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WEALTH ADVISORS

Redhawk Quarterly Commentary

September 30, 2022

Each quarter, Redhawk's Investment Committee provides a Quarterly Commentary. We look at what is going on in the investment landscape and provide our perspective on a variety of topics. These are not predictions, and it represents our perspective on important market and economic information designed to help make decisions affecting your long-term financial strategy. Our goal is to help you understand what is going on in the markets so you can more clearly define investment goals, diagnose unintended risks, and utilize portfolios that can achieve a better financial outcome.

Market Commentary

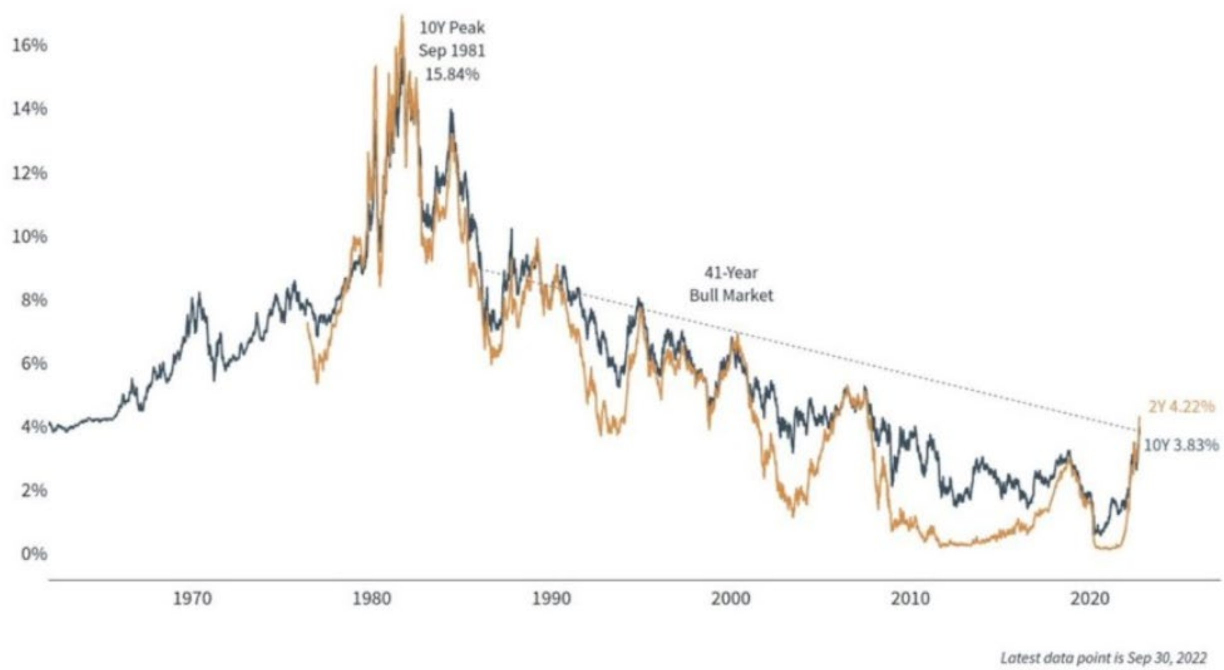
Stocks came under pressure during the third quarter as tighter financial conditions, which were driven by more aggressive rate hiking policies, weighed on market sentiment. The S&P 500 fell -4.9% during the quarter. There was some divergence in performance, as growth stocks (-3.8%) performed better than value stocks (-5.7%) and small cap stocks (-2.6%) performed better than the broad market. Notwithstanding, there was significant divergence in asset class performance to begin this year, as value stocks outperformed growth stocks by 18.5% through the end of Q3[1].

The dominant theme throughout the third quarter was a focus on more aggressive monetary policies, both domestically with the Fed and across all major global central banks. Fed officials increasingly focused on raising rates throughout the quarter as it became apparent that near-term inflation was likely to stay higher than previously anticipated. The Fed raised the fed funds rate by 0.75% at its September Federal Open Market Committee ("FOMC") meeting and raised its forecasts for future fed funds rate increases, another 0.75% hike in November followed by a 0.50% hike in December.

