Davenport Asset Management Quarterly Update | Q3 2022

September 30, 2022

Market action was wild in the third quarter, which turned out to be a tale of two halves. We saw an impressive rally from July through mid-August that coincided with hopes of the Federal Reserve backing off restrictive monetary policy. Then, we witnessed a sharp reversal as discouraging inflation data prompted the Fed to become even more resolute in its battle against rising prices. Ultimately, stocks declined for the quarter and returned to their June lows. The S&P 500® Index finished the period down 4.9% and the Russell 2000® Index declined 2.2%. Year-to-date, the S&P and Russell finished September down 23.9% and 25.1%, respectively.

Market Returns	Q3 2022	YTD
U.S. Large Caps	-4.9	-23.9
U.S. Mid Caps	-3.4	-24.3
U.S. Small Caps	-2.2	-25.1
International Developed Markets	-9.4	-27.1
Emerging Markets	-11.6	-27.2
Intermediate Term Bonds	-3.1	-9.6

Source: Morningstar Direct. Please see index for definitions.

There's been little reason to be excited of late. In fact, things have felt downright bleak. Rampant inflation, rising interest rates, restrictive monetary policy and slowing growth clearly aren't the ideal cocktail for stocks. Fed officials are fixated on quelling inflation with higher interest rates and are clearly willing to risk a recession to do so. They recently raised the benchmark federal funds rate another 0.75% to a range of 3.0-3.25%, which is the highest level since 2008, and indicated they will keep hiking rates well above the current level. Consequently, most prognosticators believe the risk of recession in 2023 is now well above 50%.

When will the Fed relent? To say all eyes are on the Fed would be an understatement. In fact, the gamification of Fed speak seems to have reached new heights. That is, investors are fixated on when the Fed will "pivot" and back off its hawkish stance. This would presumably create a much more favorable backdrop for the economy and stocks. But, this seems likely only when inflation is clearly much more subdued, with the Fed's target being 2% for the consumer price index (down from over 8% in recent months). In policymakers' eyes, the potential long-term harm from persistent inflation clearly outweighs the risk of a potential slowdown brought on by their efforts.

In addition to the specter of slowing growth and/or recession, rising interest rates have other consequences. For one, bonds have become a much more viable alternative to stocks. Consider this, a one year treasury bill now yields just over 4.0% versus 0.1% a year ago. It goes without saying that a risk-free rate over 4% offers more formidable competition for investors' dollars than it did in recent years. It's also nicely higher than the S&P 500's current yield of 1.7%. Another major side effect of rising rates is a higher cost of capital for companies. Whether refinancing old debt or raising capital for new opportunities, companies will be paying more for money. This elevates the importance of having manageable debt levels.

All of this has put a gravitational pull on equity valuations and is likely to influence corporate earnings as well. On the former, higher interest rates typically mean lower price-to-earnings (P/E) multiples for stocks. We've already seen the S&P's multiple contract from 21.4x forward earnings at the beginning of 2022 to 15.2x, which compares to the average of 16.2x since 1990. While equity prices have corrected sharply (influencing the numerator of the P/E equation), earnings estimates (the denominator) have been slower to react. The consensus currently calls for roughly 8.0% earnings growth for the S&P 500 next year and this seems too high in light of slowing growth. This suggests the broader market is not quite as cheap as it appears.

Such a backdrop clearly presents a tough environment for us as investors. However, we think some of the "glass half full" language from our last letter, when stocks were around current levels, is still relevant. To paraphrase, we noted that stocks had clearly discounted some pain already and that we were being better compensated for taking risk in many situations. The P/E multiple compression highlighted above is clear evidence of this. We went on to note that investor sentiment seems decidedly negative and that a recession seems to be a foregone conclusion at this point. Since then, the interest rate/policy backdrop for stocks has worsened. But, at some point pervasive pessimism will help the market put in a bottom. It's often a good time to be a buyer when everyone else seems to have given up.

