3Q22 Market Commentary
A No Good, Very Dreary Year

As we close out what has been one of the most challenging years that investors have experienced in decades, we realize the disappointment and anxiety that investors are facing. There have been little to no options for investors to preserve or grow capital this year and even a traditional diversified portfolio of 60% stocks and 40% bonds is on pace for its worst year of performance on record. **(Chart 1 – next page).**[1] The Federal Reserve and many other central banks are frantically playing catch up to reign in inflation that was created because of the monetary and fiscal policies of the pandemic and unfortunately this has not been easy for the economy or asset classes.

We believe the economic environment will remain challenged and investors should get used to daily volatility across all asset classes. However, in this quarterly letter we will put the depths of the market declines this year in perspective compared to past bear markets, offer opportunities where we see value and remind investors that bear markets are part of all investment cycles. Also, we want to remind investors that historically bear markets have offered opportunities for investors that remain patient and do not let emotions override discipline and their long-term investment goals.

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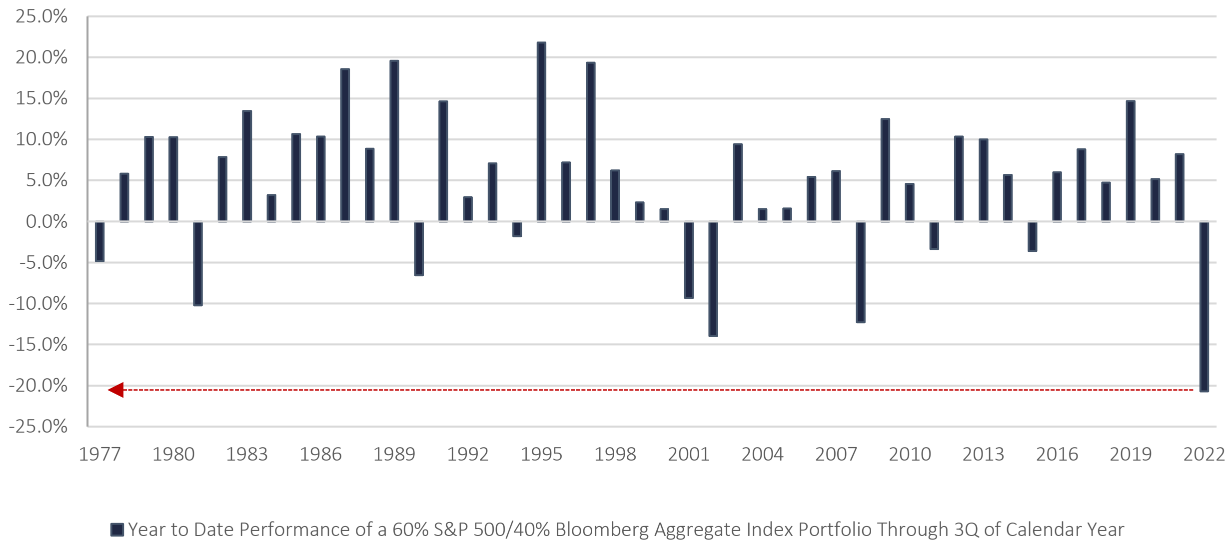
Past performance is not indicative of future returns

Chart 1

Dismal Year for Investors

Data is as of September 30, 2022. S&P 500 is price return only. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



U.S. Economy – Recession Obsession

The U.S. economy officially entered the technical definition of a recession this year (two consecutive quarters of negative GDP growth in 1Q22 and 2Q22). Regardless of when the National Bureau of Economic Research (NBER) officially dates the recession to have started in 2022 or it starts in 2023, economic conditions feel recessionary, and Americans are feeling about as dismal as any recession we have experienced. Consumer sentiment is hovering near an all-time low **(Chart 2)**, real wages are declining sharply as inflation remains stubbornly high, the savings rate has collapsed, and net worth saw its worst quarterly decline on record in 2Q22 (including the drop experienced in the early days of the pandemic) **(Chart 3).**

Chart 2

Confidence Hovering Near Record Lows

Data is as of September 30, 2022. S&P 500 is price return only. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

