KPP Financial

2022 Q3 IN REVIEW

Q3 brought more pain in markets similar to the first half of the year, but this time commodities joined the selloff party with equities and bonds. Higher rates, a resilient economy, and a flight to safety (cash) has created a rally in the dollar that is generating pain for overseas economies and sovereign bond markets. The global economy continues to decelerate, but most of the economic pain has been felt in Europe where the war has inflicted much more damage. All things considered; it is important to note that the US economy doesn't look that bad. Employment growth, while slowing, remains strong, and many measures of economic activity have continued to grow. Oil and food prices have been falling at the wholesale level, albeit still at painfully high levels and consumer spending remains positive as consumers continue to spend down the massive savings they collected during the pandemic. Inflation, however, is likely to remain a concern. Lower energy prices have begun to push down headline inflation, but core inflation has remained high. This is likely to reverse in the coming months as based effects take hold despite oil prices rising again on the back of production cuts by many oil exporting nations. Shelter, the main component of core inflation is likely to stay elevated for some time as it catches up to the steep rise in house prices over the past two years. Prices of pandemic-related services such as airfare and restaurant meals may continue rising as well, as those industries seek to replace workers who have retired or moved to other industries. Although we remain optimistic about core inflation moderating by next year, there is still a significant possibility that it will take longer for inflation to settle back to an acceptable level. Operating in such a volatile landscape where narrative changes day to day we expect a choppy environment through Q1 2023 when the Fed will likely be forced to pivot as they break markets and economic data weakens further.

See our recommendations and the economic forecast below for Q4. Or subscribe to our **Premium Newsletter** here to get up-to-date quality analysis on market conditions and stock ideas weekly.

RECOMMENDED PORTFOLIO WEIGHTINGS

AS OF SEPTEMBER 30, 2022

EQUITY SECTORS

OVERWEIGHT

- Energy
- Industrials
- Consumer Staples
- Materials

NEUTRAL

- REITs
- Financials
- Utilities

UNDERWEIGHT

- Technology
- Health Care
- Consumer Discretions
- Communications

ASSET CLASSES

OVERWEIGHT

- Short-Term Investment Grade Bonds
- Intermediate-Term Investment Grade Bonds
- Resource Commodities
- Precious Metals
- Agriculture Commodities
- High Yield Bonds

NEUTRAL

- Long-Term Investment Grade Bonds
- Cash Alternatives
- U.S. Small Cap Equities
- U.S. Mid Cap Equities

UNDERWEIGHT

- U.S. Large Cap Equities
- International Developed Equities
- International Developed Fixed Income
- Emerging Market Equities

FIXED INCOME

OVERWEIGHT

- Municipal Bonds
- Corporate Bonds
- Bank Loans

NEUTRAL

- Mortgage-Backed Securities

UNDERWEIGHT

- U.S. Treasuries
- Agency Securities
- Preferred Securities
- TIPS

INDEXES

DATA POINT	CURRENT	YEAR-END PROJECTION
S&P 500	3,586	3,600-3,900
NYSE	13,472	14,500-15,500
10-Year Treasury Rate	3.80%	3.50%
WTI Crude Oil	$79.91	$90
Gold Priced in Dollars	$1,662	$1,850
Trade Weighted Dollar	127.64	122
Effective Fed Funds Rate	3.08%	4.02%

2022 Q4 ECONOMIC & MARKET OUTLOOK

01. EQUITIES

Sentiment closed the quarter with extremely negative sentiment

Stocks had the worst quarter of the year as all 11 sectors fell in Q3. After a rally in July, equities turned lower and registered negative returns. Hopes of a Fed pause dwindled as central banks reaffirmed their commitment to fighting inflation. The Federal Reserve, European Central Bank, and Bank of England all raised interest rates in this latest period. Sentiment levels at this point are hitting extreme levels of bearishness, which could create a near-term inflection point as we move into Q4. Despite the ever changing narrative and negative longer-term outlook, earnings in the near term, are still expected to grow. Consumers are still spending their accumulated wealth built up through the pandemic, but this will slow, making an earnings recession in early to mid-2023 increasingly more likely. The effect of inflation, quantitative tightening, and interest rate hikes has a delayed impact, and we are witnessing that now as recession possibilities get pushed out further due to stronger than expected economic data. Looking deeper, we expect the underperformance of growth to continue, as the cost of capital remains elevated, and commodities continue their recent strength in anticipation of a Fed pivot and tight inventory dynamics. Into Q4 and early 2023 we see there being great opportunities in sectors that supply the basic needs to our global economy, but pressure will remain on "disruptive" companies that trade at high valuations or have poor cash flow dynamics. As the economy continues to tighten, companies with strong fundamentals will rise to the surface, and Ponzi businesses that have relied on cheap money throughout the last several years will begin to collapse. At this point we can expect the job report numbers to decelerate, creating an environment where it will not be so easy to leave and find a better opportunity at a moment’s notice. Funds will flow back into the stock market into the companies that have taken the time to build out solid infrastructure and business models capable of withstanding turbulent waters.

