3rd Quarter 2022 Market Commentary

Economic Concerns Create Drag as Markets Go One Step Forward, Two Steps Back

Various studies support the notion the market goes up more often than it goes down. One study, by Crestmont Research, shows the S&P 500 has gone up about 54% of the days in the 70 years ending in 2021. Likewise, long-term growth of the S&P 500 clearly demonstrates the absolute growth over time. However, the path of stocks can vary greatly from one cycle to the next. As disciplined, long-term, professional investors, we hope for stocks to take at least two steps forward for each inevitable step back over time. As we celebrate the 20th anniversary of our strategies next month, we stand as a testament to the success that can be achieved through long-term, disciplined, strategic investing.

However, in the 3rd quarter stocks took two steps back, as they did each of the previous two quarters. To add drama, this quarter we saw the market take a big step forward for the first half of the quarter, only to take two steps back to finish the quarter. In the two steps back, the S&P 500 posted its worst September since 2002 to finish with total a loss YTD of -23.9%.

As we discuss in the *TOPS Portfolio Strategies* section below, we remain pleased to report the bond allocations of the TOPS portfolios have performed admirably in 2022 relative to the Bloomberg US Aggregate Bond Index. Likewise, the equity allocations of TOPS have performed appropriately, balancing risk to avoid experiencing the full pullback returns of the trailing S&P 500 Growth Index.

We expect the growth trend of stocks to return at some point, providing instead two steps forward and one step back. As stocks tend to be leading indicators, they will likely return to growth before the economic front has solidified, rewarding investors for weathering the heightened volatility of this bear market cycle.

After discussing Q2 2022 financial market results, we will address three general themes important to TOPS portfolio returns and strategies:

1) The Fed, Interest Rates and Inflation
2) U.S. Dollar Soars to New Heights
3) Will We Have a Recession in next 12-24 months?

Year-To-Date Markets Review

Equity indexes continued their negative returns into the third quarter. Growth stocks (S&P 500 Growth) outperformed value stocks (S&P 500 Value), returning -3.9% and -5.8%, respectively. Midcap (S&P 400, -

2.5%) outperformed both large cap equities (S&P 500, -4.9%) and small cap equities (S&P 600, -5.2%). Developed international (MSCI EAFE) returned -9.6%, outpacing emerging markets (MSCI Emerging Markets), which returned -11.6%. Real estate (MSCI World Real Estate) and natural resources (S&P GSSI NA Natural Resourced) were both negative, down -11.7% and -2.2% respectively, in the third quarter.

With another rocky quarter, most equity indexes are showing double-digit negative returns year-to-date. The exception remains natural resources. The S&P GSSI Natural Resources Index has returned +13.4% so far this year. Value stocks (S&P 500 Value) returned -16.6% and are outperforming growth stocks (S&P 500 Growth), which have returned -31.0%. Midcap (S&P 400, -21.5%) is outperforming small cap (S&P 600, -23.2%) and large cap (S&P 500, -23.9%). Developed international (MSCI EAFE) has returned -27.1% so far this year and is slightly outpacing emerging markets (MSCI Emerging Markets) which has returned -27.2%. Real estate (MSCI World Real Estate) is down -29.1% year-to-date.

Much like the first half of the year, rising rates led to broadly negative fixed income returns for the third quarter. The 10-year US Treasury yield increased from 2.98% to 3.83%, driving the Bloomberg US Aggregate Bond Index to a -4.8% return for the quarter.

The fixed income trends of the first half of the year continued into the third quarter (Q3) with credit (ICE BofA US Corporate Index, -5.1% Q3, -18.3% YTD) underperforming government (ICE BofA US Treasury Index, -4.7% Q3, -13.5% YTD), and shorter duration holdings outperforming longer duration holdings. This was seen in both credit markets, with the Bloomberg US Corporate 1-3 year (-1.2% Q3; -4.7% YTD), and government markets, Bloomberg US Treasury 1-3 Year (-1.5% Q3; −4.5% YTD), where the shorter duration indexes outperformed the previously mentioned full duration indexes. High yield (Solactive USD High Yield Corporates, -0.9% Q3; -14.6% YTD), international bond indexes (Bloomberg Global Aggregate ex-USD, -3.1% Q3; -12.8% YTD), and investment grade corporates (iBoxx USD Liquid Investment Grade Index, -5.9% Q3; -21.2% YTD) were also negative for the quarter, adding to the losses for the year.

The Fed, Interest Rates and Inflation

Dr. Ed Yardeni, a leading U.S. economist who provides us with research and advice, recently commented, “America’s despondency stems much from the Fed’s words and deeds as it attempts to corral inflation at all costs.” There is no question investors have turned pessimistic. We see this in measures of U.S. consumer, investor, and business sentiment, along with weak stock market returns.

