AMI Quarterly Commentary

Growth Through Stability

Q3 ▪ 2022

Capital Market Outlook

Equity markets fell in Q3, with the S&P 500 down 4.9%, in a quarter that was dominated by debate over the path forward for interest rates, and the possibility that Federal Reserve rate hikes would lead to an economic recession. The first two months of the quarter saw a strong rally, driven by better-than-expected corporate earnings, as well as a belief that inflation had peaked and that the Fed will be cutting rates in 2023. However, continued elevated inflation, strong economic data, and Federal Reserve Chairman Jerome Powell's reiteration that the Fed is focused on taming inflation drove the S&P 500 down more than 9.0%, the worst monthly return in September since 2002.

Fed Chairman Powell, while speaking at a conference in Jackson Hole on August 26, reiterated what the Fed has been saying all year: that it would do what is necessary to control inflation. He also stated that Americans will likely feel "some pain", suggesting that the Fed accepts the risk of sending the economy into recession if that is what it takes to control inflation. This hawkish statement surprised investors and sparked the selloff at the end of August.

There are some signs that inflation is easing, as oil prices, and gasoline by extension, many food commodities, and used car prices have all fallen from highs. But food, shelter and labor remain stubbornly high, driving concerns of higher-for-longer inflation. Inflation, as defined by the Consumer Price Index, came in above estimates at 8.3% for August and 8.2% for September, suggesting that further tightening was needed to slow price growth. In addition, September jobs came in above estimates, with the economy adding 263K jobs, versus the 255K estimate, a sign the economy is still relatively strong.

Following a 75bps interest rate hike in July, the Fed hiked by 75bps in September to a target rate of 3-3.25%, and Fed Governors continued to signal that further tightening was necessary. At this point, another 75bps hike is priced in for November, 50bps in December, and 25bps in February 2023. With these hikes essentially "baked" into investor expectations, the main uncertainty remains when the Fed will stop tightening. Currently, strong economic readings are viewed as a negative for equities and we are in a "good news is bad news" period. Given that Fed rate hikes typically take a few quarters to filter through the economy, we should begin to see some impact soon, which will give the Fed more data.

While we are in a technical recession, defined by two quarters of negative GDP growth in Q1 and Q2, it is not the typical recession. This technical recession is mostly driven by difficult comparisons to last year's COVID recovery and the current high inflation, which led to lower GDP growth rates. The current consensus is for a return to 1.5% growth in Q3, flat GDP in Q4 and 0.7% growth in 2023. However, given the aggressive Fed rate hikes so far, these estimates are likely to come down and could prove to be overly optimistic.

Capital Market Outlook (cont'd.)

Corporate earnings have remained relatively resilient thus far, and Q2 was generally viewed as "better-than-feared." However, as the summer progressed, more companies began to warn that results would come in below expectations. Although many of the warnings were driven by the strengthening U.S. dollar and elevated costs, there were several high-profile shortfalls, namely FedEx and semiconductor companies like Micron and Nvidia, where management began to speak to some level of waning demand. Investors will focus mainly on forward guidance when companies report Q3 earnings but we would not be surprised to see earnings estimates come down for 2023.

We remain cautious on the market in the near term and we continue to invest in companies that we believe will do well in good times and bad. We also continue to urge investors to remain patient and keep a focus on the long term. The bottom in the market will only be evident after the fact and will likely come well before economic data shows improvement. While the near term will likely be volatile, we are confident in the stock market's long-term growth outlook.

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AMI
ASSET MANAGEMENT

Point of Contact: Matthew Humiston· 424-320-4002 · matt@amiassetmanagement.com

10866 Wilshire Blvd, Ste. 770, Los Angeles, CA 90024 · 424-320-4000 · www.amiassetmanagement.com