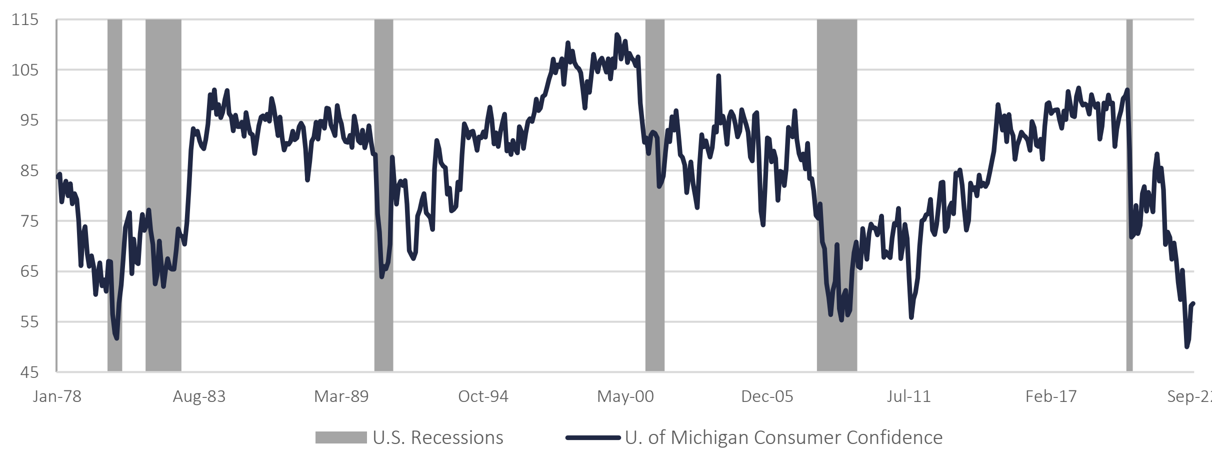
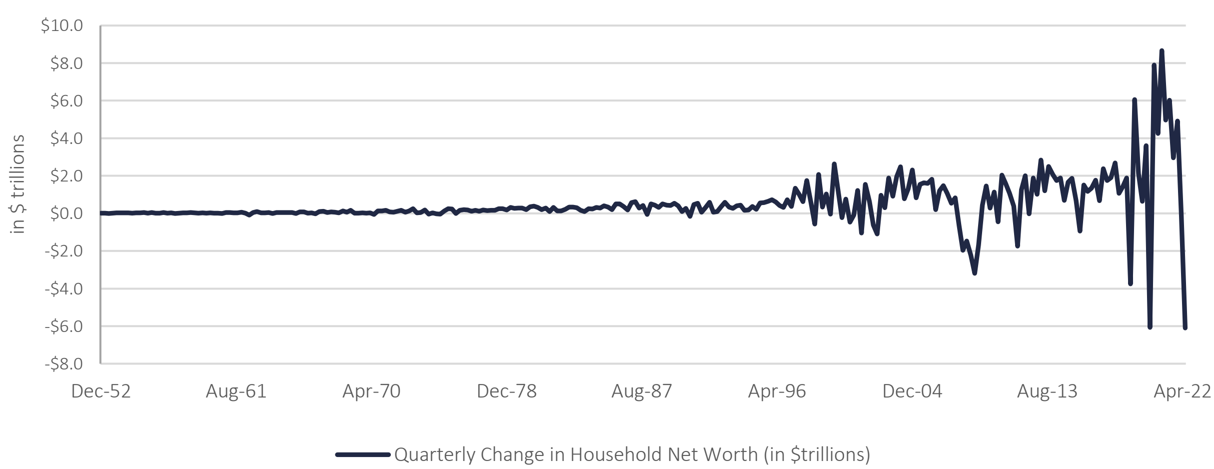


Chart 3

Collapse in Household Net Worth

Data is quarterly and as of 2Q22. Household net worth is the value of all checking, savings accounts, home equity and investment accounts minus household liabilities. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



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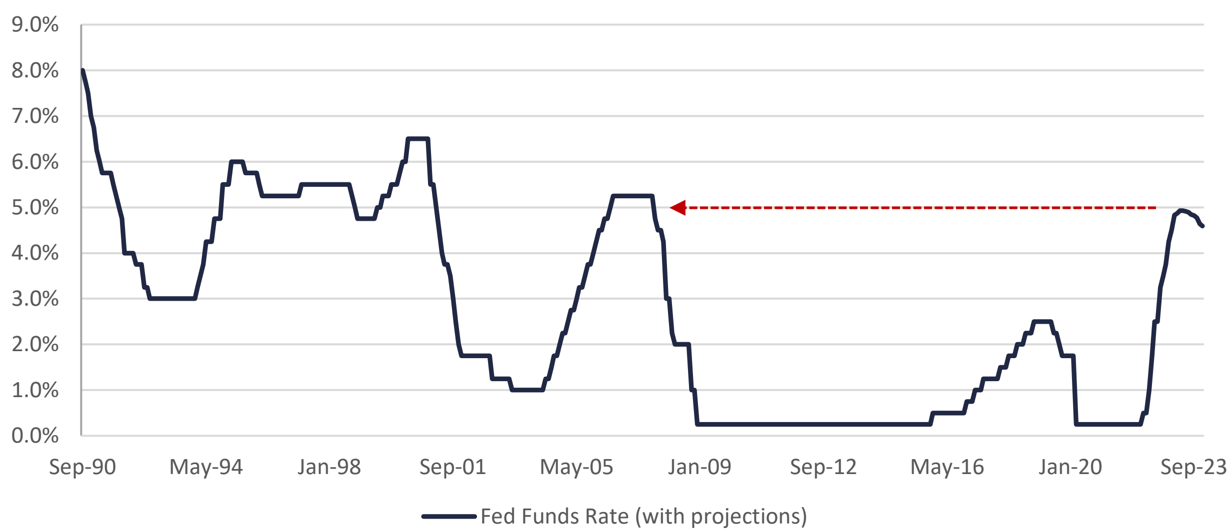
Inflation and higher interest rates continue to be the largest near-term threat to the economy. The Fed will need to continue to hike rates aggressively over the next year (at a minimum) and remove liquidity from the financial system through a reduction in their balance sheet. Currently, it is estimated the Fed will hike short term rates to levels not seen since the Great Recession, unwinding more than a decade worth of easy monetary policy **(Chart 4)**. We are already seeing the negative impact of higher rates on the housing market. The 30-year mortgage rate has jumped to the highest level since 2006 and prospective homebuyers' traffic has collapsed **(Chart 5 – next page)**. Ultimately, this reversal of not only easy monetary policy but fiscal policy should weigh on spending at the consumer and business level. While the pent-up demand for spending on experiences and travel has been resilient, we are witnessing consumer spending on select discretionary items pull back (e.g., electronics, furniture). In addition, when looking at corporate sentiment, businesses are backing away from future capital expenditure plans due to economic and political uncertainty **(Chart 6 – next page)**.

Chart 4

Federal Reserve to Remain Aggressive

Data is monthly and estimates for 2023 are as of October 17, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



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technical definition of a recession this year.

