CHARTWELL
INVESTMENT PARTNERS

Chartwell Strategies Current Outlook

"Experience isn't interesting until it begins to repeat itself – in fact, till it does that, it hardly is experience"

-Elizabeth Bowen,
Irish-British novelist, 1899 to 1973

Summary

- *Both equity and fixed income markets were weak in the third quarter as rising short-term interest rates and an inverted yield curve raised the probability of continued erratic growth and a recession in 2023.*

- *Inflation remains the major economic headwind as the FRB expresses disappointment in its progress to achieve price stability. However, they remain committed to pursue a tight monetary policy until inflation returns to less than two percent, annually. Fiscal policy has been counterproductive to the FRB's actions and goal.*

- *Energy stocks have been amongst the best market performers as demand for coal, natural gas and petroleum products outstrips supply. High technology, social media, and other glamour stocks, all of which have been market leaders in the past decade, were the worst performers in the first nine-months of this year.*

Background

The third quarter began with a strong stock rally which lasted through mid-August, however, higher short-term interest rates, initiated by successive Federal Reserve Board (FRB) hikes in the federal funds rate, brought the rally to a halt and led to a market decline that persisted through quarter-end. As a result, the major stock indices suffered losses for the three-month period; the DJIA, S&P 500, NASDAQ and Russell 2000 lost 6.17 percent, 4.89 percent, 3.91 percent, and 2.18 percent, respectively.

Inflation is the reason that the FRB has been forced to raise short-term interest rates. As a recovery began to develop after the negative economic impact of the pandemic, demand for goods and services increased in the latter half of 2021. However, the passage of multiple legislative bills since March 2021 increased demand far faster than the supply chain could satisfy. Indeed, in the past 19 months the Federal Government has passed over $5 trillion in spending bills ($5,500,000,000,000) including the American Rescue Plan, the Infrastructure Investment and Jobs Act, a $1.5 trillion spending bill in March 2022, the Inflation Reduction Act and most recently, the "CHIPS Act." Other plans by the Administration, such as Student Loan Forgiveness, may come to fruition and further aggravate the Nation's inflation problem.

The FRB's plan is to reduce demand by raising interest rates and provide time for the world economy to recover and increase supply. Consequently, fiscal policy and monetary policy are not acting in concert; this degree of discord is abnormal, and the outcome is not yet clear.

Inflation has not been a major issue in the American economy since the late 1970s and early 1980s. In an effort to stop the runaway inflation that was occurring at the time, President Carter appointed Paul Volcker to head the FRB. Volcker's policies, which were continued by his successors, Alan Greenspan and Ben Bernanke, were effective in maintaining a disinflationary environment, which promoted real economic growth for decades.

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RISE IN THE YIELD ON THE 2 YEAR TREASURY BOND FOR 2022
01/01/2022-11/01/2022

Figure 1. THE SHARP INCREASE IN SHORT TERM INTEREST RATES IS CAUSING A SLOWDOWN IN ECONOMIC GROWTH
Source: BLOOMBERG

Figure 1 above illustrates the rise in interest rates on the two-year Treasury bill. Since the beginning of 2022, the interest rate on the two-year bill has risen from 0.734 percent to a high of 4.624 percent in October. Typically, a rapid rise in interest rates has had the most detrimental effect on stocks selling at high valuations. This time has been no different as the NASDAQ Index (the NASDAQ Index is heavily weighted with technology, glamour stocks) has been the worst performing major index, down 32.0 percent for the first nine-months of the year. Most notable is Meta Platforms (formerly FaceBook) which has plummeted over seventy percent in that period.

Figure 2 below is an important illustration. It is a graph of the ratio between the performance of growth stocks as compared to value-oriented stocks over a forty-three-year period. From 1979 to 2006, except for a speculative bubble that peaked in 2000, growth and value stocks performed equally. However, since 2007 until September of 2020, growth stocks outperformed value stocks by a wide margin. This was the longest sustained period of outperformance by growth stocks in post WW II history.

