

October 2022 Market Commentary

Looking Past the Peak



Key Benchmarks: Performance and Characteristics as of 10/31/2022

Equities	MTD	QTD	YTD	1-Yr Fwd P/E: Current vs 10-Yr Range	
S&P 500	8.1%	8.1%	-17.7%	16.7x	
MSCI EAFE	5.4%	5.4%	-23.2%	11.5x	
MSCI Emerging	-3.1%	-3.1%	-29.4%	10.2x	

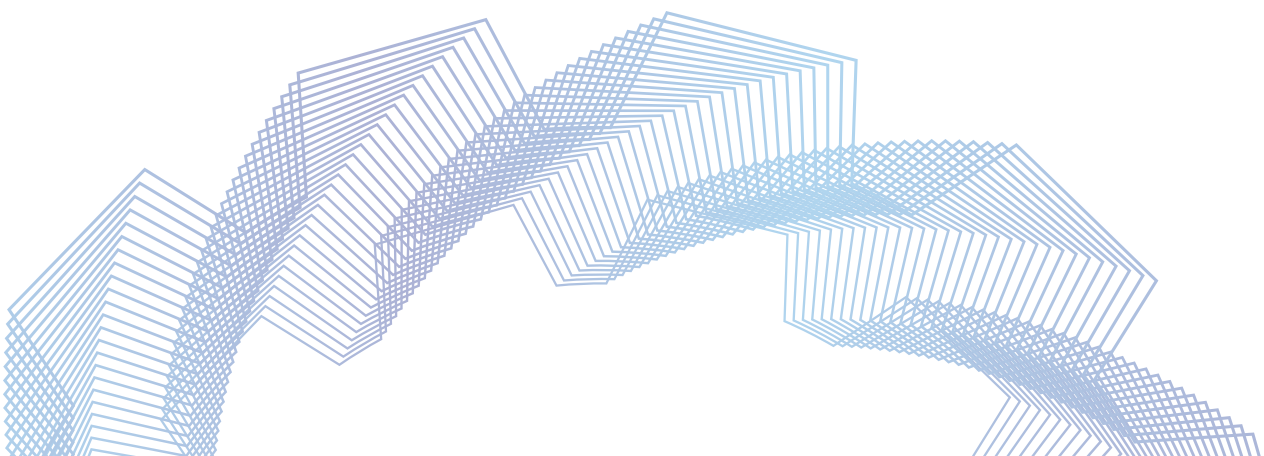
Fixed Income	MTD	QTD	YTD	Real Assets	MTD	QTD	YTD
Bloomberg Barc U.S. Aggregate	-1.3%	-1.3%	-15.7%	US REITs	3.5%	3.5%	-25.6%
Bloomberg Barc US High Yield	2.6%	2.6%	-12.5%	GSCI Commodities	6.7%	6.7%	30.0%
Bloomberg Barc Global Agg ex U.S.	-0.1%	-0.1%	-24.0%	GSCI Prec Metals	-1.4%	-1.4%	-11.5%

Data Source: Bloomberg

October 2022 Highlights:

- October saw a recovery in global risk assets with developed market equities, risky fixed income, and commodities leading a counterrally from the deep sell-off at the end of the 3rd quarter. A combination of 1) global central bank intervention to arrest U.S. dollar strength, 2) stronger-than-expected earnings growth from U.S. cyclicals/financials, and 3) expectations the Federal Reserve would follow other central banks (notably Canada and Australia) in slowing down rate hikes contributed to this month's risk-on sentiment.
- In October, the MSCI All-Country World Index (ACWI) returned 6.0%. Across major regions, Emerging Markets and broader Asia underperformed the U.S. and Europe, largely driven by a sell-off in China's equity markets following leadership changes announced at China's Party Congress. The S&P 500 Index returned 8.1% and MSCI Europe returned 7.2%, outpacing the 3.0% return of MSCI Japan, while MSCI Emerging Markets and MSCI Pacific ex-Japan were down for the month, returning -3.1% and -4.2%, respectively.

- MSCI China dropped 13.5% as overseas investors drove the selling pressure following the high-profile Party Congress deliberations. Asian currency depreciation versus the U.S. dollar also weighed on Asian market performance.
- Within the U.S., U.S. small caps outperformed large caps as the U.S. equity market recovery was broad-based, while value stocks outperformed growth stocks, as the latter suffered from earnings misses released this month by some high-profile technology growth companies. The S&P 600 Index returned 12.4% versus 8.1% for the S&P 500. S&P Pure Value outperformed Pure Growth, returning 13.0% versus 7.9%.
- Across sectors, Energy handily outperformed the other sectors helped by a recovery in energy prices as well as strong earnings releases from notable major integrations. Industrials and Financials also outperformed helped by better than expected earnings releases while interest rate-sensitive sectors such as Utilities and Real Estate underperformed as rate volatility spiked in October. Earnings disappointments from high profile growth stocks helped drag down the Consumer Discretionary and Communication Services sectors
- Among Risk Factors, Momentum and Value outperformed helped by exposure to cyclicals and financials while High Quality and Minimum Volatility lagged hurt by a combination of renewed risk appetite and earnings disappointments from highly profitable companies.
- Investment grade fixed income continued to be hurt by rising interest rates and rate volatility as well as widening risk premiums priced across securitized lending and corporate credit. The 10-Year U.S. Treasury Yield rose as high as 4.3% but then declined to end the month at 4.0%. The Bloomberg U.S. Aggregate Bond Index dropped 1.2% for the month while the Global ex-U.S. Aggregate returned -0.1%. Non-U.S. bonds outperformed helped by a recovery in European currencies versus the U.S. dollar as well as lower relative rates versus the U.S.
- U.S. high yield benefited from the U.S. equity rally as credit spreads briefly narrowed below 5% before widening just above that level. The Bloomberg US High Yield Index returned 2.6%, while Bloomberg/Barclays Emerging Market Debt LC returned -0.8% as local currency debt tends to be shorter maturity versus U.S. dollar-denominated debt.
- Within equity alternatives, Commodities recovered from the 3rd quarter sell-off, helped by a recovery in energy prices along with agricultural prices. The S&P GSCI Commodities Index returned 6.7% for the month while Dow Jones REIT Index rose 3.5%, lagging the broader equity market advance as higher interest rates continue to weigh on real estate valuations. The S&P GSCI Precious Metals Index dropped 1.4%.
- The outlook beyond the 'peak' remains murky, but investors are also being compensated with more attractive risk premiums across equities (valuations) and fixed income (interest rates). The bottom does not appear to be falling out despite fears that the Fed runs the risk of 'breaking something' through overtightening. Volatility and liquidity conditions will likely remain challenged until some clarity on the inflation front serves as a catalyst for future policy paths.



Looking Past the Peak



Source: istockphoto.com

“While on top of Everest, I looked across the valley towards the great peak Makalu and mentally worked out a route about how it could be climbed. It showed me that even though I was standing on top of the world, it wasn’t the end of everything. I was still looking beyond to other interesting challenges.”

– Edmund Hillary

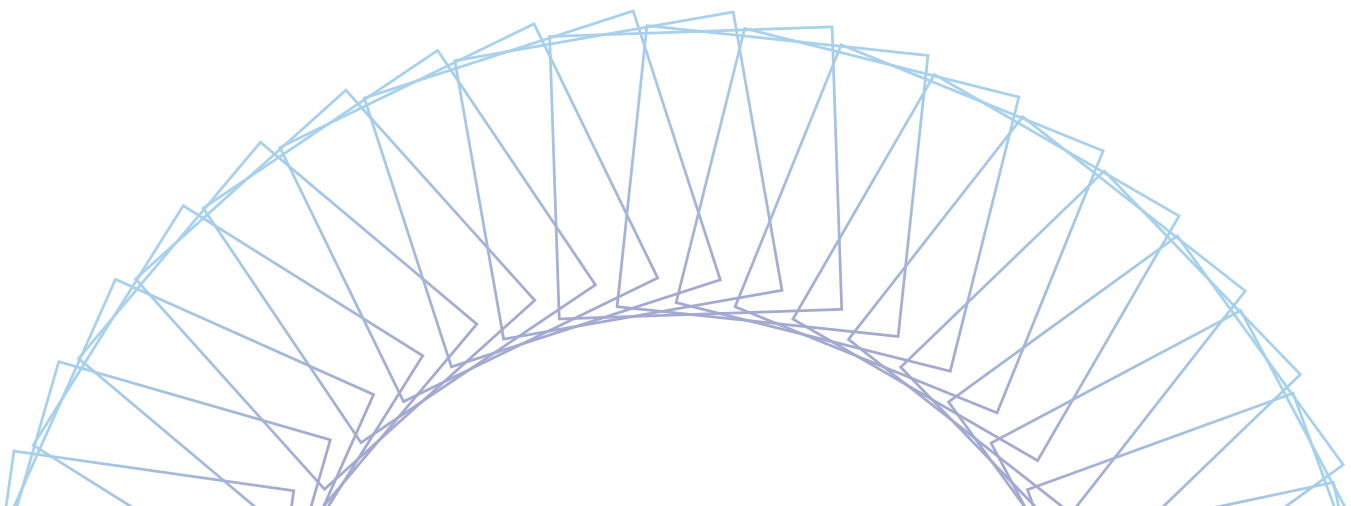
“Be careful what you wish for.”

– Aesop’s Fables



Global risk assets rallied in October over increasing signs that global central banks may be approaching the end of the rate hike cycle along with better-than-expected 3Q earnings releases that reveal an earnings and profit margin slowdown, but not crash. Are investors anticipating a ‘peak’ in the prevailing narrative, namely peak inflation, peak financial angst, peak real (inflation-adjusted) interest rates, peak labor market strength? What about peak COVID consumption of goods and services (likely the former but not the latter)? Will China finally see the peak in COVID infections for the state to withdraw their lockdowns?

And what about the state of affairs beyond the peak, assuming said peak is near? Do we really want to see what lies beyond?



Of course, market participants have become so myopically focused on day-to-day headline-driven volatility, as witnessed by the [surge in short-dated option activity](#) (options that expire within 24 hours comprising nearly half of total volume), that worrying about what lies beyond the peak is next week's problem. But we digress.

This past month witnessed what appeared to be a coordinated effort to [arrest U.S. dollar appreciation](#) (**Figure 1**) by global institutions such as the United Nations and International Monetary Fund (IMF) along with dovish policy stances taken by the European Central Bank (ECB), Bank of Australia, Bank of Canada, not to mention outright currency interventions by the Bank of Japan (**Figure 2**) and People's Bank of China. In effect, the world is conveying to the U.S. Federal Reserve (the Fed) to 'slow its roll' on its aggressive monetary tightening.

