Westwood Wealth Market Update — Q3 2022

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While market volatility persisted in third quarter 2022, it seemed early on that most major indices had maybe found a near-term bottom (support) in June. While a partial rebound ensued, growing concerns around global economic conditions and increasingly hawkish comments and actions from the Federal Reserve (Fed) and other central banks drove most indexes back below those June lows and into "correction" territory by the end of September. All three major indexes logged some of the worst quarterly performance in years with September alone marking a particularly tough month as the Dow tumbled 8.8%, the S&P 500® Index fell 9.3%, and the Nasdaq lost 10.5% in the month alone.

And despite a better than expected Q2 earnings season overall, and still relatively stable domestic economic activity, we remain vigilant and realize that the current market footing is very delicate, especially as global recession, inflation and other related risks both persist. Here in the U.S., talks and probability of a current or coming recession have increased dramatically over the last three months as data continues to suggest continued above-trend inflation. The latest comments and forward guidance from the Fed also suggest that a recession will be needed to get the Fed's inflation target back to 2%. Unfortunately, the Fed's inflation outlook, which is based heavily on personal consumption expenditures (PCE), has increased every quarter since June 2020 and is not expected to decline until 2023. We expect continued volatility for both equities and fixed income in the fourth quarter as actual effects of the Fed’s bellicose stance towards inflation and subsequent economy-slowing actions are realized, along with an increased number of market participants adjusting forecasts to account for those effects.

As equity selling resumed over the last quarter, high valuation growth stocks, namely tech-related names, continued to take the worst of the blow, while energy, consumer staples, utilities and value stocks outperformed. Investors have also been exiting riskier debt instruments and moved into more safe-haven investments such as utilities, dividend-earning stocks and Treasury debt. Investors have also been exiting wide swaths of commodities such as gold, silver, lumber, metals and more as demand fears and a strengthening U.S. dollar added pressure. Lower prices of critical input materials should help with inflationary pressures in the coming quarters and we see these trends continuing, except for oil and natural gas, which are likely to remain elevated and volatile due to complex logistical challenges related to the Russia-Ukraine war and demand for heat and electricity going into winter.

With all that in mind, we do see opportunity here using more precision, tactical approaches and our long-lived approach to investing. To that end, value stocks continued to outperform growth names in the quarter, as investors seek safety and lower volatility in portfolios. Rising rates continue to impact the discounting of high-growth stocks’ long-term cash flows, reducing the sector’s attractiveness. In the debt markets, government bond yields across all durations trended higher (prices fell) for the latter portion of the quarter as interest rate trajectories steepened. From a global perspective, the losses in government bonds during the first half of 2022 were some of the deepest in history; corporate bond prices also logged losses not seen in decades while yields obviously soared. Though the early portion of the third quarter offered some reprieve, corporate bonds continued their march lower as the period ended. We believe there are opportunities in credit but remain neutral with a focus on higher-quality selections.

