Insights: October 2022

Market Overview and Performance

As one can clearly see from the performance table below, the third quarter was an extremely challenging environment for virtually all investors as equities, bonds and commodities all declined sharply. As a result, 2022 has thus far proven to be a historically poor year, among the worst on record if it were to end today. However, just this month there has been a notable shift. While impossible to pinpoint the exact reasoning behind the transition, a confluence of factors taken together likely provide the foundation which we will discuss. At a base level however, investors seem to have grown exhausted of the bearish narrative that is so pervasive in the markets. As Michael Cembalest, Chairman of Market and Investment Strategy at J.P. Morgan wrote recently, "When bear markets occur and the investment mistakes of the prior cycle are revealed, bearish investment commentary tends to intensify. There is a confessional, self-flagellating quality to some of this research, as if its authors are trying to atone for having missed the signals and risks during the prior boom. I read around 1,500 pages of research each week and the most consistent message now is a litany of gloom on earnings, valuations, wage and price inflation, Central Bank policy normalization, housing, trade, energy, the surge in the US$, China COVID policy, etc. I am not saying that these things are not important, since of course they are. But for investors, there is a remarkable consistency to the patterns shown below: equities tend to bottom several months (at least) before the rest of the victims of a recession." Cembalest goes on to highlight how equities pivot higher *before* other important economic measures like GDP, earnings and payrolls bottom. As legendary investor Stanley Druckenmiller, recently framed current conditions, "Do not invest in the present, the present is not what moves stock prices." We would agree. While many headwinds remain, near term optimism should not be ignored. As always, thank you for reading our latest Insights.

	Quarter to Date September 30	***Year to Date September 30***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	-4.88	**-23.87**
Russell 2000 Index	-2.19	**-25.10**
MSCI EAFE Index	**-9.36**	**-27.09**
MSCI Emerging Markets Index	**-11.57**	**-27.16**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	**-4.75**	**-14.61**
Barclay's U.S. Aggregate Credit Index	**-8.57**	**-29.05**
Barclay's U.S. Aggregate Corporate High Yield Index	-0.65	**-14.74**
Barclay's Municipal Bond Index	-3.46	**-12.13**
Macro Measures		
Gold	**-7.49**	-7.12
Crude Oil	**-24.84**	5.69
CBOE Volatility Index	10.14	**83.62**
USD Dollar Index	7.10	**16.83**

Current Theme – A Very Weak Third Quarter Punctuates a Historically Negative Year Thus Far in 2022 For Many Asset Classes, But There May Be Reason for Near-Term Optimism

While the Bearish Narrative Persists in Markets, Seasonality, Mid-term Elections, Lower Yields, a Somewhat Softening US Dollar and a Less Aggressive Fed Could All Serve as Tailwinds Into Year End

Without question, 2002 has been a painful period for investors. While equities have succumbed to typical bear market drawdowns, the bond market, which is roughly 3 times the size of the equity market, is experiencing its *WORST* year on record. As the table below illustrates, the 10-Year Treasury Bond is down about -18% year to date. The next closest period would be 2009 when the 10-Year declined -11%.

Worst Year on Record for 60/40 Portfolio; Down -21.6%

S&P 500, US 10-Year Treasury, and 60/40 Portfolio (Total Returns, 1928 - 2022)

