MACRO & MARKET PERSPECTIVES

GLOOMY MARKET NEWS
SHINES SOME LIGHT

AVOIDING HASTY ASSET ALLOCATIONS IN
STORMY SEAS

EQUITY INVESTORS HOPE TO BRING BACK "NORMAL" AFTER
BRUTAL 2022

PRESENTED BY

The Investment Committee
of Oakworth Capital Bank

October 2022 | 4th Quarter

4Q

4TH QUARTER 2022 ECONOMIC OUTLOOK & OVERVIEW

TABLE OF CONTENTS

04
3RD QUARTER 2022 KEY TAKEAWAYS

06
ECONOMIC OVERVIEW

14
ASSET ALLOCATION OVERVIEW

18
EQUITY OVERVIEW

22
BOND OVERVIEW

26
A FIRST LOOK AT 4TH QUARTER 2022

JOHN NORRIS
Chief Economist

ADAM KIRKLIN
Managing Director

DAVID MCGRATH
Associate Managing Director

A letter from our

INVESTMENT COMMITTEE

Stubbornly high inflation continued to loom over the markets during the 3rd quarter of 2022. With little improvement in the trailing 12-month Consumer Price Index (CPI), consumers and investors wondered just how long this so-called transitory situation would last. It sure has felt permanent.

In this sort of a gloomy scenario, investor psyche continued to languish, especially in September. During the last month of the quarter, virtually everything seemed to come apart after a disappointing CPI report on September 13. That was all it took to drive stocks and bonds to new lows.

Equities, as defined by the S&P 500, had another dismal quarter. So did bonds, real estate and most commodities. Finally, while cash hasn't fallen like stocks and bonds, inflation has taken a big bite out of the U.S. consumer's purchasing power.

In a lot of ways, every way actually, it was great to see the 3rd quarter in the rearview mirror. It will be even better to see the calendar turn after midnight on December 31.

Interestingly, the economic data continues to be better than the markets would suggest. To be sure, growth has been less than it was in 2021, but it hasn't been the worst-case scenario either. In fact, outside of the real estate market, the U.S. economy might even be slightly in positive territory for the year.

As I wrote here last quarter, the labor market remains historically tight. Banks are flushed with liquidity. If you liked stocks at the start of the year, you will love the valuations now. Longer-term inflation expectations are moderating, so bonds likely won't continue to fall apart. This means stock prices should rebound from the 3rd quarter's red ink.

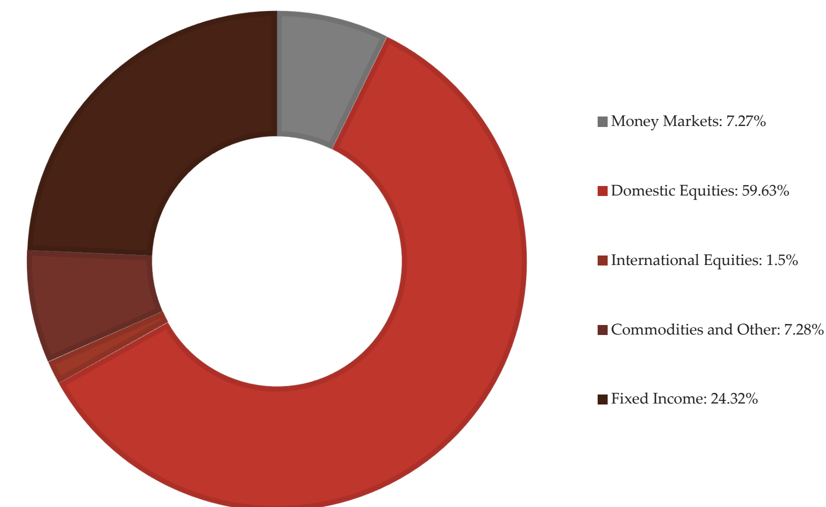
Truly, this year has been one of the worst in recent memory. However, it is almost at an end, and things really aren't as bleak as they appear. That is one of the easiest observations I have ever made. Trust me on that.

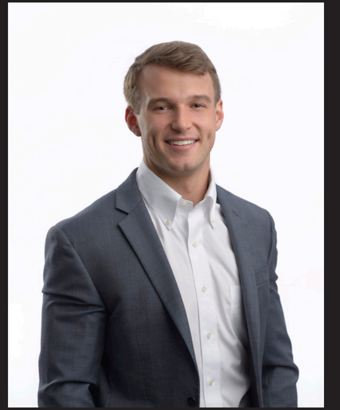
Please enjoy our thoughts about what happened in the 3rd quarter, if that is possible, and what might happen throughout the remainder of the year. Obviously, no one can look into the future with crystal clarity. However, by anticipating potential changes, we can capitalize on them for our clients' benefit.

Sincerely,

John Norris
Chief Economist

The Oakworth Capital Investment Committee distributes information on a regular basis to better inform our clients about pending investment decisions, the current state of the economy, and our forecasts for the economy and financial markets. Oakworth Capital currently advises on approximately $2 billion in client assets.





SAM CLEMENT
Portfolio Manager

SAM HARRIS
Portfolio Manager

RYAN BERNAL
Analyst

3rd Quarter 2022

KEY TAKEAWAYS

01. ECONOMY

Despite all of the bad news and angst, the U.S. economy didn't show any imminent signs of a sharp contraction, in aggregate. As is usually the case during a slowdown, some sectors will be impacted more than others. Banks remain flush with cash and are eager to make loans. It is hard to find a time in our nation's economic history when this is the case and the economy collapses.

02. INFLATION

With inflation running higher and lasting longer than anyone would like, the Federal Reserve increased the overnight target lending rate 1.50% (150 bps) during the quarter. While not quite as Draconian as the moves during the 1980s, the markets felt the pinch.

03. MARKETS

There was a strong sense of Groundhog Day during the quarter, as it seemed the markets kept living the same day over and over. Unlike the movie, which was at times funny and ended on a positive note, there were few laughs by the end of September.

04. BONDS

During August and September, it appeared the bond market finally got the message there should be a strong, positive correlation between inflation and interest rates. This had been a head scratcher. Unfortunately, bond investors got pummeled.

05. STOCKS

The best thing you can say about stocks for the 3rd quarter is their valuations appear even more cheap than they did at the end of the 2nd quarter. Since the beginning of the year, the Price/Earnings ratio on the S&P 500 index has fallen from 24.74x on 12/31/2021 to 17.85x on 9/27/2022. That is a significant move in a relatively compressed period of time.

06. JOBS

For some reason(s), there is still a historically high number of available jobs in the U.S. economy. While this will eventually ease over time, employers are asking the question, "Where did all of the workers go?"

07. MORTGAGE RATES

Higher mortgage rates and overall borrowing costs suggest real estate could have a difficult time over the next several quarters. This should not be a repeat of 2008. The U.S. banking system is in much healthier shape than it was back then.

08.FOREIGN CURRENCY

international investing has two components: 1) price appreciation, and; 2) currency fluctuation. As the dollar swamped the euro, British pound, Japanese yen and others during the quarter, foreign assets swooned as a result.

09. US CURRENCY

The U.S. dollar continued to outperform all other major reserve currencies. The dollar was stronger during the quarter than it has been in roughly two decades., causing global commodities to decline significantly during the quarter. The reason for this is simple: Most commodities trade in U.S. dollars. If the dollar is significantly stronger, it will take fewer of them to purchase, say, a barrel of crude oil.

ECONOMIC OVERVIEW

GROUND HOG DAY

by: John Norris

During the 3rd quarter, I wrote a Common Cents newsletter titled, "Common Cents & Déjà Vu, Again." The reason being it seems as though investors have been living through the same day over and over, as in the movie "Groundhog Day." Unfortunately, the movie was a lot more fun than the recent reality.

In so many ways, last quarter was eerily similar to the previous one. During April, May and June, people were wringing their hands and gnashing their teeth about inflation and the Federal Reserve. Would inflation get so red hot the Fed would have to kill the economy to kill inflation?

Guess what investors had on their collective mind from July through the end of September? That's right. They were worried about the exact same thing. Inflation and the Federal Reserve, and not necessarily in that order.

To be sure, some people talked about the ongoing war in Ukraine and Chinese bellicosity. Others discussed how the equation the government uses to calculate Gross Domestic Product (GDP) had produced two consecutive quarters of supposed contraction in the U.S. economy. So, we must be in recession, right? If not, when, how and why?

Still, where the rubber meets the road, when the dust settles, when the smoke clears and when the cows come home, the average U.S. consumer is more worried about their wallet than they are Eastern Europe or the Taiwan Strait.

The truth is not much different at the top of the house during the 3rd quarter of 2022, only at the margins and by basis points. Inflation was stubbornly high, and the Federal Reserve raised the overnight rate 1.50% (150 basis points) to help bring it down. By comparison, inflation was stubbornly high in the 2nd quarter, and the Federal Reserve raised the overnight rate 1.25% (125 basis points) back then.

So, if these primary things are still at the top of the house, what is likely to happen moving forward?