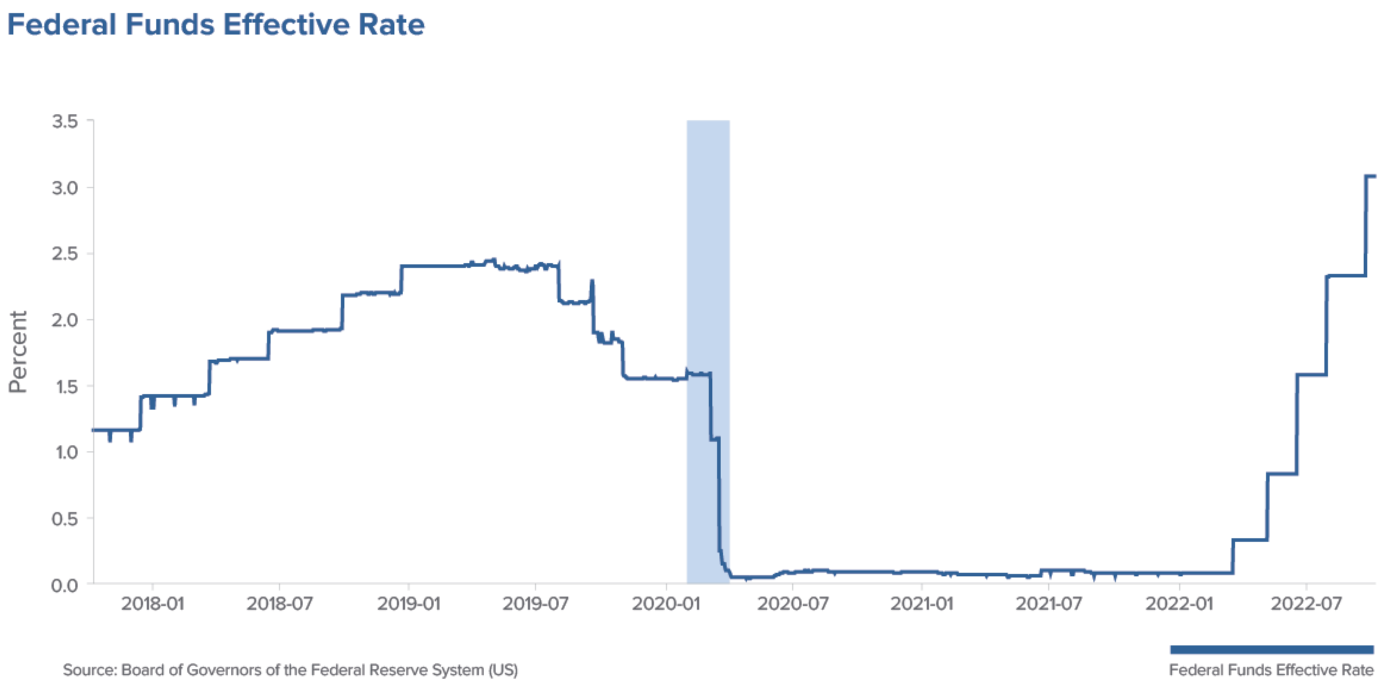
The CBOE Volatility Index, or VIX, had been trending lower from a reading of 35 in June, all the way to a bottom of 19.5 in August. The declines coincided with increasing confidence that a "soft landing" would be achieved by the Fed. Obviously, that trend and sentiment sharply reversed itself in mid-August as data and commentary from Fed members and continued above-trend inflation data modified economists' interest rate trajectory and increased probability of recession, extending the likelihood of "restrictive" policy duration by the Fed. The VIX ended the quarter at 31.62, which is just markedly above the 200-day moving average of 25.4. Remember that the VIX is the implied, annualized monthly volatility of the S&P 500®. With a VIX nearly 32, the options markets (implied volatility) are pricing in an expected one standard deviation (roughly 70% chance) monthly range, up or down, in the S&P 500 of close to 655 points – a volatile forecast for sure.

Inflation and Interest Rate Complexity

There's no doubt that the fast-tightening actions of central banks across the globe remains the biggest known risk, along with inflation, concerning market watchers. Investors continue to grapple with an increasingly murky future for the domestic and global economies, along with the continued crisis in Ukraine, energy volatility and diverging trajectories from the world's central banks (though Europe, Canada and the U.S. are all in monetary tightening phases). Domestically, the main market stressor is not just inflation, but the aggressive actions being taken to control it. For more than a decade, the Fed has been relatively accommodative. And even up until a few months ago, hope remained that a moderate, short-lived bump in rates would quell inflation and keep the growth machine going.

Prices are appearing to moderate, but we cannot confirm a trend just yet. The Consumer Price Index rose 8.3% in August from the same month a year ago but was down from 8.5% in July and from 9.1% in June, the highest inflation rate in four decades.[4] Energy price decline in the back half of the quarter contributed heavily to the reductions, but food and other even more durable prices remain elevated. We agree that long periods of above-trend inflation, aside from its obvious effects on purchasing power, can negatively impact the psyche of producers and consumers, leading to even greater price instability.

The goldilocks scenario was that the Fed would hike rates quickly, reaching a plateau expeditiously, with a possible rate decline by the end of 2023. Goldilocks has certainly left the building and now the fear is that a longer-duration of relatively higher interest rates will have a far wider and deeper impact on our daily lives. And instead of the benevolent Fed we grew accustomed to since the Great Recession, the committee's power has pivoted quickly to a "by any means necessary" agenda to tamp down inflation, regardless of the impact on economic growth.



We now believe that interest rates will peak in Q1-Q2 of 2023 and likely hold there until 2024 at which time we could see some reduction depending on economic health and labor market trends. The Fed supported our targets following the September meeting. The median Federal Open Market Committee (FOMC) member thinks the Fed's target policy rate range will still be 4.50% to 4.75% (terminal rate) by the end of next year, implying that the Fed doesn't plan to deliver any rate cuts until 2024. With that, we see 2- to 5-year yields rising, while the longer duration 10-year is likely to remain range bound, effectively flattening the curve as tightening impacts growth outlooks.

