

EQIS

EQIS Quarterly Commentary

Q3 2022



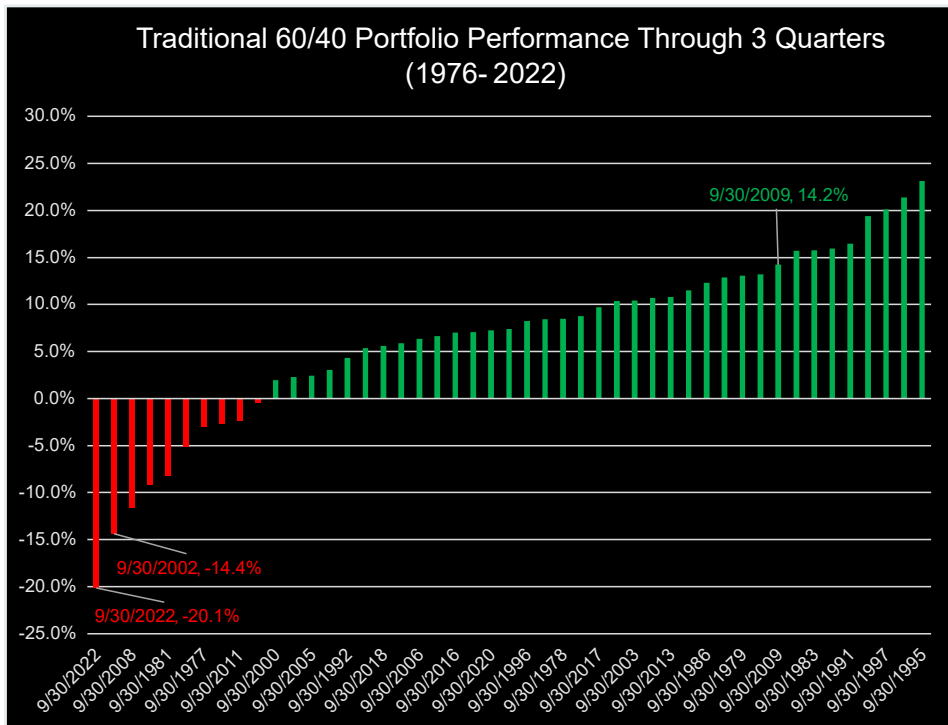
Central Bank Tightening and Recession Fears

The third quarter saw a bear-market rally over the summer months as investors hoped there would be a near-term end to tightening monetary policy. However, the Federal Reserve remained committed to increasing interest rates to fight the highest inflation in decades and acknowledged that financial tremors and increasing recession risks would not prematurely halt the path of rate hikes. As a result, the summer rally fizzled in the quarter’s final month as major equity and bond indices experienced some of their deepest single-day retreats since 2020.



Source: Bloomberg

This year has been particularly painful for investors as traditional 60/40 portfolios have experienced some of their worst losses in history. The bond and equity markets falling in tandem have increased the correlation between the asset classes that typically helps offset risk and provide a balanced return. A 60/40 portfolio has lost 20.1% through the first three quarters of 2022, its worst performance in the last 46 years.



Source: Morningstar Direct

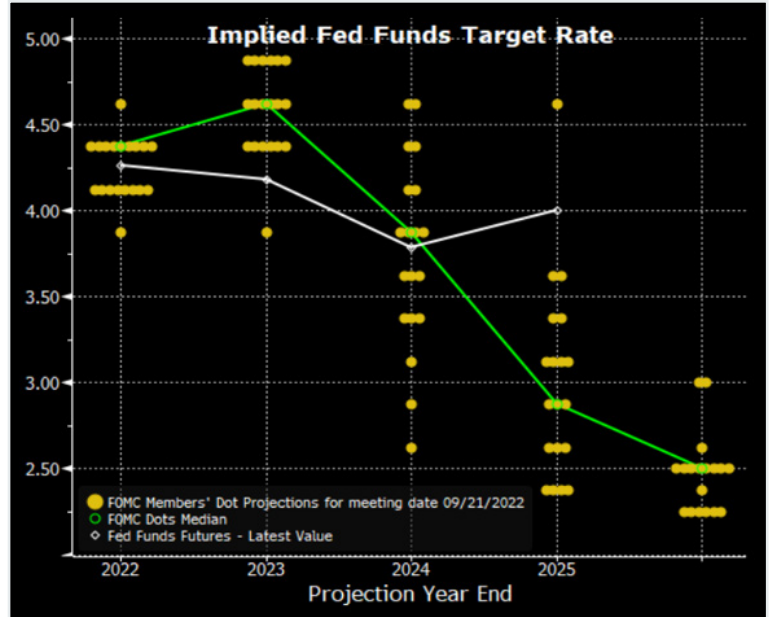
From 1976 through 2022, there have been only nine other occasions where a 60/40 portfolio had negative returns through the third quarter. Moreover, in seven of the nine instances, the blended portfolio moved higher in the subsequent fourth quarter of the year. However, the two occasions where the portfolio further deteriorated were marked by high inflation and recessionary environments. Unfortunately, those conditions are currently what global markets and central banks are contending with.

60/40 Negative Performance	3Q	YE	Year End Result
9/30/2022	-20.1%	-	-
9/30/2002	-14.4%	-9.2%	Improved
9/30/2008	-11.6%	-20.1%	Deteriorated
9/30/2001	-9.2%	-3.8%	Improved
9/30/1981	-8.2%	-0.5%	Improved
9/30/1990	-5.1%	1.7%	Improved
9/30/1977	-3.0%	-3.1%	Deteriorated
9/30/2015	-2.7%	1.1%	Improved
9/30/2011	-2.4%	4.4%	Improved
9/30/1994	-0.5%	-0.4%	Improved

