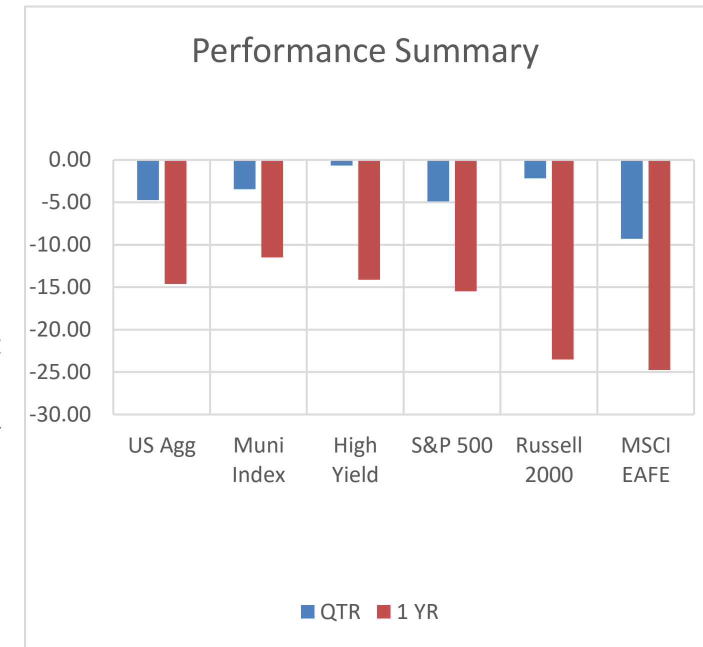
Global stocks and bonds ended September with monthly and quarterly losses amid a volatile backdrop. The ongoing financial challenges of persistent inflation, hawkish central banks, rising interest rates, weak economic data, and geopolitical risks continued to pressure financial markets throughout the quarter.



- It was a dramatic round trip for the US stock market in the third quarter. The broad market rose 14% from the end of June to mid-August, then fell 17% from that high to finish the quarter down (4.88%).
- The US market has fallen for three consecutive quarters, the kind of losses not seen since 2008.
- Dividend stocks took a hit, falling 5.6% as a group, trailing the broader market by a full percentage point.
- Bonds are having one of their worst years in modern history, core bonds are down 14.5% YTD. To stamp out inflation the Fed raised rates twice to an effective target rate of 3.00%-3.25%. Expectations are the Fed Funds rate will exceed 4% by year-end.
- The yield on two-year Treasuries jumped higher, ending the quarter at 4.22%, up from just 0.27% a year ago.
- The yield curve is now significantly inverted, a commonly cited indicator of an upcoming recession.
- The US dollar is on its strongest run in decades and is approaching a 40-year high in real terms.
- Foreign markets were pressured by higher inflation, higher rates, and a higher dollar. They finished the quarter down (9.3%).

In this quarter's commentary we focus on: From TINA to TARA; Investing Through Tough Times; and Can US outperformance Persist?