Figure 1 – Will the Federal Reserve 'Slow Its Roll' of the U.S. Dollar Wrecking Ball? A Mid-Month Coordinated Intervention Strongly Suggests Efforts Underway to Weaken the Dollar

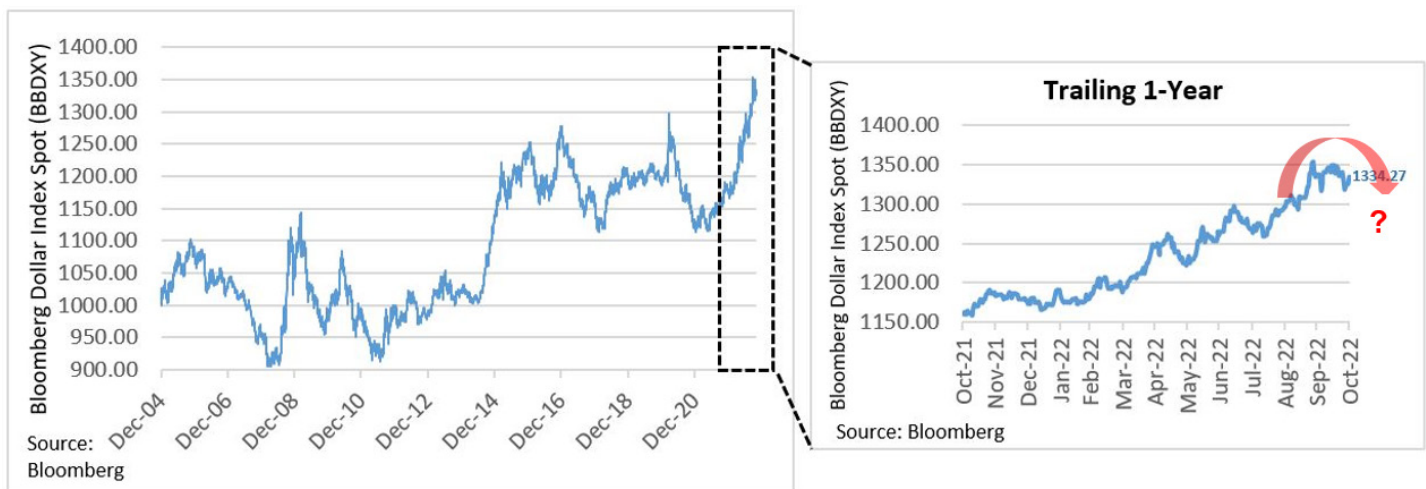
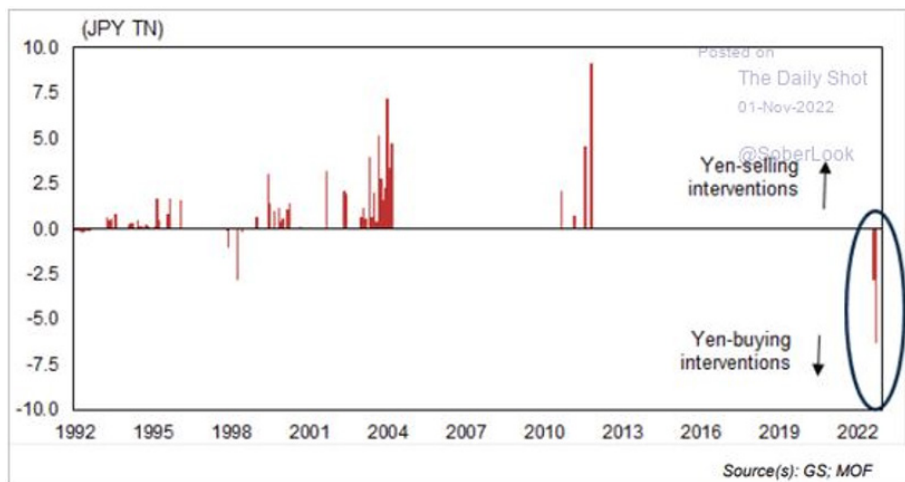


Figure 2 – Historically Large Currency Intervention by the Bank of Japan to Reverse Yen Depreciation vs the US Dollar



Source: [Goldman Sachs: III Capital Management](#)

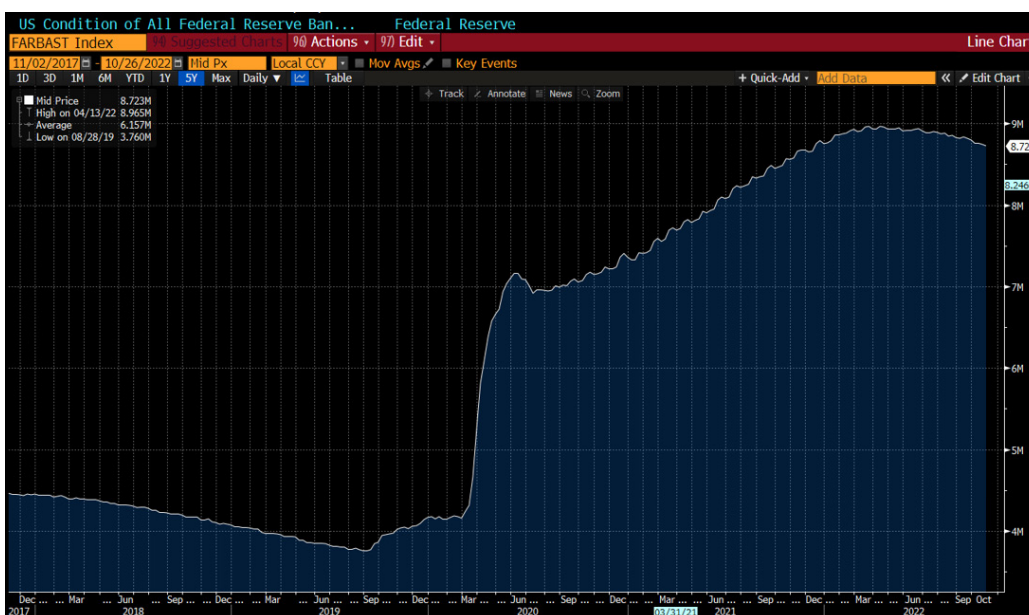
The Fed is trying to subdue persistently high inflation (latest [core PCE at 5.1%](#)), via aggressive hikes in the benchmark rate now expected to reach 5% by spring of 2023 (**Figure 3**) and contracting its balance sheet (**Figure 4**) that reached nearly \$9 trillion as it looks to roll off maturing Treasuries and Mortgage-Backed Securities accumulated during the COVID pandemic.

Figure 3 – Despite Signs of a Slowdown in Global Policy Tightening, the Terminal Fed Funds Rate Is Expected to Peak Near 5% by Spring 2023

Region: United States »		Instrument: Fed Funds Futures »			
Target Rate	3.25	Pricing Date	10/31/2022		
Effective Rate	3.08	Cur. Imp. O/N Rate	3.079		
Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M.
11/02/2022	+3.043	+304.3%	+0.761	3.839	0.250
12/14/2022	+5.455	+241.3%	+1.364	4.443	0.250
02/01/2023	+6.941	+148.6%	+1.735	4.814	0.250
03/22/2023	+7.475	+53.4%	+1.869	4.948	0.250
05/03/2023	+7.586	+11.1%	+1.896	4.975	0.250
06/14/2023	+7.449	-13.7%	+1.862	4.941	0.250
07/26/2023	+7.225	-22.4%	+1.806	4.885	0.250
09/20/2023	+6.880	-34.5%	+1.720	4.799	0.250
11/01/2023	+6.398	-48.2%	+1.600	4.678	0.250
12/13/2023	+5.926	-47.2%	+1.482	4.560	0.250
01/31/2024	+5.575	-35.1%	+1.394	4.473	0.250

Source: Bloomberg World Interest Rate Probability (WIRP)

Figure 4 – Has the Federal Reserve Balance Sheet Finally Peaked as the Fed Rolls Off Maturing Treasuries and Mortgage-Backed Securities?



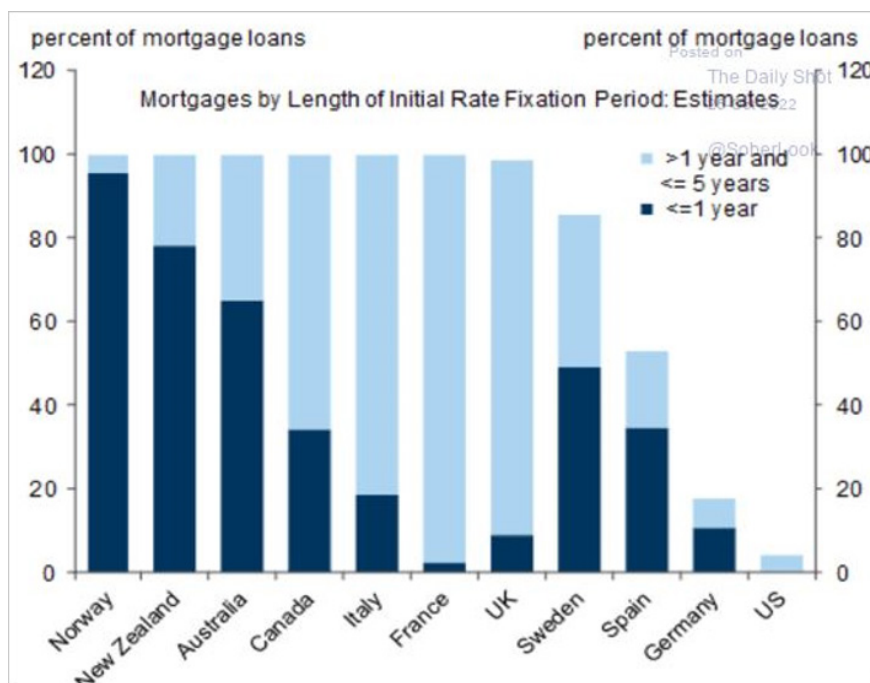
Source: Bloomberg

Aggressive Fed tightening can raise the risk of financial instability via U.S. dollar appreciation that is stressing the global financial system through higher borrowing costs, higher volatility, and lower liquidity (as we outlined in the [3Q2022 Market Commentary, “Financial Instability Risk > Inflation Risk”](#)).

Although last month’s financial ‘detonations’ (UK pensions margin calls over Gilt losses; financial challenges with [Credit Suisse](#) necessitating a desperate capital raise) appear to be contained for now, what about other problems lurking underneath the surface? What compelled the U.S. Treasury to announce an initiative to restore liquidity in trading U.S. debt via [U.S. Treasury buybacks](#) that largely amounts to another version of [Operation Twist](#) (i.e. swapping out longer-dated Notes for short-term Bills)? Did government officials get wind of some large institutional traders who were over their skis on financial leverage begging for a liquidity backstop?

Whether decelerating the pace or pausing altogether, when we finally reach the peak of central bank tightening, the question turns to how long we will remain at peak rates. For countries with mortgage holders facing rate [resets over the next 3-5 years](#) (Figure 5), the route to peak rates will likely be shorter as central banks face political pressure to minimize the fallout from the sudden increase in financial burden. The release valve for central bank eye blinking is typically through the issuing currency, so one would expect further U.S. dollar strength if other central banks preemptively abandon rate hikes in favor of backstopping their respective debt markets and domestic borrowers. Sort of defeats the purpose of global coordination to keep the dollar from further appreciation. A drop in relative currency valuations may not be even enough if such eye-blinking coincides with fiscal policy as the ill-fated Truss Ministry discovered when the UK bond market revolted against fiscal unorthodoxy.

Figure 5 – Monetary Reticence Among Countries With High Mortgage Borrower Exposure to Rate Resets?

