

# Economic & Market Update

THIRD QUARTER 2022 REVIEW | OCTOBER 2022 OUTLOOK



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Despite a mid-summer market rally fueled by a growing belief the Federal Reserve (Fed) may have been near the end of its tightening cycle, the bear market in equities resumed and new lows were made by the end of the quarter. Inflation likely peaked in the spring, but its expected decline has been disappointingly slow, which has kept the Fed laser-focused on tightening monetary policy to reduce demand. As the economy had already begun to slow heading into the year, increased use of this blunt force rate-increase instrument in addition to the simultaneous reduction in the balance sheet has likely tipped the economy into recession.

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## REVIEW OF THE QUARTER

Moving into the third quarter, equity markets were already rallying off the mid-June lows with the advances ultimately recapturing over half the bear market losses from January. The catalysts for the summer rebound were some distinct signs that inflation was peaking and a growing market perception that the Fed could be nearing the end of its tightening policies and might even begin to decrease the federal funds rate by early 2023. Steadily declining gasoline prices throughout the summer was an additional driver of improved market psychology as it would help boost overall consumer spending.

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However, the summer advance began to falter in mid-August as the Fed began to dispel the markets of any notion that it was about to pivot in their conduct of monetary policy. It appears that Chair Jerome Powell was distressed that his comments in the July post-Federal Open Market Committee press conference were construed as overly accommodative and not sufficiently focused on quickly bringing down the inflation rate. Various Fed governors, even the more dovish members of the committee, stressed in their speeches that inflation was still too high and that the Fed will continue to tighten policy until there is tangible evidence of consistent improvement. Thoughts of any near-term pivot were totally dashed at the end of August in Powell's unusually short speech at the annual Jackson Hole economic symposium when he discussed the lessons from the 1970s and the risk of easing monetary policy prematurely. He was also very explicit in his warning that the economy may have to absorb some economic pain in this battle against inflation.

The final nail in the coffin of the summer rally came in the disappointing August Consumer Price Index (CPI) report, which showed a concerning increase in core inflation. Stripping out the notable improvement in energy prices during the month, prices for shelter and medical services rose at an accelerated rate and there was not the anticipated magnitude of improvement in the various goods categories. Immediately after the report was issued, probabilities rose of a “higher for longer” tightening cycle. The Fed confirmed those probabilities by raising rates another 75 basis points (bps) to a now restrictive 3.25% at its September meeting and increasing its assessment of the terminal rate at which it could stop tightening to 4.60%.

After having held steady during the first two months of the quarter, interest rates rose across the yield curve during September, with the curve inverting further as short-term rates rose faster than intermediate- and long-term rates. An inverted yield curve is usually a strong recessionary signal, and the more aggressive Fed tightening into an already slowing economy has increased the risk of recession. Curiously, the interest rate spreads on high-yield (below investment grade) bonds remained rather stable through the quarter and are not yet flashing the historical recessionary signals. Perhaps this is due to the large weighting of energy issues in this space, which are benefiting from the year-to-date increase in commodity prices. Or it could merely be a more coincident indicator that has not yet fully reflected the heightened recessionary risks.

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Corporate earnings were another possible silver lining in this very cloudy 2022 market environment as both first and second quarter earnings failed to reflect recessionary deterioration. Businesses were able to effectively pass along cost increases to the ultimate consumer

and the energy sector showed explosive growth in earnings driven by the increase in oil and natural gas prices. Some signs of stress began to develop in the goods sectors as prominent retailers such as Walmart and Target saw margin deterioration as their shoppers purchased fewer high-margin goods from the stores because of the sharp increase in food prices. FedEx also warned during the September earnings preannouncement season that its profits would be notably below analyst estimates due to a slowdown in global economic growth that is turning to recession in many countries. There was broad anticipation at the beginning of the year for a transition from strong consumer spending on goods to services and this is occurring as the travel and leisure industries are generally producing strong profits, but these earnings could also be viewed as more of a lagging than leading market indicator.

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The ongoing Russia-Ukraine war has apparently turned into a stalemate as Russia absorbed some embarrassing military defeats and Ukraine made modest advances in recapturing previously seized territories in the country's eastern region. As much as the West is cheering the resilience of Ukraine and the exposure of a weak Russian military culture, there appears to be heightened geopolitical danger in backing Russia's president, Vladimir Putin, against a wall. Beyond some of the thinly veiled existential threats coming from Russian officials as they officially annexed four regions of Ukraine at the end of the quarter, their threats of cutting energy supplies to Europe and their apparent sabotage of portions of the Nord Stream pipeline are a reminder of how difficult this war will continue to be for the entire European continent.

