



Economic & Market Outlook

September 30, 2022

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An aerial photograph of a city skyline, likely Austin, Texas, featuring a river with several bridges and a dense cluster of skyscrapers in the background. The image is overlaid with a dark blue gradient.

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An aerial photograph of a city skyline, likely Minneapolis, Minnesota, featuring a river (the Mississippi River) and several bridges. The skyline is composed of numerous high-rise buildings, including a prominent blue glass skyscraper. The foreground shows green trees and a bridge with a road. The sky is a clear, deep blue.

Market Review

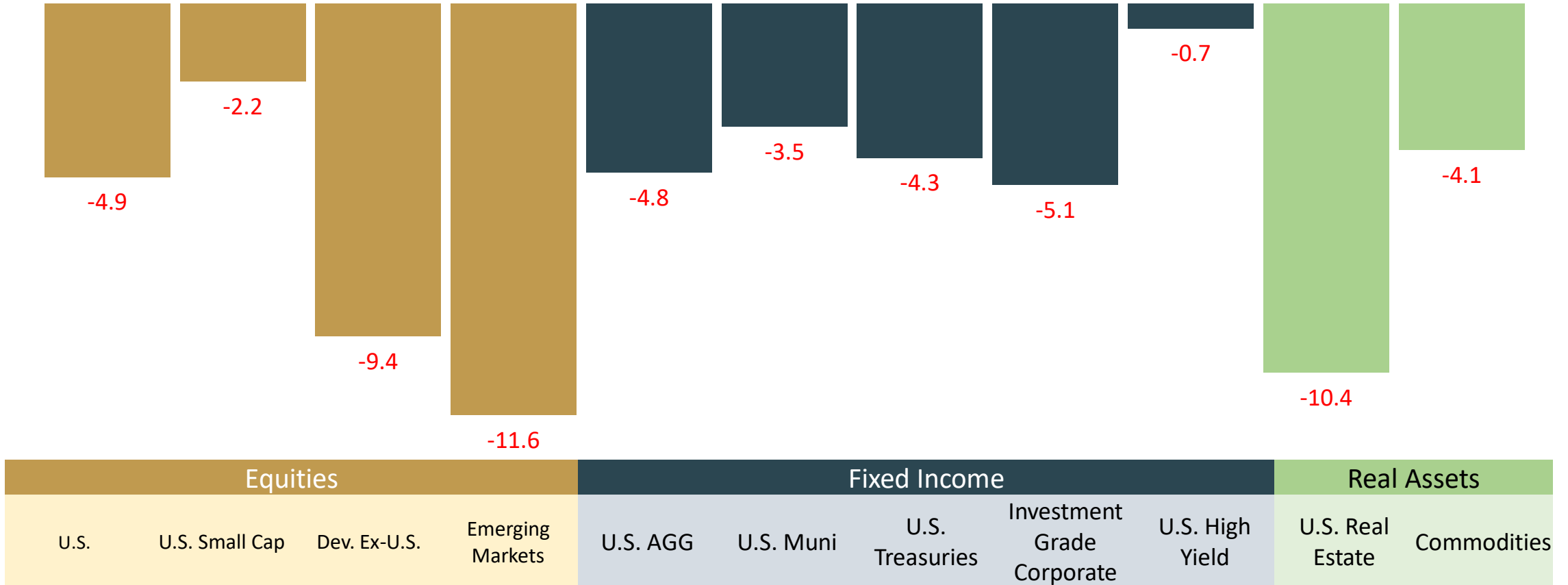
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Market Review

Q3 '22 Returns

For the third quarter in a row, stocks and bonds declined



Downshifting Picks Up Speed

September 2022

- Despite market hopes that the Federal Reserve would soon slow its tightening spree, the Fed accelerated interest rate hikes
- While consumer balance sheets remain strong and corporate earnings are still growing, leading indicators suggest significant economic slowing ahead
- Concerns around financial instability in the UK prompted the Bank of England to intervene in gilt markets
- With equity markets down more than 20% from their peak, much of the damage of this slowing has already occurred
- Any sign that inflation is slowing could prove to be a positive catalyst for markets



An aerial photograph of a city skyline, likely Minneapolis, Minnesota, featuring a river (the Mississippi River) with several bridges, lush green trees, and a dense cluster of modern high-rise buildings under a clear blue sky. The text "Economic Overview" is overlaid in white on the center of the image.

Economic Overview

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Economic Dashboard

After expanding 5.7% in 2021, the fastest pace since 1984, U.S. economic growth will likely substantially slow into 2023 as the economy adjusts to higher inflation and tighter monetary policy.

While many economic indicators remain healthy, the speed at which those indicators are decelerating will pose a challenge for both businesses and consumers.



Monetary Policy



The Federal Reserve is rapidly increasing interest rates to slow inflation and winding down its bond portfolio



Manufacturing



Manufacturing rates are in neutral territory but decelerating rapidly



Consumer



Consumers are spending down savings, yet balance sheets are healthy and confidence has rebounded



Housing



Housing inventory is climbing quickly, pressured by higher mortgage rates yet affordability is low



Labor

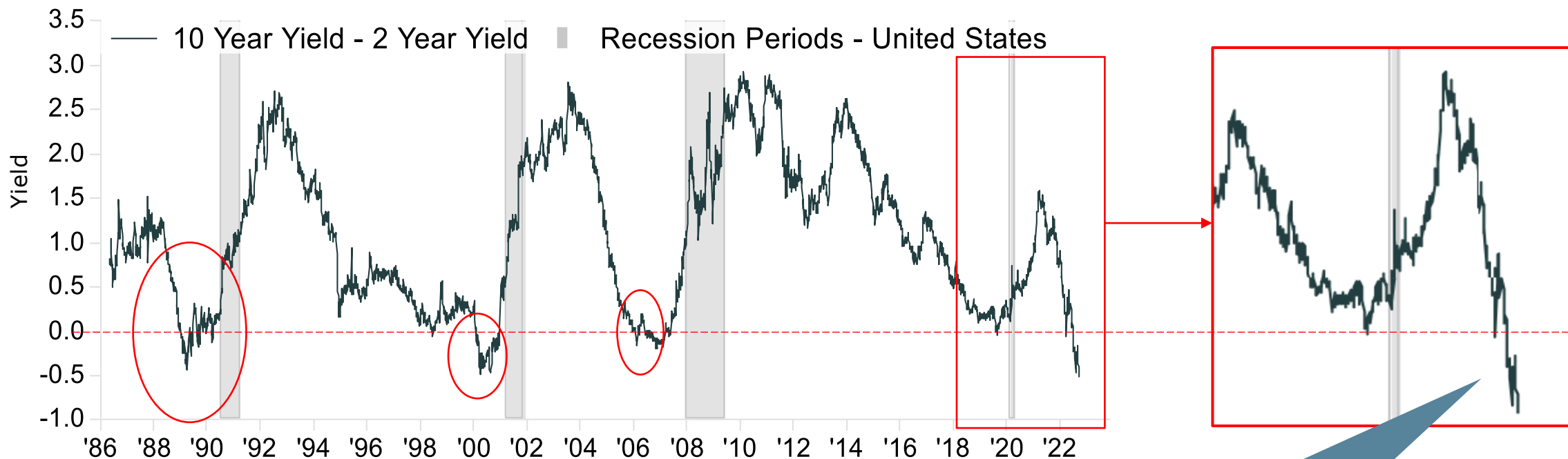


The labor market remains at its tightest levels in decades, though some signs suggest slower hiring ahead



Treasury Yield Curve Flashing a Warning Signal

Yields on the 10-year Treasury bond have dropped well below 2-year yields. In previous periods when this has happened, a recession has followed within 6 months to 2 years.

