Economic Overview

Steve Scranton, CFA, SVP, Chief Investment Officer and Economist

After two quarters of economic growth, the 3rd quarter saw activity pick up some and some of the distortions from the first half of the year ebb. Currently, the Atlanta Federal Reserve's model is projecting 3rd quarter GDP to have grown at a 2.7% annualized pace. The median forecast of economists surveyed by Bloomberg forecasts a 1/5% annualized growth rate.

Consumer

Income continued to grow for consumers as wage growth continued and other sources of income still grew. After inflation and taxes, real disposable personal income grew 0.1% in August after rising 0.5% in July. Spending matched income growth as real personal spending also rose 0.1%. So, the pace of spending by consumers is slowing. Some of this may also have been due to the drop in value in consumers' retirement plans and investment portfolios as well as home prices. This tends to impact consumer psychology when they no longer feel as wealthy as before. The drop in gas prices helped offset some of this negative sentiment.

Consumers are clearly feeling the impact of rising interest rates. Many consumers have had to resort to using their credit cards as a source of bridge financing to help pay their bills. Their strategy has been to make the minimum monthly payments in hopes that expenses will come down or salaries will go up. Unfortunately, credit card rates are tied to short-term borrowing rates and those rates are rising as the Federal Reserve raises interest rates. As a result, the interest expense on the outstanding balances is rising. For the consumer who has credit card debt or other variable rate debt, this means that more of their income was used to pay the interest expense rather than buy goods and services.

Businesses

Labor continued to be the challenge for businesses in the 3rd quarter. Not only the shortage of qualified help, but also the continued pressure to raise wages to attract workers. The problem for many "Main Street America" businesses is the challenge to fully pass on the higher expenses in the price of their product. If they cannot, then their profit margin suffers. Many small businesses may not have the financial reserves that large, publicly traded companies have. Declining margins give them less ability to absorb deteriorating business conditions when that occurs.

As a result, small businesses may once again be our leading indicator of problems in the economy. If we start to see a clear trend of small businesses reducing employee hours and/or cutting jobs, that is most likely a sign that the leading edge of a "recession storm" has arrived. At this time, the feedback that I hear from many small businesses in the markets Washington Trust Bank serves is that sales have slowed due to lack of qualified workers more than deteriorating business conditions.

Government

Government continues to suffer from the after-effects of the large fiscal spending that occurred last year. The infrastructure spending from the infrastructure bill that was passed earlier this year is still slow to be disbursed. Some of this is due to labor and supply shortages. The other is due to the bureaucracy of getting projects approved and funds distributed. The same story is true for the Inflation Reduction Act bill.

Inflation and the Federal Reserve continue to be the forces that had the biggest impact on the economy in the 3rd quarter. Sustained high prices continued to cause financial strain for consumers and rising interest rates continued to damage the interest-sensitive sectors of the economy, especially the housing market.

Third Quarter 2022 – Wealth Management Insights

Strategy Review

Derrick Wilson, CIMA®, AVP, Portfolio Manager

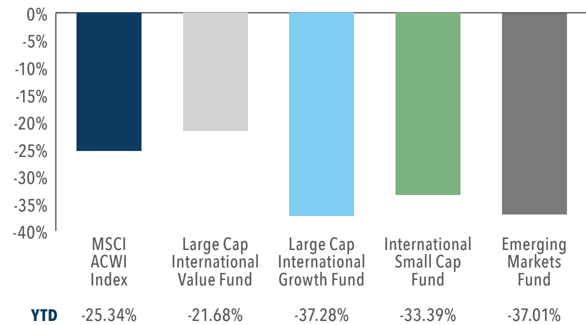
For the 3rd consecutive quarter, investors experienced further declines. The quarter had a nice start, with global equities rallying in July. Some gains were given back in August, but the flood gates really opened in September — which historically tends to be a bad month for stocks — and pushed quarterly returns into the red once again. Still-high inflation readings prompting commitments from global central banks for more aggressive monetary policies continued to keep both stock and bond markets unhinged as the prospect of slowing global economic growth increased the likelihood of recession.

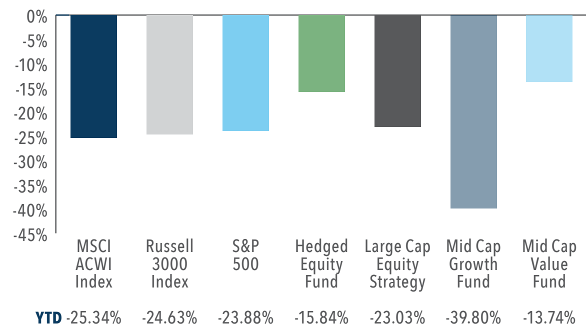
Domestic equities outperformed international in the 3rd quarter, maintaining its lead year-to-date. Within international equities, emerging markets lagged developed markets over the quarter. Overall, global equities declined 6.7% the past three months. A couple themes this year also continue to gain steam. A strengthening US Dollar has been a headwind for international equities, compounded by greater weakening in foreign currencies. Outperformance of value over growth reversed in the quarter, but a significant gap remains where value has declined 16.5% compared to growth down just over 30% this year.