First things first, inflation will start to come down. By come down, I mean the rate of the recent increases in prices will diminish. That does NOT mean prices will decrease in absolute terms. In essence, inflation will be increasing at a decreasing rate. After all, there is an old expression when it comes to prices: "They tend to go up on the express elevator, and come down by the stairs."

There is a lot of truth to that. But, why do I think inflation will start to abate?

There are numerous reasons, but I am going to tackle four. The first one being the outsized strength of the U.S. dollar. For the 20 years leading up to the Financial Crisis of 2008, there was a -0.24 correlation between the strength of the U.S. dollar (as defined by the DXY index) and the 12-month CPI. This time frame leaves out the messiness in the currency markets after Bretton Woods; the fallout from Paul Volcker's nuclear monetary policy and the extreme tactics the Fed has used over the past 14 years.

In essence, under normal situations, the dollar and inflation SHOULD move in opposite directions. This should make sense. After all, why would people want a currency that is rapidly devaluing due to inflation? Intuitively, they wouldn't.

Currently, the dollar is as strong as it has been over the past 20 years. Historically, this would mean inflation should be falling, or at least cooling its heels. Strangely enough, this hasn't been the case for a number of reasons too lengthy to mention in this short section. However, this should change. The reason being the Federal Reserve, after close to 15 years of quizzical monetary policy, is apparently attempting to restore some sense of normalcy. IF this IS in fact the case, the historic correlation between the dollar and inflation should eventually reemerge.

As the chart shows, clearly something weird has been happening over the past two years. Time will prove this is the exception and not the norm.

Then there is the curious case of the slowing money supply. Simply put, the amount of cash floating about the system, as defined by the M2 Index, has been pretty stagnant for the past 12 months and even more so YTD in 2022.

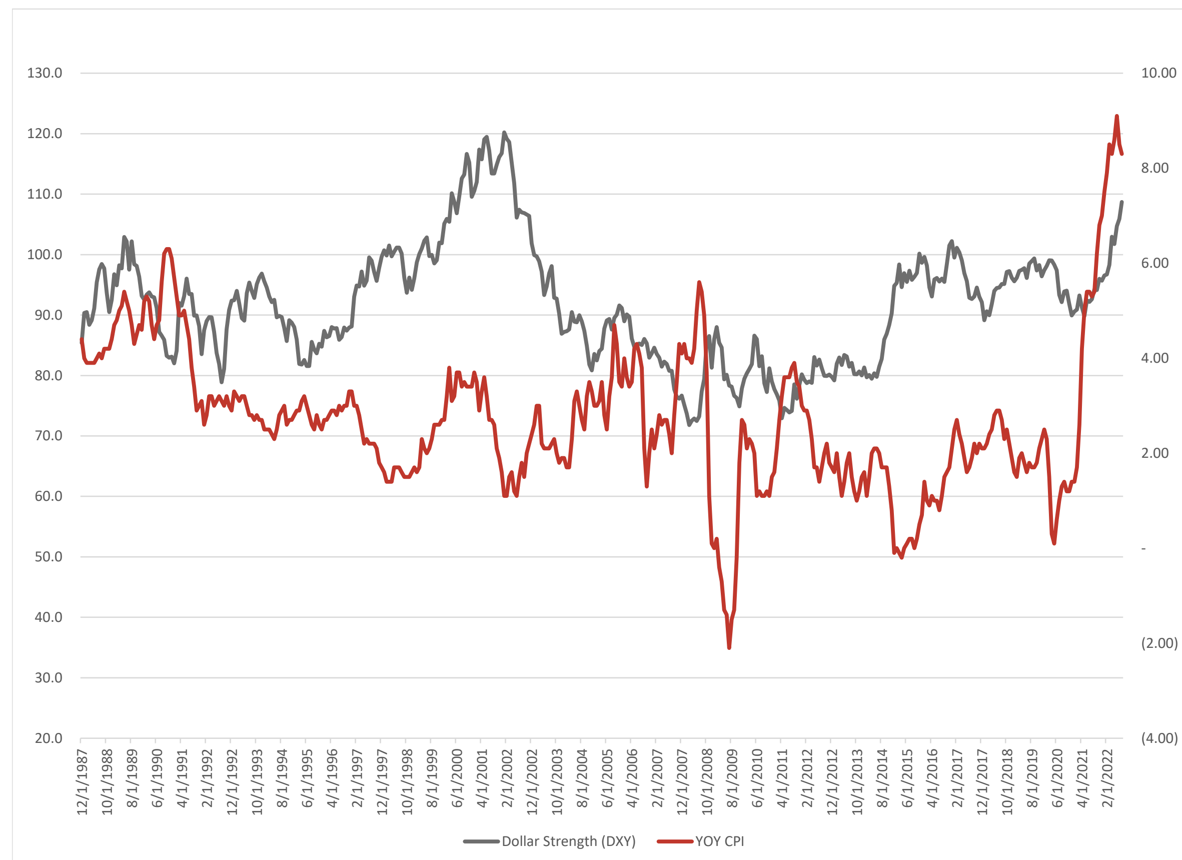
Ordinarily, and kind of counterintuitively, over the past several decades the money supply has typically grown a little faster than the rate of inflation. It isn't a perfect science, but the amount of liquidity in the system is typically relatively constant and positive sloping. By comparison, inflation can be all over the board.

However, due to the economic dislocation during the worst of the COVID pandemic in 2020, Washington (primarily) and the Federal Reserve (secondarily) flooded the markets with money that didn't previously exist. To that end, since the end of 2019 through the end of 2021, the money supply grew an eye-watering $6.17 trillion. That represented a 40.3% absolute growth rate.

Conversely, since the end of 2021 through August 2022, M2 has grown a relatively tepid $221.3 billion, or 1.03%. Over the past 12 months, the money supply has increased 4.1% and, as the chart illustrates, has been trending downward.

Intuitive for 20 Years…Then Not So Much, Particularly in 2022

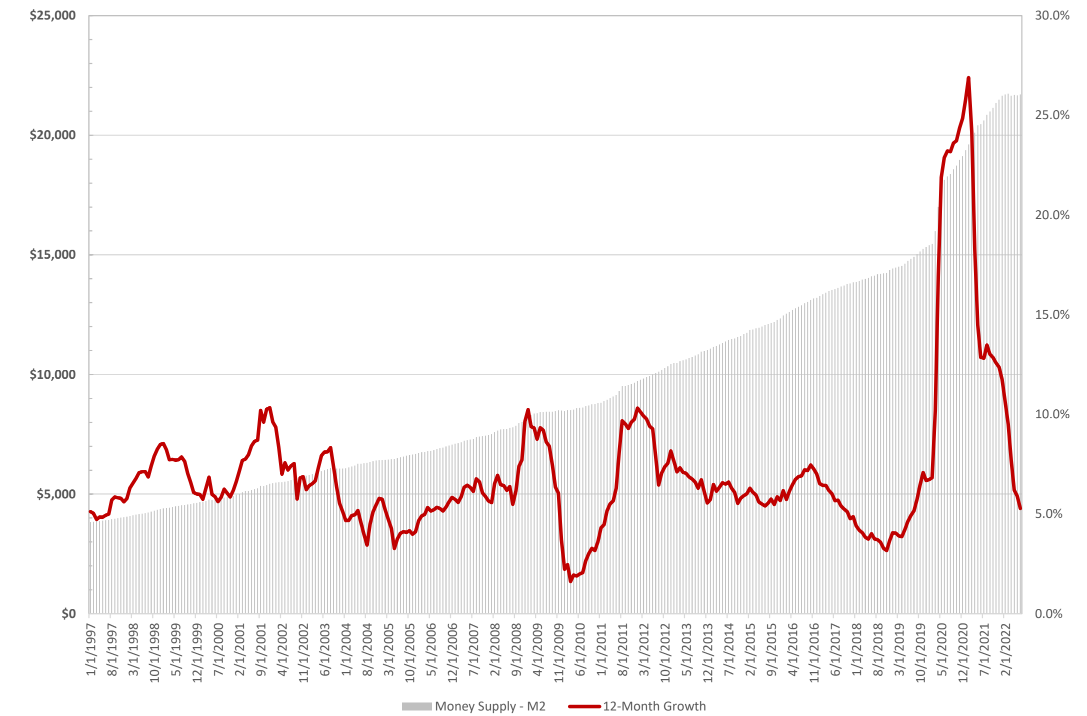
DOLLAR STRENGTH & INFLATION



Data points provided by Bloomberg

The Money Supply – How Does It Support 8% Inflation From Here?

M 2 - MONEY SUPPLY GROWTH



Data points provided by Bloomberg

The question remains: How can inflation continue to surge north of 8% when the fuel to grow it, money, is growing at roughly a 1.5% annualized clip? I submit it would be a pretty neat parlor trick.

Another thing I would like to mention on the prospects for lower inflation is inventories. More specifically, inventories have absolutely surged over the past 24 months. To the point where wholesalers and retailers will have to start considering reducing them in some form or fashion. This is even more paramount given the cost of financing higher levels of inventory has gotten more expensive as the Fed has been raising rates.

