bergankdv

QUARTERLY MARKET UPDATE

WEALTH MANAGEMENT by BerganKDV

OCTOBER 2022

MARKET LANDSCAPE

Name	2022 YTD Returns (%)
Barclays US Aggregate Bond	-14.6
Barclays US Credit	-18.1
S&P 500 TR USD	-23.9
Barclays US Corporate High Yield	-14.7
MSCI Emerging Markets	-27.2
MSCI EAFE	-27.1
Russell 2000 TR USD	-25.1

Data Source: Morningstar Direct

State of the Markets

Market pain for investors continued through September, as year-to-date declines increased with major US stock indexes falling for the third quarter in a row. The Standard and Poor's (S&P) 500 and the Dow Jones Industrial Average both posted monthly declines of around 9%, and the NASDAQ dropped more than 10%, all greater than the prior month's losses.

The S&P 500 Index is ending the quarter at an approximate 3600 level, negating an earlier 12% gain registered from July through mid-August, with all major stock indexes once again extending into bear market territory. According to Bloomberg, this marks the first time in almost 85 years that the index closed out a quarter in negative territory after experiencing a greater than 10% increase in the same quarter.

US stock indexes have fallen six of the past seven weeks. Additionally, the yield on the 10-year Treasury reached its highest level since 2008, almost breaching the 4% mark. It closed the quarter at 3.83%.

Global financial markets experienced this significant pressure in the last week of the quarter as global central banks, led by the US Federal Reserve (Fed), have collectively raised rates, and expressed a desire and willingness to keep them elevated higher and for longer to address aggressive inflation.

Exacerbating the situation, especially in Europe, are spiking energy costs resulting from, among other things, the Russian-Ukraine conflict. Eurozone inflation rose at an annual 10% rate in September, up from 9.1% the previous month. Notably, Germany reported an even steeper increase, with inflation climbing to 10.9% from 8.8% the previous month.

Meanwhile, the aggregate weight of these economic and geopolitical risks within the global economy, including China's economic issues related to Covid and its real estate sector, have driven investors to the US Dollar as a haven, making it the strongest against the Euro in two decades, putting American manufacturers at a pricing disadvantage against many foreign competitors.

Companies that depend on exports from the US for their overseas revenue will struggle in a prolonged, ultra-strong dollar environment. Not to mention the issues this causes for most emerging market (and even developed) economies as their currencies depreciate.

Given the challenging economic backdrop, analysts have begun reducing their forecasts for the third-quarter S&P 500 earnings growth. As of the end of September, analysts had reduced their consensus earnings forecast for the S&P by 6.6% relative to what they had expected three months earlier, according to FactSet. These adjustments to the downside likely still have further to go.

Sector Returns

S&P 500 Sectors	2022 YTD Returns (%)
Communication Services	-39.0
Consumer Discretionary	-29.9
Consumer Staples	-11.8
Energy	34.9
Financials	-21.2
Health Care	-13.1
Industrials	-20.7
Information Technology	-31.4
Materials	-23.7
Real Estate	-28.8
S&P 500	-23.9
Utilities	-6.5

Data Source: Morningstar Direct

Fed Funds Rate Normalizing

The market pain experienced in 2022 can be tied to one primary change in the macro-economic backdrop, which is of course the emergence of inflation. More specifically, though, markets

Continued on next page

have responded to the removal of an exceptionally accommodative monetary regime which has artificially depressed interest rates for the better part of a decade, testing the economy's ability to handle this transition.

Since the financial crisis of 2008, US economic growth has been significantly catalyzed by the availability of abundant liquidity and exceptionally low borrowing costs. Consumers have been able to finance spending on housing, automobiles, etc., while corporations and governments have had seemingly limitless ability to cheaply finance operations and fiscal deficits, respectively. It seems this era is coming to an end.

This change has driven mortgage rates to their highest levels in over a decade, activating a profound price level reset in bonds, and especially impacting speculative investments such as technology stocks, IPO's, cryptocurrencies, etc. As the economy adjusts, more turbulence likely lies ahead within flustered markets.

From a historical perspective, the Fed's benchmark lending rate, the federal funds rate (FFR) has experienced notable changes over the past number of decades. Starting around 1% in the mid-1950s, it peaked around 20% in 1980 as it then reversed course to embark on a 40-year decline, culminating in an era of ultra-low interest rates over the past decade.