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Chart 5

Housing Market Taking a Hit From Higher Rates

Data is as of September 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

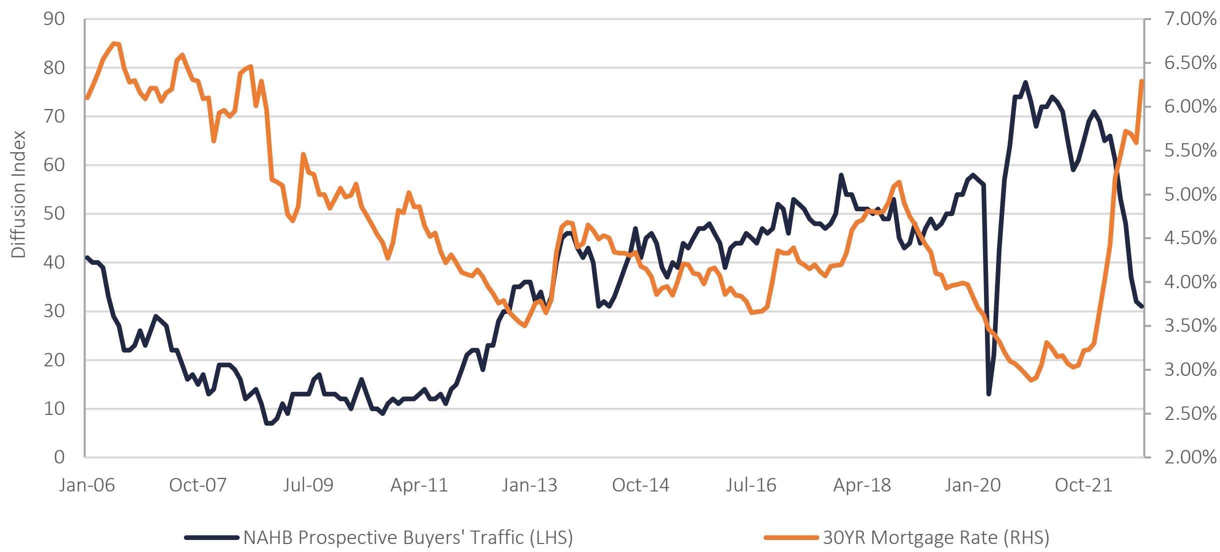
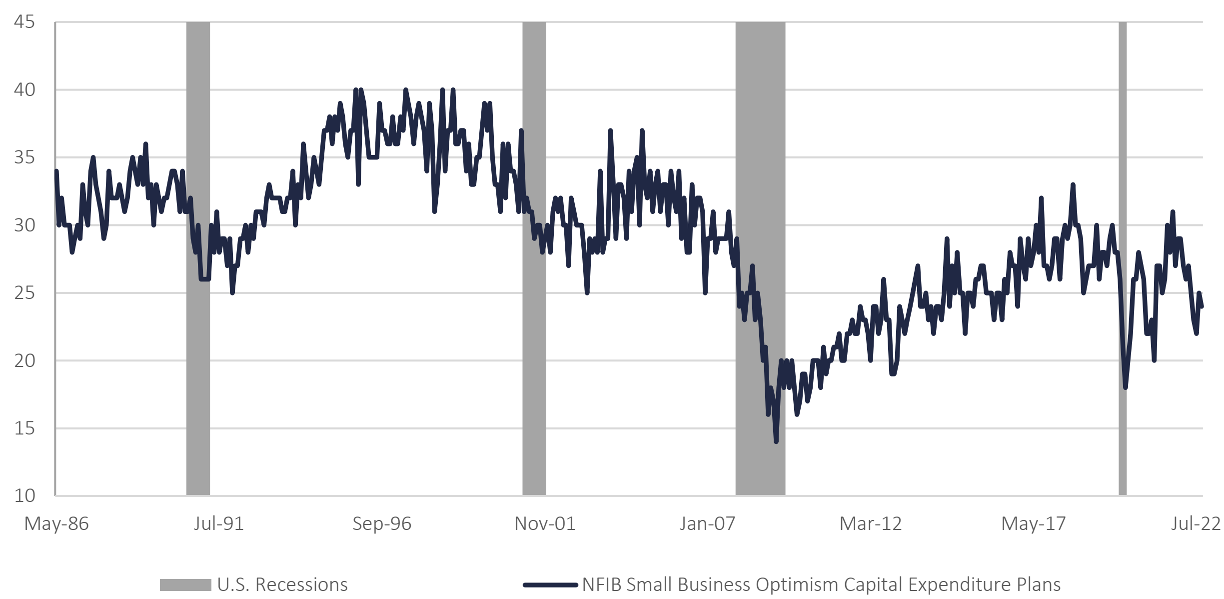


Chart 6

Businesses Pulling Back… For Now

Data is monthly and as of September 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



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We acknowledge that recessions are healthy and a necessary part of any economic cycle. However, we also sympathize that when recession rhetoric heats up, gauging the magnitude of the economic contraction is at the forefront of investors' minds. We do not believe we are headed for a 2007-2009 style near economic collapse, where the banking system, housing market, credit market and consumers all broke down at the same time. In fact, we see a path for this to be a healthy correction in what has been an unsustainable surge in economic activity and one where we can come out on a more solid footing for the next economic expansion. Some of our reasons include:

- **Consumer strained not disappearing:** While the excess savings created during the pandemic have evaporated due to the higher costs of everyday necessities (e.g., food and gas), Americans used the decade of easy monetary policy to shore up their own personal finances. In fact, the household debt service ratio remains historically low, despite its uptick in recent quarters. **(Chart 7)**. Therefore, consumers are not as leveraged as they have been in past economic downturns.

Recessions are healthy and a necessary part of any economic cycle.

