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# A View from the Bevy – 3Q22

## Market Review

It was another tough quarter for both stocks and bonds. For stocks, a mid-quarter rally saw indices briefly flirt with bull market territory, but it turned out to be short-lived. In fact, by quarter-end many of these same indices were back near their lows for the year. This is the first time in more than a decade that all major U.S. stock indices have been down for three consecutive quarters.

As shown in the table below, there was nowhere to hide as markets fell globally, with most indices now down more than 20% year-to-date, and the U.S. slightly outperforming the rest of the world.

| Market Indices | 3rd Quarter 2022 | Year-to-Date |
|---|---|---|
| S&P 500 | -4.88% | -23.87% |
| S&P 500 (Equal-Weight) | -4.79% | -20.68% |
| Dow Jones Industrial Average (DJIA) | -6.17% | -19.72% |
| NASDAQ Composite | -4.11% | -32.40% |
| Bloomberg US Aggregate Bond | -4.75% | -14.61% |
| Russell 2000 | -2.19% | -25.10% |
| MSCI World ex U.S. | -9.20% | -26.23% |
| MSCI Emerging Markets | -11.57% | -27.16% |

Source: AJO. Data supplied by FactSet Research Systems.

As for bonds, the U.S. Federal Reserve (Fed) rattled investors after announcing another 0.75% interest rate increase in late September. Chairman Powell's comments indicated that the Fed would remain fiercely committed in its fight against inflation, even at the risk of potentially sending the economy into a recession. The U.S. 10-year Treasury subsequently had its largest monthly yield gain in nearly two decades.

The major challenges facing markets in the 3rd quarter continued to be the familiar issues of inflation and the war in Ukraine. Inflation has remained high and continues to be the dominant economic story around the globe. The war in Ukraine also continues to escalate, as does the rhetoric of Russian President Putin. His annexation of four Ukrainian territories on the last day of the quarter was met with immediate U.S. sanctions and global condemnation. This move, along with Putin's mention of the use of tactical nuclear weapons, rattled already unnerved investors further.

Near quarter-end, we saw how skittish global markets were in the face of unexpected news. In the United Kingdom, a budget plan was introduced by the new Prime Minister to lower taxes on high income earners. The unfunded stimulus sent the British Pound down to historically low levels and increased borrowing costs as yields spiked. The Bank of England was forced to intervene by reversing its bond selling program to calm markets.

## Market Outlook

As we enter the fourth quarter, there are some signs that markets could be finding a bottom, although volatility is likely to continue. Keep in mind that markets will bottom before headlines get better. As an example: when stocks bottomed during the Great Recession in March 2009, there were still major questions about the solvency of the financial sector. AIG posted a $62 billion quarterly loss forcing the government to restructure the company's bailout on March 3. On March 9, 2009, a *Wall Street Journal* article started with the question: "Just how low can stocks go?" It turned out they would not fall any further, and markets found their footing despite the lingering questions.

Markets face plenty of questions today, although, to be clear, none of them are nearly as big as the issues from the Great Recession. The Fed's commentary in late September has led to some short-term pain, sending stock prices down and market yields higher. However, it did bring a bit of clarity. The Fed signaled that three more interest rate increases are likely – 0.75% in November, 0.50% in December and 0.25% in January. Time will tell if the Fed is able to execute on the forecasted path for rates, but improved visibility should help markets stabilize.

Meanwhile, rising interest rates in the U.S. have pushed up the value of the U.S. Dollar to a 20-year high. The strong dollar poses an additional threat to the economy, as increases import prices, which is a burden for consumers. A stronger dollar has also had a substantial negative impact on corporate earnings of multinationals, as the rising dollar decreases the value of revenues earned abroad. Corporate balance sheets have remained strong, however, leaving companies well positioned to weather the current environment.

On the bright side, global central banks seem increasingly sensitive to market stress and economic weakness. Their willingness to intervene gives investors more confidence in the stability of financial markets. Additionally, consumer spending has remained strong despite higher costs. There are signs of moderating inflation, particularly in energy prices which have a sizable impact on consumers. Commodity prices like lumber and copper have also decreased significantly amid the slowdown in the housing market, and companies such as Target and Nike have already announced price cuts in the face rising inventories. More of this deflation could nudge the Fed towards fewer interest rate hikes, and hopefully household spending stays resilient until that time comes.

The early November midterm elections could also help soothe markets as uncertainty around party control in Congress is removed. Interestingly, if you look back over the last seven midterm elections, markets have risen during the six months following an election regardless of which party was in control, or if control was split.

According to U.S. Bancorp Securities, since 1962, stocks (as measured by the S&P 500) have increased by 15.1% on average in the six months after midterm elections. In contrast, stocks only rose 0.3% on average in the year leading up to the midterm elections. If you look back even further – all the way back to 1926 – the trajectory of stocks has been positive regardless of which party is in power or if power is split.

