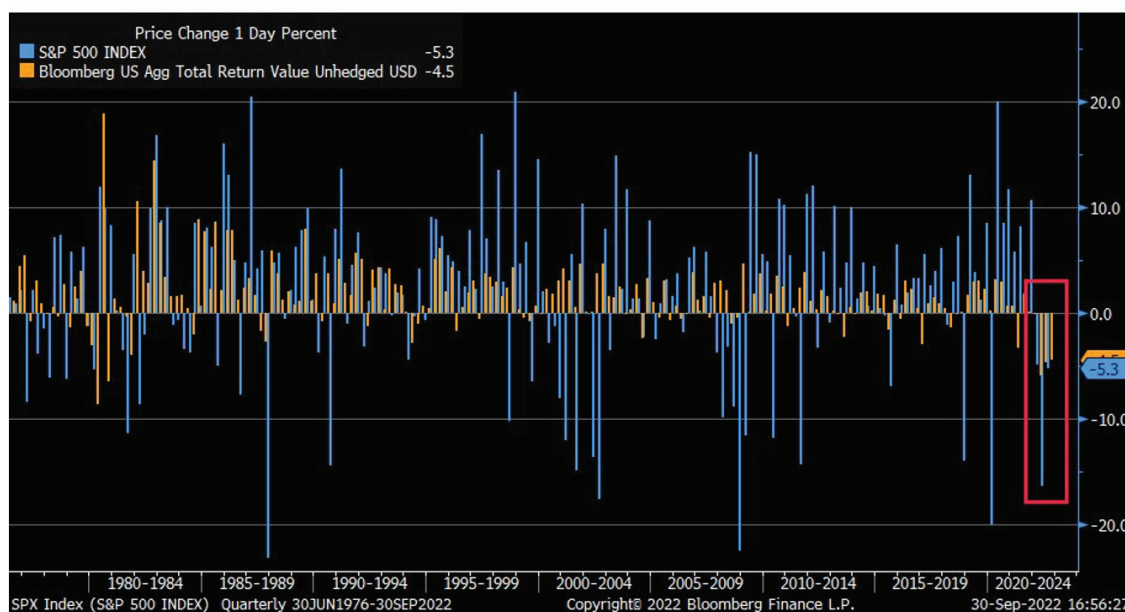


# 2022 Third Quarter Commentary

## ECONOMIC RECAP AND MARKET SUMMARY

Coming off another quarter of decline, the US economic outlook remains dismal. As the Federal Reserve forged ahead in its fight against inflation with additional rate increases, financial markets faltered in the face of depressed demand. This story is best illustrated by the 2022 YTD performance of stocks and bonds. The third quarter end this past Sept. 30th marked three consecutive quarters of decline for both the S&P 500 (blue) and the Bloomberg Agg Bond Index (orange). We haven't seen such a stretch in the past 50 years (earliest available returns data for the latter index is 1976). As previously detailed, there are several geopolitical, economic, and liquidity-related challenges that require allocators' attention as they navigate the market ahead. These matters are complicated by the unprecedented amount of debt and record high level of inflation in the economy. Given this set of circumstances, we may start to see politicians and central bankers taking an "all gloves off approach." However, we anticipate that price discovery dynamics will continue to drive rotations across asset prices for the remainder of the year (both at the macro and micro levels). Let us first cover the macroeconomic backdrop in more depth and then review our perspectives on each asset class.

### EXHIBIT I: BOND AND STOCK HISTORICAL QUARTERLY RETURNS, 1977-2022



Source: Bloomberg, Schwab

## BELOW, A RECAP OF ASSET CLASS RETURNS FOR Q3 2022 AND THE YEAR-TO-DATE

The global 60/40 portfolio<sup>1</sup> (the “benchmark” for investing) was down nearly -6% for the quarter and -21% for 2022. Though an equity/fixed income-only portfolio was once considered to be sufficiently diversified, this view is rapidly changing. We firmly believe that a fortuitous concurrence of low inflation and “easy money” bolstered this type of portfolio for years. But it is now proving itself to be woefully unsuited to more challenging market environments. The past two years have exposed the inadequacies of this long-duration portfolio during periods of elevated inflation. Will the 60/40 bounce back quickly as it has in recent market drawdowns? Perhaps, but if inflation is more structural, the road to recovery will be far rockier. Furthermore, now that 1-year Treasury bills are paying close to 4%, they present an attractive “alternative” for investors.

