November 2022
Market Commentary

First Affirmative
FINANCIAL NETWORK
Invest for a Sustainable Future

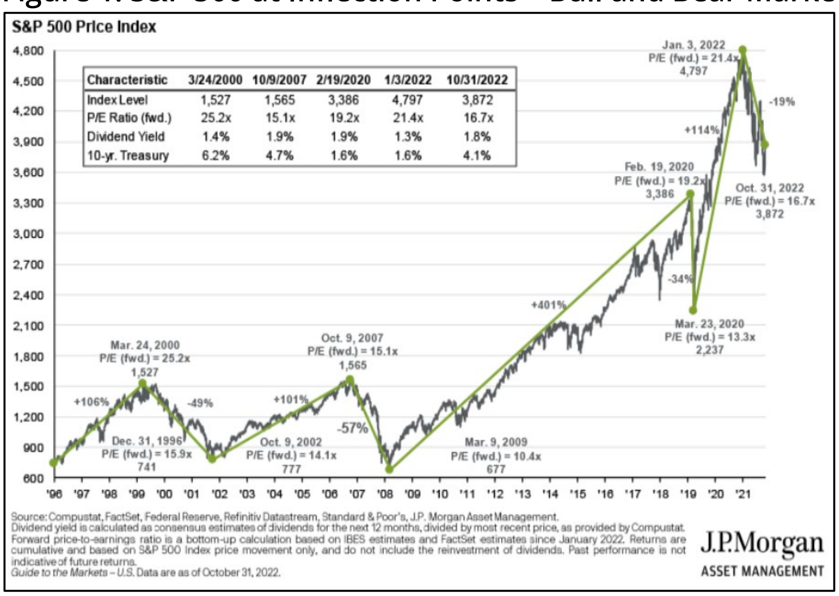
Recession looms – But "it's always darkest before the dawn"[1]

By Theresa Gusman
November 10, 2022

Overview

After recording their worst first half in more than 50 years, US stocks fell 4.8% in the third quarter bringing the full year decline to 24.9% (see Figure 1, below) before an October rally pushed the S&P 500 up more than 5%. Equity valuations have become more attractive (see Figure 2, page 2), the Fed continues to act quickly to mitigate inflation, and following a short, possibly sharp, economic downdraft, we anticipate a return to trendline growth. This backdrop suggests stabilization followed by a choppy rebound in equity markets.

Figure 1. S&P 500 at Inflection Points – Bull and Bear Markets, 1996 to Date



Characteristic	3/24/2000	10/9/2007	2/19/2020	1/3/2022	10/31/2022
Index Level	1,527	1,565	3,386	4,797	3,872
P/E Ratio (fwd.)	25.2x	15.1x	19.2x	21.4x	16.7x
Dividend Yield	1.4%	1.9%	1.9%	1.3%	1.8%
10-yr. Treasury	6.2%	4.7%	1.6%	1.6%	4.1%

The Equity Market Valuation Pendulum – Overvalued to Undervalued

The equity market valuation pendulum had swung from overvalued coming into 2022 to undervalued at third quarter end. As noted by Morningstar[2] and shown in see Figure 3, page 2, although near-term earnings remain under pressure, according to its long-term valuations, the market has overcorrected to the downside and is trading deep into undervalued territory. High inflation, rapidly rising interest rates, waning consumer confidence, slowing economic growth, and US dollar strength will continue to pressure earnings in the near term. However, the sharp equity market correction, combined with the likelihood that the trajectory of inflation, interest rate, and the US dollar increases will flatten, and the economic downdraft will be in the rear-view mirror, suggests stocks could recover in 2023.

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[1] Thomas Fuller, A Pisgah-Sight of Palestine and the Confines Thereof, c. 1650.