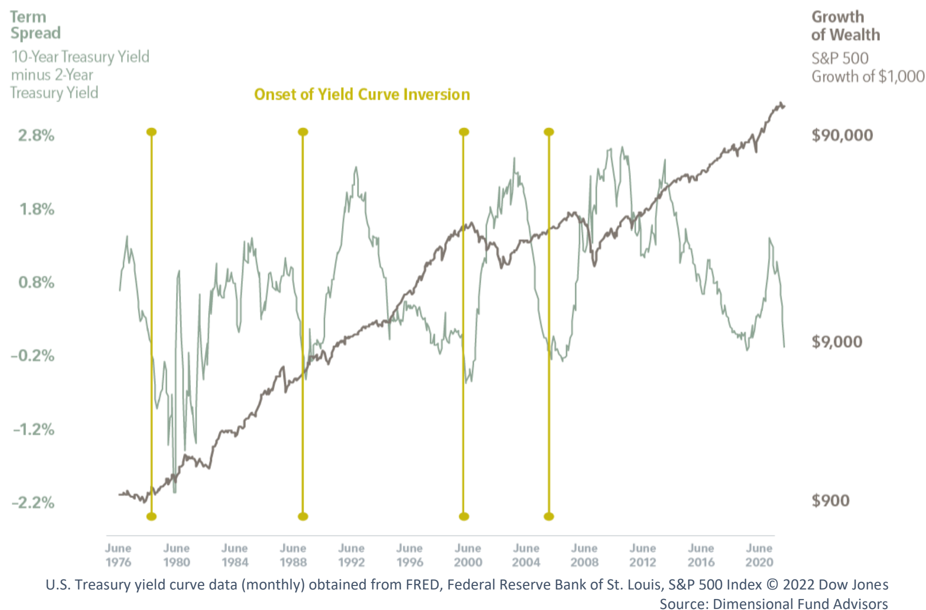
We are keeping our eyes on all of these developments and will adjust portfolios as circumstances dictate. As always, do not hesitate to contact us with any questions, and enjoy the Fall and lead-up to the holidays!

# Of Interest: Is a Yield Curve Inversion Bad for Stocks?

The yield curve plots the yield of bonds with different maturities, usually Treasuries. Normally, a longer dated bond should have a higher yield than a shorter dated bond. Many investors see yield curve inversions - when short-term bond yields exceed long-term yields - as foreboding for the economy.

On April 1, 2022, the U.S. 10-year Treasury note's yield dipped below that of the 2-year Treasury, inverting that portion of the yield curve for the first time since 2019 (this is the most watched yield ratio). While this initial inversion did not last too long, another inversion occurred on June 13th.

Does an inverted yield curve signal a stock market downturn? No. Data from the U.S. and other major economies show yield curve inversions have not historically predicted stock market downturns. As markets incorporate news and events around the world, bond yields change, which causes yield curves to change.




U.S. Treasury yield curve data (monthly) obtained from FRED, Federal Reserve Bank of St. Louis, S&P 500 Index © 2022 Dow Jones
Source: Dimensional Fund Advisors

The inversion prior to the 2008 financial crisis is an interesting case study. As shown in the graph above, the U.S. yield curve inverted in December 2005, which was then followed by a positive 12-month return for the S&P 500 Index. The yield curve's slope shifted to positive again in June 2007, well prior to the stock market's major downturn from October 2007 through March 2009.

Investors who pulled out of stocks would have missed out on subsequent stock market gains. And if those same investors had bought back into stocks when the yield curve's slope became positive, they would have been exposed to the market downturn that followed.

If you looked at all four of the previous 2-year/10-year yield curve inversions, as shown in the table below, the S&P 500 Index gained another 29% on average and peaked around 17 months later (according to LPL Research and the St. Louis Federal Reserve Bank).

| Date of Inversion | Bull Market Peak | S&P 500 Index Return | Months Until Bull Market Peak |
|---|---|---|---|
| 12/13/1988 | 7/16/1990 | 33.2% | 19.1 |
| 5/26/1998 | 3/24/2000 | 39.6% | 22.0 |
| 12/27/2005 | 10/9/2007 | 24.6% | 21.4 |
| 8/27/2019 | 2/19/2020 | 18.0% | 5.8 |

Furthermore, if you expand the sample internationally to include yield curve inversions dating back to 1985 in four additional major developed nations, in 10 out of 14 cases of inversion, local investors would have had positive returns in their home markets after 36 months. These results are similar to the historical frequency of positive returns over any three-year span, regardless of the shape of the yield curve, showing that it is difficult to predict the timing and direction of market moves following a yield curve inversion.

So, what can you do if you are concerned about continued potential stock weakness? Commit to your long-term investment plan, one that is in line with your risk tolerance, look past short-term noise and focus on investing in a systematic way that will help you meet your long-term goals.

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