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Chairman Powell's Plan

"Everyone has a plan until they get punched in the face." Thank you, Mike Tyson, for that timeless wisdom which so accurately describes the current moment in the economy and markets.

Economists, central bankers, and investors have certainly taken a lot of punches lately. Consider the rapid and sizeable increase in interest rate expectations, the rate at which major economies are slowing, the duration and increasing magnitude of the war in Ukraine (and its ongoing impact on commodity prices), just to name a few. Then there's the pervasiveness of China's zero-COVID policies and their ongoing supply chain impact. All of these have forced central bankers to bob and weave while trying to avoid a knockout blow. Chair Powell faces an arduous task, and the range of likely outcomes for the US economy has narrowed significantly (and to the downside) as this bout of volatility continues to unfold.

It's no surprise that both equity and fixed-income markets have responded sharply to the shifting momentum, with global stocks down 25.7%, municipal bonds down 7.7%, and taxable bonds down 14.6% year-to-date. Even a broad index of commodities, which was up almost 50% for the year after the Russian invasion of Ukraine, is now up a mere 8.3%.

There's no sugarcoating it. The losses across stocks and bonds, the pillars of most investment portfolios, have made 2022 one of the most painful years in recent memory. This feels particularly grueling following the lengthy bull market of the 2010s and the extreme bullishness in the face of the COVID pandemic. You know it's been an exceedingly challenging stretch for investors when the US dollar and the *volatility* of Treasury bonds are the top-performing major investable assets on a risk-adjusted basis over the past three quarters—while municipal bonds and 10-year US Treasuries rank as the worst-performing.

Before reflecting on the actions we've taken, let's take stock of where we are, revisiting the familiar table below to gauge the market's driving forces. This quarter, we've added a column noting the factor's influence on the market. They're all important, of course, but the market's focus shifts depending on the moment. Currently, the two variables that stand out to us include inflation/interest rates and corporate earnings. Contrast that to earlier this year when China and Ukraine received more attention; while both remain critical, their influence has diminished relative to other concerns.

An Evolving Picture

Factor	Importance to Market	End Q2	End Q3	Better/ Worse
Inflation/ Interest Rate Trajectory	Very high	High, centered in services inflation, some goods pressures fading organically. Tighter financial conditions will be necessary	Higher, more broad-based. Housing inflation still high and expected to remain that way. Some pressures, including commodities, fading organically. Financial conditions will need to further tighten to have an impact	Worse
US Earnings Trajectory	High (critical for US investors)	Consensus estimates of ~10% in both 2022 and 2023	Consensus down to 7.8% growth in 2022 and 8.2% growth in 2023, with the 2023 number likely to fall further and cuts in estimates starting to occur	Worse
Recession Risk in the US and Europe	High	Elevated risk of recession in US and recession as base case in Europe	Shallow recession now more likely in US. Recession base case in Europe	Worse
China	Medium	Emerging from COVID-19 lockdowns. High likelihood of large fiscal stimulus in back half of 2022	Emerging from COVID-19 lockdowns. High likelihood of large fiscal stimulus in back half of 2022	Same

Can They Stick the Landing?

Six months ago, we acknowledged the serious challenge the Federal Reserve faced in managing a soft landing given the strong economic crosswinds. Yet that was their goal and it seemed as though they could pull it off, having done so before in 1994.

But the longer inflation persists—and the larger the interest rate hikes required—the more likely we experience an outright recession.

In their latest forecasts from mid-September, the Fed conveyed their belief that they can continue raising rates sharply through year-end, hike a little more in early 2023, and see the fruits of their labor (i.e., dissipating inflationary pressures) emerge in 2023 and 2024. What's more, the Fed appears convinced they can achieve this without causing a recession or a significant increase in unemployment. We're more skeptical, with the odds of a notable slowdown or a shallow recession far more likely now than just a quarter ago.

Additionally, the Fed governors have spoken clearly: they're willing to trigger a recession if that's what it takes to bring inflation under control. As our chief economist has noted, if their goal is to bring down inflation and it requires a recession to do so, then any resulting economic slowdown is not a policy error.

Silver Linings Playbook

Amid the gathering clouds, opposing positive forces are making this cycle even harder to forecast and adding credence to the possibility of a more mild outcome. While the picture has deteriorated for inflation and rates, the labor market is stronger than it's been in decades. With the economy running hot, jobless claims continue to come in below expectations, unemployment remains low, and participation rates have ticked up. That may cause the market to fret over wage-related inflationary pressures, but we generally prefer to see more people—not fewer—gainfully employed.

