Public Equities

The equity market environment continued to highlight the uncertainty and unease of 2022 during the third quarter.

The market enjoyed a nice relief rally into July and mid-August, driven in large part by hope that the Fed would shift to a more dovish stance. That optimism soon faded over the second half of Q3, leading the S&P 500 to drop 17% from its August 16th high, passing through its earlier June low. The S&P 500 ended this rollercoaster of a quarter down just 5% but down nearly 25% year-to-date.

Equity Markets	Q3 2022
US Large Cap (S&P 500 TR)	-4.9%
Nasdaq	-3.9%
US Small Cap (Russell 2000)	-2.2%
Japan (TOPIX)	-0.9%
Europe (MSCI Europe)	-4.1%
China (CSI 300)	-14.3%
Global EM (MSCI EM)	-11.5%

Bond Markets	Q3 2022
US 2yr	132.5
US 10yr	81.6
US 30yr	59.3
German 10yr	77.2
German 30yr	47.7
UK 10yr	186.4
UK 30yr	126.1
JGB 10yr	1.3
JGB 30yr	15.1

Currency Markets	Q3 2022
DXY	7.1%
EUR	-6.5%
GBP	-8.3%
JPY	-6.2%
MSCI EM Currency Index	-4.5%

Commodity Markets	Q3 2022
Crude Oil (WTI)	-24.8%
Nat Gas	24.7%
Gold (Spot)	-8.1%
Steel (Rebar)	-12.6%
Ag & Livestock (Bloomberg)	-0.4%

RCG HF Indices	Q3 2022
All Hedge Funds	-1.1%
Equity Hedge	-2.7%
Absolute Return	2.1%
Equity Market Neutral	0.9%
Event Driven	-0.7%
Global Macro	1.7%

Source: RockCreek

While record profit margins and robust earnings for US corporations were the story in Q2, we wrote in last quarter's letter about how such record earnings would be unsustainable in the face of the inflation and policy tightening that were beginning to take hold. Consensus earnings forecasts were reflecting continued profit growth and not pricing in the evidently mounting risks.

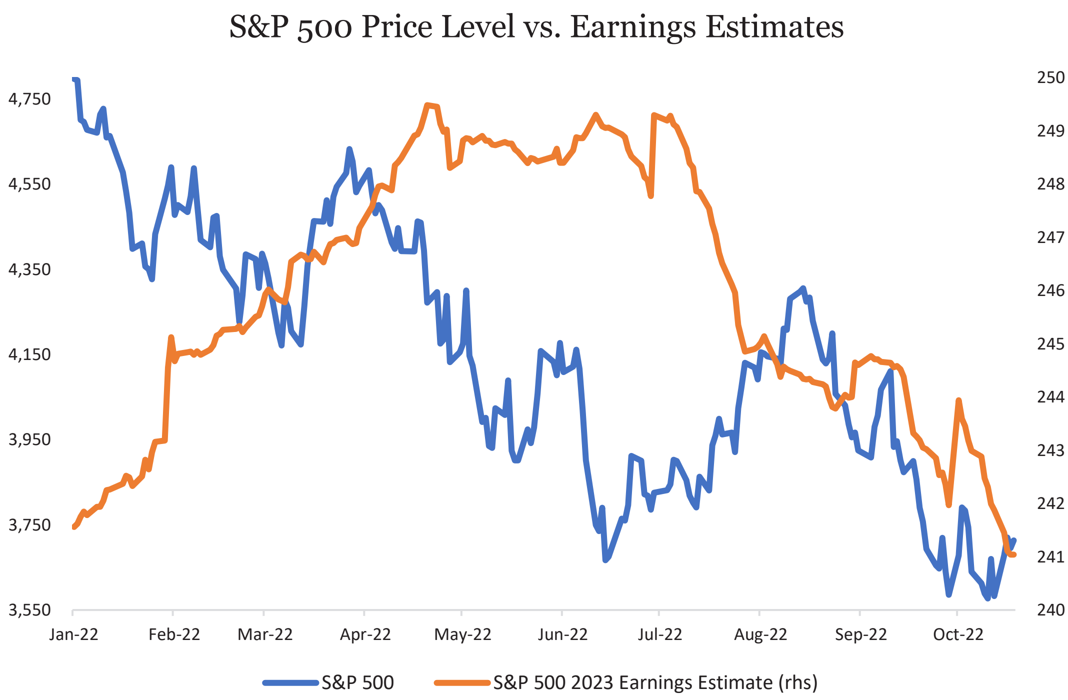
Sentiment indicators again reflect extreme bearishness, especially across the institutional investor community. While this could always set the market up for a potential Q4 rally, such a rebound would likely need to endure a potent dose of negative news on the earnings front to sustain itself.