Chart 7

Consumers Still Have Solid Balance Sheet

Data is quarterly and as of 2Q22. Data Source: Bloomberg Finance LP, Verdence Capital Advisors

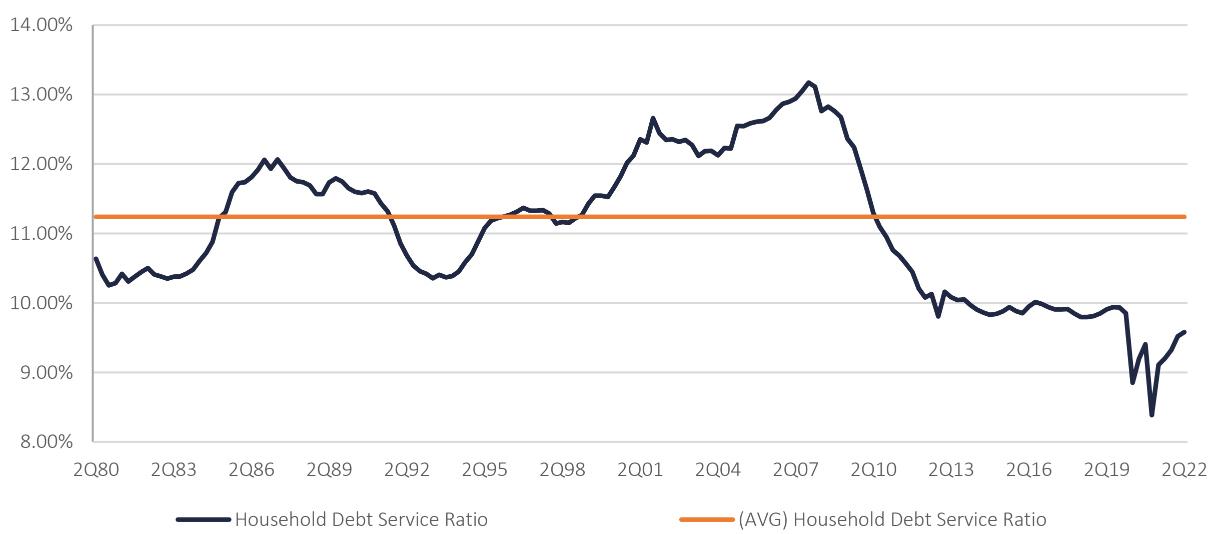

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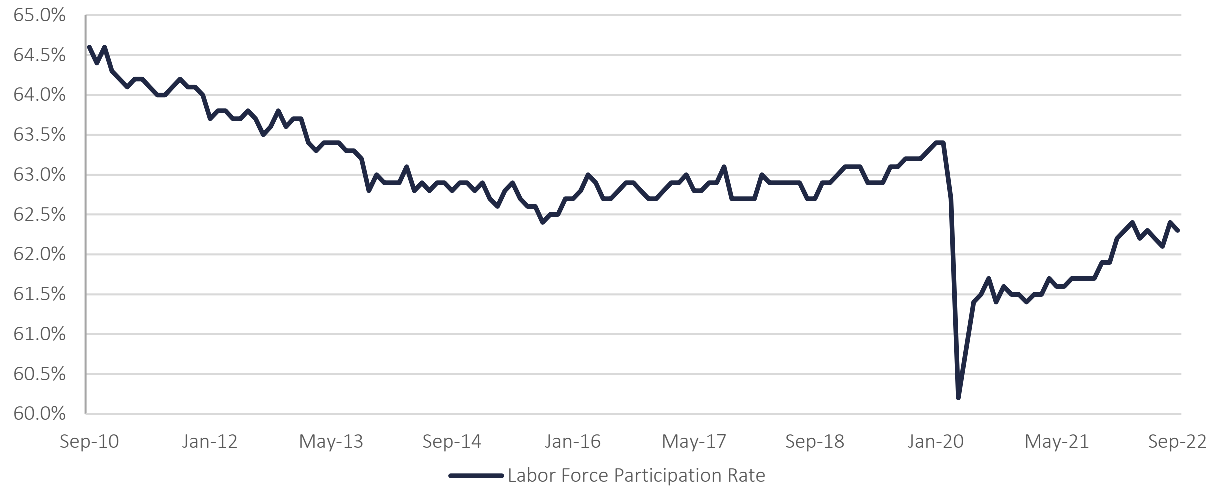
Chart 8

Still Plenty of Jobs to Come Back To

Data is monthly and as of September 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



- **The labor market to get weaker but still strong:** We understand and expect the unemployment rate will likely rise from current levels as growth remains weak. However, the demand for labor is historically strong and the labor force participation rate has not yet returned to pre-pandemic levels. (Chart 8). This means there is still room for Americans to come back to work if necessary to support the higher cost of living. While job postings are declining, as needed to limit wage inflation, there is still more than one job posting for every unemployed American.

There is still room for Americans to come back to work if necessary **to support the higher cost of living**

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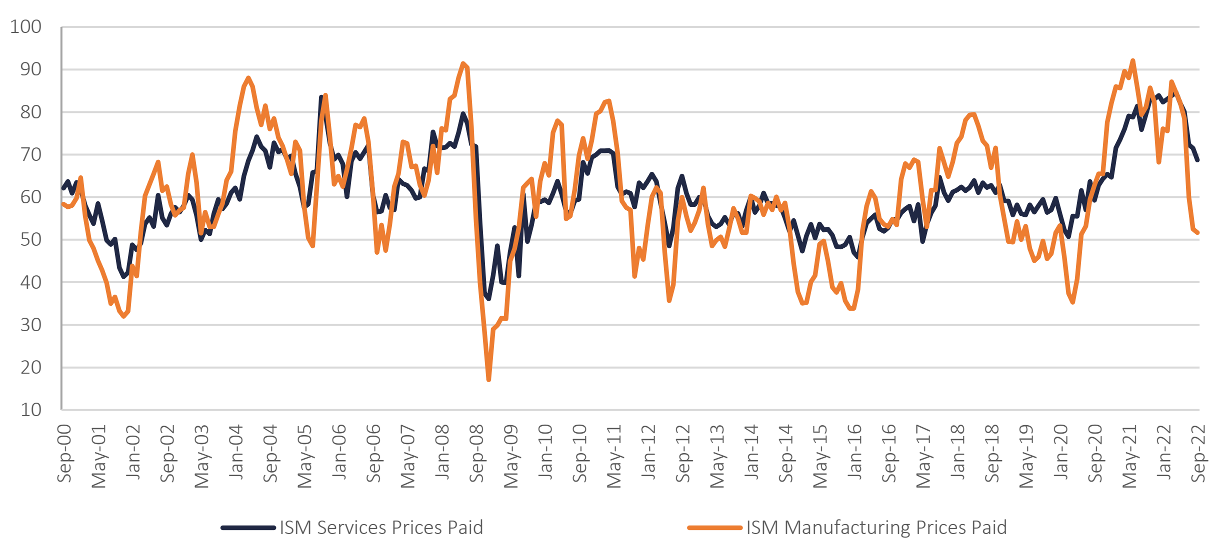
- **Weaker growth and a tight monetary policy should slow inflation:** While we do not expect in the foreseeable future, inflation to fall back to the 1.00% - 2.00% annual growth rate we enjoyed over the past decade, we do think inflation will gradually come down. The biggest risk to this assessment is fiscal policy error. We simply cannot spend the way we have over the past two years and expect inflation to come down. However, we are seeing improvements in the supply chain which should help inflation. Prices paid in both the manufacturing and services sectors are falling sharply and should eventually filter into inflation indices. **(Chart 9)**. Transportation costs (as measured by the cost to ship a 40 ft container) have collapsed and are near pre-pandemic levels. In addition, according to the NFIB Small Business Sentiment Survey, the least amount of business owners surveyed since January 2021 are expecting to raise prices in the next three months.

