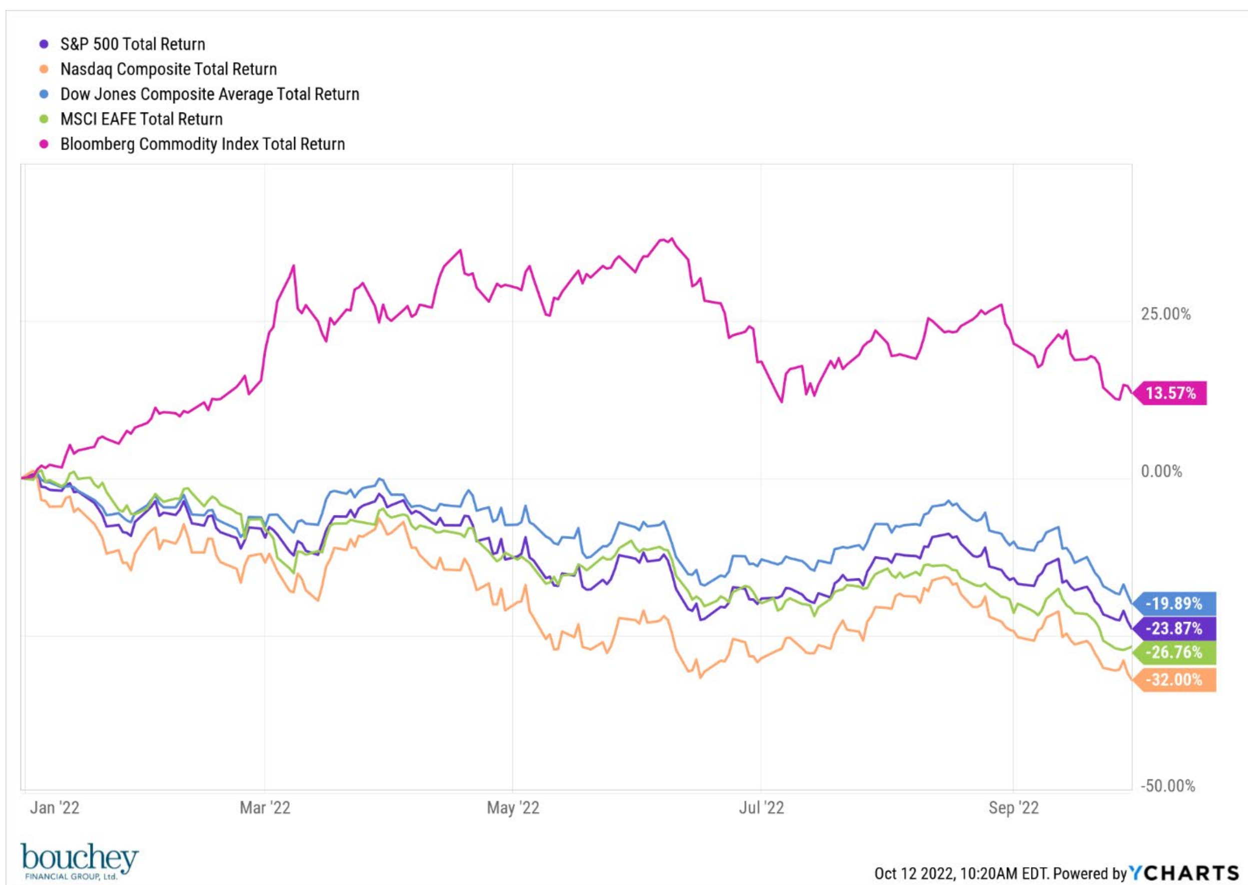
Q3 - 2022 BFG Quarterly Economic and Market Review

Market Review – Re-testing & Surpassing the Low's

The stock market previously bottomed in mid-June, with the S&P 500 closing down almost 23% for the year on June 16th. From there, we started to see a nice recovery for the next two months and into the start of the 3rd quarter. Just as hope began to emerge, inflation stayed stubbornly high. Readings for July were elevated, but showed some relief. Then came the sticker shock of August's inflationary readings in mid-September. Since then, expectations of a soft landing quickly faded. The markets closed the quarter on a bit of a sour note, reaching new lows for the S&P 500 on the final trading day of the quarter. As Jerome Powell stated, the Fed is here to stop inflation no matter the cost.



Inflation & the Fed

It's clear now and goes without saying, but the Fed's recent mismanagement of inflation and interest rates will be written about and studied for generations to come. It was no easy task and there is no playbook on how to deal with a once in a lifetime global pandemic combined with its lasting effects. But even last fall many questioning the Feds transitory categorization of inflation. It was obvious that the economy was improving, we had avoided the worst of things, and with the enormous amounts of

money being pumped into the system, inflation would be more than a blip on the radar. Unfortunately, the Fed dragged their feet and were left playing catch up. Inflation is still near its highs, with no signs of a meaningful slowdown. Many measures of inflation are showing signs of slowdown, namely energy and housing prices, but what's keeping the lofted numbers seems to be the tight labor market. Wages have been elevated, and just like toothpaste, once it is out, you cannot put it back in the tube. The Fed has a dual mandate – to keep inflation and unemployment low. They have succeeded at one end (low unemployment), now to the detriment of the other mandate (inflation). With both working against each other, the only way to see change it seems is for one to give.