Fed Chair Powell struck a hawkish tone, noting that combating inflation may require a sustained period of below-trend economic growth. The still extraordinarily strong labor market also played into the tighter policy narrative, with Fed Chair Powell noting the labor market had shown only modest evidence of cooling off.

Bond yields rose through the third quarter on the back of tighter monetary policy, and bond prices consequently came under pressure. The yield curve inverted, as measured by the difference between 2-year and 10-year treasuries, with shorter-dated bond maturities having a higher yield than longer-dated maturities. The 10-year U.S. Treasury yield moved higher, from 3.0% to end the third quarter at 3.8%. At the same time, the two-year Treasury yield rose 1.3% and finished the quarter at 4.2%, bringing the widely followed 2-year / 10-year yield differential into inversion (see the chart below).

10-year and 2-year yields since 1960



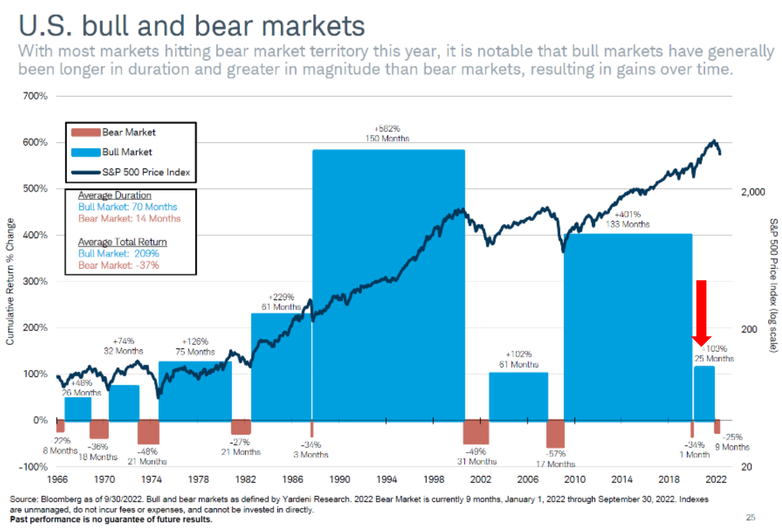
Geopolitical tensions remained elevated as Russia continued to weaponize energy flows, annexed four Ukrainian regions and ratcheted up its nuclear warnings. At the same time, the messaging between the U.S. and China over Taiwan continued to escalate. Negative seasonality was also highlighted, with September historically a weaker month for the stock market, and company sponsored buyback activity slowed down. While stable demand was a broad theme across industries and sectors, there was some focus on elevated recession concerns as well as caution around margin pressures, as some high-profile companies announced plans to scale back hiring or announced layoffs.

U.S. Market

The third quarter was a continuation of challenges from the previous two quarters. Two of the assets most used to hedge equities, bonds and gold, both performed poorly as rising rates harmed bonds at the same time as stocks. The shifting perception of the Fed as an inflation fighter at all costs weighed on gold. While cash was a haven, its appeal was dampened by rising rates. In the long run, the loss of purchasing power was an important risk to guard against, since lost purchasing power can often be permanent, while stock market losses are often temporary[2].