Year	S&P	10-Yr	60/40	Year	S&P	10-Yr	60/40	Year	S&P	10-Yr	60/40	Year	S&P	10-Yr	60/40	Year	S&P	10-Yr	60/40
1928	43.8%	0.8%	26.6%	1947	5.2%	0.9%	3.5%	1966	-10.0%	2.9%	-4.8%	1985	31.2%	25.7%	29.0%	2004	10.9%	4.5%	8.2%
1929	-8.3%	4.2%	-3.3%	1948	5.7%	2.0%	4.2%	1967	23.8%	-1.6%	13.6%	1986	18.5%	24.3%	20.8%	2005	4.9%	2.9%	4.0%
1930	-25.1%	4.5%	-13.3%	1949	18.3%	4.7%	12.8%	1968	10.8%	3.3%	7.8%	1987	5.8%	-5.0%	1.5%	2006	15.8%	2.0%	10.2%
1931	-43.8%	-2.6%	-27.3%	1950	30.8%	0.4%	18.7%	1969	-8.2%	-5.0%	-7.0%	1988	16.6%	8.2%	13.2%	2007	5.5%	10.2%	7.4%
1932	-8.6%	8.8%	-1.7%	1951	23.7%	-0.3%	14.1%	1970	3.6%	16.8%	8.8%	1989	31.7%	17.7%	26.0%	2008	-37.0%	20.1%	-13.9%
1933	50.0%	1.9%	30.7%	1952	18.2%	2.3%	11.8%	1971	14.2%	9.8%	12.4%	1990	-3.1%	6.2%	0.7%	2009	26.5%	-11.1%	11.1%
1934	-1.2%	8.0%	2.5%	1953	-1.2%	4.1%	0.9%	1972	18.8%	2.8%	12.4%	1991	30.5%	15.0%	24.1%	2010	15.1%	8.5%	12.3%
1935	46.7%	4.5%	29.8%	1954	52.6%	3.3%	32.9%	1973	-14.3%	3.7%	-7.1%	1992	7.6%	9.4%	8.2%	2011	2.1%	16.0%	7.7%
1936	31.9%	5.0%	21.2%	1955	32.6%	-1.3%	19.0%	1974	-25.9%	2.0%	-14.7%	1993	10.1%	14.2%	11.7%	2012	16.0%	3.0%	10.7%
1937	-35.3%	1.4%	-20.7%	1956	7.4%	-2.3%	3.6%	1975	37.0%	3.6%	23.6%	1994	1.3%	-8.0%	-2.4%	2013	32.4%	-9.1%	15.6%
1938	29.3%	4.2%	19.3%	1957	-10.5%	6.8%	-3.6%	1976	23.8%	16.0%	20.7%	1995	37.6%	23.5%	31.7%	2014	13.7%	10.7%	12.4%
1939	-1.1%	4.4%	1.1%	1958	43.7%	-2.1%	25.4%	1977	-7.0%	1.3%	-3.7%	1996	23.0%	1.4%	14.2%	2015	1.4%	1.3%	1.3%
1940	-10.7%	5.4%	-4.2%	1959	12.1%	-2.6%	6.2%	1978	6.5%	-0.8%	3.6%	1997	33.4%	9.9%	23.8%	2016	12.0%	0.7%	7.3%
1941	-12.8%	-2.0%	-8.5%	1960	0.3%	11.6%	4.9%	1979	18.5%	0.7%	11.4%	1998	28.6%	14.9%	23.0%	2017	21.8%	2.8%	14.1%
1942	19.2%	2.3%	12.4%	1961	26.6%	2.1%	16.8%	1980	31.7%	-3.0%	17.8%	1999	21.0%	-8.3%	9.2%	2018	-4.4%	0.0%	-2.5%
1943	25.1%	2.5%	16.0%	1962	-8.8%	5.7%	-3.0%	1981	-4.7%	8.2%	0.5%	2000	-9.1%	16.7%	1.2%	2019	31.5%	9.6%	22.6%
1944	19.0%	2.6%	12.4%	1963	22.6%	1.7%	14.2%	1982	20.4%	32.8%	25.4%	2001	-11.9%	5.6%	-4.9%	2020	18.4%	11.3%	15.3%
1945	35.8%	3.8%	23.0%	1964	16.4%	3.7%	11.3%	1983	22.3%	3.2%	14.7%	2002	-22.1%	15.1%	-7.1%	2021	28.7%	-4.4%	15.3%
1946	-8.4%	3.1%	-3.8%	1965	12.4%	0.7%	7.7%	1984	6.1%	13.7%	9.2%	2003	28.7%	0.4%	17.2%	2022*	-23.9%	-18.1%	-21.6%

Source: Compound Capital Advisors

As a result, a 60% Equity/40% Fixed Income Portfolio, a benchmark for many investors, is down an astounding -21.6% year to date. Only 5 years since 1928 have seen simultaneous declines in both stocks and bonds.

