MALVERN CAPITAL MANAGEMENT

MCM

3rd Quarter 2022 Commentary and Market Outlook

October 2022

3rd Quarter 2022 Review

After staging a "bear" market rally which began in mid-June 2022, the selling resumed at the end of August. The selling occurred as a result of "Hawkish" comments made by Federal Reserve Chairman Jerome Powell at the Jackson Hole, Wyoming Federal Reserve conference. Until the selling began, it seemed that perhaps the bear market was over. However, the selling in the month of September accelerated and we realized a rather ugly month. The S&P 500 fell 9.21% in September. Looking at the 3rd quarter of 2022 in its entirety, it does not tell the whole story of the intensity of selling that occurred in just the last month of the quarter. The technology and growth stock-heavy Nasdaq 100 Index did even worse than the S&P 500 Index falling 10.55% in the month of September.

Even bonds performed poorly with the Bloomberg Barclays U.S. Aggregate Bond Index dropping by 4.32% in September while high-yield junk bonds declined by 3.97% for the month. Cash was the only "safe haven" in the month of September.

In recent years the indices have been largely driven by the largest market capitalization stocks such as Microsoft, Apple, Google, Meta (Facebook), and Netflix. However, this year there has been a shift away from the largest stocks as they have sold off harder than the stocks with smaller market capitalizations. We can see this by comparing two indices. If we look at the market capitalization-weighted S&P 500 Index (where the larger companies make up a larger percentage of the index) versus an equal-weighted S&P 500 Index (where all 500 companies have the same percentage of the index), we see that the equal-weighted index has done better this year. For the year 2022, the S&P 500 Index has returned -23.87% while the equal-weighted S&P 500 Index has returned -20.77% (as represented by the Invesco S&P 500 Equal Weight ETF). This suggests that the larger stocks that dominate the market-cap-weighted S&P 500 Index did not do as well as the broader market this year.

Indices Performance

Category	Representative Index	Sept. 2022	3rd Qtr 2022	Y-T-D 2022	12 Months	3 yr*	5 Yr*	10 Yr*
Mature US Large Companies	DJ Industrial Average	-8.76	-6.17	-19.72	-13.40	4.36	7.42	10.45
Broad US Large Companies	S&P 500 Index	-9.21	-4.88	-23.87	-15.47	8.16	9.24	11.70
US Small Cap Companies	Russell 2000 Index	-9.58	-2.19	-25.10	-23.50	4.29	3.55	8.55
US Mid Cap Companies	Russell Mid Cap Index	-9.27	-3.44	-24.27	-19.39	5.19	6.48	10.30
Largest 100 NASDAQ Companies	NASDAQ 100 Index	-10.55	-4.42	-32.35	-24.72	13.21	13.95	15.91
Large "Value" Stocks	Russell 1000 Value Index	-8.77	-5.62	-17.75	-11.36	4.36	5.29	9.17
Large "Growth" Stocks	Russell 1000 Growth Index	-9.72	-3.60	-30.66	-22.59	10.67	12.17	13.70
Developed International	MSCI EAFE Index	-9.35	-9.36	-27.09	-25.13	-1.83	-0.84	3.67
Emerging Markets	FTSE All Emerging Markets	-10.59	-10.28	-23.75	-24.53	-0.72	-0.51	1.71
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	-4.32	-4.75	-14.61	-14.60	-3.26	-0.27	0.89
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	-3.97	-0.65	-14.74	-14.14	-0.45	1.57	3.94
Commodities	Bloomberg Commodity	-8.11	-4.11	13.57	11.80	13.45	6.96	-2.14
Total US Market (all cap stocks)	Russell 3000 Index	-9.27	-4.46	-24.62	-17.63	7.70	8.62	11.39
Real Estate Investment Trusts	Wilshire US REIT Index	-12.26	-10.23	-29.66	-17.60	-2.17	2.88	6.15
Cash	US T-Bill 90 Day	0.26	0.66	1.01	1.02	0.60	1.14	0.68

** 3 year, 5 year and 10 year returns are annualized. All periods ending September 30, 2022.*
All returns include the reinvestment of dividends.