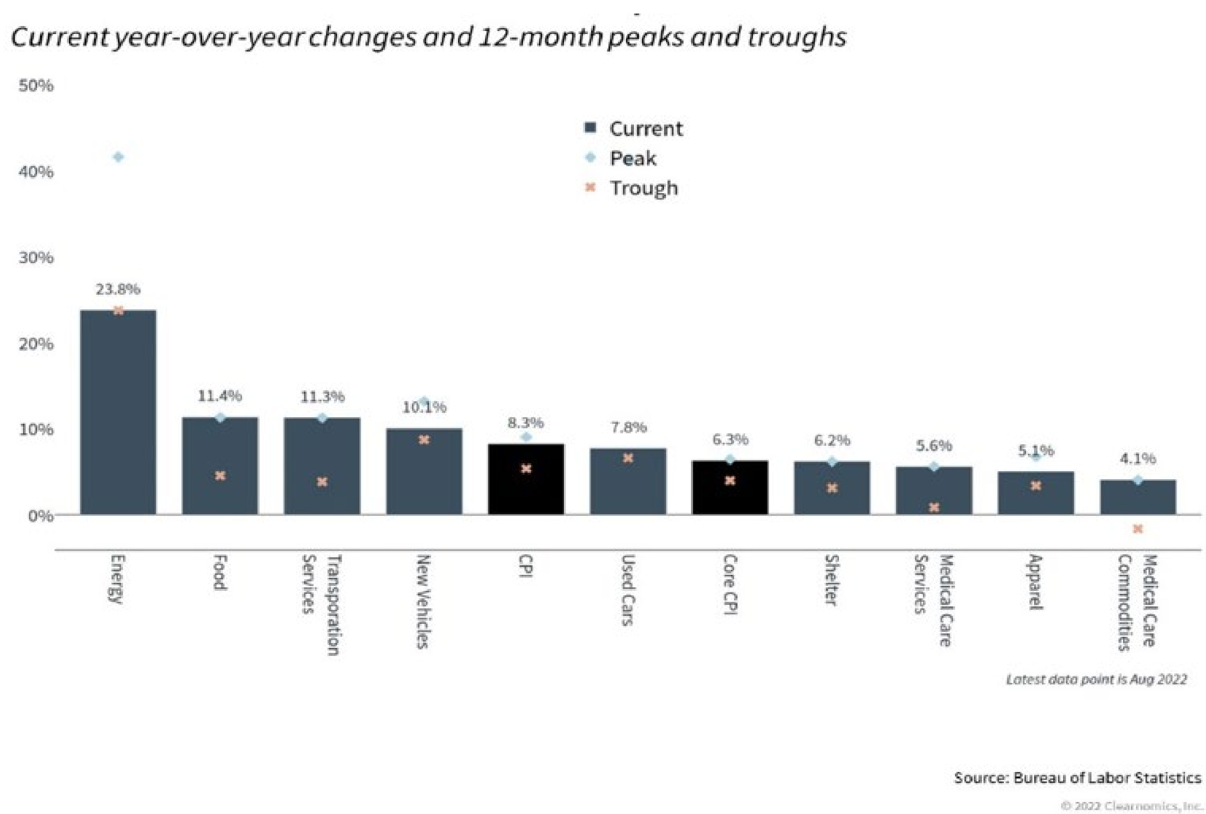
Markets rallied beginning in June but abruptly reversed course in late August. The turn in the market coincided with Fed Chair Powell's speech at Jackson Hole during which he emphasized that the Fed would continue to fight inflation by keeping interest rates higher for longer. This message was then reiterated at the Fed's September meeting with the third 0.75% hike in a row and higher projections through 2023. This jump in both policy and market rates broke a 40-year pattern of declining interest rates. It is no wonder that financial markets have been volatile as they adjusted to a higher cost of capital and slower economic growth. Regardless, both history and the summer period showed that markets can move forward[3].

While the first three quarters of this year have experienced poor returns, it is important to maintain perspective on the past few years. Last year experienced some of the best returns as the world emerged from the pandemic. In all, markets are still quite positive since 2020 and the S&P 500 has gained 103% over 25 months since the COVID-19 recession (see red arrow in the chart on the right).



The increase in inflation was driven primarily by supply chain bottlenecks, surging energy prices, strong consumer demand caused by a solid labor market, and massive amounts of stimulus. Although several readings have decelerated from peak levels, inflation is still extremely high. During the third quarter, there was some moderation in energy and new vehicles. However, higher prices were experienced by food, transportation, and shelter.