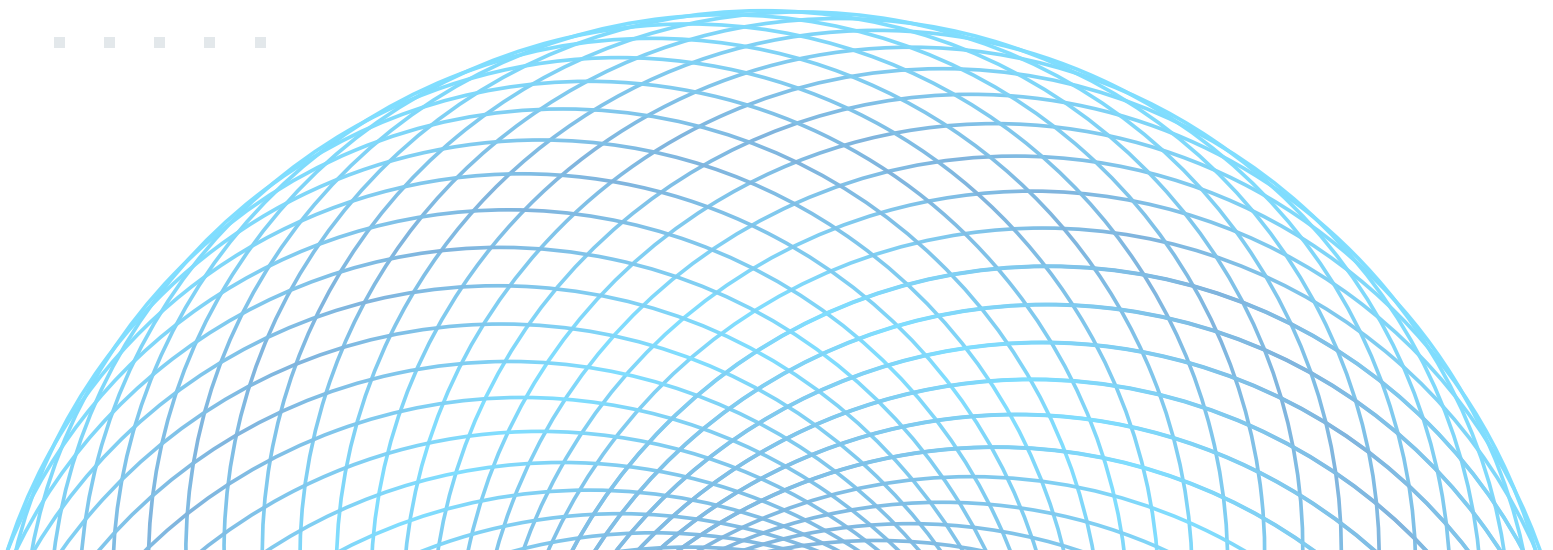
Source: Morningstar Direct

Domestic Fixed Income Markets

The Federal Reserve raised the benchmark interest rate by 75 basis points (bp) for the third consecutive time in September, bringing the federal funds rate to a range of 3.0% to 3.25%. The Federal Open Market Committee (FOMC) remained steadfast in fighting inflation and expects to continue hiking rates through 2022 and into 2023. The terminal level for the federal funds rate is estimated at 4.6% for the end of 2023, suggesting that there will be further increases in the next year with no decreases. The pace of this rate hiking cycle is the most aggressive since 1990. The FOMC members estimate that unemployment will rise to 4.4% next year from a current level of 3.7% and that GDP growth will slow to 0.2% by the end of 2022. The downward revision of GDP growth is a sharp cut from the 1.7% estimate in June.