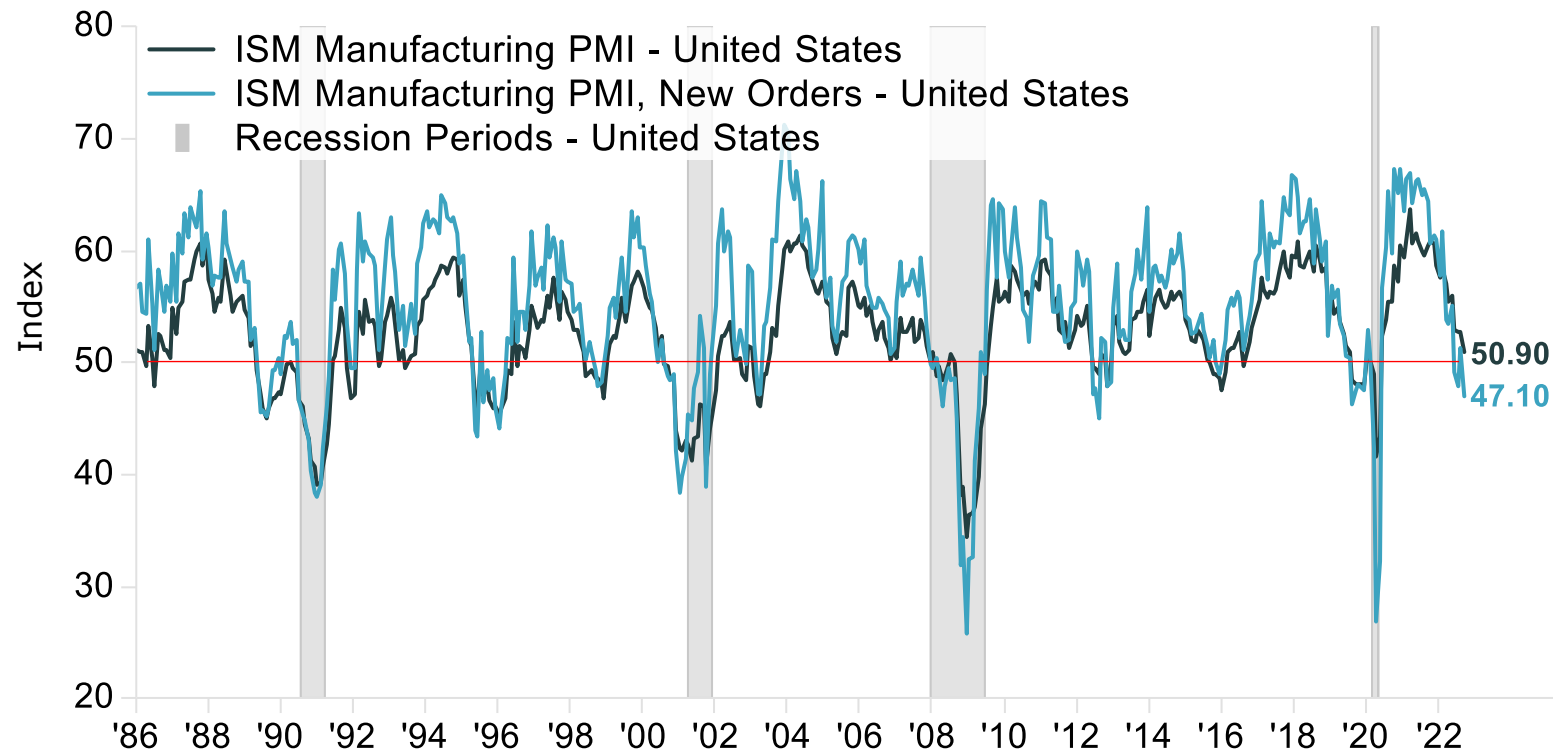


Yield curve has been inverted for over five months and is currently inverted by more than 40 basis points

Slowing Manufacturing Activity Points to Likely Recession

- ISM New Orders dropped below 50, suggesting that the headline index will soon drop below that level as well
- ISM Manufacturing below 47 has been consistent with a recession

