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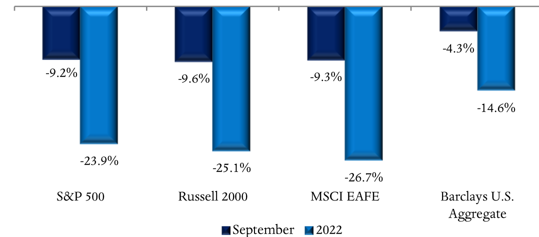
Markets

Extreme volatility, a strengthening US Dollar, negative equity returns, and rising bond yields, all present throughout 2022, continued to saturate the investment landscape in the third quarter. Financial markets attempted to price-in interest rate cuts from the Federal Reserve in 2023, stoking hopes of a soft landing for the economy. However, central bankers dashed those hopes, reiterating that their priority remains the fight against inflation, even if it leads to a recession. In the face of higher interest rates and fears of softening economic growth, the bellwether S&P 500 stock index fell -4.9% in Q3 (-23.9% ytd). Overseas, the MSCI EAFE developed market equity index dropped -9.3% for the quarter (-26.7% ytd). The European Stoxx 600 index tumbled -4.3% in Q3 (-18.0% ytd). In Asia, equity declines have generally been more subdued but China's Shanghai composite performance accelerated to the downside (-9.7% in Q3; -14.8% ytd). In Japan, the Nikkei 225 index was resilient, falling -0.8% in Q3 (-8.1% ytd). The US Dollar continued to exhibit strength, notably versus the Yen, Pound Sterling and Euro, leading the Dollar index higher by +7.1% in Q3 (+16.8% ytd).

Fixed income markets were also rattled, as central banks backed up their tough talk with quarterly policy rate hikes totaling 1.50% from the Federal Reserve, 1.25% from the European Central Bank and 1.00% from the Bank of England. Additionally, investors contended with a much more aggressive path of future rate hikes, with interest rates now expected to rise to 4.50%, 3.50% and 5.75% by next year in the US, Europe and UK respectively. As a result, the Bloomberg Barclays US Aggregate bond index declined -4.8% in Q3 (-14.6% ytd).

Commodities declined over the past quarter, alleviating some of the inflationary pressures of which they had been a main driver. WTI crude oil prices retreated by nearly 30% during the quarter, to $79.49/barrel, driven in part by reduced consumption, streamlining of supply lines, and the release of some of the US's strategic petroleum reserves. Meanwhile, the Food and Agriculture Organization world food price index dropped to its lowest level since the start of the war in Ukraine. In this context the S&P GSCI commodity index pulled-back -14.3% last quarter (+8.3% ytd).



Geopolitics

As the Russo-Ukrainian war entered its seventh month, Ukraine was successful in its first counter-offensive, pushing back Russian troops and retaking large swaths of its country. The increasingly sophisticated weapons supplied to Ukraine by the West appear to be having a meaningful impact. As a result, Russia began calling up military reservists and instituted a draft. Thereafter, it claimed that staged referendums in four occupied regions of Ukraine showed the people chose to join the Russian Federation. Lastly, in a symbolic move, Ukraine applied for "accelerated" NATO membership.

The death of Queen Elizabeth II was mourned and honored by Britain and the world. Aged 96, she had reigned for 70 years, the UK's longest serving monarch.

United States

Economic data published in the third quarter continued to highlight the resilience of the US economy. The university of Michigan's consumer confidence survey, which had been trending downwards, rebounded

thanks in part to household income gains. The latest employment and JOLTS (Job Openings and Labor Turnover Survey) reports highlight ongoing momentum in the jobs market, with the latest unemployment figure coming in at a near-record low 3.5%. Wages and salaries have risen circa 10.0% over the past year, reflecting a 5.2% increase in average hourly earnings and a 4.1% rise in payroll jobs. In addition, manufacturing activity still remains in expansionary territory.

On the inflation front, consumer prices eased for the second straight month in August, with the year-over-year inflation rate falling to 8.3%. Notable drivers were the 10.5% decline in gasoline prices, partially offset by shelter costs (a lagging indicator), which rose by 0.7%. Looking ahead, inflation is expected to moderate in the coming months, but remain well above the Federal Reserve's 2% target for an extended period of time.

As a result of inflation and the Fed's tighter monetary policy long-dated fixed mortgage rates have more than doubled to between 6 and 7%, the highest levels since 2007. Consequently, housing activity data are in a steep downward trend. Nevertheless, home ownership fundamentals are stable as 95% of mortgages have long-term fixed rates while the percentage of subprime loans has dropped from 14.0% in 2008 to 2.3% today.

Europe

In Europe, the energy crisis continued to dominate the headlines as Russia completely halted gas flows through the key Nord Stream 1 pipeline at the start of September. However, what had been considered the worst-case scenario for Europe didn't lead to new highs in gas prices, which after having reached more than €300 per megawatt hour in August dropped back to approximately €200 by the end of the quarter. This was thanks to the above-average imports of liquefied natural gas filling 85% of the region's underground gas storage capacity. The EU also embarked on an electricity savings plan, with a broad consumption reduction target of 10%; a cap on energy prices; and a tax on the revenues of fossil fuels producers.