FedEx's withdrawal of its full-year guidance while citing declining macroeconomic conditions was a clear warning to investors and a harbinger of more cautionary announcements to come.

More than 10% of S&P 500 companies preannounced Q3 earnings in an effort to manage investor expectations. This is consistent with very challenging and uncertain operating environments of the past.

Restoration Hardware reported decent numbers but soft guidance, Adobe was clobbered on news of its Figma acquisition and mixed guidance, Nike cited supply chain issues and an inventory glut in its cautious guidance, and Micron's earnings suggested we could see a sharper semiconductor downturn than expected. Warning signs have been plentiful and high P/E multiple companies will be under significant pressure to meet expectations.

As shown in the chart below, the Street was increasing 2022 earnings estimates through the first half of the year even as the S&P 500 was trending down, which meant the market's valuation did not come down as much as it otherwise would have. Earnings forecasts finally peaked in July though the market ignored this and continued its rally. Only in recent weeks has the S&P 500 latched on to earnings. The key question now is whether the market continues pricing in a real slowdown or finds renewed hope in a more accommodative Fed.



Source: Bloomberg

European markets also fell further in Q3 with the Stoxx 600 ending 5% lower for the quarter and 21% lower year-to-date. Every sector posted negative returns with the ongoing energy crisis, rising inflation, and deteriorating economic growth outlook weighing on market sentiment. Investors have largely abandoned the region in a manner not seen since the 2011-12 Eurozone crisis. European equity funds have suffered eight straight months of outflows approaching nearly $100 billion.

The saving grace for European companies has been FX declines due to European companies' high international exposure. While US corporate earnings were revised downward by 3%, European 2022 EPS was revised up by 4% (1% excluding energy). This may not be sustainable. The ECB and BOE are in tightening mode and euro area manufacturing PMI recently fell to its lowest level since June 2020, which is a strong indicator we will see earnings revisions to the downside, particularly within cyclicals. The European consumer has been quite resilient thus far, but winter heating season and other inflationary pressures will take a bite. Lastly, consensus is pricing in flat margin growth though European corporate margins look quite vulnerable to higher input, labor, and borrowing costs, as does the US.

New opportunities to benefit from this theme are emerging across many different areas from solar, energy storage, EVs, and carbon capture to the many materials and ancillary services needed to fill the growing demand for clean energy.

Until we begin to see some green shoots, defensive sectors and high-quality stocks seem to be the best areas to overweight within equities. A good example is renewable energy, which is getting overlooked because of its history of boom/bust cycles. However, the Inflation Reduction Act is the most substantial climate legislation in the history of the US and most of its provisions will be enacted over the next 10 years, which will help alleviate many of the past uncertainties afflicting the sector. Many experts in the space have commented that few investors recognize the magnitude of this imminent inflection point.

Emerging Markets

It was a woeful quarter for EM Asian equity markets, with China, Korea, and Taiwan all down double digits but the rest of EM fared noticeably better, led by India, Indonesia, and Brazil. Q3 encapsulated the bifurcation in performance between North Asia and the rest of the developing world that we have highlighted now for close to two years. Now that the leadership 'election' has taken place in China, we are paying close attention to the senior leadership roles that have been handpicked to support President Xi. While we are still deciphering the fallout, we believe a cadre of competent pro-growth and pro-business deputies will, in our view, be welcomed by the market and could usher in a short-term rally. But as we've seen over the last decade, President Xi values loyalty, and sometimes, we dare say, values loyalty over competency. To underscore the obvious, things remain uncertain, to the detriment of overall sentiment for emerging markets.

