THIRD QUARTER 2022 REVIEW & OUTLOOK
EXECUTIVE SUMMARY

October 12, 2022

PORTFOLIO THEMES

- We believe a new bull market appears close and the equities hit hardest during the downturn are likely to benefit most in the initial recovery.
- This bear market likely ends without broad capitulation and we expect solid returns moving into 2023 with existing fears already largely priced in.
- Inflation will remain elevated relative to recent history but should moderate going forward, easing pressures on central bankers to tighten excessively. Equities better suited to a slow growth, moderating inflation environment should benefit.

MARKET OUTLOOK

- **Global Markets Look Primed to Recover:** Global markets reflect well-known fears and the likelihood of severe economic problems above and beyond what is already priced in seems low. Meanwhile, positive economic factors continue to be largely ignored.
- **Dour Investor Sentiment Supports an Unexpected Recovery:** Depressed sentiment, driven by concerns on inflation, global monetary policy, China's lockdowns and a variety of other factors has significantly lowered investor expectations, allowing room for reality to exceed expectations, spurring a new bull market.
- **Global Markets Typically Reward US Political Gridlock:** The incumbent party routinely loses power during midterm years, reducing political uncertainty and the likelihood of extreme legislation. Increased gridlock is largely underappreciated by investors and likely acts as a tailwind for global markets going forward.

Q3 again tested investors' patience globally as a midyear rally gave way to new bear market lows late in September, leaving the MSCI ACWI Index down -25.6% year to date[i]. Emerging markets (EM) paralleled developed markets ending the quarter at new bear market lows. While we are disappointed we didn't forecast this period correctly and reposition portfolios for a down market, there are lessons to be learned from 2022 on inflation and more. However, looking forward is crucial now. Hard as it may be to fathom when equities are falling, bull markets always follow bear markets. We see many reasons to believe one is close and will bring a far brighter 2023.

While we do think fears over rising rates have hampered equities this year, the theory of a fundamental connection presumes equity returns and bond yield moves are meaningfully negatively correlated, which isn't accurate. Equities often move upward alongside high and rising rates. Take the 1970s, for instance—the last time inflation fears erupted. In the seven years 10-year Treasury yields' annual change was positive during this period, the S&P 500 fell in just one: 1976.[ii]

i Source: FactSet, as of 10/03/2022. MSCI ACWI Index return with net dividends, 12/31/2021 – 09/30/2022.

ii Source: Global Financial Data, Inc. and FactSet, as of 10/03/2022. 10-year Treasury yield and S&P 500 total return, 1970 – 1979.

Weak sentiment tied to ongoing fear of contraction in Europe due to energy shortages likely weighed on markets, too. We don't dismiss the possibility of continued shortages leading to severe energy rationing this winter, especially as Russia has been intermittently shutting off gas supply as likely retaliation for economic sanctions. However, shortage fears should alleviate as the EU continues curbing gas consumption, relies on higher-than-average inventory levels (presently over 80% of storage capacity), continues completing new European LNG infrastructure and gas pipeline projects (e.g. Baltic Pipe) faster than expected and increases LNG imports from big LNG-producing countries (e.g. Qatar, US). Overall, given the extremely dour expectations on this topic, combined with steps to mitigate and potentially add new supply faster, the risks skew towards upside surprise. Additionally, while EU energy prices have spiked, it does not mean it will have the same spillover effects globally.

In EM, large Asian constituents China, Taiwan and South Korea were hit particularly hard during the quarter on concerns over persistent COVID restrictions, geopolitical concerns and the strong US dollar. However, we believe sentiment particularly toward China is generally too negative and this EM bear market has already been uncommonly long. Economic fundamentals, while not stellar, do not indicate a hard landing is unfolding. Retail sales' sharp acceleration to 5.4% y/y in August may have stemmed primarily from the base effect, but the primary headwind remains the zero-COVID policy, which continues hampering activity.[iii] Meanwhile, growth in fixed asset investment has returned to its pre-COVID trend. Long-term corporate lending recently increased, likely tied to the government's steps to loosen credit to support infrastructure investment and small and mid-sized enterprises—a positive change from July. By now, President Xi Jinping's "common prosperity" and anti-corruption drives, which heightened investors' awareness of regulatory risk, are very well known and should fade into the long-term backdrop.

