BUCKHORN
INVESTMENT ADVISORS

Third Quarter Market Review and Comment
October 2022

Updated Market Performance

Returns	3rd Quarter 2022	Year to Date 2022	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**-4.88%**	**-23.87%**	**-15.47%**	**8.16%**	**9.24%**	**11.70%**
DJIA	**-6.17%**	**-19.72%**	**-13.40%**	**4.36%**	**7.42%**	**10.45%**

Performance: July reversed June's loses returning 9.22% after dividends. August and September continued this year's downward trend respectively returning -4.08% and -9.21%. This left us with a 3rd quarter 2022 total return of -4.88%. This leaves us a year-to-date return of -23.87% which marks the worst year to date return through the 3rd quarter since 2002's decline of -28.94%. The only silver lining is that the 4th quarter 2002 gained 7.92%.

After the 2nd quarter 2022 posted a loss of -16.10%, the 3rd quarter 2022 started off positive, but wavered leaving us with a return of -4.88%. The Dow Jones Industrial Average (DJIA) unperformed the SP500, posting -6.17% loss over the same period. For the previous twelve months the SP500 has returned -15.47%, underperforming the DJIA which returned -13.40% over the same period. The annualized three-year returns for the SP500 were 8.16%, the DJIA three-year returns trailed the average increasing 4.36%. Over the last five years the annualized returns are running around historical norms (around 10.50%), with the SP500 returning 9.42% and the DJIA posting 7.42%. The ten-year annualized numbers are running above long-term averages (around 10.50%), with the S&P500 returning 11.70% versus the DJIA which turned in 10.45%.

Breaking down the returns for Q3 2022, we note that there were five outperforming sectors and 6 underperformers. **The best sectors were Consumer Discretionary (4.13%), Communication Services (-3.51%) and Energy (1.16%%)**. **The underperformers during the quarter were Real Estate (-11.66%), Materials (-7.64%) and Consumer Staples (-7.24%).** The best sectors over the last twelve months were Energy (39.58%), Utilities (2.45%) and Consumer Staples (-2.63%). Following behind, were Communication Services (-28.16%), Consumer Discretionary (-21.50%) and Information Technology (-20.73%).

Economy: Growth in the economy has increased the second half of this year after negative growth the first half of the year. However, growth is still below average (Historical growth is ~3.00%). Expectations are that next year we will see another deceleration in growth. Inflation is still running hot although it seems to have peaked. The Fed has been aggressively tightening monetary policy to get inflation under control. Normally when the federal reserve tightens monetary policy and raises short term rates, they usually end up hindering growth and causing the economy to go into a recession. Recession risks are currently high. We had a technical recession in the first half of the year which is defined as two negative quarters of GDP. We think a more meaningful recession will occur sometime in 2023 or 2024.

The advance estimate of 3rd quarter 2022 Gross Domestic Product (GDP) is 2.6% according to the report released at the end of October by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the 3rd quarter increased 3.2% from the 2nd quarter 2022 third estimate of -.60%. GDP for 2021 came in at 5.7% compared to -3.5% in 2020, 2.2% in 2019, 2.9% in 2018 and 2.2% in 2017. Currently Trading Economics estimate (Forecast of U.S. GDP Growth) has forecasted 2022 Q4 GDP growth at .90%. By comparison, China says their GDP increased at 3.9% in the 3rd quarter of 2022. Increasing from 2nd quarter 2022 reading of 2.7%. China's 2021 GDP was 8.1%, 2.3% in 2020, 6.1% in 2019, 6.6% in 2018 and 6.8% in 2017. Growth rates for the European Union (EU) and the Euro Area were 4.20% and 4.1% respectively in the 2nd quarter 2022. For 2021, GDP grew 5.3% for the EU and 5.3 for the Euro Area. For 2020, GDP fell -6.1% for the EU and -6.37% for the Euro Area. For 2019, GDP rose 1.5% for the EU and 1.2% for the Euro Area. This is down from the 1.9% growth achieved by the EU and the 1.8% achieved by the Euro Area in 2018. GDP Growth forecasts for the end of the 3rd QTR 2022 are 1.50% for the EU and .30% for the Euro Area.

Unemployment is continuing to trend below historical norms (~5.76%). Even with increased layoffs in the headlines unemployment remains resilient. According to the Bureau of Labor Statistics, September unemployment edged down 3.5% from August. Unemployment for 2021 came in at 5.36%. Unemployment was 8.11% and 3.67% in 2020 and 2019 respectively. The number of unemployed decreased to 5.8 million in September. These are minor changes from their pre-pandemic levels in February 2020 of 3.5% and 5.7 million, respectively. The labor force participation rate was little changed in September at 62.3% but remains 1.1% lower than in February 2020.

Inflation increased 8.2% in September continuing to run hot and above average trend, but we are beginning to see characteristics of it peaking. After averaging 8.67% in the 2nd quarter 2022, inflation as measured by the Consumer Price Index (CPI) increased to an average of 8.33% for the 3rd quarter 2022. The average rate of inflation for 2021 was 4.70% and was above average by historical standards (~2.47% over last 30 years and 3.23% from 1914-2021). The energy index increased 19.8% for the 12 months ending September, a smaller increase than the 23.8% increase for the period ending August. The food index increased 11.2% over the last year.

Consumption is an important driver of the economy as it represented 68.4% of 2nd quarter 2022 nominal GDP. The U.S. Census Bureau announced in October that retail sales for September 2022 were up 0.0% from August and were up 8.2% above September 2021. Gasoline stations were up 20.6% from June 2021, while the Non-store retailers were up 11.6% over the same period.