For the quarter, there were a few bright spots. Leading the way in daily liquid alternative strategies was systematic trend following, which delivered a +3.94% quarterly return, and is now up +22.65% on the year as a peer group (see chart below for daily liquid strategy performance). The other strategy that showed resilience and positive performance for the quarter was established multi-strategy private placement managers.

### EXHIBIT 2: ASSET CLASS RETURNS

Total Returns	3Q 2022	YTD 2022
<b>US Fund Systematic Trend</b>	<b>3.94</b>	<b>22.59</b>
Bloomberg Commodity TR USD	-4.11	16.32
<b>US Fund Multistrategy</b>	<b>-1.23</b>	<b>-2.72</b>
Bloomberg US Treasury 3-10 Yr TR USD	-4.17	-12.05
ICE BofA US High Yield TR USD	-0.68	-12.76
<b>Bloomberg US Agg Bond TR USD</b>	<b>-4.75</b>	<b>-15.61</b>
<b>iShares Core Growth Allocation ETF</b>	<b>-5.95</b>	<b>-18.27</b>
S&P 500 TR USD	-4.88	-18.60
Russell 2000 TR USD	-2.19	-18.78
MSCI EM NR USD	-11.57	-29.12
<b>NASDAQ Composite TR USD</b>	<b>-3.91</b>	<b>-29.44</b>
iShares 20+ Year Treasury Bond ETF	-10.12	-33.90

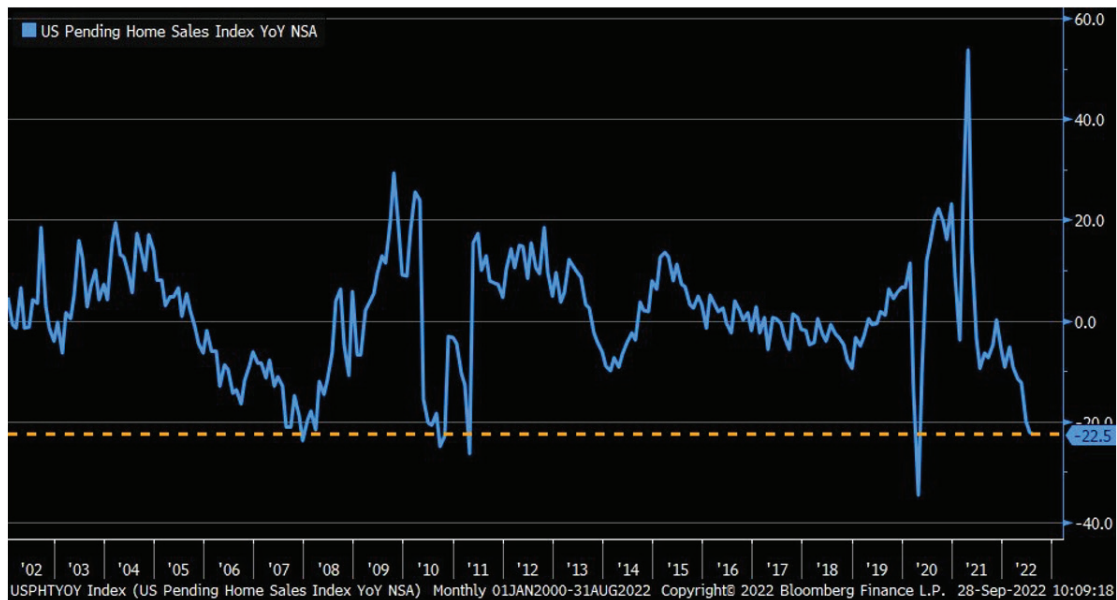
Source: Morningstar, as of 9/30/2022. See end of the commentary for a description of asset class returns.

