundamentals come under pressure in the coming quarters.
- So far, only 1 of our 10 indicators for identifying major stock market bottoms has triggered, suggesting equity market conditions will likely worsen before they improve.
- Despite maintaining a poor cyclical outlook, equities may have reached oversold conditions in the near term and are likely poised for another bear market rally. However, the time frame is likely too short to favor repositioning for.

Fixed Income

Favor transitioning from neutral to underweight fixed income until Fed hawkishness moderates.

- The US Aggregate Bond Index fell **-4.8%** in Q3 and is currently down **-16.8%** in 2022. If the year ended today, it would reflect its worst year in history[1] by a factor of 5x.
- We had favored legging into bonds over the summer based on our view that inflation had peaked, but, in hindsight, this move was too early. Bonds will likely remain under pressure until the Fed moderates its ultra-hawkish stance, at which point we will favor adding to high-quality bonds further out on the yield curve.

Commodities

Favor being overweight commodities via gold.

- The Goldman Sachs Commodity Index declined **-10.3%** following a red-hot first half of the year where the index climbed **+35.8%**.
- If the global economy enters a recession, we expect demand for commodities will slow, presenting a risk to commodity prices, despite current supply constraints.
- We favor being overweight gold, which should perform well when upward pressure on real yields moderate.

Summary

Favor a defensive posture while challenges to economic growth persist.

- We favor being underweight equities and bonds, overweight cash, and overweight commodities via gold until our economic growth outlook improves.
- We plan to favor adding to bonds when the Fed eases its ultra-hawkish guidance and to favor adding to equities as our market bottoming signals trigger.

POSITIONING HIGHLIGHTS:

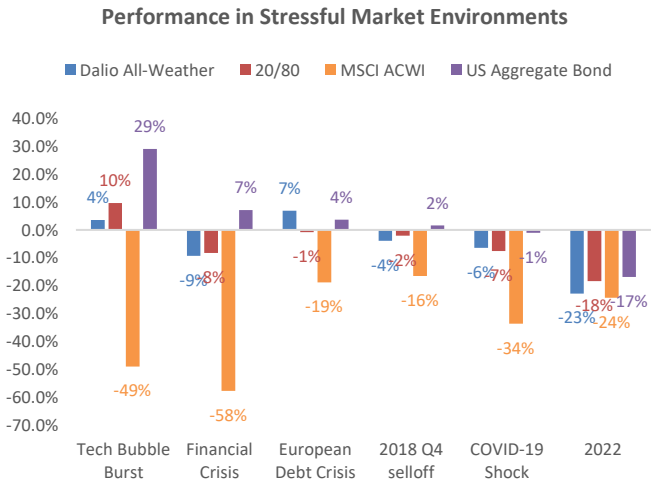
UNDERWEIGHT	UNDERWEIGHT	OVERWEIGHT	OVERWEIGHT
Global Equities	Fixed Income	Commodities	Cash

Note: *This document, including important disclosures on Page 10, is meant to be read in its entirety.*

[1]The US Aggregate Bond Index was incepted in 1976.

Third Quarter Review

2022 has been a challenging investment environment, particularly for diversified investors. Although global equities have only fallen **-24%** from their high, diversified stock–bond portfolios are on pace for their worst-year ever. Whether that feat is realized remains to be seen. To provide context, a portfolio consisting of 20% stocks and 80% bonds is performing more than twice as poorly as it did during the worst of the 2008 financial crisis. Furthermore, the hypothetical Dalio All-Weather portfolio—a portfolio consisting of commodities, stocks, and bonds designed to weather all environments—is down **-23%**. The reason diversified portfolios are participating in more downside in the current environment relative to previously volatile environments is because this time, bond and stock prices are declining at the same time, whereas, during recent bear markets, bonds appreciated while stocks declined.



Source: Kwanti, Bloomberg, GMAG Research

Disclosure: Returns are presented gross-of fees and do not include the effect of transaction costs, management fees, performance fees or expenses, and tax management if applicable. Historical drawdowns are hypothetical results based on the performance of the underlying constituents of the hypothetical portfolios. Actual results may significantly differ from hypothetical returns being presented. The 20/80 portfolio reflects a hypothetical asset allocation consisting of 20% MSCI All World Equity and 80% US Aggregate Bond, rebalanced annually. The Dalio All-Weather Portfolio reflects a hypothetical asset allocation consisting of 40% US long-term treasury bonds, 30% MSCI All World Equity, 15% US intermediate-term treasury notes, 7.5% gold, and 7.5% broad commodities proxied by the S&P Goldman Sachs Commodity Index, rebalanced annually.