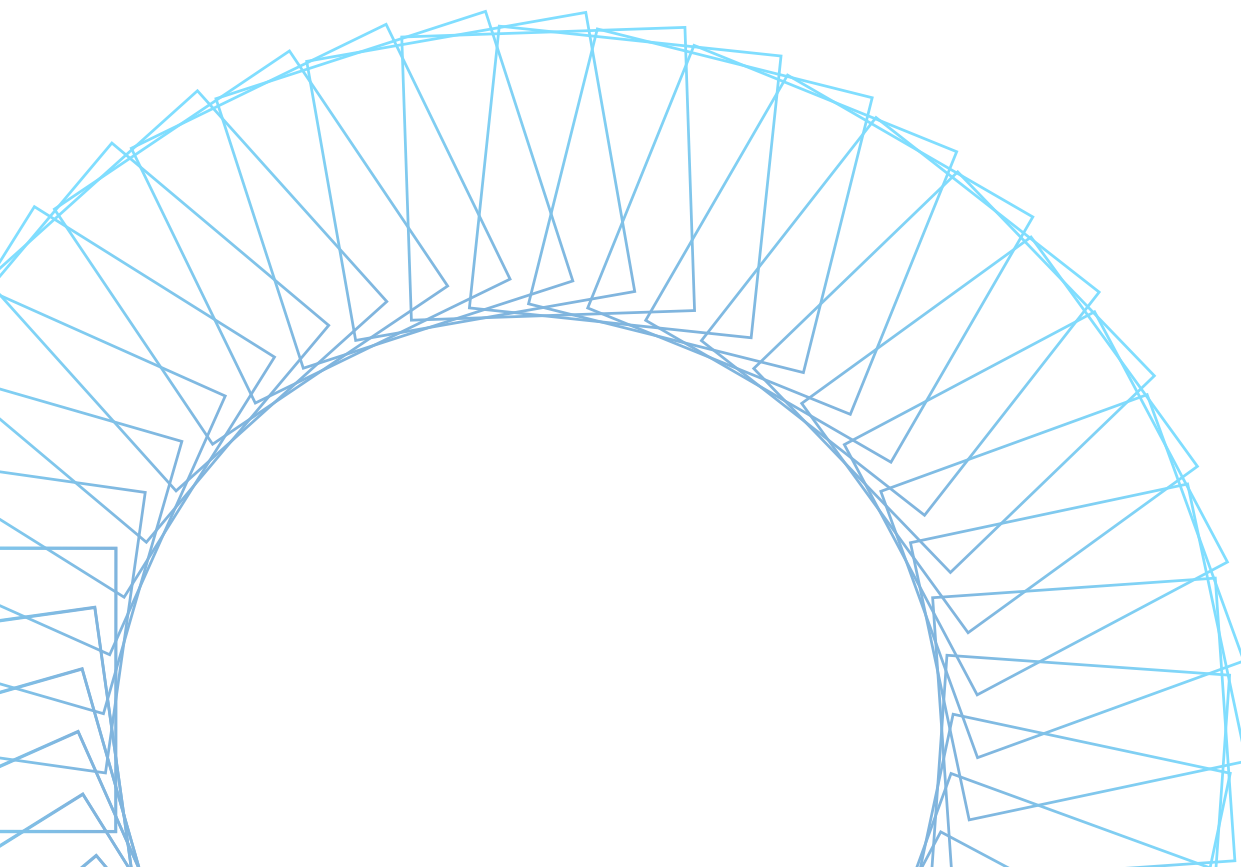
Source: Bloomberg



The Fed’s campaign of tighter monetary policy continued to take a toll on the performance of fixed income in the third quarter. Longer-dated government bonds underperformed as 30-year Treasuries ended down 10.82% for the quarter and 30.59% for the year. However, there has been incremental improvement in the short-end of the Treasury curve as 1-, 3-, and 6-month returns have clawed back early negative returns. Meanwhile, corporate bonds have proven to be one of the market’s worst performers as investors fled high-yield and investment-grade bonds in favor of safer Treasuries. Yields on junk bonds have climbed to 9.4% from 4.4% in the US, while European companies have seen yields rise to 7.8% from 2.8% since the start of 2022.

Rates	QTD%	YTD%
USTREAS T-Bill Cnst Mat Rate 1 Mon	0.49	0.61
USTREAS T-Bill Cnst Mat Rate 3 Mon	0.33	0.31
USTREAS T-Bill Cnst Mat Rate 2 Yr	-1.61	-4.72
USTREAS T-Bill Cnst Mat Rate 10 Yr	-6.27	-16.81
USTREAS T-Bill Cnst Mat Rate 30 Yr	-10.82	-30.59
Benchmark 1: Bloomberg US Treasury Bills TR USD	0.40	0.42

Fixed Income	QTD%	YTD%
ICE BofA US Corporate TR USD	-5.11	-18.33
Bloomberg US Corporate High Yield TR USD	-0.65	-14.74
Benchmark 1: Bloomberg US Agg Bond TR USD	-4.75	-14.61

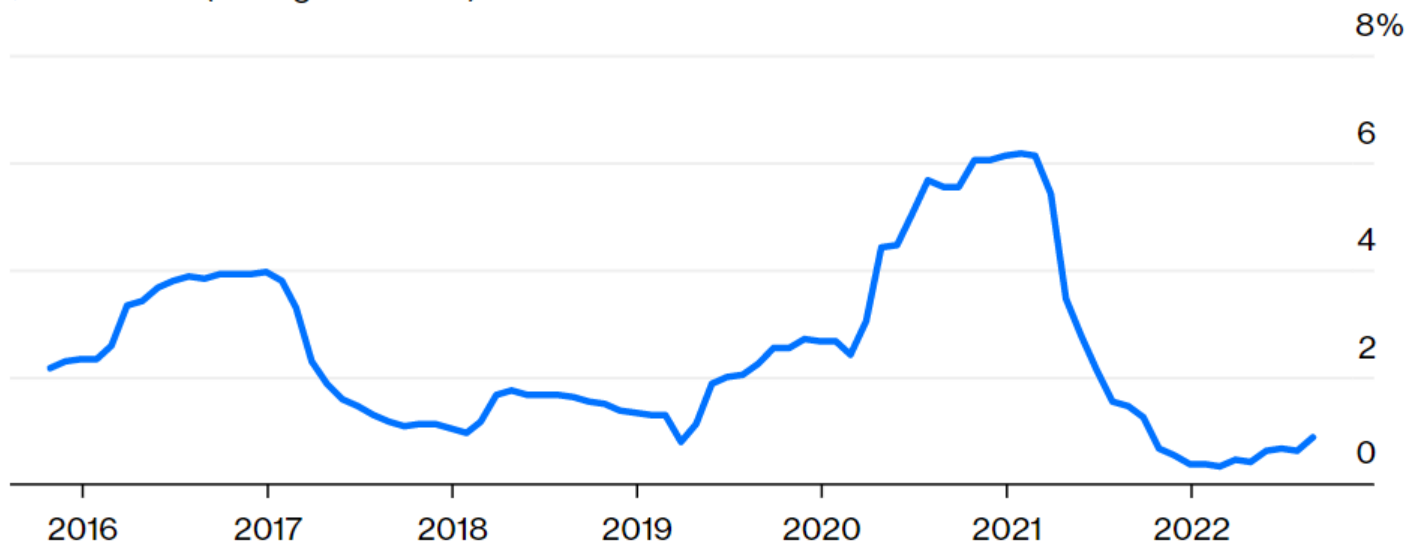


Despite the selloff in corporate debt, it is essential to note that publicly listed companies in the US still maintain relatively strong balance sheets. Currently, they have an aggregate interest-coverage ratio of 6.7x, much stronger than the level in 2000 of 3.6x. In addition, Bloomberg's measure of bankruptcy activity hit its lowest level on record earlier in 2022 and has only incrementally increased throughout the year. While there are significant economic headwinds for US corporations, Moody's Investors Service analysts forecast that default rates for high-yield bonds will continue to increase but remain below the 39-year historical average through at least August of 2023. However, leveraged loans typically provided to riskier businesses may face issues from floating rates in a rising rate environment.

Trickle of Defaults

The percentage of bonds defaulting in a high-yield index remains low

Default % (trailing 12 months)