## NOTABLE ECONOMIC OBSERVATIONS

We are starting to see the broader impacts of rising borrowing costs, hurting some sectors more than others. The housing sector is clearly slowing. Because this market is highly sensitive to interest rates, the Fed's rapid rate hikes have dramatically affected demand and transaction activity. The chart below shows a 22.5% year-over-year nosedive in pending home sales, which is among the sharpest drops on record. Declining sales is generally accompanied by a rise in inventory, which is a headwind for housing prices.

<sup>1</sup> As represented by the Russell 3000 Index to represent the 60% equity exposure, an allocation of 40% to the Barclays Aggregate Bond Index for the fixed income allocation.

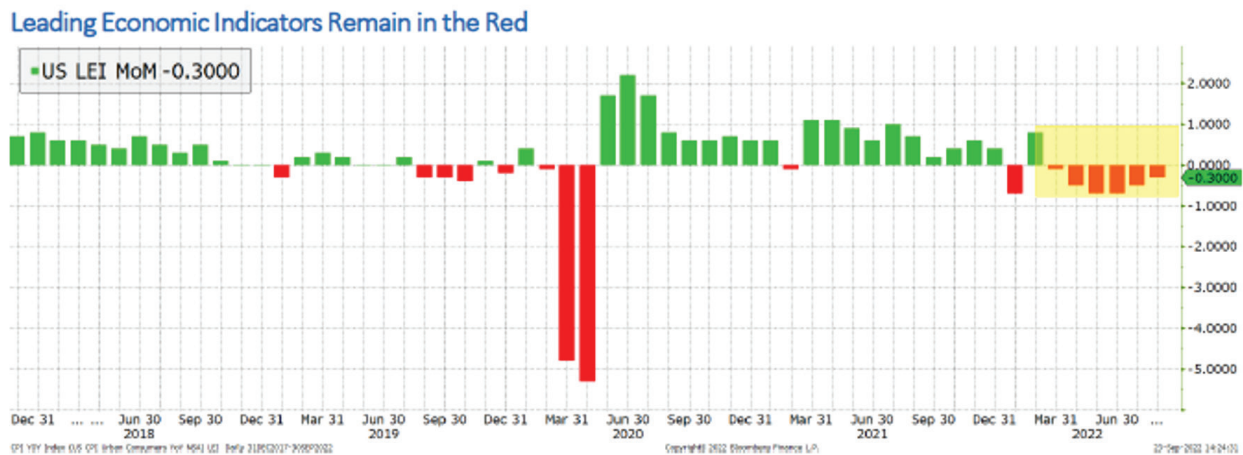
### EXHIBIT 3: PENDING HOMES SALES YEAR OVER YEAR TRACKING ON BLOOMBERG, 2002-2022



Source: Bloomberg, Schwab

Many key economic indicators remain negative, reinforcing the likelihood that a recession will be officially declared in the coming months.

### EXHIBIT 4: CONFERENCE BOARD LEADING ECONOMIC INDICATORS INDEX, 2018-2022



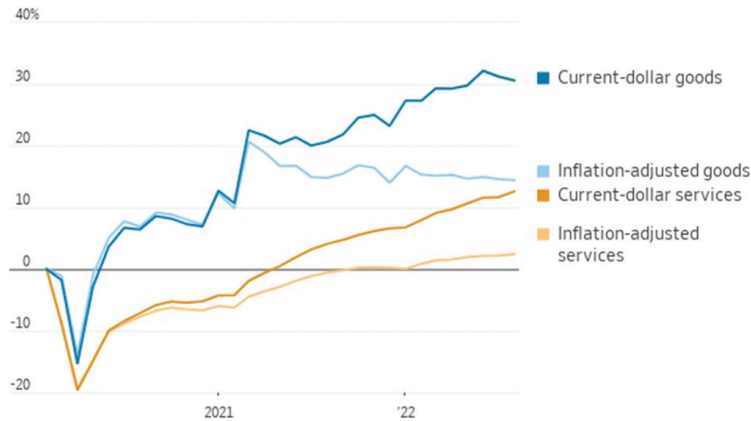
Source: Bloomberg

Consumer demand is evidently less robust than the headline numbers may suggest. The underlying data shows that consumption of both goods and services has flatlined (in real terms), most likely in response to surging prices. Inflation, of course, chips away at the take-home earnings for consumers and corporates, which also ultimately leads to less consumption. As such, consumption baskets shift away from discretionary items.