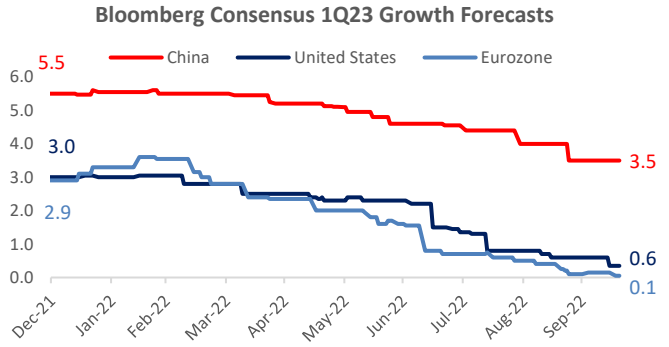
MARKET REPORT CARD – September 30, 2022

Performance Reported in US Dollars	3Q22	Year-to-Date	Trailing 1-Year
Equities			
Global (MSCI All World Equity Index)	-6.8%	-25.6%	-20.7%
United States (Russell 3000 Index)	-4.5%	-24.6%	-17.6%
International Developed (MSCI EAFE Index)	-9.4%	-27.1%	-25.1%
Emerging Markets (MSCI EM Index)	-11.6%	-27.2%	-28.1%
Fixed Income			
Bloomberg Barclays US Aggregate Bond Index	-4.8%	-14.6%	-14.6%
Long-Term Treasuries (Barclays 20+ Year)	-10.1%	-30.1%	-27.7%
Investment-Grade Bonds (Barclays US Corp)	-5.1%	-18.7%	-18.5%
High-Yield Bonds (Barclays US HY Corp)	-0.6%	-14.7%	-14.1%
Commodities			
Commodities (S&P GSCI Index)	-10.3%	+21.8%	+23.6%
Crude Oil (S&P Crude Oil Index)	-21.0%	+22.3%	+25.8%
Gold (LBMA Gold PM Price Index)	-8.0%	-7.4%	-4.1%
Hedge Funds			
Hedge Funds (HFRX Global Hedge Fund Index)	+0.5%	-4.6%	-4.5%

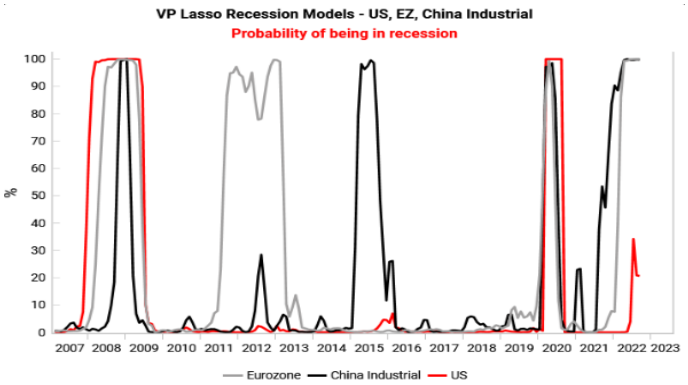
Source: Bloomberg, GMAG Research

Economic Data Check (1): Risk of a global recession has risen considerably.

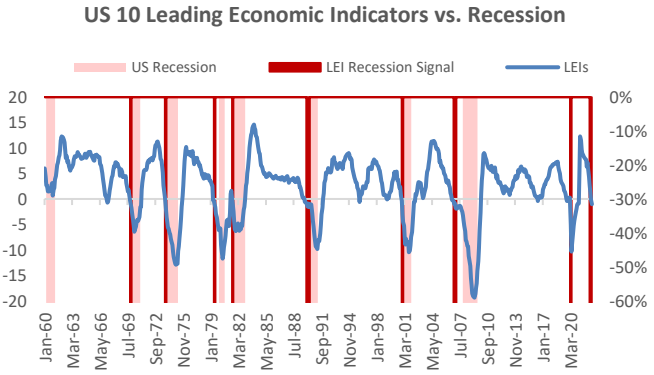
- Since February, growth forecasts for the world's largest economies have consistently been revised lower (**Chart 1**), and, from our perspective, there is no shortage of risks that could cause these estimates to deteriorate further. Such risks include but are not limited to (1) the lagged impact from higher interest rates, (2) the fading impulse from COVID-19 stimulus, (3) an escalation of the Russia–Ukraine War, (4) incessant strength of the US dollar, and (5) a potential deleveraging of China's property sector.
- **Chart 2** illustrates that the Eurozone and China have likely already entered a recession, and although the US has not yet done so, that risk is rising. **Chart 3** shows the US Leading Economic Indicators Index contracted by 1% in August. Historically, when this index has contracted by 1% or more, a recession has followed within four months, on average.
- The two datapoints we would highlight as evidence that the US is not yet in a recession are the resilience of the consumer and tightness of labor market conditions. Real personal consumption—a metric adjusts for inflation—is still growing at about +2% year-over-year. Meanwhile, the unemployment rate is tied with a 50-year low. In our view, this provides a headwind to future growth because, when most people that want jobs already have jobs, then there are fewer people available to bring into the workforce to power the economy higher. Per **Chart 4**, lower unemployment rates generally coincide with lower expected returns for stocks. As a result, we believe the potential for economic growth and stock prices to expand from current levels is limited without first going through a reset.
- The Fed recently communicated it expects the unemployment rate will reach 4.4% next year. We believe this is wishful, because, if that target is reached, it will be unlikely to stop there. Bank of America recently communicated it expects unemployment to climb to 5.5% in 2023, which we believe is a more realistic forecast. That would equate to about 3.3 million lost jobs, which would almost certainly create a drag on economic activity. **We believe the worst is likely in front of us.**