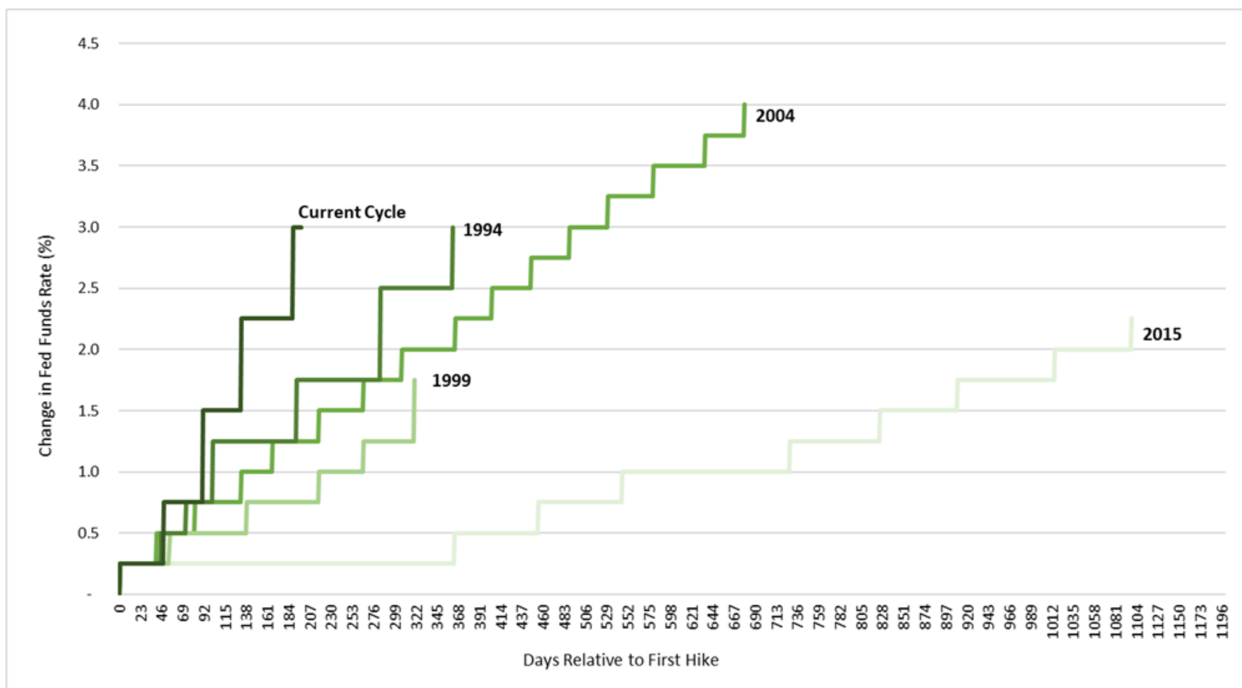
The period following the 2008 credit crisis is a particular interest, as it ushered in an almost uninterrupted era of financial excess born of access to inexpensive capital. Speculation was the name of the game, as investors capitalized on continued central bank largesse.

Market growth in risk assets was further augmented by a lack of ability to earn investment on savings. The acronym TINA (there is no alternative - meaning no other asset class other than stocks were viable generators of return) became operative. Investors looking to earn any measure of yield were forced to step away from historically safer instruments into more volatile securities.

Policymakers were aware of the risks a perpetual, artificially low FFR could present, yet the emergence of the COVID pandemic required the deferral of policy normalization. This, combined with trillions of federal stimulus dollars, various global supply chain disruptions, a war in Ukraine, etc., has resulted in the current 8.3% inflation rate in the US, necessitating a current rate hike regimen by the Fed. Chart 1 demonstrates the urgency with which the Fed has responded.

The main take away from the inflation conversation is that it seems we could finally be exiting a prolonged and secular era of artificially low interest rates, which if true, will have significant implications

Chart 1 - Rate of Fed Funds Increase



Source: ***US Federal Reserve via Ycharts & Fedprimerate.com***

Continued on next page

moving forward. Given market behavior over the past six weeks, it seems as though investors are beginning to understand this.

In prior years, the Fed had made overtures to normalize interest rates on several occasions. However, any meaningful negative market reaction would trigger a reversal in policy, calling into question its long-term commitment to the normalization of rates. Fed chairman Jerome Powell, as well as other committee members, have recently made it abundantly clear that this time there will be no "Fed Pivot" to rescue stocks prices.

Members of the Federal Reserve are unanimous in their position that containing inflation is a much higher priority than supporting the markets. They have communicated their intention to continue increasing the FFR to levels sufficient to curtail consumer demand and raise unemployment (as increasing wages are inflationary) to, in our view, recessionary levels. Stock prices are not part of their consideration.

A caveat for the Fed's commitment to higher rates relates to the emergence of disorderly markets. If conditions deteriorate sufficiently to cause systemic risk to credit markets or intolerable levels of economic and financial stress, then the Fed might reverse course.