Returns Following Weak 9 Months Have Been Strong

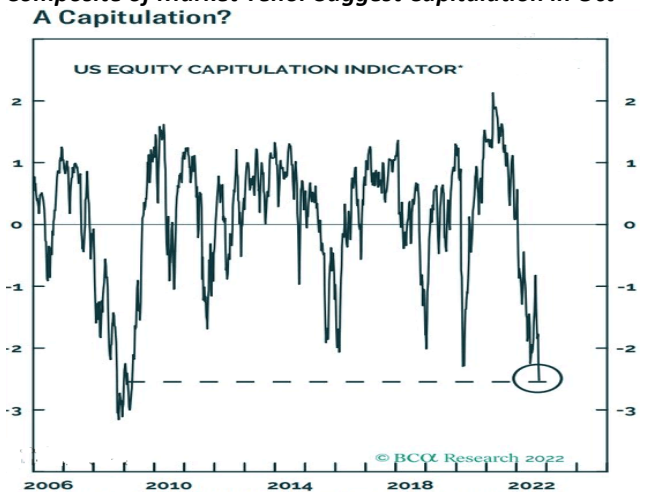
Wilshire 5000 - Worst 9 Months Periods & Forward Returns (1971 - 2022)

Worst 9 Month Periods				Forward Total Returns					
Rank	Total Return	Start Month	End Month	3-Month	6-Month	1-Year	3-Year	5-Year	10-Year
1	-46.7%	Jun-08	Feb-09	26%	42%	56%	102%	189%	372%
2	-39.3%	May-08	Jan-09	8%	23%	35%	73%	147%	309%
3	-37.0%	Jul-08	Mar-09	17%	36%	52%	91%	167%	341%
4	-34.5%	Jan-74	Sep-74	9%	36%	41%	84%	153%	392%
5	-32.3%	Mar-08	Nov-08	-16%	6%	27%	53%	132%	288%
6	-30.6%	Apr-08	Dec-08	-11%	4%	28%	52%	134%	246%
7	-29.7%	Aug-08	Apr-09	14%	20%	41%	72%	142%	315%
8	-28.6%	Feb-08	Oct-08	-14%	-7%	11%	41%	108%	250%
9	-28.1%	Nov-73	Jul-74	-5%	1%	21%	50%	90%	255%
10	-27.2%	Mar-74	Nov-74	19%	35%	36%	65%	123%	334%
11	-27.2%	Sep-08	May-09	12%	20%	23%	53%	135%	268%
12	-27.0%	Apr-74	Dec-74	25%	46%	38%	70%	135%	356%
13	-26.6%	Jan-02	Sep-02	8%	4%	26%	66%	115%	129%
14	-25.9%	Jan-22	Sep-22						
15	-25.0%	Dec-73	Aug-74	-1%	18%	29%	62%	121%	333%
16	-23.7%	Feb-74	Oct-74	7%	22%	26%	51%	100%	318%
17	-22.0%	Oct-73	Jun-74	-25%	-18%	19%	41%	75%	236%
18	-21.8%	Feb-01	Oct-01	8%	5%	-13%	18%	53%	58%
19	-21.6%	Apr-02	Dec-02	-3%	13%	32%	58%	93%	113%
20	-21.2%	Jul-00	Mar-01	7%	-10%	3%	9%	33%	55%
Average Worst Periods				**4%**	**16%**	**28%**	**59%**	**118%**	**262%**
Average All Periods				**3%**	**6%**	**12%**	**41%**	**79%**	**218%**
Differential				**2%**	**10%**	**16%**	**18%**	**40%**	**44%**

Source: Compound Capital Advisors

Fortunately, as the previous table illustrates, after poor 9-month periods, the S&P 500 has a well-established track record of rebounding over the following months. For example, out of the last 20 largest declines, the forward one-year return was positive in every instance except 2001 with average 12-month return of +28%.

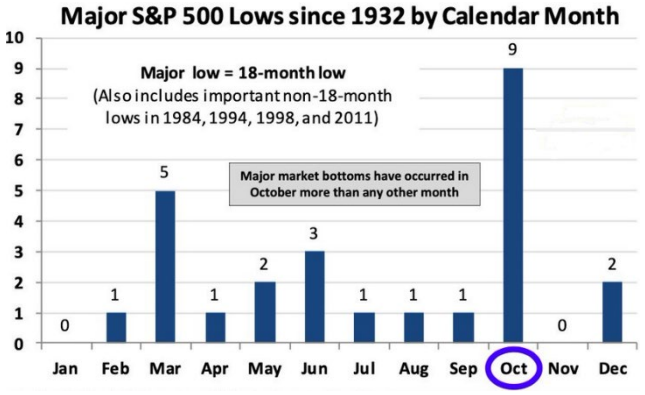
Composite of Market Tenor Suggest Capitulation in Oct



Source: BCA Research, Soberlook.com, Isabelnet.com

While certainly no guarantee of future results, these historical patterns suggest that investors turn more constructive after the negative narrative has become exhausted. This type of "capitulation" may have occurred in October. The image above from BCA Research charts a composite measure of equity breadth, trader sentiment, insider buys/sells and momentum. As one can see, it has reached levels last seen during the Global Financial Crisis.