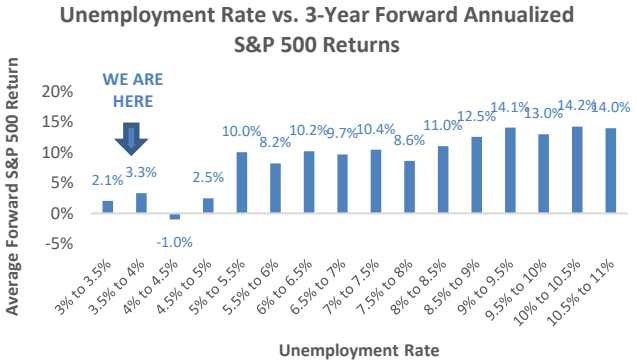
Source: Bloomberg, GMAG Research



Source: Variant Perception



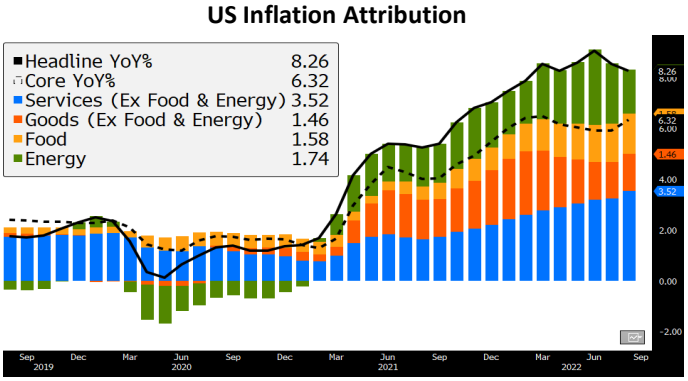
Source: Bloomberg, GMAG Research



Source: Bloomberg, GMAG Research
Calculations in the above illustration have been performed using monthly data from 1960 to present.

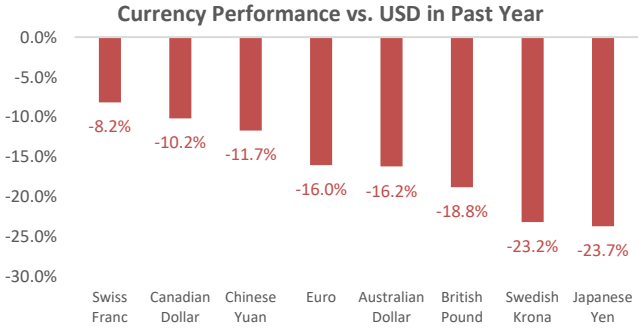
Economic Data Check (2): Sticky inflation has caused the Fed to keep its foot on the gas, increasing systemic risks.

- Although headline inflation has likely peaked, core inflation remains sticky (**Chart 1**), and it will likely prolong inflation's well-desired return to the Fed's 2% target. The primary contributor to inflation over the past few months has been owners' equivalent rent (OER)—a metric used to approximate the cost of shelter—and it represents ~24% of the headline CPI basket and 42% of the services basket. Although energy prices have rolled over, OER continues to accelerate. As a result, the Fed believes inflation is more than just a commodity supply issue, and, therefore, continued aggressive interest rate hikes are necessary to bring inflation down to its preferred target.



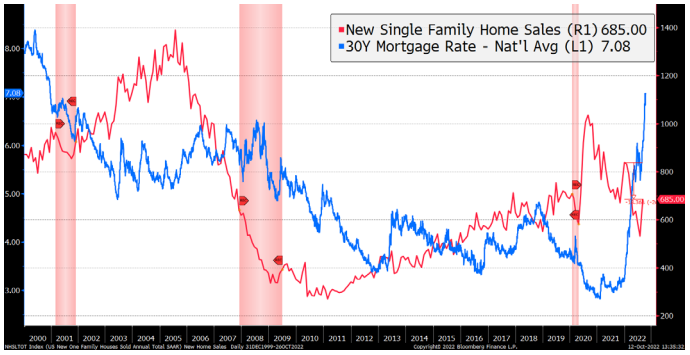
Source: Bloomberg

- Although it can be argued whether or not the Fed's current level of hawkishness is required, it's clear it has profound implications on economic and financial market conditions:
  - The relative strength of the US economy has allowed the Fed to raise interest rates faster than its developed peers, which in turn has helped catalyze a broad and substantial debasement of their respective currencies (**Chart 2**). If the Fed doesn't moderate its hawkish guidance, we could reach a point where global financial markets break. One could argue that what's currently happening in the UK—pension funds have been fire-selling assets and the Bank of England has engaged in Gilt purchases to provide financial stability—serves as evidence we're not too far from that point.



