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PALOS

Weekly Commentary

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Third Quarter Review

Over the first six weeks of the third quarter equity markets in the U.S. continued to rise, albeit at a slower pace than we saw in the final two weeks of July. Fueling the rally was improving investor sentiment as signs of weakening inflation were apparent in softening commodities prices, as indicated by weaker PPI (Producer Price Index) and CPI (Consumer Price Index) data. The U.S. 10-year government bond, a key indicator of interest rates, saw its yield hovering slightly above 3.0%, below its mid-June high of 3.5%. This trend implied that interest rates may have peaked along with inflation, a bullish catalyst for equities.

However, on August 26 at the annual Jackson Hole, WY economic symposium, hawkish comments on interest rates from the U.S. Federal Open Market Committee (the “Fed”) quickly extinguished the positive tone that pushed prices higher from mid-July through mid-August. Markets peaked in the final week of August and closed in negative territory for the month and the quarter. In fact, all major indices are trading near 2-year lows with the S&P500 down 24.8% for the year, the NASDAQ Composite down 32.4%, and Canada’s S&P/TSX Composite lower by 13.1% (source: Bloomberg). Canadian equities have been relative outperformers year-to-date.

Adding to concerns are a continuation of negative geopolitical headlines: government mandated Covid shutdowns continue to hamper economic activity in China, potential escalation of the war in Ukraine, an energy crisis in Europe, and rising tensions between Taiwan and China. Domestically, higher interest rates are having a negative impact on consumer debt obligations, mortgage rates and housing prices. Although lower home prices are seen as positive for rebalancing the market and improving affordability, higher mortgage rates are offsetting the positive news on pricing. With rising rates, fixed-income markets (bonds) which normally act as a “safe haven” have had their worst year in decades. Without a doubt, 2022 has been the most difficult year for investors in recent memory.

Fed Chairman Jerome Powell has been clear: the committee will remain “data dependent” regarding its interest rate decisions and will remain aggressive until the battle against rising inflation is won. However, an excessively “hawkish” Fed has left a growing number of observers pondering whether the Fed has been overly aggressive on interest rates, thus elevating the risk that Fed policy will create conditions that send the economy into a global recession. We need to keep in mind that during the pandemic, central bankers lowered interest rates to unprecedented levels to stimulate economic activity. Numerous critics have gone on record with their view that the Fed erred by keeping rates too low for too long which in turn fueled the highest levels of inflation in decades. In other words, was there a policy error?

Despite challenging markets, there are positive signs emerging. As we enter the final quarter of 2022, there are signs of inflation easing. Prices for gasoline and natural gas are well off their mid-summer highs as are agricultural commodities and industrial materials like copper, iron ore and lumber. Shipping costs are significantly lower and some high-profile corporations have recently announced layoffs. In our view, recent inflation information is signaling that prices are falling across many parts the economy. Given that much of this information appears with a time lag (they are lagging indicators), this information will gradually appear in the data that the Fed has become so dependent on. Although we remain cautious, we are cognizant of the fact that the best investment opportunities arise during times of fear and uncertainty.

Another fact we cannot stress enough is that markets are forward-looking mechanisms that usually turn from bearish to bullish well before the bad news ends. Equity markets peaked in late 2021/early 2022 and the current bear market has lasted almost a year. The average length of a Bear Market is 11 months, and the average decline is 23% (source: BMO Mutual Funds). In all likelihood, we are much closer to an investable bottom then we have been at any time this year.

Further, empirical research has shown us that returns following a market bottom can be swift and spectacular. Like all others Bear markets throughout history the most recent one will come to an end. This is why it's so important to focus on the long term and that remaining invested is the best strategy for achieving your long-term investing goals.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$7.95	-13.35%
Palos Equity Income Fund - RRSP	PAL101	$6.23	-12.99%
Palos Merchant Fund L.P. (Dec 31, 2021) [2]	PAL500	$1.16	24.67%
Palos WP Growth Fund - RRSP	PAL213	$12.39	-34.29%
Palos-Mitchell Alpha Fund [3]	PAL300	$8.35	-18.66%
S&P TSX Composite (Total Return with dividends reinvested)			-10.30%
S&P 500 (Total Return with dividends reinvested)			-22.70%
S&P TSX Venture (Total Return with dividends reinvested)			-35.20%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			3.88%
Canadian Government 10-Year			3.39%
Crude Oil Spot			US $92.64
Gold Spot			US $1,667.30
US Gov't10-Year/Moody BAA Corp. Spread			217 bps
USD/CAD Exchange Rate Spot			US $0.7279

[1] *Period ending October 7th, 2022. Data extracted from Bloomberg*

[2] *Fund is priced annually*

[3] *Fund is priced weekly on Tuesdays*

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