September 2022 Economic Statistics

	Sep-22	Dec-21	Dec-20
Federal Funds Target Rate	***3.00 - 3.25%***	0 - 0.25%	0 - 0.25%
Consumer Confidence Index	***108.0***	115.8	88.6
Manufacturing PMI Index	***50.9%***	58.7%	*60.7%*
Unemployment Rate	***3.5%***	3.9%	*6.7%*
JPY/USD	***144.75***	115.08	*103.24*
USD/EUR	***0.9799***	1.1368	*1.2213*
Gold/oz.	***$1,659.67***	$1,828.39	*$1,896.49*
Oil (WTI)/bbl	***$79.49***	$75.21	*$48.52*

With regard to the EU economy, the situation continued to deteriorate during the third quarter, to the extent that a recession now looks likely. Relevant data published in the quarter pointed to a slowdown. For example, the euro area composite PMI business survey, which descended into contractionary territory. Industrial production dropped sharply in July and the union's consumer confidence dropped to a new all-time low in September. Inflation, which reached 9.1% year-over-year in August may not yet have peaked and may persist. As a result, the European Central Bank became more hawkish, hiking its policy rate by 0.75% in September, and is expected to increase rates by another 0.75% in October and by 0.5% in December, to bring them to 2.00% by year end.

In the UK, the economy continues to show a loss of momentum. Consumer confidence fell to an all-time low in September and the PMI business survey dropped further into contractionary territory. The labor market, however, remained a bright spot as the unemployment rate fell to 3.6% in July, its lowest level since 1974, with associated wage growth annualizing at 5.5%. Inflation remained elevated with August's CPI reading softening to 9.9% from 10.1%, yet core CPI increased from 6.2% to 6.3% year-over-year. With a further increase expected in October on the back of higher energy bills, the Bank of England was called into action, announcing two rapid 0.50% rate hikes, with more expected to follow in the near future.

However, it was the UK's fiscal policy that attracted all the market attention as the new government an-

nounced a substantial unfunded spending package that would significantly increase government borrowing. Markets reacted very negatively to the announcement, with sterling falling sharply and Gilt yields increasing substantially. In fact, UK borrowing costs rose so rapidly following the announcement of the fiscal package that the Bank of England was forced to intervene to purchase long-dated government bonds towards the end of September. At quarter-end UK 10-year Gilt yields stood near 4.0% compared with 2.2% three months earlier.

Asia

The Chinese economy continues to grapple with the country's zero-covid policy, weather-related disruptions and persistent weakness in the housing market. As the third quarter progressed, however, local economic data started to improve, aided by policy measures which supported fixed asset investment and industrial production. Weak domestic demand has allowed China to sidetrack the inflationary pressures faced by most other countries. Both CPI and producer price index (PPI) inflation came in below expectations in August, dropping to 2.5% and 2.3% year-over-year, respectively. This benign inflation environment allowed the People's Bank of China to symbolically ease monetary policy by lowering its policy rate 0.1% to 2.75%. In addition, China's State Council, chaired by Premier Li Keqiang, announced modest new measures, signaling that ongoing deflationary tendencies are likely to persist. Meanwhile, slowing growth in advanced economies is just now starting to hit China's export sector. In all, the fragility of China's economy has increased, after decades of mal-investment.

Outlook

The global economy is set to slow, with some countries likely to enter recession over the coming year. The magnitude in the US will be substantially dependent on the Federal Reserve's policies and whether they favor the fight against inflation over supporting growth. Europe will have to contend with tighter monetary liquidity, the impact of the energy crisis on households and businesses, as well as the trajectory of the Russia-Ukraine war.

While the economic growth outlook remains challenging, many stocks are already pricing in a relatively high probability of at least a moderate recession. This makes valuations, which have generally fallen below their 25-year averages, look more attractive for long-term oriented investors. In the US, the average stock trades on a price-to-earnings ratio of 15.6 vs. a long-term average of 16.6. We must, however, offer the caveat that current valuations are based on consensus earnings forecasts, which are being gradually revised down. A final market bottom may be awaiting such earnings downgrades, but our favored quality-oriented global growth stocks should be able to weather the storm and emerge stronger than before.

Government bond prices are discounting a significant amount of further central bank liquidity tightening. In fact, fixed income securities have sold off far more, in relative terms, than stocks during the current interest rate cycle. The 6-month to 7-year segment of the US Treasury yield curve now offers investors a circa 4% yield (rising from near-zero levels in the near-past). Relative to inflation expectations, a 5-year US Treasury note, bought today, is likely to produce positive total-real returns through maturity, serving to preserve capital with modest associated volatility.

We remain conservative with regard to portfolio construction. Quality stocks can be augmented with a portion of non-market correlated alternative assets, in addition to short duration fixed income. In terms of special situations, the agriculture sector is set to benefit from inflationary trends and food security concerns, offering solid investment prospects. For long-term investors, seeking to capitalize on disruptive technology trends, we are focusing on attractive growth and venture opportunities in the food and beverage, edu-tech and cybersecurity sectors. We also wish to reiterate the compelling growth prospects of the companies in our Nordic Technology and Innovation Fund, whose valuation the manager believes to be "lower than we have seen during the past 10 years."

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Sources: Barclays, Bloomberg, Bureau of Labor Statistics, Conference Board, Department of Agriculture, Federal Reserve, Financial Times, IMF, Institute for Supply Management, MSCI, Reuters, Russell, Standard & Poor's, and the Wall Street Journal.