[2] https://mscontent.morningstar.com/mstar/9/Mstar_4Q2022_US_MarketOutlook20221004.pdf

Figure 2. S&P 500 Valuation Measures, 1997 to Date

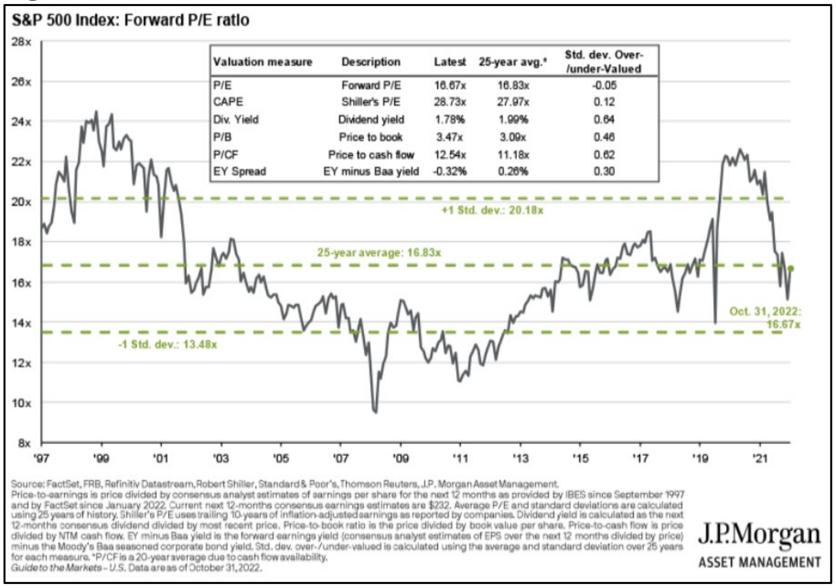
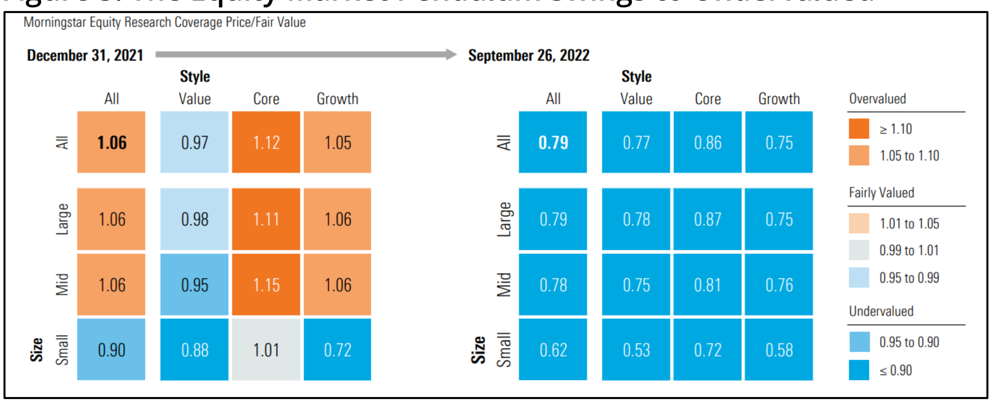


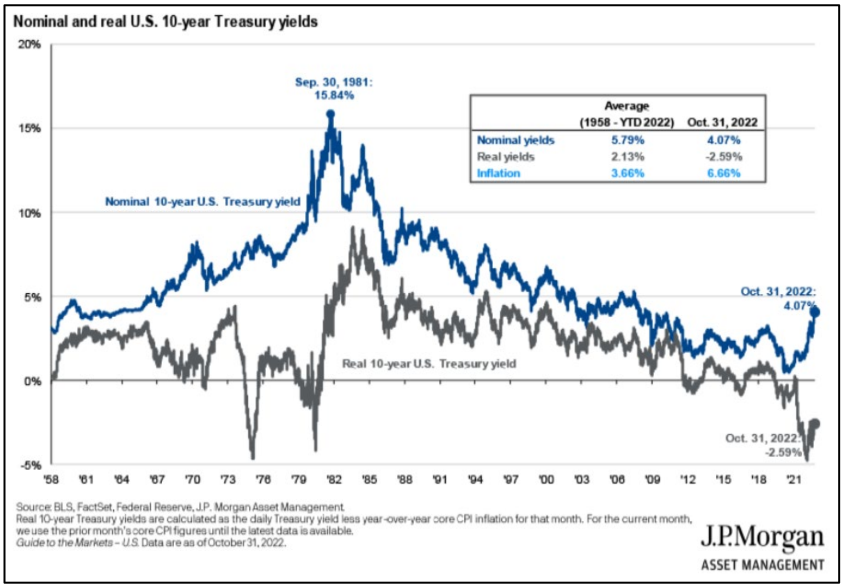
Figure 3. The Equity Market Pendulum Swings to Undervalued



We are heartened by continued closure of the gap between inflation expectations and reality as evidenced by the recent decline in real interest rates (see Figure 4, below). As noted in previous Market Commentaries, either nominal rates must rise to reflect the surge in inflation, inflation will retreat, or we will see some combination of the two (as we expect). The narrowing of the gap continued in the third quarter as the Fed raised interest rates, market sentiment shifted, and commodity prices stabilized after retreating. Fiscal spending (excluding outlays for the war in Ukraine) has also moderated following the flood of pandemic-induced spending over the past two years – and this moderation should continue with the mixed election results.