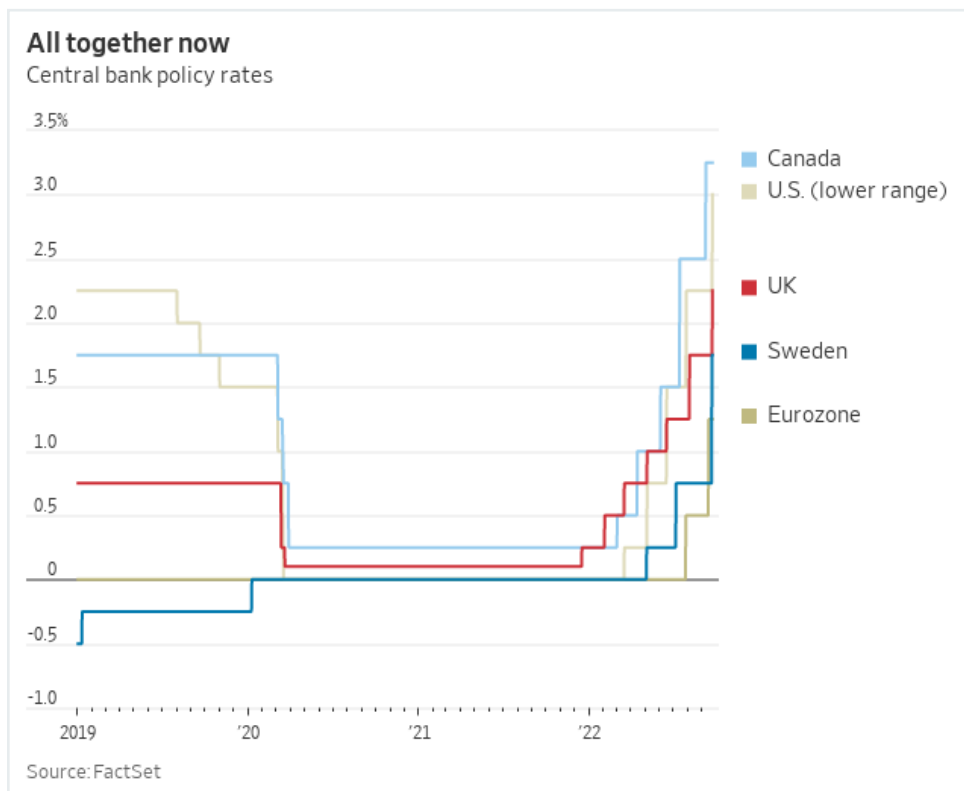
Source: Bloomberg Intelligence

Note: Based on Bloomberg US Corporate High Yield Bond Index

Source: <https://www.bloomberg.com/opinion/articles/2022-09-30/corporate-bond-doomsayers-are-a-little-premature>

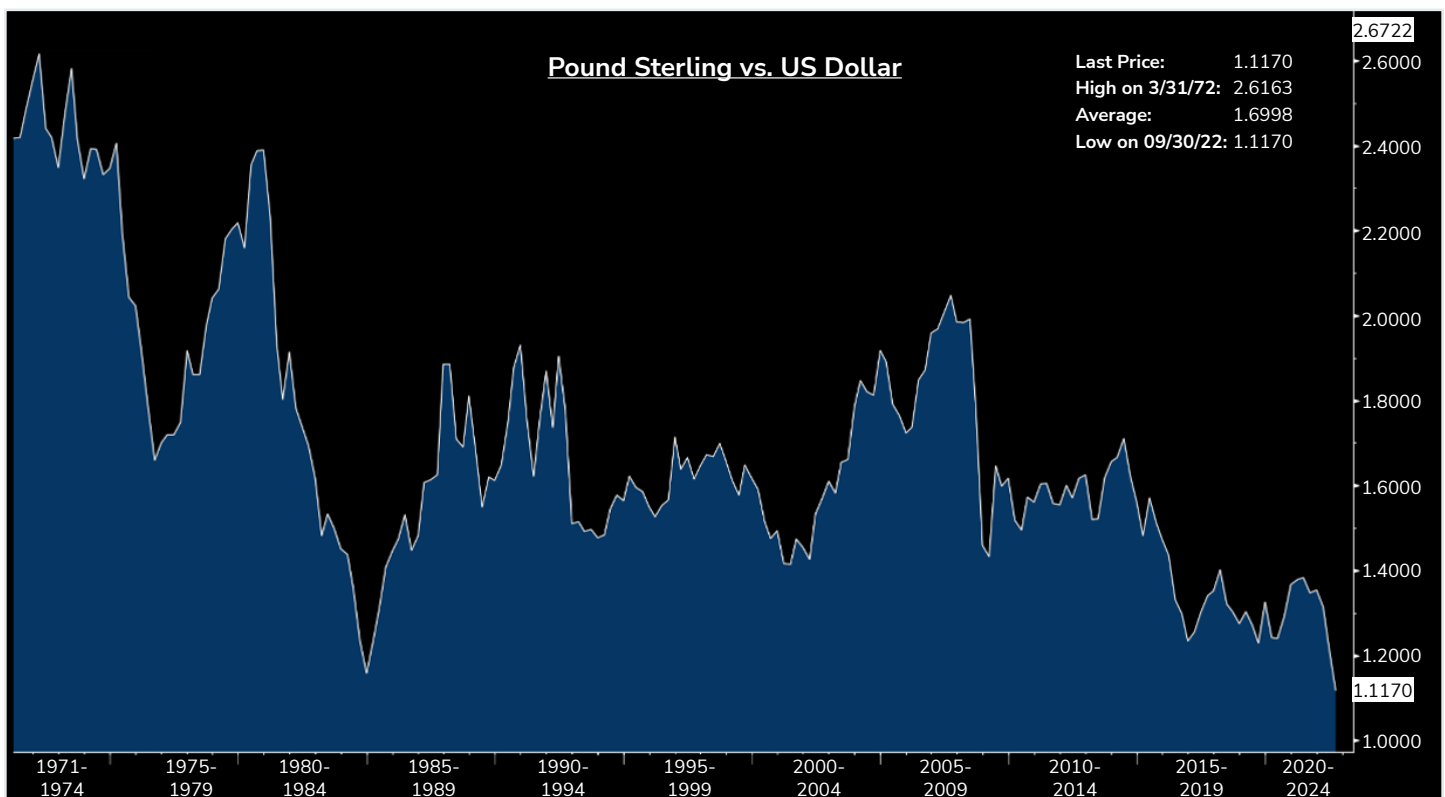
International Fixed Income Markets

September saw many global central banks hike rates in tandem with the Fed pushing up global investors' expectations for recession and lowering expectations for corporate earnings. In Europe, inflation readings for the common currency area reached double digits as concerns remain over potential energy cuts in the winter. The 10% inflation reading is the highest since records began in 1997, and for individual countries like Germany marks the highest inflation since 1951. As a result, the European Central Bank (ECB) will likely hike rates again at the meeting in October as consumer price pressures continue. German 10-year Bund yields rose above 2.2% in September and ended the third quarter at 2.01% after starting the year in negative territory. Meanwhile, Italian 10-year government bond yields rose to a fresh high of 4.5%, a level not seen since the European debt crisis.