More Market Bottoms in October Than Any Other Month

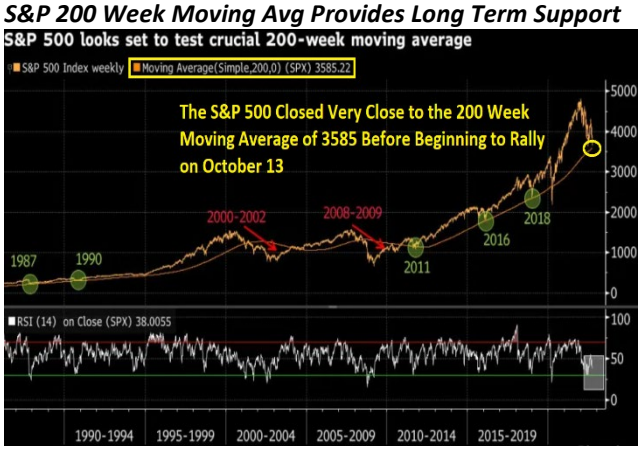


Source: Oppenheimer, Bloomberg, Callum Thomas

If that indeed proves to be the case, the timing of the shift would not be especially surprising. First, as the chart above from Oppenheimer highlights, since 1932,

the majority of market bottoms bouncing off of significant negative periods have occurred during the month of October, far outpacing any other month.

S&P 200 Week Moving Avg Provides Long Term Support



Source: Bloomberg, WealthAdvisor

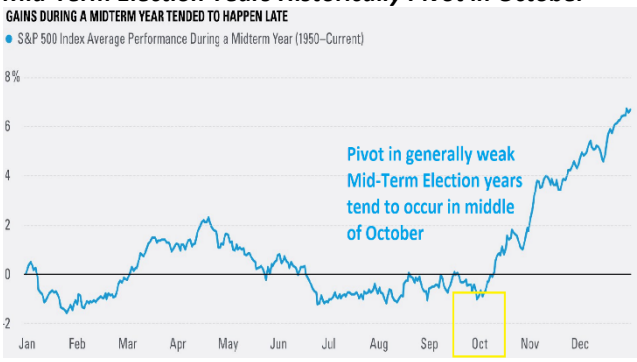
Second, while not widely followed by the everyday investor, technical analysts often refer to the 200-week moving average of the S&P. The reason being that stretching all the way to the 1970's, that measure has acted as a strong support level for the S&P 500 with the exception of the dot-com bubble of 2001 and the Global Financial Crisis in 2008. On October 12th, the S&P 500 closed right at the current 200 week level of approximately 3580. The next day, the market shifted.

+10% Rally for S&P 500 in 10 Trading Days in October

Source: Refinitiv

On October 13th, the US Bureau of Labor Statistics announced that inflation as measured by the CPI increased at a higher than expected 8.2% over the year earlier period. As seen above, after digesting the initial headline, the market began to rally from that technically significant level presumably on the thesis that this report would mark the high-water mark in headline inflation. In the subsequent 10 trading days, the S&P 500 climbed steadily higher by +10% as of October 26th. While large cap technology companies have generally disappointed in their earnings results this month, the remainder of the market has largely exceeded expectations, most notably the financial, industrial and consumer staples sectors. This has provided a fundamental basis for the index to move higher over this period.

Mid-Term Election Years Historically Pivot in October



Source: LPL Research, Factset

The third significant timing factor comes from a non-market segment of the macro picture. Since 1946, the S&P 500 has a *PERFECT* record of rising in the 12 months following mid-term elections. Importantly, this pattern holds true regardless of party in the White House and regardless of a change in control of Congress which is typical. This is not an unknown phenomenon. As such, after a historically flat results based on the average of mid-term years, the S&P 500 traditionally pivots in mid-October as seen above.