Given the interdependence of global economies and the large non-US components of the earnings of multi-national companies, better news in the US will be tempered as we move through 2023. The surge in the US dollar relative to the euro and Russia's stranglehold on European energy supplies suggest the inflation pain in Europe could far exceed that of the US. Also, the ECB is behind the Fed in its response to inflation. Energy price controls and supply mitigation efforts so far have softened the blow to European consumers and businesses. Ultimately, these will break and the downdraft in European economies could be severe. China remains a COVID enigma – trying to eliminate it, rather learning to live with it – which has continued to negatively affect global supply chains and economic growth.

Figure 4. Nominal and Real 10-Year Treasury Yields, 1958-September 30, 2022



Third Quarter Market Review

Only Latin America and India stock funds (among long-only strategies) posted increases in the third quarter and cash did not decline in the third quarter. Large Value Funds fell 5.91%, underperforming Large Growth Funds (-4.09). Non-US equities underperformed US equities as Developed Markets fell 10.35% and Emerging Markets dropped 12.46%. The US Aggregate Fixed Income index declined 3.55% (see Figures 5 and 6, page 4).

Figure 5. Global Equity, Fixed Income, and Real Assets Performance (Percentage Change), 3Q 2022

		3Q2022	2022 YTD	Last 12 Months	Last 24 Months Annualized
Equity	**US Equities**	-4.77	-18.74	-16.89	9.42
	US Large Cap	-4.96	-24.64	-17.28	4.04
	US Mid Cap	-4.45	-19.06	-18.03	9.11
	US Small Cap	-2.93	-16.12	-16.96	10.92
	Non-US Equities	-10.86	-24.40	-24.90	-1.43
	Non-US Developed Markets	-10.36	-23.17	-23.11	1.66
	Non-US Emerging Markets	-12.46	-29.62	-31.34	-10.91
Fixed Income	**US Aggregate**	-5.05	-15.61	-15.64	-8.40
	US Treasuries (Intermediate)	-4.18	-12.18	-12.10	-7.40
	Municipals (Intermediate)	-3.23	-13.97	-13.04	-5.88
	Investment Grade Corporate	-5.19	-18.96	-19.14	-9.17
	US Corporate High Yield	-1.21	-12.25	-11.41	-1.92
	Bank Loan	1.09	-3.32	-3.05	1.23
	Emerging Markets	-5.46	-24.13	-24.41	-11.42
Real Assets	**Commodities**	-10.21	21.38	18.62	40.75
	Energy (Oil/Gas)	8.18	69.05	63.54	106.34
	Energy Pipelines (MLPs)	7.45	34.79	29.05	52.87
	Precious Metals	-8.04	-13.30	-12.23	-9.05
	Industrial Metals	-8.20	-20.29	-17.02	6.32
	Agriculture	-1.91	0.75	2.94	16.91
	REITs (Real Estate)	-11.28	-26.78	-21.42	7.64

Source Morningstar Direct as of 09/30/2022
Note: Coloring is relative. Deeper green indicates higher relative return, deeper red indicates lower relative return.

