The Cobblestone Advisor
Investment Brief

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COBBLESTONE
CAPITAL ADVISORS

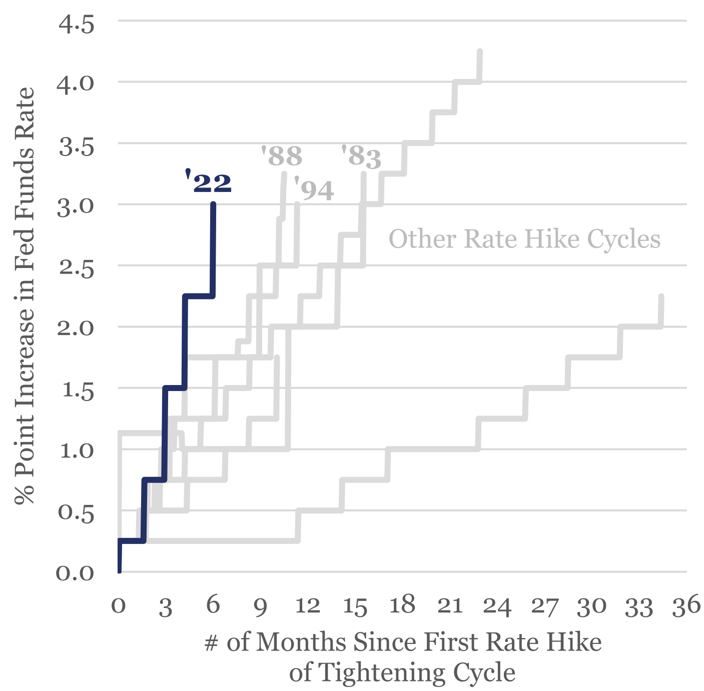
The Usual Suspects

Although headline inflation has come down from levels reached in June, it remains unacceptably high. Fed policymakers have reacted by aggressively raising interest rates as they look to bring inflation closer toward their longer-run target of 2%. The current rate hike campaign—designed to curtail demand and achieve the Fed's stated inflation objective—has policymakers raising the target range for the Fed funds rate at the quickest pace in history (right chart).

Beyond inflation and the Fed's policy response to it, further clouding the outlook is the economic environment in which the aggressive policy tightening is taking place. Typically, tighter monetary and fiscal policies are desirable when the economy is at risk of overheating. Tighter policies are intended to bring equilibrium to capital markets and wring out financial and economic excesses.

This is not an environment we find ourselves in today. The economy is not at risk of overheating. Rather, US economic growth is slowing—as is global growth—increasing the risk that the Fed makes a policy error by overtightening financial conditions and sends what is already a fragile US economy into recession.

Amid this precarious backdrop, equities declined for the third consecutive quarter during the three months through September, ending the period back in bear market territory and at a new low for the year. The year-to-date selloff has been entirely driven by a decline in valuations, or the price that investors are willing to pay for a company's earnings. While earnings have remained resilient, investors have become unwilling to pay the high prices for them that were previously



Source: US Treasury, Bloomberg.

demanded by the market as Fed policy and the outlook for US economic growth shifted.

Concerns surrounding inflation and the Fed have not only driven equities lower. Bond markets have deeply sold off as well after they too declined for the third consecutive quarter. As of late September, the broad US bond market had experienced its largest drawdown on record, declining -17% from its August 2020 peak.

Considering the weakness across both stocks and bonds, it should come as no surprise that the correla-

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Total Return (%), Ending 9/30/2022				Annualized		
	Qtr	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 Stock Index	-4.9	-23.9	-15.5	8.1	9.2	11.7
Russell 2000 (Small-Cap Stocks)	-2.2	-25.1	-23.5	4.3	3.5	8.5
MSCI EAFE (International Stocks)	-9.4	-27.1	-25.1	-1.8	-0.8	3.7
MSCI EM (Emerging Markets)	-11.6	-27.2	-28.1	-2.1	-1.8	1.0
Bloomberg Barclays US Aggregate Bond Index	-4.8	-14.6	-14.6	-3.3	-0.3	0.9
Dow Jones US Select REIT	-10.4	-29.3	-17.2	-3.3	1.9	5.5
Consumer Price Index (% Chg over Period; One-Month Lag)	1.3	6.2	8.3	4.9	3.8	2.5

tion between them—or the tendency for their prices to move together in the same direction—has risen to an abnormally high level this year, reaching heights not seen since the mid-90s. The result is that 2022 is on track to be the worst year since the 1930s for a portfolio of 60% stocks and 40% bonds, which was down -20% through the end of September.

The good news here is that this is highly unlikely to persist, as the correlation between the two asset classes over the last 20 years has generally oscillated in a low range, helping to dampen overall portfolio volatility. Ultimately, the stock/bond correlation should return to more normal levels, leading to diversification benefits that multi-asset investors have become accustomed to.

Looking ahead, we see at least two potential paths forward for markets. One potential path hinges on company earnings. Not only have earnings remained resilient, but estimates for 2023 and 2024 earnings also remain elevated. Investors currently expect S&P 500 company earnings to grow at an annual rate of 8.1% in 2023 and 8.5% in 2024, or roughly in line with the average historical earnings growth rate. In other words, investors are not currently contemplating a recession in their earnings outlook.

The risk is rising that inflation coupled with the Fed's policy response—and the potential for a recession—will weigh on company earnings. If investors start placing higher odds on this outcome, we would expect to see estimates for earnings get revised lower, leading to further equity market declines in the quarters ahead.

Conversely, if consumer sentiment improves and company earnings hold up, markets could move higher sooner. To add context—and as shown in the chart below—after falling to a record low in June, consumer sentiment remains depressed. Extreme levels of pessimism have historically been followed by periods of strong equity market returns (+28% one-year forward return on average). If inflation declines to acceptable levels and the Fed pulls back on its aggressive tightening campaign, consumer sentiment could improve and support company earnings, leading to a rebound in equities.

We believe in being prepared for a range of outcomes, and we are doing just that. Having a flexible perspective can better equip us to adapt to changing market conditions, stick to our long-term investment plan, and avoid rash decisions that can lead to suboptimal investment outcomes.

Cobblestone's investment strategies are designed to navigate a variety of market environments, including challenging ones. Our multi-asset investment strategies have benefited from the broad range of diversifying investments within our portfolios. We have long been proponents of incorporating alternative sources of return as part of a client's overall asset allocation, first investing in alternative asset classes and private investments more than a decade ago. We have continued to increase our exposure to these areas of the market as well as to newer alternative strategies such as private infrastructure, farmland, timberland, reinsurance, and consumer and small business loans. These alternative asset classes have provided diversification benefits beyond those typically provided by traditional asset classes, helping dampen overall portfolio volatility and enhance returns, benefits that are magnified during periods of market duress such as the one we find ourselves in today.