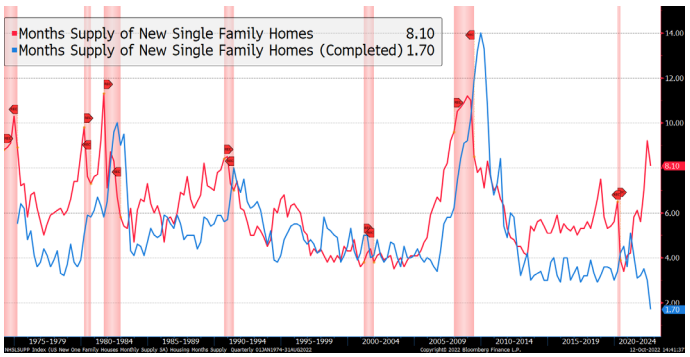
Source: Bloomberg, GMAG Research

  - The Fed's tightening has also increased the cost of borrowing for both consumers and corporations. The second order effect of this is perhaps no more obvious than in the US mortgage market, where the 30-year average fixed rate has ballooned beyond 7% for the first time since the year 2000 (**Chart 3**). This has drastically decreased home affordability, causing new single family home sales to decline by **-18%** so far in 2022. This will likely lead to lower home prices, but the question is, how much lower?



Source: Bloomberg

  Improved household balance sheets combined with extraordinarily tight inventories (see **blue** line in **Chart 4**) will likely prevent home prices from sliding like they did in 2008. That said, Redfin estimates 18% of home purchases in 4Q21 were made by investors, a cohort of participants who are less likely to hold on to their properties if their investment portfolios continue to decline. The longer interest rates remain elevated, the more likely it will cause inventories to rise and home prices to fall.

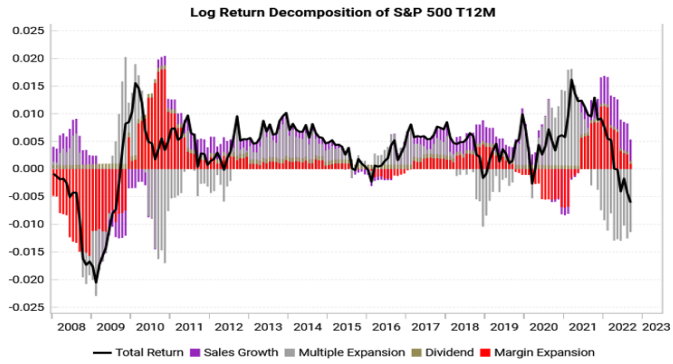


Source: Bloomberg

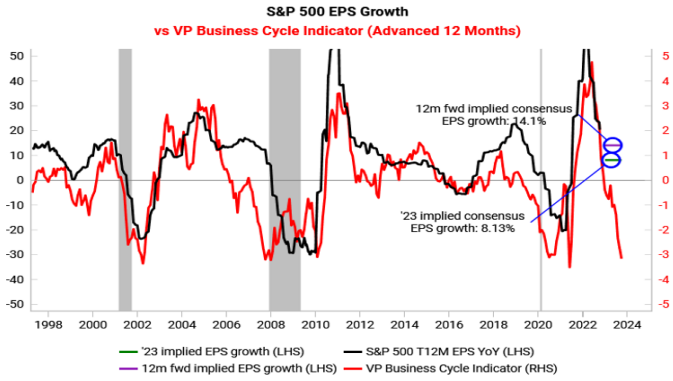
Equities (1): Favor Underweight

We expect earnings risk will replace interest rate risk as the primary driver of equity volatility in the coming quarters.

- Up to this point, the decline in equity prices has largely been driven by multiple compression due to higher interest rates (**Chart 1**). Recall that, all-else-equal, higher rates reduce the present value of future cash flows and push asset prices lower.
- Going forward, we expect the primary driver of equity volatility will transition from interest rate risk to earnings risk. Consensus believes S&P 500 earnings will grow by 14% over the next 12 months, and that margins will expand in the process. We believe this is unlikely, and economic conditions suggest earnings growth may actually be negative (**Chart 2**). We expect to see material downward earnings revisions in the quarters ahead.
- Earnings deterioration would not be abnormal in this environment because, historically, bear markets have coincided with material contractions in corporate profits. **Chart 3** shows that, during the past 12 bear markets, the average contraction in trailing S&P 500 earnings has been **-25%**, and that equity prices, on average, haven't bottomed until said contraction reaches about **-10%**. We don't expect this time will be different, and, so far, S&P 500 earnings remain near all-time-highs. This suggests earnings have plenty of room to decline before equity prices find a floor, and the attached chart suggests earnings may have already peaked.
- Market participants have highlighted the fact that forward equity valuations have retreated toward long-term averages, as a cause for optimism. Although we believe the contraction in valuations is undeniably healthy, we also observe that (1) forward metrics are less useful if earnings forecasts are materially overestimated, and (2) valuations tend to overshoot to the downside during recessions. Historically, the trailing price-to-earnings (P/E) multiple for the S&P 500 has generally bottomed in the low-teens (12.7), whereas today, that multiple is still elevated at 17.6. Therefore, if we are headed into a recession, equities likely face more downside after factoring in a further contraction in valuations and earnings.