Figure 6. Morningstar Style Box Analysis, 3Q 2022

QTD 3Q2022 Return

Size	All	Style: Value	Style: Core	Style: Growth
All	**-3.1%**	-5.3%	-2.5%	-3.0%
Large	-2.9%	-5.7%	-1.8%	-1.6%
Mid	-3.5%	-4.1%	-3.8%	-2.7%
Small	-4.0%	-4.5%	-3.7%	-3.7%

≥ 8% · 4% to 8% · 0% to 4% · -4% to 0% · -8% to -4% · ≤ -8%

Year To Date Return

Size	All	Style: Value	Style: Core	Style: Growth
All	**-23.7%**	-12.2%	-22.4%	-36.2%
Large	-23.8%	-11.9%	-22.1%	-40.3%
Mid	-23.1%	-12.2%	-22.8%	-35.7%
Small	-24.7%	-15.2%	-23.2%	-35.3%

≥ 20% · 10% to 20% · 0% to 10% · -10% to 0% · -10% to -20% · ≤ -20%

Outlook – Global Economic Activity Slowing

Economic activity is slowing rapidly, and inflation remains high worldwide, as shown in Figures 7 and 8. Rapid Fed action is slowing the economy and earnings growth significantly – and it has had *a big* impact on the equity market. Barring faltering Fed resolve or an unnecessary attempt by the federal government to "fix" the economy (i.e., another stimulus package or even worse price controls), we believe the economic downdraft will be short lived. Against this backdrop, the equity market could recover as we move through 2023. The rest of the world may not fare as well.

Figure 7. Global Economic Activity Momentum, 2009 to present

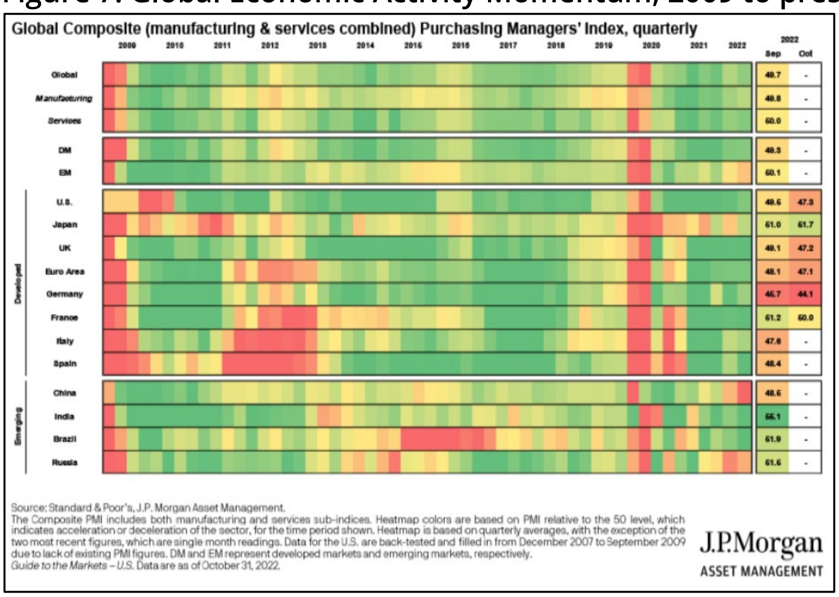
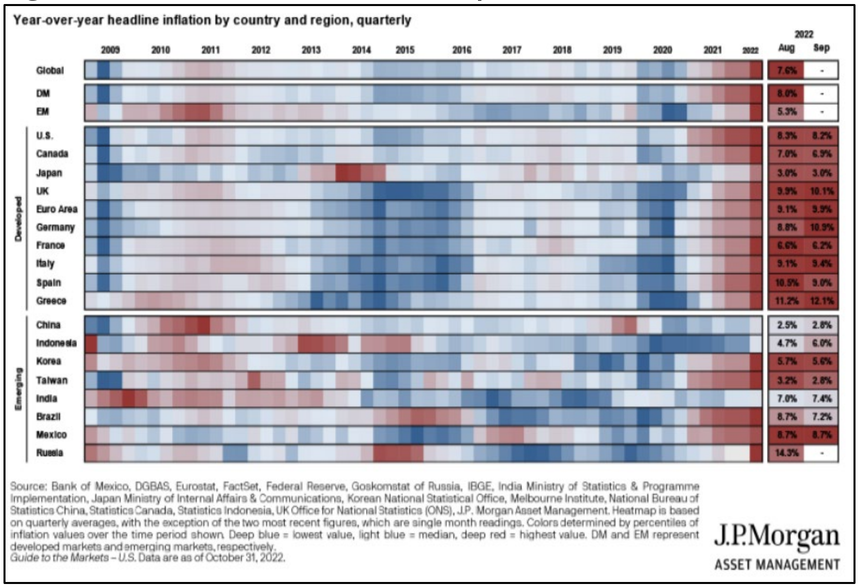


