William Blair

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Private Wealth Management
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Market Review and Outlook

Index		YTD	Q3	1Y
S&P 500	US Large Cap	–23.87	–4.88	–15.47
DJIA	US Large Cap	–19.72	–6.17	–13.40
Russell 3000	US All Cap	–24.62	–4.46	–17.63
Russell 2000	US Small Cap	–25.10	–2.19	–23.50
MSCI EAFE	Developed International	–27.09	–9.36	–25.13
MSCI EM	Emerging Markets	–27.16	–11.57	–28.11
Bloomberg Barclays US HY	US High Yield	–14.75	–0.65	–14.14
Bloomberg Barclays US Agg	US Core Bond	–14.61	–4.75	–14.60
Bloomberg Barclays Muni	US Muni Bond	–12.13	–3.46	–11.50
MSCI US REIT	US Real Estate	–28.26	–9.96	–16.56

Source: Bloomberg

The U.S. economy feels like it has been treading water over the last quarter, with some parts of the economy exceptionally weak and others still showing a remarkable degree of strength. For example, the new home sales—which is at the front end of interest rate sensitivity and has a high-multiplier impact across the rest of the economy—were 40% lower in the first seven months of the year due to rising mortgage rates, high and rising house prices, and negative real income growth. Against this weakness, there has been continued strength in a number of other important areas: industrial activity, consumer spending on services, and most importantly, employment growth. The strength has been such that although a number of boxes of the National Bureau of Economic Research recession dating committees' criteria are being ticked, the sum is still unlikely to be enough to officially declare the start of a recession.

However, the economy will not continue to tread water forever, and a number of important leading economic indicators are now pointing to a more marked deceleration. With regard to employment growth, for example, there has been a sharp slowdown in hours worked—a reflection of demand moderation and a typical precedent to reduced hiring and/or layoffs. As for industrials, the September ISM reading plunged to 50.9% from 52.8%, well below expectations, and is now just above the 50% expansion/contraction line. Meanwhile, the Conference Board's basket of 10 leading economic indicators has fallen for the last six consecutive months—the longest run since the 22 months from June 2007 to March 2009—though the coincident and lagging indicators are still demonstrating momentum. In addition, strong household and corporate balance sheets, coupled with a structurally tighter labor market and the Biden administration pouring funds into the economy, suggest that at this point any recession is still likely to be relatively moderate.

Internationally, the growth situation is somewhat bleaker. Both the EU and the U.K. (among others) are in the midst of a severe energy crisis resulting from the war in Ukraine, which was exacerbated this quarter with the shutting off of Russian gas supply—and the recent pipeline ruptures ensure it won't return anytime soon. While Europe should have enough energy supply to get through a normal winter with only some modest demand reductions, a colder-than-average winter, coupled with any other potential supply disruptions, is still a major risk. Consumers will be paying extortionate prices, and many energy-intensive businesses are already warning of trouble to come with regard to production shortfalls. Meanwhile, Russian oil to the EU is scheduled to terminate on December 5, 2022, and all petroleum products are scheduled to terminate on February 5, 2023.

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China is in the midst of a major residential property slowdown, and its government is still keen to play whack-a-mole with extreme COVID restrictions. On the upside, the situation is effectively a government-manufactured one, the banks are state-owned, there is very low inflation and plenty of room to support growth if desired, and the significantly weaker yuan is helping to support export growth. The government is also well aware that a full housing market crisis would not be conducive to the strong consumer it needs to help extricate the nation from the middle-income trap.

Outside of China, many emerging markets have so far held up surprisingly well in the face of what have historically been three major headwinds for emerging markets—a stronger dollar, rising global interest rates, and higher commodity prices.

The dollar's continued strength was another major feature of the recently ended quarter. On a trade-weighted basis, the currency increased by 4.6% during the third quarter (5.8% against the advanced economies and 3.5% against the emerging markets). This included a sharp 6.7% gain against the yen, 7.0% against the euro, and a whopping 9.0% against the pound sterling, following a disastrous mini-budget by the freshly minted Truss government.

The strength was just as much about the weakness and uncertainty in foreign economies as it was a reflection of financial market volatility and the Fed's more aggressive tightening stance relative to those central banks abroad.

Through the first half of the quarter, financial market participants were in what they thought was a winning tug of war with the Fed, with the stock market rallying through late June to mid-August, on the belief that weaker growth would soon cause the Fed to pivot toward fewer hikes and earlier cuts. The resulting easing of financial conditions was not what the Fed wanted, however; inflation is still well above its 2% target and stickier than the Fed would like to see at those higher levels. The Fed also wants to make doubly sure that inflationary expectations remain well anchored.

The Fed's response to this tug of war came during Chair Powell's Jackson Hole address, where he—channeling former Fed Chair Volcker—was unequivocal that the Fed would "keep at it" until the job was done. That is to say, any market belief that the Fed would tolerate a new sustained 4% inflation equilibrium was unfounded, and current rate expectations were far too low. This view was reiterated in a subsequent speech by the chair and then again following the FOMC meeting and the publication of the dot-plot. Markets finally got the message that the Fed was serious, and rate expectations jumped from a cyclical peak rate of 3.3% (in early July) to a significantly higher 4.7% by the end of the quarter. The market's pivot resulted in renewed tightening of financial conditions wiping out any hopes of a positive return on the quarter.

The tightening led to the S&P 500's third consecutive quarterly loss, the longest quarterly losing streak since 2009 (when the market fell for six consecutive quarters). Weakness was also evident across the board in just about every major asset class, from commodities to real estate to bonds and equities. The implication of such a broad sell-off was that this was a classic risk-off move by market participants on the back of global central bank tightening and rising geopolitical uncertainty, rather than being related to problems in any one specific stock, sector, style, or asset class—as, for example, was the case during the tech bubble of 2001 and the banking system in 2008-2009.

While the S&P 500's decline was broadly based, two major sectors did manage to increase during the quarter. The first, not surprisingly, was the energy sector, which rose 1.2%. The second was consumer discretionary (up 4.2%), led by autos and apparel retailers, both of which benefited from the ongoing improvements in supply chains.

The economic uncertainty is, however, still putting upward pressure on corporate credit spreads. This is taking place in both the shorter-term commercial paper market and the longer-term corporate debt market, where spreads have risen to high levels, but not so high as to yet be associated with a major crisis or the need for major market intervention.

In short, the leading economic indicators continue to point to a further slowing in growth and most likely a recession. This is certainly the case across Europe, which is in the midst of a worsening energy crisis. Any domestic U.S. recession will likely be a milder one due to strong household and corporate balance sheets, ongoing fiscal spending, and continued tightness in the labor market. Nevertheless, with inflation

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still high, geopolitical tensions similarly elevated, and the Fed and other global central banks still in interest rate ramp-up mode for at least another quarter, investors should expect further market volatility. For investors, such an environment continues to warrant a dedicated active management approach, especially during periods of greater dislocation, when significant opportunities can arise for quality growth equities.

Wealth Management Tip

The tax cuts and jobs act of 2017 temporarily lowered tax rates until 2025. At that time, the estate tax exemption will decrease and income tax rates will also increase. Those with income that can be accelerated may wish to plan ahead. For example, exercising stock options (if the market hasn't affected the values) may be a tax-efficient strategy to consider before the end of 2025.

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