Source: Variant Perception



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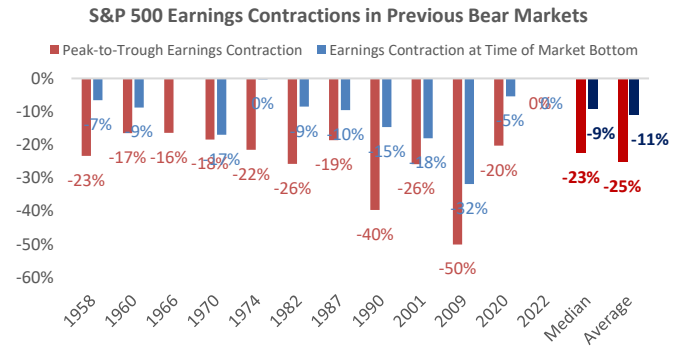
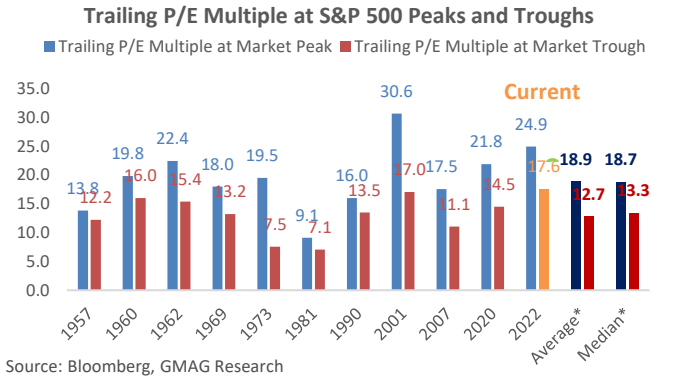


Source: Bloomberg, GMAG Research
Calculations in the above analysis use trailing 12-month earnings

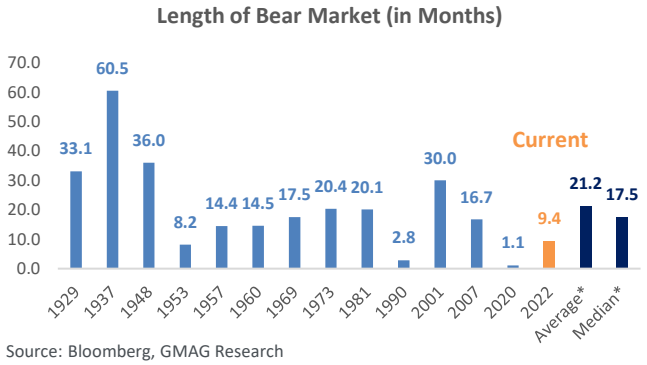


Source: Bloomberg, GMAG Research

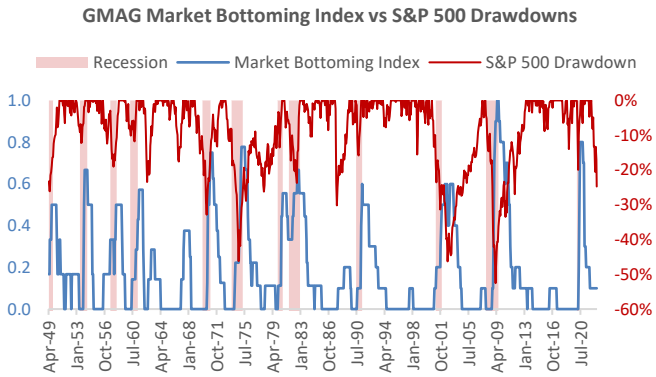
Equities (2): Favor Underweight

History suggests we're likely in the middle innings of this bear market. However, stocks may be oversold in the near term, potentially setting the stage for another bear market rally.