Developed international equity markets continued to outperform U.S. equities in their local currencies only to have that relative performance wiped out by currency depreciation against the U.S. dollar. In addition to the safe haven aspect of the U.S. dollar in times of heightened geopolitical turmoil, the Fed has been much more aggressive in implementing monetary tightening compared to other central banks, which has given the U.S. dollar a pronounced interest rate advantage in attracting foreign capital.

Whenever financial conditions tighten notably within the global financial system, there is a risk of severe market dislocation developing in certain markets. The concept of the central banks tightening “until something breaks” rose at the end of the third quarter with the British pound sterling and U.K. gilt markets showing pronounced weakness despite the Bank of England (BOE) coming closest to the Fed among global central banks in implementing rate increases. The pressure began to intensify in the U.K. markets when the new government recently formed under Prime Minister Liz Truss announced a series of tax cuts with no commensurate decrease in spending. The anticipated increase in the budget deficit provoked broad selling of U.K. bonds and a dramatic decline in the British pound, which forced the BOE to temporarily reintroduce longer-term bond buying to support both the gilt market and the currency. This quarter-end drama may have exposed the limitation of the fiscal policymakers in providing much support to economies that are battling generationally high inflation.



## GLOBAL ECONOMY OUTLOOK

After two negative quarters to begin the year, the U.S. economy likely eked out some growth in the third quarter as consumer spending advanced slightly in real terms and businesses continued to spend on both inventory replenishment and productivity-enhancing technology investments. The jobs market continued to grow at a healthy rate during the quarter and unemployment remained at generational lows, allowing most consumers to pay higher prices for products and services. We may be in one of those unusual periods in which good economic news about consumer and business spending is met with a negative market reaction as the Fed will be forced to react more aggressively to prevent inflation from becoming entrenched.

Inflation may have peaked but it is declining very slowly in both the CPI and Personal Consumption Expenditures monthly readings. The raw signals being received from retail markdowns, lower freight rates, lower home prices and cheaper gasoline have yet to be fully reflected in the monthly statistics as shelter and medical inflation remains stubbornly high. Consumer sentiment indicators are reflecting lower inflation expectations likely driven by the decline in gasoline prices and purchasing managers' surveys are showing a consistent decline in prices paid and an improvement in delivery times in a slowing economy. Market indicators such as the breakeven inflation rate in Treasury Inflation-Protected Securities are showing signs of muted future inflation expectations with the inflation forecast declining to a range of 1.75%–2.25% over the next five years.

Notwithstanding these more anecdotal indicators of falling inflation, the Fed shows no sign it is about to move to the sidelines and end its activist stance as the “raise and hold” message has been consistently reinforced over the past six weeks. Mortgage rates broke above 7% at the end of the quarter, which will further challenge the already receding housing market. The Fed remains most concerned about the tight labor market which if left at current levels could lead to entrenched wage inflation as workers effectively demand more pay to match the rising cost of living.

While the Fed will probably not explicitly state it would like to see more unemployment, the acknowledgement of the possibility that current monetary policy may exert an amount of pain on the economy is a tacit admission that it would like to see some loosening in the labor market. The potential for a more benign “soft landing” scenario can be found in the unusual gap between published job openings and the number of unemployed individuals in the workforce. A decline in job openings may be enough to loosen labor markets and constrain wage inflation without necessarily provoking a large increase in unemployment and a deeper recession. The Fed’s attempt to thread that needle will become more difficult the higher the reported inflation rate remains.

Inflation in Europe is higher than it is in the United States, as the United Kingdom and the European continent are much more heavily impacted by the sharp decrease in imports of oil and natural gas from Russia. Central bankers in Europe were more hesitant to tighten as aggressively as the Fed but they have reluctantly acquiesced in signaling more aggressive rate increases knowing that this tool only impacts demand when the inflation problem is largely due to supply constraints. A European recession beginning as early as the third quarter is the likely outcome as the benefits of the economic reopening fade and the pain of sharply higher energy prices and higher interest rates begin to be felt.

Japanese gross domestic product growth has held up rather well year to date as the economy has largely reopened and the weak currency has helped boost the net trade component. While the Bank of Japan may be welcoming an inflation rate it has been trying to revive for years, the economy will not be immune from the demand destruction effects of higher energy and other input costs.