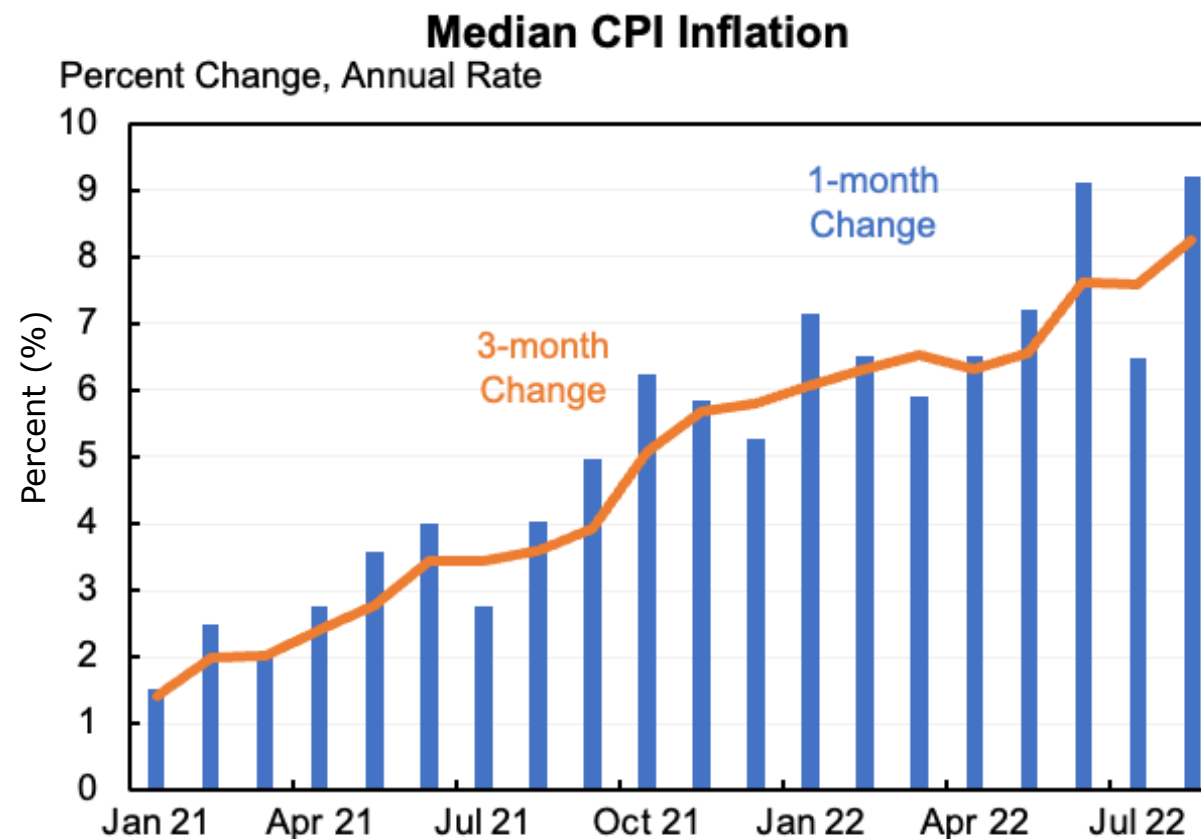
ISM Manufacturing PMI



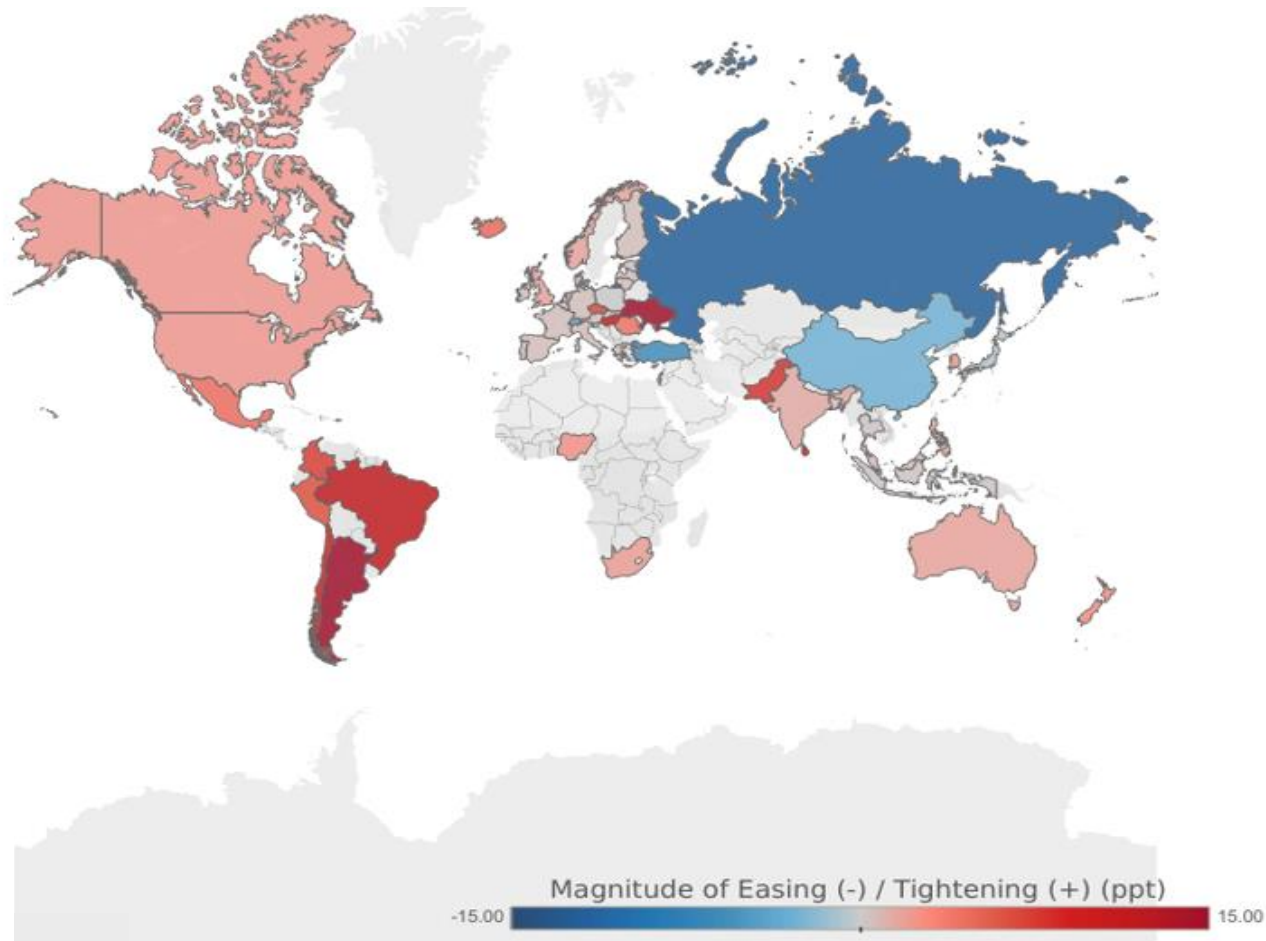


Inflation at New Highs

- Consumer prices are soaring by the fastest pace in over a decade
- The prices of various services such as medical care and transportation continue to climb at an alarming rate
- Goods prices are much more likely to be impacted by supply chain disruptions, which appear to be abating



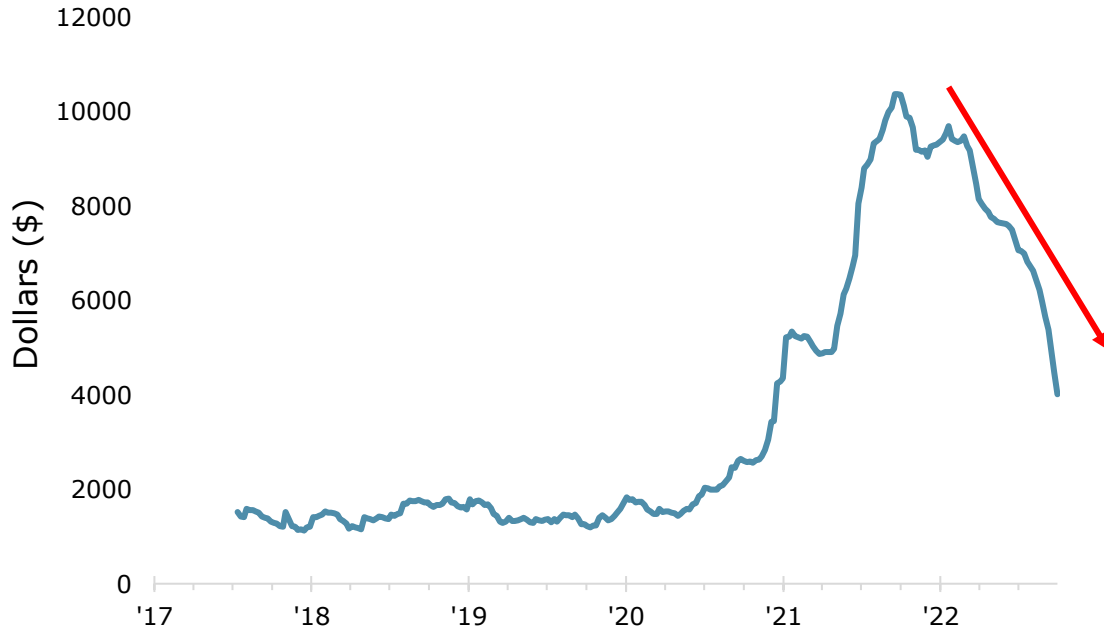
Central Bank Easing and Tightening Around the World



- A majority of economies around the world are hiking interest rates to combat inflation
- Russia and China are notable exceptions

Supply Chain Pressures Easing

Drewry World Container Index (\$/40ft)



In a sign that supply chain disruptions are easing, the cost of shipping containers of goods from overseas continues to decline. Given softening demand, this trend will likely accelerate.