Source: <https://economics.cmail19.com/t/ViewEmail/d/6FCBFAE922A71F592540EF23F30FEDED/BE1A3E3255C21673A4A88C2FAEAC43DE?alternativeLink=False>

The United Kingdom recently saw particularly dramatic moves in its government bond market. New Prime Minister Liz Truss announced the country's most significant tax cuts since the early-1970s. The package included subsidies for households and businesses to offset increasing energy prices and spur economic growth. The plan also called for tax cuts for the highest income earners and highlighted that it would require billions in additional bond issuance. The prime minister's plan for fiscal stimulus put the government at odds with the central bank, as the Bank of England (BOE) has been working to fight inflation with higher interest rates. The International Monetary Fund (IMF) published a rare rebuke of the UK's spending plans.



Source: Bloomberg

Investors quickly dumped UK government bonds (Gilts) and pound holdings after the unfunded spending and tax cuts were announced. As a result, the pound experienced one of its worst one-day selloffs and dropped to a 37-year low of \$1.0689 against the dollar. Yields on government bonds shot up to such an extent that the BOE was forced to intervene. The BOE announced it would buy long-dated Gilts on whatever scale was necessary to prevent financial contagion. The central bank was forced to abandon its policy of quantitative tightening in the short term and postponed sales of government bonds to stabilize the market. Bond prices on the longer-dated Gilts recovered in response to the intervention, and the BOE remained committed to purchasing securities through at least mid-October. By the end of September, the prime minister walked back part of her plan, including the unpopular tax cuts for high earners.

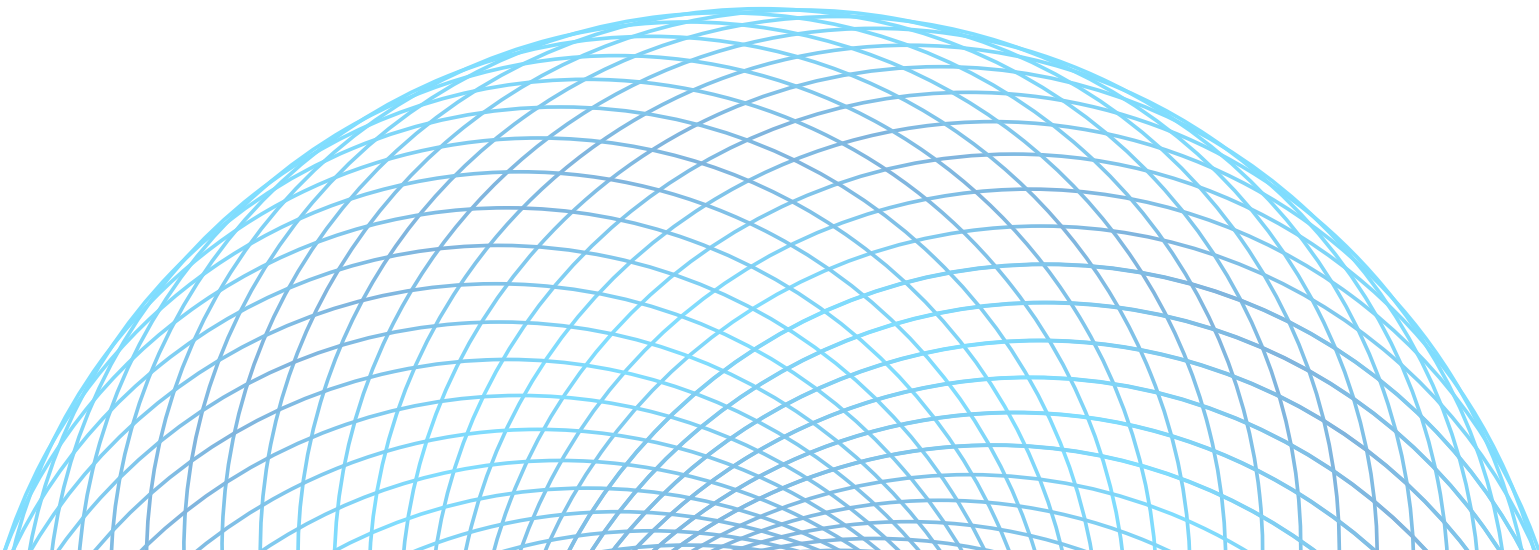
US Equity Markets

The S&P 500 continued to test its June market low of 3666.77 and ultimately broke through that level to finish September at 3585.62. The S&P 500 ended the quarter down 4.88% and -23.87% on the year. The peak-to-trough drawdown for the S&P 500 represents a 25.25% decrease from its January 3rd high of 4796. September's meeting of the FOMC highlighted that there is likely to be further pain ahead for equity investors as Fed officials signaled there is currently no end in sight for policy rate hikes. Any potential shift in investor sentiment toward policy loosening will likely again be met with continued central bank tightening.

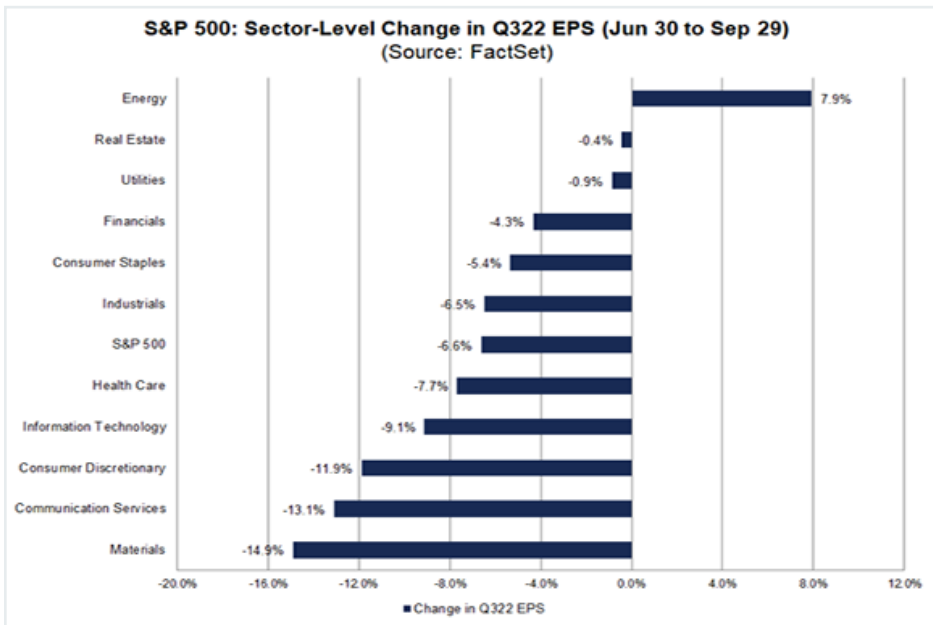
9 of the 11 sectors finished the quarter in negative territory, with Consumer Discretionary and Energy posting gains of 4.36% and 2.35%, respectively. In addition, in the size and style category, growth continues to underperform across the market cap segment on a year-to-date basis.