In sum, we have been expecting to enter an era of more subdued returns following years of easy monetary policy and outsized gains. This year's drawdown clearly suggests that era is upon us and we aren't holding our breath for policymakers to come to the rescue. This doesn't mean, however, that we can't earn respectable returns following this period of pain, especially as broad market weakness offers us some bargains. Rather than being fixated on Fed speak and other short-term indicators, we are staying very focused on buying businesses that trade at attractive prices, even when considering the risk of slowing growth. Thank you for your trust.

Four themes dominated the third quarter – continued inflation, escalating interest rates, the labor market, and economic growth concerns. These factors led to heightened rate volatility that continues to challenge market participants, from central banks to retail investors.

Ongoing geopolitical risks exacerbate heightened market sensitivity. Approaching midterm elections, an ongoing Russian and Ukrainian war coupled with aggressive Chinese and North Korean posturing do not inspire near term stability.

Corporate America has battened down the hatches to navigate this uncertainty. CarMax tells of an evolving auto market narrative due to waning consumer confidence and higher borrowing costs. Apple's ubiquitous iPhone has seen reduced demand. Cautious FedEx guidance heading into the usually robust holiday season is yet another bellwether portending the challenges facing corporate America.

The housing market is feeling the impact of relatively higher mortgage rates. It is not a great feeling to buy what could likely be a near term depreciating asset, akin to what happens when a new car leaves the lot. Dependable consumer activity has largely propped up the economy, but has also contributed to rising pricing across good and services.

With the traditional 60/40 portfolio not working very well, investors remain rightfully concerned. The first sovereign debt bear market in over 70 years somewhat speaks for itself. Many of the aforementioned headwinds are the outcome of removing practically free money and abundant market liquidity. This is all part of the process of a consolidated economic cycle attributed to the multifaceted impacts of Covid. Many market segments have seen significant repricing but don't forget markets have been irrational in the past on both the upside and downside. Many argue parts of the economy are already in a recessionary phase, and capital markets clearly reflect this.

The Federal Reserve's hawkish rate trajectory will ultimately dampen inflation. The cost to fixed income assets, particularly longer duration (interest-rate sensitive) bonds, extends well into bear market territory. Keep in mind this includes AAA U.S. government securities.

Now for the silver lining: better days are ahead. Maybe not next month, but further out on the horizon returns will stabilize. Where there is such market dislocation, there is opportunity. For example, a roughly 4% yield is earned on a one-year Treasury bill compared to a few basis points not long ago. Longer-dated bonds offer the opportunity to buy securities trading at significant discounts to par. The Fed is approaching its terminal rate, which is a neutral rate (think Goldilocks*) that brings price stability and maximum employment.

The fixed income market analysis below provides in-depth details into data that illustrates the market dynamics and outlook.

Comparative Total Returns

Sep 30, 2022	Short-Term Cumulative Returns						Annualized Returns			
	YTD	WTD	1Mo	3Mo	6Mo	1yr	2yr	3yr	5yr	10yr
US										
Treasury	-13.48%	-0.77%	-3.88%	-4.72%	-8.18%	-13.18%	-8.51%	-3.23%	-0.26%	0.53%
High Grade Corp.	-18.33%	-1.87%	-5.62%	-5.11%	-11.37%	-18.19%	-8.72%	-3.50%	0.06%	1.78%
High Yield Corp.	-14.62%	-1.34%	-4.48%	-0.68%	-10.53%	-14.06%	-2.13%	-0.67%	1.41%	3.86%
Leveraged Loans	-3.35%	-1.17%	-2.35%	1.37%	-3.13%	0.47%	4.36%	3.25%	3.60%	3.76%
Municipals	-12.56%	-1.08%	-3.76%	-3.61%	-6.61%	-11.82%	-4.69%	-1.93%	0.55%	1.83%
Convertibles	-20.66%	-0.83%	-6.03%	0.72%	-16.48%	-22.17%	0.14%	11.59%	10.13%	11.26%
Preferreds	-14.74%	-0.78%	-4.03%	-0.95%	-8.24%	-14.72%	-4.54%	-1.66%	1.06%	3.65%
Mortgage Markets										
Mortgage Master	-13.67%	-0.56%	-5.19%	-5.38%	-8.86%	-14.03%	-7.49%	-3.68%	-0.89%	0.51%
US Equity Market										
S&P 500	-23.87%	-2.88%	-9.90%	-4.88%	-21.44%	-15.47%	4.83%	8.15%	9.23%	11.70%