While we expect the economic trajectory to remain challenged over the next year, we outlined some positive underlying fundamentals that can help us avoid a long and protracted contraction in growth. In addition, consumer sentiment is already so weak, and most Americans believe we are either in recession or headed that way[2]. Therefore, we believe there is room for upside surprises in economic sentiment. The upcoming midterm elections will be a test to the current administration and history tells us that the best period of economic growth is in the second half of a President's term. We will continue to monitor the economic climate but accept that part of the near-term pain is payback for an extended period of easy policy over the past decade and specifically since the pandemic.

Chart 9

Prices are Coming Down in Right Parts of the Economy

Data is monthly and as of September 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



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Global Equities – Is the Damage Done?

This year has been difficult for equities as investors try to assess what unwinding a prolonged period of easy money means for valuations. In addition, a stubbornly high inflation environment has been difficult for corporations to absorb, and we are starting to see the negative ramifications in margins that are falling from record highs. **(Chart 10)**. We are nine months into the current bear market and investors are absorbing heightened volatility with large daily moves. In fact, just this year alone the S&P 500 has seen 10 trading days with a daily move of 3% (either up or down)[3]. To put this in perspective, outside of the pandemic, we have not seen this type of daily volatility since the Great Recession and European Peripheral debt crisis. On average since 1980, the S&P 500 only experiences five days a year with a daily move of 3% or more **(Chart 11)**.

Chart 10

S&P 500 Profit Margins Starting to Fall from Record Highs

Data is as monthly and as of September 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

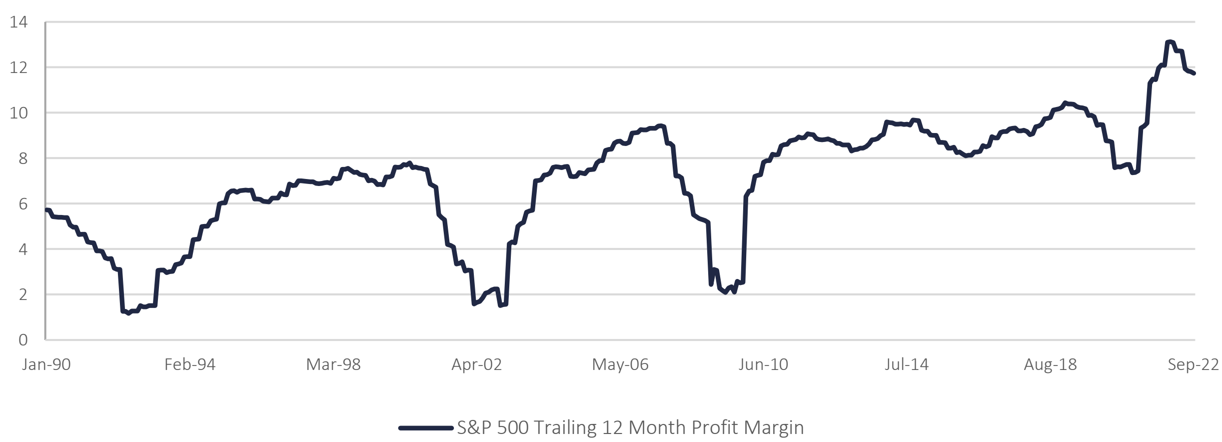
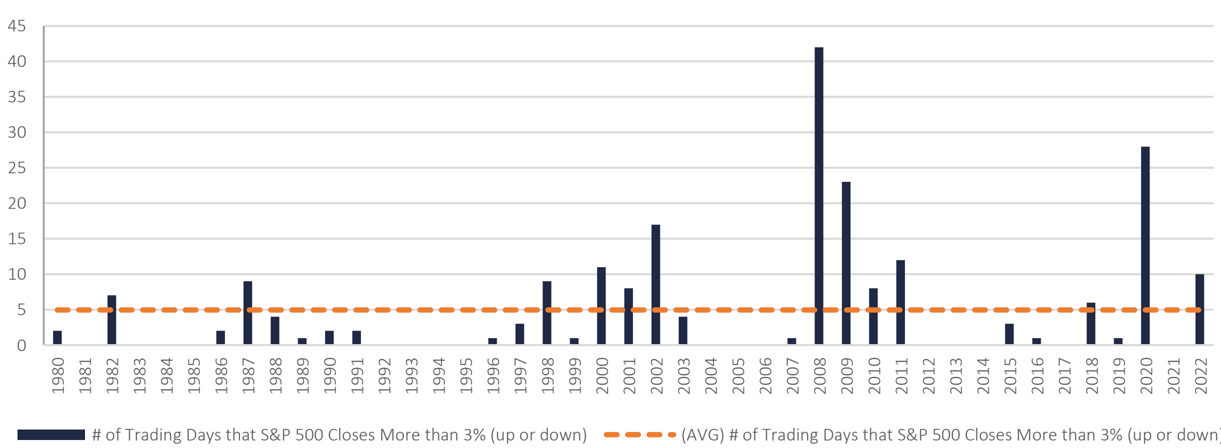


