3rd Quarter 2022 Commentary

"The Federal Open Market Committee's overarching focus right now is to bring inflation back down to our 2% goal. Price stability is the responsibility of the Federal Reserve and serves as the bedrock of our economy." – Jerome Powell[1]

The markets brief rally in July and August quickly faded into memory on account of Powell's hawkish speech in Jackson Hole. His comments proved to be a turning point in the quarter, with the S&P 500 dropping 11.5% from August through September, as other committee members declared their unconditional support for additional monetary tightening through yearend to rein in inflation. Minneapolis Federal Reserve President Neel Kashkari recently provided additional color on the committee's determination.

"I've been on the Federal Open Market Committee now for almost seven years. The only time I have seen us this united was at the beginning of the pandemic, when we had to act boldly to support the economy through the pandemic and through the downturn. We are united in our job to get inflation back down to 2%. And we are committed to doing what we need to do in order to make that happen. And that leads to more tightening of monetary policy in the near term."[2]

This determination to regain price stability will likely continue to present a headwind to the economy. Further, it suggests market volatility will remain with us for some time.

While the ride suggested otherwise, the S&P 500 only dropped 5% in the quarter. This brings the year-to-date decline to nearly 24%. Mid-cap, Small-cap, and international asset classes offered little help and also finished lower. Bonds, which are meant to protect portfolio values in such markets, closed lower for the third quarter in a row. The iShares Core U.S. Aggregate Bond Exchange Traded Fund for instance, which tracks investment grade bonds, is now down over 15% in 2022. This marks the third consecutive quarter of stock and bond losses and the first time in modern financial history.[3]

The Fed's tightening policy also calls for unwinding of the Federal Reserve's balance sheet. The bloated balance sheet is a result of several rounds of record stimulus dating back to the Great Recession of 2008. To stimulate the economy, the exercise saw the Fed purchasing a set amount of Treasury's, Mortgage Back Securities, and even High Yield Bonds (in the Pandemic) each month to make sure rates were favorable for consumers and businesses. The unwinding of the policy means the Federal Reserve is no longer actively suppressing rates as the "buyer of first resort". In other words, interest rates in the economy are, for the first time in a while, tracking interest rate policy and market supply and demand. The absence of the bond markets biggest participant over the last decade is now clearly creating upward pressure on rates too.

Consumers, for instance, are experiencing higher financing costs from housing (mortgage rates recently rose to 6.5%) to the automotive industry. Both the automotive industry and housing markets are now showing signs of weakness as overall costs increase. Businesses have also been impacted. After a decade of bingeing on cheap debt, businesses (Corporate America) have significantly curtailed issuance of new

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[1] Powell, Jerome. Jackson Hole. August 26, 2022
[2] WSJ Interview With Neel Kashkari and Lawrence Summers. September 27, 2022. [Transcript]
[3] Trennert, Jason. Quarterly Review in Charts. October 3, 2022. Strategas

bonds. Unprofitable companies (e.g. Peloton) that are dependent upon these markets to raise cash have now been forced to cut jobs and costs to survive.

Higher rates, however, have not been all bad. Money market funds, or cash alternatives for instance, now yield more than 2% which, compared to the .65% the 10-Year Treasury yielded in September 2020, has savers and investors jumping for joy.[4]

On a repetitive note, "interest rates are to asset prices like gravity is to the apple".[5] Higher interest rates or the prospect of higher rates will likely present a continued headwind to valuations and a market advance. Up until now, underlying corporate earnings have been quite resilient. Weakening consumer demand, signs of lower shipping volumes (truck, air, and ocean freight), and inventory/supply constraints, however, have led some analysts on Wall Street to start reducing corporate earnings expectations for 2022 and 2023. While lower earnings would likely act as another leg down in the current market environment, many individual stocks are already pricing in this outcome (Figure 1 below shows the overall drop in the markets valuation). We are focused on these opportunities.

