THE PORTFOLIO STRATEGY GROUP, LLC

50 MAIN STREET
SUITE 1280
WHITE PLAINS, NEW YORK 10606
TEL: (914) 288-4900 FAX: (914) 328-6670
(800) 535-5110

Third Quarter Commentary
October 6, 2022

The stock market had another volatile and difficult quarter. A strong bear market rally in July, totally reversed in September, led to negative quarterly results. The S&P 500 lost 4.88% for the quarter. Growth stocks outperformed value stocks for the first time this year, but value stocks remain well ahead of growth stocks year-to-date. With the exception of a very small gain for small cap growth stocks, U.S. stock indices generally lost 2% - 6% for the quarter. Foreign stock indices had a weaker quarter with developed international equity down 9.36% and emerging markets declining 12.48%. Gold was down 8% and bitcoin gained 5%, while still down 58.9% for the year. Hedge funds generally lost less than the overall market, both for the quarter and year-to-date.[1]

Year-to-date, the S&P 500 is down 23.87%. Growth stock indices are mostly down approximately 30%, while value stock indices are down 17% - 21%. Foreign stocks have declined about 28%.[1]

Treasury yields continued to increase in the quarter. The Fed raised the overnight lending rate twice for a total of 1.5%, while inflation remained high. The Fed Chairman stated that fighting inflation is the main priority and to expect more rate increases even if a recession is the result. Bond prices continued to decline and many bonds, especially those with longer maturities, have lost 10% or more in value. Higher rates also mean that investors can now earn more on lower risk bonds than they have in years. Our clients own individual bonds which will have positive returns to their call or maturity dates. Owning a bond fund or ETF does not guarantee that result and could lead to losses.

The following are Treasury yields for various maturities:

Maturity*	12/31/21	6/30/22	9/30/22
3 Month	0.05%	1.64%	3.23%
2 Year	0.73%	2.93%	4.20%
5 Year	1.26%	3.00%	4.04%
10 Year	1.51%	2.98%	3.80%
30 Year	1.90%	3.12%	3.76%

**Source: FactSet*

Note the inverted yield curve between the two, ten and thirty year maturities. The bond market is signaling a future economic slowdown and the possibility of a recession.

The stock market dislikes uncertainty and as can be seen in the news every day there is not only economic uncertainty but global political uncertainty. The key variables which are affecting the stock and bond markets are:

- Higher interest rates due to Fed tightening;
- High inflation;
- Disruption of global supply chains caused by the pandemic;
- The war in Ukraine and its effect on energy and food prices;
- The effect of the war on European economies;
- A mid-term election which may change control of Congress

---

[1] Developed international is MSCI EAFE NR USD; Emerging markets is MSCI Emerging Markets; Value indices include the Russell 1000 Value, Russell Mid Cap Value and Russell 2000 Value; Growth indices include the Russell 1000 Growth, Russell Mid Cap Growth and Russell 2000 Growth

There is a debate among economists whether we are in a recession already or whether we will be in one over the next year. We have had two consecutive quarters of negative economic (GDP) growth, which is one common definition of a recession. To us this definition is not relevant. Usually when we hear recession, we think of a contracting economy, jobs lost and people cutting back on spending. The last six to nine months have not felt like a recession. This is because nominal spending, the actual dollars people have been spending and creating in the economy, has been growing at the strongest rate in decades. Personal Consumption Expenditures (PCE), a measure of consumer spending, is up 8% over last twelve months and up 20% compared to 2019 levels! People are spending more money than ever. Consumers are not getting 20% more in goods and services for their money, due to the effects of inflation, but they have the money and are spending it. This is a key factor why prices are up so much and has alarmed the Fed, which is now determined to break the back of inflation. The Fed is indicating it will use its interest rate tools (increasing short-term interest rates via the Fed funds rate and raising long-term interest rates through quantitative tightening) to reduce this strong spending, which it views as enabling the higher prices, regardless of the impact on near term economic and job growth or the stock market.

As investors, what we care most about is the valuation of stocks and bonds and how those values are likely to change. Since the beginning of the year, stock and bond valuations have declined considerably. This decline in stocks has been caused by price/earnings ratios (P/E) going down, not by lower earnings. Valuations had been elevated because of low interest rates and the liquidity in the economy. As interest rates increased, valuations declined for stocks and bonds. When inflation is brought down, interest rates should follow and stock and bond valuations will level off and turn up again. The market has historically anticipated this.

Corporate earnings are expected to come under pressure for some companies and business sectors. Thus far corporate earnings have been resilient, probably because of strong consumer spending. So, even though stock prices have declined, they may not currently reflect the lower earnings that are possible over the next year as economic growth slows further. If earnings decline and P/E ratios remain steady, stocks will go down further. We also are not certain we have seen the bottom in P/E ratios.

At this point, we expect market volatility to remain very high with short term rallies followed by declines as economic and global uncertainty remain high. There are just too many wild cards, such as the potential use of nuclear weapons, to have a high level of confidence. We do believe we are closer to a market bottom if we have not hit one already, but the ride could be bumpy as the market navigates these uncertainties. The positive news is corporate balance sheets and banks are in solid shape, the job market has been strong and consumers are still spending. Owning high quality stocks and bonds and being diversified is even more important in this environment.