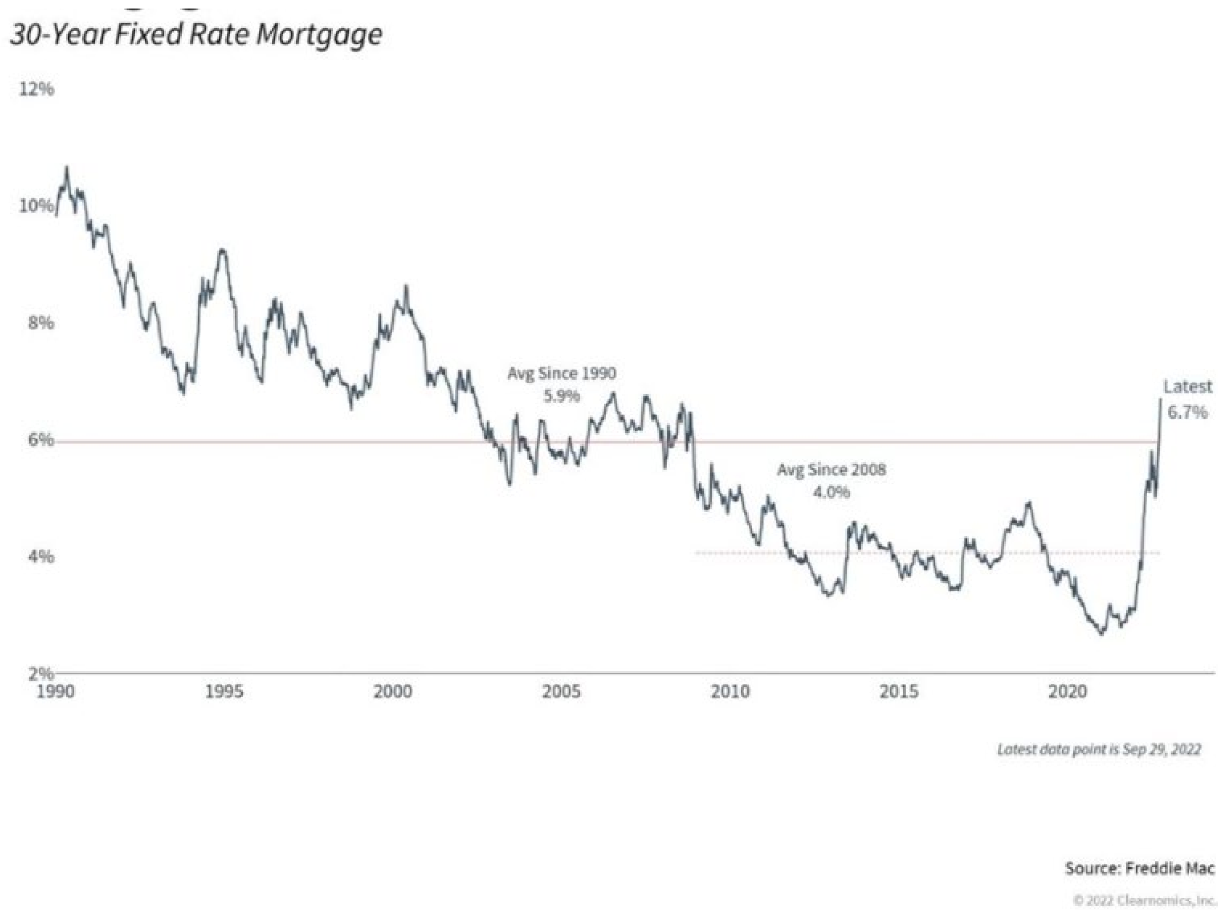
Energy prices plummeted throughout the third quarter, reversing much of the effect of Russia's invasion of Ukraine on oil and gas markets. This helped to bring gasoline prices down, although they are still higher than during any other period over the past decade. Headline inflation, which includes food and energy, eased as a result (see the chart below).



The Fed communicated that it would keep interest rates higher for longer. This increased investor concerns over whether the Fed can bring down inflation without creating a deep recession, or a "soft landing" versus a "hard landing." This is a difficult balancing act for the Fed as they try to achieve their dual mandate of both price stability and maximum employment. The markets continued to adjust to these new expectations, sometimes in a very volatile manner during the quarter.