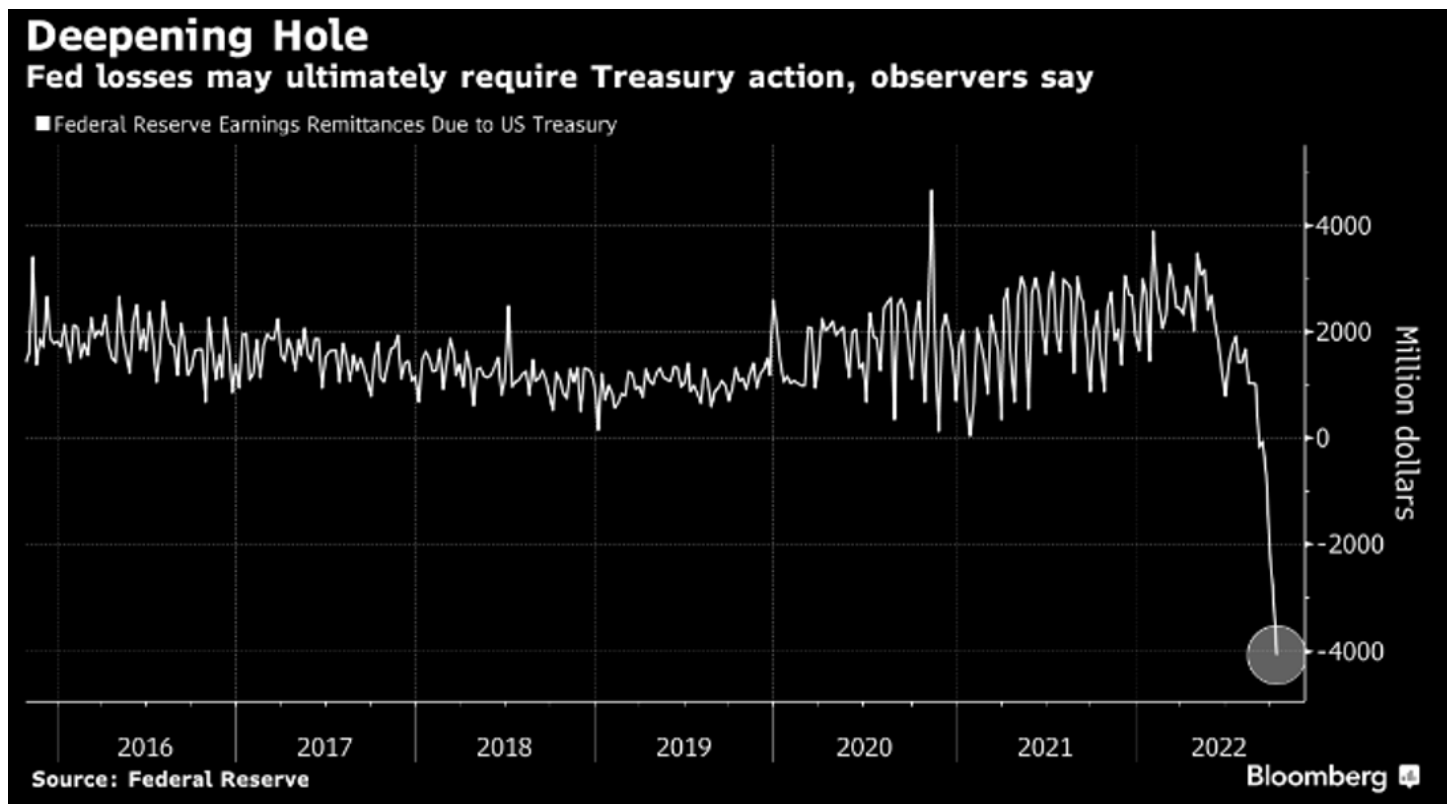


Goldman Sachs: III Capital Management



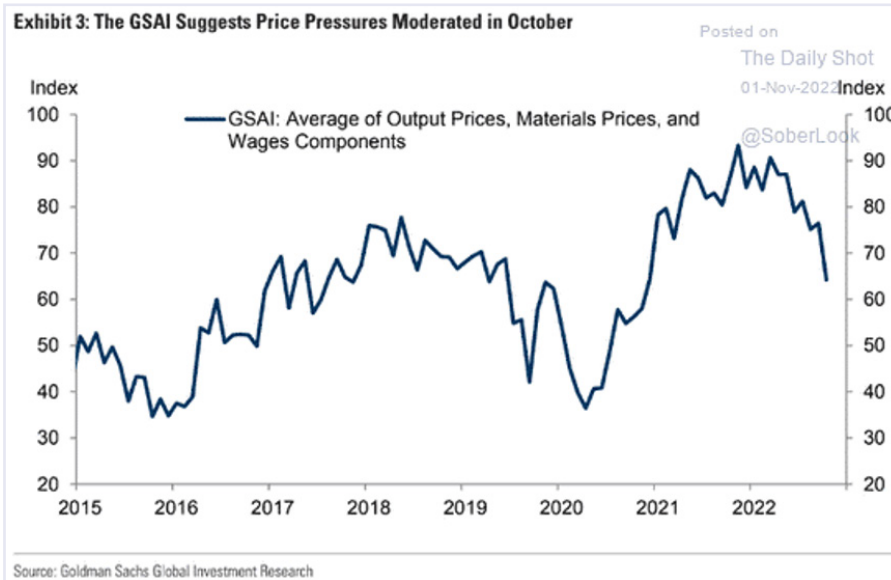
The Fed is trying to thread a very narrow needle as higher rates pressure the financial system and broader economy (with a typical 6-18 month lag), causing [political angst among some politicians](#), while also facing political pressure over the issue of [negative remittances to the U.S. Treasury](#) as the interest income earned on its balance sheet is not enough to cover the interest paid out on bank excess reserves and standing repo facilities (**Figure 6**). To address the latter, the Fed would need to accelerate quantitative tightening or balance sheet reduction, currently set at a pace of \$95 billion/month.

Figure 6 – Negative Remittances from the Fed to the Government Could Get Political



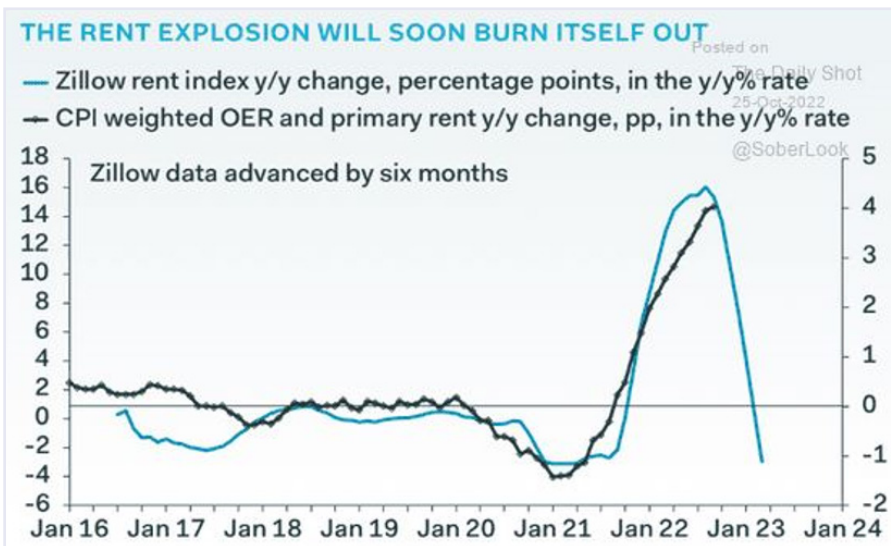
The Fed is also facing criticism that it's too reliant on backward-looking data and is extrapolating current labor market strength to continue into the future, regardless of the lagged detrimental impact on the economic activity from higher rates. Higher interest rates and higher inflation are already starting to affect end demand. Despite post-pandemic highs reached in consumer borrowing (i.e. credit card balances), consumers are responding to higher inflation by [reducing purchases on household goods and durables](#) (i.e. appliances). Business sentiment also seems to be indicating that input cost pressures have already peaked and are expected to decline as the year rolls on (**Figure 7**).

Figure 7 – Will a Slowdown in Input Prices Help Moderate Overall Inflationary Pressures?



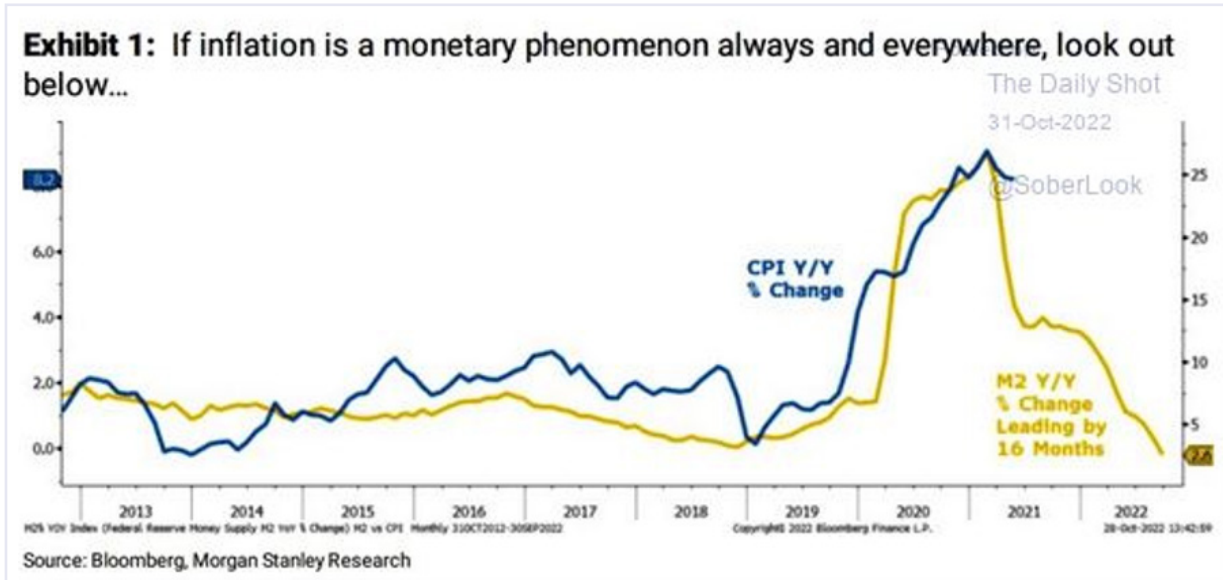
And there are signs that housing expenses (current lease trends → shelter costs and owner's equivalent rent components that go into CPI) may have also peaked, which should help moderate forward inflation measures (Figure 8). A slowdown in broad money supply aggregates (M2) also portends a potential slowdown in inflationary pressures (Figure 9).

Figure 8 – Will a Slowdown in Current Rental Rates Help Moderate Headline Inflation?



Source: Pantheon Economics via Daily Shot

Figure 9 – Will a Slowdown in Current Rental Rates Help Moderate Headline Inflation?