02. Fixed Income

More rate hikes are priced in, but the timing of a Fed pivot is unknown

The Federal Reserve (Fed) intensified its rate increases in an attempt to catch up to rising inflation they once classified as transitory. The Fed tagged another 75 bps increase onto existing rates in September which brought the rate to between 3% and 3.25%. This is the fifth interest rate in the year so far. There are emerging signs that these efforts, along with natural base effects, are having a calming impact on inflation. Central Banks around the world are also raising rates to stem the tide of imported inflation from the US. Government bond yields were mostly higher and credit spreads wider across the global market, due to fears that tighter monetary policy could undermine further economic growth prospects. This has weighed heavily on market returns. Long-duration assets continue to be a bad place to be, but high-yield credit markets are holding up, relatively speaking. Across global credit, returns were poor as the market drawdown has continued. Sterling investment-grade bonds have been the worst performers as their yields do not make up for losses due to duration. European investment grade and high yield, as well as emerging markets credit, fared better, but returns have remained negative in that area as well. All things considered, it makes sense to stay short in duration and garner extra yield by taking smart credit risk. Looking forward, the Fed is likely to take a pause by year-end or early Q1 of 2023, as financial stress will get to be too much for the markets. This should lead to a reprieve for long-duration assets for some time but is likely to be short-lived.

03. Commodities

The strong dollar has kept a lid on prices despite tight inventory

The S&P GSCI Index recorded a negative performance in the third quarter, driven lower by weaker prices for energy, industrial metals, and precious metals. Energy was the worst-performing component of the index in the quarter, with sharply lower prices for crude oil, Brent crude, and unleaded gasoline, which offset higher prices for natural gas. Despite this pullback, commodities remain marginally higher than the level they saw at the end of 2021. China has had a significant impact in this space as their zero covid policy and a weakening economy tempered demand, while the Strategic Petroleum Reserve (SPR) release and increased drilling activity brought on supply. These factors look to be more short-term or limited in nature. Regardless, inventory remains tight across most markets. This likely means higher energy prices into year-end and in 2023. Base and precious metals also had a pullback due to the strong dollar, but most of them held long-term support. We see precious metals forming a long-term bottom as they price in sticky high inflation and a Fed who will have their hands tied by keeping financial stability over truly taming inflation. We also see a significant pullback in the dollar a likely scenario as the Fed approaches the end of its tightening cycle.

CONCLUSION

The markets appear to be at a significant inflection point moving into Q4. Long rates are coming off their biggest monthly gain in 2022, equity benchmarks are beginning to make fresh lows previously established back in June, and earnings multiples have begun to compress. Elevated inflation, the sharp rise in interest rates, and the strength of the dollar have created headwinds for the entire global economy to manage. The Federal dollar have created headwinds for the entire global economy to manage. The Federal Reserve is still at the near end of its elevated tightening cycle and the government balance sheet remains close to $9 trillion. Markets are still expecting further interest rate hikes over the final two Fed meetings in 2022, and we haven't even seen the full economic impact of the prior hikes this year. Geopolitical tensions and risks continue to impact markets creating a narrative-driven environment that changes day to day. Attention remains on the Fed, which has reemphasized its role in maintaining price stability to support consumer and business confidence. The Fed has signaled plans to continue raising rates until inflation returns to its target rate of about 2%. The market will closely watch key indicators such as the Consumer Price Index (CPI), and Personal Consumption Expenditure (PCE) numbers to help forecast the impact of the rate increases and what that would mean for a potential recession. Moving into year-end, and early 2023, we expect a choppy environment. The elevated level of fear and uncertainty typically brings a lot of quality opportunities, and we see this period as no different.

DISCLAIMER

There is no assurance that any of the target prices or other forward-looking statements will be attained. Any market prices are only indications of market values and are subject to change. Past Performance is a no guarantee of future results.

The prices of small and mid-company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.
Technology and internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

There are special risks associated with investing in preferred securities. Preferred securities generally offer no voting rights with respect to the issuer. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer's capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. Preferred dividends are not guaranteed and are subject to deferral or elimination.

Income from municipal securities is generally free from federal taxes and state taxes for residents of the issuing state. While the interest income is tax-free, capital gains, if any, will be subject to taxes. Income for some investors may be subject to the federal Alternative Minimum Tax (AMT).

Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline of the value of your investment. Investing in fixed income securities involves certain risks such as market risk if sold prior to maturity and credit risk especially if investing in high yield bonds, which have lower ratings and are subject to greater volatility.

All fixed income investments may be worth less than original cost upon redemption or maturity.

Although Treasury Inflation-Protected Securities (TIPS) are considered free from credit risk, they are subject to other types of risk. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate, and deflation risk, which may cause the principal to decline and the securities to underperform traditional Treasury securities. TIPS have special tax consequences, generating phantom income in the "inflation compensation" component of the principal. A holder of TIPS may be required to report this income annually although no income related to "inflation compensation" is received until maturity.

The yield, average life and the expected maturity of mortgage-backed securities are based on prepayment assumptions that may or may not be met. Changes in prepayments may significantly affect yield, average life and expected maturity.

Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

Investments in the energy sector are subject to the adverse economic events within that industry. A downturn in the energy sector of the economy, adverse political, legislative or regulatory developments or other events could have a large impact on a portfolio's investments in this sector.

Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. Products that invest in commodities may employ more complex strategies which may expose investors to additional risks.

Real Estate investments have special risks, including possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions.

Additional information available upon request.

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