US Equity Size	QTD%	YTD%
Russell 1000 Growth TR USD	-3.60	-30.66
Russell 1000 TR USD	-4.61	-24.59
Russell 1000 Value TR USD	-5.62	-17.75
Russell Mid Cap Growth TR USD	-0.65	-31.45
Russell Mid Cap TR USD	-3.44	-24.27
Russell Mid Cap Value TR USD	-4.93	-20.36
Russell 2000 Growth TR USD	0.24	-29.28
Russell 2000 TR USD	-2.19	-25.10
Russell 2000 Value TR USD	-4.61	-21.12
Benchmark 1: Russell 3000 TR USD	-4.46	-24.62

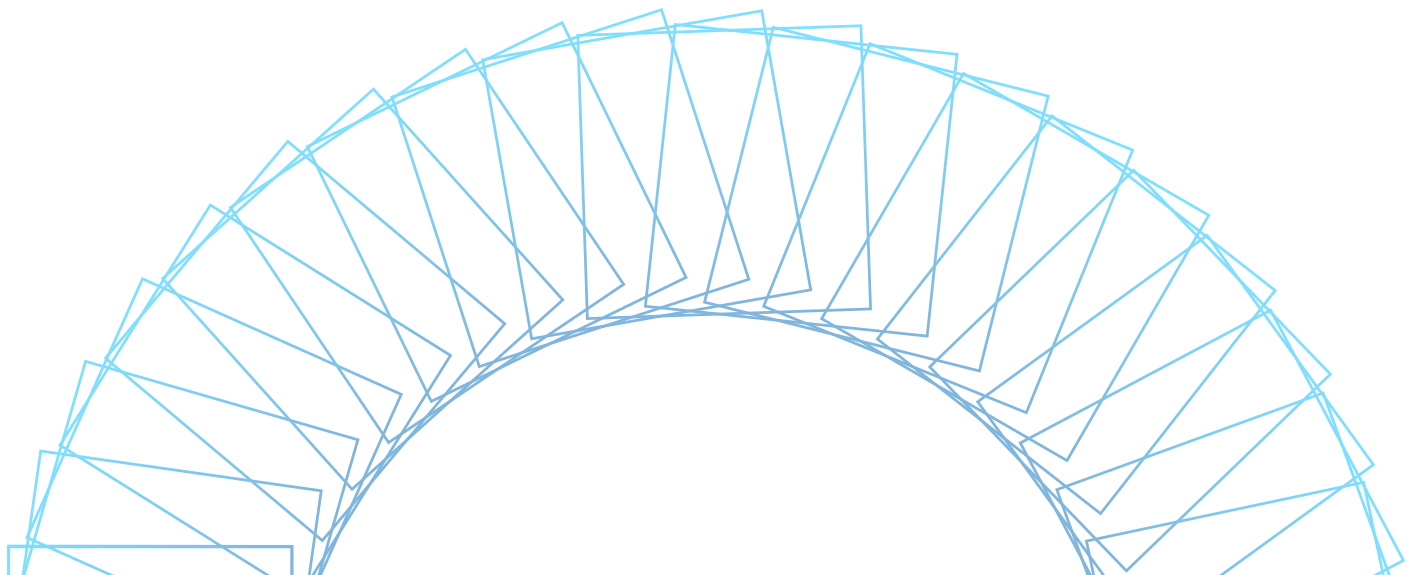
Source: Morningstar Direct



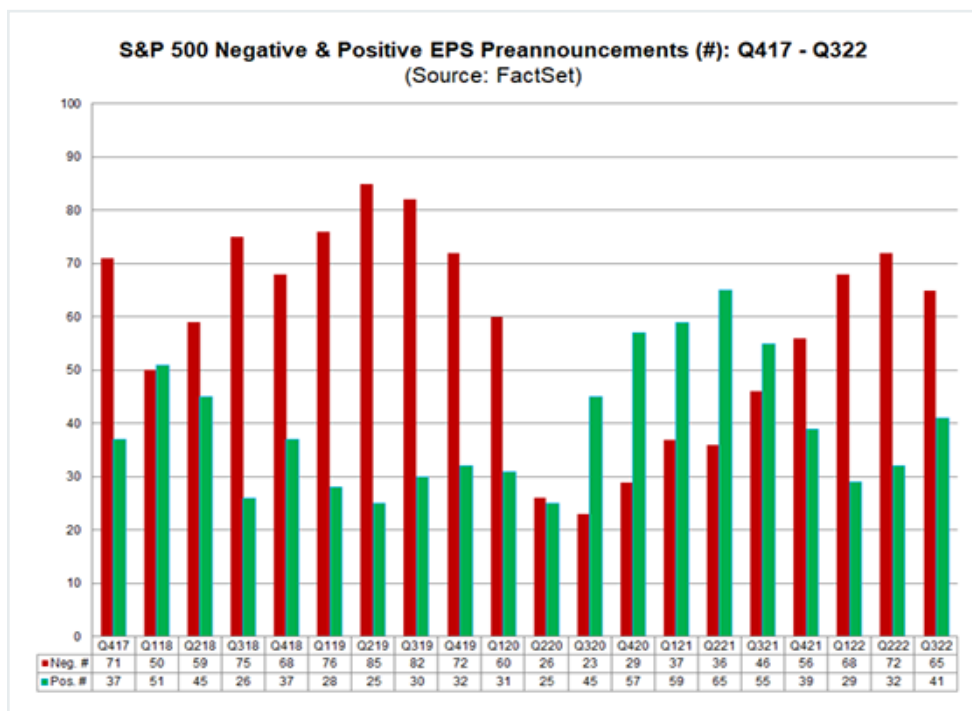
Analysts lowered earnings per share estimates (EPS) for the S&P 500 in the third quarter by 6.6%, from \$59.44 to \$55.51. The estimate is an aggregation of the median EPS estimates for the third quarter for all companies in the S&P 500 index. The decline in bottom-up EPS estimates was greater than the 5-, 10-, 15-, and 20-year averages. The decrease in bottom-up EPS estimates was also the most significant since the second quarter of 2020. In addition, 10 of the 11 sectors experienced declines in the bottom-up EPS estimates, with the Energy sector being the only industry to record an increase at 7.9%.