Bond market indicators seem to be pointing towards a significant economic slowdown if not outright recession sometime in 2023. The 2-10 year term structure remains deeply inverted while inflation expectations (breakeven rates between TIPS vs nominal Treasuries) is elevated but still hovering around 2.5% (Figure 10). Numera Analytics published a 10-year Treasury rate scenario (Figure 11) where a recession would likely drive long-term bond yields lower, assuming inflation pressures also drop. A stagflationary scenario of lower economic growth and higher inflation would be the least ideal outcome.

Figure 10 – 2-10 Year Term Structure Remains Deeply Inverted Suggesting a Sharp Slowdown Is Expected While Inflation Expectations Hover Around 2.0-2.5%

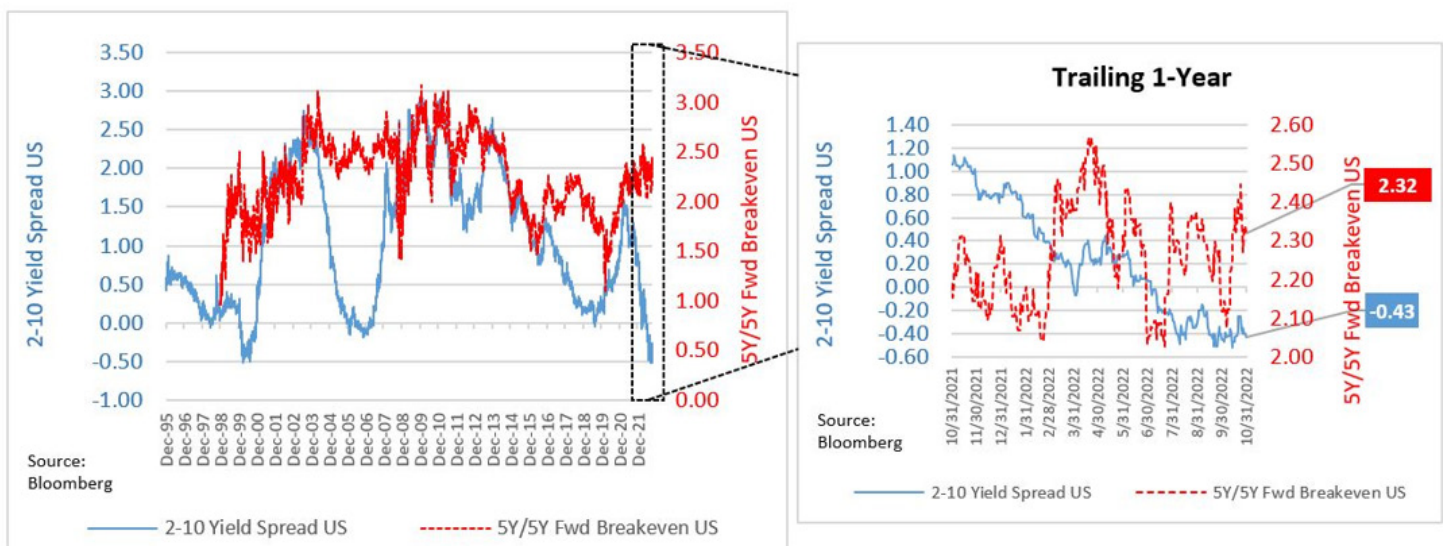
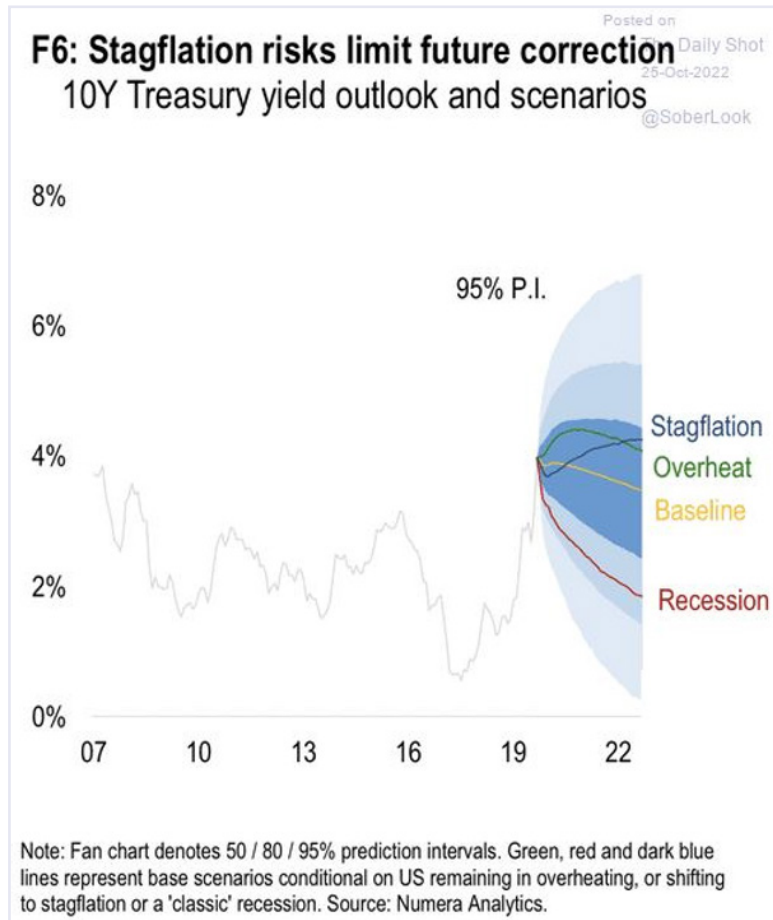


Figure 11 – Scenario Paths for the 10-Year Treasury Yield



Finally, a slowdown across China could also alleviate demand-driven inflation, although global supply chains may be adversely impacted. Renewed Zero-COVID lockdowns across China (**Figure 12**) as well as slowing housing activity (**Figure 13**) could also point towards a muted longer-term economic growth outlook (**Figure 14**), as indicated by a major slowdown in steel rebar demand (**Figure 15**). Representing the world's 2nd largest economy, China remains the marginal price setter for material inputs and manufacturing labor. It's heavy reliance on exports to fuel economic growth has also led Chinese monetary authorities to devalue the Yuan in order to keep pace with Japanese yen depreciation (**Figure 16**).