As we have discussed in previous messages, the Federal Reserve is carrying out a monetary policy of aggressive tightening to combat historically high levels of inflation in the U.S. This is in stark contrast to an environment of easy money since the Financial Crisis, which saw rates stay historically low and the Fed Balance sheet balloon from $4.1 Trillion (just before COVID) to $8.8 Trillion. The Federal Reserve’s preferred measure of inflation is the Personal Consumption Expenditures (PCE) price index. The PCE rose 0.3% in August, after dropping in July, for an annual increase of 6.2%. The Fed is aiming to slow consumer spending to reduce inflation, and it is not an easy task.

Monetary policy has been described like turning on a faucet which has been off for a while. At first, the water is cold; then you turn it warmer, yet end up overcompensating and burning your skin. There is a delay in monetary policy changes, and the delay is typically much longer than our water faucet example. The main tool of the Fed is raising the Fed Funds Rate (the faucet in our example), and markets are trying to figure out the point at which the rate rises stop, called the "terminal rate."

During the aforementioned big step forward markets took the first half of this quarter, a belief solidified among investors the terminal rate would be reached after a 50 bps. rise in the Fed Funds Rate in September. However, an 8-minute speech given by Fed Chairman Jerome Powell at the conclusion of the Fed's annual Jackson Hole, WY meeting August 25-27 put the brakes on stocks and reset expectations for the terminal rate. Chair Powell's comments (after a 0.75% rise), as discussed in our September message, outlined the Fed's resolve to break inflation and set expectations rates were going higher for longer to make that happen. As a result, the market took two big steps back to end the 3rd quarter. We called his comments a "pivot."

We feel the Fed will continue their path until they believe inflation is effectively reversed, or they break something. If they break something, they may be forced to take a pause. Examples include breaks in credit markets (like they did to the overnight repo market a few years ago) or untenably high levels of unemployment. The goal is arriving at the conceptual "neutral rate," the rate at which monetary policy is neither accommodative nor restrictive, with inflation under control and maximum employment achieved.

Mary Daly, President of the Federal Reserve Bank of San Francisco recently outlined the FOMC will lift rates into "restrictive territory," and stay there until inflation gets firmly back to 2%. While rate rises are powerful, there is typically a long delay until their impact on the economy and rate rises cannot control supply side inflation, they can only impact the demand side. In other words, they are meant to influence the spending of consumers and businesses, but lose impact if spending is driven by lack of supply. For example, State Street Global Advisors recently estimated there may be a 3-million-unit shortage of housing, per demand, in U.S. Likewise, consumers are unlikely to reduce demand until they see weaknesses in the employment market. We are starting to see some early signs of potential weakening in employment, but the employment market is coming down from red hot levels with job openings remaining strong.

How does this affect stocks and bonds? Rising interest rates have a direct impact on bond values. As interest rates rise, bond values decrease. This relationship has led to the weak returns in bond markets overall. The TOPS allocations have performed relatively well during this year's rate rise, as the portfolio management team positioned the portfolios to have less interest rate risk than the Bloomberg US Aggregate Bond Index coming into the rate rise cycle.

Stocks, as leading indicators, have fallen considering the expected softness in the economy. Over the last few years, stocks have been trading largely at above average valuations. This means investors were willing to pay a higher price for each dollar of earnings than normal. So far, markets are down mostly in line with multiple contraction. In other words, stocks have gone from being historically overvalued to being average (large cap US) to undervalued (small cap, international, emerging markets). At some point, we could see earnings drop, which would push up valuations if not met with a subsequent decrease in prices.

As we look forward for stocks, it is important to remember a few key things. First, efficient market hypothesis outlines stock prices should reflect all available public information. So, current stock prices reflect what we know and have already discounted all the bad information. Stock prices in the next 12-36 months will be driven by good news or bad news (in short periods, also the expectation of good or bad news). Second, markets typically are not driven purely by whether news is good or bad, they are primarily driven by whether it is better or worse than expected. Jumping ahead, the S&P 500 started the 4th quarter with the best two day stretch of returns in more than two years (WSJ). This was largely due to news that was not necessarily good, just better than expected on balance.

Lastly, one of the best indicators of long-term return expectations is valuations at the beginning of the investment period. As we sit currently, valuations for stocks (nearly across the board) look historically attractive. Some asset classes, such as small cap U.S. stocks, are selling at rock bottom valuations. These valuations reflect the expectation of very bad news. The opportunity exists for stocks to recover amidst even a relatively weak economic environment, it only takes news to be better than the low expectations and some relief in the high level of uncertainty regarding the Fed rate path. Mike Arone, Chief Strategist for SSGA recently stated, “Markets will start pricing in a recovery before we hit a bottom economically.” Regardless, valuations bode well for long-term investors, supporting continued investment. As we have noted in most commentaries this year, we expect the current market cycle to take patience though.