In addition to prices, the Fed is also focused heavily on the perceived strength in the jobs marketplace, despite an increasing number of layoffs announced by large and medium-sized companies as the economy slows. This could mean that the jobs market may need to experience an uncomfortable contraction in unison with declines in inflation readings. The obvious impacts to consumer sentiment and housing are yet to be seen but are likely to be worse than previously anticipated. The latest 75-basis-point hike in late September was widely anticipated, but the Fed certainly jolted markets as it made predictions for below-trend economic growth over the next few years, a fairly substantial rise in unemployment and sticky inflation until 2024. Put simply, investors should prepare for a long haul of increased volatility, uncertainty and declining economic activity laws, as we still don't know how deep this recession will have to go to meet the Fed's strict new guidelines.

Market pundits are comparing current market conditions, at least partially, to the Taper Tantrum of 2013, which was the last time America experienced relatively aggressive monetary tightening. The event certainly offers some clues into the psyche of investors during this period, but with 40-year highs in inflation, and the monetary, fiscal and supply chain effects of a global pandemic lingering, the complete picture becomes a bit opaquer and thus mitigates the correlations, causations one might find between the two periods. It also reduces the chances of forming an accurate outcome prediction to the current tightening trend.

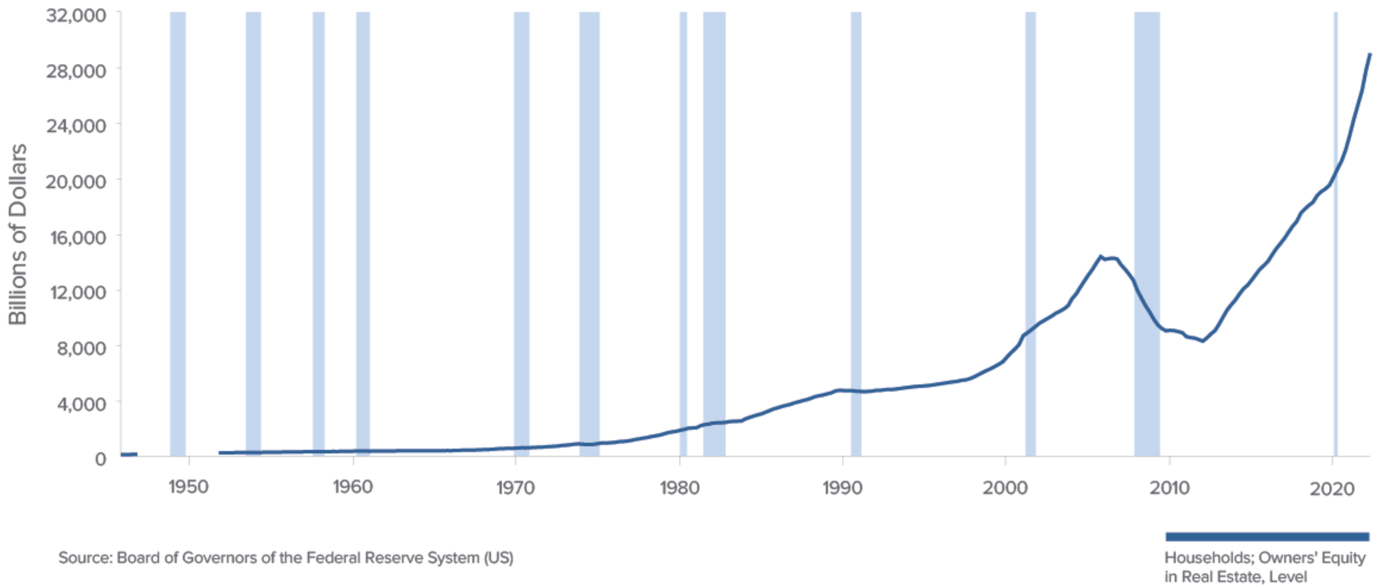
Regardless, the Fed is no-doubt being forced to play a game of catch-up, and the fear is that their unprecedented shift to extreme monetary tightening will be met with a sharper-than-expected drop in demand, propelling the economy into a swift recession — the very thing they were originally trying to prevent. Unfortunately, the steep rate hikes were likely needed to shock global prices into submission, but how much shock and restriction is too much? There has not been a time in history when the Fed has dramatically and unexpectedly shifted gears so quickly, enacting one of the most aggressive rate hike trajectories ever. We also cannot predict the longer-term effects of pandemic-related stimulus and/or the cultural reordering it has triggered.

The Housing Market — A Critical Element

Let’s be clear that we do not see a Great Recession-type event occurring in the current cycle. Today’s marketplace is supported by better overall credit quality, much higher amounts of typical equity (lower average loan-to-value ratios), and heavy participation and ownership by investors and institutions with much lower typical leverage compared to 2007.