In essence, the stuff sitting on the shelves is starting to cost companies money. How much longer will they be able to withstand the status quo?

But how and why did this happen? Why did the trajectory in inventory growth suddenly steepen so dramatically? You have to remember, government-imposed economic lockdowns stifled both consumption and production. When these were over, the same government flooded the economy with cash in order stimulate demand…which had already been building.

This caused a massive supply-demand mismatch, as companies couldn't keep up with the ravenous U.S. consumer. As a result, purchasing departments started buying supply regardless of cost.

You can call it a Fear of Missing Out (FOMO) approach to inventory management. There was no way companies were going to be long on orders and short on supply again. Since the pandemic nadir in inventories in June 2020, companies in the United States have added $423.1 billion to their shelves.

Unfortunately, this led to the following chart, which intuitively isn't sustainable. Something has to give, and the more the Fed raises rates, the more likely it is wholesalers and retailers will cut their losses as much as they can. After all, a sudden surge in consumer demand at this point would be, well, unusual.

Finally, my last point on the prospect for lower inflation moving forward is the recent decline in commodity prices. A better way of putting it is the collapse in prices since the middle of June 2022. This only accelerated during September.

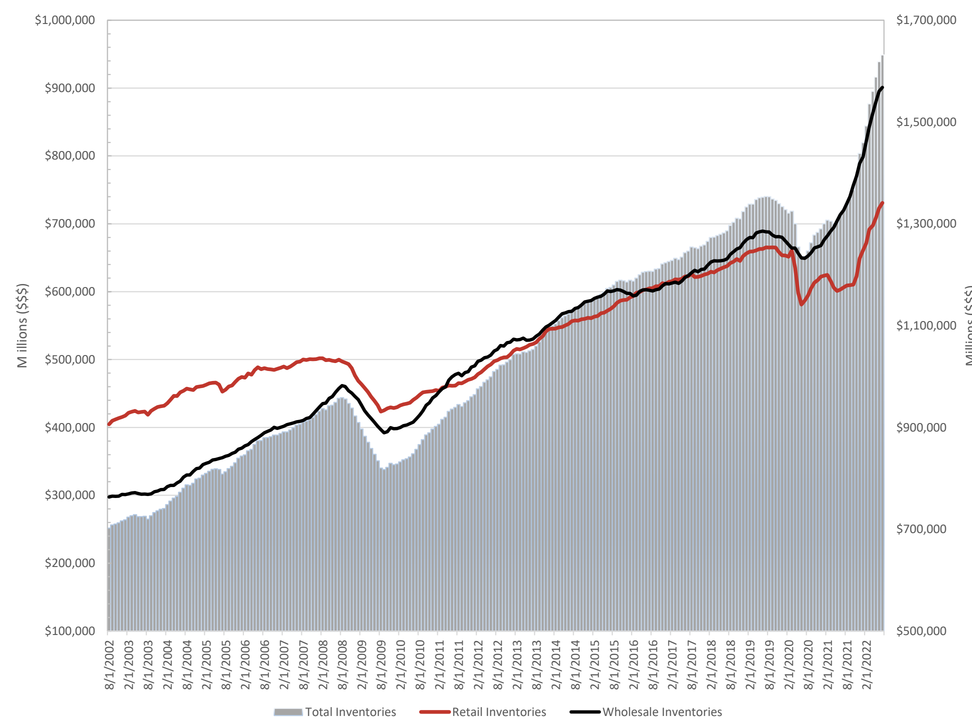
Thanks to the soaring U.S. dollar, already bloated inventories and a softening in end-consumer demand, commodity prices have come back to more reasonable levels. While still higher than at the start of the year, they are far more workable than they were. Further, with the exception of the shock to the energy sector to start the year, which has remained to a lesser degree, commodities have generally been falling since the end of the 1st quarter. In fact, many agricultural and industrial commodities are actually negative for 2022.

Who would have thought? I imagine very few. Regardless, the following chart illustrates just how far down commodity prices have fallen since June. Intuitively, this should help unit labor costs across all sectors of the economy. Historically, this has benefited the U.S. consumer, and there is no reason to think this time is different from the last.

It seems I always end up eating my words whenever I say that.

Too Much Inventory Given Current Demand

WHOLESALE & RETAIL INVENTORIES



Data points provided by Bloomberg

As for the overall economy, there appears to be somewhat of a disconnect between perception and reality. If you are to believe the headlines, the economy is in a sorry state, maybe even a recession or worse. However, anecdotally, the planes and restaurants are all full. The interstates are frustratingly crowded, especially with trucks hauling stuff hither and yon. Companies are having trouble finding people to work. Banks are still looking to extend credit. The list goes on and on.

The question remains: How can we be in an economic downturn when things seem to be okay? Shoot, outside of real estate, most business owners with whom I have spoken have told me they are having another good year.

Frankly, the data is as weird as it has been in my career. Some things look pretty good. Others look just okay. Still others look pretty bad. When combined, the outcome is the economic equivalent of a plain hot dog. It isn't the worst thing in the world; however, it could be much, much better. All the more so when we were eating steak in 2021.

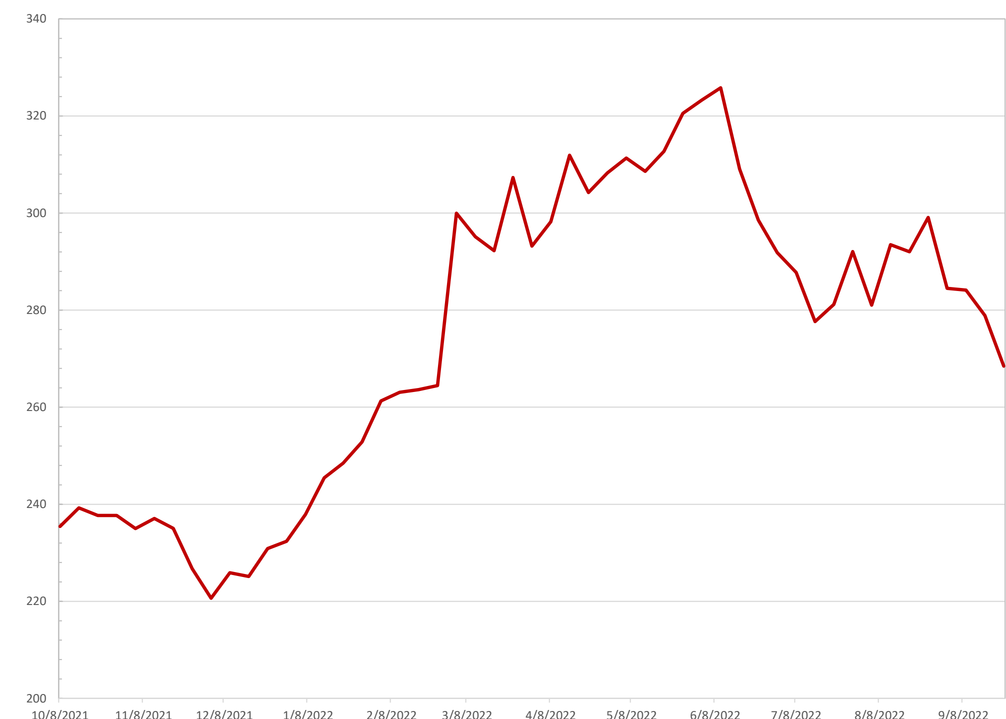
I hope that analogy makes sense.

To be sure, economic growth has slowed in 2022 from the previous year. That was a given, and part of the reason things might seem worse than they actually are. After all, the economy grew at a feverish pace last year, the hottest growth since 1984. There was no way we were going to top that. The question was, just how much slower would it be?

As I type, part of the answer remains in the GDP equation: C+I+G +/- Net Exports. During the first half of the year, a slight tweak here and another one there would have produced different results. For instance, our trade deficit ballooned during the 1st quarter, as

Input Prices Have Been Falling, Are Consumer Prices Next?

REFINITIV/CORECOMMOFITY CRB INDEX EXCESS RETURN



Data points provided by Bloomberg

businesses were stockpiling inventory. In the 2nd quarter, businesses grew their inventories at a decreasing rate. These parts of the equation sent the economy officially into negative.

By comparison, the U.S. consumer was actually okay during the first six months of the year. In an economy where consumer expenditures make up 68.4% of the equation, the strength of the consumer is crucial. During the 1st quarter, the consumer grew 1.3%, and it grew 2.0% during the 2nd. While these are awesome observations, they aren't the worst-case scenario either.

Basically, if the U.S. consumer isn't falling apart, it is incredibly difficult to forecast the U.S. economy falling apart. So, where are we?