Both household and corporate debt appear to be in good shape, too. While interest rates are rising, the burden of debt service is still rather low by historical standards. At the margin, that favors the chance of a "slowdown" rather than a "recession." But it also means that even if a recession materializes, it would more likely be mild or moderate.

In addition, the financial system is much stronger today, which may help prevent the type of large-scale meltdown we saw a decade and a half ago during the Global Financial Crisis. In the aftermath, banks spent the ensuing decade building up their reserves and protecting their balance sheets. As a result, another financial crisis—which tends to be at the heart of the deepest recessions—appears unlikely.

So, What Should I Do Now?

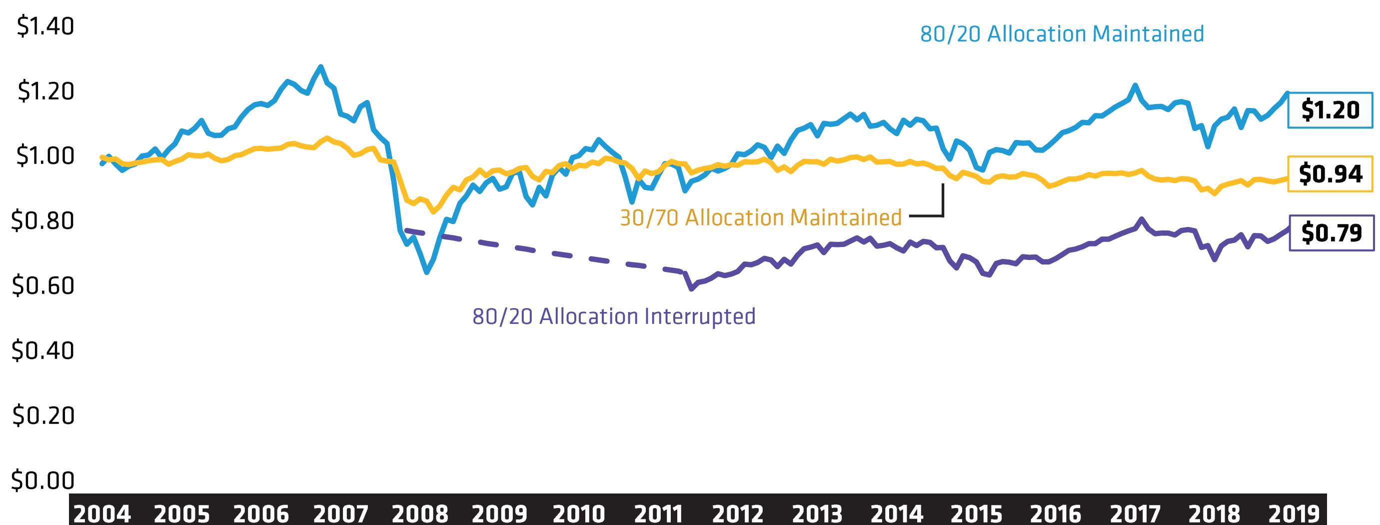
For long-term investors with a sound plan and asset mix, times like these tend to spur questions around strategic—and tactical—asset allocation. In most situations, the best course of action is to stick with your financial plan and existing allocation. Investors whose portfolios benefited from the strong markets of the past few years should still be well within their expected range of returns, or perhaps even above their original targets. Plus, attempting to de-risk portfolios to catch the market bottom often ends in mistimed moves and buying back after a sharp recovery is well underway (**Display**).

As always, economic turbulence and market volatility opens the door to future opportunities—you'll find some interesting strategies outlined in this recent blog. At a security level, our equity portfolio managers have been shifting toward companies with stronger balance sheets and pricing power, while also taking advantage of select market dislocations. Our fixed-income portfolio managers have been capturing the much-awaited higher yields offered by new issues and positioning carefully across the yield curve. In short, our teams are "fortifying the defenses" within their respective portfolios.

That said, if your spending needs or risk tolerance have changed, we'd recommend speaking with your Financial Advisor and considering additional risk management solutions. Keep in mind, there are no free lunches in this market. For instance, in exchange for protecting against the first 15% of market losses, defined outcome ETFs (sometimes referred to as "buffered ETFs") sacrifice upside beyond a certain point. But they could be a useful element in your portfolio.