PERFOMANCE OF LARGE CAP GROWTH vs VALUE STOCKS SINCE 1979

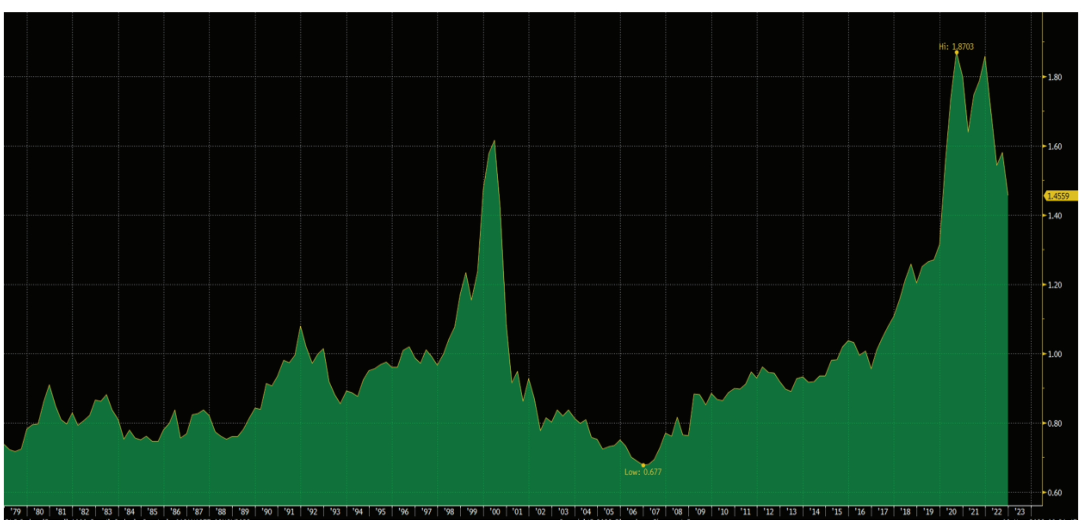

Figure 2. FROM 2007 TO 2020 GROWTH STOCKS HAD AN UNPRECEDENTED RISE VERSUS VALUE STOCKS
Source: BLOOMBERG

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The speculative bubble that burst in January 2000 ended badly for most "momentum" investors. In fact, it took the NASDAQ Index fifteen years to regain the level that it reached in 2000. The underperformance of growth stocks since 2020, which accelerated this year, is probably signaling more difficulty for growth and momentum stocks in the months ahead. In the first nine-months of this year, the Russell 1000 Growth and Value indices declined 30.66 percent and 17.78 percent, respectively. As always, value investors need to remain cautious, but their fortunes have turned for the better over the past two years and this trend may continue for the foreseeable future.

While Figure 2 illustrates how the relative outperformance of large-cap growth stocks peaked two years ago as compared to large-cap value-oriented stocks, Figure 3 below shows that small-cap stocks are selling at historically low valuations to large-cap stocks. Since many of our portfolio holdings are value stocks and smaller in market capitalization, together, Figures 2 and 3 argue that our portfolios offer low risk on a relative basis, at this time.