Growth in China will continue to slow from its formerly high rate as the economy confronts several headwinds, some sourced externally, but some of the Chinese government’s own making. The government’s insistence on continuing zero-COVID policies as the variants have become more contagious but less severe has been the biggest impediment, but continued trade wars with the United States and growing stress in the banking system may further impair growth in demand and the provision of credit.



## EQUITY MARKETS OUTLOOK

With the 2022 bear market in equities largely driven by the dramatic increase in interest rates across the maturity spectrum, the focus will now turn to corporate earnings as the bulk of rate increases have already factored into stock prices. In addition to the third quarter earnings results, the accompanying management commentary will provide a strong indication of economy-wide demand and any margin deterioration from the inability to push rising input costs to the ultimate consumer. In the disinflationary environment that existed most of their careers, corporate managements needed to maintain constant discipline in controlling costs. That training should serve them well in adapting to this new inflationary environment driven by shortages and supply chain disruptions.

It is difficult to confidently call a market bottom given the sticky inflationary environment that will keep the Fed biased toward increasing rates even more. But the anecdotal evidence of a decline in price pressures provides more confidence that a light is brightening at the end of this dark inflationary tunnel. U.S. consumers will slow, but not decrease, their overall spending, and businesses should continue to invest in people and technology as they bring more manufacturing back onshore.

International markets are notably cheaper than those in the United States although they are also dominated by the more cyclical industries so any pronounced economic weakness caused by sharply higher energy prices and interest rates could have a larger impact on revenue growth in these markets. The stronger U.S. dollar should help translate into stronger earnings in local currencies as these markets contain many multinational corporations.



## BOND MARKETS OUTLOOK

After hovering in a tight trading range through most of the spring and summer months, interest rates resumed their relentless climb back to more “normalized” levels in August. As long as the Fed stays aggressive in bringing short rates ever higher, there will be continued upward pressure on rates across the maturity spectrum although intermediate and longer rates will reflect heightened recessionary risks by climbing less than the shorter maturities. With inflation rates expected to decrease over the coming months, most of the rate increases for intermediate maturities should be largely in bond prices, with total return expectations now at rather attractive levels.

High-yield bond spreads have widened but not yet to alarming levels as there has been no discernible increase in expected default rates. The asset class has become more attractive as “real” yields are positive when factoring in inflation. Earnings strength and stronger balance sheets in the energy sector have also been helpful in keeping credit concerns muted. The strong U.S. dollar has had its biggest negative impact on emerging market debt as issuers need to pay more to accumulate U.S. dollars to pay interest and principal maturities. Yields have become very attractive in this space although more U.S. dollar strength would be a continued headwind to returns.



## CURRENCIES &amp; COMMODITIES OUTLOOK

With many other central banks now catching up to the Fed in the aggressiveness of their respective tightening cycles, U.S. dollar appreciation should slow somewhat. Growing geopolitical risk and weak equity markets will prevent any substantial depreciation though.

The oil market is currently reflecting recessionary concerns as opposed to the specter of continued supply constraints that drove prices sharply higher earlier in the year. The coming winter and the threat of more supply restrictions should prevent any further declines and keep energy prices in a rather tight trading range until year-end.

Industrial metals may remain under pressure as the global economy slows and supply continues to be replenished as production returns closer to full capacity. Agricultural prices, however, may see upward pressure on low crop yields due to the ongoing Russia-Ukraine war and the resulting sanctions on Russian fertilizer chemicals.

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## WHAT THIS MEANS FOR INVESTORS

The markets and more importantly the Fed will need to see the anecdotal evidence of easing price pressures better reflected in the published inflation reports. Another important indicator that could presage the end of the monetary tightening cycle would be a decline in wage inflation in the payroll employment reports. Lack of confirmation that inflation is declining could bring the potential for a 5.0% federal funds rate into play, which would extend the bear market in equities.

Consumer and business spending resilience could keep any resulting recession short and shallow, but the ultimate effect on corporate earnings and profit margins remains uncertain. Greater clarity may be gained in the upcoming third quarter earnings season.