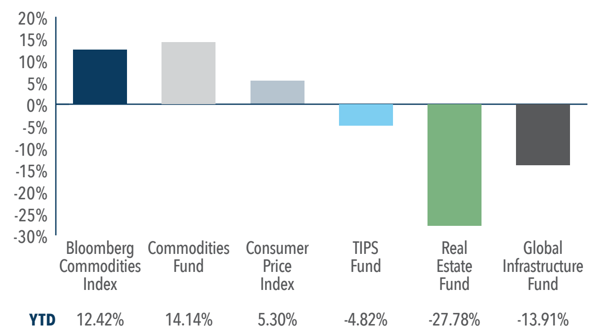
The pain fixed income investors have felt during this historic decline continued as rates ratcheted higher. Intermediate investment grade bonds fell another 3% over the quarter. Emerging market bonds were down further, lower by 4.5% and GNMA MBS down around 5%. Broader diversification and risk management was underpinned by ultrashort bonds where quarterly losses were just over 1% while below investment grade high yield was down less than 1%. On the flip side of all the volatility, the opportunity to reinvest at higher coupons has substantially increased income for investors over what markets previously provided.

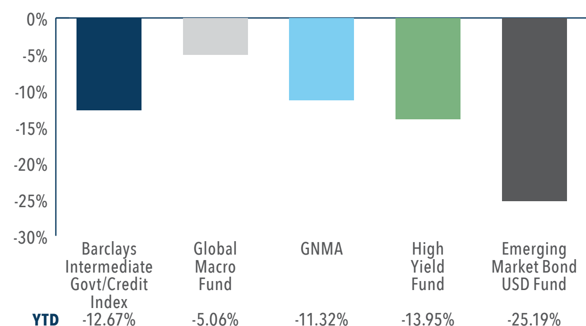
Concerning alternative strategies, commodities gave back some gains in the quarter, dropping just over 4%, although still positive on the year. Managed futures trend-following saw further gains provided the pronounced and persistent market moves. The strategy climbed nearly 7% over the quarter with the ability to be long or short markets. Global macro struggled to gain, closing nearly flat for the quarter. Lastly, real estate and global infrastructure fell the most, down 10.8% and 9.6%, respectively.

Entering the final stretch of the year, volatility should remain elevated. Inflation, leading to central bank tightening and the potential for recession in the future, could keep markets on edge. Furthermore, mix in geopolitical goings on and mid-term elections, which may only add to any uncertainty.









Domestic Equities

Gayle Sprute, VP, Senior Portfolio Manager

The 3rd quarter was akin to "A Tale of Two Cities." Challenging performance in the first half of the year was driven by worries about the Federal Reserve's (Fed) pivot from the view of transitory inflation (patience) to one of persistence (urgency with regard to fighting inflation). This ushered in concern that aggressively rising interest rates might produce a policy error and a recession. But, in July and early August, the market started down the "wishing, hoping, praying" road, hoping that the Fed would back off on the pace of rate increases — and which brought a strong rally.

Those hopes were quashed in late August, after Fed Chair Powell said that it will keep raising rates "until the job is done" on reducing inflation. He also noted that the Fed is willing to risk recession in order to break the back of inflation. This aggressive message drove a painful sell-off in September and ushered in a bear market for the domestic indices (i.e., a decline of 20% or more).

During the 3rd quarter, only two sectors delivered positive returns (consumer discretionary, +4.3%, and energy, +2.2%). The worst two were communication services, -12.7%, and real estate, -11.0%, (versus the S&P 500's -4.9%). September was the most difficult month of the quarter, with all sectors in the red. The best performers were healthcare, -2.6%, and financial services, -7.8%. Real estate -13.1%, and communication services, -12.1%, delivered the worst returns (versus the S&P 500's -9.2%).

Going into the 4th quarter, the Fed's aggressive rate increase campaign (and whether that will trigger a recession) continues to permeate investor psychology. Concern is elevated regarding how the economy and earnings might be impacted. At the start of 3rd quarter, analysts forecasted earnings growth of 10.5% year/year on 9.7% revenue growth. By quarter-end, expectations had fallen significantly, to forecasted earnings growth of 2.9% on revenue gains of 8.7%. Notably, the larger downward revision to earnings versus revenues highlights the challenges of protecting profit margins in this continued rising cost environment amidst a continued economic slowdown. We expect volatility to remain elevated as investor psychology works its way through these uncertainties.

Fixed Income

Brian Brill, CFA, VP, Senior Portfolio Manager

After a miscommunication early in the quarter, the US central bank (Fed), as well as other major world central banks, made sure investors understood that its resolve to fight inflation was rock solid. As a result, yields increased at their fastest clip in many years. Fixed income investors are now facing year-to-date losses, depending on duration and credit quality, ranging between -4.50% and -29.00%.