The current bear market, which is arbitrarily defined as a drop of 20% in the major market indices, began at the start of 2022. Before the current bear market, there have been 11 bear markets since 1956. Usually, but not always, a bear market coincides with a recession. Since 1956, the deepest losses occurred during the bear market from 2007 to 2009, in conjunction with the "great recession." The S&P 500 Index fell 56.8% during that entire bear market. The longest bear market since 1956 was from March 2000 to October 2002 which lasted 31 months. The shortest bear market since 1956 occurred in 2020 which lasted just one month. The shallowest losses in a bear market occurred in 1990 at -19.9% (not officially a 20% drop but it is often considered a bear market). The average bear market since 1956 has lasted 13 months with an average loss of 34.2%. The bear market we currently are experiencing is just nine months old so far.

The Federal Reserve and Interest Rates

In June of 2021, Federal Reserve Chairman Powell claimed that the then-current high inflation was "transitory" or temporary. Such a proclamation suggested that the Federal Reserve board members felt little urgency toward combating inflation. As time went on, it became more apparent that inflation would be more persistent than originally expected. Powell was wrong last year, and the fear is that he is wrong again now by going too fast and too far in being "hawkish" toward curbing inflation. Rather than a "soft landing" where inflation falls back to the Fed's target level of 2% and the economy continues to grow at a steady rate, it is feared by many investors that the Fed will overreach and cause a "hard landing" whereby the economy slips into a recession.

Since March of this year, the Federal Reserve has increased the Fed Funds rate by 300 basis points (currently in a range of 3% to 3.25%) versus the previous 0.00% to 0.25% and it has made it clear that it is not finished raising interest rates. Further, the Fed has been trimming its balance sheet by selling U.S. Treasuries and mortgage-backed securities. These are the primary tools it has to fight inflation but to date, the consumer price index (CPI) has been little changed. Although the Federal Reserve traditionally only directly impacts short-term interest rates, the trimming of its balance sheet does affect longer-term interest rates causing those rates to rise as well.

We fear that the Federal Reserve may be going too far. We believe it should pause raising interest rates at the next meeting and give its current efforts time to work. Otherwise, it will increase the likelihood that we will have a recession.

Recessions and the Market

A recession is defined as a decline in Gross Domestic Product (GDP) for two consecutive quarters as well as other factors and is declared by the National Bureau of Economic Research (NBER). For the second quarter of 2022, the GDP declined by 0.6% following a decline of 1.6% in the First quarter of 2022; two consecutive negative quarters. The NBER has not declared a recession at this time.

It is difficult to declare a recession when we have strong monthly job growth numbers. The Bureau of Labor has reported strong job growth numbers all year so far. Further, the Conference Board reported consumer confidence rose to 108.0 in September from 103.6 reflecting strong consumer confidence. This rating is not consistent with a recession.

Needless to say, since 1953, the average length of the 11 recessions is 10.3 months. The 2020 recession lasted just two months while the "Great Recession" lasted 19 months. In the year before a recession, the average S&P 500 Index return has been -3.0%. In the six months before a recession, the S&P 500 Index returned -2.0% while during a recession the average return was -1.0%. Whether one year prior, six months prior, or during a recession, returns were positive half the time. The January through July 1980 recession saw the S&P 500 Index advance 16.4% but the "Great Recession" realized a loss of 35.5%. Markets tend to look forward while economic statistics are backward-looking. Many economic indicators are lagging indicators,

telling us what has already happened. The stock market is considered a leading economic indicator, giving us a prediction of future economic conditions. After the recession is over, returns on the S&P 500 grow increasingly as time goes by. Stocks tend to rise more frequently than they decline.

We may or may not be in a recession right now. Year-to-date the S&P 500 Index is down 23.87% (through September 30, 2022) well below the average losses described above. This suggests that the magnitude of the current negative returns may be more reflective of rising interest rates than fears of recession. We can surmise that should we enter a recession, the worst for the stock market may be over and better days are ahead.

As an illustration in the following chart, we reference the historical bear markets and their severity. The most interesting point is that following the bear market, there tend to be some very favorable positive years.