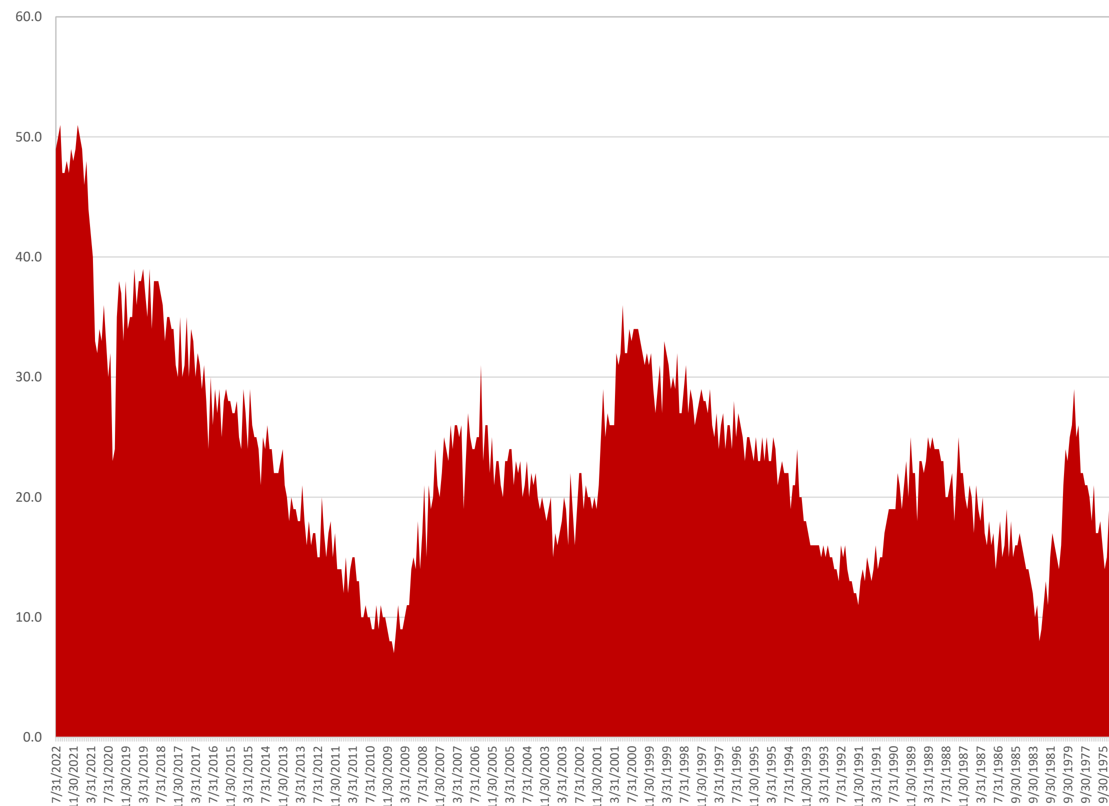
The following two charts sum up the health of the U.S. consumer at the end of the 3rd quarter. The first one is the number of jobs available in the economy. The second is consumer confidence. Not surprisingly, there is ordinarily a positive correlation between the two. After all, when the labor market is strong, as evidenced by job openings, workers feel better about their situation. When they do, they are more prone to spend money.

The first chart is from the Bureau of Labor Statistics (BLS) and illustrates just how strong the labor market is right now. Make no mistake about it, employees have more leverage now than they have in decades. Historically, it is hard to find a strong economic contraction when this is the case.

Please note the vast disparity between the number of jobs open now and during 2008. This is nowhere near the same situation.

A Historic Number of Jobs in a Consumer Driven Economy

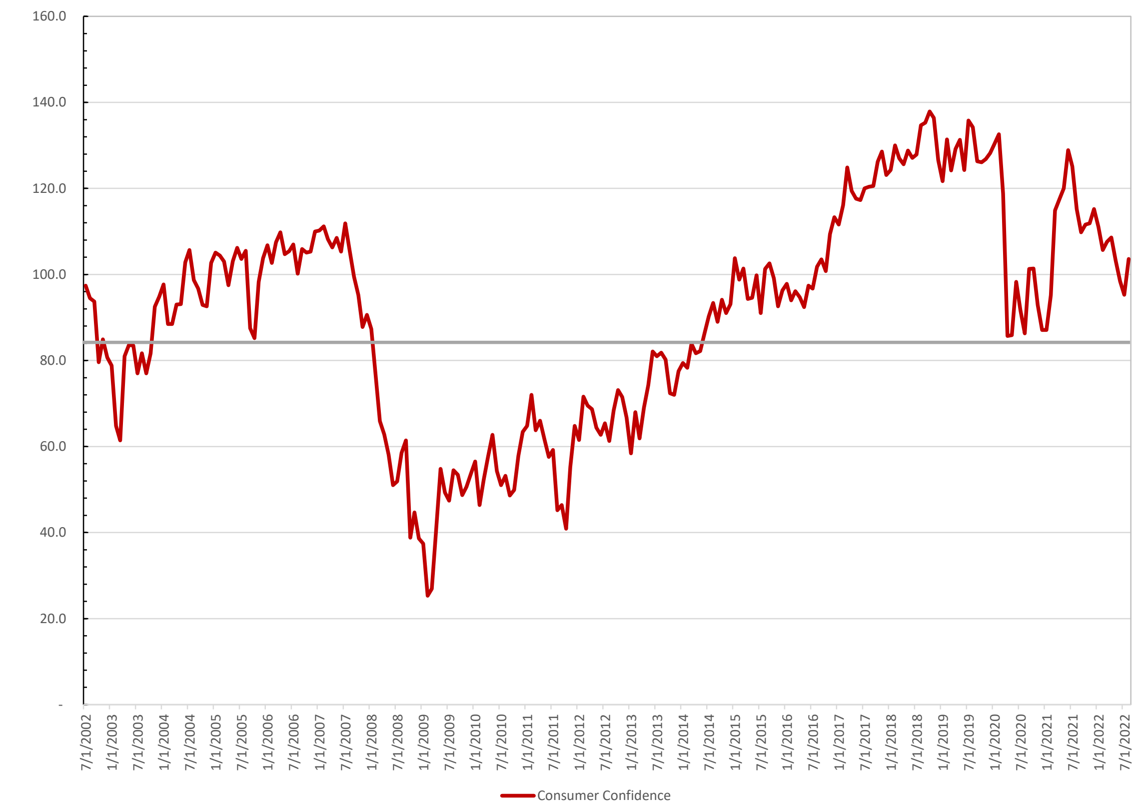
OFFICIAL JOB OPENINGS IN US ECONOMY



Data points provided by Bloomberg

The Headlines Say One Thing…The Surveys Say Something Different

CONFERENCE BOARD CONSUMER CONFIDENCE



Data points provided by Bloomberg

Therefore, perhaps it isn't too surprising consumer confidence has remained reasonably robust despite the spike in inflation. To be certain, it has come down near historic levels. However, the most recent gauge suggests the U.S. consumer feels much better about things than during previous downturns. Further, the current level of 108.0 is comfortably above the 20-year average, 90.9.

Therefore, we can honestly ask the question: "with the job market as strong as it is and with a reasonably confident US consumer, how will we get to the worst-case economic scenario we hear about in the media?"

I don't have a good answer for that.

In concluding this section, the 3rd quarter was much like the 2nd quarter in terms of economic activity. It wasn't awful, but it wasn't great either. However, it was much better than perhaps we thought it was. When you factor out some anomalies in the GDP equation, the economy is weaker than it was last year. That was to be expected. Still, it isn't completely falling apart either.

Unless something unforeseen happens, inflation should start to come down, perhaps significantly, over the next two quarters. This will give a boost to consumer confidence, as well as allow the Fed to slow down the tightening process. If this happens, the U.S. economy will go through a period of sideways economic growth where businesses work down their inventories and the perception will seem worse than the reality.

In other words, welcome to Punxsutawney, Pennsylvania. It's Groundhog Day.