Chart 11

Outsized Daily Moves the Norm in 2022

For 2022, the data is as of October 17, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



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What we know about successful long-term investing is that trying to time the bottom of a bear market is impossible. We also know that as painful as bear markets feel while we are in them, they are much shorter in length than bull markets and the S&P 500 even declines much less than it rallies in bull markets. As can be seen in **(Table 1)**, the average bull market sees a rally of 126% and lasts ~four years while the average bear market sees a drop of ~30% and lasts 13 months. With the S&P 500 already down ~25%, selling at this point in the bear market would only be locking in losses and missing the chance to participate in the next bull market and when using history as a guide, it would suggest it is much closer than it feels.

Table 1

Bear Markets Feel Awful but Bull Markets Take Away the Pain

All bull and bear markets from 1942 to present. The Present 2022 bull bear market is the decline and time as of October 17, 2022. Price Return Only. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

BULL Market Analysis		
Bull Market Years	**% Rise in Bull Market**	**Length of Bull Market (in Months)**
1942-1946	157.70%	50
1949-1956	267.10%	87
1957-1961	86.40%	50
1962-1966	79.80%	44
1966-1968	48.00%	26
1970-1973	73.50%	32
1974-1980	125.60%	75
1982-1987	228.80%	61
1987-1990	64.80%	32
1990-1998	301.70%	95
1998-2000	59.60%	19
2002-2007	101.50%	61
2009-2011	101.20%	26
2011-2018	166.60%	85
2018-2020	44.00%	14
2020-2022	114.40%	22
Avg. Bull Market	**126.30%**	**49**
Median Avg. Bull Market	**101.40%**	**47**

BEAR Market Analysis		
Bear Market Year(s)	**% Decline in Bear Market**	**Length of Bear Market (in Months)**
1946-1949	-29.60%	37
1956-1957	-21.60%	15
1961-1962	-28.00%	7
1966	-22.20%	8
1968-1970	-36.10%	18
1973-1974	-48.20%	21
1980-1982	-27.10%	21
1987	-33.50%	3
1990	-19.90%	3
1998	-19.30%	2
2000-2002	-49.10%	31
2007-2009	-56.80%	17
2011	-19.20%	5
2018	-19.80%	3
2020	-33.90%	1
2022 (as of 10/17/22)	***-25.40%***	***9***
Avg. Bear Market	**-30.60%**	**13**
Median Avg. Bear Market	**-27.50%**	**8**

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We realize there are some sectors of the equity market that may have to endure further pain before valuations are aligned with the expected economic and inflation environment. Technology and large cap growth stocks are still trading at a steep premium compared to large cap value stocks **(Chart 12)**. Investors will need to see a sustainable improvement in inflation and the Fed to slow interest rate hikes before we think the technology/growth sector is out of the woods. However, we would focus on the areas where capital has been scared to deploy. These areas have been beaten down so badly that prices may already be reflecting the upcoming challenging economic and interest rate environment. Some areas that we believe may be reflecting the bulk of the bear market damage and pose attractive upside potential include:

- **U.S. small and midcap:** The steep downturn in small and midcap stocks this year may be reflecting the expected economic weakness. Compared to large cap stocks, small cap stocks have been underperforming large cap stocks on a rolling three-year basis since before the pandemic **(Chart 13)**. In addition, valuations have corrected in the current bear market and are trading at a steep discount to the historical average, suggesting a good entry point for a long-term investor.

Chart 12

Large Cap Growth May Still Have Pain to Endure

Data is as of October 17, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

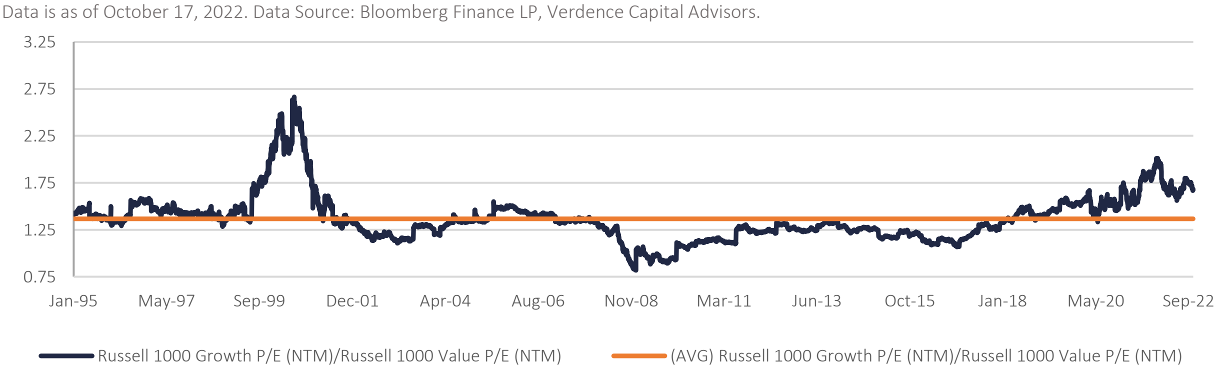

Chart 13

Small Cap Stocks Underperforming for Too Long

Data is from September 1993 – September 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

International equities: Despite the heightened uncertainty about economic growth due to the Russia/Ukraine war and ensuing energy crisis we believe the underperformance of developed international equities and collapse in many developed market currencies compared to the U.S. dollar is pricing in the risks. For example, the Euro is trading less than parity versus the U.S. dollar. Meaning one Euro is worth less than one U.S. dollar. That has not happened since the dotcom bubble and creation of the European Union! In addition, the British pound is trading at the lowest level versus the U.S. dollar since the mid-1980s. **(Chart 14)**. This suggests that investors are pricing in the expected economic challenges. In addition, European equities have not been this cheap compared to the U.S. since the Great Recession.