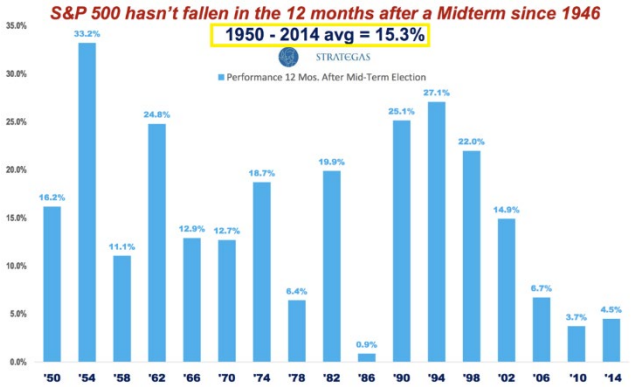
Strongest Seasonal Period is From Mid-Term to Summer

Source: Ned Davis Reserach

Fourth, the seasonality of the US Presidential cycle is strongly supportive of a rally in equities taking hold sometime in October. The above graphic from Ned

Davis Research charts the historical path of the S&P 500 dating back to 1928 from mid-term elections years and forward. As the yellow box highlights, the Index not only typically turns markedly higher beginning in October, but notably, also continues to climb at a rapid pace all the way through the following summer.

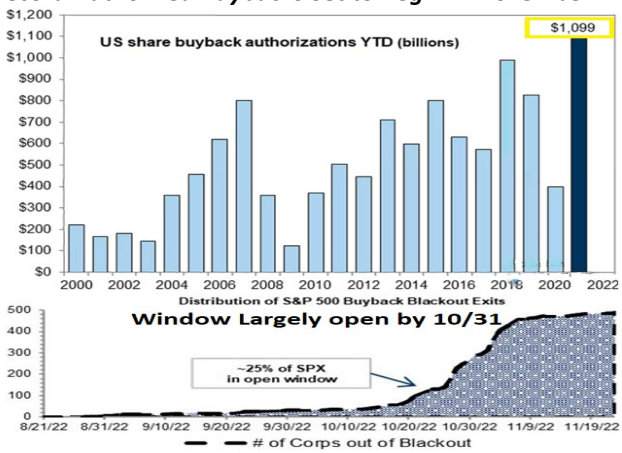
S&P Avg Return of +15.3% After Mid-Terms – No Declines



Source: Strategas Research Partners

As mentioned, this pattern has a 100% track record of positive returns starting from 1950 (91% success from 1930). As the chart above from Strategas Research documents, the average annual return post elections is +15.3% (2018 not shown above was 13.7%).

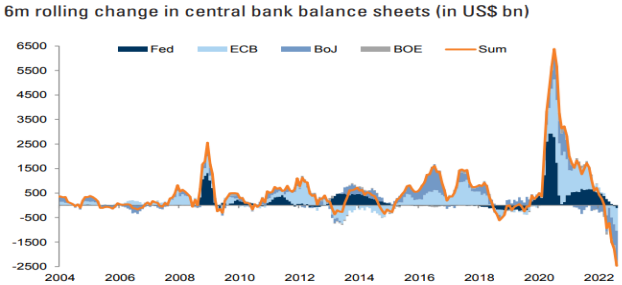
Record Authorized Buybacks Set to Begin in November



Source: Goldman Sachs Global Investment Research

And finally, the last element serving as a possible driver behind an October rally is the fact that corporations are ready and waiting to buy back their own stock. As the chart above from Goldman Sachs illustrates, a record number of authorized stock buyback programs, $1.1 trillion worth, is slated to be at least partially executed by the end of the year. Further, as one can see in the lower panel, most of the companies in the S&P 500 have been in a buyback "black-out" period meaning that they are not allowed to purchase their own stock around earnings releases. That window largely opens back up by October 31st.

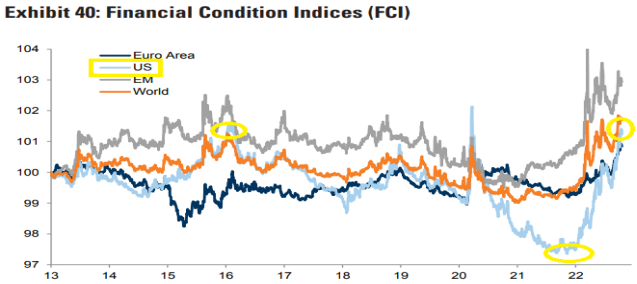
Massive Global Quantitative Easing is Now Tightening



Source: Goldman Sachs Global Investment Research

With all that being said, it would be naive to believe that any near-term strength could not just as easily evaporate. Many challenges remain as we look to 2023. First and foremost, as seen above, global central banks have rapidly removed liquidity from the financial system throughout 2022.