## EXHIBIT 5: PERSONAL CONSUMPTION EXPENDITURES ADJUSTED FOR INFLATION SINCE FEBRUARY OF 2020 THROUGH AUGUST 2022

When accounting for inflation, consumer spending on goods has been flat for more than a year, while spending on services has gradually increased.

U.S. personal-consumption expenditures, change from level in February 2020



Note: Seasonally adjusted  
Source: Commerce Department

While the Fed's rate hikes are making their intended impact on the economy and asset prices (a decreased wealth effect), core inflation and services-based inflation metrics remain elevated. Although a 3.7% unemployment rate may seem like a cause for hope, a closer look at the underlying consumer fundamentals reveals a more dire situation. Real income growth remains negative, consumption and spending growth are decelerating, and excess savings are now negative. Corporate fundamentals are also deteriorating, with consumer strength all but exhausted by this point. Just as trees don't

grow to the sky, waning demand puts a cap on profits. In 2021, the equity market (S&P 500 used as proxy) achieved record profits and margins, largely due to record levels of fiscal stimulus and monetary easing. Government handouts spurred consumer demand, while access to credit at record-low interest rates allowed for buybacks and massive spending by businesses. All these drivers are rapidly fading.

### EQUITIES

Equity markets posted negative returns during the quarter. Large-cap stocks represented by the S&P 500 index significantly underperformed, losing 5.28%. The Russell 2000 Index, which tracks small-cap companies, returned -2.53%. Growth-style stocks outpaced value by a little over 2.0%.

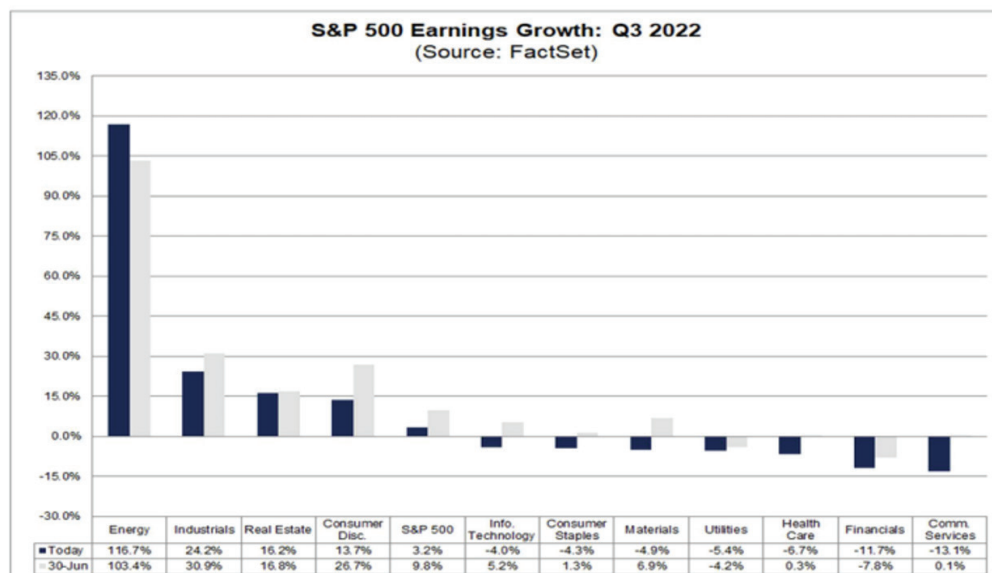
Two interesting developments during the quarter that resonated with us:

1. Exxon overtook Meta's (formerly Facebook) market value for the first time in 5 years.
2. Peloton announced the sales of its exercise equipment in Dicks Sporting Goods stores, while Netflix announced plans to move forward with ad-based subscription plans. Both are now trading meaningfully below their pre-Covid lows.