Manufacturing economy grew in September. Economic activity in the manufacturing sector expanded for the month of September, with the overall economy notching its 28th consecutive month of growth. The Purchasing Managers Index (PMI®) registered 50.9; a decrease of 1.9 from August's reading of 52.8. The Manufacturing PMI® continued to indicate sector expansion and U.S. economic growth in September. Of the five subindices that directly factor into the Manufacturing PMI®, three (Production, Supplier Deliveries, and Inventories) were in growth territory. Of the six biggest manufacturing industries, four (Machinery, Transportation Equipment, Food, Beverage & Tobacco Products, and Computer & Electronic Products) registered moderate to strong growth in September. The Production Index increased 0.2 percentage point and remained in expansion territory. The Supplier Deliveries Index slowed at a slower rate while the Inventories Index grew at a faster rate, indicating continued easing of supply chain congestion. Seven of the 10 subindexes were positive for the period; a reading of 'too low' for the Customers' Inventories Index is considered a positive for future production. A reading above 50 indicates that the manufacturing economy is generally expanding; below 50 indicates that it is generally contracting. The overall economy grew for the 28th consecutive month, according to the nation's supply executives in the latest Manufacturing ISM® *Report on Business®*. Based on historical relationships between PMI and GDP, a PMI of 50.9 corresponds to a 0.8% increase in real gross domestic profit (GDP) on an annualized basis.

Home prices continued to decrease in August but still have strong year over year gains. However, increasing mortgage rates should increase supply in turn continuing to lower prices. According to the S&P Case-Shiller Home Price Indices home prices in August rose 13.0% over the last 12 months which is down 2.6% from the previous month's 15.6%. Miami, Tampa, and Charlotte had the largest year over year increases with 28.6% for Miami followed by 28.0% for Tampa and 21.3% for Charlotte. According to the National Association of Realtors, the year-over-year change in existing home sales was –17.9% in September for Single family homes between $250,000-$500,000 and housing supply continued to remain tight in September with 2.4 months of supply.

Markets: The markets have continued to retreat after hitting an all-time high on the S&P 500 January 3rd, 2022, at 4,796.5. We went from being in a Bull market to being in a Bear market. At this time, the market continues to be driven by hawkish monetary policy, inflation, recession fears, decreasing corporate earnings growth, and the conflict between Russia-Ukraine.

What will move the markets moving forward:

- **Earnings: Earnings growth for the SP500 is expected to increase 1.5% for the 3rd quarter 2022 which is the lowest growth rate since 3rd quarter 2020 (-5.7%).** According to FACTSET, of the SP500 companies that have reported earnings as of October 21st (approximately 101), 72% reported earnings above the mean estimate, and 70% have reported sales above the mean estimate. Looking at future quarters, analysts project earnings growth for the 4th QTR 2022 to be 2.7% and 5.1% for the 1st QTR 2023.
- **Valuations: Valuations have come down meaningfully this year.** The current 12-month forward Price to Earnings is 15.15 (21.4 on January 3rd, 2022). The 20 Year average P/E is 15.5, which is .35 above our current levels. There is some room for more contraction without meaningful growth. Lower interest rates have historically allowed for higher multiples, which would allow for some P/E expansion or cushion if we don't see growth.
- **Monetary Policy/Interest Rates: Short Term Interest Rates remain low by historical averages. The average effective Fed Funds rate since July 1954 is 4.60%. The average over the last 10 years is 0.69%.** The Federal Reserve raised the federal funds rate by.75% to a range between 3.0%-3.25% in its latest meeting in September and is expected to raise rates by at least .50% in September. The Fed projections suggest a fast cycle of rate hikes over the next year, with the median projection indicating a rate of 3.375% by the end of 2022. The Fed will continue reducing its holdings of Treasury securities, agency debt, and agency mortgage-backed securities, as described in the Plans for Reducing the Size of the Federal Reserve's Balance Sheet that were issued in May. The Committee is strongly committed to returning inflation to its 2 percent objective. The spread between the 2-year and 10-year Treasury yields have narrowed sharply as short-term rates have risen faster than long-term rates amid expectations for Fed monetary policy tightening. The yield curve is currently inverted (2-year yield is higher than the 10-year yield) and financial conditions are tightening. **Ten of the last Twelve recessions have occurred during a rising interest rate environment when short term rates were higher than long term rates (Inverted Yield Curve), which leads to our ongoing concern of the Fed raising rates too fast. It is not if, but when.**

- **Inflation: Inflation has been stubborn and remained high so far this year, but we are beginning to see some softening which should lead to lower inflation.** The only silver lining is that Social Security will be increasing 8.7% in 2023. Inflation currently does not seem to be going anywhere. We had thought inflation would cool off the second half of the year, but the Russia-Ukraine conflict has increased oil and gas prices as well as other commodities. Currently the Fed has committed to increasing interest rates and decreasing their balance sheet to try to fight inflation. This comes at a time when growth is about to slow. If growth slows too much and inflation stays elevated/high, we may end up with stagflation.
- **Russia-Ukraine Conflict: The current conflict is expected to weaken the European economy more than the US economy, with some speculation of a recession in some countries (especially Germany).** We are currently feeling the impact through higher oil and commodity prices. At this time, it is hard to determine the total impact this conflict will have on the US.

Forecast:

We think the biggest threats to the stock market are interest rates continuing to increase accompanied by runaway inflation, the Fed tightening monetary policy, and economic contraction. We think the SP500 will end the Q4 2022 between 4000 and 4100. At this juncture, we venture a guess that stocks will end the year somewhere between -15% and -18% for the year.

For the next six to twelve months, the Federal Funds rate will most likely increase from its current range of 3.00%-3.25% to 4.00-4.25%. **The 10-year Treasury which is currently priced at ~4.04% should remain in a range between 3.80%-4.00% through the end of the 4th quarter.**

As always, we appreciate your continuing confidence in our firm. Please let us know if you have questions.

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