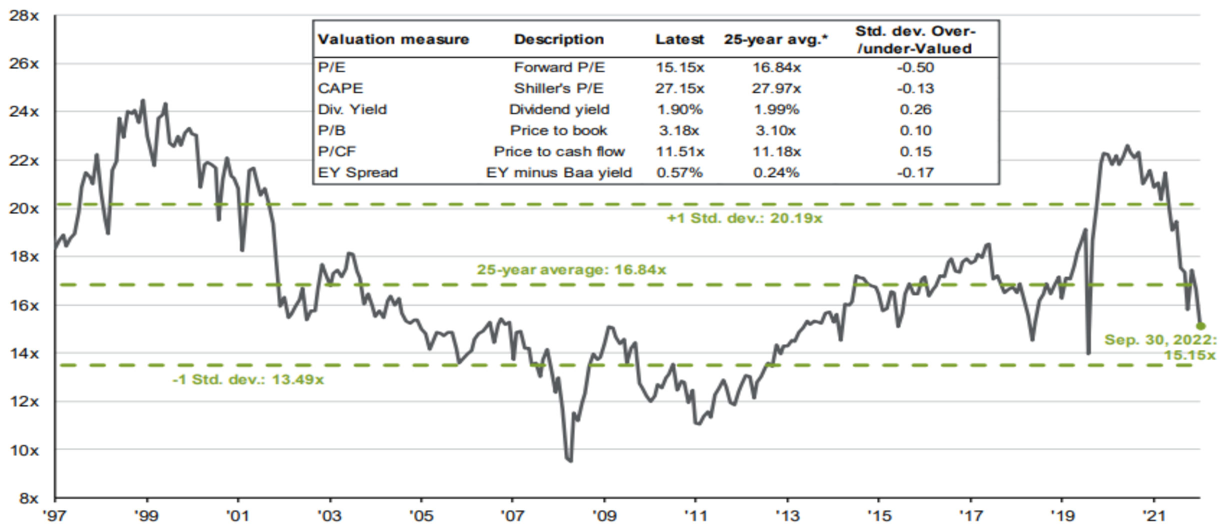
For too long this year, the entire stock market has hinged on inflation anticipation and the Fed. The market historically hates surprises, a surprisingly high inflation figure meant more Fed intervention and subsequent market volatility. The good news is with the markets being well off their highs and in bear market territory, stock valuations are falling more in line with historical averages.

Earnings & The Economy

We seem to be in the stage of "good news is bad news" for the stock markets. If the economy stays strong, that puts even more pressure on the Fed to slow down the economy. If the Fed puts more emphasis on rising rates, it will drive stocks lower. How will earnings affect all of this?

Stocks are priced appropriately for expected Q3 & Q4 earnings. The 25-year average of Price-to-Earnings (P/E) ratio for the S&P 500 has been 16.84x. As of September 30th, the P/E ratio has moved to 15.15x. As long-term investors this is a good thing. This indicates more upside than downside on a long-term basis. But in the short-term? This is much harder to predict.

S&P 500 Index: Forward P/E ratio



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	15.15x	16.84x	-0.50
CAPE	Shiller's P/E	27.15x	27.97x	-0.13
Div. Yield	Dividend yield	1.90%	1.99%	0.26
P/B	Price to book	3.18x	3.10x	0.10
P/CF	Price to cash flow	11.51x	11.18x	0.15
EY Spread	EY minus Baa yield	0.57%	0.24%	-0.17

Source: FactSet, FRB, Refinitiv Datastream, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since August 1997 and by FactSet since January 2022. Current next 12-months consensus earnings estimates are $241. Average P/E and standard deviations are calculated using 25 years of history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure. *P/CF is a 20-year average due to cash flow availability.
Guide to the Markets – U.S. Data are as of September 30, 2022.