When the S&P 500 is Down 25% or Worse Since 1950

Peak	Trough	% Decline	+1 Year	+3 Years	+5 Years	+10 Years
12/12/1961	6/26/1962	-28.0%	31.2%	69.2%	94.8%	171.1%
11/29/1968	5/26/1970	-36.1%	32.2%	44.3%	27.9%	97.5%
1/11/1973	10/3/1974	-48.2%	1.4%	23.8%	42.0%	188.4%
11/28/1980	8/12/1982	-27.1%	43.9%	81.2%	238.6%	403.9%
8/25/1987	12/4/1987	-33.5%	14.7%	34.1%	96.8%	387.1%
3/24/2000	10/9/2002	-49.1%	0.2%	1.9%	21.5%	38.3%
10/9/2007	3/9/2009	-56.8%	-6.9%	3.7%	61.2%	209.6%
2/19/2020	3/23/2020	-33.9%	56.4%	???	???	???
1/3/2022	9/30/2022	-25.2%	???	???	???	???
Averages		**-37.6%**	**21.6%**	**36.9%**	**83.3%**	**213.7%**

Data: Ycharts

Inflation and Stocks

The current annualized year-over-year inflation rate in the United States is 8.3% (as of August 2022). This was down from 8.5% in the month of July. Surprisingly, the inflation rate hasn't fallen more given that commodity prices, including oil, have been down sharply in recent months. Despite the strong jobs reports this year, there has not been much wage pressure as wages are rising less than the inflation rate. According to a wages study by Salary.com, the "Actual Median Total Increase for 2022 is 4%." 4% is far below the 8.3% current inflation rate suggesting that workers are falling far behind in income versus their expenditures.

Inflation acts like a tax increase and affects the whole economy. Individual consumers are forced to cut back on spending, ultimately affecting Gross Domestic Product growth. For corporations, higher prices for goods and services due to rising inflation will lead to higher "nominal" profits for many companies. However, not all companies will be able to pass price increases through to their end customers. Some of the companies will be able to pass price increases off to their customers and will also be able to increase dividend payouts that equal or exceed the inflation rate. For this reason, value stocks become more attractive than growth stocks in this environment.

Periods of high inflation (especially if unexpected) will cause greater uncertainty and can discourage firms

from making risky investment decisions. This uncertainty can lead to lower economic growth and lower "real" profitability for firms, making shares relatively less attractive. Because of high inflation, investors may sell stock and put a higher percentage of their portfolio in perceived 'safer' options, such as inflation-linked government bonds, or physical assets that hold their value, such as real estate, gold, or other commodities. Stocks can perform poorly during periods of high inflation. Stocks and bonds perform poorly primarily because interest rates rise during periods of high inflation. A good example is the high inflation of the 1970s which led to higher interest rates and poor stock market returns. During the high inflation period of 1979 to 1982, the real (adjusted for inflation) S&P 500 Index's return on shares fell 11.6%.

No Place to Hide?

We are undergoing an unusual occurrence in the financial markets right now. Usually, when we see the stock market decline as it has, we see the bond market rise. Currently, with interest rates rising, both stocks and bonds are declining in price. Institutional traders who have exited stocks and bonds are moving to the safe haven of cash rather than moving to some other asset class like commodities and real estate. Some commercial real estate is doing well but the housing market is in decline due to rising interest rates. With the rising U.S. dollar, international investments also are not performing well.

In the bear market of 2007 to 2009, investors fled stocks and corporate bonds to invest in U.S. Treasuries. In the bear market of 2000-2003 small-cap value stocks and real estate investment trusts did very well, and due to falling interest rates at the time, U.S. Treasuries and corporate bonds performed well. Only cash seems to be working at this moment.

However, traditionally, investors have invested in the so-called 60/40 portfolio, that being 60% stocks to 40% bonds (or some combination of stock and bonds based on risk tolerance). In recent years the traditional 60/40 portfolio has almost disappeared because bonds have been very expensive and unattractive. The declining price of bonds means bond yields are rising. Now with the yield on the 2-year U.S. Treasury note above 4% and the yield on the 10-year U.S. Treasury note hovering just below 4%, bonds have become more appealing. Investors can now allocate a portion of their portfolio toward fixed-income investments and achieve traditional portfolio diversification.