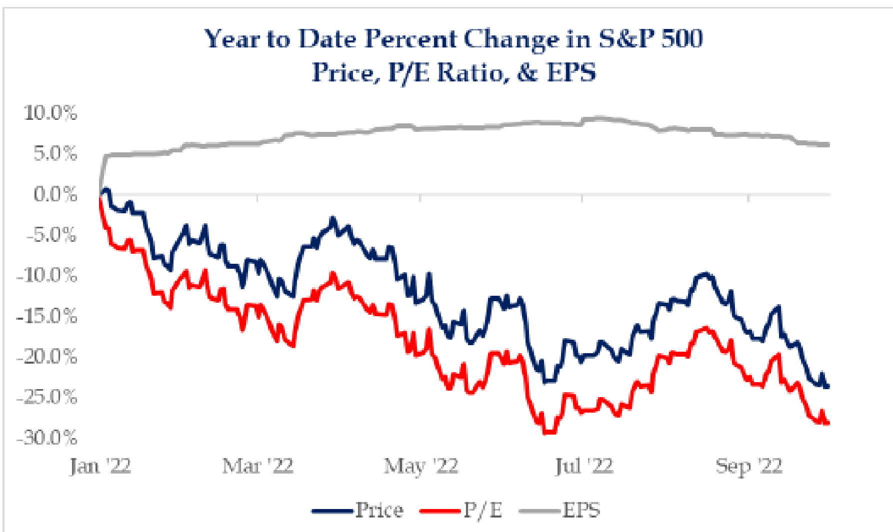

Fig. 1. Year to Date Percent Change in S&P 500 Price, P/E Ratio, & EPS (Source: Strategas)

The Federal Reserve Board is also intent on reducing the future expectations of inflation in the economy. This is important because the expectation of lower cost increases from consumers and businesses typically leads to smaller incremental wage and price increases now. San Francisco Fed President Mary Daly said it best, "Inflation hasn't really gotten into the psychology of Americans, but keeping it that way will require that we follow through on our commitments to bring inflation down, which does mean further rate hikes and holding those restrictive policies in place until we are truly done with bringing inflation back to target."[6] While it may be hard to believe inflation is not entrenched in the economy

[4] Trennert, Jason. Quarterly Review in Charts. October 3, 2022. Strategas
[5] Buffett, Warren. 2001.
[6] Daly, Mary. August 2022.

when shopping for groceries or pumping gas, recent polling results (Figure 2) suggests that inflationary forces are starting to recede. That is good news for consumers, investors, and the market.

Fig. 2. Inflation Expectations: Median Three-Year Ahead (Source: Strategas)

For contrarians, investor sentiment also suggests that markets may be getting closer to a bottom. According to the American Association of Individual Investors (AAII), "expectations that stock prices will fall over the next six months rose to its highest level since March 2009".[7] The best days and weeks in the market typically follow the worst. That was certainly the case in March 2009.

Finally, while past performance is never a predictor of future returns, midterm elections typically bode well for investors over the following twelve months. The S&P 500, for instance, has generated positive returns in the 12 months following a midterm election dating back 80 years.[8] Figure 3, which shows the prior 7 midterm elections, exhibits this relationship.

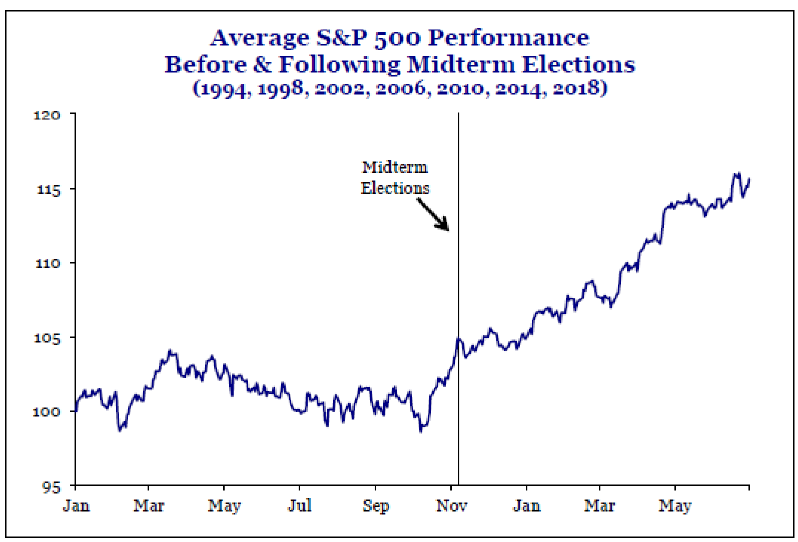

Fig. 3. Avg. S&P 500 Performance Midterm Elections (Source: Strategas)

Regardless of the short-term outcome, we continue to focus on owning simple businesses with durable competitive advantages at attractive valuations. We are finding ample

[7] Langley, Karen. Wild Moves Send Stocks and Bonds Lower in Third Quarter. September 30, 2022. Wild Moves Send Stocks and bonds Lower in Third Quarter

[8] Ibid.

opportunity in today's market after the recent decline.

Sincerely,

J. August Gerhardt, CFA

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