We believe these events confirm our views on price discovery. Many high-flying "story" stocks and SPACs (Special Purpose Acquisition Companies) are trading at all-time lows as investors redefine what is a "good" business to own. The previous years of "easy money" allowed for compelling corporate narratives to rule over sound fundamentals and valuation discipline. With that said, the fact that Exxon beat Meta in terms of market capitalization does not mean that Meta is no longer a strong company. Plenty of fund managers are now looking to buy names like Meta and Snapchat given more reasonable valuations. Looking forward, we

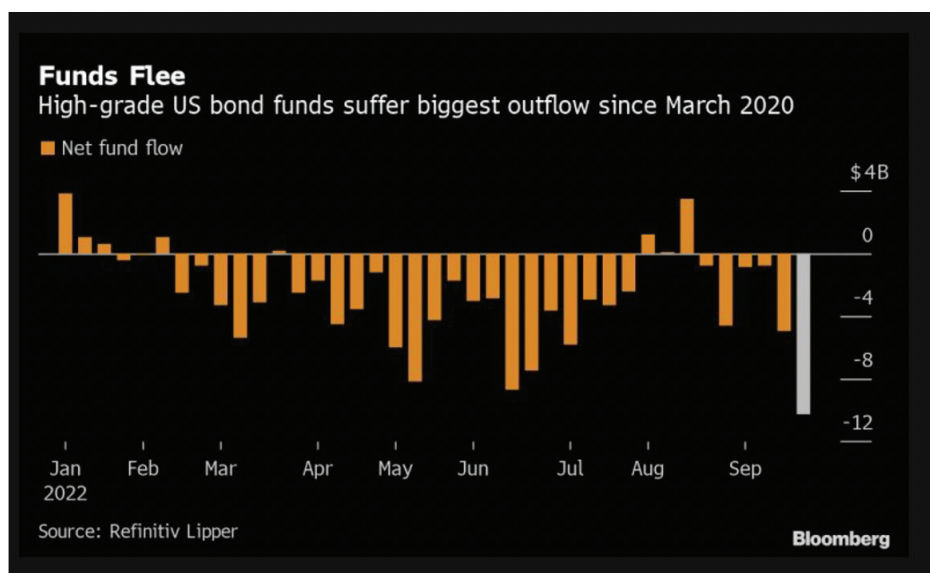
still favor an active stock selection approach that emphasizes cash flow yield and value characteristics (many value portfolios now incorporate names like Meta and Netflix). FactSet data indicates that Q3 earnings-per-share estimates have taken their largest cut since Q2 2020 (-6.6%). This should be conducive to disciplined managers aiming for relative outperformance.

## EXHIBIT 6: S&P 500 EARNINGS REVISIONS



## FIXED INCOME AND CREDIT

### EXHIBIT 7: 2022 BOND FUND FLOWS



The US bond market (as proxied by the US Bloomberg Barclays Aggregate Bond Index) was down 4.70% during Q3. Persistent core inflation has put the asymmetric downside risk profiles of bonds on full display. The year-over-year CPI through August 2022 came in at 8.3%. While headline numbers have been dramatic, the more concerning measure for bond investors was the hot August core inflation print, which excludes



food and energy price changes, with the August month-over-month coming in at 0.6% higher versus the July figure. Bond markets responded with increased selling pressure. US investment-grade bond funds suffered their third-largest cash exit on record, with \$10.3 billion of capital withdrawals from bond funds during the week of Sept. 28, according to Refinitiv Lipper. This marks the sixth straight week of redemptions. We maintain our cautious view on bonds given their value is highly interlinked with inflation, and the pace at which inflation will fall and its eventual resting place in the post-Covid era remains uncertain. On the credit side, prices are generally cheaper. Investors can earn around 9% on high-yield bonds. With that said, we remain skeptical about these assets because, like equities, their valuation reset has been largely a function of rates and not credit/growth risk. Taking this view, one could argue that credit still has an opportunity to reprice significantly. Our investment committee would like to see more spread widening in corporate credit markets to reflect this reality.