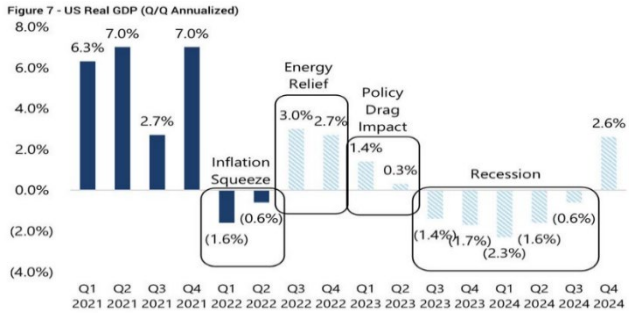
US Financial Conditions – Ultra Easy to Tightest Since '16



Source: Goldman Sachs Global Investment Research

As a result, financial conditions have tightened dramatically. As the Goldman Sachs composite measure shows above, the environment is the least conducive to growth since 2016 globally.

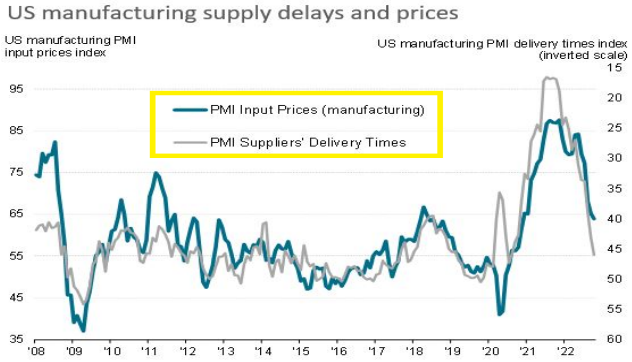
Consensus View Expects US Recession By 2H 2023



Source: Haver, Jefferies Economics

Given that central banks have demonstrated a strong commitment to fighting inflation by raising rates rapidly and by large increments, the market is naturally fearful that these actions will "break" something. That generally translates into many people believing that the US will experience a recession sometime in 2023. The chart from Jefferies Economics paints the consensus path – stronger GDP growth in the 2H of 2022 (Q3 GDP was +2.6%) before fiscal policy mistakes sap growth in 1H of 2023 and eventually lead to recession in 2H 2023.

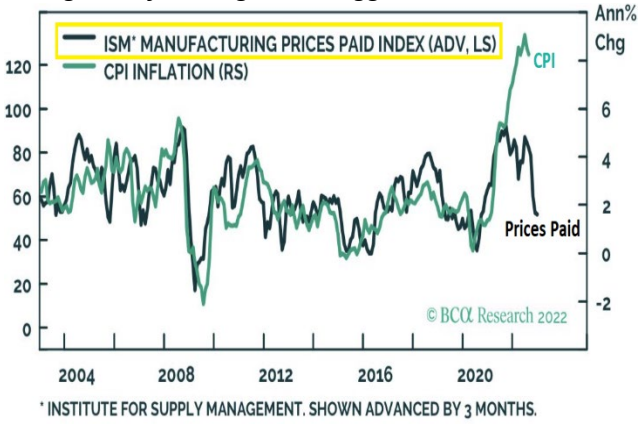
Input Prices and Supplier Delivery Times Have Collapsed



Source: S&P Global

That scenario may or may not come to pass, but there is ample evidence that inflation – The Fed's main target – is contracting in most areas of the economy. There are many ways to measure this, but the above chart from S&P Global highlights the fact that both input prices and delivery times for manufacturing have fallen significantly.

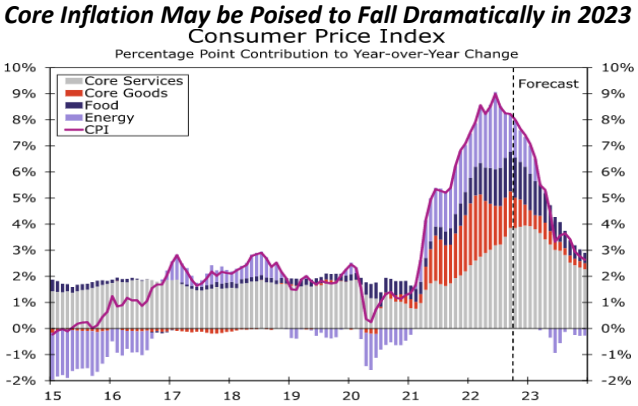
Falling Manufacturing Prices Suggest CPI Will Decline



Source: BCA Research

This is particularly important because manufacturing prices paid have historically been highly correlated with the CPI inflation measure. The presumption then is that CPI should also decline in a similar fashion. Breaking CPI down to its component levels further illustrates why this might be the case. While Services inflation is still on the rise (gray bars below), Goods, Food and Energy prices are all contracting. As the chart from Wells Fargo Economics (and many others) suggest, the future path of CPI should take the measure down close to the Fed's target of 2% by the end of 2023 or shortly thereafter.