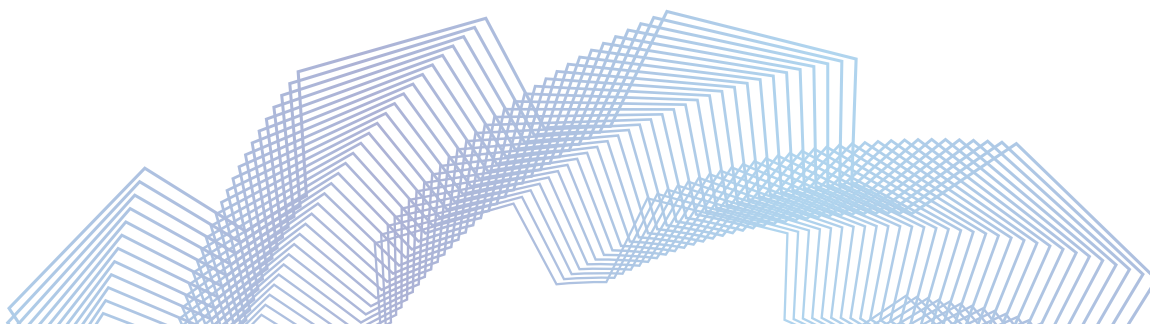


Figure 12 – COVID Lockdowns Remain Prevalent Across China Impacting GDP

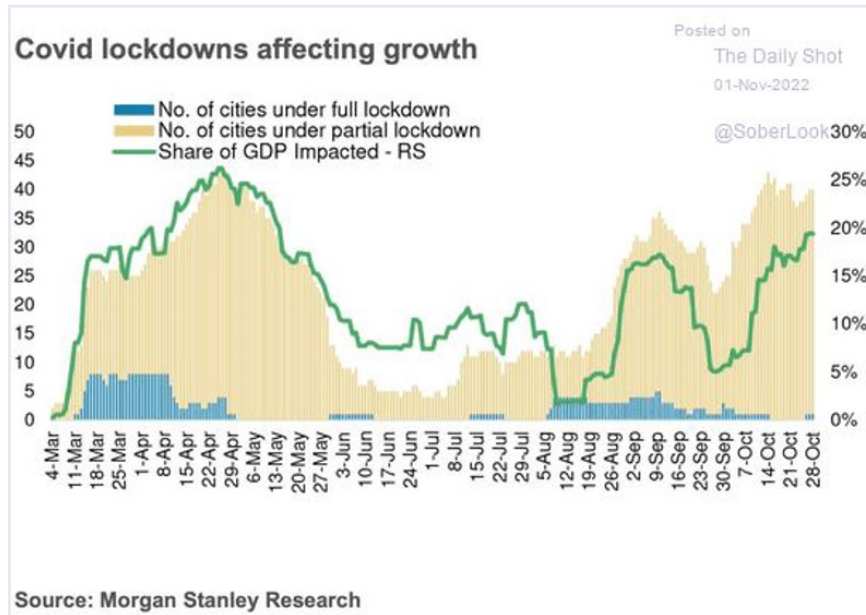


Figure 13 – Real Estate Development Contracting Further in China

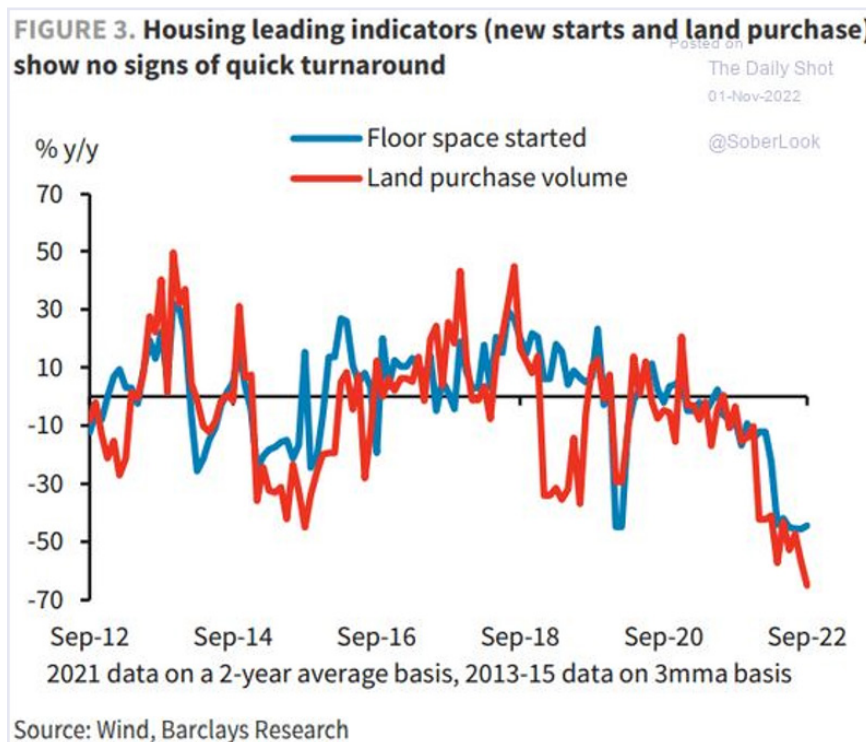


Figure 14 – A More Muted Growth Outlook for the Chinese Economy

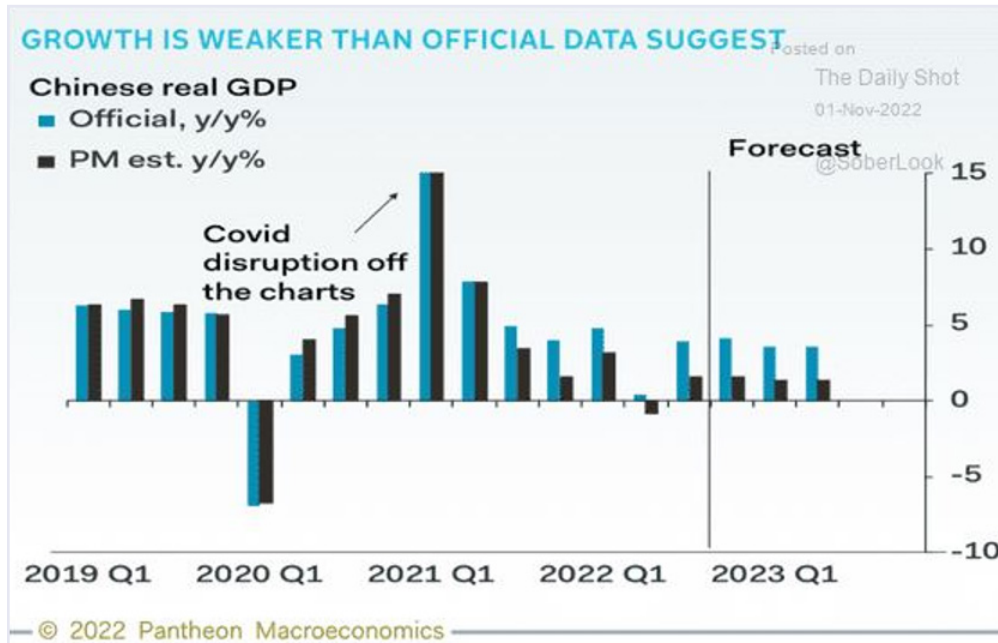


Figure 15 – China Experiencing Softening Steel Demand

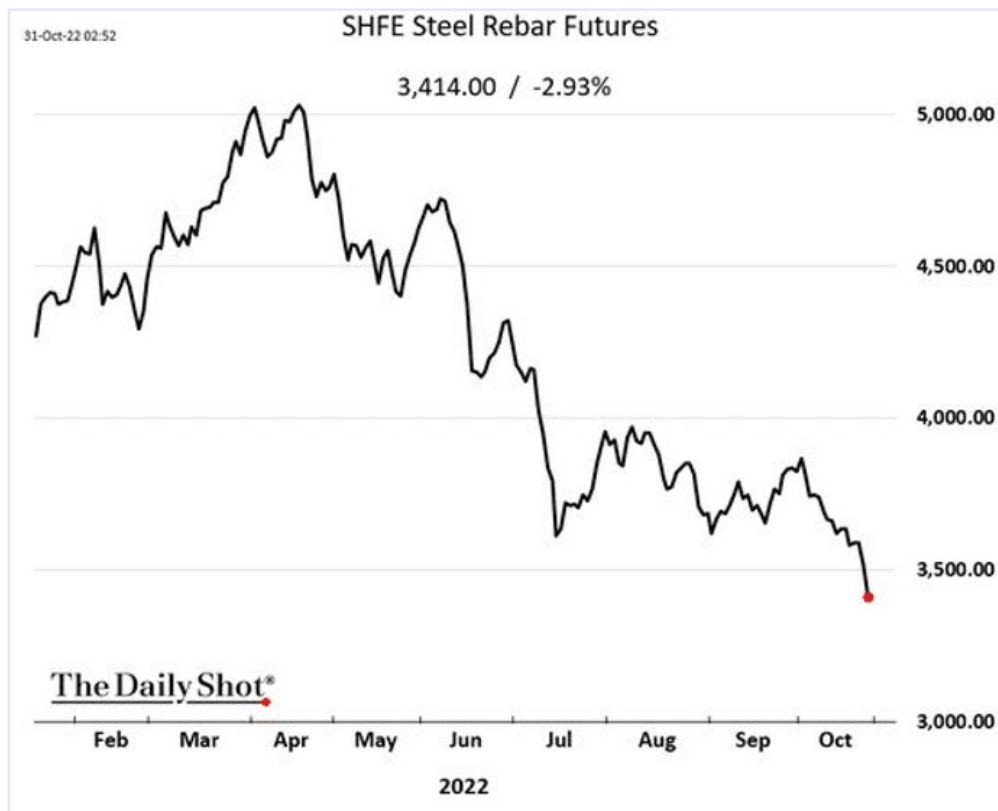
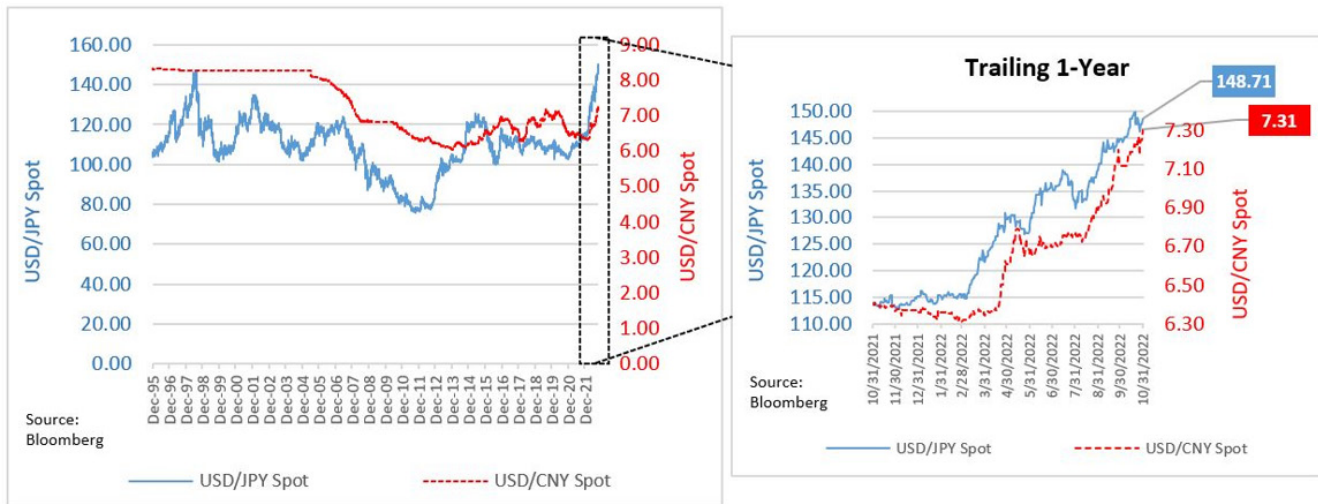
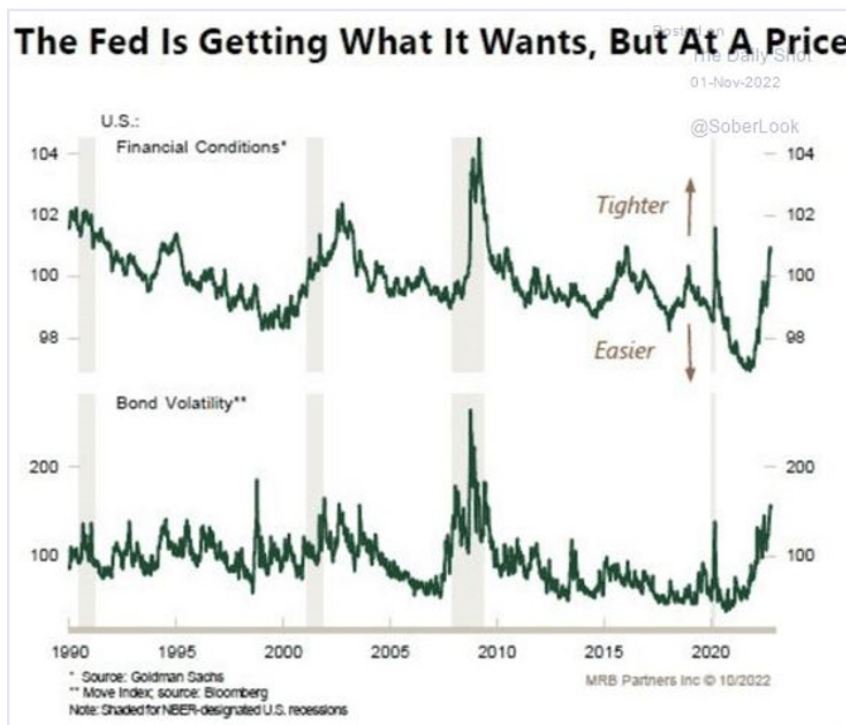


Figure 16 – A Race to the Bottom as Chinese Yuan Depreciation Tries to Keep Pace with Japanese Yen Depreciation vs the US Dollar



As mentioned earlier, overall financial conditions have recovered from the September swoons although remain elevated, largely due to interest rate volatility (Figure 17). Perhaps, tightening credit conditions and availability is one primary aim of Fed policy to bring down demand-driven inflation.

Figure 17 – Rising Bond Volatility Goes Hand in Hand with Tighter Financial Conditions



Bond volatility has mainly affected borrowing costs for securitized lending (e.g., mortgage, autos, collateralized loans) via wider risk premium spreads demanded by investors. However, corporate lending has not been as adversely affected as high yield spreads (**Figure 18**) have narrowed with the broad market advance; high yield investors hold a more sanguine outlook for the sector given the extended maturity wall (**Figure 19**).