Volatility has remained very elevated as investors looked for clues for any changes to monetary policy. Investors thought that was the case in late July where anticipation grew due to Fed commentary that it may pause the pace of raising rates. With the consumer price index indicating inflation at over 8% year over year, this was the wrong message they wanted to convey.

Fed officials took this challenge to heart and began communicating, through various speaking venues, their resolve to fight inflation. Even some of the most historically dovish members indicated that interest rates needed to rise substantially. This resolve was clear at the Fed's September 21st meeting where they raised the Fed Funds rate another 75 basis points and updated their quarterly economic projections. The updated projections, especially those regarding the Committee's expectations for the Fed Funds Rate, were much more hawkish than the market was expecting. First, the year-end 2022 projection of 4.375% implies that there is potentially another 75bps rate hike on the table for November and 50bps in December. Second, the market was expecting that the Fed would begin decreasing rates, due to worries about dampening economic growth, sometime in early-mid 2023; the Fed projected an increase, albeit small, in rates in 2023.

Other world central banks are also raising rates due to elevated inflation but also to defend their currency vis a vis the dollar. This tit for tat is causing a negative feedback loop that has the potential to cause an unforeseen crisis.

The rapid pace of rate increases seems to be starting to have its desired effect as there are indications that economic data is showing a deceleration.

Time will tell if we have reached peak rates, but for now the Fed continues to focus squarely on inflation and it is still too high.

International

Matt Clarke, CIMA®, VP, Senior Client Portfolio Manager

The 3rd quarter was ugly once again for the international markets. The combination of **surging energy prices in Europe and the UK, core inflationary pressures persistently stuck near multi-decade highs, and rising geopolitical risks** continued to weigh heavily on the foreign markets. Persistent global inflation forced central banks to tighten further and broadcast that they are not yet done. Of note in the 3rd quarter, the Bank of Canada (BOC) hiked rates by 1.75%, the Reserve Bank of Australia (RBA) by 1.50%, the European Central Bank (ECB) by 1.25% and the Bank of England (BoE) by 1.00%. The markets clearly received the message from global central banks and priced in additional increases over the coming months, weighing on both stocks and bonds. As a result, the MSCI All Country World Index (ACWI) ex US closed out the quarter lower by -9.80% and YTD -26.17%, while the MSCI Europe, Australasia, and far East (EAFE) finished the quarter lower by -9.26% and YTD -26.71%. At the same time, Bloomberg Global Aggregate (measure of global investment grade debt) closed lower by -6.94% and -19.89% respectively.

Of note and in a surprising turn of events, in late September **the UK unveiled plans to offset the impact of tighter monetary policy (higher interest rates) and crippling energy costs with looser fiscal policy (tax cuts, borrowing and spending).** The news spooked the financial markets, sending the pound to a record low against the US dollar and bond yields to the highest levels in more than a decade. The announcement also quickly drew global criticism, including the International Monetary Fund (IMF) which suggested the proposals would likely increase inequality. In an effort to smooth out the ensuing volatility, the BoE was forced to intervene and pledged unlimited purchases of long-dated bonds.

While the developed international markets had a rough quarter, emerging markets took it in the chin with the MSCI Emerging markets index finishing the quarter lower by -11.46% and YTD -26.99%. **A stronger dollar continued to weigh on developing countries – discouraging foreign investment and increasing the cost of dollar denominated debt.** China continues to remain in the spotlight, suffering on multiple fronts: slower growth, rising youth unemployment, and a faltering housing market. Their zero-COVID policy (on and off economy) also only complicates matters for them – and the global community for that matter.

As we peer into the final quarter of the year, it is clear that we're not out of the woods yet. Inflationary pressures, central bank policy and geopolitical instability remain at the forefront of the macroeconomic landscape. **Still, we continue to remain disciplined in our approach and focused on the long term,** all while leaning into the benefits of diversification, active management, and strategic allocation.

Additional and expanded information to this newsletter discussion may be obtained by contacting your Relationship Manager. We will be happy to expand our discussion with you to meet your individual requirements as a client of Wealth Management & Advisory Services.

Contact Our Advisors

Western Washington

Seattle
601 Union St., Suite 4747
Seattle, WA 98101
206.667.8954
888.254.0622

Bellevue
10500 NE 8th St., Suite 1100
Bellevue, WA 98004
425.467.1781
888.445.7166

Spokane
717 W Sprague Ave., Suite 900
Spokane, WA 99201
509.353.3898
800.725.4449

Portland
760 SW Ninth Ave., Suite 1900
Portland, OR 97205
503.778.7060

Southern Idaho / Boise
945 W Bannock St.
Boise, ID 83702
208.345.3343

North Idaho
218 Lakeside Ave.
Coeur d'Alene, ID 83814
208.667.7993

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