DE-RISKING AT POINTS OF MAXIMUM STRESS CAN CAUSE PERMANENT DAMAGE

Historical Example of Investment Performance Sacrificed Around Global Financial Crisis, 2005–2019



Past performance is not necessarily indicative of future results.

Results for 15-year period starting January 1, 2005. Assumes 5% annual withdrawal rate." Then change reference to Feb 28, 2021 to December 31, 2019. Results for 80/20 Allocation Interrupted assumes 80/20 allocation from January 1, 2005 through October 31, 2008, cash allocation from November 1, 2008 through March 31, 2012, and 80/20 allocation from April 1, 2012 through February 28, 2021. All figures are pretax. 30/70 is modeled as 30% global equities and 70% bonds, 80/20 as 80% global equities and 20% bonds, and cash as three-month US Treasury bills. Global equities are modeled as the MSCI ACWI IMI Index. Bonds are modeled as the Bloomberg Barclays 1-10 Yr Municipal Bond Index. US equity is represented by the S&P 500 Index, developed international by the MSCI EAFE Index, and emerging markets by the MSCI Emerging Markets.

Source: Bloomberg Barclays, MSCI, Standard & Poor's, and AB

In addition, with many individual stocks suffering losses this year, tax-loss harvesting strategies may make sense. Our proprietary tax-loss harvesting strategy, PaTH, is an effective tool to consider.

Finally, while small consolation to investors living off their portfolios, yields and expected future returns on assets now sit higher than in January. Those who are still adding to their portfolios or in savings mode should welcome that news. In fact, whether for stocks, bonds, or other assets, our long-term expected returns have risen over the course of the year.

What to Do in Bear Markets?

As a firm, our aim is to worry about your portfolio, so you don't have to. And we strive for that across multiple levels of the organization. Your Financial Advisor and our Investment Strategy Group work together to ensure your allocation will achieve your financial goals. Our portfolio managers are constantly rebalancing, adding to positions they expect to outperform their benchmark and reducing positions with dimmer prospects.

But what should you do in times like these?

First, it may be better for your mental well-being and long-term financial health to steer clear of financial broadcasts—even if we are on the show! The adage, "If it bleeds, it leads" holds true not just for general news, but for financial news as well.

Second, consider having conversations with your advisor to ensure:

- Your investment implementation remains aligned with your financial objectives
- Your inflation sensitivity is reflected in your portfolio
- Your cash allocation is properly sized, given your spending needs and other goals
- You have appropriate diversifying exposures in alternative asset classes and non-US equities. Several of our alternative strategies have served as notable stabilizers in client portfolios this year
- Your investments match your values if you're interested in purpose-driven portfolios
- You're optimizing your tax planning and are prepared for any upcoming tax changes

Finally, if you have cash on the sidelines ready to deploy, we'd recommend being *really* ready. If our base or bull scenarios, which will be discussed in our quarterly deck, play out from here, the recent market lows will swiftly become a receding memory. And if our bear case of a recession comes to pass (triggering a further sell-off), the types of opportunities long-term investors dream about will likely emerge.

After a hot and eventful summer, we hope you're enjoying the tastes of fall, the fresh air, and the turning leaves. To our clients who may have been impacted by this destructive hurricane season, we hope you and your loved ones are safe and that you find the resilience to rebuild.

In the meantime, reminders are all around that renewal is a part of life. While world and market events continue to capture our attention, we know that, for everything, there is a season. Fall may be the time for harvesting, but market downturns (including those around recessions) tend to be the season to plant the seeds for future long-term returns.

Thank you for your ongoing confidence in us as your investing partner.

Best,

Beata and Alex

Alex Chaloff

Beata Kirr

Alex Chaloff and Beata Kirr are Co-heads of the Investment Strategy team at Bernstein, a group of senior investment professionals who develop our investment advice and are responsible for investment outcomes. The team oversees Bernstein's investment offerings, ensuring that our asset allocation advice, suite of strategies, and development of new investment ideas are continuously focused on moving our clients forward with strong after-tax risk-adjusted returns. Both Alex and Beata have spent their Bernstein careers refining our investment platform, listening to clients, and conducting deep research into investment topics that are critical to achieving clients' goals.

Past performance does not guarantee future results. Alternative investments involve a high degree of risk and are designed for investors who understand and are willing to accept these risks. **There can be no assurance that any alternative investment strategy will achieve its investment objectives.**

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