Figure 18 – High Yield Spreads Narrow from the September Stress Levels Although Lower Investment Grade Spreads Remain Relatively Wider

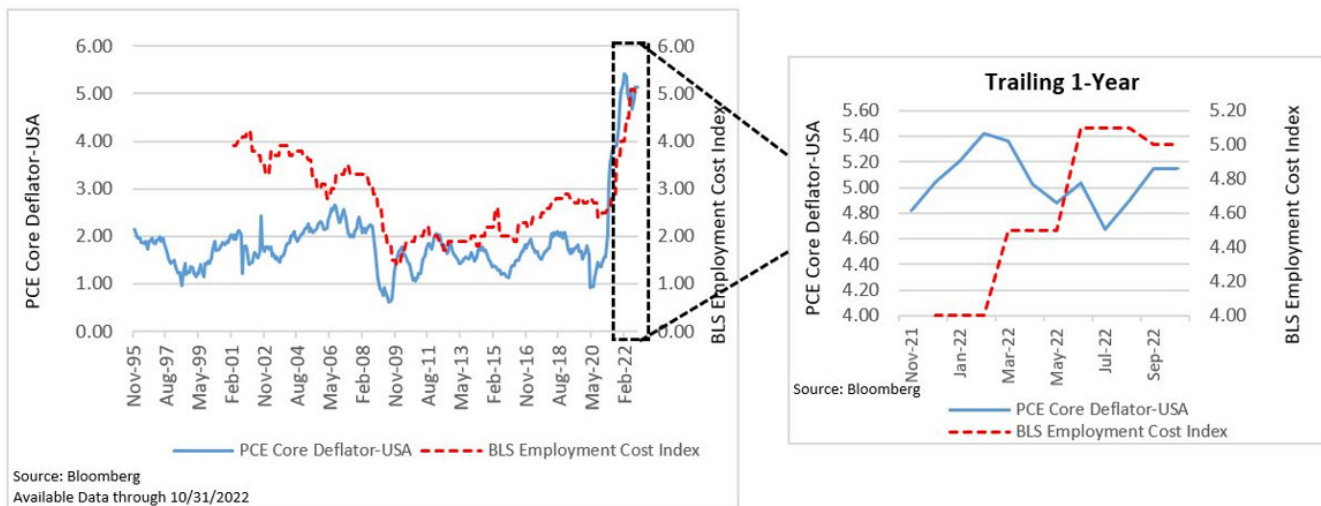
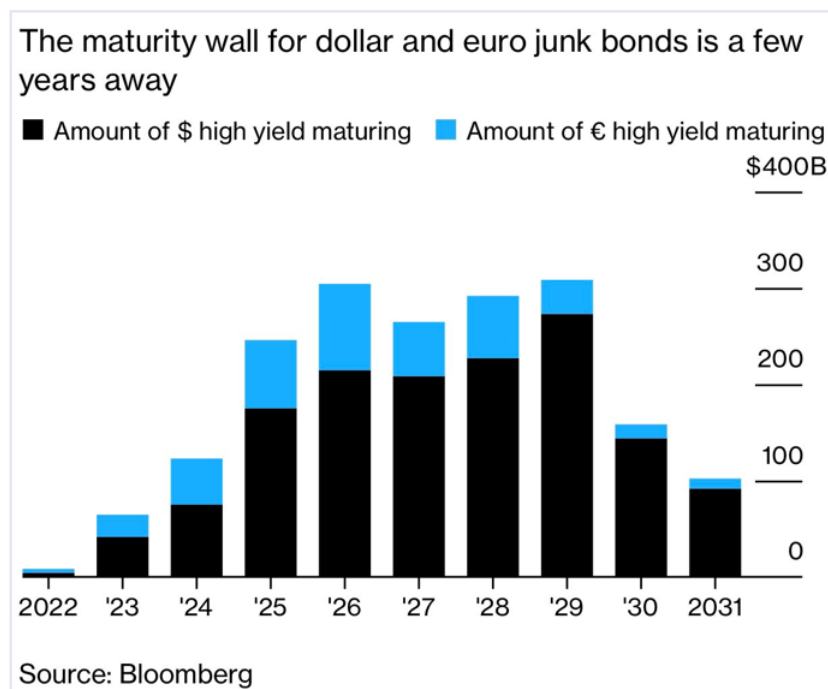


Figure 19 – Little Pressure for Near-Term Refinancing of Heavily Levered Corporate Borrowers



So, with financial conditions having meaningfully tightened and risk of financial instability having moderated, the risk is that a return of investor 'animal spirits' in expectations of a peak in central bank tightening will re-emerge in the form of higher commodity prices and excess financial speculation. This would create a risk of pivot-and-reverse on the part of central banks as any preemptive easing could manifest itself in renewed inflation. Federal Reserve comments still remain focused on the resilient labor market as wages continue to rise alongside core inflation readings (Figure 20) while excess household savings, albeit primarily upper income cohorts, represent more fuel for further spending (Figure 21).

Figure 20 – Core Inflation Remains Elevated Alongside Higher Labor Costs

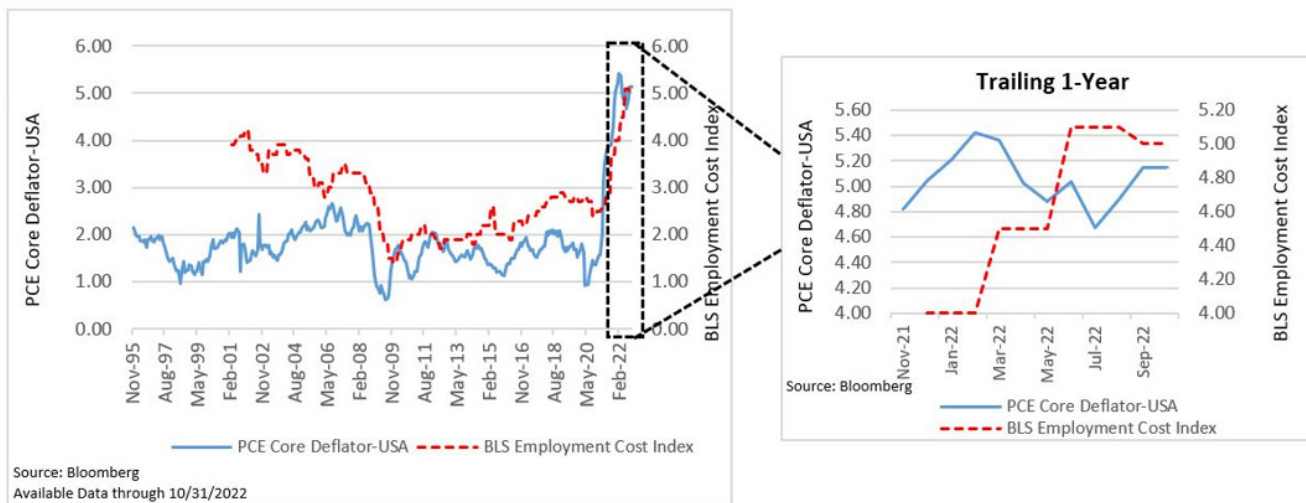
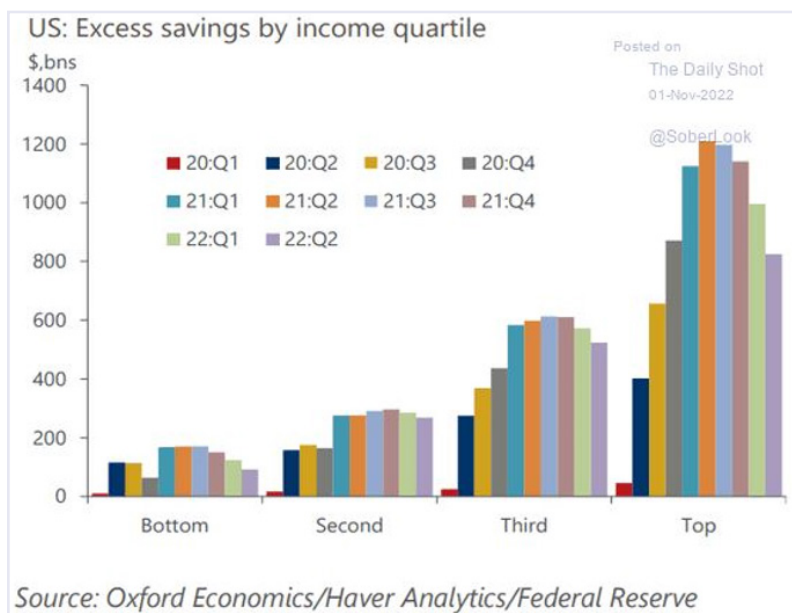
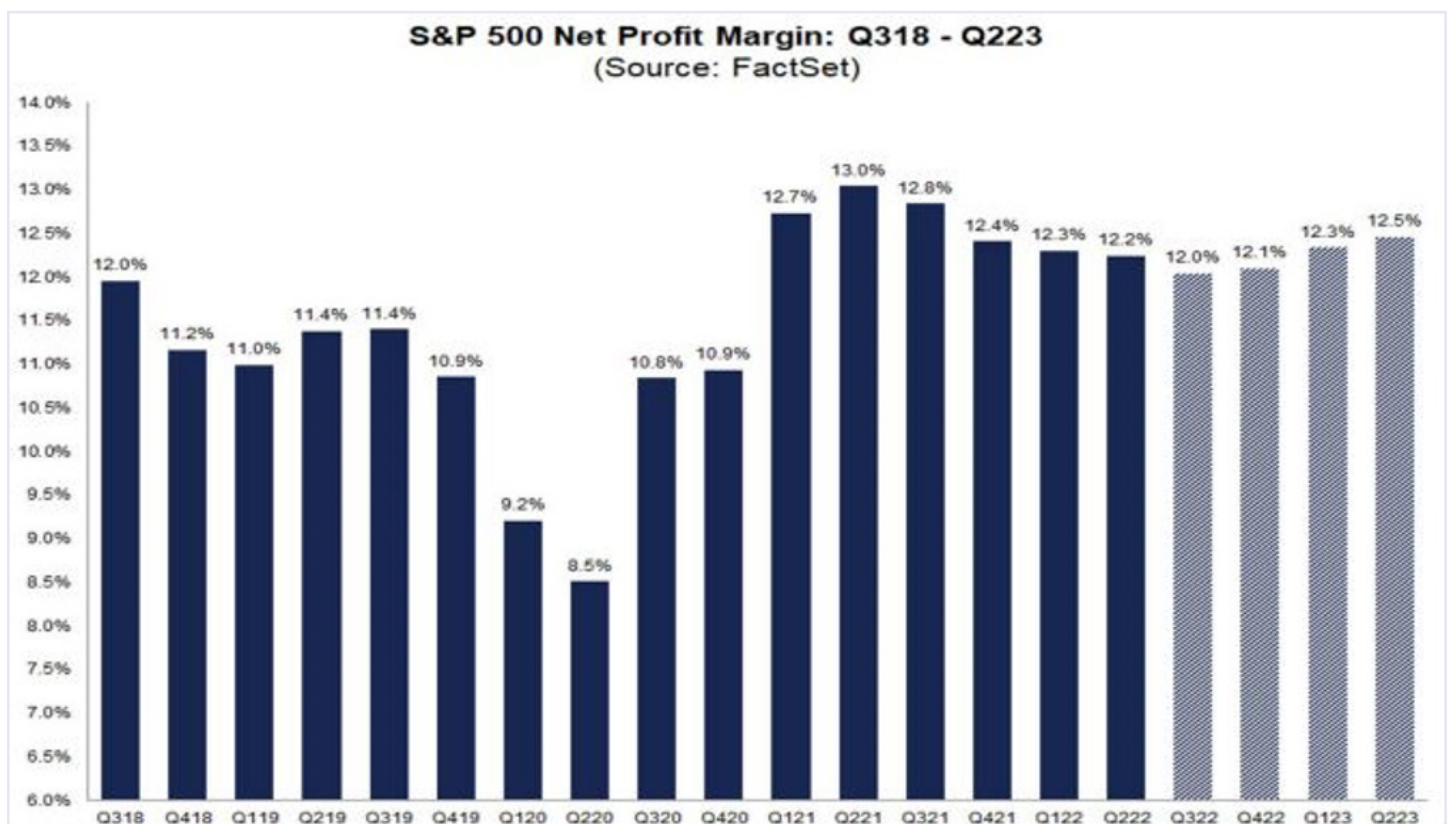


Figure 21 – Although Down from Peak Levels, Excess Household Savings Could Fuel Further Spending



3rd Quarter earnings releases for the S&P 500 Index have been a mixed bag so far, with a further decline in projected earnings growth for this year and next year. According to [Factset Earnings Insight \(10/28/2022\)](#), the blended earnings growth rate for 3Q2022 is 2.2% for 52% of the S&P 500 companies that have reported so far, the slowest growth rate since 3Q2020. Ex-energy, earnings have actually contracted. For CY2022, the projected earnings growth has been revised down to 6.1% (had been 8% before earnings season) while CY2023 is now projected to grow at 6.4% (on top of revenue growth of only 3.7%). The good news for investors is that profit margins are expected to remain around 12% for the foreseeable future (**Figure 22**) as companies have been largely able to pass on cost pressures to final prices without significantly impacting end demand. Industrial cyclicals (namely Energy) are expected to drive forward growth and margin expansion over the next few years.