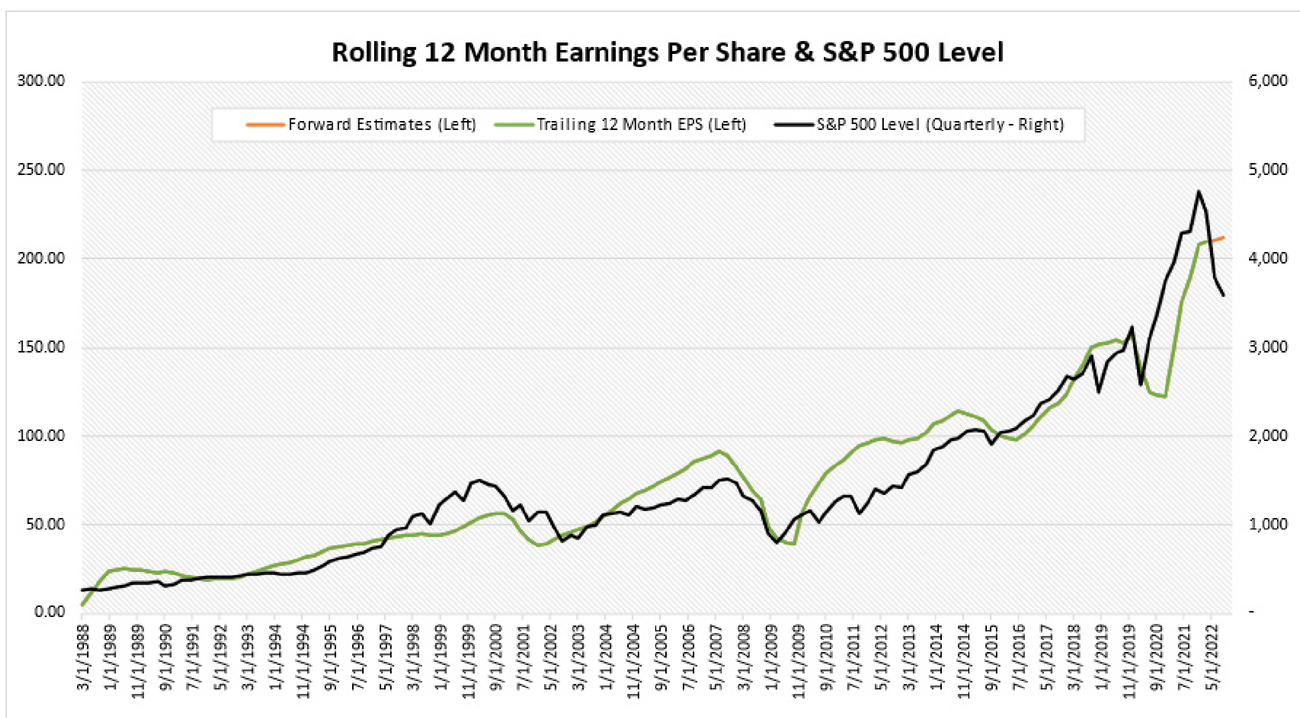
Market Earnings Expectations

While the Federal Reserve is committed to tightening monetary conditions, it hopes to engineer a "soft landing," where economic growth slows sufficiently to reduce inflation to its stated target (2%), without causing significant economic contraction. The likelihood of this occurring is small, and expectations of a recession in 2023 (or even later) seemed justified. The amount of monetary tightening (both in terms of the FFR and quantitative tightening [QT]) required to control inflation is in our view too significant to avoid recession.

So, what should we expect from equity markets? One way to analyze this question is through the lens of market valuation. The most used gauge of relative value is the price-to-earnings (P/E) ratio. According to FactSet, the current forward 12-month P/E ratio of the S&P 500 is currently 15.4, which sits below its 10-year average of 17.1, indicating a better value proposition than in the recent past.

Chart 2 supports this notion by visually representing how the current price of the S&P has dropped below forward earnings-per-share (EPS) estimates, a marked change from the last two years. This would imply the market provides better value when compared to its long-term average. This does not mean, though, that it is historically "cheap."

Chart 2 - S&P 500 Forward EPS vs. Price



Source: ***Howard Silverblatt S&P 500 Earnings and Estimates Report – S&P Global & FactSet***

Continued on next page

Cheap would imply a P/E multiple in the 10-12 range. We are not forecasting the market to reach these levels, though we would expect earnings estimates to decline from current levels as economic conditions become more challenging for businesses. As earnings projections decline, index levels can also decline without negatively impacting P/E levels. That is, it's possible to maintain our current P/E level of 15.4 even if markets continue to weaken.