ASSET ALLOCATION

HASTY ASSET ALLOCATION BEST AVOIDED IN STORMY SEAS

by: Sam Clement

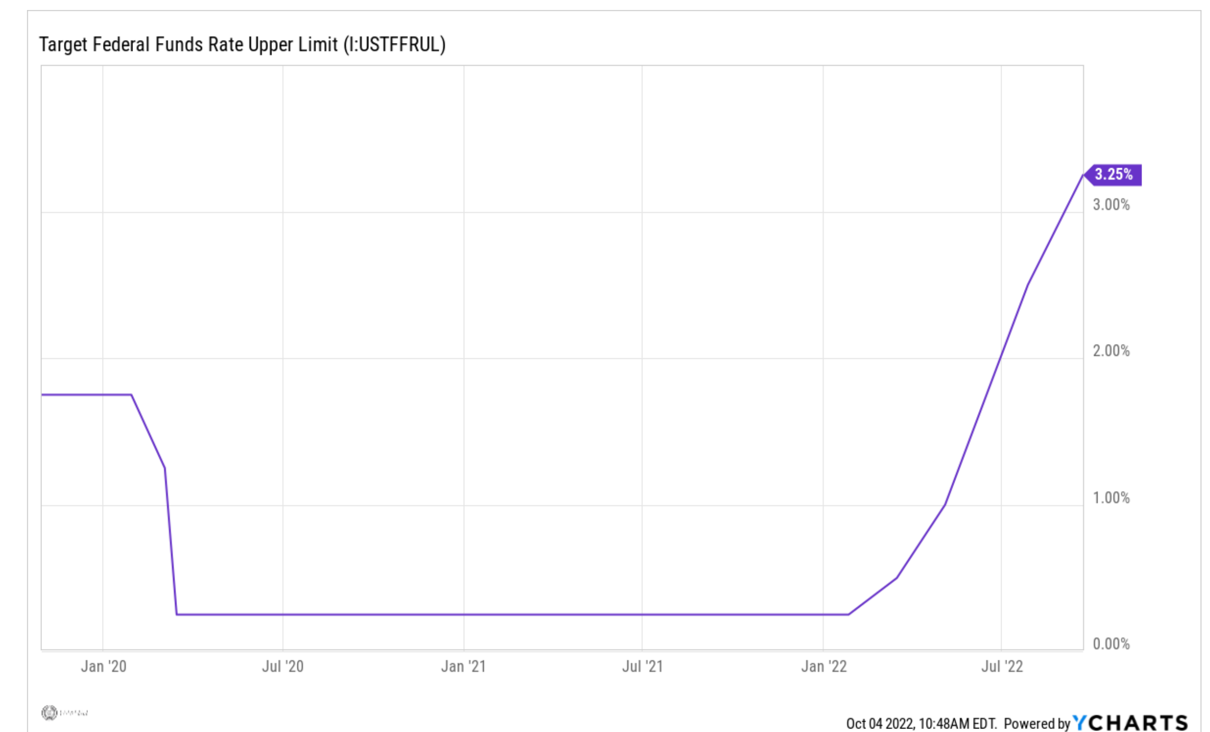
When people reflect on the 3rd quarter this year, what they will really be thinking about is the back half of it. As they say, it's not how you start, but how you finish, and if that's the case the 3rd quarter gets an F minus. What started off as a promising quarter with returns upwards of 12% quickly reversed into a drab quarter full of red ink.

The main cause of the blood in the streets was pretty simple. Continued inflation, the Federal Reserve and their steadfast approach to hiking interest rates and the resulting strength of the U.S. dollar. While the day-to-day movement in financial markets is always complex and contains countless things to point the finger at, these broader trends were the difference makers.

The fun, or at least intellectually stimulating, part is the application of these trends. With inflation still running hot, the Fed continuing to promise additional rate hikes and the dollar soaring to several-decade highs, how do we position an allocation?

Using a top-down macroeconomic approach to asset allocation like we do, the first step is to determine our broad asset class allocation. Stocks to bonds to cash. The sentiment has been extremely negative with very few reprieves. Really for most of the year. Our overweight to equities of 2021 was due to several factors, including continued earnings growth, a strong economy and low rates. Low rates mean a higher multiple for stocks but it also means cash is not paying much. Who wants to be in an asset class that guarantees them an eroding purchasing power? Not I.

Those are the two sides of the "higher interest rates coin," and a simple yet effective way to look at the headwinds and tailwinds for the equity market. The Fed has continued to affirm a desire to raise interest rates to bludgeon inflation. They have taken every chance they can to make sure the market knows that they are going to complete their objective. This has meant the Federal Funds rate has gone from close to zero to start the year, to what is now expected to be close to 4.5% by the end of the year. That is a massive, massive move and a far cry from what the voting members of the Fed expected to happen this year when they met 12 to 18 months ago.



This has been a torrential headwind for the equity markets and has been the driving factor for us to move our equity allocation to a slight underweight — the first time I can say this in the past few years. I emphasized slight because it is an extremely important look into our thoughts and sentiment. While we understand the headwinds in place for equities, and the brutal year-to-date performance of them, we do not share the doom and gloom sentiment for the asset class that some do. Earnings have held up relatively well and like a pendulum, as quick as sentiment can change in one direction, it can equally change in the other.

The next layer in a top-down approach for equities is a look into our geographic allocation. Do we want to be more in domestic, developed international or emerging markets? That brings up the last of my major focal points for the quarter: the strength of the dollar. As shown below, the dollar has essentially moved in one direction. While this may intuitively seem odd as we have experienced historic inflation, it's worth noting that the strength of currencies are relative. While we have been in a tough spot, it has been much worse abroad. The dovish central banks and the energy crisis in Western Europe has caused inflation levels abroad to make ours look like a walk in the park.

The international sector is where the majority of our move to a slight underweight in equities has come from. Again, while things have been rough domestically, they have been worse abroad and the outlook is equally gloomy. That begs the question, if we have moved our equity weightings lower, it had to go somewhere? The answer has been cash. Back to the flip side of higher interest rates. It means cash is finally paying a somewhat meaningful rate of return, at least enough so to make it more appealing.

The "cash is trash" from Ray Dalio has quickly shifted to a "cash is king" mantra as investors look for the only area that has not been absolutely clobbered to start the year. Cash now is at least doing a little to fight the loss of purchasing power from inflation, and on top of that removes volatility from a portfolio and creates "dry powder" for when the time is appropriate to reinvest. It is times like these that remind people the value of having cash on the sidelines, and we have taken measures to reflect that in our portfolios.

The third major asset class is fixed income, the biggest driver of what has made this bear market historic. Rising interest rates are bad for fixed income, but equally important is the speed in which rates rise. The Fed has done an about-face since the start of the year once it set in that inflation was not going away quickly, and the market started to realize this. Continuous rate hikes above the standard 25-point hike have made short-term rates skyrocket, and the continued poor inflation prints have shifted longer-term interest rates up quickly as well. Again, the speed of the movement in rates is what has made this the worst start to a year for a 60/40 portfolio since 1931! We have pretty much never seen such a downward move synced up between both stocks and bonds, and this is what has made fixed income so unattractive for most of the year.

While we have written in previous quarters how we have moved some of our exposure into short-term floating rate bonds that weather the move in rates, this quarter was the first in some time where we made a focused move in to treasuries. While the year-to-date move in the sector has been ugly, at some point the music has to stop and the upward movement in rates will slow. With the 10-year treasury getting near 4% for the first time, really since 2008, it appears to be an attractive entry point into the space. While this does not mean a massive shift into fixed income as a whole, but a more focused effort into this asset class.

There is no way around it that this has been an extremely tough year. The downward move in essentially all markets, combined with the duration of the sell-off, has made it tough both financially and psychologically. I would argue that it has been much tougher than the Covid sell-off of 2020. While not always what someone wants to hear, it is times like this when having a sturdy plan that investors can stick to pays off. Making shifts in allocation is effective and can help drive long-term performance; however, sticking to the broader plan is the most efficacious way to financially succeed in the long term.

As always, the sun will rise again in the East, set in the West, and better days will come.

EQUITY

EQUITY INVESTORS HOPE TO BRING BACK "NORMAL" AFTER BRUTAL 2022

by: David McGrath

Every year, new words are added to the English dictionary. It can be interesting to look at these new words to give us some idea on how society is changing. One of the new words in 2021 was "doomscrolling." The definition of doomscrolling is "to continue to surf or scroll through bad news, even though that news is saddening, disheartening or depressing." Well, equity investors have had an excellent opportunity to do a little doomscrolling in 2022.

The one word you could make an argument for removal from the dictionary the past few years is "normal." Nothing about the economy, or the stock market, has been normal since the start of the COVID pandemic in early 2020.

The 3rd quarter had a very similar feel to the first two quarters of 2022. Rising interest rates, coupled with slowing economic growth, has been a toxic mix for equity returns. Every major equity index provided a third consecutive negative quarterly return this year.

	Q1	Q2	Q3	YTD
S&P 500	-4.60%	-16.11%	-4.89%	-23.88%
DOW	-4.10%	-10.78%	-6.17%	-19.72%
NASDAQ	-8.94%	-22.27%	-3.91%	-31.99%
Mid Cap	-4.89%	-15.44%	-2.48%	-21.54%
Small Cap	-5.64%	-14.13%	-5.21%	-23.19%
EAFE	-5.77%	-14.32%	-9.26%	-26.71%

The last quarter can be viewed in two parts, with August 26 the turning point. As we entered July, there were two main questions, (eerily similar to our current situation) that needed to be answered. First, how was high inflation and a slowing economy affecting corporate earnings? Second, would we finally start to see a break of soaring inflation, and how would that affect the strategy of the Federal Reserve?

On the corporate earnings front, there was fear in the market that 2nd quarter earnings could come in significantly below analysts' expectations. In the end, actual earnings for the 2nd quarter finished 3.4% above expectations. This daily drip of positive earnings news helped the stock market advance.

What also helped equity prices was the first lower-than-expected inflation number, more specifically the July CPI report. To give you a frame of reference, here were the monthly CPI numbers before the July reading:

MONTHLY 2022 CPI						
January	February	March	April	May	June	July
0.7%	0.8%	1.2%	0.3%	1.0%	1.3%	0.0%

So when the July number came in at 0.0%, there was a sense of optimism that the inflation "corner" had finally been turned. This is when a bit of patience would have been a good thing for equity markets. This one data point was used to assume that the Federal Reserve could now change its tone and stop its rate hikes. This news, coupled with the strong earnings results, allowed the S&P 500 to show a positive 13% return from the beginning of July to mid-August.