Figure 22 – S&P Company Profit Margins Expected to Remain Elevated Around 12%



The outlook beyond the 'peak' remains murky, but investors are also being compensated with more attractive risk premiums across equities (valuations) and fixed income (interest rates). The bottom does not appear to be falling out despite fears that the Fed runs the risk of 'breaking something' through overtightening. Volatility and liquidity conditions will likely remain challenged until some clarity on the inflation front serves as a catalyst for future policy paths.

October 2022 Market Review

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Across major regions (**Figure 23**), Emerging Markets and broader Asia underperformed the U.S. and Europe, largely driven by a sell-off in China's equity markets following leadership changes announced at China's Party Congress. In October, the S&P 500 Index returned 8.1% and MSCI Europe returned 7.2%, outpacing the 3.0% return of MSCI Japan, while MSCI Emerging Markets and MSCI Pacific ex-Japan were down for the month, returning -3.1% and -4.2%, respectively. Asian currency depreciation (**Figure 24**) versus the U.S. dollar also weighed on Asian market performance.

MSCI China dropped 13.5% as overseas investors drove the selling pressure following the high-profile Party Congress deliberations (see Bloomberg ["Frustrated and Angry,' Global Funds Worry About Xi's New China"](#)). By populating the influential leadership functions with party loyalists, investors questioned the future growth outlook stemming from Chairman Xi Jinping's leadership changes, not to mention ongoing Zero COVID lockdowns, [saber rattling over Taiwan](#), and [U.S. trade restrictions on high-end semiconductor](#) production and U.S. personnel working for Chinese technology companies (although [narrower](#) than initial feared).

Figure 23 – Emerging Markets and Broader Asia Outperform the U.S. and Europe

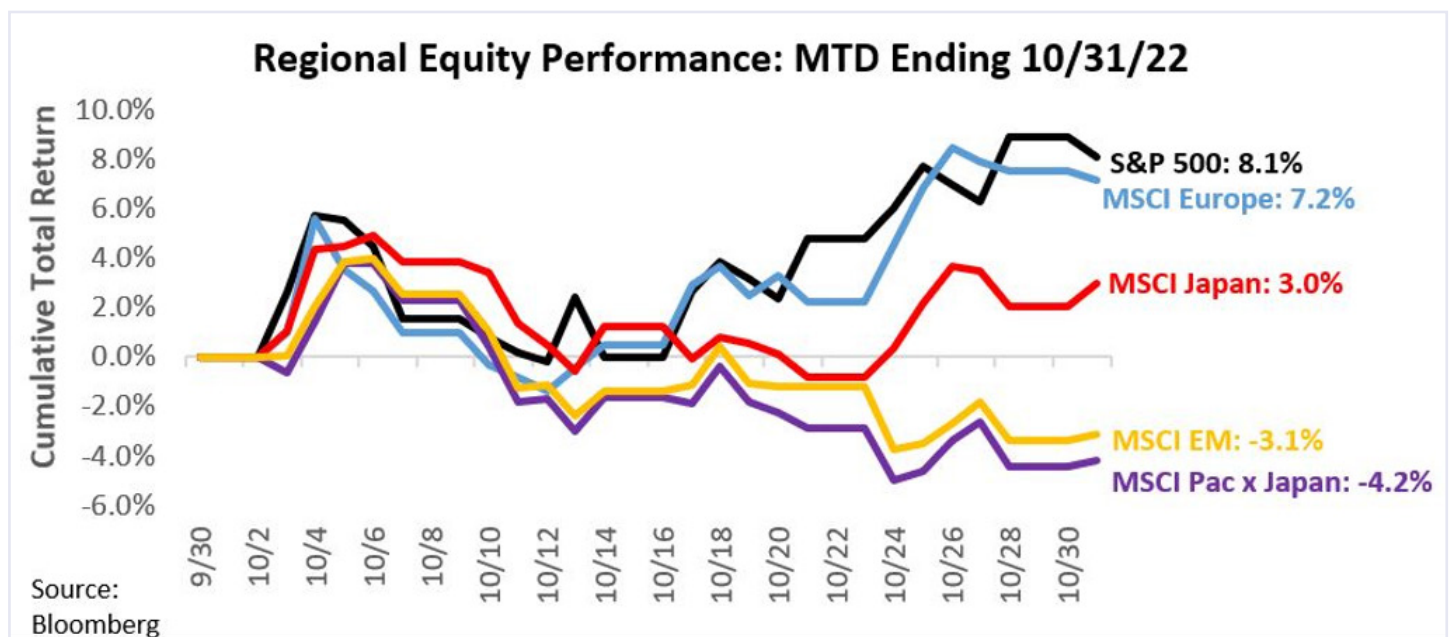


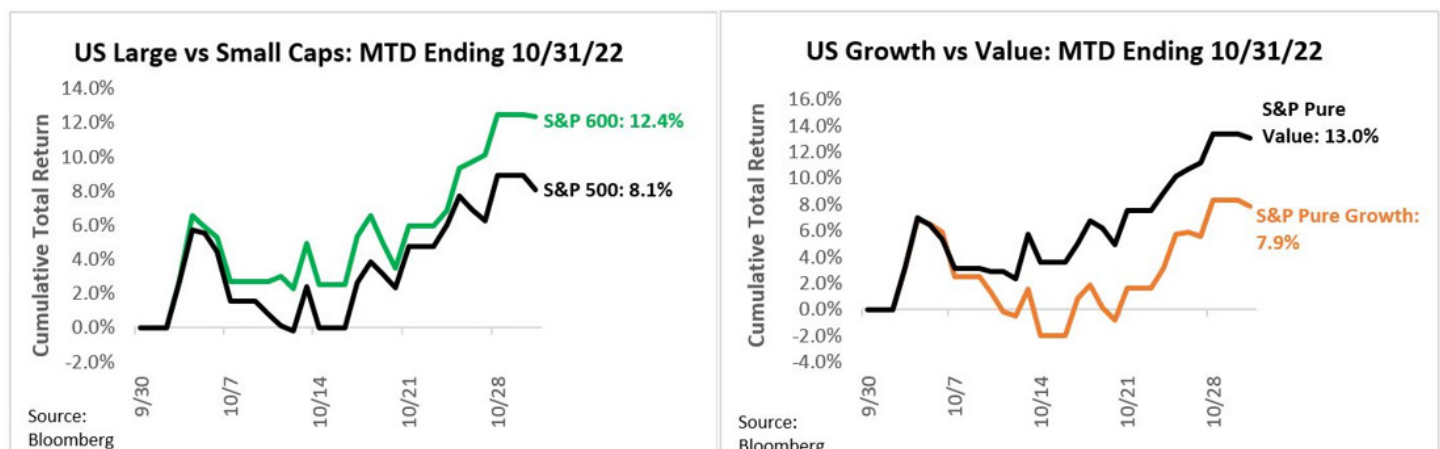
Figure 24 – Asian Currencies Remain Under Heavy Pressure As Asian Markets Largely Miss Out on the Recovery in Equities



Source: Bloomberg Asia Currency Index

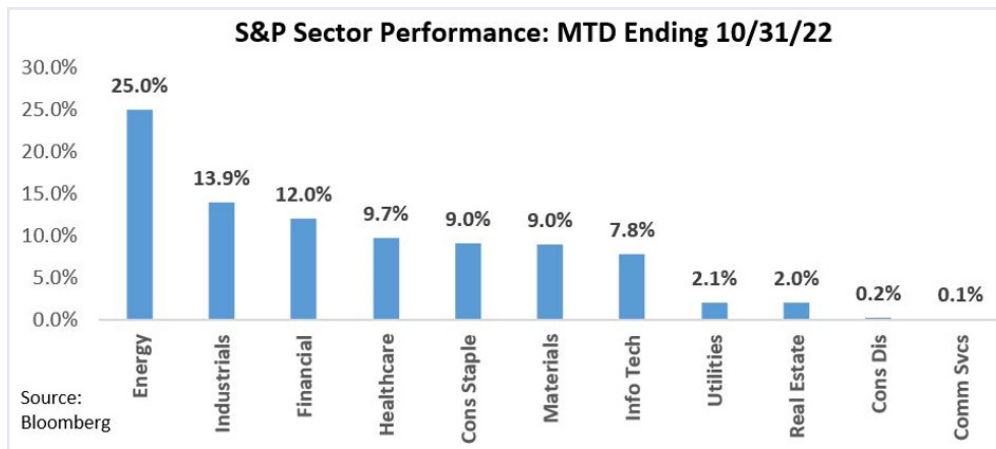
Within the U.S., U.S. smalls caps outperformed large caps as the U.S. equity market recovery was broad-based, while value stocks outperformed growth stocks, as the latter suffered from earnings misses released this month by some high-profile technology growth companies. The S&P 600 Index returned 12.4% versus 8.1% for the S&P 500. S&P Pure Value outperformed Pure Growth, returning 13.0% versus 7.9% (Figure 25).

Figure 25 – Small Caps Outperformed Large Caps While Value Outperformed Growth



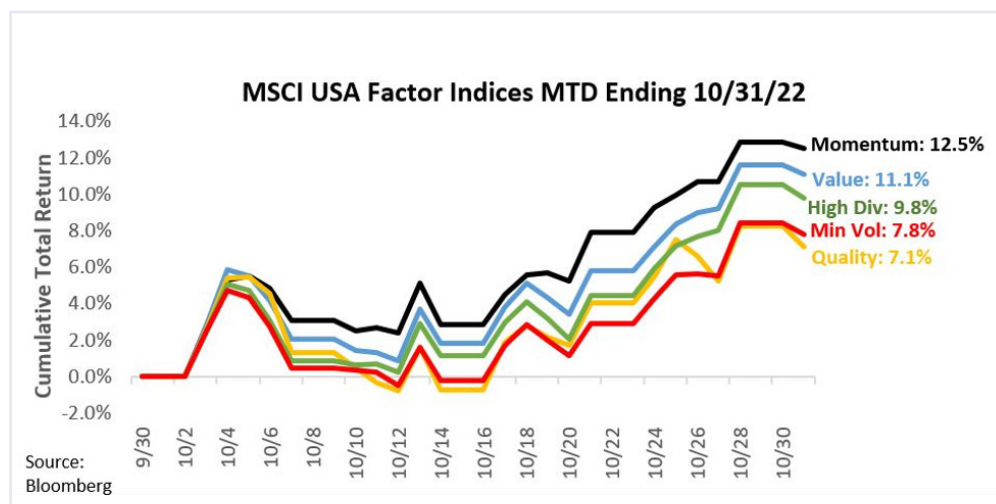
Across sectors (**Figure 26**), Energy handily outperformed the other sectors helped by a recovery in energy prices as well as strong earnings releases from notable major integrations. Industrials and Financials also outperformed helped by better than expected earnings releases while interest rate-sensitive sectors such as Utilities and Real Estate underperformed as rate volatility spiked in October. Earnings disappointments from high profile growth stocks helped drag down the Consumer Discretionary and Communication Services sectors.