Figure 8. Global Inflation, 2009 to present

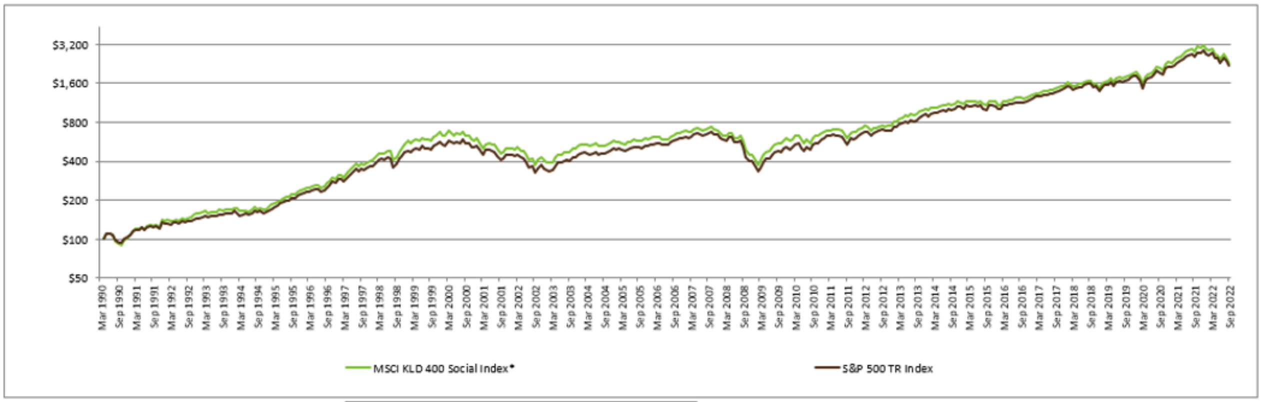


Achieving Long-Term Investment and Impact Objectives

As evidenced by the enthusiasm at our recent ESG for Impact! Conference, the shift into sustainable, responsible, and impact (SRI) investments continues – albeit at a slower pace. Following years of excess performance, as shown in Figure 8, below, the MSCI KLD 400 index underperformed the S&P 500 index in the year to date amid surging prices for fossil fuels and other commodities. This setback notwithstanding, the sustained, consistent performance of this standard SRI/ESG benchmark over time supports our view that strategies incorporating environmental, social and governance (ESG) factors – with an eye toward making the world a better place – and mainstream financial returns can be achieved simultaneously.

As always, everything we do at First Affirmative is driven by our dedication to enabling advisors to deliver financial results to clients and belief in the power of capital to bring about lasting environmental and social change. Our new, innovative Values-Aligned Direct Index Solution (VADIS) and Sustainable Managed Mutual Fund and Multi-Manager Investment Solutions are built to enable clients to achieve their financial goals over the long term, along with their individual environmental, social, governance, ethical, and values-based objectives. Each portfolio is carefully constructed to be well diversified across assets, sectors, geographies, securities, and management styles –– and designed to weather periods of uncertainty and volatility.

Figure 8. MSCI KLD 400 vs S&P 500 Indices, September 30, 2022



	MSCI KLD 400 Social Index*	S&P 500 TR Index
Annualized Return Since 5/1/90:	10.91%	9.88%

Source: Morningstar. *Data prior to 9/1/2010 is that of the MSCI KLD 400 Social Index GR, while data since 9/1/2010 is that of the MSCI KLD 400 Social Index NR. Indexes are unmanaged groups of securities. Index performance does not include the impact of cash, fees, or transaction costs. Investors cannot invest directly in indexes but may purchase mutual funds or other investment products designed to track the performance of various indices.

First Affirmative
FINANCIAL NETWORK

First Affirmative Financial Network

5475 Mark Dabling Boulevard, Suite 108, Colorado Springs, Colorado 80918
719-478-7036 | www.firstaffirmative.com
Registered Investment Advisor (SEC File #801-56587)

Advisor Inquiries

phone: 719-478-7036
businessdevelopment@firstaffirmative.com

Business Development, Marketing, and Media Inquiries

phone: 719-478-7036
businessdevelopment@firstaffirmative.com

Service Inquiries

phone: 719-478-7036
service@firstaffirmative.com

General Inquiries

service@firstaffirmative.com