The Chairman of the Federal Reserve, Jay Powell, ended those dovish dreams with his comments on August 26. He reminded the

markets that the Federal Reserve was focused on killing inflation, and there were more interest rate hikes to come. In his words, there is "some pain" still ahead. He was correct.

When the next CPI report was released on September 13, the expectation was for another 0.0% report. The actual number was 0.1%, higher than expected. Even though the 0.1% number was still much better than the first six readings from 2022, the report was met with more pain for the markets. Just eight days later, the Fed did raise the Fed Funds rate by another 75 basis points and implied there was more to come (see the dot plot chart in the bond comments). All of the positive results from the strong earnings season, and a first sign that inflation was starting to abate, was gone. That 13% positive return for the S&P 500 turned into an almost 5% decline for the quarter.

The equity markets underestimated the resolve of the Federal Reserve to tackle inflation. Each member of the Fed has been using the same talking points all year, saying that they must take whatever action necessary to bring inflation back to their 2% target. They don't want to cause a recession, but a recession may end up being a result from the needed action to reduce inflation.

This quarter even gave market participants a reason to argue what, exactly, is a recession. The common definition of a recession was two consecutive quarters of negative economic growth, or negative GDP. That environment is almost always accompanied by rising unemployment, slow (or even negative) wage growth and cooling consumer spending.

Well, we have the two consecutive quarters of negative GDP. These negative GDP numbers in the 1st and 2nd quarters of 2022 were accompanied by very low unemployment, over 11 million job openings, strong wage growth and continuing strength with consumer spending. This is not normal.

The correct answer to the question of "when are we in a recession?" is when the Business Cycle Dating Committee from the National Bureau of Economic Research (NBER) says we are in a recession. To date, this committee has not declared whether or not the U.S. economy is in a recession. But the stock market certainly has decided, and we are currently pricing in one heck of a recession.

Higher interest rates in most cases will bring a lower valuation to the equity markets. First, higher borrowing rates for corporations will mean lower margins, and thus lower earnings (all else being equal). Secondly, owning bonds may become a more compelling option for investors. Some decline in the price to earnings ratio, or P/E, should have been expected this year, given the dramatic increase in interest rates. This decline in the P/E ratio for the S&P 500 shows just how strong of a recession is getting priced into the market.

Another new phrase for the 2022 dictionary may be "full employment recession." That may be the best phrase to describe what we are going through. Before this incredibly strange period, it would be hard to imagine a recession where companies can't find enough workers to hire. We start the 4th quarter with 6 million unemployed Americans and 11.2 million job openings. If we are currently in a recession, we can say with some confidence that it is not a "normal" recession.

The 3rd quarter proved difficult for just about all of the economic sectors of the market, with nine of the 11 sectors showing a negative return for the quarter. Only the Energy (+2.16%) and Consumer Discretion (+4.36%) sectors had a positive return for the quarter. The Energy sector performance continues to be volatile, as supply disruptions and intermittent surges and lags in demand makes this the most unpredictable sector in the economy.

The Consumer Discretion sector, after posting the worst performance of any economic sector for the first two quarters of 2022, had a nice rebound in the 3rd quarter. The American consumer remained strong in the face of higher prices, and a strong 2nd quarter earnings season provided a springboard for the discretion stocks to have a nice bounce-back quarter.

On the other end of the spectrum, Communication Services (-12.71%) and Real Estate (-11.03%) showed the largest losses for the quarter. Communication Services stocks, led by Alphabet (Google) and Meta (Facebook), struggled as digital ad revenue fell in the quarter. Rising interest rates and a slowing economy is an especially bad mix for real estate, and the struggles for that sector continued in 2022.

As we move into the final quarter of 2022, there is still some optimism that we can salvage at least a bit of respectability for the equity markets. The first hope revolves around the potential that we can start to see soaring inflation numbers finally begin to come under control. Starting in November, we start to "roll off" some extremely large monthly inflation numbers. As was mentioned under the economic review, we believe that by summer of 2023, the inflation numbers should start to give us some welcome relief. This should allow the Federal Reserve to slow, and then stop, the increases to interest rates that we have seen all year.

INDEX	Q1	Q2	Q3	YTD
Energy	39.00%	-5.29%	2.16%	34.49%
Utilities	4.80%	-5.09%	-5.99%	-6.51%
Consumer Staples	-1.00%	-4.62%	-6.62%	-11.83%
Healthcare	-2.60%	-5.91%	-5.18%	-13.02%
Industrials	-2.40%	-14.78%	-4.72%	-20.72%
Financials	-1.50%	-17.50%	-3.10%	-21.25%
Materials	-2.40%	-15.90%	-7.13%	-23.75%
Real Estate	-6.30%	-14.72%	-11.03%	-28.93%
Consumer Discretionary	-9.00%	-26.16%	4.36%	-29.89%
Technology	-8.40%	-20.24%	-6.21%	-31.44%
Communication Services	-11.90%	-20.71%	-12.71%	-39.04%

Looking Forward:

Next, we are looking to 3rd quarter earnings season to give us a better idea on the true strength of the U.S. economy. We don't have to wait very long to start to get an answer to that question, as we start earnings season in the second week of October. If we finish 3rd quarter earnings season near current analysts' expectations, equity prices should be able to gain back some of the losses that were suffered in late September.

Finally, this quarter will give us a mid-term election. The stock market has shown its strongest performance with shared power in Washington, D.C. If Republicans can gain control of either the House or the Senate, the single-party control that markets do not like, will be over. Just as an FYI, the strongest market returns had been with a Democrat in the White House while Republicans control both chambers of Congress. That is still a possible outcome for 2023 and 2024. Either way, the markets typically rally after an election, given we have some political certainty for a couple of years.

There is no way to put enough lipstick on this pig. The year 2022 has been a brutal one for equity investors. As we move forward to the 4th quarter of 2022 and beyond, we hope the word "normal" can soon return to the dictionary.

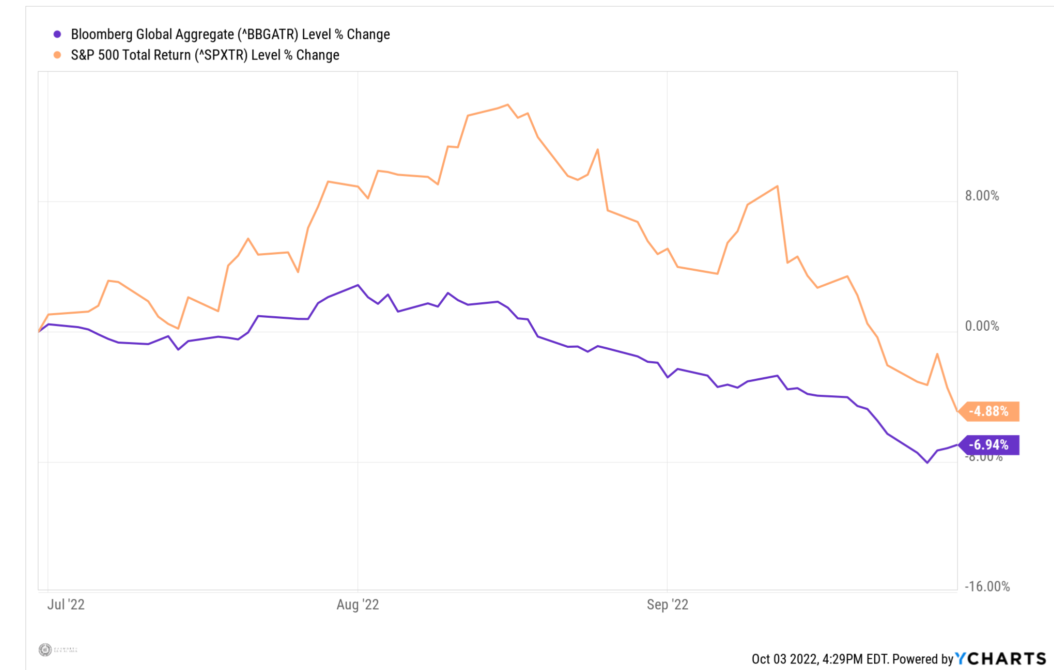
BONDS

POSSIBLE OPPORTUNITY WITH SLOWING RATE HIKES ON THE HORIZON

by: Sam Harris

The Federal Reserve's Open Market Committee (FOMC) has made its intentions crystal clear: Interest rates will continue to rise in order to kill inflation. As evidenced by the 150bps (or 1.50%) of increase in the 3rd quarter alone, the Fed's dual mandate remains definitively in place. While comparing current Chairman Jerome Powell to the late Paul Volcker remains a bit of a stretch, the prior remains determined in moderating the inflationary pressures felt within the economy.