U.S. Dollar Soars to New Heights

Among major economies, the U.S. carried out the strongest fiscal response to the COVID crisis. This strong fiscal response helped the U.S. economy recover faster than the rest of the world. Likewise, our interest rates have been rising faster as well. This environment has led to a dramatically stronger U.S. Dollar (USD). From January 2021 to September 30, 2022, the U.S. Dollar Index rose 24.8%

The USD tends to be viewed as the safe-haven currency; in periods of high uncertainty, it is not uncommon to see investors flock to the USD. This natural relationship, along with the manufactured rate hikes by the Federal Reserve, have stacked the deck in favor of the USD in a nearly unprecedented way. If the USD is the safest and paying a relatively attractive yield, it’s not hard to figure out why money is flowing into USDs. Dollar strength has been further exasperated by financial struggles in Japan, and war in Europe.

The strong USD has numerous impacts. First, every percentage increase in the USD results in a dollar-for-dollar decrease in international returns. Therefore, -24.8% of the returns of international stocks for U.S. investors over the above-mentioned period were simply due to currency changes. Second, more than 80% of the world's transactions are done in the USD, so extreme USD strength may be impacting credit markets. Third, the stronger USD puts pressure on exports and increases U.S. imports, increasing our trade deficit, negatively impacting economic growth as well as corporate profits (as a strong dollar negatively impacts the foreign earnings of U.S. multinationals). This could lead to reduced earnings forecasts and lower P/E multiples (Swedroe).

We have written about the USD many times over the last two decades. In the first decade of the millennium, we saw a long cycle of USD weakness. That cycle has been followed by several strengthening cycles, or a big super-cycle, depending on how you look at it. Either way, we expect currencies to cycle in and out of favor over time. If the USD does begin to weaken in the next 12-24 months, it would have a direct positive impact on international returns. Lastly, if we see USD softening, it may be a sign Fed is getting towards the end of their tightening cycle.

Will We Have a Recession in the Next 12-24 months?

Recessions are defined as a broad-based contraction in economic activity. In the U.S., recessions are officially labeled by the National Bureau of Economic Research (NBER). As we discussed earlier this year, we have seen some recessionary indicators already in 2022. However, we have yet to experience an official recession, according to the NBER.

Will we have a recession? Will it be mild? Will it be a growth recession? Will it be a devastating recession? We feel whether we have a recession or not is outweighed by how long and deep the recession would be. Many believe a recession may be inevitable, but it is unclear whether it is imminent. Again, we expect this cycle to take patience.

If we do get a recession, we are likely to see job losses. Further, typical earnings decline in a recession is 30-40%. However, often times, a recession is over before it is even labeled a recession. Likewise, stocks typically fall in anticipation of a recession and rally before the recession is behind us.

It took former Fed President Paul Volcker three years and two recessions in the early 1980s to defeat inflation. Jerome Powell's story is playing out in front of us. The early chapters have not gone so well for Chair Powell, with famed investor and Wharton Professor Jeremy Siegel recently giving the Fed a "D" grade. At this point, all rhetoric from the Fed points towards an ending which results in lower inflation. However, the collateral damage to get there and the length of the novel remain very much up in the air. As we often state, the economy and the stock market are two distinctly different things. Regardless of recession, we feel our long-term strategies remain poised to provide appropriate long-term results for our investors.

TOPS Portfolio Strategies

We are pleased to announce the TOPS portfolio management program will be celebrating our 20th anniversary next month. As one of the longest running and largest ETF portfolio managers, we are not familiar with many who have more direct experience managing ETF portfolios than us. Over the last 20 years, we have experienced all types of market environments through numerous cycles. While our strategic portfolios continue to evolve over time, we have made very few changes to the core investment philosophy of TOPS.

We describe TOPS as “A Strategic Approach to Active Indexing.” Our portfolio management team strives each day to make money for our investors and give them what we feel is the best opportunity for success. We have a saying that goes, “Never mention return, without mentioning risk in the same sentence.” This is the easy way of saying that we strive to optimize risk adjusted return through a strategic approach to active investing.

Attributes such as tax efficiency, index investing, sophisticated trading and cost management help drive our ability to deliver appropriate results for investors over time. We thank each of our investors for your continued faith in us, with a special thank you to our investors who will be celebrating 20 years of success along with us. We feel our strategies have never been more appropriate than now and we look forward to continuing to serve those who have entrusted us.

There is no guarantee that any investment will achieve its objectives, generate positive returns, or avoid losses.

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