Source: <https://insight.factset.com/largest-cuts-to-eps-estimates-for-sp-500-companies-for-q3-2022-in-more-than-two-years>

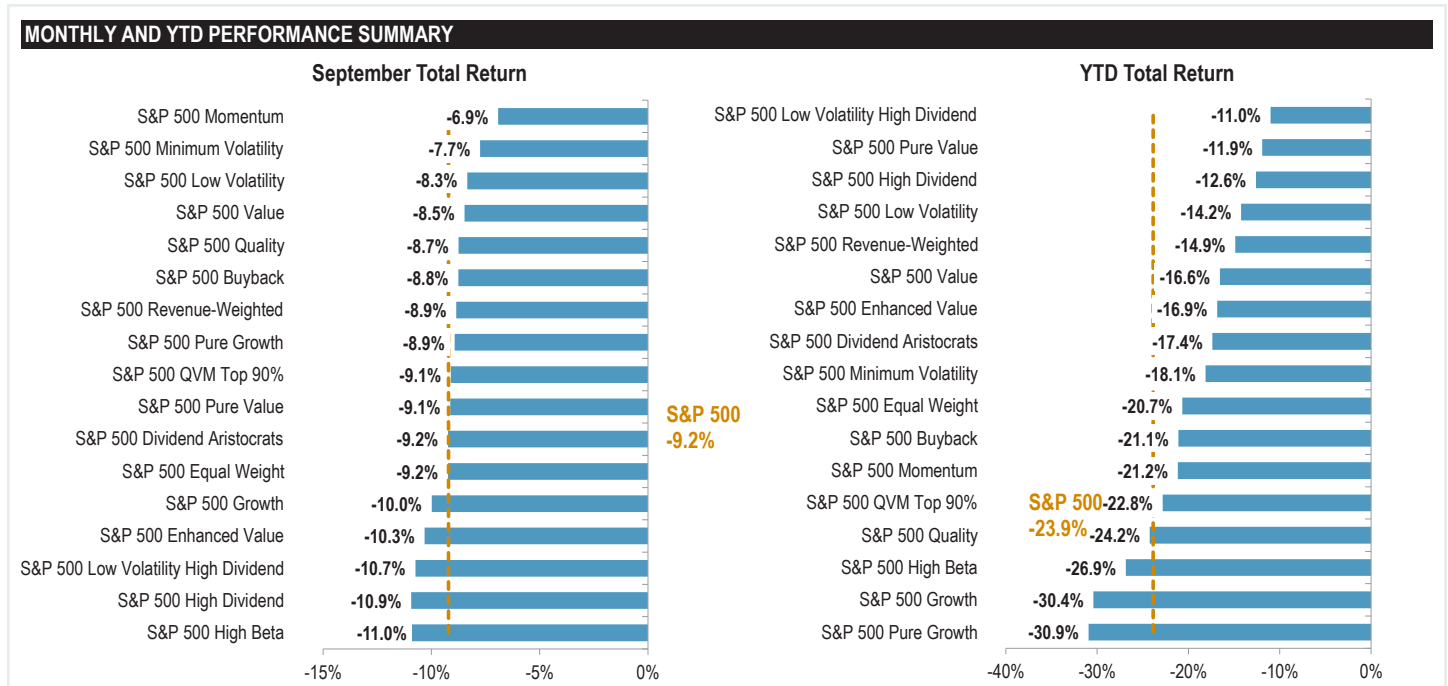


While analysts have revised many of the companies' EPS estimates downwards, the company guidance has been more positive than average. So far, 106 companies in the S&P 500 have issued guidance for the third quarter. Sixty-five companies issued negative guidance, while 41 issued positive guidance. The 41 companies that have issued upbeat guidance for the third quarter are above the 5- and 10-year averages and the Q1 and Q2 2022 guidance. On average, the companies that have reported positive or negative guidance have been rewarded and punished more than their 5-year average.



Source: <https://insight.factset.com/more-sp-500-companies-issuing-positive-eps-guidance-for-q3-compared-to-past-two-quarters>

Factor returns continue to reflect a risk-off environment as Low Volatility, High Dividend, Pure Value, and High Dividend outperformed their risk-on peers in Pure Growth, Growth and High Beta. The expectations for persistent and sticky inflation, higher interest rates and potential recessions continue to favor the Low Volatility, High Dividend and Pure Value factors.



Source: <https://on.spdji.com/rs/838-LDP-483/images/dashboard-sp-500-factor-2022-09.pdf>

International Equity Markets

International equity markets have similarly experienced drawdowns as inflation and central bank tightening has left few regions unaffected. The broad-based MSCI ACWI ex-US index fell 9.91% for the quarter, bringing its year-to-date return to -26.5%. Europe has experienced acute pain as its energy dependence on Russia has hurt several regional industries. Eurostat estimated that prices for household energy rose 40.8% from the prior year. Moreover, price increases from energy have spilled over into other sectors of the economy as core inflation rose to 4.8%, and recent estimates from the Organization for Economic Cooperation and Development (OECD) expect the average inflation rate for 2022 to be 8.1%. The complex macroeconomic environment has resulted in developed European markets experiencing some of the worst drawdowns in recent history. For example, Sweden, Austria, The Netherlands, and Germany all posted double-digit losses in the third quarter, bringing their total year-to-date returns to -43.7%, -40.5%, -39.7%, -39.1%, and -38.6%, respectively. The lone positive contribution to global markets was the Latin American Emerging Markets, where Brazil and Chile posted quarterly returns of 8.18% and 3.35%, respectively.

