3rd Quarter 2022

Highlights

- **Inflation and the Fed kept the markets' attention during the quarter. In the final weeks, unhelpful data and a stern Fed brought markets down. Our portfolios delivered mixed results.**
- **Economic data confirmed consumers remain healthy and recession is not yet imminent. Inflation remained elevated and, ironically, good news on the economy abetted the Fed's resolve.**
- **Interest rates continued to rise and now look attractive. Along with wider spreads, we believe fixed income sectors look compelling in an asset allocation context.**

Markets

		Returns (%)			
GIA*	Average Quality	3Q22 Gross	3Q22 Net	12 Months Gross	12 Months Net
Core Plus Composite	**(A)**	**-4.18**	**-4.27**	**-15.27**	**-15.57**
Global Investment Grade Composite	**(A-)**	**-4.88**	**-4.97**	**-17.16**	**-17.49**
Global Credit Plus Composite	**(BBB+)**	**-3.66**	**-3.78**	**-16.29**	**-16.71**
High Yield Composite	**(BB-)**	**-1.18**	**-1.32**	**-14.41**	**-14.88**
Emerging Market Corporate Debt Composite	**(BBB-)**	**-3.29**	**-3.44**	**-18.08**	**-18.57**
Benchmark Bonds					
Bloomberg U.S. Agg. Index	(AA+)	-4.75		-14.60	
Treasury	(AAA)	-4.35		-12.94	
Corporate	(A-)	-5.06		-18.53	
Mortgage	(AAA)	-5.35		-13.98	
Government/Credit	(AA)	-4.56		-14.95	
ICE BofA U.S. Corporate & Yankees	(A-)	-4.91		-17.77	
ICE BofA U.S. Corporate	(A-)	-5.11		-18.19	
ICE BofA U.S. High Yield	(B+)	-0.68		-14.06	
ICE BofA EM Corporate Plus	(BBB)	-3.47		-18.58	
ICE BofA Global Gov't ex-US	(AA-)	-3.84		-12.24	
JPM Emerging Markets EMBI GD	(BB+)	-4.57		-24.28	
JPM CEMBI Broad Diversified	(BBB-)	-2.64		-16.73	
JPM GBI-EM Global Diversified	(BBB+)	-4.73		-20.63	
Benchmark Equities					
S&P 500	NA	-5.28		-16.76	
Nasdaq Composite	NA	-4.11		-26.81	
Russell 2000	NA	-2.53		-24.48	
MSCI EAFE	NA	-10.01		-27.17	
MSCI Europe	NA	-10.85		-26.71	
MSCI Japan	NA	-8.64		-30.93	
MSCI Emerging Markets Equity	NA	-12.48		-30.11	

* Please refer to the respective factsheets for the long-term composite and benchmark returns for each strategy.

Markets

Inflation and the Fed! The economic malady and the U.S. central bank summarize the focal points of financial markets during the third quarter of 2022. Despite easing after June's torrid print, consumer price reports continued to disappoint in August and September. The Fed's Governors, concerned by the magnitude of the year-over-year price changes and seemingly complacent investors, took every opportunity to remind markets they were serious. These warnings culminated in a stern admonition following the Bank's September 21 meeting. Even though Fed Governors' economic forecasts envisioned a "soft landing," Chairman Powell admitted the economy would likely suffer, and unemployment would probably rise as the inflation battle was waged. As if surprised by the severity of the expected moves, financial markets cratered in the final weeks of the quarter. In September alone, the S&P 500 declined -9.34% which reversed a modest recovery in July and August and took the quarter's results down to -5.28%. Bond markets fared worse in relative terms as interest rates jumped in September, and the yield curve inversion reached 45 b.p. For the quarter, the two-year treasury rose 132 b.p. in yield, closing at 4.28% while the ten-year rose 81 b.p. to 3.83%. Higher rates caused U.S. treasuries and the Bloomberg U.S. Aggregate Index to decline -4.72% and -4.75%, respectively, for the quarter, and an unprecedented -13.48% and -14.61% during 2022.

Investment grade credit posted the worst returns among fixed income sectors as the combination of higher yields and wider spreads affected the longest duration securities. During the first nine months of 2022, liquidity was poor and investment grade funds suffered recurring outflows. The investment grade corporate bond index, the ICE BofA U.S. Corporate Index (C0A0), was down -5.11% for the quarter and -18.33% year-to-date. By comparison, the U.S. treasury index (G0Q0) returned -4.72% for the quarter and -13.48% year-to-date. Corporate option adjusted spreads (OAS) widened 4 b.p. to 167 b.p., while the yield to worst of the index increased from 4.66% to 5.71%. Investment grade issuance decelerated as market volatility, wider spreads and higher yields made issuers hesitate. For the quarter, issuance was $336.5 billion compared to $373.7 billion for the third quarter of 2021. For the nine months, issuance totaled $1.18 trillion compared to $1.35 trillion in 2021. Given conditions in bond markets, we expect fourth quarter issuance to remain subdued compared to the last two years.