Mid-term Elections

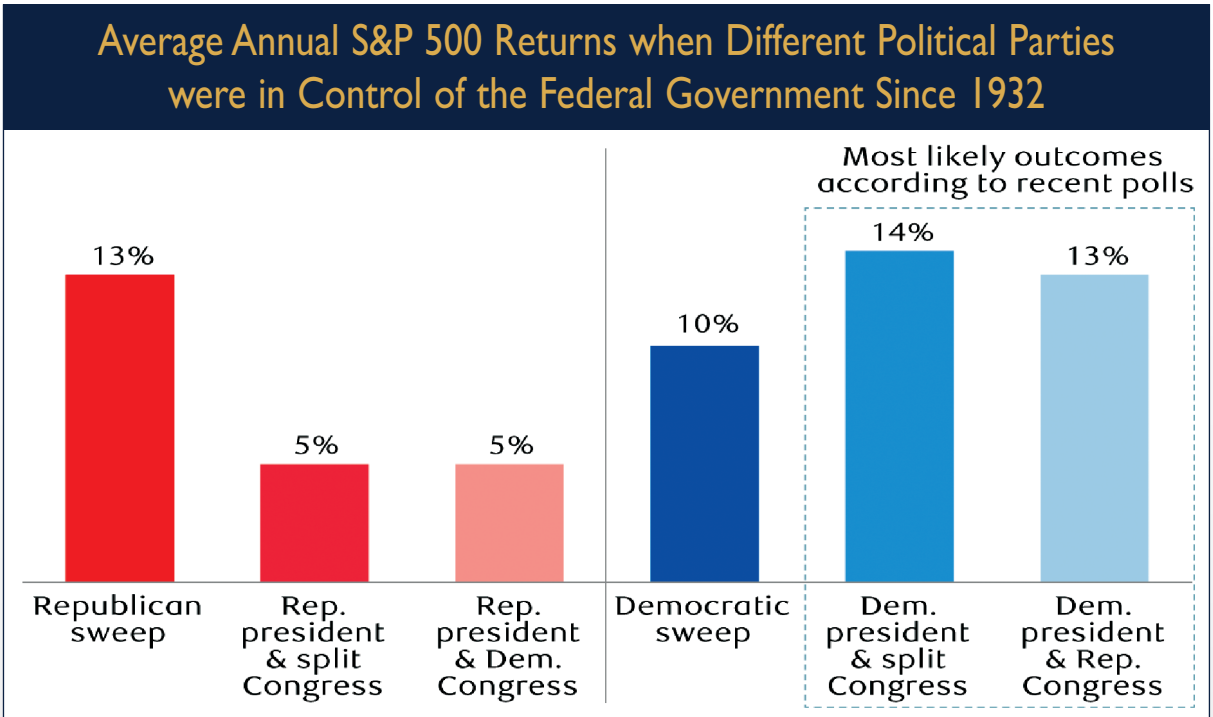
It is not unusual for the party of the President to lose seats in the House and Senate during the mid-term elections. Popularity or job approval of the President at the time of the mid-term elections generally determines the magnitude of such losses.

As of September 28, 2022, *Real Clear Politics* projected that the Republicans will win 218 seats in the House of Representatives to the Democrats at 184 with 33 toss-ups. Even if the Democrats pick up all 33 toss-ups, they will still be short by one seat and Republicans would take control of the House. In the Senate, *Real Clear Politics* projected that the Senate will fall into Republicans hands with 52 seats to 48 Democrats. There is still a lot of time before the November election and the results can certainly change.

Should the Republicans take control of both chambers of Congress, such a situation may bode well for the equity markets. Since 1932, the average annual return for the S&P 500 Index when there is a Democrat president and a Republican House and Senate is 13%. This is in contrast to the 10% annual return when the Democrats have full control of the White House and Congress. What the markets may be telling us is that it likes a divided government and the checks and balances it puts in place.