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							Annualized			
		4Q21	1Q22	2Q22	3Q22	YTD	1-Year	3-Year	5-Year	10-Year
US EQUITY BENCHMARKS		PRICE								
Dow Jones Industrial	28,725.51	7.87	(4.10)	(10.78)	(6.17)	(19.72)	(13.40)	4.36	7.42	10.45
Nasdaq Index Composite	10,575.62	8.45	(8.95)	(22.28)	(3.91)	(32.00)	(26.25)	10.63	11.25	14.22
S&P 500	3,585.62	11.03	(4.60)	(16.10)	(4.88)	(23.87)	(15.47)	8.16	9.24	11.70
Russell 1000 (Large Cap)		9.78	(5.13)	(16.67)	(4.61)	(24.59)	(17.22)	7.95	9.00	11.60
Russell 1000 Growth		11.64	(9.04)	(20.92)	(3.60)	(30.66)	(22.59)	10.67	12.17	13.70
Russell 1000 Value		7.77	(0.74)	(12.21)	(5.62)	(17.75)	(11.36)	4.36	5.29	9.17
Russell Mid Cap		6.44	(5.68)	(16.85)	(3.44)	(24.27)	(19.39)	5.19	6.48	10.30
Russell Mid Cap Growth		2.85	(12.58)	(21.07)	(0.65)	(31.45)	(29.50)	4.26	7.62	10.85
Russell Mid Cap Value		8.54	(1.82)	(14.68)	(4.93)	(20.36)	(13.56)	4.50	4.76	9.44
Russell 2000 (Small Cap)		2.14	(7.53)	(17.20)	(2.19)	(25.10)	(23.50)	4.29	3.55	8.55
Russell 2000 Growth		0.01	(12.63)	(19.25)	0.24	(29.28)	(29.27)	2.94	3.60	8.81
Russell 2000 Value		4.36	(2.40)	(15.28)	(4.61)	(21.12)	(17.69)	4.72	2.87	7.94
S&P GICS SECTORS		WEIGHT								
Consumer Discretionary	11.7%	12.84	(9.03)	(26.16)	4.36	(29.89)	(20.89)	6.70	10.51	13.19
Consumer Staples	6.9%	13.31	(1.01)	(4.62)	(6.62)	(11.83)	(0.09)	6.24	7.60	9.51
Energy	4.5%	7.97	39.03	(5.17)	2.35	34.94	45.70	13.44	6.09	3.52
Financials	11.0%	4.57	(1.48)	(17.50)	(3.10)	(21.25)	(17.65)	4.92	5.47	11.38
Health Care	15.1%	11.17	(2.58)	(5.91)	(5.18)	(13.08)	(3.37)	12.46	10.18	13.68
Industrials	7.9%	8.64	(2.36)	(14.78)	(4.72)	(20.72)	(13.87)	4.02	4.87	10.39
Information Technology	26.4%	16.69	(8.36)	(20.24)	(6.21)	(31.44)	(20.00)	14.93	16.74	17.09
Materials	2.5%	15.20	(2.37)	(15.90)	(7.13)	(23.74)	(12.15)	7.62	5.89	8.56
Communication Services	8.1%	(0.01)	(11.92)	(20.71)	(12.72)	(39.04)	(39.05)	(0.05)	1.95	3.76
Utilities	3.1%	12.93	4.77	(5.09)	(5.99)	(6.51)	5.58	3.66	7.82	9.85
Real Estate	2.8%	17.54	(6.22)	(14.72)	(11.03)	(28.85)	(16.37)	0.40	5.79	7.76