Intl Equity	QTD%	YTD%
MSCI China NR USD	-22.50	-31.23
MSCI AC Asia NR USD	-11.73	-27.34
MSCI EM Asia NR USD	-14.03	-28.82
MSCI FM Asia NR USD	-9.49	-34.28
MSCI ACWI NR USD	-6.82	-25.63
MSCI World ex USA NR USD	-9.20	-26.23
MSCI ACWI Ex USA PR USD	-10.63	-28.25
MSCI EAFE PR USD	-10.01	-28.88
MSCI Europe NR USD	-10.15	-28.83
MSCI EM NR USD	-11.57	-27.16
MSCI EM Latin America NR USD	3.61	3.02
Nikkei 225 Average TR JPY	-0.83	-8.07
Nikkei 225 Average NR JPY	-1.01	-8.45
Benchmark 1: MSCI ACWI Ex USA NR USD	-9.91	-26.50

Source: Morningstar Direct

The Chinese market continues to wrestle with its own unique challenges. China recorded GDP growth of 0.4% in the second quarter, its lowest economic output level since the start of the pandemic. Notably, the vital real-estate sector experienced a 7% contraction. The downturn in the housing market was caused by regulators placing curbs on developers' borrowing as they sought to avoid a real estate bubble that was pricing much of the population out of housing. Thirty property developers have defaulted on their international debt as sales plunged and credit dried up. Lack of progress on the construction of pre-sold homes has seen owners threatening to boycott mortgage payments. With lower sales and demand, the funding to finish pre-sold apartments was amplified by lower available credit and has led to a shutdown in many projects. Central-government policymakers have refrained from stepping in to bail out the real-estate sector so far, citing that "Houses are for living in, not for speculation."¹ Instead, the government has asked local governments to work with home buyers and developers to ensure unfinished projects are completed.



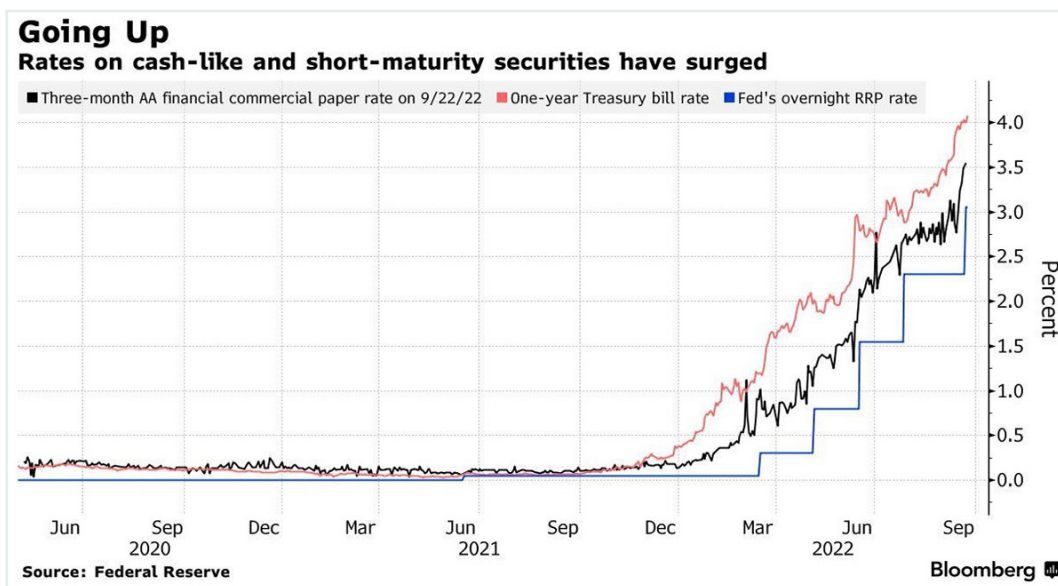
Source: https://www.wsj.com/articles/chinas-property-market-has-slid-into-severe-depression-real-estate-giant-says-11661863259?mod=article_inline

Spillover effects have appeared in the country's private banks and state-owned asset managers specializing in troubled and distressed debt. For example, China Merchant Bank and Ping An Bank, two of the largest and most well-known private lenders, have seen their share prices tumble 32% and 25%, respectively. Further declines in real-estate assets will harm the banks' mortgage business and wealth management products that have exposure to the developers' debt. While liquidity in the broader market is not a concern, the lack of investor confidence and willingness to borrow will slow growth and investment. The government's continued reliance on draconian measures to contain COVID-19 has also weighed on economic activity. As a result, the World Bank cut its GDP forecast for 2022 to 2.8% from a June forecast of 4.8%.

1. https://www.wsj.com/articles/bursting-chinese-housing-bubble-compounds-beijings-economic-woes-11660235003?mod=article_inline

Investment Strategy and Outlook

Money-market mutual funds have been significant beneficiaries of the current investment environment. \$4.6 trillion was stashed in money-market funds, with an additional \$150 billion in ultra-short bond funds. Cash inflows continue to pile up as yields have risen from near-zero levels to paying upwards of 2%. Specific segments, particularly the Three-month AA commercial paper rate and One-year Treasury bill rate, are now yielding between 3% and 4%. The rise in rates has kept traders from deploying capital into more risky areas of the markets, even as equities trade at attractive prices. Investors have realized that the Fed is maintaining a hawkish policy stance and is unlikely to change that anytime soon. While global bonds and equities are experiencing bear markets and the Fed looks more likely to slow US growth to stem inflation, the yields are increasingly attractive.



Source: <https://www.bloomberg.com/news/articles/2022-09-26/traders-who-just-want-to-survive-sit-on-5-trillion-cash-pile#xj4y7vzkg>

Our outlook for the remainder of the year continues to be neutral on equities, given the monetary policy headwinds from tight labor markets and sticky service industry inflation. The current economic environment and Fed stance do not point to a loosening of monetary policy to act as a tailwind and is expected to continue into the new year. Equities have the potential to set new lows as EPS guidance comes in lower for 2022 and should result in more defensive positions, but also offer the best opportunity to rebound. Equities often trade higher in anticipation of recoveries rather than the realization of an economic recovery. Although we continue to be cautious on long-dated fixed income, the neutral equity outlook will position portfolios to take advantage of any potential upswing while many investors continue to wait for data confirmation.

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Except as otherwise specifically stated, all information and portfolio manager commentary are as of September 30, 2022.