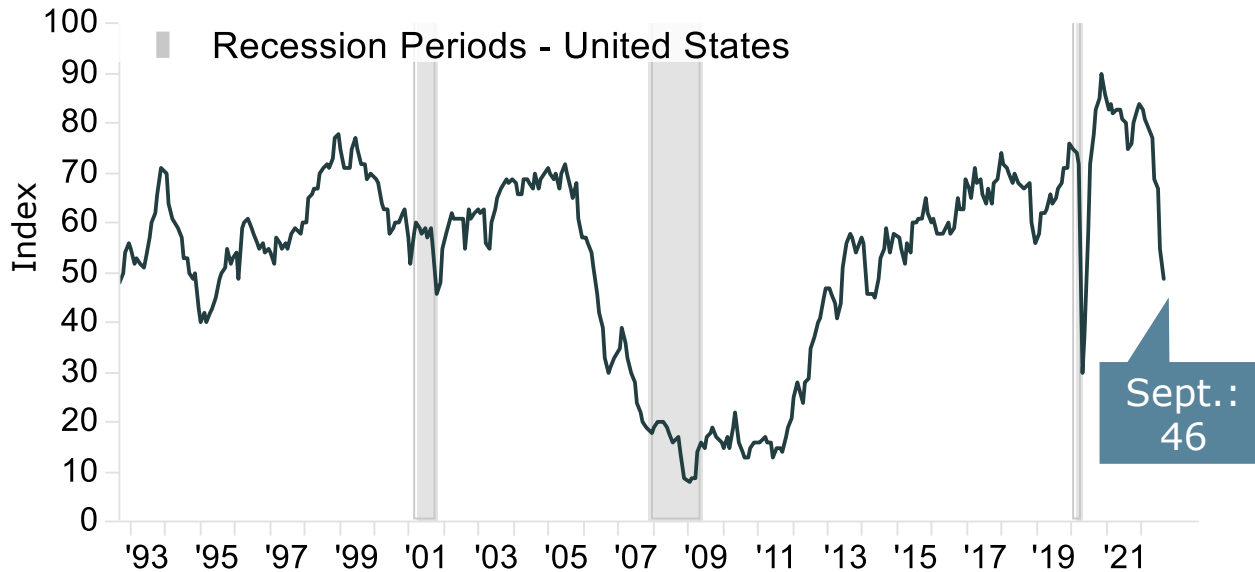
Used Car and Trucks 1-Year Percent Change



Autos were among the most negatively impacted goods during COVID-related supply chain disruptions. Price increases are now quickly subsiding as cars become more available.

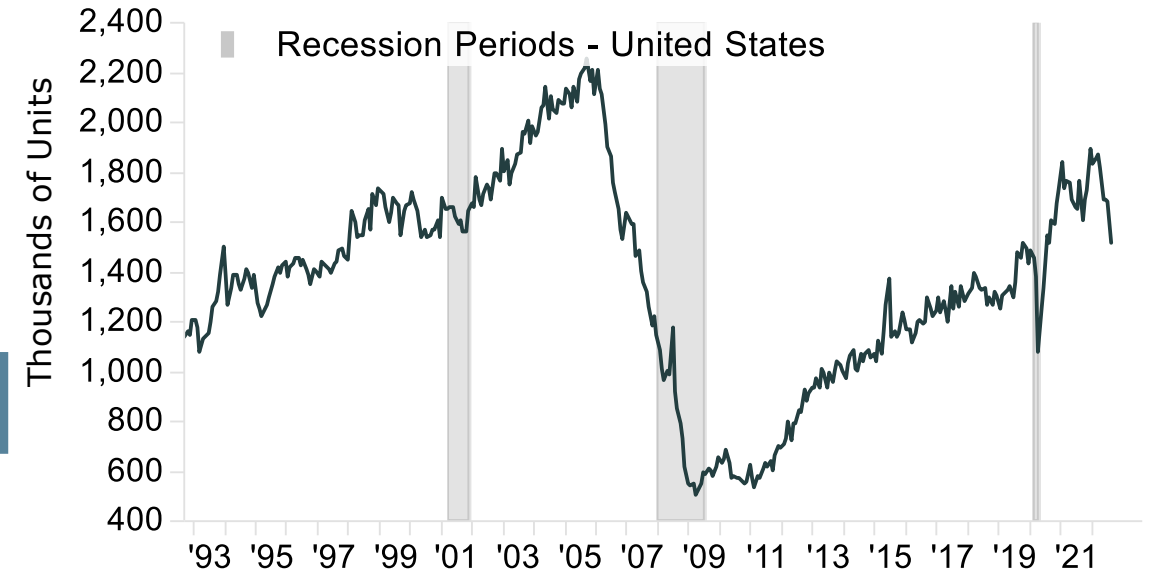
Housing Market Weakening

NAHB/ Wells Fargo Housing Market Index



Housing sentiment has dropped swiftly. Index numbers below 50 suggest declining activity.

