

HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

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We usually look to economic data for clarity on the state of the U.S. economy. But the usual analysis is difficult at this time. Every day, observers change their stance, as one day's news provides a different picture from the previous day's news. And often, it seems we have a never-ending stream of bad news—if it's news about inflation (and the Fed's reaction) one day, the next day's headlines indicate a possible recession, followed by more bad news about inflation. As opposed to clarification, we think all this reporting and analysis has added to the stock market volatility of recent months.

We expect the outlook to remain confused in the months ahead. Inflation will remain stubborn given continued supply chain problems, the Ukraine war, and Covid lockdowns in China. The Federal Reserve has announced its intention to maintain aggressive monetary policy until inflation is contained. The big questions are: Where does inflation go from here and how will the Fed respond? Will that response be too overly aggressive and push the economy into recession? How will the stock market react?

Some analysts argue that we may be poised for recovery in the stock market. They believe inflation is now subsiding and the Fed will pull back from its current policy. We certainly hope the Fed will be cautious about further rates hikes at its November meeting. But we cannot predict at this time what will happen. We think the market will remain unsettled in its current trading range for at least the next six months – and that further declines are certainly possible. The good news is that portfolio income has remained the same or slightly elevated with higher short-term yields and consistent dividend payouts among quality companies.

In this environment, we are advising clients to be calm and maintain their identified portfolio strategies. Equities remain the best long-term investment and we look for sectors and companies that can push beyond the current turmoil. We also are acting on new opportunities in the non-equity portion of client portfolios.

MARKET TRENDS

The accompanying chart summarizes stock and bond market trends in the third quarter and first nine months of 2022. Both markets took a strong hit from all the negative economic news and from the onset of much higher interest rates.

Equity Market: The stock market had rallied in July and early August based upon some evidence that inflation might be abating. That optimism was dashed when the Fed moved

ahead with three rate hikes that brought the short-term rate to 3.25%. The Fed was tough with its words and actions on the need to squash any inflationary spiral. The market then tumbled for the rest of the quarter putting U.S. stocks on path to their worst year since the fiscal crisis of 2008. The S&P 500 ended the third quarter with a decline of 4.88% and was down 23.87% for the year-to-date. The Dow Jones Industrial Average was off 6.88% for the quarter and 19.89% for the year-to-date. The Russell 2000 was down 2.9 % for the quarter and 25.1% for the year. The worst performer was the Nasdaq Composite which was down 3.9% for the quarter and 32% for the year. The market has fluctuated in the early days of October.

Fixed Income Market: The monetary tightening by the Fed has sent bond yields surging, hurting bond prices, and eliminating the hedge that bonds often offer against stocks. Some analysts observed that it has been 50 years since stock and bond prices fell this much in unison. The yield on the benchmark 10-year U.S. Treasury Note (which moves inversely to prices) ended on September 30 at 3.873% up from 1.496% at the end of December. The Bloomberg U.S. Aggregate Bond Index was down more than 16%, its worst year since 1976.

MAJOR MARKET INDEXES

	YTD Return
Dow Jones Composite Average TR	-19.89
S&P 500 Index TR	-23.87
Russell 2000 Index TR	-25.10
NASDAQ Composite TR	-32.00
EAFE Index NR	-27.09
Bloomberg Aggregate Bond Treasury TR	-13.09

Source: Morningstar® as of September 30, 2022

THE OUTLOOK

The Economy: Inflation is top of mind at the Federal Reserve. Stripping out volatile fuel and food prices, to get a sense of underlying inflationary pressures, the consumer index climbed 4.9% over the year through August, an acceleration from 4.7 % the month before. The Fed is determined to reverse this trend. The situation may be complicated by the decisions of OPEC Plus to cut oil production.

The recovery from the pandemic doesn't appear to be over just yet. Employment growth remains strong as indicated in the September jobs report – which showed a cooling but still

solid trend. Consumer activity remains positive as consumers continue to spend down the massive savings they accumulated during the pandemic.

That said, the U.S. economy is slowing. Growth in GDP is now expected to be under 1% for the 2022 year as compared to a forecast of 3% at the start of the year. The prospect of a global recession is real and will certainly affect the U.S. The International Monetary Fund now estimates that countries accounting for about a third of the world economy will experience at least two consecutive quarters of contraction in 2022 or 2023. The IMF warns of the global repercussions as most central banks raise borrowing costs and the Ukraine war drags on.

The Market: Amidst these confusing economic signals, investors will be watching closely in coming weeks as corporations report their earnings for the third quarter. At the start of 2022, analysts were generally predicting earnings growth of about 10%. Looking ahead, they now expect earnings growth of 6% for Q3 and Q4 2022. Fitch Ratings has said corporate earnings trends, historically a leading indicator of recessions, will continue to weaken through 2023.

We always look carefully at Price/Earnings ratio. The forward 12-month P/E ratio is now 17.8. – as compared to over 20 in the past two years. So stocks are now more reasonably priced but still higher than the 100 year average of 17.1 and all time average of 15.98. The effect of lower corporate earnings on this ratio going forward remains to be seen.

At Hudson Advisors, our concern is that a material slowdown in economic growth has not yet been fully priced into stocks, and there will be more volatility as that happens. As stated, we expect stocks to remain in their current trading range for the next six months. We also will not be surprised if stocks dip lower for a period until the economic picture becomes clearer and more positive. One ray of hope is that the U.S. stock market will be more attractive than most international markets.

OUR STRATEGIES

Asset Allocation: Most clients should stick to portfolio strategies previously identified. We advise against an increased allocation to equities at this time. For some clients, we may recommend taking some money off the table right now. For new clients, we will recommend a 60% allocation to equities to be phased in over a 12- to -18- month period. The other 40% of assets will be short to intermediate term bonds, cash, and alternative investments.

Preferred Equities: As always, despite market conditions, we look for long-term equity opportunities. Our focus is on companies that can weather both the short-term period and flourish in a longer time frame. We want fundamentally sound companies with reasonable valuations and that pay dividends. In that context, we are looking at these sectors:

HEALTH CARE: This sector has proven to be economically resilient and has provided good returns historically.

UTILITIES: Companies in this sector have provided consistent earnings and good dividends.

TECHNOLOGY: We are interested in selective technology companies with emphasis on innovation, especially those helping to build out 5G infrastructure.

CONSUMER STAPLES: Some of these companies can actually do well in an inflationary environment where consumers stick to basics like food and household items.

FINANCIALS: Higher interest rates can improve banking net interest income and we are interested in regional banks.

Other Assets: Our aversion to long-term bonds remains and is reinforced by the inflationary outlook. We like bond maturities under two years which now have higher rate returns than previous years. We like laddered investments with a mix of U.S. Government, municipal, and high- quality corporate bonds. We also like the new better-paying opportunities in money market funds.

Dow Jones U.S. Sectors Total Return (Percent Change for YTD, Ending September 30, 2022)

Source: Morningstar®

Oil & Gas	34.55	Consumer Services	-30.70
Basic Materials	-20.89	Telecommunications	-14.65
Industrials	-24.68	Utilities	-6.78
Consumer Goods	-22.47	Financials	-22.64
Health Care	-14.85	Technology	-35.34

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