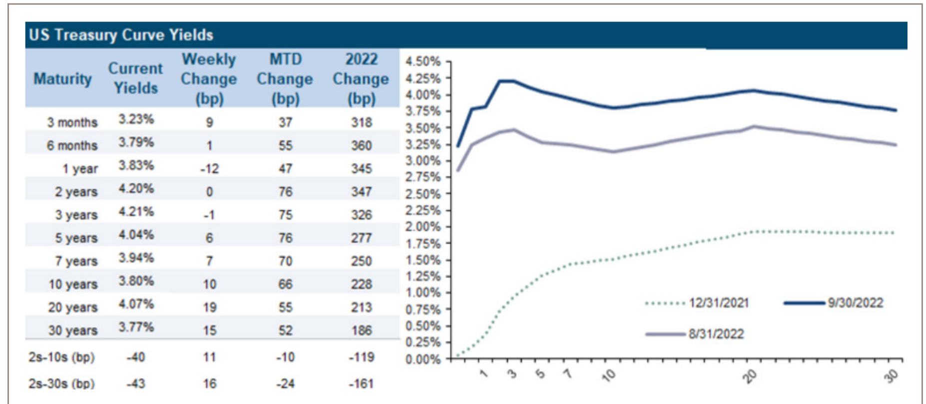
Source: CreditSights, BofA/ML, S&P/LSTA, Bloomberg.
Treasury=G0Q0, HG=C0A0, HY=H0A0, LL=SPBDPL, Muni=U0A0, Convert=V0S0, Pref=P0P1, Mortgages=M0A0, S&P 500=SPX

- Pockets of safety have been hard to locate. Year-to-date total returns reflect the breadth and depth of a hawkish Fed.
- We remain underweight duration across our strategies which has been the biggest driver of relative outperformance versus the benchmarks.
- Rate volatility is expected to persist. Rising rates remain the base case with anticipated Fed Funds hikes in November and December. 2023 should see more tempered monetary policy as inflation falls towards the 2% target.
- Credit spreads are vulnerable to a possible hard landing. Additional credit compensation has increased this year, especially lower in the rating's spectrum.

*A Goldilocks economy is an economy that is not too hot or cold, in other words sustains moderate economic growth, and that has low inflation, which allows a market-friendly monetary policy.

US Treasury Curve Yields

- The 2022 rise in rates across the curve has been significant, with the 2-year up almost 350 basis points.
- The curve inversion is historically a precursor to economic headwinds. The 2s-10s curve, which is the term premium from moving out the curve, illustrates this risk.
- We continue to see greater value in the front of the curve as the long-end does not offer an enticing risk/reward profile. Floating rate corporate and Treasury securities continue to dampen portfolio interest rate sensitivity.



US Treasury Curve Yields

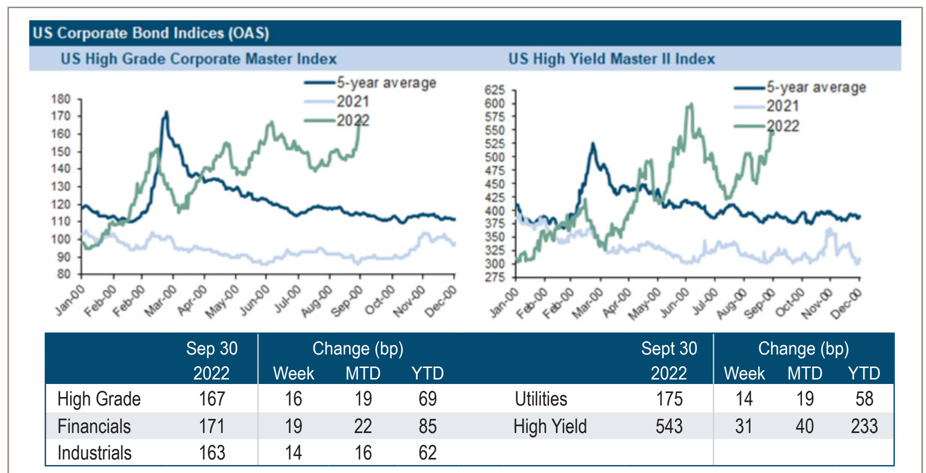
Maturity	Current Yields	Weekly Change (bp)	MTD Change (bp)	2022 Change (bp)
3 months	3.23%	9	37	318
6 months	3.79%	1	55	360
1 year	3.83%	-12	47	345
2 years	4.20%	0	76	347
3 years	4.21%	-1	75	326
5 years	4.04%	6	76	277
7 years	3.94%	7	70	250
10 years	3.80%	10	66	228
20 years	4.07%	19	55	213
30 years	3.77%	15	52	186
2s-10s (bp)	-40	11	-10	-119
2s-30s (bp)	-43	16	-24	-161