During the third quarter, the housing market deteriorated for multiple reasons. The primary reason was that mortgage rates shot up to 6.7% (see the chart below). Housing prices also drifted lower but are still historically high with a third quarter median sales price of $454,900, which is up 38.3% from the first quarter of 2020 figure of $329,000, according to data from the

Census Bureau and Department of Housing and Urban Development. With high mortgage rates and historically high home prices, a down payment has become increasingly more difficult to pull together for would-be homeowners.

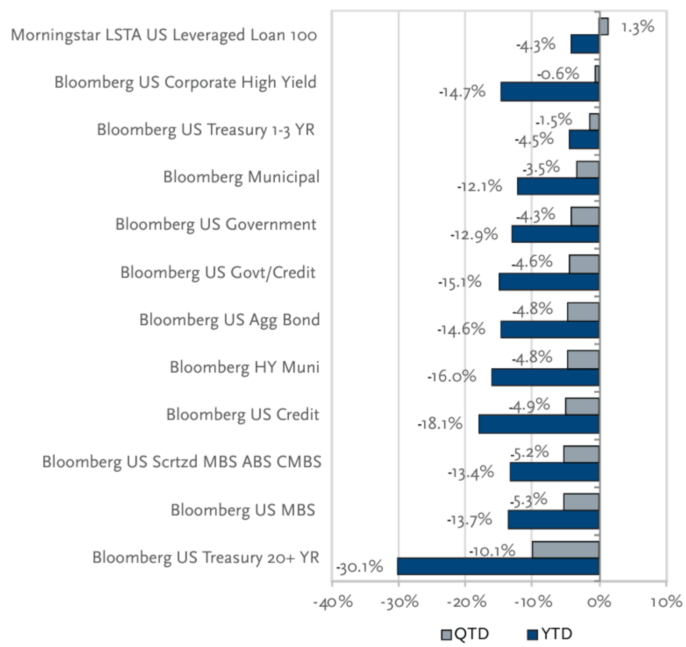


Fixed Income Markets

The third quarter of 2022 continued where the second quarter left off with few, if any, sectors to hide in fixed income as the U.S. central bank continued its fight against rising inflation, the result of excessively low interest rates and historic fiscal stimulus in the aftermath of the pandemic. As expected, higher credit quality and shorter duration assets performed well, in relative terms, but the best performing sectors of fixed income still experienced mid-to-high single digit declines in market value year-to-date. An outlier, although experiencing negative double-digit returns year-to-date, was the taxable high yield sector which performed well against peer sectors during the third quarter in relative terms[4].

Yields increased during the quarter, particularly for shorter maturities. The 3-month Treasury yield increased by 1.61% to 3.33%, while the 2-year and 10-year Treasury yields rose by 1.30% and 0.85%, respectively. The highly watched Bloomberg US Agg Bond Index was down 4.8% for the quarter and 14.6% for the year. Mortgage-backed securities ("MBS") returns, as tracked by the Bloomberg US MBS Index were also negative during the quarter (see the chart on the right).

U.S. Fixed Income Performance Through 9/30/22



Source: Morningstar Direct
Indices are provided for comparison only and are not available for direct investment.

Additional quarterly fixed income performance highlights included[5]:

- Negative quarterly returns for credit despite unchanged investment grade credit spreads and tighter high yield credit spreads. The Bloomberg US Credit Index returned -4.9% while the Bloomberg US Govt/Credit Index returned -4.6%.

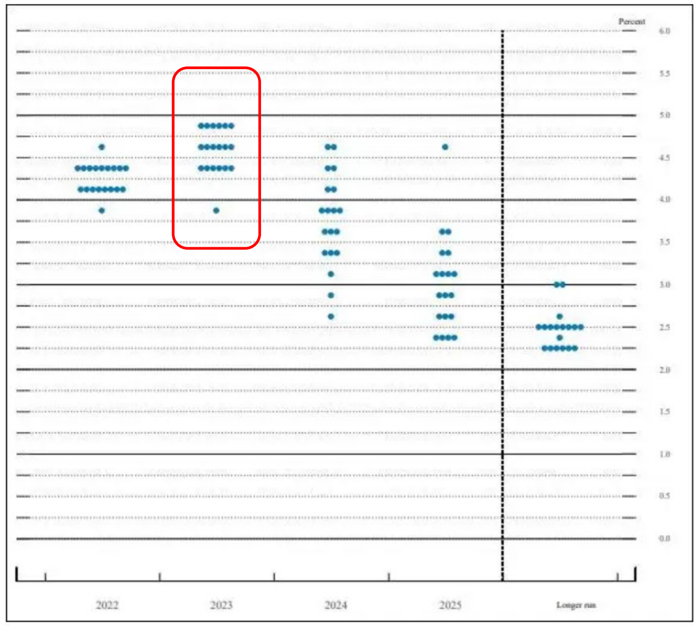
- U.S. leveraged loans was the best performing fixed income segment as the Morningstar LTSA US Leveraged Loan 100 Index returned 1.3%.