Despite our less than optimistic view of the economy in the next 12 months, we would not recommend reducing equity exposure at this time. We believe the bulk of the damage to global equities has been done. We do not disagree that we may retest or even make a new bear market low as we navigate through these highly uncertain times, but we would still look for opportunities for investors with a long-term time horizon. History also tells us that since 1945, on average, it takes the S&P 500 11 months to surpass its prior peak once it makes a bear market low. Therefore, trying to time the low or sell into a bear market would likely have a negative impact on your long-term performance. Lastly, equities are in the middle of a positive seasonal time (i.e., October – December) and since 1934 have been positive in the one year after a midterm election in every midterm election year except one (i.e., 1938).

Chart 14

Developed Market Currencies May be Pricing in Collapse of Economies

Data is as of October 18, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

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Fixed Income – Pain to Continue

The pain for fixed income investors has not let up in the second half of 2022 with a broad index of the U.S. bond market (i.e., Bloomberg Aggregate Index) on pace to have its worst annual performance on record **(Chart 15)**. This is difficult for investors who have enjoyed positive annual returns for bonds 85% of the time since 1977. Unfortunately, the outlook for bond returns remains hampered by aggressive Fed tightening and stubbornly high inflation. If we simply used history as a guide, it would suggest long-term yields have further to rise (prices to fall) from current levels. The historical difference between the fed funds rate and the 10-year Treasury yield is 1.30%. **(Chart 16)**. Therefore, if the Fed needs to hike the fed funds rate to 4.50-5.00% it would not be unrealistic to see a 10-year Treasury between 5.75-6.25%. That means long term bonds could experience more pain over the next year. Therefore, investors might consider the following relative to fixed allocations.

Chart 15

Pain Has Not Let up for Fixed Income Investors

Data is year to date as of September 30, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

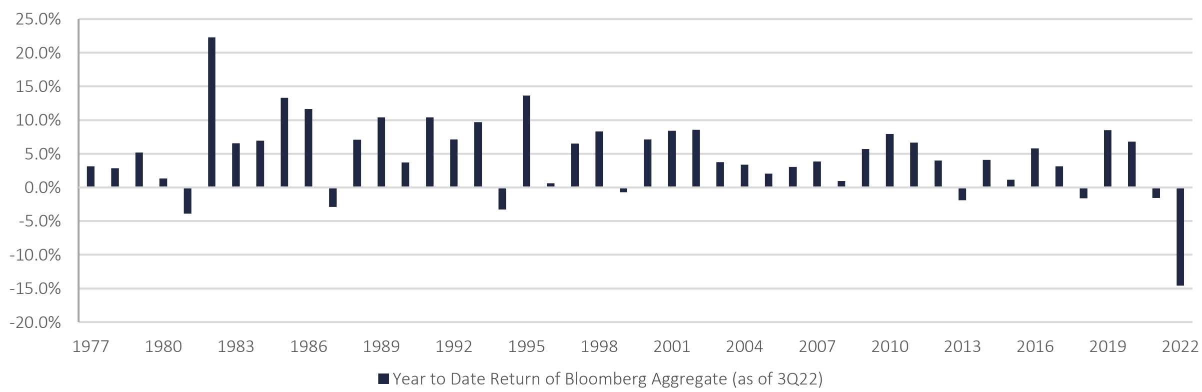
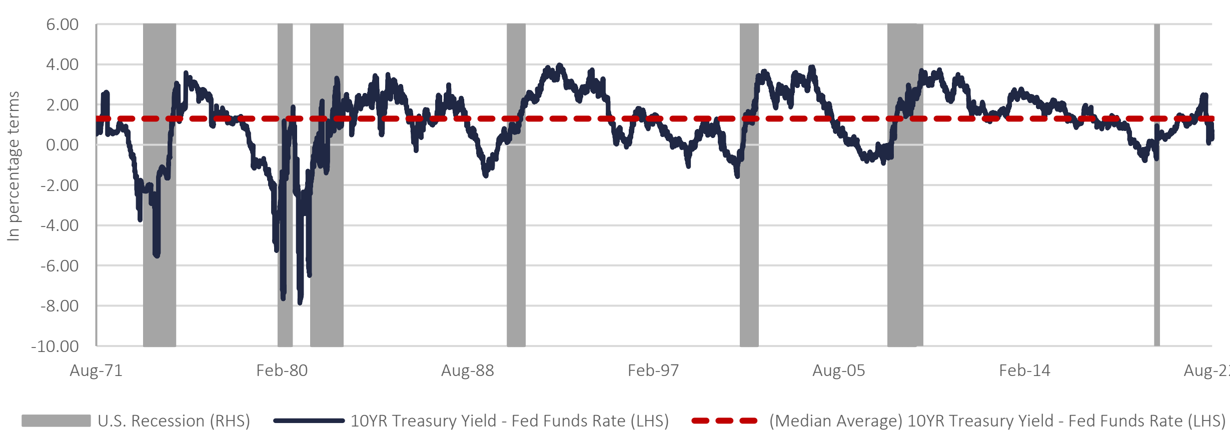


Chart 16

Long Term Bonds Could See More Pain

Time period reflects August 1971 to October 18, 2022. The 2022 recession is not shaded because it has not been confirmed by the NBER.
Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