Core Inflation May be Poised to Fall Dramatically in 2023



Source: Wells Fargo Economics, US Department of Labor

So if inflation is in fact decreasing as intended, then perhaps the Fed does not need to be so aggressive in it's pursuit of raising interest rates. The market certainly hopes this is the case, and in fact, increasingly believes it to be so as shown below.

Investors Increasingly See a Fed Policy Pivot in Next 12M

Source: BofA Global Fund Manager Survey

The Fed itself is helping bolster this view. Last week's messaging included Fed President Waller stating, "We will have a very thoughtful discussion about the pace of tightening at our next meeting" and Fed President Daly adding, "We don't just keep going up at 75bps increments; We will do a step down, not to pause, but to 50bps or 25bps increments at some point". The Market awaits.

Going Forward

As we discussed, much of 2022 has been characterized by a relentlessly negative narrative, a "litany of gloom" as Michael Cembalest described it. Without a doubt, there are several quite legitimate reasons for investors to feel concern. We share those concerns as well since many may come to roost in 2023. However, as Michael Batnick, Chief Strategist at Ritholtz Wealth Management wrote recently, "When you see things like "A litany of gloom" you can be sure that the market is aware of the situation we're in and has adjusted risk assets accordingly. Nobody knows where we go next, but the stock market has already priced in some carnage, removing 25% from the S&P 500, 35% from the Nasdaq-100. Overweighting today's news, for better and for worse, gets investors in trouble because today is already priced in." We would agree and as we discussed at length, many factors have fallen into place at the current time which are historically supportive of a move higher in risk assets.

The question now becomes how long does a rally in equities (and bonds and commodities for that matter) last? It's a difficult question to answer and one that we would suggest will, as always, be dependent on the data we see going forward. Under the bullish scenario, there is a change in control of Congress in early November, inflation measures confirm that we are past peak levels, and the Fed suggests that they are satisfied with the progress they have made on the taming of inflation and will remain at a steady level of rates (the Market believes this to be 5%). As a result, the US Dollar declines from its extremely elevated level, yields on bonds decline somewhat, corporate growth and profitability endures, and prices can continue to rise until Summer as prescribed by the Presidential cycle. Conversely, the recent rally could falter primarily on the basis of stronger than expected inflation data and a Fed that remains steadfastly wedded to the idea of rising rates aggressively, and corporate results (earnings) heading sharply lower as the cost of operations increase while consumer demand dampens.

As of now, the Bullish case is winning the tug of war, particularly in light of the fact that even with the largest components of the indices, large cap technology primarily, disappointing on the earnings front, the remainder of the sectors have delivered better than expected results. As such, the market has continued its climb higher and volatility has come down.

Due to the uncertainty of the market this year, we have maintained a higher than normal cash allocation. However, as the shift in sentiment evolved in mid-October we began to aggressively put capital to work namely in the information technology, financial, energy, industrial and healthcare sectors. We continue to do so and have used the most recent earnings reports to opportunistically add to selected names.

Small and mid-cap stocks have suffered more than their large cap alternatives throughout much of 2022. However, given that these companies generate almost all of the of their sales domestically and are therefore not harmed by a strong Dollar, they are poised to benefit from an improving inflation and rate scenario.

Regions outside of the US remain challenged at the moment, particularly in light of the rise in the US Dollar. Given the conflict in Europe and the severe policies being used to combat COVID in Asia, we prefer to wait for better entry points.

Within fixed income, we continue to place our emphasis on shorter duration exposures and unconstrained strategies. We also continue to find opportunities within municipal bonds. More recently however, we have taken advantage of the climb in treasury yields to allocate a portion of our exposure into laddered short-term treasuries as a way to capture risk-free yield for fixed income portfolios.

We believe that commodity exposure including both gold and non-precious metals (agriculture, industrial metals, energy) will continue to be additive due to the nature of the current supply constraints.

Thank you for taking the time to read our thoughts on the markets and we look forward to speaking soon.