## **ALTERNATIVE INVESTMENTS**

In general, we believe alternative exposures helped us navigate the third quarter as stocks and bonds fell in synchrony. Standout strategies were those that were able to short assets. Most notable were trend following strategies which again performed well during the period as their short positions in equities, bonds, rates, and foreign exchange allowed managers to profit from the negative sentiment and downward trends in markets. Predicated on following prices during periods of exacerbated market moves, the current regime tends to be a favorable backdrop for dynamic strategies like trend following. It is also worth noting breadth; we think investors may profit from moves in all four major asset class markets.

The other bright spots during the quarter came from various multimanager/multi-strategy private fund exposures. As a reminder, these are diversified private fund portfolios that look to distribute capital across a variety of portfolio management teams that span different asset classes and investment strategies. Such portfolios are generally run market neutral and exhibit low correlation to broader equity and fixed-income markets. Again, by emphasizing the ability to go short, these exposures were able to deliver positive absolute returns during the period.

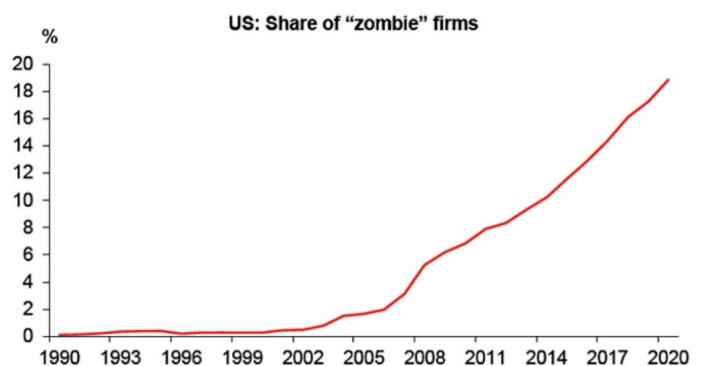
As economic activity slows and risk sentiment turns decidedly more negative, even hedged strategies and alternative assets will face challenging times. For example, our hedged equity and fixed-income strategies endured a negative quarter, albeit less severe than broad market moves. Lastly, private real estate and credit managers performed well during the period. With that said, however, we maintain our view from last quarter that private markets have more downward repricing to endure given the lagged valuations that they are accustomed to.

## OUTLOOK

The state of the global economy remains uncertain. Geopolitical tensions persist and may be escalating further, as appears to be the case with the Russia-Ukrainian conflict. Europe is already in the throes of a deep recession, and despite a slight amelioration in fuel costs, Europeans are still paying 9-10X more for energy than they did just a few years ago. Politically driven fiscal interventions may provide some relief, but the truth is that these are just temporary band-aids. Europe's energy crisis is a structural issue that requires

long-term capital investment. Inflationary stress is severe for Europeans, and many economists fear that these pressures are here to stay for several years. To date, China's contribution to global economic growth has been subdued given the start-and-stop quarantine rules that have been in place for much of the year. Domestic cargo throughput volumes are estimated to be running at half the rate observed prior to the first lockdowns in March 2022, according to Carlyle Group. There is a general expectation that consumption should pick up starting in Q4 of 2022 with the loosening of restrictions. We question this as a major driver of growth in the near term given debt and credit issues that also impact the Chinese economy.

US: Rising share of companies with debt servicing costs that are higher than profits



Note: Firm-level data is used to calculate the share of listed firms that are more than ten years old with an interest coverage ratio less than one for three years in a row.

Source: Datastream, Worldscope, DB Global Research

On that note, we will leave you with another pertinent observation. The chart below provides a glimpse of the excess that has built up in the system. Such a high degree of "zombification" is only possible when money is free. While decades of low inflation allowed for leverage to accumulate, its efficiency is now being called into question as borrowing costs rise rapidly. Deleveraging cycles create opportunities but avoiding troubled exposures will be key. As we look forward to the close of the year, our playbook remains unchanged. We emphasize capital preservation and diversification through our alternative strategies. As markets continue to digest this period of price discovery, we believe our approach will prove to be highly valuable for client portfolios.

