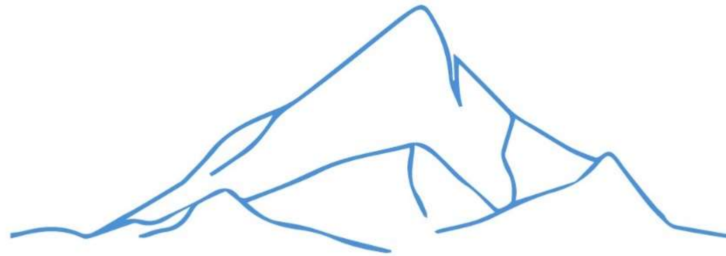

Quarterly Letter to Clients 3Q 2022

Quarterly Letter
3Q 2022

Ryan Phinney, CFA

Mr. Phinney is a Portfolio Manager at Vail Valley Asset Management and works within the firm's investment management and risk management functions where he researches, constructs, and monitors portfolios. Mr. Phinney earned his B.A. and an M.B.A. from the University of Denver. He is a CFA charterholder.

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MARKET SUMMARY

Ryan Phinney, CFA

The equity markets domestically and internationally have been hit hard this quarter. With many central banks around the world raising interest rates in response to inflation, equity markets have been under pressure. As you can see from the table below, negative performance across major equity market indices has continued:

Index (as of Sept 30)	2022 Q3 Performance	2022 YTD Performance	1 Year
S&P 500 Total Return	-4.88%	-23.87%	-15.47%
NASDAQ	-4.6%	-33.2%	-25.3%
Dow Jones Industrial Average	-6.17%	-19.72%	-13.4%
MSCI World ex USA	-9.11%	-25.88%	-23.50%
MSCI Europe	-10.11%	-28.42%	-24.33%

Fixed income markets have been under pressure as well. Bonds have not been a source of risk diversification in 2022 and instead have been a source of losses as the Fed engages in the fastest rate hiking cycle in history. The Bloomberg U.S. Aggregate Index, an index covering the U.S. investment grade fixed rate bond market, was down 4.92% in Q3 of this year and is now down 14.6% YTD. Similarly, the Bloomberg U.S. Treasury Index is now down 13.1% YTD, while the Bloomberg U.S. Corporate Bond Index, an index representing investment grade corporate bonds, is down 18.7% YTD.

The U.S. housing market was already struggling with affordability but rising mortgage rates will continue to pressure home affordability. During the quarter, new purchase 30-year fixed rate mortgages hit a high of 7.08%. While actual price declines in home values are uncommon throughout history, the historical low point of home affordability could put pressure on home prices. This appears to be one of the goals of the Fed's recent efforts to fight inflation. The Bureau of Labor Statistics (BLS) compiles the "basket of goods" used to measure inflation levels; housing represents roughly 1/3 of that basket and is the largest single component. If the world's central banks are going to tackle inflation, housing affordability will have to be part of that discussion.

A NOTE ON VALUATIONS AND A SURPRISING ASSET ALLOCATION DECISION

Sean Abbey, CFA

2022 has been a challenging period for both U.S. and Global Capital Markets. After a brief bounce in the summer, 3Q2022 saw continued weakness across U.S. equities markets and fixed income markets. For context, the classic 60/40 portfolio composed of 60% equities and 40% fixed income is down roughly 20 percent YTD and has had the worst YTD performance through 3Q2022 since the 1930s, while the U.S. was in the middle of the Great Depression.

"***We believe high operating margins capitalized at relatively high multiples is a challenging setup for future real returns across large cap U.S. equities***."

On the fixed income side, we continued to position client portfolios with a bias towards low duration exposure and high credit quality while avoiding fixed income instruments with negative convexity such as residential MBS (extension risk). Notably, we continued allocating a higher proportion of client portfolios to short-term treasury securities. T-bills have been unloved for good reason over the last monetary policy cycle where deeply negative real interest rates persisted. Recently, the shape of the yield curve has offered unique opportunities for attractive yields on short-term T-bills versus higher duration investment grade credit. Through 3Q2022, our fixed income positioning has allowed clients to largely avoid the worst of the YTD declines in the fixed income markets mentioned above. While higher duration treasuries and investment grade bonds have delivered painful losses YTD, low duration fixed income has been a source of stability and recently, attractive short-term yield.

Where possible, we also kept our clients' U.S. and international equities exposures lower than policy targets to reflect our bearish near-term view. While we remain bullish over the long-term on U.S. equities and despite the recent declines of major U.S. equity indices, current valuations appear stretched based on a number of measures. As of September 30, 2022, the Shiller total return CAPE Ratio remained high at 30.93, and the so called "Buffett Indicator" or the ratio of the Wilshire 5000 Total Market Index to U.S. GDP was 152% and just above the March 2000 peak of 142%. Meanwhile, reported quarterly S&P500 operating profit margins remain near all-

time highs. We believe high operating margins capitalized at relatively high multiples is a challenging setup for future real returns across large cap U.S. equities. Valuations should not be used to make short-term trading decisions; however, we believe valuations can be a useful tool to think about longer term expected returns. The 2022 long-term capital market assumptions from J.P. Morgan, Blackrock, and Vanguard all suggest a 10-year period of modest nominal returns for U.S. equities far below recent trends. We do not disagree. Despite our relatively bearish views on cap-weighted major U.S. equity market indices, we continue to add modestly to long-term positions in select companies we find attractive.

In this period of high inflation and weakening U.S. and global economic trends, we remain alert to the second and third order impacts of the Fed's aggressive monetary policy tightening. Stresses in the US dollar (USD) funding markets make emerging market economies look susceptible to vulnerabilities from a strong dollar and tight U.S. monetary policy. In the U.S., the regulated banking sector appears to be in better condition than in the period leading to the Great Financial Crisis while leverage in the non-banking sector appears high relative to historical trends. High systemic leverage in the non-banking sector during a period of aggressive monetary policy tightening could be a recipe for stress in the credit markets.

Against this challenging backdrop, U.S. credit markets have been holding up remarkably well given the myriad headline risks, with credit spreads remaining surprisingly tight in our opinion. For example, the ICE BofA US High Yield Index Option-Adjusted Spread was at 5.43% as of 9-30-22, well below previous periods of credit market stress. With credit spreads relatively tight, losses in fixed income markets have been driven primarily by rate increases and duration exposure. Deteriorating economic conditions could elevate credit risk and we are watching credit spreads closely.

We look forward to continuing to serve our clients and welcome any questions you may have about your portfolios or our views on markets.

Sean Abbey, CFA

Mr. Abbey is the founder and Chief Investment Officer at Vail Valley Asset Management. Mr. Abbey earned his B.S. from Colorado State University and his M.B.A. from Yale University. He is a CFA Charterholder.

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