Investment Newsletter

Third Quarter 2022

Equity markets continued their streak of poor performance. The S&P 500 Index declined -5.00%, the third consecutive quarterly drop. September was especially weak, down -9.25%, and year to date the Index is down -24.14%. The MSCI All-Country World ex-U.S. Index dropped -9.91% and is down -26.50% year to date.

The key trigger for the September selloff was the realization that inflation remains stubbornly high. This was reflected in the August report of the Consumer Price Index (CPI), which came in at +8.3% versus the +8.1% consensus estimate – the sixth straight month over +8.0%. This cemented the Federal Reserve's resolve to continue aggressively raising interest rates to combat inflation, even if it causes a recession. Consequently, the Federal Reserve raised interest rates to a range of 3.00-3.25% and wants to reach 4.10-4.40% by year-end.

With interest rates rising, demand is starting to slow and that has led to weakening asset prices across the board – agricultural commodities, crude oil, precious metals, cryptocurrencies, equities, real estate, and fixed income. Expectations for both economic growth and corporate earnings growth for 2023 have been reduced.

Equities were also negatively impacted by the war in Ukraine, continued pandemic lockdowns in China, U.S.-China geopolitical tension over Taiwan, the U.S. Dollar relentlessly climbing to a 20-year high, and excessive global debt that is projected to reach 352% of global GDP by year-end.

Fixed income markets also performed poorly. The Bloomberg U.S. Intermediate/Government Index declined -3.06% and is down -9.62% year to date. The Bloomberg Municipal Bond Blend 1-5 Year Index declined -2.04% and is down -5.64% year to date.

Fixed income markets were unusually volatile as it became clear the Federal Reserve was determined to fight inflation with higher interest rates. Yields were pressured higher as demand for bonds decreased. Bond funds experienced high investor outflows, and demand from foreign investors declined due to the rising U.S. Dollar.

At the same time, support from the Federal Reserve's Quantitative Easing (QE; buying of bonds to support lower interest rates), which was restarted in 2019, has reversed as the Federal Reserve began implementing Quantitative Tightening (QT; no longer buying bonds). The combination of rising rates, lack of demand for bonds, and the Federal Reserve's exit from the bond market resulted in a sharp spike in yields. The 10-year Treasury note traded in a range of 2.57% to 4.00% - a significant move in a short amount of time.

All sectors of the fixed income market were negatively affected. Municipal bonds, which had been outperforming for most of the year, experienced one of the worst quarters in years. Like last quarter, the only maturities to post positive returns were short-duration Treasury bills.

Looking forward, we expect continued volatility as the Federal Reserve's policy is highly data dependent. Investors will be focused on inflation data and any signs of an economic slowdown that might shift that policy. Our fixed income strategy remains cautious and defensive. We are opportunistically purchasing higher coupon, short- and intermediate-maturity bonds to increase the income generated in our clients' portfolios.

With such volatility in equity and bond markets, What needs to happen for the investment environment to become more favorable again? Here are the key developments to watch:

1) Inflation obviously must come down. The good news is the CPI has trended down sequentially the last two months, albeit at too measured a pace. Inflation would decelerate more rapidly with the following events:

   a) Resolution of the COVID-19 pandemic. Global new infections have fallen dramatically to 3.1 million last week versus the peak of 23.2 million. Despite posting four consecutive weeks of lower new infections in China, the country still has over 20% of its citizens in lockdown. Reopening China would allow global supply chains to normalize. Resolution of the pandemic would also encourage more workers who have been fearful of becoming infected to return to the workforce.

   b) Normalization of the U.S. labor market. The U.S. needs more workers, which would both alleviate supply chain constraints and lower wage growth. 'Long COVID' is keeping 2-4 million workers out of the workforce. There are 1.7 available jobs for each unemployed worker, nearly the highest on record. Wage growth, the biggest driver of inflation, has been too hot at +6.7% for the last three months.

   c) Higher unemployment and lower consumer spending. The U.S. unemployment rate is low at 3.7% and some economists estimate it will have to increase to 5.0% or higher to get consumer spending down. Job openings were 10.1 million in August, a decline from 11.2 million in July – a sign that higher interest rate hikes are having the desired effect.

   d) Ending the war in Ukraine. It has contributed to an energy crisis in Europe, pressured Europe's economic growth, and contributed to global supply chain constraints.

   e) Lowering the excessive U.S. federal budget deficits and debt. The deficit is projected to average $1.6 trillion from 2023 to 2032 and interest on the $31 trillion of debt could exceed national defense spending by 2029. Reigning in government spending and repaying the debt would help crimp inflation.

2) The Federal Reserve must finish raising interest rates. This would weaken the dollar, which would help U.S. corporations doing business abroad and mitigate inflationary pressures in other developed countries whose currencies have been crushed by the strong dollar. It would also allow asset prices to recover.

3) Lapping the tough sales growth comparisons for technology companies whose products experienced a two-year acceleration in demand from consumers working and studying from home.

4) Despite the improved valuation for the S&P 500 (P/E of 16.0x versus its 10-year average of 17.0x), its consensus estimate for earnings growth in 2023 must bottom out (currently +7.8% vs. +10.1% previously).

5) The economy and investors must adjust to a reversal of 15 years of easy-money U.S. fiscal and monetary policies. This will likely require more patience.

Because we cannot predict exactly when these positive events will materialize – coupled with the fact that the stock market will anticipate them well in advance of their completion – we continue to actively and prudently make new investments in great companies for the long term at significantly discounted valuations that have compelling innovation and growth, stellar management teams, superior business models, and low debt. In addition, we are taking advantage of the attractive yields in the Treasury markets to increase portfolio income (e.g., the 1-Year Treasury yield is currently 3.97% versus the S&P 500's dividend yield of 1.75%), while ensuring clients have the proper forward-looking asset allocation.

Sources: CBO, Federal Reserve Bank of Atlanta, Bureau of Labor Statistics, Bloomberg, FactSet and Institute of International Finance.

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