- Municipal bonds declined as higher rates impacted bond prices. The Bloomberg Municipal Index fell -3.5% for the quarter while the Bloomberg HY Muni Index had a loss of -4.8%.

- Emerging market sovereign debt, both local and U.S. dollar denominated, declined as all major developed and emerging market currencies depreciated relative to the U.S. Dollar.

According to the latest Statement of Economic Projections released by the Fed, the year-end estimate for U.S. GDP growth was revised downward significantly for the second straight time (from 1.7% in June, to 0.2%). Unemployment expectations for 2022 and 2023 were revised upward, and Core PCE inflation projections (the Fed's preferred measure of inflation) was raised from 4.3% in June, to 4.5%. The median "dot-plot" estimates for the year-end Fed Funds rate also increased from 3.5% to 4.5% (see the chart to the right)[6]. Most importantly, these forecasts suggest the Fed is willing to let the economy slip into recession to get the rate of inflation down.

US Fed Dot plot September 2022



Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. One participant did not submit longer-run projections for the federal funds rate.

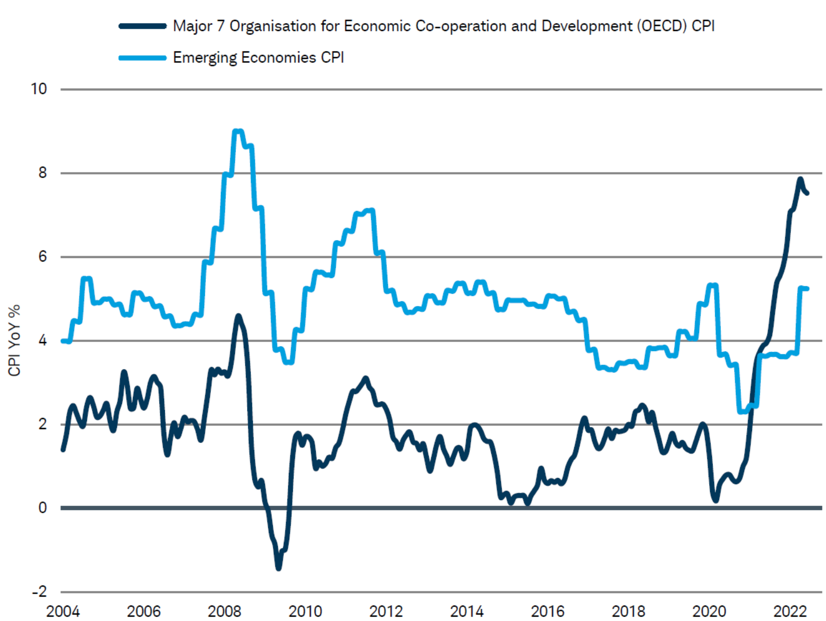
International Markets

Global equity markets outside of the U.S. have completed a third negative quarter, with the MSCI ACWI ex US IMI Index down 11.26% in the three months through October 30. Year-to-date, this index is down 27.19%, which clearly indicates a "bear market." By historical standards, global stock markets are very highly oversold. Risk-off sentiment strengthened as the quarter progressed.