Latin America was relatively strong in Q3 on mixed economic drivers and hopes for less political uncertainty as we move toward 2023. Brazil's first round of their election was closer than many expected, but the late-October runoff will result in a winner mitigating political uncertainty, especially with Former President Lula expected to moderate further after failing to win an outright majority in October 2's first round.

We believe there are many underappreciated drivers that underpin the coming recovery. The US Midterm Miracle is one. From the beginning of reliable data in 1925, the three calendar quarters commencing with midterm years' fourth quarters are the most positive of any three sequential quarters in history tied to increased gridlock. S&P 500 returns in that nine-month span average 19.6% and are up 91.7% of the time since 1925.[iv] While this isn't perfect, it also isn't coincidence. Globally, markets are highly correlated to this. Better still, most people today can't fathom this potential—just as they couldn't heading into the third year of former President Donald Trump's term. Then, it seemed the Midterm Miracle wouldn't come, as investors reeled from a rough end to 2018, when equities flirted with a bear market at year's end. But markets soared in 2019, starting in the first half. Furthermore, when markets are down in the midterm year, a big third year is increasingly likely.

The Midterm Miracle isn't the only positive hiding in plain sight—falling political uncertainty globally, easing supply chain pressures, healthy bank lending and increasingly strong corporate profit margins despite elevated inflation are but a few notable positives. We aren't dismissive of existing negatives, but we believe markets are effectively discounting known concerns and largely ignoring positive drivers.

iii Source: FactSet, as of 09/30/2022.

iv Source: Global Financial Data, Inc., as of 09/28/2022. Average S&P 500 total return and frequency of gains from September 30 of midterm years through June 30 of the following, 1926 – 2021.

Whenever times are bad, investors seemingly forget how quickly—and how high—equities can rebound. It happened in 2020, when the MSCI ACWI Index jumped 70.5% between late March's pandemic low and that yearend.[v] We believe many investors are forgetting the strength of market recoveries now, manifesting in a sentiment phenomenon called the "pessimism of disbelief." Headlines emphasize bad news and either ignore positives or position them as problems-in-waiting, mostly centering on inflation, the Fed and recession risk. When inflation began slowing, headlines warned the real problem wasn't consumer prices, but that inflation wasn't slowing enough to prevent draconian rate hikes that would sink the world's economy. In the UK today, pundits warn the problem isn't high energy prices, but that the government's response will crash the pound and import runaway inflation. Much of this is circular, but when markets are reeling and emotions are elevated, illogic can be hard for many to spot. The full Review will elaborate on these and many other issues we think the world sees wrong now.

By almost any measure, sentiment is depressed, which lowers expectations and is foundational to new bull markets. Some point to the broad lack of capitulation—violent selling amid strong outflows from equities and low overall liquidity—and claim this indicates much more downside ahead. But capitulation doesn't always define bear market lows, as 1966 and 1982's lows demonstrate. Today, we think that hunt for capitulation is a sign of investors' deep pessimism—one that doesn't acknowledge today's specifics. Selling out of equities is only one side of a trade. Broadly speaking, there is nowhere valid for pessimistic folks to go. Typically capitulation is cascading panic selling that shifts money from equities to perceived "safe havens." None of the standard safe havens look viable now. Not with bonds and gold down too, crypto crashing, inflation eroding cash, the dollar at generational highs and high mortgage rates shaking real estate. That is the bad news. The good news: When investors are this dour, reality needn't be anywhere near perfect to deliver positive surprise.

While the global economy isn't problem-free, it is holding up better than most coverage implies. We realize that the strength of the economy has become a political talking point, and our aim in pointing out the global economy's resilience isn't at all political: Rather, equities move on the gap between expectations and reality. That gap is big now. Existing fears aren't anything equities haven't already confronted—and priced in to a large degree. Meanwhile, positive developments go unheralded. While we don't know exactly when, we believe markets will shift positively as we move through Q4 and into 2023. We are looking to that period now and putting every effort into positioning portfolios for it.

v Source: FactSet, as of 09/30/2022. MSCI ACWI Index return with net dividends, 03/23/2020 – 12/31/2020.

Should you have any questions about any of the information in the Third Quarter 2022 Review and Outlook, please contact us at (800) 851-8845 or FisherInstitutional@fi.com.

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