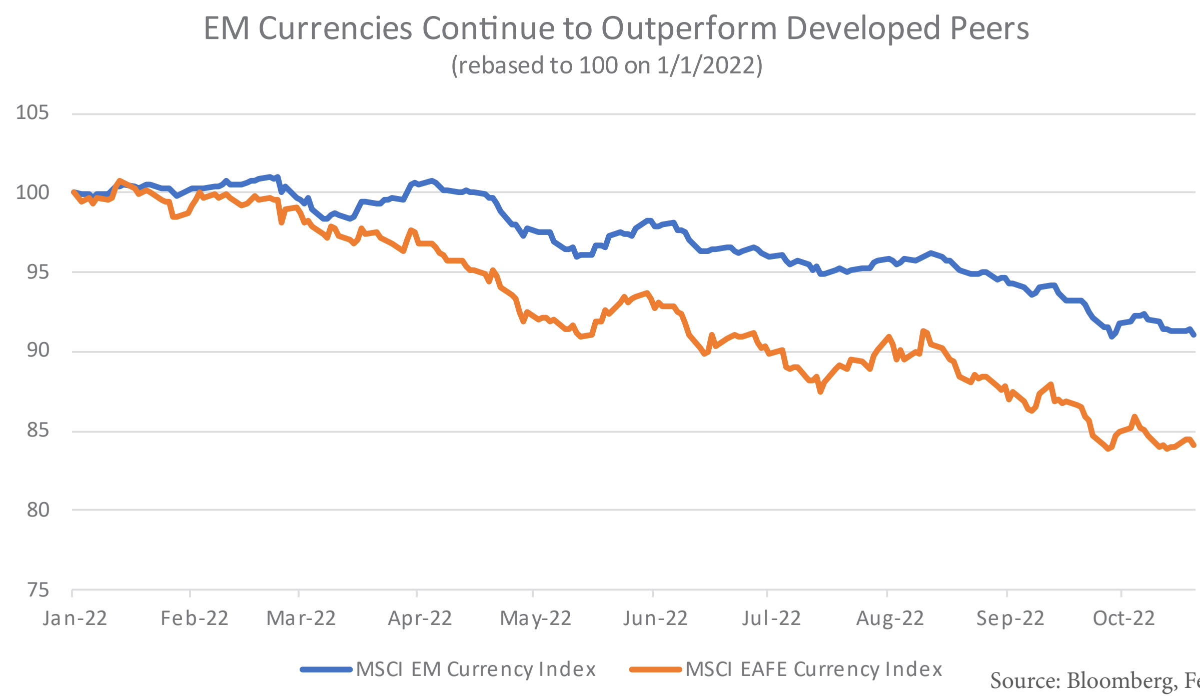
Nevertheless, it's in times of uncertainty, low investor interest, and cheap valuations that one discovers some of the best opportunities. As we've highlighted before, we have found these opportunities in India and the ASEAN region. Our bullish stance on these areas has served us well over the last year, and we see little reason to pivot away. Even if China leads a great North Asia re-opening in the coming year, investors have voted with their dollars, in ways both opportunistic and permanent.

In India, we continue to like banks, pharmaceuticals, and telecom, while underweight materials, consumer discretionary and industrial names given where we are in the cycle. While hawkish moves from the RBI have been largely priced in, the growth scare tied to a global slowdown has not. In the ASEAN region, we remain bullish Indonesia where we continue to see evidence the country has had one of the strongest post-pandemic rebounds globally, and Thailand where we are only in the beginning stages of that country's re-opening. We are also positioned well to take advantage of Vietnam's role as a source of both Western and Chinese capital flows as the world's supply chains are divided along spheres of influence.

We are willing to take more risk in consumer related names given the pent-up demand post COVID, but also because it makes sense in the long term. ASEAN's population is increasingly urbanizing with projections that over half a billion people in ASEAN countries will populate the major urban centers by the middle of the century.

The urban migration will bring with it significant social changes, creating huge demandfor additional infrastructure (both hard and soft) and housing, particularly in Indonesia and the Philippines. Inflationary pressures and a strong USD remain, but a manageable one.

On this last point, it's worth noting one bright spot in EM has surprisingly been currencies. As shown below, a Fed trade-weighted dollar basket of emerging markets has handsomely outperformed a similar basket of developed markets currencies. For USD based investors this is good news, particularly if exposures have been concentrated in star performers like the Chilean Peso, Brazilian Real, and Indian Rupee. The monetary policy discipline shown by these countries over the past 18 months has allowed them to weather the greenback's impressive run and put them in a position to stimulate growth in 2023 – an advantage developed markets central banks may well envy in a few months' time.



Source: Bloomberg, Federal Reserve

RockCreek 2022 Emerging Markets Conference

Join us on October 25th for an in-depth look at the opportunities and challenges of investing in emerging markets today, and where opportunities may like in the future. We will discuss global trends and regions and countries of focus with experts like Ruchir Sharma; World Bank Chief Economist Indermit Gill; Richard Haass, President of the Council on Foreign Relations; New York Times Correspondent David Sanger; Smithsonian Institution CIO Amy Chen; IFC's former COO and Senior VP Stephanie von Friedeburg.

Check out the full lineup here.