# The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets October 2022



From: *Philadelphia* Investment Management Group


## OVERVIEW

- ***The Federal Reserve is "Behind the Eight Ball" in Bringing Inflation Under Control.*** *Its policies have to reduce inflation without causing a recession, and this is a tall order.*

- ***A Surging U.S. Dollar From the Rise in Interest Rates is Driving Other Countries' Currencies Lower, Compounding Their Fight to Rein in Inflation and Ward Off Recession.*** *The cost of imports and servicing dollar-denominated debt are just two examples of the impact the strong dollar has on other countries' economies.*

- ***The War in Ukraine Continues to Pose a Risk to the Global Supply of Food and Oil.*** *Also, some industries, including automobiles, remain severely disrupted with a lack of needed supplies for their business.*

## THE ECONOMY

Central banks around the world are raising their key interest rates in the most widespread tightening of monetary policy on record. And there are few signs that central bankers are going to pause and take stock of the impact of their rate increases to date on the world economy. The concern is that these rate increases will push the world economy into a downturn that is deeper than necessary.

Rumors of looming recession are everywhere, but the Fed still has inflation not falling rapidly until 2023 and unemployment rising only modestly to a high of 4.4%. That is about as soft a landing as could be expected, and that is also counting on no financial surprises along the way. Chairman Powell continues to reiterate that the failure to restore price stability will foster much greater pain than higher interest rates, slower growth and softer labor market conditions.

While the economy in the U.S. has been weathering the effects of rising interest rates, a strong dollar and a slowing global economy remarkedly well, this most likely cannot continue for all U.S. manufacturing. The rise in U.S. dollar strength is making it harder for U.S.-based manufacturers to compete on price, at home and abroad, with their overseas counterparts. Worse, the dollar's strength stems, in large part, from an atrocious economic outlook overseas. While the news of U.S. factories may not be uniformly bad and be able to continue to do well, thus giving the Federal Reserve the flexibility to raise rates, the extent of the rises needs to be carefully reviewed as they affect our entire economic and business outlook.

These rate increases are already slowing demand in interest rate-sensitive sectors, such as housing, but it will take time for the full effect of the increases to work through the economy and lower inflation. A sharp drop in vacancies in the labor market with a corresponding increase in unemployment, hopefully, will alert the Fed that a soft landing is in sight in the economy.

## FINANCIAL MARKETS

### EQUITIES

All four major stock indices posted negative returns for the third quarter. After reversing gains from July and the first half of August, the S&P 500 closed out the quarter down 4.88%, bringing its year-to-date decline to 23.87%. Volatility remains at a very high level and investors are confused as to just how far the Fed will go to lower inflation. Majority opinions expect two additional rate increases in the final quarter of 2022.

| | Equity Returns* | | | |
|---|---|---|---|---|
| **Index** | **3rd Qtr** | **2nd Qtr** | **1st Qtr** | **YTD** |
| S&P 500 | -4.88% | -16.10% | -4.60% | -23.87% |
| Dow | -6.17% | -10.78% | -4.10% | -19.72% |
| NASDAQ | -4.11% | -22.44% | -9.10% | -32.40% |
| Russell 2000 | -2.19% | -17.20% | -7.53% | -25.10% |

*Total: price change + reinvested dividends

As we review the performance of the various popular indices, one point sticks out in the third quarter results. The Russell 2000 index of smaller capitalization companies had a negative 2.19% return for the quarter versus -4.88% and -6.17% for the S&P 500 and Dow Jones, respectively. This tells us, with smaller companies primarily in business in the U.S., that the multinational large companies are being penalized with the poor economies in Europe and around the world. Our strong dollar makes it very expensive for foreigners to purchase U.S. goods.

| Sector | Weight | Returns* 3rd Qtr | 2nd Qtr | 1st Qtr | YTD |
|---|---|---|---|---|---|
| • Energy | 4.5% | 2.35% | -5.17% | 39.03% | 34.94% |
| • Materials | 2.5% | -7.13% | -15.90% | -2.37% | -23.74% |
| • Industrials | 7.9% | -4.72% | -14.78% | -2.36% | -20.72% |
| • Cons. Discretionary | 11.7% | 4.36% | -26.16% | -9.03% | -29.89% |
| • Consumer Staples | 6.9% | -6.62% | -4.62% | -1.01% | -11.83% |
| • Health Care | 15.1% | -5.18% | -5.91% | -2.58% | -13.08% |
| • Financials | 11.0% | -3.10% | -17.50% | -1.48% | -21.25% |
| • Info Technology | 26.4% | -6.21% | -20.24% | -8.36% | -31.44% |
| • Commun. Svcs | 8.1% | -12.72% | -20.71% | -11.92% | -39.04% |
| • Utilities | 3.1% | -5.99% | -5.09% | 4.77% | -6.51% |
| • Real Estate | 2.8% | -11.03% | -14.72% | -6.22% | -28.85% |