The high yield market had another volatile quarter as robust fundamentals gave way to recession fears. After an impressive recovery in July, worries about the Fed's rate hikes and deteriorating creditworthiness caused spreads to widen back toward the year's highest levels. The ICE BofA U.S High Yield Index (H0A0) was down -0.68% for the quarter and -14.62% year-to-date. High yield returned +6.02% in July as investors anticipated a shorter tightening cycle. That expectation was shattered by September when declining commodity prices did not deliver a better inflation outcome. At quarter-end the spread to worst for the sector was narrower by 46 b.p. from 590 b.p. to 544 b.p. By ratings, spreads were: BB +372 b.p., B +576 b.p., and CCC +1,259 b.p. Despite falling oil prices, energy, the largest industry in the index, outperformed returning +1.24% for the quarter and -9.32% for the nine months. With the improvement in spreads, the yield to worst for the sector declined from 8.88% to 8.51%. High yield retail investors compounded the market's fragile sentiment by withdrawing funds eight out of nine months this year for a quarterly total of $8.7 billion, and a year-to-date sum of $53.6 billion, the largest nine-month outflow on record. The default rate including distressed exchanges rose to 1.57% (0.66% not including distressed exchanges) but remained well below the historical average of 3.2%. The new issue market remained inactive after record borrowing last year. For the quarter, issuance was only $18.9 billion the lowest quarterly issuance since the first quarter 2009, and $90.0 billion for the nine months, down from $395 billion for the same period last year.

Emerging markets bonds, which did relatively well early in the quarter, got swept up by the tighter financial conditions trifecta of higher rates, tighter liquidity, and a stronger dollar. While China's Covid lockdowns eased, the housing crisis deteriorated, and policy support remained tepid. The Russia/Ukraine conflict showed no signs of resolution and global commodity demand began to falter. Like U.S. credit sectors, EM experienced fund outflows and worsening investor sentiment. For the quarter, the JPM Emerging Market Bond Index – Global Diversified (EMBIGD), a dollar denominated sovereign index that included Russian and Ukrainian external debt, was down -4.57% and a painful -23.95% year-to-date, the JPM Corporate Emerging Markets Broad Diversified Index (CEMBI BD) fared better declining -2.64% for the quarter and -16.21% for the nine months through September, and the JPM Global Bond Index – Emerging Markets Global Diversified (GBI-EM Global Diversified), a local markets index, declined -4.73% for the quarter and -18.57% year-to-date, with currency contributing over 10% of that decline.

Economy

Economically, the year has defied expectations and challenged all forecasts. Early on, the reopening was supposed to carry 2021's momentum into the first half of 2022. Instead, Omicron delayed the services recovery. Then in late February, Russia invaded Ukraine and unleashed a spike in commodity prices that exacerbated an already frothy inflation surge. Belatedly, the Fed stepped into the game, determined to quell demand before price increases became embedded in expectations. Ultimately, real GDP declined in both the first and second quarters, although the economy's underlying momentum dispelled concerns a recession had started.

As often happens, well-intended measures from the federal government and central bank to stem an emergency laid the groundwork for a surge in demand. Away from failing to recognize their emergency aid was no longer necessary, a major challenge for the Fed is that some drivers of the price surges emanated from unique circumstances outside their control. Labor markets, production data, corporate earnings, and consumer behavior during the last nine months confirm the economy continued to recover from the pandemic. Sadly for the economy, however, the Fed's delays forced it to raise rates at the fastest pace since the 1979 – 1980s inflation episode. Looking forward, success will likely require a meaningful slowdown and perhaps a moderate recession to bring inflation back down.

A review of industries indicates companies continue to perform well. Banks, in particular, enjoy robust balance sheets and better-than-expected delinquency metrics. During the quarter, a few companies, especially retailers, expressed concern with their outlook and consumer demand. In many cases, excess inventories (due to supply chain issues) were the culprit. Analysts expect companies to express cautionary outlooks for the fourth quarter and into 2023 given the Fed's actions.

Scenarios

We propose three scenarios for the U.S. economy over the next 6 months:

1. Our most likely case has the U.S. economy growing about 1.5% to 2.0% at an annual rate in 4Q and slower (0.5% to 1.0%) in 1Q 2023. The 3Q GDP report will likely show the economy grew at about 3.0% annual rate. This improvement reflects both health in consumer demand and a reversal in the first half's net export figure. Despite a meaningful decline in housing, consumer demand should hold up through the holiday season. In addition, China will likely recover from its Covid-induced shutdowns to contribute favorably to global growth. However, the Fed and other central banks will likely succeed in lowering economic activity as the new year begins. PROBABILITY 60%

2. A second scenario has the economy slowing to a rate of -0.5% to 0.5% at an annual rate during the next six months. In this scenario, the economy's headwinds prevail leading consumers and corporations to retrench. Specifically, high prices, Fed tightening, and deteriorating financial conditions cool housing and "high ticket item" demand. Consumers remain engaged in services where pent-up demand keeps activity strong. The economy's pause enables logistics networks to adjust relieving the price and supply burdens on the economy. PROBABILITY 25%

3. A third scenario has the economy expanding at a faster pace of 2.5 to 3.0% at an annual rate during the next six months. In this scenario, personal consumption remains robust aided by low unemployment and higher income.