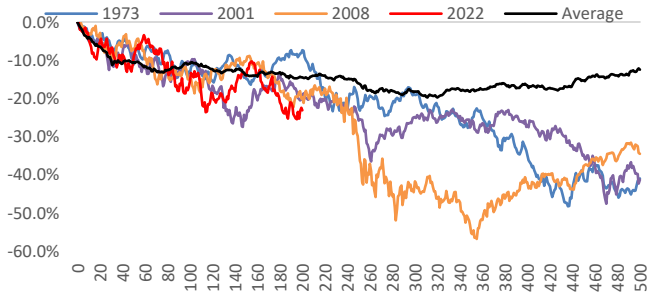
- The average and median length of US bear markets dating back to the Great Depression are 21 months and 18 months, respectively (**Chart 1**). Given that we're less than 10 months into the current bear market, history suggests we're unlikely near the end of it yet. We further note that, historically, on average, only ~40% of the peak-to-trough drawdown in the S&P 500 has occurred prior to the start of the recession, and given it's unlikely that the US is in a recession yet, this implies the majority of the drawdown in stocks is likely ahead of us.
- We are keying on our market bottoming indicators to determine when to favor increasing allocations to equities. However, still only 1 of our 10 indicators have triggered (**Chart 2**). Furthermore, it is unlikely that many of these indicators will trigger within the next 3 months based on the current trajectory of the underlying data, which is just one more reason that leads us to believe that if the US economy is heading into a recession then equity prices likely have further to fall.
- Although our cyclical outlook is poor, US stocks may be poised for another bear market rally. **Chart 3** shows the S&P 500 has endured a larger selloff in the first 200 trading days of this bear market than even the worst bear markets in the past 50 years (e.g., 2008, 2001, and 1973). We also know prices don't go straight up or straight down, and that bear market rallies are extremely common. Between the 2001 and 2008 bear markets, there were 8 instances (4 in each) where the S&P 500 rallied more than 10% prior to declining to new lows. Furthermore, many short-term buy-the-dip signals, which include indicators like strong breadth, poor sentiment, high cash balances, and robust insider stock purchases have triggered (**Chart 4**), suggesting the time may be ripe for a rally. However, we do not believe it is prudent to position for this, given the short time frame and the absence of a supportive fundamental outlook.



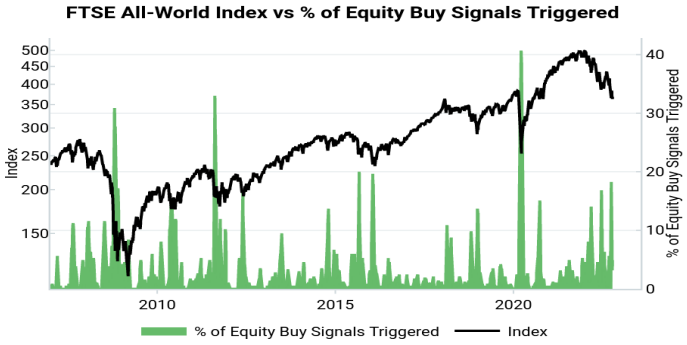
Source: Bloomberg, GMAG Research



Source: Bloomberg, National Bureau of Economic Analysis, GMAG Research



Source: Bloomberg, GMAG Research

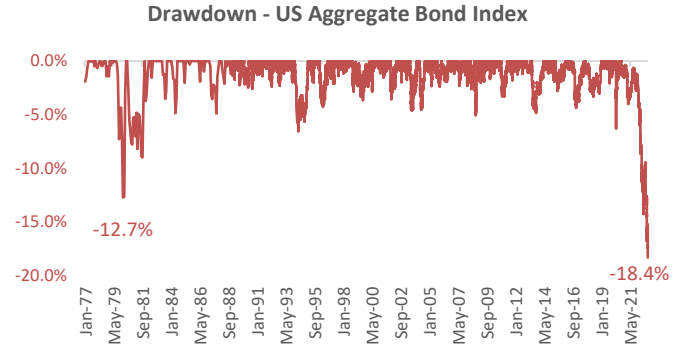


Source: Variant Perception

Fixed Income: Favor Underweight.

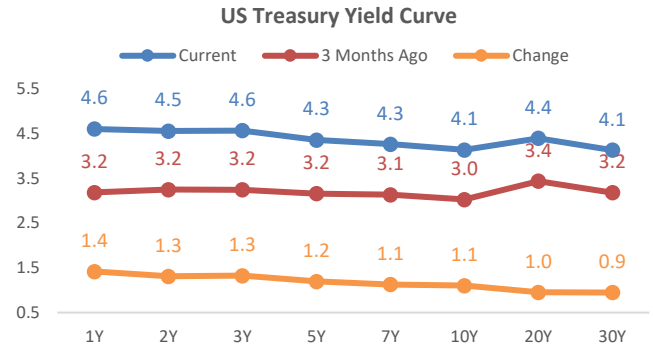
We favor being underweight bonds until the Fed moderates its hawkish guidance.

- It has been a challenging environment for bonds. The US Aggregate Bond Index has declined **-18.4%** from its high, recording its worst drawdown since its inception in 1976 (**Chart 1**).