Advanced-market equities performed slightly better than emerging markets during the third quarter, while emerging-market equities are slightly in the lead for the year. The Eurozone and UK economies are now in or close to recession. Business activity in Germany's private sector declined as the third quarter ended and inflation was persistently high. It is important to note, that increased energy costs are a major headwind for German equities and the MSCI Germany Index declined 15.79% over the quarter. The French economy, in contrast, recorded a slight increase in growth in September, following a low in August, driven by recovery in the services sector and particularly in tourism. Nevertheless, French equities also eased and the MSCI France Index declined 12.31%[7].

There are several factors putting pressure on both equity and bond markets. In a response to stronger and more persistent inflation, central banks, except for the Bank of Japan and the People's Bank of China, have raised interest rates and reduced their balance sheets. This is occurring at a time when demand has contracted, and earnings estimates are being downgraded. Geopolitical uncertainty is high, with respect to the Russia-Ukraine conflict, where no de-escalation is in sight.

Global inflation remains hot given the lingering supply chain disruptions and labor shortages, which have been exacerbated by the war in Ukraine and its commodity related effects. Yet, inflation in emerging economies remains stable despite the U.S. dollar's rally (see the chart below).



Consumer Price Index YoY %	
Russia	14.3
Eurozone	10.0
Germany	10.0
United Kingdom	9.9
Italy	8.9
Brazil	8.7
United States	8.3
India	7.0
Canada	7.0
South Korea	5.7
France	5.6
Japan	3.0
China	2.5

Source: Charles Schwab, Bloomberg, as of 9/30/2022. Major 7 refers to the seven major countries as defined by the OECD: Canada, the U.S., Japan, France, Germany, Italy, and the U.K.

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UK manufacturing registered a sharp drop in production in September, falling at the fastest pace since January 2021, with inflationary pressures running extremely high. The destabilizing policy missteps of the new UK government required dramatic action by the Bank of England. UK equities, which earlier in the year had been outperforming, declined 2.8% over the quarter, according to the UK FTSE 100 Index.

Two other advanced markets fared better in the third quarter. Canada's manufacturing PMI signaled contracting output in both August and September and an economy that is losing steam, with a deepening correction in housing. Rising interest rates, easing oil prices, and weaker external demand from the U.S. and other economies are projected to lead to very weak growth in the current quarter and in 2023. The Canada S&P/TSX Index declined 1.4% in the quarter. In Japan, where a modest economic recovery continued in the third quarter despite weakening external demand, the equity market outperformed the advanced-market average. The Japan Nikkei 225 Index lost just 0.90%.

Emerging-markets outperformed advanced-markets earlier in the year, but as the growth prospects for their economies deteriorated, that outperformance faded. Reduced global growth means weaker external demand. The strengthening of the U.S. dollar and increasing interest rates are significant headwinds for emerging-market economies. The Chinese economy has slowed to an estimated 2.7% growth for the current year after last year's 8.1% advance as China continues its restrictive zero-Covid policies and battles a property market collapse. This projection is well below the World Bank's estimate of 5.3% growth for the rest of the Asia Pacific region. The China CSI 300 Index dropped 14.3% in the third quarter and is down 21.4% for the year. India's economy performed well, growing more than an estimated 6% this year. In Latin America, an economic recovery in Brazil led to the MSCI Latin America Index gaining 3.6% in the third quarter and achieving a positive 3.3% advance for the year.