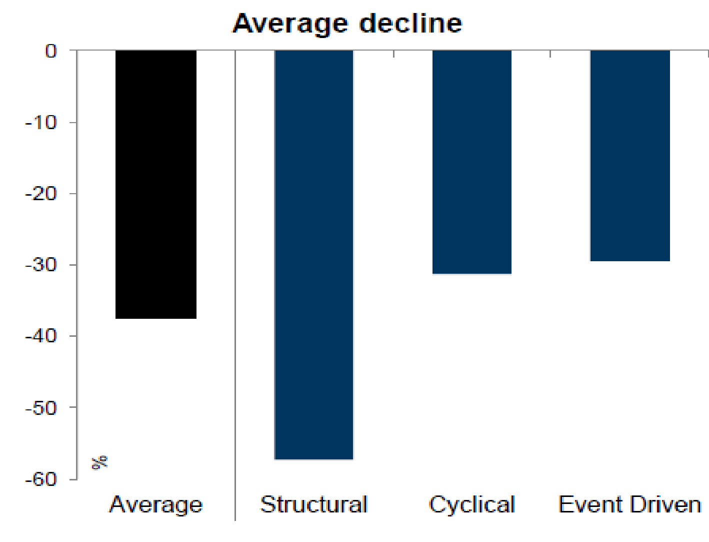
From TINA to TARA

Since the Great Financial Crisis of 2007-08, the financial markets have been dominated by the concept of TINA (There Is No Alternative). The term TINA refers to the process of the Federal Reserve driving interest rates so low after the crisis that investors had no alternative but to turn to stocks for income and growth. The period of TINA came to a peak during COVID when interest rates were driven down towards zero and valuations in the stock market and other financial assets were driven to extremes (e.g.-unprofitable tech stocks, SPACs, crypto, meme stocks, etc.). However, with the Federal Reserve raising five times from zero to 3.25%, and expectations they will raise rates to over 4.5% in 2023, the era of TINA may be coming to an end. A new era of TARA (There Are Reasonable Alternatives) may be emerging. For the first time in years, the bond market may be offering some competition for stocks and a place for investors to find relatively safe yields and a source of return. The biggest implication is the era of wildly speculating on overpriced financial assets because of TINA is

probably over. This may return some normalcy to the financial markets and force investors to rely on the fundamentals and valuation of a potential investment, and not just speculate on higher prices!

Investing Through Tough Times

With most major stock indices down more than 20% year to date there's reason to believe the US is either in a recession or is in the process of discounting a recession in the not-too-distant future. As we've written before, outside of major structural bear markets like the Great Depression in the 1930s or the Great Financial Crisis of 2007-2009, recessions on average led to stock market declines close to 30% (see chart to the right). The actual decline will vary with the severity of the recession but usually falls in the range of down 20-40%. The implication being a lot of the potential downside for this business cycle may already be priced in, but not necessarily all of it. What makes trying to time the markets so challenging is the severity and length of a recession is unknowable, and recessions typically only get identified after the fact.



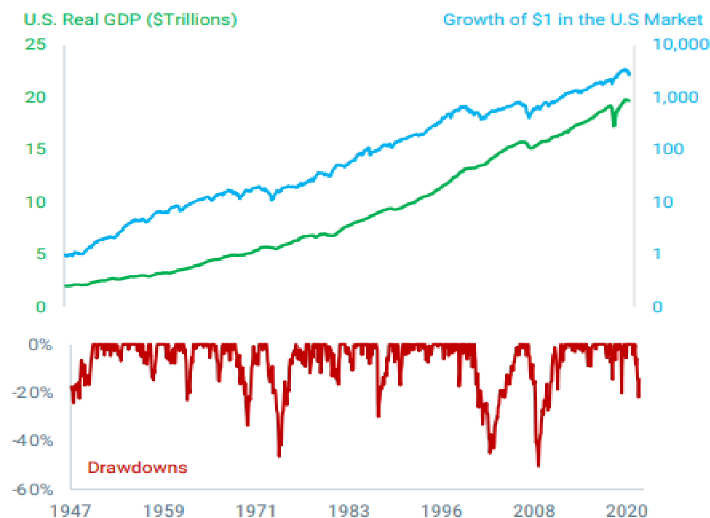
Source: Goldman Sachs Global Investment Research

In general, the stock market does a pretty good job of sniffing out economic downturns and recoveries. The research team at Avantis Investors measured stock returns during the past seven recessions over the past 50 years. They calculated the average monthly returns during recessions to be (-0.21%), while the average monthly returns during expansions were 1.20%. The most interesting part of their study was that monthly returns during the 1st half of a recession were deeply negative at (-2.51%), while the monthly returns during the 2nd half of the recession were very strong at 2.15% (see the chart to the right). The key takeaway is the stock market typically anticipates and reacts quickly to both economic slowdowns and recoveries. Keep in mind, the economic news and sentiment during the 2nd half of recessions are usually very negative, but the market tends to look past this negative and starts to anticipate better times (and returns) ahead.

Figure 2 | U.S. Stocks Have Enjoyed Strongly Positive Returns in the Second Half of Recessions