Recent data from CoreLogic revealed that U.S. homeowners with mortgages (roughly 63% of all properties) have seen their equity increase by a total of over $3.6 trillion since the second quarter of 2021, a gain of 27.8% year over year with the average home gaining $60,000 in equity between Q2 2021 and Q2 2022.

Households; Owners' Equity in Real Estate, Level



Source: Board of Governors of the Federal Reserve System (US)

All that is good news, but home value appreciation is slowing and the Fed is having an impact on the marketplace. From a transactional perspective, home-buying activity, indicated by U.S. existing home sales, fell for the seventh straight month in August, the longest streak of declines in more than a decade. Home-buying volume was down a total of 20% from a year ago with sales activity of previously owned homes the weakest since May 2020, during the height of the pandemic. Homes are sitting on the market longer and mortgage rates are more than double where they were last year, now approaching 7%.[7]

Proponents of the housing market say that the lack of inventory should prevent a crash, and we believe that fact is certainly a positive force for the marketplace. That said, if the current economic recession deepens, relative consumer confidence turns into fear, or deep cuts occur in the labor market, short-term downward pressure on the housing market, in many metros, could increase substantially. With rates having moved so fast, home-buying affordability is the lowest it's been in decades, which means that the pool of would-be buyers to support prices has dried up considerably.

Last month, Zillow reported that the average home price fell 0.1% in July, the first in more than a decade, and there's further evidence that home prices and confidence have already begun a deeper descent as evidenced by the fastest month-over-month decline of the 20-city Case-Shiller Home Price Index in July. We've also noticed more leading indicators that show an already established slowdown in the housing market. When the average American purchases a home, they typically add furnishings, appliances, lighting and other accoutrements to personalize their new dwelling. The sales of these items are directly correlated with the health of the housing market itself. According to the Commerce Department, sales declined last month at a seasonally adjusted pace of 1.6% at furniture and home-furnishing stores, and by 5.7% at electronics and appliance stores.

We see a continuation of this cooling trend in housing for the balance of 2022 and into 2023, but on average, do not see dramatic price declines that could trigger a crisis. The good news is that we still are at the point of no return and it's likely that the Fed will recognize and respond quickly to abnormal price declines or systemic risks that develop. Again, we see a low probability of another domestic housing or systematic financial meltdown, but certain metro areas are likely to experience fairly substantial cuts in home values if rates remain at a restrictive level for an extended period.

The Road Ahead

Expect the next 12 to 24 months to look much different than the preceding. We see continued volatility, lower average earnings growth, and as predicted before, a necessary adjustment in investment style and allocation. Investors will need to rethink high-level strategy and tactics to best capture alpha in what's likely to be more of a range-bound broad market in equities and bonds. Washington has few arrows in its quiver to address current market risks as any further stimulus is likely to stoke inflation, which is the one thing that MUST be quelled. In the coming quarter, energy is likely to remain an outperforming sector, along with health care, communication services and certain materials and financial names. But unlike prior years, we may see a greater bifurcation of performance within sectors themselves, with the higher-quality names for outperforming peers.

Larger, more systematic risks do exist across the pond and in Asia. Europe continues to suffer from an energy crisis that there is no real solution for. It's likely that the Union could go into a deep and protracted recession, and Germany's four leading economic institutes now expect Europe's largest (and once most resilient) economy to slip into recession in 2023. The World Bank recently slashed its estimates for GDP growth in China to just 2.8% for 2022. In August, new home prices in 70 Chinese cities fell by a worse-than-expected 1.3% year on year, according to official figures, and nearly a third of all property loans are now classed as bad debts. We also see continued weakness in China but believe the communist nation will be able to navigate continued struggles, albeit while losing foreign investment to some of its neighboring countries. There is a possibility that a deeper slowdown in China could push key energy and material prices lower, reducing global inflation and allowing central banks to shift strategy back to more simulative policies.

We see a continued slowdown in earnings growth for the S&P 500®. Excluding the Energy sector, Q3 earnings are expected to be down -5.7% at present, a significant decline from consensus expectations for +2.1% growth at the beginning of July. This means that analysts have already revised estimates lower to account for slowing economic growth, and we expect estimates to continue to fall for the current and future quarters as

the Q3 earnings season begins. Estimates for full-year 2023 still seem fairly optimistic, and are expected to be up +6.2% as a whole and +8% excluding the energy sector. Market expectations are already fairly tempered, but there is a risk that the market's already "factored-in recession" may be too shallow and that we see an increase in negative earnings surprises. At the moment, we see a $220 operating earnings per share for the S&P 500® in 2023. This implies a price to earnings ratio of 16.2x.

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