							Annualized			
		4Q21	1Q22	2Q22	3Q22	YTD	1-Year	3-Year	5-Year	10-Year
GLOBAL EQUITY BENCHMARKS		PRICE								
MSCI ACWI	553.37	6.68	(5.36)	(15.66)	(15.66)	(25.63)	(20.66)	3.75	4.44	7.28
MSCI AC World x-USA	247.05	1.82	(5.44)	(13.73)	(13.73)	(26.50)	(25.17)	(1.52)	(0.81)	3.01
MSCI EAFE	1,661.48	2.69	(5.91)	(14.51)	(14.51)	(27.09)	(25.13)	(1.83)	(0.84)	3.67
MSCI EAFE Growth	1,516.08	4.09	(11.94)	(16.88)	(16.88)	(33.02)	(30.28)	(1.49)	0.67	4.70
MSCI EAFE Value	2,171.49	1.17	0.33	(12.41)	(12.41)	(21.08)	(20.16)	(2.79)	(2.74)	2.39
MSCI Emerging Markets	875.79	(1.31)	(6.97)	(11.45)	(11.57)	(27.16)	(28.11)	(2.07)	(1.81)	1.05
MSCI BRIC	241.10	(5.01)	(13.28)	(4.32)	(12.70)	(27.56)	(31.19)	(5.07)	(3.03)	1.01
MSCI Japan	2,776.82	(3.96)	(6.61)	(14.63)	(7.67)	(26.38)	(29.30)	(2.65)	(0.63)	4.84
INTEREST RATES		YIELD								
3m Treasury Bill	3.27	0.05	0.32	1.67	3.27	0.05	0.04	1.79	0.99	0.08
US LIBOR 3m	3.75	0.21	0.96	2.29	3.75	0.21	0.13	2.09	1.33	0.36
US Treasury 3m	3.23	0.05	0.52	1.64	3.23	0.05	0.05	1.81	1.06	0.09
US Treasury 10yr	3.80	1.51	2.32	2.98	3.80	1.51	1.47	1.64	2.31	1.63
US Treasury 30yr	3.77	1.90	2.45	3.12	3.77	1.90	2.04	2.10	2.87	2.82
FIXED INCOME										
Citi 3-month T-bill		0.01	(0.02)	0.01	0.33	0.31	0.32	0.51	1.06	0.62
BC U.S. Gov't & Related 5-7		(0.65)	(5.36)	(3.11)	(3.97)	(11.94)	(12.52)	(2.35)	0.43	1.29
BC Municipal Bond 1-10 Year		0.18	(4.76)	(0.84)	(2.30)	(7.72)	(7.55)	(0.83)	0.71	1.41
BC TIPS		2.36	(3.02)	(6.08)	(5.14)	(13.61)	(11.57)	0.79	1.95	0.98
BC Aggregate		0.01	(5.93)	(4.69)	(4.75)	(14.61)	(14.60)	(3.26)	(0.27)	0.89
ML High Yield Master II		0.66	(4.51)	(9.97)	(0.68)	(14.62)	(14.06)	(0.67)	1.41	3.86
Citi World Gov't Bond Index		(1.10)	(6.46)	(8.91)	(7.61)	(21.27)	(22.14)	(7.03)	(3.07)	(1.76)
JPMorgan EMBI Global		0.02	(9.26)	(10.55)	(4.20)	(22.24)	(22.23)	(6.10)	(2.31)	0.95



						Annualized									
						1-Year	3-Year	5-Year	10-Year						
						4Q21	1Q22	2Q22	3Q22	YTD					
REAL ESTATE															
MSCI US REIT						16.02	(4.28)	(17.16)	(10.28)	(28.86)	(17.46)	(3.08)	1.72	4.92	
FTSE EPRA/NAREIT Europe						5.81	(7.15)	(28.22)	(21.55)	(47.71)	(44.67)	(14.05)	(7.44)	1.06	
COMMODITIES															
Bloomberg Commodity Index						(1.56)	25.55	(5.66)	(4.11)	13.57	11.80	13.45	6.96	(2.14)	
Energy						(13.03)	47.91	7.02	(5.36)	49.80	30.28	11.37	6.77	(6.26)	
Agriculturals						6.26	19.91	(5.72)	(0.20)	12.82	19.88	21.26	8.16	(2.10)	
Livestock						1.85	5.77	(8.68)	2.55	(0.95)	0.88	(6.21)	(4.69)	(3.52)	
Softs						5.67	7.92	(4.30)	(3.86)	(0.71)	4.92	18.79	4.63	(3.22)	
Industrial Metals						8.61	22.73	(26.35)	(7.27)	(16.18)	(8.97)	8.23	3.92	(0.38)	
Precious Metals						4.33	6.88	(10.54)	(7.60)	(11.65)	(7.83)	2.62	3.49	(2.85)	
CURRENCIES										PRICE					
ICE Dollar Index						112.117	1.84	2.44	6.48	7.10	16.83	19.00	4.10	3.79	3.44
Euro / US Dollar						0.980	(1.88)	(2.16)	(6.04)	(6.29)	(13.85)	(15.48)	(3.50)	(3.69)	(2.69)
Pound / US Dollar						1.116	0.45	(2.79)	(7.76)	(8.08)	(17.58)	(17.22)	(3.24)	(3.61)	(3.62)
US Dollar / Yen						144.745	3.21	5.40	11.93	6.54	25.70	29.75	10.23	5.16	6.40

Source: Factset, Morningstar Direct, iShares website

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