Global equity market summary

Total returns as of 9/30/2022

Global	Price	3-month	YTD	1-year	3-year	5-year	10-year
MSCI All Country World Index	553	-6.7%	-25.4%	-20.3%	4.2%	4.9%	7.8%
Americas							
USA Dow Jones Index	29,085	-6.2%	-19.7%	-13.4%	4.4%	7.4%	10.4%
USA S&P 500 Index	3,626	-4.9%	-23.9%	-15.5%	8.1%	9.2%	11.7%
USA NASDAQ Index	10,660	-3.9%	-32.0%	-26.2%	10.7%	11.3%	14.3%
Canada S&P/TSX Index	18,444	-1.4%	-11.1%	-5.3%	6.6%	6.6%	7.3%
MSCI Latin America Index	2,055	3.6%	3.3%	0.7%	-3.2%	-2.4%	-2.1%
EMEA							
Europe Euro Stoxx 50 Index	3,323	-3.7%	-20.4%	-15.3%	0.4%	1.5%	6.5%
UK FTSE 100 Index	6,881	-2.8%	-3.8%	0.8%	1.2%	2.5%	5.8%
France CAC 40 Index	5,756	-2.5%	-17.1%	-9.0%	3.1%	4.5%	8.8%
Germany DAX Index	12,141	-5.2%	-23.7%	-20.6%	-0.8%	-1.1%	5.3%
Spain IBEX 35 Index	7,415	-8.4%	-13.5%	-13.9%	-4.9%	-3.9%	2.7%
Italy MIB Index	20,874	-2.5%	-21.6%	-15.9%	0.8%	1.4%	6.5%
Asia/Pacific							
Japan Nikkei 225 Index	25,937	-0.9%	-8.2%	-10.1%	8.1%	7.0%	13.4%
Hong Kong Hang Seng Index	17,223	-20.1%	-24.0%	-27.5%	-10.2%	-6.0%	1.5%
China CSI 300 Index	3,805	-14.3%	-21.4%	-20.1%	1.9%	1.9%	7.5%
Australia S&P/ASX 200 Index	6,474	0.4%	-9.6%	-7.7%	2.6%	6.7%	8.4%

Economic Outlook

This year has been among the toughest in history for investors. Very rarely do stocks and bonds move down in tandem. Multiple investor and consumer sentiment indicators are as low as they have been since 2008. Since the Great Financial Crisis in 2008, central banks around the world have been backstopping the global economy via some of the lowest interest rates in history. Starting this year, they have exited that role and focused on taming inflation. Consequently, assets have been repriced with the backdrop of higher inflation and interest rates.

However, there are some signs that stocks may be nearing a bottom. The median decline in the S&P 500 during the last ten recessions is 24%, which is where the S&P 500 ended the third quarter. The S&P 500 is trading at 15 times forward earnings, historically an attractive level and well below the twenty-one times level to start the year. However, domestic stocks will need a catalyst to break the downtrend and persuade investors to begin purchasing riskier assets. Within the U.S., until inflation shows a strong downward trend, the Fed pivots to a less aggressive stance, or corporate earnings prove more relevant than inflation, its unlikely stocks will stage a strong recovery.

International equities are trading at attractive values relative to earnings and relative to U.S. markets. A conclusion to the war in Ukraine could help tame European energy prices and improve investor sentiment and earnings. Chinese stocks are trading at exceptionally low values, less than 10 times earnings and a softer Covid policy or higher vaccination rates could unlock notable upside potential. Bond yields are at levels we have not seen since 2008. For the first time in well over a decade, bond yields exceed inflation expectations. Although rising rates have reduced bond prices, going forward both interest and principal can be reinvested at much higher rates. Future bond return expectations have increased and given the Fed's recent transparency it is likely that rates will not move much higher, and prices will stabilize.

Acknowledgements

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3. "Quarterly Commentary: Q3 2022," Valley National, October 11, 2022. https://valleynationalgroup.com/quarterly-commentary-q3-2022/
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5. "Quarterly Commentary 3rd Quarter 2022," Oppenheimer Investment Management. https://www.oppenheimer.com/asset-management/oim/pdf/2022/q3/oim-3q22-fixed-income-commentary.pdf
6. "US Fed dot plot September 2022 with target level for the federal funds rate." Sunil Dwahan, Financial Express, September 26, 2022. https://www.financialexpress.com/investing-abroad/featured-stories/us-fed-dot-plot-september-2022-with-target-level-for-the-federal-funds-rate/2686380/
7. "International Equity Markets in Q3 2022," William H. Witherell, Ph.D., Cumberland Advisors, October 5, 2022. https://www.cumber.com/market-commentary/international-equity-markets-q3-2022

It is not enough to own a portfolio personalized for your situation, based on your comfort with risk and long-term financial goals. You must be patient and disciplined, too. With Risk-Guard™, our risk management process, our investment committee is reviewing the market conditions and underlying investments on a weekly basis. Please contact your Redhawk financial advisor to learn more.

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