**S&P 500**

09/30/22
*Price + income
Source: S&P Dow Jones

The sector weights of the S&P 500 for the third quarter were very similar to those posted at the end of the second quarter. On a sector level, just two of the eleven S&P sectors finished the third quarter with positive returns. Consumer Discretionary posted a positive return thanks to strong consumer spending and still low unemployment. The Energy sector finished with a small gain, with energy stocks benefiting from solid earnings and strength in natural gas prices. More broadly, traditionally defensive sectors relatively outperformed over the past three months. It appears that investors are positioning for slower future economic growth.

Again, as in the second quarter analysis of sector weights, there is very little change in investors' attitudes as to the state of our economy. Demand/supply constraints, an unusual strength in the U.S. dollar, war in Ukraine affecting food and energy worldwide, all these issues plus others continue to exert confusion on our securities markets.

# FIXED INCOME

Bonds are having their worst year in modern history as the Corporate/Government Bond Index fell 15.22% for the year to date through September 30th, as shown in the chart below. The yield on the two-year U.S. Treasury ended the quarter at 4.28%, the highest it has been since October 2007. The yield curve is now significantly inverted, marking a commonly cited indicator of impending recession. This is the most inversion the bond market has been since 2000.

**Fixed Income Returns**

| Index | 3rd Qtr | 2nd Qtr | 1st Qtr | YTD |
|---|---|---|---|---|
| Corporate/Govt. | -4.78% | -4.84% | -6.43% | -15.22% |
| Int. Corporate/Govt | -3.16% | -2.28% | -4.58% | -9.70% |
| Long Corporate/Govt | -9.35% | -11.48% | -10.92% | -28.52% |
| **U.S. Treasury** | -4.72% | -3.85% | -5.56% | -13.48% |
| - Intermediate | -3.17% | -1.59% | -4.02% | -8.54% |
| - Long | -9.89% | -10.93% | -10.14% | -27.88% |
| **Corporate** | -5.11% | -6.71% | -7.74% | -18.33% |
| - Intermediate | -3.23% | -3.75% | -5.53% | -12.01% |
| - Long | -8.99% | -12.19% | -11.51% | -29.29% |
| - Quality | | | | |
| - AAA | -6.69% | -7.35% | -8.49% | -20.89% |
| - AA | -5.56% | -6.36% | -7.50% | -18.19% |
| - A | -5.16% | -6.01% | -7.18% | -17.26% |
| - BBB | -4.95% | -7.32% | -8.21% | -19.14% |
| **Municipal** | -3.62% | -3.30% | -6.18% | -12.56% |
| - Intermediate | -2.22% | -0.75% | -4.44% | -7.25% |
| - Long | -4.65% | -5.16% | -7.45% | -16.30% |

Source: ICE BofA

Treasury yields reached new highs in September, capping a difficult quarter for bonds. The 10-year Treasury set a new year-to-date closing high at 3.95% on September 27th. Corporate spreads widened on heightened volatility. Investment grade bonds rose as a result of fears of a slowing economy. Agency residential mortgage-backed securities experienced heavy volatility with spreads widening in part due to reduced demand from the Fed and banks.

The inverted yield curve, with shorter maturing bonds yielding more than longer maturities, will remain in place as long as there is a recession fear and confusion as to the intermediate term outlook for the economy.

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In summary, economists remain hopeful that healing supply chains, a slowing housing market, cooling consumer demand and a moderating labor market will combine to pull inflation lower in the months ahead. In August, as reported in September, spending on goods fell for the second month, easing pressure on factories. Overall spending may slow, as well, as consumers draw down the extra savings built up during the pandemic. Nevertheless, the Fed will continue to raise rates, not wanting to make a mistake by curtailing these increases too soon. The central bankers do not want to see any inflation embedded in our economy.

While the above remarks are hopeful for the economy, there remains a serious question as to the length of time required to return to the desired two percent inflation rate. In the present environment, our recommendation, as in previous quarters, is to maintain a well-diversified portfolio of high-quality companies with fixed income securities in the short-to-medium maturity range.

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