Building Permits for New Private Housing Units

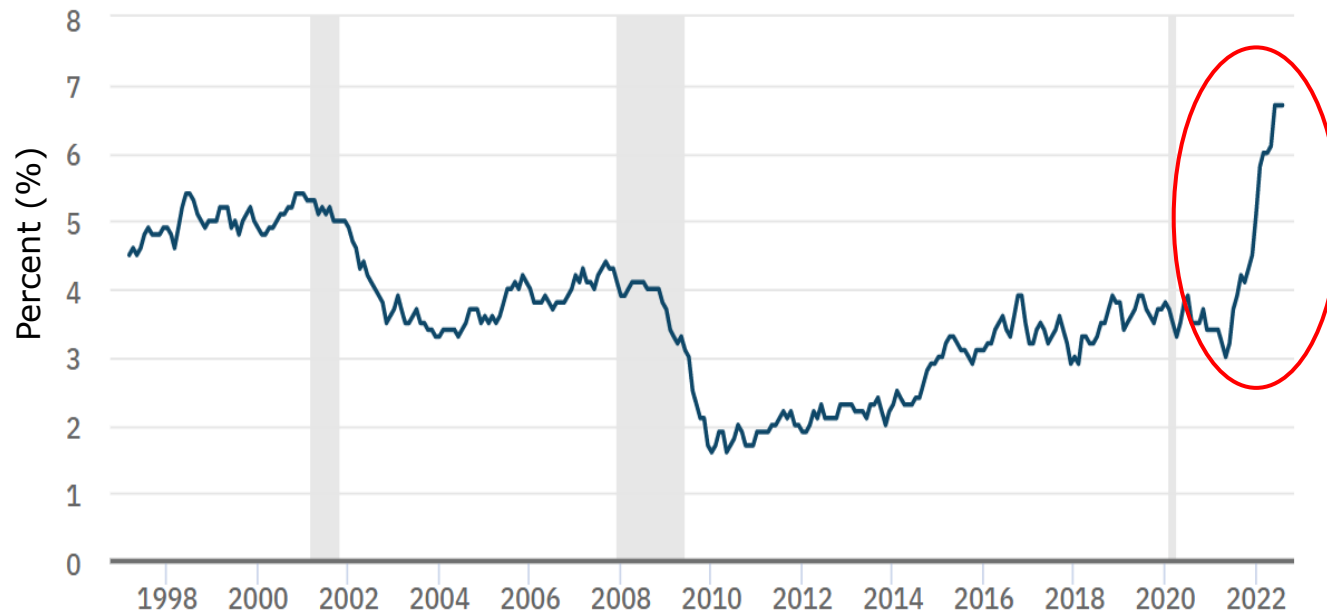


Builders slowing new activity and dropping prices

The Fed's Primary Remaining Challenge: Wage Gains

Wage Growth Tracker

Three-month moving average of median wage growth, hourly data



- The labor market remains very tight with employment costs rising
- The Fed will need to see wage gains meaningfully slow before declaring victory over inflation
- As high as wage gains have been, they have not kept up with price increases, hurting consumer purchasing power

An aerial photograph of a city skyline, likely Minneapolis, Minnesota, featuring a river (the Mississippi River) with several bridges, including the Hennepin Avenue Bridge and the Stone Arch Bridge. The skyline is composed of numerous high-rise buildings, some with glass facades reflecting the sky. The foreground shows green trees and a road with a few cars. The overall scene is captured in a slightly dim, dusk-like lighting.

Stocks and Bonds

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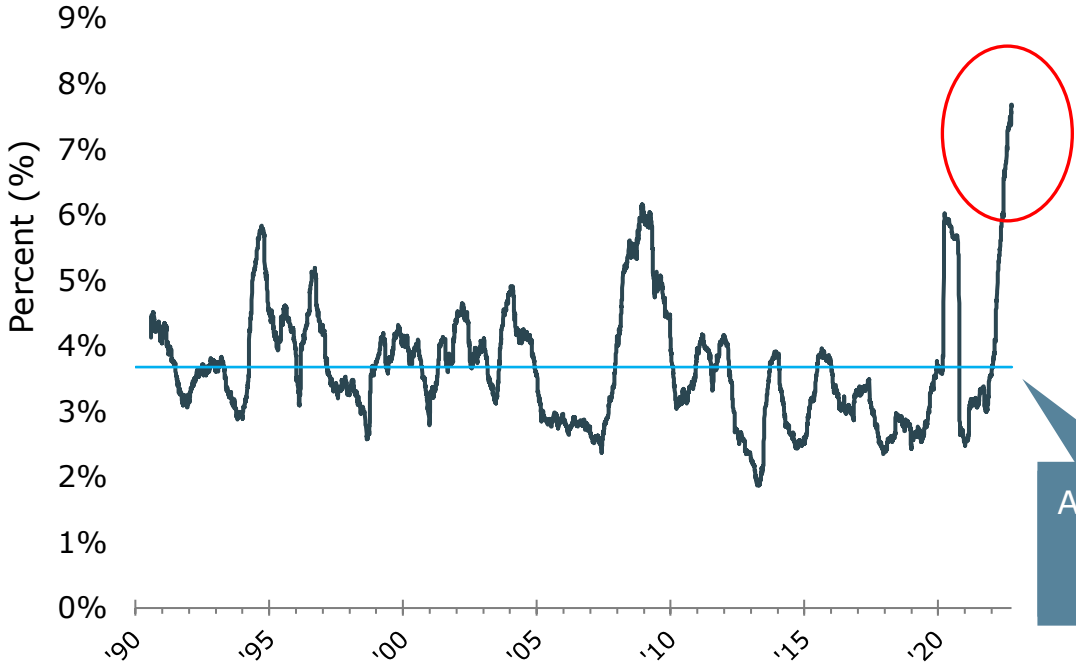
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B. Rich — HEDGEYE
With apologies to Bugs Bunny



Bond Volatility at Extremes

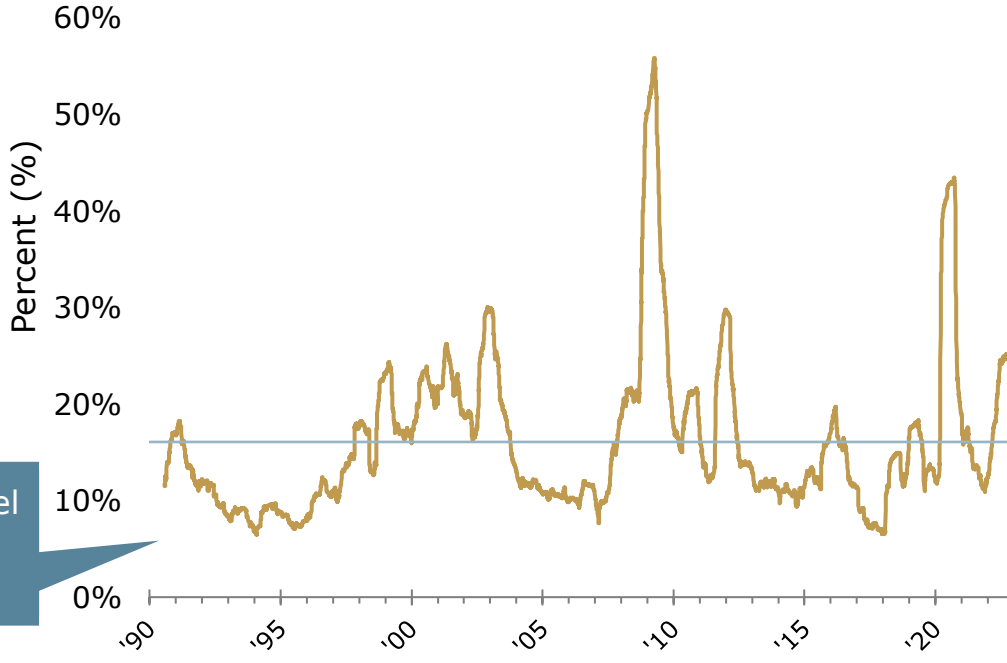
Bond Volatility: Bloomberg U.S. Aggregate



