Quarterly Market Update – 3Q, 2022

Market Summary & Outlook

Recap

- **High Inflation Drives Positive Stock-Bond Correlations –** The negative correlation between stocks and U.S. treasuries during low periods of inflation has shifted positive in 2022, as market participants and consumers cope with a higher inflationary regime similar to that of the mid-1970's and 80's.
- **Challenging Environment, Global Yields Rise –** A maturing business cycle and slowing economic growth has ramped up the Fed's tightening cycle. Most asset prices dropped in Q3 as interest rates and the U.S. dollar moved sharply upward, creating a particularly challenging environment for fixed-income markets.
- **Broad-Based Decline Across Asset Classes –** Q3 saw negative returns in fixed-income reach multi-decade highs, with Long Government and Credit Bonds down -28.9% and Large Cap stocks posting -23.9%, YTD.
- **Earnings Changes Key to U.S. Market Trend –** Not all bear markets are created equal. From 1872-2022, non-recessionary drawdowns were shallower at -22%, while the change in earnings remained a positive 7%. During deeper recessions, the average market return was -35% as earnings slipped in tandem -18%.
- **Supply Shocks Diminish, Cooling Demand –** The bottleneck effects of COVID-19 on global supply chains have eased as consumer demand tempers. However, energy costs remain elevated particularly in Germany and parts of eastern Europe, where a larger share of their natural gas supply previously came from Russian exports.
- **U.S. Job Market Supportive, Openings High –** U.S. job openings rate of over 6% remains persistently above its long-term average, with unemployment hovering near 4%. Suggesting a potential labor shortage, as some U.S. workers who have recently left their job might be considering permanently leaving the workforce.
- **Profit Growth Remains Positive, Margins Under Pressure –** S&P 500 earnings are currently expected to remain positive through 2023, however, growing at a slower rate than a year ago. Putting profit margins under pressure and leaving companies with fewer options to maintain profitability.
- **Credit Maturing But Not Recessionary –** Since 1950, yield curve inversions of the 10-year minus the 3-month have occurred before the last 8 recessions, also occurring twice without a recession (1966, 1998). With peak inversion ranging 35-373 basis points and recessions averaging 1 year. As of 9/30/22, inversion is +53 bps.
- **Multi-Year Dollar High –** Purchasing Power Parity (PPP) has strengthened for U.S. consumers compared to currency valuations of the GBP and EUR, as 10-year real yield for U.S. debt has outpaced other developed markets in 2022. Creating a strong dollar environment with the DXY index reaching its highest level since 2002.

ABOUT THE FIRM

Virtus Capital is an independent investment advisory firm serving high net-worth individuals, families, and business owners.

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Performance

Equity Benchmarks	Returns as of 9/30/22 3 Month	YTD
S&P 500 PR	-5.28%	-24.77%
DJ Industrial Average PR	-6.66%	-20.95%
Nasdaq Composite PR	-4.11%	-32.40%
Russell 2000	-2.19%	-25.10%
MSCI AC World Index ex USA Net	-9.91%	-26.50%
FTSE Emerging Index	-10.27%	-23.72%

Bond/Commodity Benchmarks	Returns as of 9/30/22 3 Month	YTD
Bloomberg US 1-5 Year Treasury	-2.25%	-6.35%
Bloomberg US 5-10 Yr Treasury	-4.86%	-13.60%
Bloomberg US Long Treasury	-9.63%	-28.84%
Bloomberg US 5-10 Yr Corp	-4.70%	-17.03%
Bloomberg Municipal Bond	-3.46%	-12.13%
Bloomberg Commodity Index TR	-4.11%	13.57%