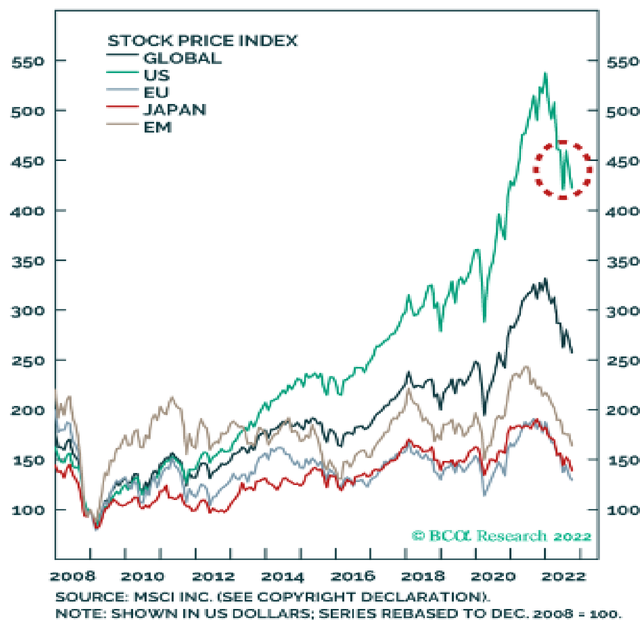
	Recessions		Expansions		All Months
	1st Half	2nd Half	1st Half	2nd Half	
Average Monthly Market Return	-2.51%	2.15%	1.34%	1.05%	1.02%

It can be helpful to occasionally remind ourselves that both the economy and stock market have historically gone through major declines, but the long-term trend is higher. The periodic drawdown of stocks is the price investors endure to participate in the long-term growth and prosperity of the stock market. The chart illustrates how the economy and stock market have overcome many rough periods throughout history.



In our opinion, this is a good time for investors to be reviewing their investment strategy and to start thinking about the investment decisions they want to implement in the months ahead. At some point, the markets and economy will stop going down and the investors with a plan will reap the biggest rewards. For more information on our outlook see our asset class rankings on page 6.

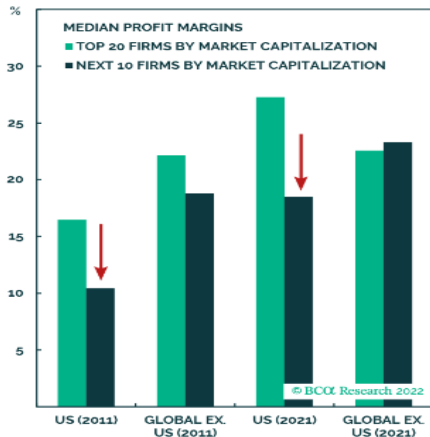
US Equities Outperformed The Global Benchmark By About 170% Over 2008-22YTD



Can US Outperformance Persist?

Stocks in the US have vastly outperformed their global peers since the Great Financial Crisis (GFC). The chart to the left shows the US stock market has outperformed the global benchmarks by roughly 170% since 2008. This raises a couple of questions- why have US stocks outperformed? And can it persist? The answer to the first question is relatively straightforward, the US has experienced higher sales growth and profit margins than its global competitors. However, the second question requires a little more nuance to answer.

The reality is the stellar performance in the US has been driven by a small handful of companies such as Facebook, Amazon, Netflix, Microsoft, etc. The chart on the next page shows how the median profit margins for the top 20 largest firms in the US are much higher than their global peers. However, once you look beyond the top 20 US stocks any margin advantage is lost, in fact, margins on the next largest firms are lower in the US than they are globally.



Looking forward we believe the trend in profit margins will revert back towards the long-term averages. Other reasons we think profit margins in the US are unsustainable is the combined costs of tax expenses and interest rates for corporations are at extreme lows and likely to increase in the future, see the chart below. We've already started to see interest rate costs increase this year and we're confident taxes will also trend higher in the future as well.

In summary, we don't believe the extreme outperformance of US stocks relative to global stocks is sustainable. Here's a summary of the reasons why:

- The US outperformance has been concentrated in a small group of stocks and we don't believe their relative performance will be repeated going forward.
- We expect profit margins in the US to be lower in the future as bond interest costs and corporate tax rates increase.
- Valuations in the global markets are significantly lower than in the US, which will benefit relative performance in the global markets.
- The US dollar is near 40-year highs in real terms, and global markets will benefit as the dollar reverts towards historical means.

If you have any questions about your portfolio or investment strategy don't hesitate to give us a call.