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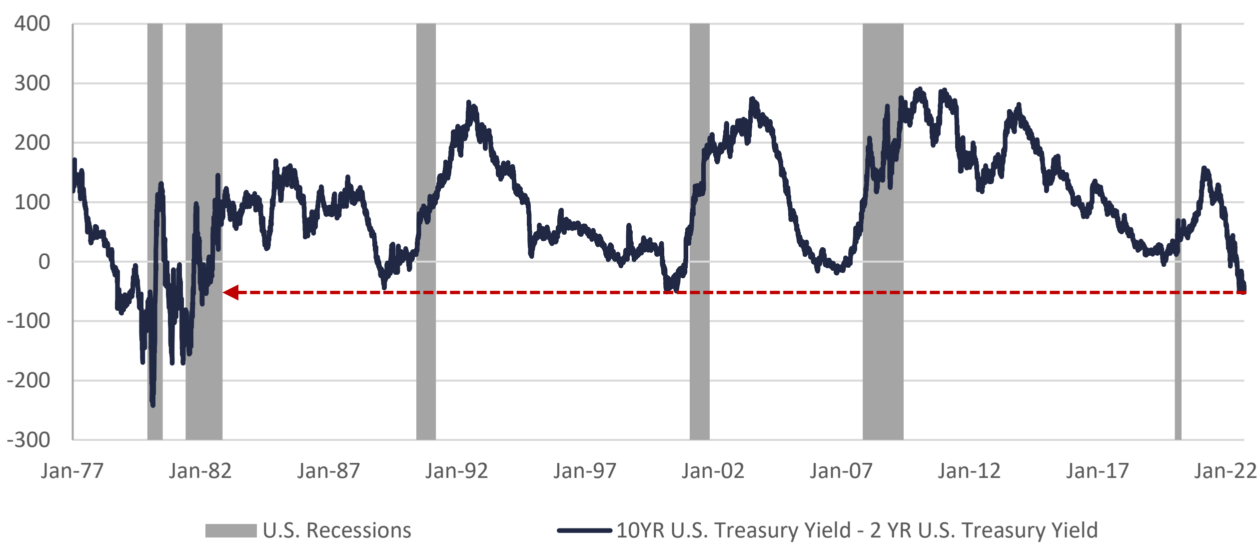
- **Short term bonds are most attractive:** Not only do short term bonds typically exhibit less interest rate sensitivity in a rising rate environment but now they are yielding higher than long term bonds. In fact, the difference between the 10YR Treasury yield and 2YR Treasury yield just surpassed the level in the early 2000s and reached the widest level since the early 1980s! **(Chart 17)**. Therefore, investors can earn some of the highest interest rates seen since 2007 (2YR Treasury) and mitigate interest rate sensitivity.

- **Credit Complacency:** Typically, an economic slowdown and/or recession does lead to some increase in defaults. We do not think the extra yield investors are being paid to own credit (either investment grade or high yield) is correctly reflecting the associated risk as the economy slows and the Fed unwinds their balance sheet. We will continue to monitor weakness and assess the credit environment to see if there is an opportunity for investors to be rewarded for the added risk.

Chart 17

Yield Curve Most Inverted Since 1980s

Data is as of October 18, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



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Alternatives – Traditional 60% Equity/40% Bond Portfolio Still has Headwinds

Until we see a peak in inflation and interest rate hikes, investors focused on a strict 60% equity/40% fixed income portfolio will likely not receive attractive risk adjusted returns. We do not believe we have seen the cyclical peak in yields which means more downside in bond prices is ahead. In addition, while the bear market in equities has likely priced in the bulk of the downside for the economy, volatility will continue as we navigate through the Fed tightening cycle and economic slowdown. Commodities have been the sole asset class to post positive performance year to date, however we expect commodity returns to be challenged by demand weakness as global economic growth slows. Therefore, for qualified investors, we would prefer looking at other alternative investments, especially in the private space where we believe valuations are more attractive, investments are less correlated to traditional asset classes and are not subject to the daily volatility seen in the public markets. Sectors in the private alternative space that we favor include:

- **Real Assets** offer a low correlation to other asset classes, diversification and in some cases an inflation hedge. We would focus on real asset investments like infrastructure, land and select opportunities in the real estate space (e.g., flex industrial and multi-family).
- **Credit** in the public market continues to look expensive with spreads near historically low levels. However, we believe private credit offers better yield potential.
- **Hedge Funds:** Especially low volatility hedge funds, can offer another layer of diversification, add return potential, and serve as a hedge for investors public market equity exposure.

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60% equity/40% fixed income portfolio
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Bottom Line:

As difficult as it has been to digest the losses this year it is important to focus on long-term investment objectives and understand that bear markets typically occur every four to five years. In addition, as painful as bear markets feel, historically the subsequent bull market has been much longer, and equities rallied much more than they fell in the bear market. This year has been extraordinarily unique as investors have been offered limited options to hedge portfolios as correlations across asset classes have moved in tandem and diversification has offered little support. At this point in the bear market, it is important to focus on the market's discounting process. Evaluating whether the pendulum of pessimism has swung too far to the negative side and may already be reflecting the bulk of the downside risk to an investment is important. Also, we are approaching a potentially market moving event with the upcoming midterm elections. If we get a gridlock situation (one party does not control both chambers of Congress) equities have typically favored this as the odds of major changes to legislation are muted. We believe that volatility will continue until the Fed can get control of inflation and we will continue to monitor the portfolios for opportunities that balance the risk versus the reward for investors. In addition, we remain confident that active management is the best way to benefit in this highly abnormal and volatile time, taking advantage of opportunities as they arise.

As always, if you have any questions about our perspective, please do not hesitate to reach out to your advisor.

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[1]: Records for the Bloomberg Aggregate Index (a broad index of bonds) began in 1977.

[2]: https://www.washingtontimes.com/news/2022/may/19/over-8-10-americans-think-recession-coming-poll/

[3]: As of October 19, 2022

Disclaimer:

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