A divided government may lead to policy changes that are formed on common ground rather than policy skewed toward the extreme wing of one of the two political parties. It will also take the raising of corporate and personal taxes off the table unless President Biden can get such a proposal accomplished in a

lame-duck Congress before the end of this year. Although the Trump tax cuts will sunset in 2026 for personal income taxes and revert to the prior tax law unless extended, taxes will remain low for the next three years. The Corporate tax rate does not sunset in 2026. Low corporate taxes will continue to be good for corporate earnings.



Source: RBC Wealth Management, "*Equities and the Election Effect*", 9/8/2022.

Corporate Earnings

In the 2nd quarter of 2022, 71.4% of S&P 500 companies beat their earnings estimates. 71.5% of companies beat on sales. Corporate earnings to date have been pretty good despite all the talk about a possible recession. Nonetheless, earnings estimates are coming down for the upcoming quarters. As of June 30, 2022, analysts at Standard & Poor's Corporation projected the full-year 2023 earnings on the S&P 500 Index to be $249.01 per share. As of September 30, 2022, these same analysts projected full-year 2023 earnings to be $238.54 per share. The $238.54 represents a decline of 4.2% since June 30th.

Given the expectations for a slowing economy, we expect earnings estimates to continue to come down over the next few months. Earnings are a key driver of stock prices.

Market Valuation

At present, the S&P 500 Index is not over-valued. Based on historical averages, it may be even slightly undervalued. The current trailing price-to-earnings (P/E) ratio is 17.23 (based on the September 30, 2022 closing price of 3585.62 for the S&P 500 Index). The 25-year average trailing P/E ratio is 19.99 (based on an average of the quarter-end P/E ratios for the past 25 years). The forward P/E ratio is currently 15.35 while the 25-year average forward P/E ratio is 16.84 times.

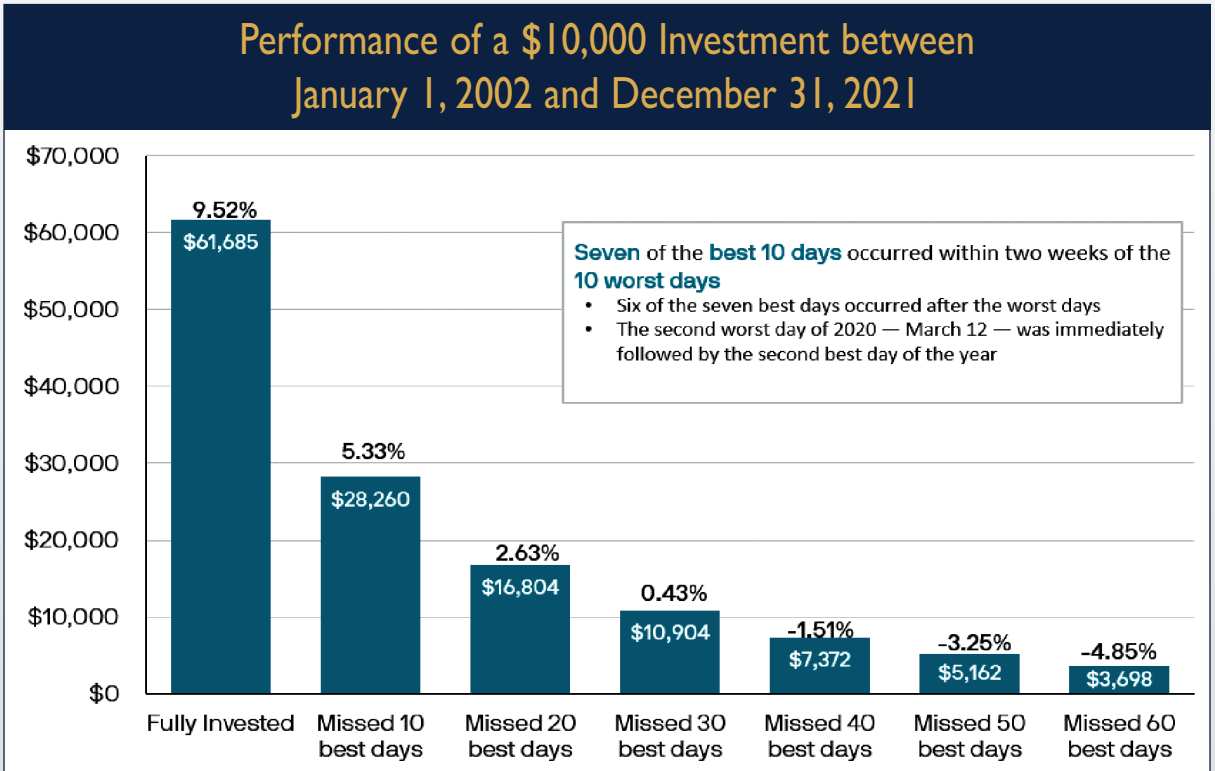
However, if earnings estimates do come down further, then P/E ratios could rise suggesting a market that is no longer under-valued. We will need to keep our eyes on the estimates going forward over the next few quarters. With the fear that estimates do come down, caution is in order before we sound the "all-clear" on the stock market.