Best regards,

Steve Giacobbe, CFA, CFP®

Asset Class		* ↔ Neutral weight ↓ Underweight ↑ Overweight
Equities	***View****	***Comments***
U.S. Large Cap	↓	Valuations improve during bear markets, making them an excellent time to start investing and/or start targeting stocks you want to buy. Often all companies get sold off, including the good ones. We would focus on upgrading portfolios with wide-moat (lasting competitive advantages) stocks and resist the temptation to speculate on beaten-down low-quality stocks.
U.S. Small/Mid Cap	↔	Valuations are attractive and small-cap stocks tend to outperform when the economy exits a recession. This is a good time to start building positions in small-cap companies, with a small bias toward value.
International Developed	↔	Valuations are attractive relative to U.S. stocks, and they should outperform in a multi-year time frame. In the short term, strong $ and recession fears are weighing on foreign stocks.
Emerging Markets	↔	Valuations are attractive for the long term. Emerging markets tend to be volatile and are always susceptible to further selloffs, but over a multi-year time frame, they should outperform. We may upgrade and add to positions on further weakness.

Fixed Income		
Investment Grade	↔	Interest rates rose again this quarter, making bonds in general a more attractive options to stocks. We have gradually started to lengthen the duration in portfolios as interest rates have increased.
High-Yield Bonds	↓	High-yield bonds continue to sell off and have a fair amount of downside in a recessionary environment. We are watching yields, defaults, and the economy for opportunities to buy this asset class. We're not there yet.
Municipal Bonds	↑	With higher yields, municipal bonds are attractive, especially for high tax bracket investors.
TIPS	↔	TIPs are a hedge against higher inflation, we would hold positions in tax-deferred accounts as a long-term hedge against inflation hedge.
Floating-Rate Loans	↓	Similar to HY bonds, FRLs have a significant risk in a recessionary environment, we would be underweight in this asset class.
Emerging Markets	↔	EM bonds have sold off sharply this year and may have a further downside in a recessionary environment. Longer-term we believe valuations have improved and there should be an opportunity to buy this asset class and generate above-average returns in the year ahead

Alternatives		
Absolute-Return/Alternatives	↑	We like alternative funds as a way to hedge volatility, provide real returns, and improve the risk vs reward in portfolios. We favor simple and low-cost strategies like hedged equity, real return, clean energy transition, and global macro. Over a full market cycle, they should add value to portfolios. If traditional stocks and bonds become "cheap" we would reduce our weighting in this asset class.
REITs	↔	We are neutral on REITs. There are diversification benefits from owning REITs, however, we recognize REITs may be structurally impaired in the future as a result of secular trends. Rising rates may also be a headwind to REIT performance.
Commodities/Gold	↔	We view exposure in this area as an effective way for long-term investors to diversify their portfolios and hedge against higher inflation. These positions can be volatile in performance but may provide some relief over a full market cycle.

U.S. Stocks

Market Performance, Third Quarter 2022

Index	Q3 2022	1 YR
S&P 500	(4.88%)	(15.47%)
Russell 1000	(4.61%)	(17.22%)
Russell 1000 Value	(5.62%)	(11.36%)
Russell 1000 Growth	(3.60%)	(22.59%)
Russell Midcap	(3.44%)	(19.39%)
Russell 2000	(2.19%)	(23.50%)

Source: Morningstar

- Stocks dropped across the board in the second quarter, with all major indices were down low to mid-single digits.
- Value stocks sold off the most in the quarter but continue to lead over the past year.
- Small-cap stocks held up the best during the quarter and are trading at attractive valuations for long-term investors.

International Stocks

Market Performance, Third Quarter 2022

Index	Q3 2022	1 YR
MSCI EAFE	(9.29%)	(24.75%)
MCSI EME	(11.42%)	(27.80%)
MSCI BRIC	(12.59%)	(30.99%)

Source: Morningstar

- Foreign developed market stocks sold off sharply during the quarter amid concerns about inflation, the economy, and geopolitical risks. Long-term valuations look attractive, and investors should maintain positions.
- Emerging market stocks were down sharply and similar to developed market stocks are attractively valued for long-term investors.

Fixed Income

Market Performance, Third Quarter 2022

Index	Q3 2022	1 YR
Vanguard Total Bond Index	(4.68%)	(14.74%)
Bloomberg Muni Bond	(3.46%)	(11.50%)
Bloomberg US High-Yield	(0.65%)	(14.14%)
JPM GBI- EM Global Diversified	(4.73%)	(20.63%)
iShares TIPS Bond	(5.20%)	(11.76%)
BofA Merrill Lynch 3-month Treasury Note	0.33%	0.32%

Source: Morningstar

- Interest rates on core bonds have increased sharply this year, making them more attractive as a long-term investment.
- High-yield bonds were down slightly for the quarter. Yields have increased this year and are starting to approach attractive values. We are looking to upgrade and add positions on further sell-offs.
- Similar to high-yield bonds we are watching for opportunities to upgrade and buy EM bonds.