Source: CreditSights, Factset. Data as of 09/30/2022

- If long rates move higher, increasing duration will be on our radar. The 10-year briefly breached 4% last quarter, which caught our attention for total return. The Bank of England (BoE) announced unlimited long debt purchases that impacted sovereign debt markets in recent days.
- Inflation, employment and economic data will directly play into coming Fed actions.

US Corporate Bond Indices

- Investment grade spreads increased during the quarter and we took advantage of higher yielding corporate debt issuance.
- Lower rated BBB credits generically offer roughly an additional 135 basis points over top rated credits. Elevated credit spread sensitivity in 2022 illustrates the importance of credit selection in a prudent search for yield.
- Higher borrowing costs have dampened the new issue market. Some investment grade borrowers have stood down hopeful for better conditions. Lower-rated companies often don't have that luxury and face a hostile market amidst rate volatility.



	Sep 30 2022	Change (bp) Week	MTD	YTD		Sept 30 2022	Change (bp) Week	MTD	YTD
High Grade	167	16	19	69	Utilities	175	14	19	58
Financials	171	19	22	85	High Yield	543	31	40	233
Industrials	163	14	16	62					

Source: CreditSights, BofA/ML Indices (C0A0) (H0A0)

US IG & HY Corporate Yield to Worst

- The Fed's hawkish pivot is biggest factor behind higher yields as it seeks a dual mandate of price stability and maximum employment. So far in 2022, Fed Funds have risen 3% (or 300 basis points) and will likely end the year closer to 4%.
- Monetary policy is challenging. The BoE has raised borrowing costs to manage inflation and also suppressed ten year and greater yields to maintain financial stability as systematic leverage driven margin calls created forced selling.

US IG & HY Corporate Yield to Worst (%) by Rating, Tenor

	IG	AAA	AA	A1	A2	A3	BBB1	BBB2	BBB3	BB1	BB2	BB3	B1	B2	B3
Index	5.74	4.76	5.01	5.16	5.43	5.54	5.79	5.97	6.61	7.26	7.75	8.15	9.22	9.64	11.05
3Y	5.36	4.59	4.78	4.87	5.19	5.26	5.44	5.52	6.20	7.03	7.46	7.90	9.36	10.13	11.62
5Y	5.71	4.62	4.88	5.09	5.50	5.61	5.67	5.86	6.62	7.46	7.86	8.29	9.61	9.71	11.09
7Y	5.84	4.68	4.97	5.15	5.56	5.56	5.83	6.02	6.72	7.40	7.77	8.10	8.87	9.38	10.27
10Y	5.94	4.95	5.00	5.22	5.66	5.70	5.91	6.23	6.75	7.28	7.57	8.10	8.56	8.58	9.78
30Y	5.94	4.89	5.27	5.51	5.59	5.76	6.04	6.34	7.01	7.34	9.27	9.25	7.64	N/A	N/A

Source: CreditSights, ICE Data Indices, LLC. Data as of 10/01/2022

- Credit spreads continue to play second fiddle to interest rates in their contribution to higher yields. July was a strong month for fixed income, but was offset by a weaker August and September as strong inflation reports (CPI and PCE) persisted.

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