Average level of volatility from 1990

Bond volatility is at extremes relative to historical levels

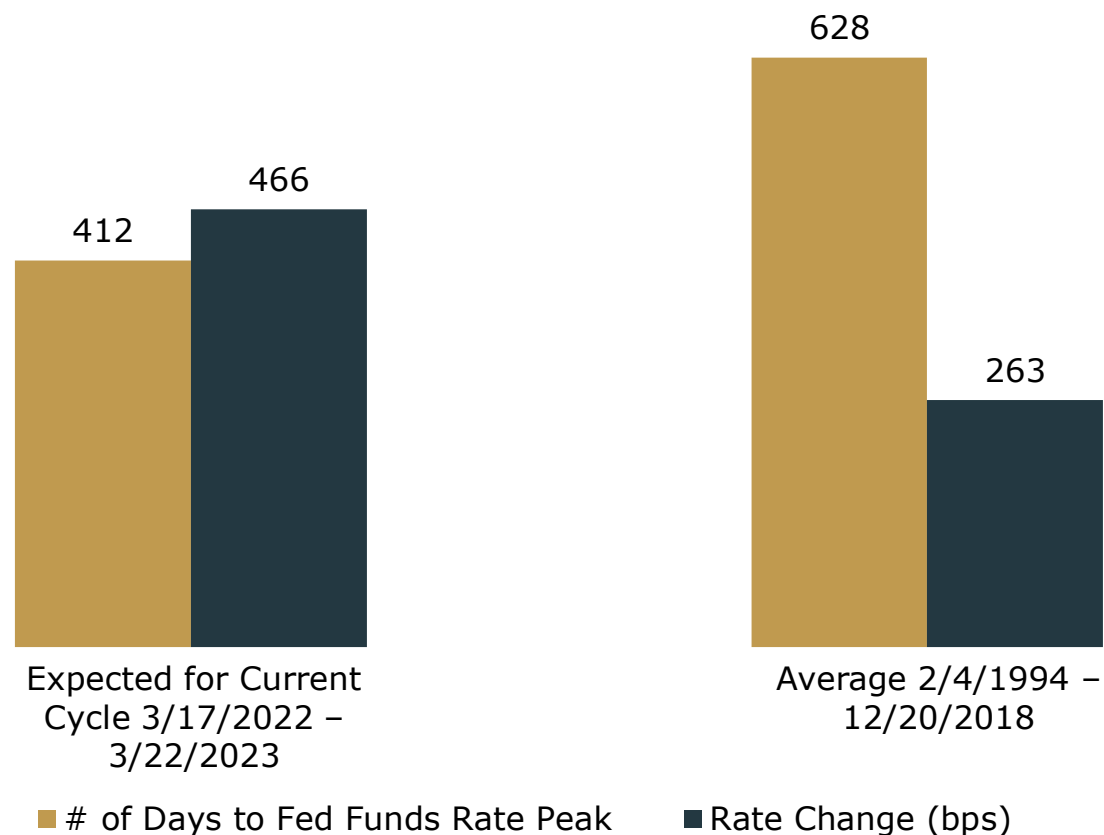
Stock Volatility: Russell 3000



Stock volatility, while high, is not at extreme levels

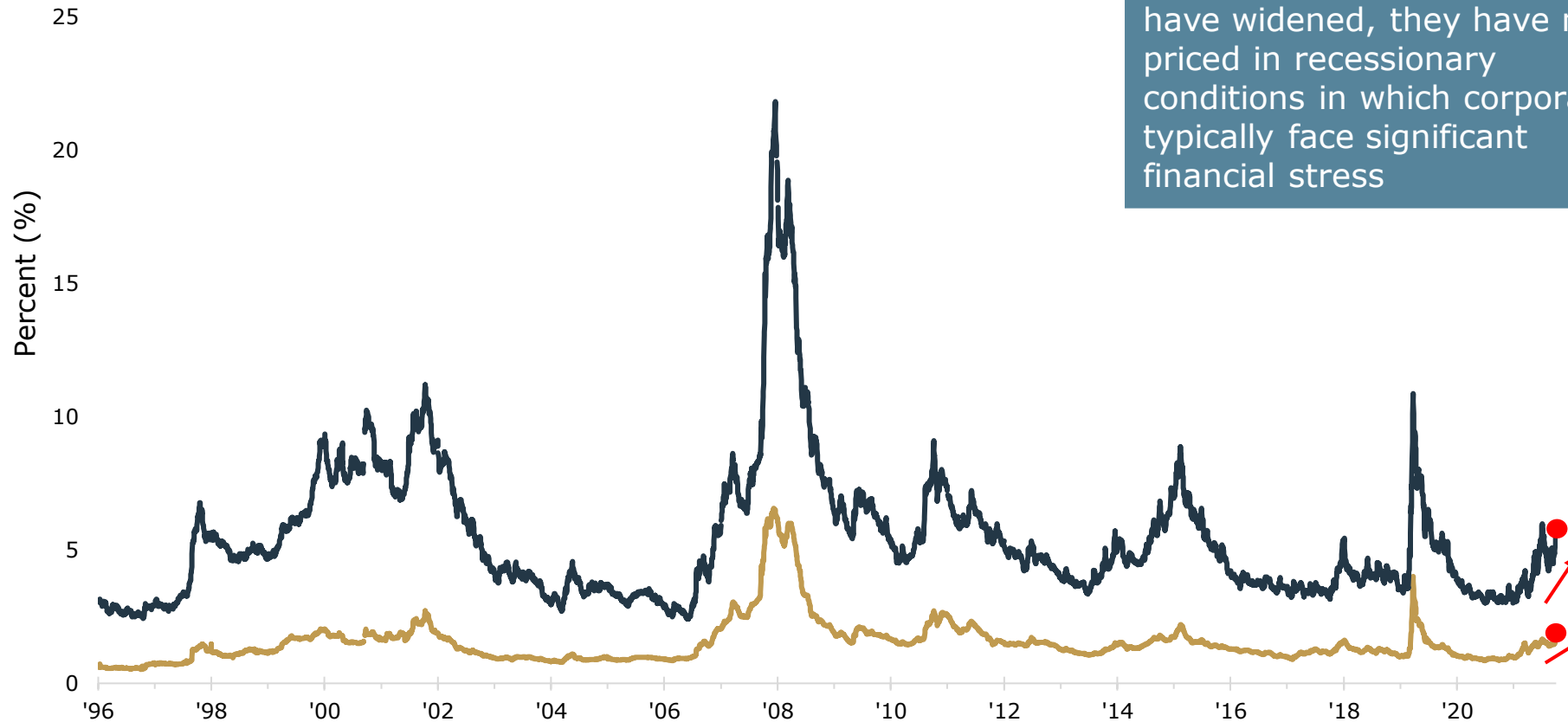
Fed Rate Hikes – Swift and Steep

- This rate tightening cycle is among the fastest and steepest that we have seen, forcing the market and the economy to digest an extraordinary amount of tightening in a very compressed time period
- Bonds prices largely reflect these higher interest rates