Another way to analyze the data is to apply a standard corporate profit discount model to the S&P 500 using the current 10-year Treasury yield as a discount rate. Doing that, it's also reasonable to conclude the market is trading at fair value. If the expectation of continued interest rate increases as operable, applying a 4% or higher discount rate to the calculation would imply further declines of 10% or more from current levels.

To be clear, these are not market forecasts; they are simply calculations based on current data. As we have seen over the course of market history, aggregate investor psychology and behavior are often more relevant to market outcomes then quantitative inputs. Markets have a long history of trading away from fundamentals, and as such, investors should pay attention to how developments impact sentiment in the coming months and quarters.

When Might Market Headwinds Abate?

Given the current economic and geopolitical realities, the prospect of continued volatility and diminished return prospects in the coming quarters is not unwarranted. In fact, given the specter of recession, reduced earnings forecasts, and persistent inflation pressures, they seem quite reasonable.

However, conditions will eventually change, with markets likely anticipating the improvements before they occur. If a meaningful curtailment of inflation takes hold, stocks will begin to move higher in anticipation of a Fed pivot. Markets will not wait for the Feds long-term inflation target to be reached.

Another signpost investors should watch for involves the labor market. Contrary to conventional thinking, stocks should begin to rebound when we see a sustained increase in jobless claims, with an eventual rise in unemployment. This will indicate traction in the Feds efforts to reduce wage pressures in their fight against inflation, ultimately leading to relief from tighter conditions.

Regarding the likelihood of downward corporate earnings revisions, risk assets should become less volatile if they perceive that sufficient attention has been paid to this possibility. As realistic earnings revisions occur, markets will be more comfortable resuming a more endearing uptrend.

Generally, greater risk-on attitudes will resume as global growth estimates stabilize, financial stress levels are better quantified, and more clarity regarding prospective Fed actions emerges. This general easing of financial conditions should cause the US dollar to peak, giving some other asset classes more room to breathe. These events will be beneficial not only to US markets, but international developed and emerging markets as well.

Looking Ahead

As we've stipulated, financial conditions have become challenging given the Fed's monetary tightening. On a very basic level, stocks now face competition from other asset classes that are now offering more competitive yield, something that had been missing for years. This emergent competition has been painful for equities.

Of course, fixed income holders have also endured discomfort (in many ways on a greater level given the historically more stable volatility profile of bonds), though the price declines have given way to higher yield, which is something savers and yield seekers have been looking forward to for some time (given the preponderance of return from a bond comes from coupon payments, not price).

For investors comfortable with their allocations, cash flow plan and risks levels, action during these periods of heightened volatility is generally not necessary. However, for those with long-term time horizons who are comfortable with more potential downside risk, now presents good opportunity for additional deployment of capital. This isn't so much a market timing suggestion, rather than an obvious acknowledgement that valuations are more attractive than a year ago and returns from these levels over time should be compelling.

Minneapolis
3800 American Blvd W
Suite 1000
Minneapolis, MN 55431
952.563.6900

St. Cloud
220 Park Avenue S.
P.O. Box 1304
St. Cloud, MN 56301
320.650.0250

Cedar Rapids
417 First Avenue SE,
Suite 300
Cedar Rapids, IA 52401
319.294.8000

Coralville
2451 Oakdale Blvd.
Suite 204
Coralville, IA 52241
319.354.3000

Des Moines
12100 Meredith Dr.
Suite 200
Urbandale, IA 50323
515.727.5700

Waterloo
100 East Park Ave.
Suite 300
Waterloo, IA 50703
319.234.6885

Kansas City
10401 Holmes Road
Suite 400
Kansas City, MO 64131
816.525.2590

Omaha
16924 Frances St.
Suite 210
Omaha, NE 68130
402.330.7008

bergankdv.com

This newsletter provides generic information intended for a diverse audience, but cannot give individualized investment advice. Investors seeking a better understanding of how a sell-decision process might apply to their specific situation, or who have questions about their investment guidelines for liquidity or risk, should contact a professional financial advisor to review their financial plans and portfolio asset allocations.

WEALTH MANAGEMENT
by BerganKDV

This market update provides commentary on current economic and market conditions and is not directly relevant to any particular client account. The information contained herein should not be construed as personalized investment advice or recommendations to buy or sell any security or adopt an investment strategy. There can be no assurance that the views and opinions expressed in this article will come to pass. All investing involves the risk of loss, including the possible loss of principal.

Past performance is no guarantee of future results. Information contained herein is subject to change without notice.

All indices are unmanaged and cannot be directly invested in.

Please contact a qualified attorney, tax or financial advisor regarding your personal situation.

Investment Advisory Services offered through BerganKDV Wealth Management LLC, an SEC Registered Investment Advisor.