Please reach out to me or our advisors if you have any questions.

Best,

Johann Lee  
Director of Research

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- **BLOOMBERG BARCLAYS CAPITAL US AGGREGATE BOND INDEX:** The index consists of approximately 17,000 bonds. The index represents a wide range of securities, from investment grade and public to fixed income.
  - **ICE BOAML HY INDEX:** The index is a commonly used benchmark index for high-yield corporate bonds. It tracks the performance of US dollar denominated below investment grade rated corporate debt publically issued in the US domestic market.
  - **RUSSELL 3000 INDEX:** The Russell 3000 Index is a market-capitalization-weighted equity index maintained by the FTSE Russell that provides exposure to the entire U.S. stock market. The index tracks the performance of the 3,000 largest U.S.-traded stocks which represent about 98% of all U.S incorporated equity securities.
  - **RUSSELL 2000 INDEX:** The Russell 2000 Index is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.
  - **MSCI ACWI (ALL COUNTRY WORLD) INDEX:** The MSCI ACWI is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI Index is comprised of stocks from both developed and emerging markets.
  - **MSCI EMERGING MARKETS INDEX:** The MSCI Emerging Markets Index is used to measure the financial performance of companies in fast-growing economies around the world. The index tracks mid-cap and large-cap stocks in 27 countries, dominated by Chinese, Taiwanese, and South Korean companies.
  - **S&P 500 INDEX:** S&P 500 index is a float-adjusted market-cap weighted index, largely reflecting the large-cap US equities. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.
  - **NASDAQ 100 INDEX:** The Nasdaq 100 Index is a basket of the 100 largest, most actively traded U.S companies listed on the Nasdaq stock exchange. The index includes companies from various industries except for the financial industry, like commercial and investment banks.



- **PURCHASING MANAGERS' INDEX (PMI):** PMI Index is an indicator of economic health for manufacturing and service sectors. The purpose of the PMI is to provide information about current business conditions to company decision makers, analysts and purchasing managers.
- **ISM MANUFACTURING INDEX:** The ISM Manufacturing Index is a widely-watched indicator of recent U.S. economic activity. The index is often referred to as the Purchasing Manager's Index (PMI).
- **THE BLOOMBERG COMMODITY TOTAL RETURN INDEX:** The BCOM TR Index is composed of futures contracts and reflects the returns on a fully collateralized investment in the BCOM. This combines the returns of the BCOM with the returns on cash collateral invested in 13-week (3 Month) U.S. Treasury Bills.
- **CBOE VOLATILITY INDEX (VIX INDEX):** The VIX Index is a real-time market index used to measure the market's expectation of future volatility. Being a forward-looking index, it is constructed using the implied volatilities on S&P 500 index options (SPX) and represents the market's expectation of 30-day future volatility of the S&P 500 index which is considered the leading indicator of the broad U.S. stock market.

## MORNINGSTAR CATEGORIES

**MORNINGSTAR MULTI-STRATEGY:** This is a Morningstar alternative strategy category. For a multi-asset strategy to qualify in an alternative category, greater than 30% of a strategy's gross exposure must be allocated to alternative substrategies. Alternative substrategies should provide an 'alternative' exposure to the dominant risk factors found in traditional indices, and as standalone strategies, would generally fall into one of the other Morningstar alternative categories: Equity Market Neutral, Event Driven, Macro Trading, Options Trading, Relative Value Arbitrage, and Systematic Trend.

**MORNINGSTAR SYSTEMATIC TREND:** This is a Morningstar alternative strategy category. Systematic trend funds mainly implement trend-following, price-momentum strategies by trading long and short liquid global futures, options, swaps, and foreign-exchange contracts. Strategies invest across geographies and assets, including equities, fixed income, commodities, currencies, and more.

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