Spreads Widening

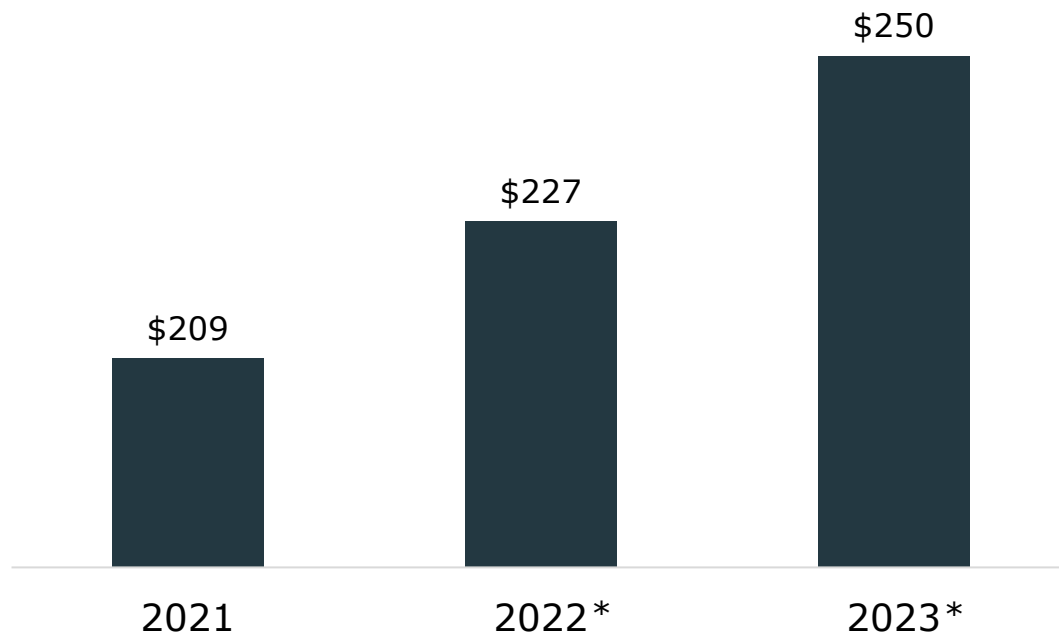
Corporate and High-Yield Bond Spreads



While corporate credit spreads have widened, they have not priced in recessionary conditions in which corporates typically face significant financial stress

Corporate Earnings Expectations Holding Steady

S&P 500 earnings per share, historical and forward estimates

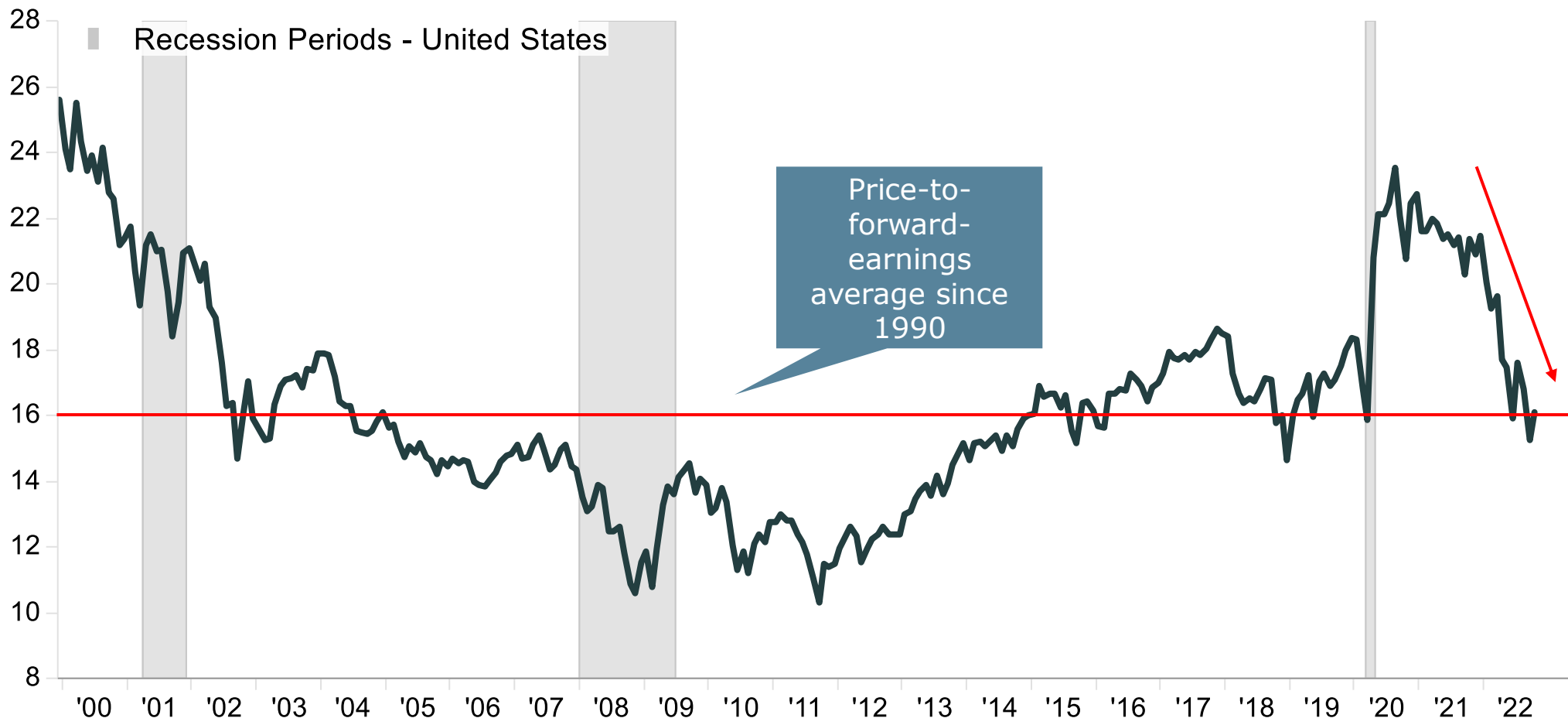


*Forward estimates

- Despite the negative headlines, earnings estimates have barely budged since the beginning of the year
- Current estimates represent 9% growth over 2021 earnings levels
- Given the tightening in business conditions, we expect earnings estimates to decline from here, especially for 2023