Why Not Time the Market?

The reason we don't market time is that it rarely works out well. You have to be right twice; when you get out of the market and when you get back into the market. The equity and bond markets are re-pricing right now for higher interest rates and fears that the economy will slow down and go into a recession. Financial models used on Wall Street reflect a lower valuation for the market as interest rates rise and the markets adjust their prices accordingly. A slowdown in the economy or a recession usually means that corporate earnings fall which also affects the valuations in financial models. If that does happen, the markets can no longer justify the higher prices and they further adjust accordingly.

There are traders and there are investors in the market. Traders, including short sellers, tend to move with the current momentum in the market in or out of stocks. Traders believe they have an advantage over investors but the "efficient markets hypothesis" suggests otherwise. The hypothesis assumes that all market participants have access to all available information at the same time. Having equal access to available information, investors take a long-term approach by buying and holding onto their investments. Our investment philosophy leads us to be investors, not traders.

Those investors who pull out of the market when it declines are expecting to get back in at lower prices. A study by J.P. Morgan Asset Management (as well as similar studies by other firms) shows that if an investor misses the 10 best days of market returns by sitting on the sidelines, the investor nearly cuts their returns in half versus an investor who stays fully invested at all times. The study further shows that the best days for the market usually occur right after the worst days. Investors that pull out of the market after experiencing one of the worst days in the market increase the likelihood that they will be on the sidelines when the market experiences one of its best days affecting their long-term returns.



Source: JP Morgan Asset Management. Returns are from the S&P 500 Index and assume that dividends are reinvested. Returns shown are annualized for the entire 20-year time period.

We realize that it can become very painful to watch account balances shrink. But in our opinion, the best approach to investing is to be properly invested based on your risk tolerance as well as your goals and objectives, focus on the long-term, and disregard the short-term noise. History is on the side of the investor who stays fully invested at all times.

Conclusion

September was a brutal month with the major averages declining sharply. The Federal Reserve's interest rate activity and assumed future activity are the primary reason for the markets' declines. The concern is that the Fed will go too far with raising interest rates and will cause a recession. If we enter or have entered a recession, on average they last 10.3 months (average since 1953). The Fed is trying to curb inflation. Inflation acts like a tax increase on consumers which takes disposable dollars out of the economy.

Given the low-interest rate environment in recent years, there has been no place to hide. But perhaps the return of the "60/40" portfolio is in store where investors can now find value in bonds as a portfolio complement to stocks.

The upcoming mid-term elections offer us the potential for a divided government. Historically, the market performs better when Congress is in Republican hands and the White House is held by Democrats.

Based on the current trailing and forward P/E ratios, the market may be undervalued right now. But earnings estimates may likely come down further suggesting a market that would be no longer under-valued.

Why not time the market and move to the sidelines in times of market turmoil? Timing the market is difficult to do and investors risk being out of the market during some of its best days which can adversely affect long-term performance.

Three key factors in the coming weeks will influence market performance. They are the latest inflation data (CPI) during the second week of October, the next Fed meeting and subsequent statement in early November, and finally the outcome of the mid-term elections. Of all of these, the actual Fed statement after their November meeting may have the most impact on the direction of the markets.

As such, we are here to listen, counsel, and provide direction to all of our clients.

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