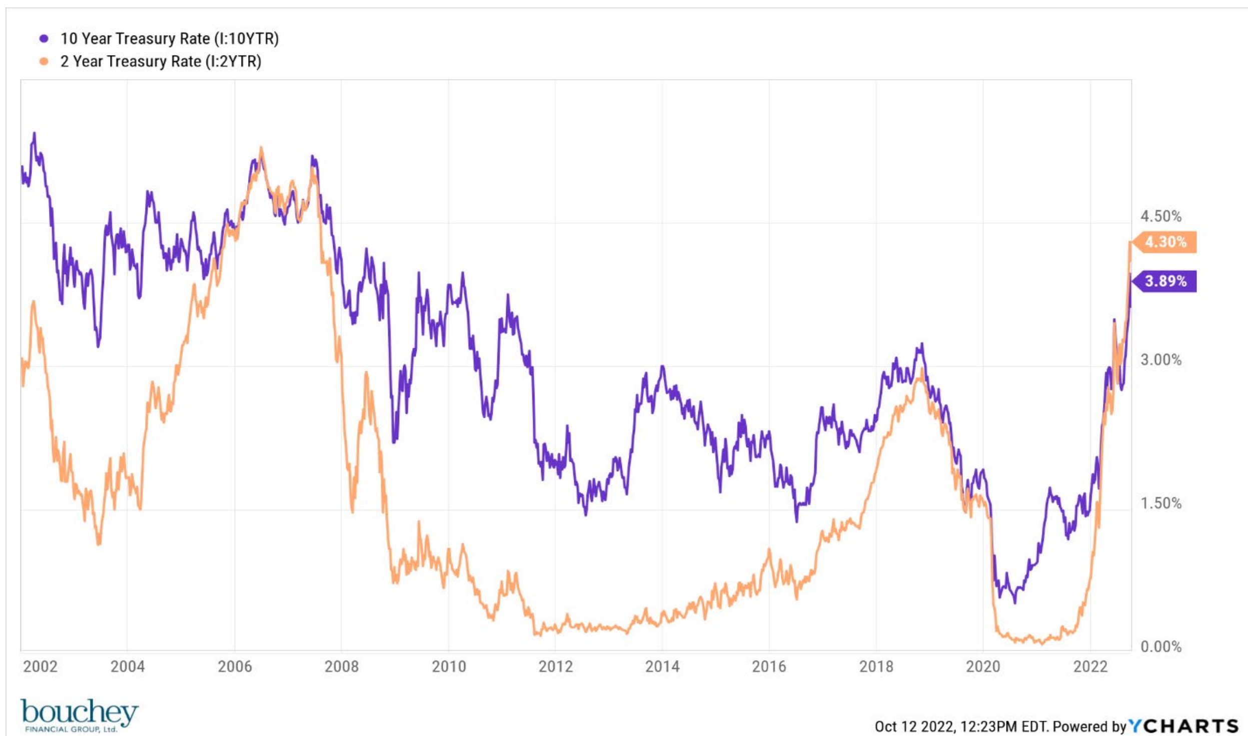
J.P.Morgan
ASSET MANAGEMENT

So far this year we have seen small decreases in future earnings expectations from where they were at the start of the year. This could also explain some of the losses in stocks. If we start to see signs that companies are not keeping up with earnings expectations and they fall short for Q3, or they get revised lower for Q4, could we see additional volatility? It is certainly possible. What is already baked in the stock price cake? Impossible to say.

Fixed Income Impact

This has been the worst year for bonds, and it's not even close. The Barclays Aggregate Index is off around 15%. The worst year for bonds before this was 1994 – ONLY down 2.9%! It's amazing how fast bonds have fallen. A year like this can have a massive negative impact on what our feelings are for certain asset classes. For most of the year, many wondered why you would ever own bonds if they had this type of volatility? It was one of the reasons we moved to alternatives early in the hiking cycle.

While it made sense to feel this way early on, the recent rise in rates have brought bonds back into favor for investors. Even more so for conservative investors, or savers looking for yield. As rates begin to stabilize, there will be good entry points into the fixed income market. We felt very comfortable adding more alternatives to the portfolio earlier in the year, but as we begin to see attractive yields, you will see more purchases of bonds and bond funds in our portfolios. We will never be able to time the bottom for bonds, but the risk metrics have made them attractive enough to gain exposure again. And whether you own individual bonds or bond funds, you must have a long-term approach with them, much like equities. If the value goes down, it means rates have risen. And if you hold long enough, the higher yields and total returns will make up for any short-term loss in market value.



What's Next

We really haven't seen the market trade lower based on bad economic or earnings data this year. We've continued to see robust earnings, strength in the economy, and high consumer demand. The major volatility spikes and downturns have been driven by inflation & Fed expectations. What happens if we start to see a slowdown? Has the market priced this in yet?

We think some of this could be priced in. Obviously higher Fed rate hikes will have that impact, so it must be somewhat baked into current prices and valuations. What happens to investor sentiment when we see the impact of weaker earnings? If earnings miss, or expectations come down, the possibility of further volatility is certainly there. We want to be prepared for that.

The likelihood of a sharp bounce back in stocks like we saw during Covid is small. Covid-19 was such an isolated period that it is difficult to see a sharp, extended rally as we saw in the late stages of 2020 and 2021.

We want to be positioned for some of the extended volatility we could experience from the Fed's insistence on slowing the economy. But let's not forget, the market will always be forward thinking. The market will begin its to recovery ascent when the news and headlines are at their rock bottom. In times of extended strength or weakness, the market and the economy tend to move together. But at peaks and troughs, the market will be quicker to respond. We want to be positioned for short-term volatility, yet prepared to capitalize on good opportunities. If we have the right time horizon, the next 3-5 year period will be very advantageous for the patient investor. Now is not the time to overreact to the negative headlines, and we will want to be in a position to take advantage of the next five years if history is our guide, such as the chart below.