Factors that played a meaningful role in the price spiral may ease as a result of more flexible Covid policies in China, properly functioning supply chains, and a softening in Russian hostilities. While these are unexpected in the near term, enabling the unimpeded flow of commodities would have an immediate effect on prices and permit monetary authorities to temper the magnitude of their tightening. This scenario would quickly boost global activity, including in the U.S. PROBABILITY 15%

Market Outlook

The U.S. economy is slowing, Europe may already be in recession, the Federal Reserve insists further rate hikes are necessary, and financial markets delivered abysmal nine-month performance. Despite the negative news and an abundance of caution, consumers and corporations remain financially healthy and labor markets are robust. For the U.S. and Asia, certain indicators offer rays of optimism. Some of the intransigent sources of inflation have begun to ease and productivity is improving. Furthermore, China appears to be shedding draconian Covid policies and assisting the economy's restoration. Finally, while the Fed insists further rate hikes will come, we are closer to the end of the hikes. Markets expect the Fed to raise another 75 b.p. in November and 25 to 50 b.p. in December. Combined with poor market liquidity, these moves would put monetary policy well into restrictive territory and closer to the end of the cycle.

We believe the worst of the stock and bond market performance is near, or behind us. In bonds, absolute yields offer return expectations investors have not seen in years. While the rate increase was abrupt and damaging to returns, we believe they foreshadow an end to the era of negative real (and absolute) rates. Investors can look forward to positive real yields and an asset class that contributes more than risk mitigation in asset allocation. On top of that, attractive spreads enable credit investors, both in investment grade and high yield, to build portfolios with competitive return expectations. Even buyers of securitized instruments are being well-compensated for the risk they are taking.

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Index Definitions

Bloomberg U.S. Aggregate Index
The Bloomberg U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

Bloomberg U.S. Treasury Index
This index is the U.S. Treasury component of the U.S. Government index. Public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Bloomberg U.S. Government/Credit Index
The Government/Credit Index includes securities in the Government and Credit Indices. The Government Index includes treasuries and agencies. The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

Bloomberg U.S. Corporate Index
This index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers. (Future Ticker: I02765US)

Bloomberg U.S. Mortgage Backed Securities Index
This index is the U.S. MBS component of the U.S. Aggregate index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

ICE BofA U.S. Corporate & Yankees Index
The ICE BofA U.S. Corporate & Yankees Index tracks the performance of US dollar denominated investment grade debt publicly issued in the US domestic market by US and non-US corporations and non-US quasi-governments.

ICE BofA U.S. Corporate Index
The ICE BofA U.S. Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch) and an investment grade rated country of risk (based on an average of Moody's, S&P and Fitch foreign currency long term sovereign debt ratings).

ICE BofA U.S. High Yield Index
The ICE BofA U.S. High Yield Index tracks the performance of below investment grade US dollar-denominated corporate bonds publicly issued in the US domestic market.

ICE BofA US Emerging Markets Corporate Plus Index (EMUB)
The ICE BofA US Emerging Markets Corporate Plus Index is a subset of The ICE BofA Emerging Markets Corporate Plus Index including all securities denominated in US dollars.

ICE BofA Global Government Excluding the U.S. Index (N0G1)
The ICE BofA Global Government Excluding the U.S. Index tracks the performance of publicly issued investment grade sovereign debt denominated in the issuer's own domestic currency. N0G1 excludes U.S. government bonds.

Emerging Markets Bond Index Global Diversified (EMBI® Global Diversified):
The EMBI Global Diversified is a uniquely-weighted version of the EMBI Global. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts of debt outstanding. The countries covered in the EMBI Global Diversified are identical to those covered by the EMBI Global.

JP Morgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI Broad Diversified)
The CEMBI tracks total returns of US dollar-denominated debt instruments issued by corporate entities in Emerging Markets countries. Two variations are available: CEMBI Broad and CEMBI. The CEMBI Broad is the most comprehensive corporate benchmark followed by the CEMBI, which consists of an investable universe of corporate bonds. The CEMBI Broad Diversified limits the weights of those index countries with larger corporate debt stocks by only including a specified portion of these countries' eligible current face amounts of debt outstanding.

JP Morgan Government Bond Index-Emerging Markets (GBI-EM)
The GBI-EM is the first comprehensive, global local Emerging Markets index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure. Variations of the index are available to allow investors to select the most appropriate benchmark for their objectives.

S&P 500 Index
An index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

Nasdaq Composite Index
An index that tracks the change in the total market value of all companies listed on the Nasdaq Stock Market.

Russell 2000 Index
An index measuring the performance of the 2,000 smallest companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small cap stocks in the United States.

MSCI EAFE Index
The index is a capitalization weighted index that monitors the performance of stocks from Europe, Australasia and the Far East.

MSCI Europe Index
The index is a free-float weighted equity index measuring the performance of Europe Developed Markets.

MSCI Japan Index
The index is a free-float weighted equity JPY index.

MSCI Emerging Markets Equity

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.