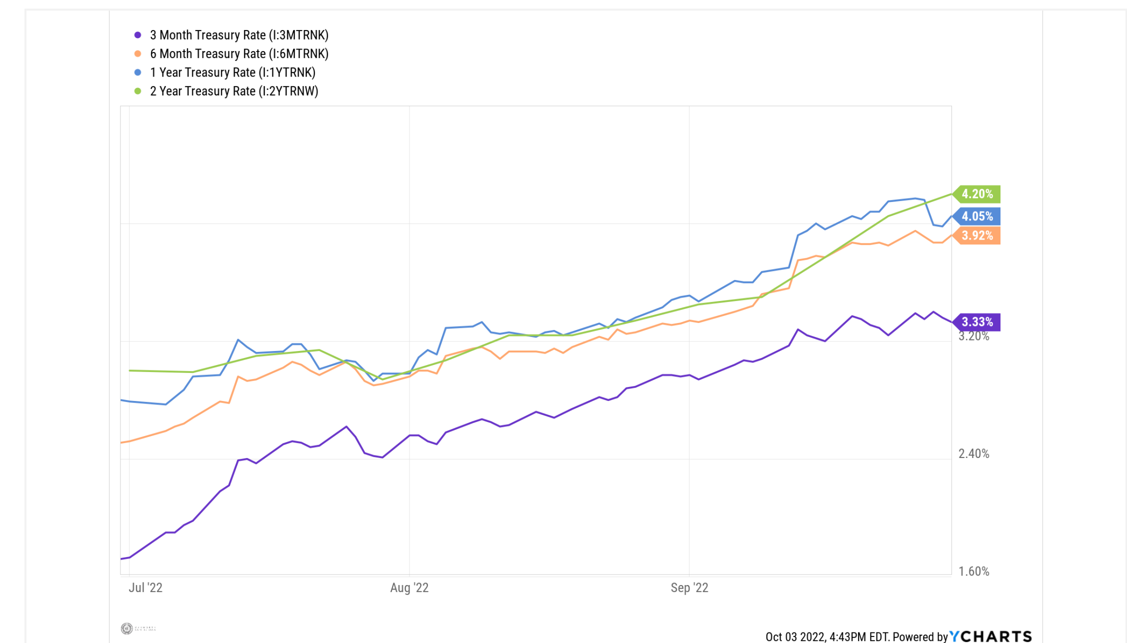
The U.S. monetary body is not alone in its upward trajectory on rates, though, as the 3rd quarter saw central banks worldwide increase their overnight lending rates – effectively making the cost of money "more." Because of this, we saw bonds slump – much like stocks – though at a historic rate of decline. In the 3rd quarter, the S&P 500 Index produced a total return of -4.88%; however, by comparison, the Bloomberg Global Aggregate Bond Index produced a total return of -6.94% (see below). Obviously, bonds'



(and fixed income as a whole) reputation as a safe haven asset during times of volatility proved not so true.

Still, though, the fixed income sector as a whole did produce some areas of historic (at least by recent standards) opportunities. By the end of the 3rd quarter, a treasury bill with a 6-month maturity yielded nearly 4.00% (really 3.92%), and a 2-year treasury threw off a yield of 4.20%(!!!). This level of absolute return seen at the shorter end of the yield curve was met with emphatic investor demand as folks grappled with their traditional money center banks evidently unwilling to budge money market rates.

Digging into the other bond sectors, aside from high-yield junk (which, if you like risk, you've got it there), there was minimal room for relative alpha – the quarter came and went with similar effects across the board, as seen below.



The real story, though, lies well beneath the surface, as the proverbial "smart" money hunkered down in the belly of the curve, with a definite focus around the benchmark 10-year treasury. As evidenced by the movement in its yield, the 10-year became a hiding spot for the risk- and volatility-averse – largely institutional books of business – due to the shared inverse relationship between interest rates and bond prices.

What does this mean? Well, it means the proverbial smart money does not fall victim to the belief of all hell breaking loose over the next 24 to 48 months and instead is quite comfortable allocating to the smack-dab middle of the yield curve. This rush to the belly of the curve also tells us sovereign wealth (a.k.a. foreign investors) is comfortable with the current U.S. political, societal and governing bodies. Perhaps this is a notion our own elected officials, as well as bureaucrats of all sorts, should also share; however, that is neither here nor there. Or perhaps it just accentuates how crummy things are in other pockets of the world. But I digress.

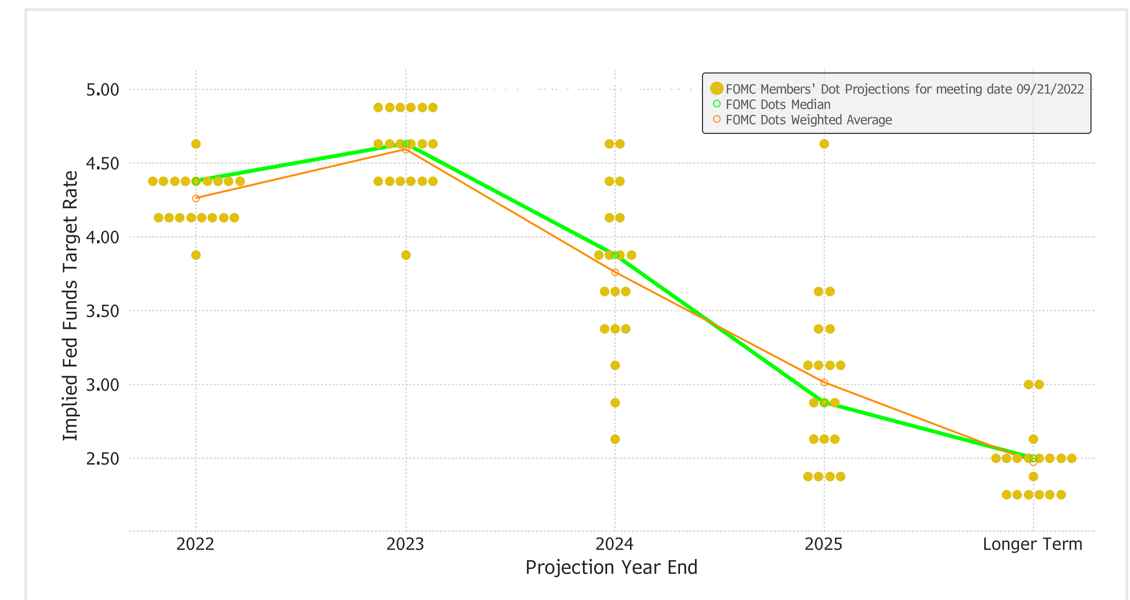
TICKER	SECTOR	2Q PRICE RETURN	2Q TOTAL RETURN
AGG	Broad US Market	(5.06)	(4.58)
GOVT	U.S. Treasury Debt	(4.05)	(3.74)
LQD	Corporate Debt	(9.02)	(8.40)
VTEB	Municipal Debt	(3.16)	(2.75)
MBB	Mortgage Debt	(4.30)	(3.87)
HYG	High Yield	(10.55)	(9.48)

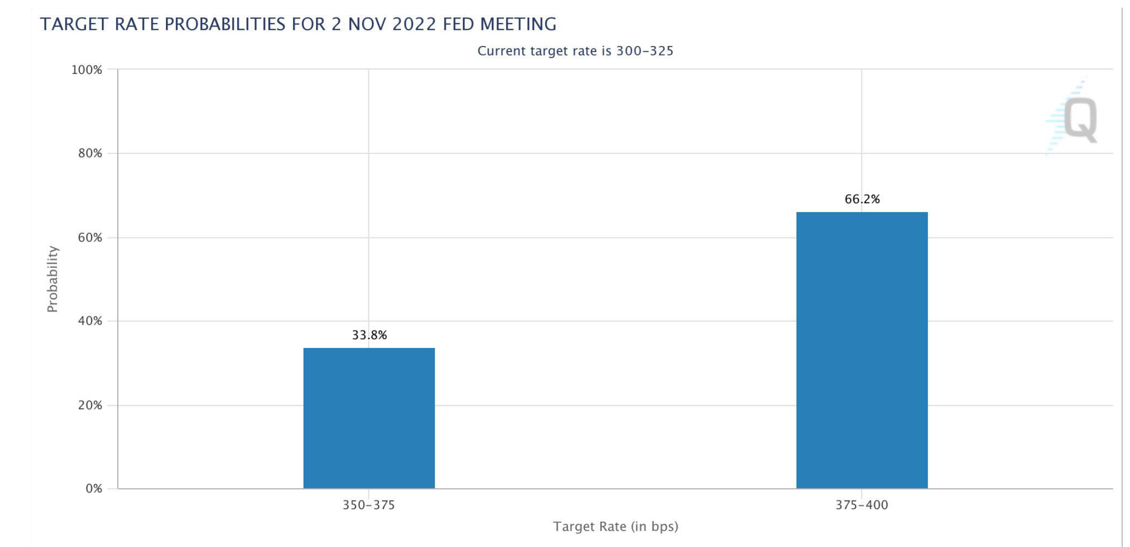
It has been said time and time again in 2022, but it bears repeating: There has been nowhere to hide. Like stocks? Enjoy sharp skids only to be met with dead weight bounces. Like bonds? Tell me what your principal investment looks like compared to the start of the year. Like cash? Try going to the supermarket and buying the same goods that $100 got you a year or two ago. While not quite as prominent, the same can be said within fixed income – breaking down each bond sector.