Source: Bloomberg, GMAG Research

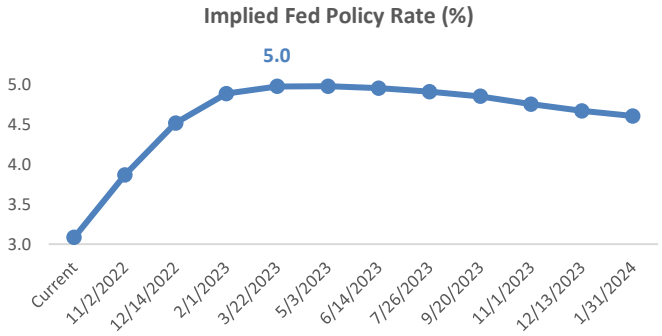
- The cause has been high and persistent inflation and perhaps more importantly, the Fed's reaction to it. In an effort to rein in inflation, the Fed has embarked on its most aggressive tightening cycle in more than 40 years, which in turn has pushed interest rates up and bond prices lower across the entire yield curve (**Chart 2**).



Source: Bloomberg, GMAG Research

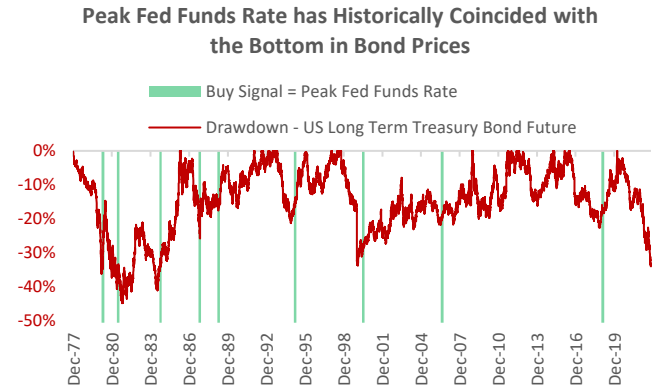
We have been surprised by the amount that long-term yields have risen relative to the short-term yields over the past few months because, generally, long-term yields reflect the market's expectation of future growth and inflation and are less influenced by changes in the Fed Funds rate. As a result, when the Fed raises front-end interest rates, long-term rates tend to increase as well, but at a slower pace than front-end rates to reflect falling growth and inflation expectations—recall that more restrictive monetary policy causes growth and inflation expectations to slow, which is why the Fed is raising rates.

However, over the past 3 months, long-term rates have increased at a faster pace than we expected, which could signal that the bond market expects Fed policy to remain aggressive for longer. Given the persistence of inflation and uncertainty of current economic conditions, we believe it is prudent to wait until the Fed eases its guidance as opposed to trying to front-run a pivot in policy. We view this as a better to be late, than early scenario.



Source: Bloomberg, GMAG Research

- **Chart 3** illustrates the market currently expects the Fed Funds Rate to peak at about 5% in March—which implies 7 additional rate hikes from current levels—and then begin to descend from there. If this trajectory is correct, then Q1 should present an attractive opportunity to favor adding to bonds because historically, bond prices have generally bottomed within a few months of the peak in the Fed Funds Rate (**Chart 4**).



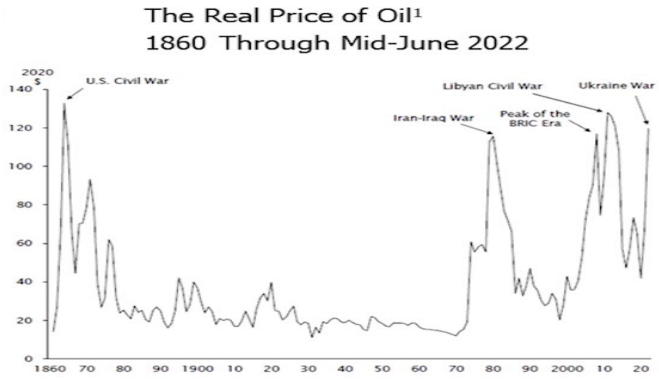
Source: Bloomberg, GMAG Research

Commodities: Favor Overweight.

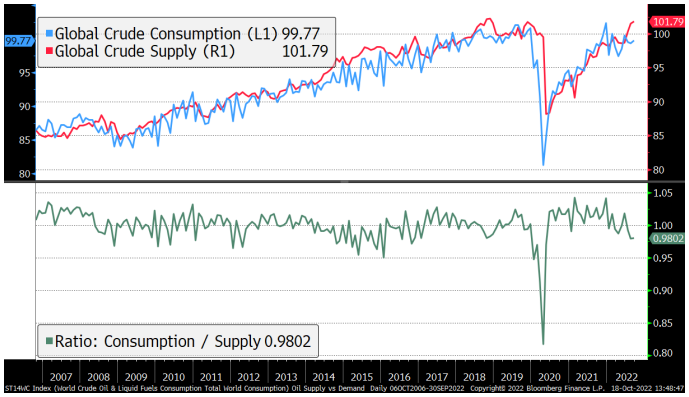
Favor underweight to broad commodities as recession risk looms but overweight in gold, which we expect will benefit when the Fed eventually pauses.