Alternative Assets

Market Performance, Third Quarter 2022

Strategies	Q3 2022	1 YR
AQR Diversified Arbitrage	0.43%	(4.29%)
BNY Mellon Global Real Return	(3.16%)	(6.71%)
JPMorgan Hedged Equity	(4.72%)	(10.08%)
PIMCO All Asset	(6.16%)	(14.90%)
Vanguard REIT	(10.98%)	(18.71%)

Source: Morningstar

- Alternatives make a lot of sense in this environment of low-interest rates and higher inflation. We are selectively bullish on alternatives and believe they can add value to portfolios over a full market cycle.
- We like alternative assets as a strategic way to reduce risk and increase absolute returns in portfolios. We expect alternatives to significantly outperform bonds over the full market cycle. We view real return, commodity, precious metal, and alternative strategies in general as an effective way to hedge against higher inflation.

Appendix:

Benchmark Definitions

U.S. Equity		Description
S&P 500	Index	The index includes 500 leading US companies and captures approximately 80% coverage of available market capitalization.
Russell 1000	Index	The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe and includes approximately 1000 of the largest securities. The Russell 1000 represents approximately 92% of the U.S. market.
Russell 1000 Value	Index	The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.
Russell 1000 Growth	Index	The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.
Russell Midcap	Index	The Russell Midcap Index measures the performance of the mid-cap segment of the U.S. equity universe. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership.
Russell 2000	Index	The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.
International Equity		**Description**
MSCI EAFE	Index	The EAFE (Europe, Australasia, Far East) index consists of 21 developed market country indexes, excluding the US & Canada. It is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets.
MCSI EME	Index	The index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of emerging markets and includes 23 emerging market countries in the index.
MSCI BRIC	Index	The index is a free float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of the following four emerging market country indexes: Brazil, Russia, India, and China.

Fixed Income		Description
Vanguard Total Bond Index	Index Fund	This index measures a wide spectrum of public, investment-grade, taxable, fixed income securities in the United States—including government, corporate, and international dollar-denominated bonds, as well as mortgage-backed and asset-backed securities, all with maturities of more than 1 year.
Barclays Aggregate Bond	Index	The U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM pass-through bonds), ABS, and CMBS sectors.
Barclays Muni Bond	Index	The U.S. Municipal Indices cover the USD-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.
Barclays US Corp High-Yield	Index	The index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market and excludes Emerging Markets debt.
JPM GBI- EM Global Divers	Index	The index tracks returns for actively traded external debt instruments in emerging markets. Included in the index are US-dollar-denominated Brady bonds, Eurobonds, and traded loans issued by sovereign entities.
iShares TIPS Bond	ETF	The iShares TIPS Bond ETF seeks to track the investment results of an index composed of inflation-protected U.S. Treasury bonds.
BofA Merrill Lynch 3-month Treasury Note	Index	The 3-month US Treasury Note Index is comprised of a single issue purchased at the beginning of the month and held for a full month. At the end of the month, that issue is sold and rolled into a newly selected issue.
Alternative Assets		**Description**
PIMCO All Asset All Authority	Mutual Fund	The investment seeks a maximum real return, consistent with the preservation of real capital and prudent investment management. The primary benchmark for the fund is the S&P 500, with a secondary objective of the Consumer Price Index +650 basis points.
AQR Diversified Arbitrage	Mutual Fund	The investment seeks long-term absolute (positive) returns. It invests in a diversified portfolio of instruments, including equities, convertible securities, debt securities, loans, warrants, options, and other types of derivative instruments.
JPMorgan Hedged Equity	Mutual Fund	The investment seeks to capture the majority of the returns associated with equity market investments while exposing investors to less risk than other equity investments. The fund invests in a broadly diversified portfolio of common stocks, while also selling index call options and purchasing index put options.

Alternative Assets		Description
Vanguard REIT	ETF	The investment seeks to provide a high level of income and moderate long-term capital appreciation by tracking the performance of a benchmark index that measures the performance of publicly traded equity REITs.
BNY Mellon Global Real Return	Mutual Fund	The fund allocates its investments among global equities, bonds, and cash; and generally, to a lesser extent, other asset classes, including real estate, commodities, currencies, and alternative or non-traditional asset classes and strategies, primarily those accessed through derivative instruments.