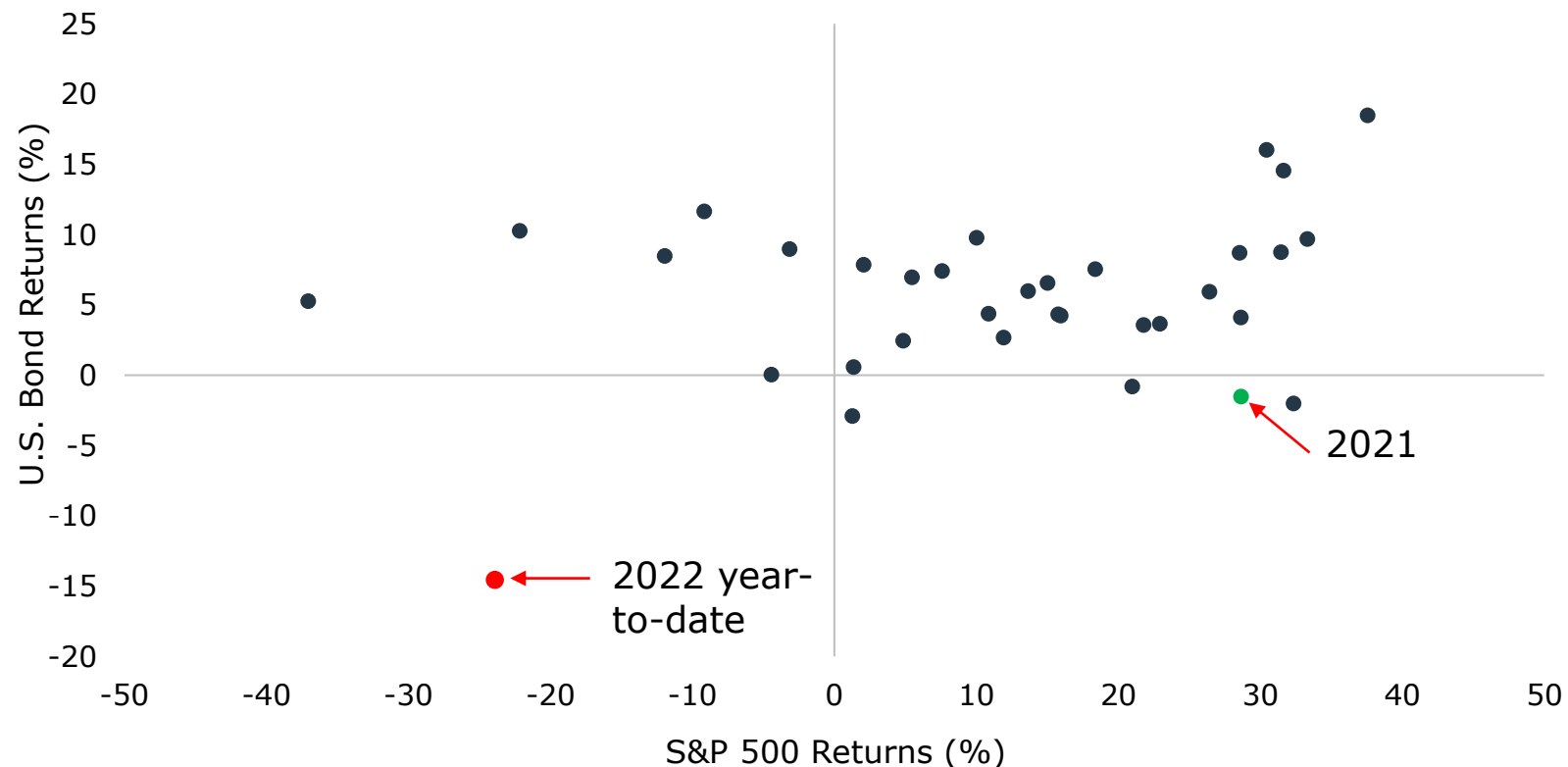
Valuations Have Backed Off Their Lofty Heights

S&P 500 Price to Forward Earnings (Next Twelve Months)



Tough Start to the Year Presents an Opportunity

S&P 500 vs U.S. Bloomberg Aggregate Bonds, annual returns, 1988-2022

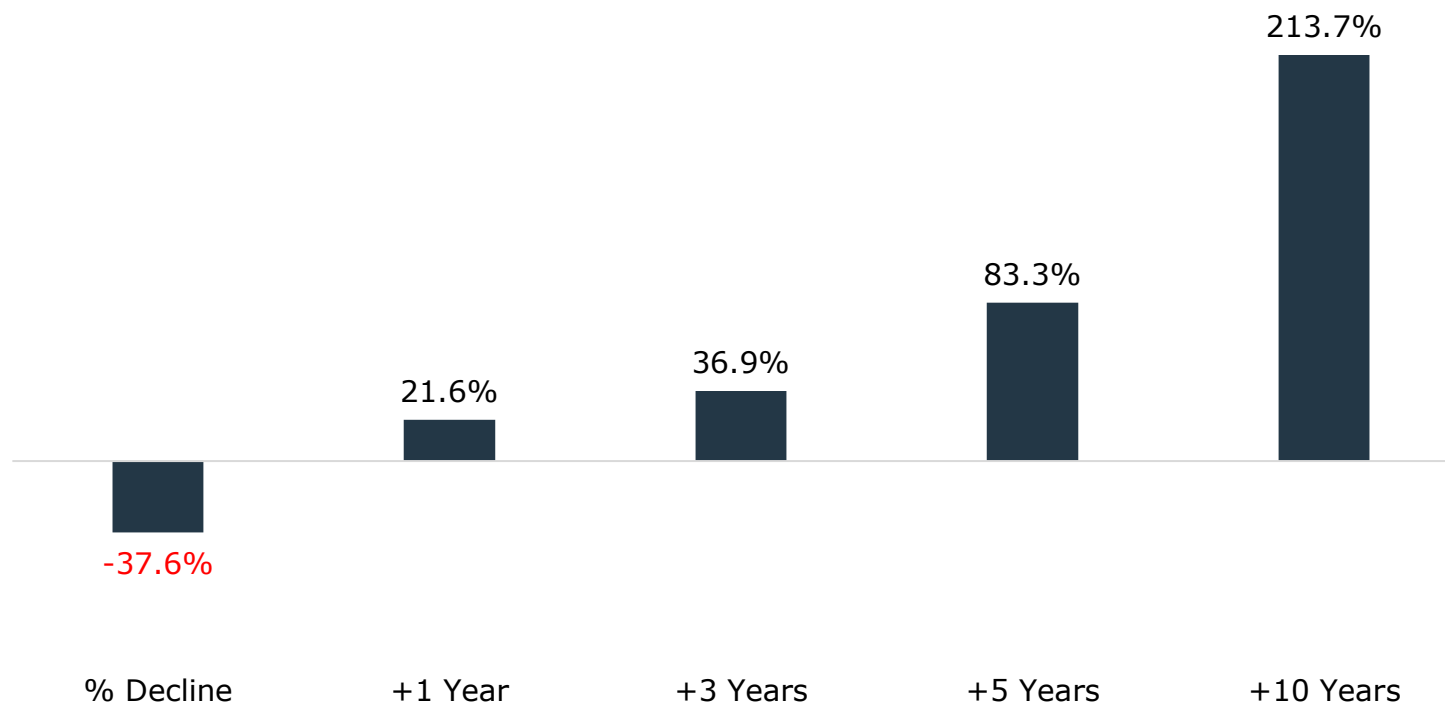


“In its brief 232 years of existence... there has been no incubator for unleashing human potential like America. Despite some severe interruptions, our country’s economic progress has been breathtaking. Our unwavering conclusion: Never bet against America.”

— Warren Buffet 2/7/21

Bears Are Followed by Bulls – for the Patient Investor

S&P 500 Returns After a Drop of 25% or More, Since 1950





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Live Richly**

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