- Despite constrained energy supply, we are skeptical that broad commodities, and particularly energy (which accounts for ~60% of the index), will resume their climb. Historically, when the real price of oil has reached its current level, it has subsequently fallen sharply (**Chart 1**).
- Why? Often, the best cure for high prices is high prices. Although energy is somewhat inelastic, if the cost of filling up a gas tank increases by 2–3x, at some point, people use less of it. According to data from the US Energy Information Administration, global oil consumption has faded in recent months, whereas supply has steadily increased (**Chart 2**), a development that has likely contributed to the **-30%** price decline in WTI Crude from its high in March.
- Some market participants speculate a shift in China's zero-COVID policy will unleash pent-up demand that would push energy prices to new highs. Although we sympathize with this view, we would highlight three risks to this framing:
  1. China's zero-COVID strategy may continue well-into 2023. It still has not administered mRNA vaccinations, nor announced a plan to do so.
  2. Oil demand in China has remained elevated despite zero-COVID, which makes us question whether material pent-up demand exists (**Chart 3**).
  3. The resulting hit to oil demand if the US enters a recession could more than offset any increase in demand as a result of relaxing COVID restrictions.

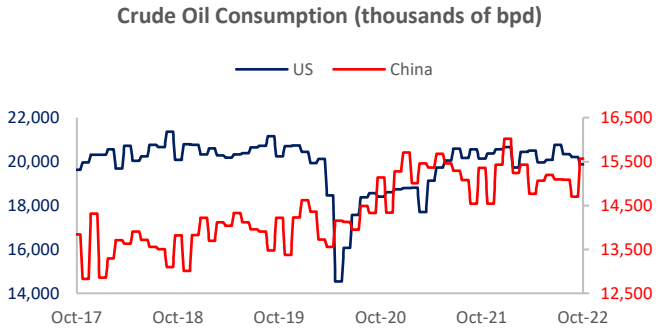
  Bottom line: we believe the prospect of a global recession presents a material risk to commodities demand and their respective prices.
- Gold has been weighed down by the Fed in 2022, as tighter monetary policy has pushed the 10-year real yield up by +2.8%, the sharpest increase since real yields were introduced in the late 90s. Gold has a strong inverse relationship with real yields, and this has been the primary factor weighing on the precious metal. That said, we have been impressed with gold's resilience (**Chart 4**), despite the sharp increase in real rates and expect it to perform well when the Fed's guidance moderates.



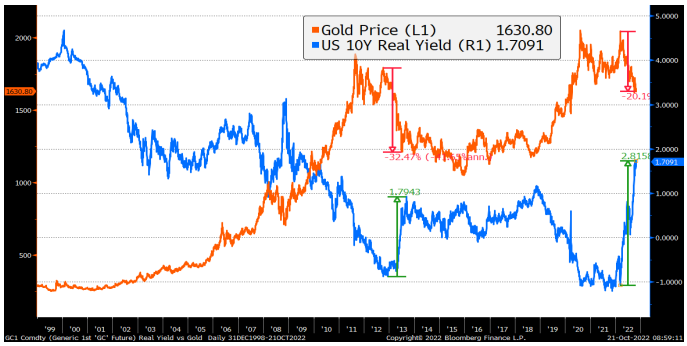
Source: JO Hambro, Empirical Research Partners
[1]Dollars based on US CPI



Source: Bloomberg



Source: Bloomberg, US Energy Information Administration, GMAG Research



Source: Bloomberg, US Energy Information Administration, GMAG Research

POSITIONING SUMMARY:

UNDERWEIGHT	NEUTRAL	OVERWEIGHT	OVERWEIGHT
Global Equities	Fixed Income	Commodities	Cash

Positioning Details:

- **Equities: Underweight**
  We favor being underweight equities because we expect economic activity to slow and believe the risk of recession is material. Within equities, we favor being overweight US equities relative to international equities while the conflict in Ukraine, European energy shortage, and lockdowns in China persist.

- **Fixed Income: Underweight**
  Recently we began adding to high-quality fixed income at the front-end of the yield curve via low duration US treasury securities. We favor shifting back to an underweight duration posture until longer term rates begin to behave as we would expect them to (i.e., curve flattening when short-term rates rise) or the Fed moderates from its ultra-hawkish stance.

- **Commodities: Overweight**
  We favor being overweight, particularly gold, to hedge against inflation, and plan to favor reducing this exposure as our thesis that inflation has peaked is confirmed. We view gold as a hedge against a more entrenched inflation and expect it to outperform broad commodities if economic activity slows.

- **Cash: Overweight**
  We have favored being overweight cash given the rising risk of recession. Cash should help client portfolios realize lower levels of performance volatility and provide them with dry powder to reinvest opportunistically. Within cash, we favor holding short-term treasuries.

As always, we thank you for your ongoing trust and confidence. Please do not hesitate to reach out with any questions relating to our outlook or the management of your individual portfolio. We will keep you apprised of any important developments.

Sincerely,

gmag

Please see below for important disclosures.

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