If an investor likes volatility, then they loved the 3rd quarter – especially within the global debt market. In the final week of September, we saw the collapse of the 30-year (and 10-year, for that matter) British gilt, or bond. It fell by a whopping 24.00%, sending yields sky-high and forcing the newly appointed Prime Minister Liz Truss to walk-back some of her more aggressive tax-cutting strategies proposed earlier in the month.

As such, since central banks are interconnected, the Bank of England's decision to both raise rates AND purchase long-dated paper in an attempt to bring some element of calmness reverberated throughout global markets – including our own. While this differs from the QE, or Quantitative Easing, completed by leading Global Central Banks over the past 12 to 30 months, it remains far from a QT, Quantitative Tightening, move, like the United States has undergone.

What can/should be done about all of this? The adage, "Don't fight the Fed" remains tried and true. As long as the Federal Reserve continues to raise interest rates, the bond market should reprice to follow. Looking at the FOMC's most recent statement (and the subsequent release of the dot plot), the Central Bank's intentions remain apparent. With the median estimate for the 2022 end-of-year overnight lending rate sitting at 4.25% as of the September 21 meeting, the benchmark rate should see an additional 100bps (1.00%) of upward movement. With this is tucked away in mind, though, the Fed futures market is pricing an additional 75bps (0.75%) of hikes in the November FOMC meeting alone.





This brings me to the final, and most crucial, point that according to the reserve board's own members, the majority of "front-loaded" rate hikes should be done by mid-November – thus allowing for the bond market to reprice accordingly from there out. As evidenced by the last week of September and the first few trading sessions of October, bond yields have slumped – perhaps suggesting we have already seen the peak in yields as investors clamored to each speculative word Powell (and the rest of his cronies) upchucked.

In 2022, bonds have not been an asset class that investors particularly fell in love with – and rightfully so. Why, in good faith, allocate capital to an asset class that did and should (in the short term) only erode in principal? A question for those who felt the need to clamor to the asset class's inherent traditional "risk-aversion," I suppose. As we wrap up an abysmal year for capital markets in general, though, bonds do present an area of opportunity. The vast majority – as I sit here and type this – of rate hikes are completed for this accelerated cycle, and as a result, we begin to peer into 2023 with a relatively weak, by recent memory, economy – though still expanding. As such, bonds producing absolute returns in the 4.00% - 6.00% range may present investors with a compelling area of opportunity, especially since we know equities, or stocks, are merely the projected future cash flows of publicly traded corporations.

PREDICTIONS

A FIRST LOOK AT 4TH QUARTER 2022

- The number of job openings will start to gradually make its way lower due to tepid economic activity; an acknowledgment the workers simply aren't out there; and businesses starting to spending more on technology to provide the necessary capacity.

- As was the case during the 3rd quarter, the Federal Reserve will continue to increase the target overnight lending rate, despite tepid economic growth and concerns of a recession. It will likely be 4.25% by the end of December.
- Although other central banks have started to raise their overnight rate equivalents, the United States seems "ahead of the curve" by comparison. As a result, the dollar should continue to remain strong.
- Due to the dollar's continued strength, commodity prices and international investments should remain under stress.
- Trailing 12-month inflation rates will start to show some signs of moderating during the quarter. Essentially, prices will be increasing at a decreasing rate. By the end of Q2 2023, the Consumer Price Index (CPI) should start to look somewhat normal again.
- The November elections will be very contentious. Republicans will likely gain control of one house in the Congress. This will be enough to produce gridlock in Washington, which is exactly what the economy needs moving forward.
- A couple of favorable inflation numbers during the quarter should break the current Doomsday psyche in the markets. As a result, expect stocks to produce positive returns during Q4. Investors won't get all of it back by the end of the year, but they should be able to recoup some of 2022's losses.
- Tensions in Europe won't show any significant signs of improvement. The war in Ukraine will languish, and the western allies will need to regroup after sharp shifts to the political right in both the United Kingdom and Italy. Unfortunately, no one will heed Otto von Bismarck's famous advice: "The secret of politics? Make a good treaty with Russia."
- Asia will continue to simmer, as relations between South Korea and Japan remain frosty, and the region questions America's effective power and actual influence in the region.
- The humanitarian crisis in Haiti goes from worse to unconscionable. Washington will begrudgingly have to intervene at some point in the not-so-distant future to keep that beleaguered country from outright collapse.
- The U.S. economy will make it through the end of the year with investors still wondering whether it is in recession. While overall economic activity is mediocre, especially when compared to 2021, the equation the government uses to calculate Gross Domestic Product (GDP) suggests things are worse than they actually are.
- Winter weather conditions will be colder than normal east of the Rocky Mountains. As chilly as it will get, and as much as Southerners will complain, the Europeans will fare much worse as their energy prices spike.

JOHN B. NORRIS, V

Managing Director & Chief Economist
Investments & Thought Leadership

Contact:
Office: (205) 263-4716
Mobile: (205) 910-1219
Email: john.norris@oakworth.com

Mr. Norris oversees Investments and Thought Leadership for Oakworth Capital Bank. Prior to helping to start Oakworth, Mr. Norris was also Chief Economist, Chairman of the Investment Strategy Committee, and a Senior Fund Manager for Regions Financial Corporation's Morgan Asset Management (MAM) subsidiary. Before joining Regions, he served as the Chief Investment Officer for The Trust Company of Sterne, Agee & Leach, Inc. and started his professional career with Mercantile-Safe Deposit & Trust Company in Baltimore, Maryland, as an Institutional Fixed Income Portfolio Manager.

As part of his role at Oakworth, Mr. Norris hosts a podcast, writes a weekly blog, and speaks publicly on the economy and the markets to a wide variety of audiences. Outside of Oakworth, he currently serves on the Board of Directors for the IPC Foundation, serving as the finance chair, and was recently appointed to Board of Directors of the Alabama Trust Fund by Governor Ivey. Mr. Norris also serves on the advisory board for Gabriella White LLC (Summer Classics), as well as the advisory board for the economics/finance department at Samford's Brock School of Business. Finally, he is a member of the Birmingham Rotary Club. He received his Bachelor of Arts from Wake Forest University and his Master of Business Administration from the University of Baltimore.

Central Alabama Office
850 Shades Creek Parkway
Birmingham, Alabama 35209
Phone: (205) 263-4700

South Alabama Office
1 St. Louis Street, Suite 3200
Mobile, Alabama 36602
Phone: (251) 375-7800

Middle Tennessee Office
5511 Virginia Way, Suite 110
Brentwood, TN 37027
Phone: (615) 760-1000

THOUGHT LEADERSHIP

We believe communication is the key to successful client relationships. While sharing useful information is beneficial, regardless of source, Oakworth believes in the value proposition of developing and having its own experts and ideas. By generating our own market commentaries, economic newsletters, topical subject analysis and serials, and even conversational podcasts and videos, our clients know we are using our knowledge, creativity and expertise to help them succeed.

Our Podcast

Trading Perspectives

In this weekly podcast, Chief Economist John Norris, Portfolio Manager Sam Clement and Director of Wealth Business Services Courtney Truss exchange perspectives on the driving factors influencing our economy. Trading Perspectives can be found on Apple Podcasts, Spotify, Google Play, YouTube, and all other major podcast outlets.

Our Blog

Common Cents

Started over 20 years ago, Common Cents is a weekly blog written by Chief Ecomist John Norris detailing and explaining the events that impact our economy. John distills the latest information, making it easy to understand how these events affect daily life.

ABOUT OAKWORTH

After the largest capital raise in the state of Alabama, we opened our doors to the public on March 31, 2008. Over the years, we have developed a reputation as one of the safest banks in the United States. In 2016 we expanded our markets in Alabama, adding a South Alabama office in Mobile. In 2020 we expanded to the state of Tennessee, opening a Middle Tennessee office in Brentwood.

We are a privately owned company with fewer than 400 shareholders. All managing directors and the majority of our associates directly own shares of the company. We believe this instills a strong business-owner mentality throughout the company.

In addition to your client team, our bank's leadership team consists of experienced and well-versed individuals, allowing us to offer a wide range of Private and Commercial Banking, Wealth Management and Advisory Services. Our core values and overall mission are building blocks for the long-term success of our clients, associates, shareholders, and communities.

This report does not constitute an offer to sell or a solicitation of an offer to buy or sell securities. The public information contained in this report was obtained from sources and vendors deemed to be reliable, but it is not represented to be complete and its accuracy is not guaranteed.

The opinions expressed within this report are those of the investment committee of Oakworth Capital Bank as of the date of publication. They are subject to change without notice, and do not necessarily reflect the views of Oakworth Capital Bank, its directors, shareholders, and employees.

Member FDIC

OAKWORTH.COM