*Data Source: Morningstar and Vanguard Funds

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VIRTUS CAPITAL

Discussion

Strengthening headwinds for the global business cycle left investors with few places to hide to start the second half of 2022, as late-cycle framework in North America led to moderating economic activity and tightening credit conditions. While the UK and Eurozone appear to be entering into a full-on economic growth recession, the U.S. may be right on their heels with back-to-back quarters of negative GDP growth in both Q1 and Q2 of -1.6% and -0.6%, respectively. However, as this is written in the latter half of October, the "advanced read" on Q3's GDP is crystalizing a positive 2.6%, according to the Bureau of Economic Analysis' (BEA) press release on Thursday, October 27. With multiple confirmation reads in the coming weeks, investors will have to wait and see if Q3 did indeed reverse the negative growth trend; but for how long? China's growth recession is showing short-lived signs, however, policy makers may still find growth elusive, with less than 50% of industries in China expanding in 2022, well below their trailing 15 year average. As the world's second largest economy by GDP, China's production outputs have a significant effect on global inventories and supply chain cycles, particularly with respect to consumer discretionary, staples, and industrial materials sectors. De-globalization pressures from policy makers domestically and abroad represent a potential secular shift in geopolitical and financial interests, which in the short-term, can have a magnified impact on global supply chain shocks and overall price inflation. Central banks are united in their effort to combat the pain of high global inflation, with U.S. Fed Chairman, Jerome Powell, shifting tone in his September, 21 comments saying that "Chances of a soft landing are *likely* to diminish". This tonal shift effectively increases the chances that the Fed will use their financial tools to tighten longer and deeper, potentially even well past recession indicators. Unsurprisingly, Powell's remarks sent intra-day financial markets further down, as the 10-year treasury yield climbed to its highest level since 2007. The Federal Reserve has now raised interest rates in five consecutive meetings, the fastest rate of change since the Fed started unofficially targeting the money supply in 1979 to regulate inflation. With another 0.75%, or 75bps added in September's meeting, the base borrowing rate now stands between 3-3.25%. Inflation is still the talk of town, with the latest September print continuing its shock-and-awe campaign, with the year-over-year, unadjusted PPI and CPI reading 8.5% and 8.2%, respectively. The seasonally adjusted PPI increased 0.4%, month-over-month on final demand, indicating the Fed still has some work to do in taming the input costs that are partly driving multi-decade high inflation. With the significant and sharp increase in domestic interest rates, treasury yields and dollar-strength have begun to shift investors' perspective on the opportunity-cost of fixed-income vs. equities. The global economy relies heavily on the green-back for its stability and liquidity in times of uncertainty, and as yields continue to rise, U.S. dollar-denominated debt becomes more attractive to foreign investors seeking to hedge their currency risk, capture yield, and service their dollar-debt. This buying activity is a tailwind that creates an even stronger U.S. dollar, which helps U.S. consumers increase their foreign purchasing power, but conversely reduces emerging market participants profitability when exchanging their domestic currency for USD. A primary implication of a strong dollar for investors is that financial market participants become more attune to companies that derive a large portion of their earnings from overseas sources.

Outlook

With inflation still the primary risk-driver of positive, real economic growth, market participants are treading lightly and de-risking out of growth-oriented companies with weak pricing power and questionable business models. The slogan, "growth at any cost", that worked wonders to inspire shareholder confidence in the previous bull-cycle, has not sat well recently with equity investors, as the "heady" times of low interest rates, access to cheap capital, and an expansionary business environment has all but evaporated for the unprofitable, high-growth category of the market. Price-to-earnings (P/E) multiples have significantly contracted year-over-year, with the S&P 500 shedding 25% from October 1, 2021-2022, down from 24.39 to 18.25. The modern-era average multiple for the S&P since 1950 is approximately 19.6, suggesting the index is currently close to "fair value". Emerging markets have also seen their multipliers come down in Q3, with some of the cheapest valuations seen since the pre-pandemic period. However, emerging markets may have greater exposure to currency exchange risk and suffer profit margin erosion when converting revenues to USD. On this note, if earnings for emerging and developed markets can remain resilient during the current market cycle, this could be a saving grace for equity markets to stave off a long duration drawdown. As noted in the recap, maintaining positive earnings growth during bear market cycles tends to provide a pull force for the market, lifting returns and creating a shorter incubation period till the next bull run. With respect to fixed-income investments, as the Fed begins to slow their pace of interest rate hikes, or even slightly reverse course, this represents an opportunity for assets with higher duration exposure, potentially driving the price appreciation and total-return of fixed-income securities. We'll have to watch closely to see when and if rates stabilize in the near-term. Virtus Capital's near-term approach to security selection maintains a slight emphasis on high-quality names in the consumer staples, information technology, and healthcare sectors. As part of a well-diversified portfolio, Virtus Capital seeks to provide investors with risk-adjusted performance over the long-term and tax-efficiency opportunities in current market cycles. Additionally, opportunity exists for the savvy investor to dollar-cost-average contributions during this current down-market cycle, which may help to offset current-year paper losses. Increasing portfolio holdings in long-term, competitively advantaged companies being offered at a discount to fair-value is a time-tested, successful investment strategy.

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Q3, 2022 Quote:

"Great investment opportunities come around when excellent companies are surrounded by unusual circumstances that cause the stock to be mis-appraised."

- Prolific Investor – **Warren Buffett**

Sources

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(5) SP 500 Data - https://www.currentmarketvaluation.com/models/price-earnings.php#:~:text=The%20current%20S%26P500%2010%2Dyear,historical%20trend%20of%20this%20ratio.

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