VALUATION OF SMALL CAP STOCKS TO THE S&P 500

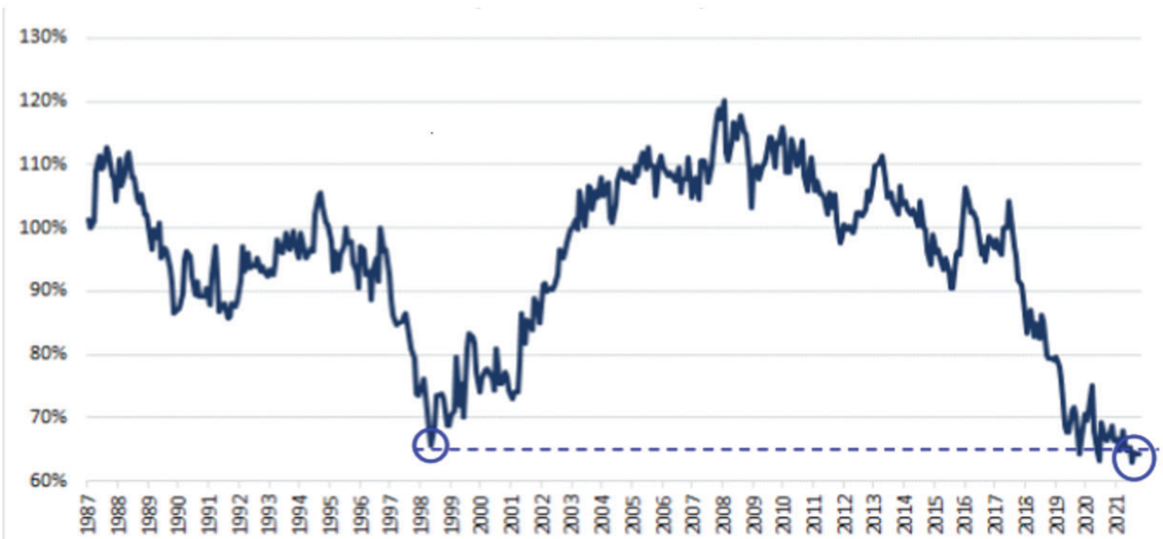

Figure 3. SMALL CAP STOCKS ARE SELLING AT HISTORICALLY LOW VALUATION LEVELS AS COMPARED TO LARGER CAP STOCKS.
Source: FUREY RESEARCH PARTNERS AND FACTSET. DATA AS OF 9/30/22. REPRESENTS MEDIAN P/E USING LATEST AVAILABLE TRAILING 12 MONTH EARNINGS. PROFITABLE COMPANIES ONLY*

Another aspect of the 2022 market environment has been the superior performance of energy stocks, specifically coal, natural gas and petroleum related companies. These fossil fuel enterprises, which typically fall into the "value" category, have been underperforming the stock market averages for years and at the beginning of this year, represented only about five percent of total U.S. stock market capitalization. In the last decade or more, they have not reinvested the majority of their "free cash flow" back into their companies. Due to excessive government regulation, attacks by environmentalists, and climate extremists in particular, they have been shrinking shareholder equity by repurchasing shares and paying generous dividends. Lack of access to new capital with attractive terms has also been a problem. Consequently, as the economy opened-up after the COVID pandemic, energy supplies, particularly diesel fuel and gasoline have been in short supply and prices have risen sharply. Without question, this has been a serious problem that needs to be addressed. Without inexpensive and reliable energy sources, the U.S. economy will not be able to grow at the pace required to pay for the Country's unfunded liabilities such as Medicare and Social Security programs, or, maintain a competitive military presence. Contrarian investors may want to take a second look at both "old economy" and emerging energy businesses.

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**P/E is the Price to Earnings Ratio and is used to determine the relative value of a company's shares. To calculate, it is the price the stock is selling at divided by the annual earnings.*

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As stated in the preceding paragraphs, the equity market slide continued in Q3, as stocks were held hostage by the bond market. The Federal Reserve (The Fed) continued their inflation-fighting campaign with 150 basis points** of additional increases to the Fed Funds rate in the quarter, and the 10-yr Treasury yield rose from 2.97% on 6/30, to 3.80% on 9/30 and went as high as 4.23% in October. With the increase in rates and an "inverted" yield curve, the probability of a recession in 2023, accompanied by slower growth in corporate earnings, is heightened.

As reflected in the letter, 2022 has shaped up to be a quite different and a little more volatile year than 2021. It's market conditions like these where we believe active investment management can make a difference. If you wish to receive additional information about the IMAP program please contact Chartwell at (610) 296-1400 or info@chartwellip.com.

Past performance is no guarantee of future performance. All investing involves risk of loss. An investor cannot invest directly in an index. The Index returns are provided to show an example of alternate return potential during the relevant time periods; however, indices may possess different investment attributes that may make comparisons difficult such as volatility, liquidity, market capitalization, and security types. This commentary is for informational purposes only. It is not an offer to buy or sell any security and should not be construed as investment advice. The views in this report were those of the Adviser at the time of writing this report and may not reflect our views on the date this report is first published or anytime thereafter.