Figure 26 – Energy Stocks Surged on the Back of Higher Oil/Gas Prices While Utilities and Financials Also Outperformed



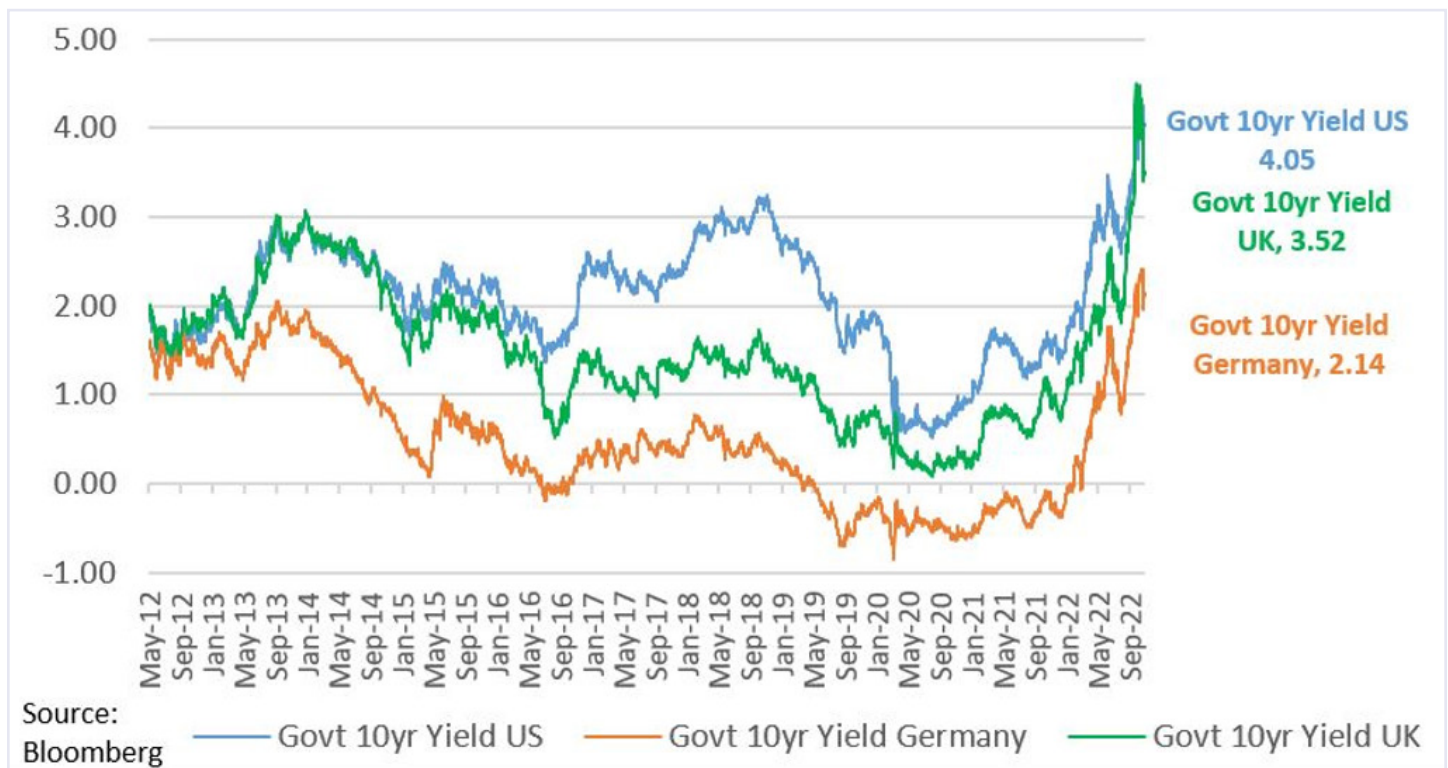
Among Risk Factors (**Figure 27**), Momentum and Value outperformed helped by exposure to cyclicals and financials while High Quality and Minimum Volatility lagged hurt by a combination of renewed risk appetite and earnings disappointments from highly profitable companies.

Figure 27 – High Quality Underperformed All Other Major Risk Factors But All Other Factors Outperformed the Broader Market in August



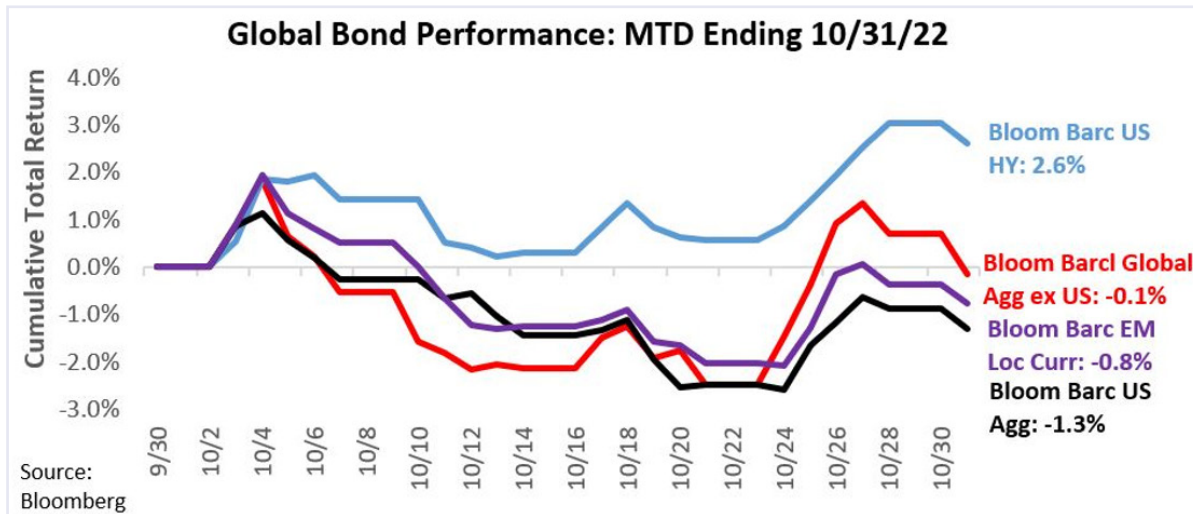
Investment grade fixed income continued to be hurt by rising interest rates and rate volatility as well as widening risk premiums priced across securitized lending and corporate credit. Global rates spiked earlier in the month but then eased around mid-month based on an [apparent coordinated attempt by central banks](#) to arrest U.S. dollar appreciation (so-called [USD Wrecking Ball](#)) while also signaling that the pace of rate tightening may be slowing as both the Bank of Canada and Australia did not raise rates as high as expected. The 10-Year U.S. Treasury Yield rose as high as 4.3% but then declined to end the month at 4.1% (**Figure 28**).

Figure 28 – Interest Rates Rose in October But Off Mid-Month Highs



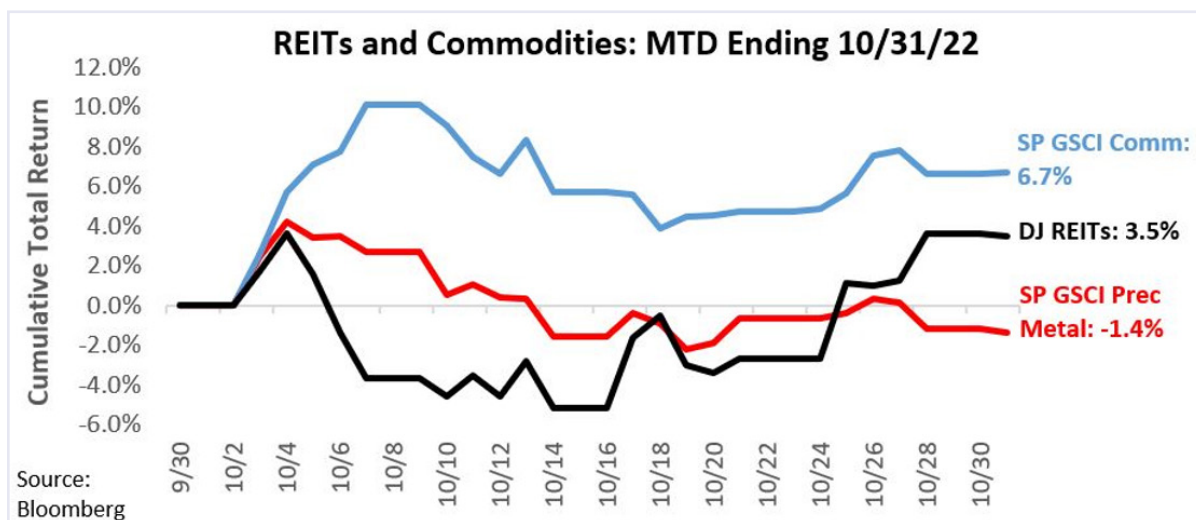
Bond returns recovered from the mid-month sell-off over [unofficial reports that the Fed may signal a policy shift at the November FOMC meeting](#), such as a slowdown or pause in rate hikes over concerns of financial instability brought on by higher rates. The Bloomberg U.S. Aggregate Bond Index dropped 1.2% for the month (**Figure 29**) while the Global ex-U.S. Aggregate returned -0.1%. Non-U.S. bonds outperformed helped by a recovery in European currencies versus the U.S. dollar as well as lower relative rates versus the U.S. U.S. high yield benefited from the U.S. equity rally as credit spreads briefly narrowed below 5% before widening just above that level. The Bloomberg US High Yield Index returned 2.6%, while Bloomberg/Barclays Emerging Market Debt LC returned -0.8% as local currency debt tends to be shorter maturity versus U.S. dollar-denominated debt.

Figure 29 – Fixed Income Hurt By Rising Rates and Widening Risk Premiums for Securitized Debt (MBS, ABS) and Investment Grade Credit



Within equity alternatives (Figure 30), Commodities recovered from the 3rd quarter sell-off, helped by a recovery in energy prices along with agricultural prices following reports that [Russia would exit the Black Sea shipment accords](#). The S&P GSCI Commodities Index returned 6.7% for the month while Dow Jones REIT Index rose 3.5%, lagging the broader equity market advance as higher interest rates continue to weigh on real estate valuations. The S&P GSCI Precious Metals Index dropped 1.4% as global central banks continue to raise rates, albeit at an expected slower pace.

Figure 30 – Commodities Rose in October Helped by Higher Energy and Agricultural While Real Estate Lagged Broader Market Advance Due Higher Interest Rates





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