Review & Outlook

Third Quarter 2022

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Review and Outlook

The third quarter of 2022 started off well, but finished with a particularly weak September. Overall, the S&P 500 index ended down 6% for the quarter, and bonds have been equally disappointing. For the year, the S&P 500 has fallen roughly 24%, and the broader CRSP U.S. index is down slightly more than that. The Bloomberg U.S. Aggregate Bond Index is down over 14% for the year, falling more than 5% in the third quarter alone. Their performance can be seen in Charts 1 and 2, where the green line reflects the CRSP US Total Market Index (Total Return), and the brown line reflects the Bloomberg U.S. Aggregate Bond Index.

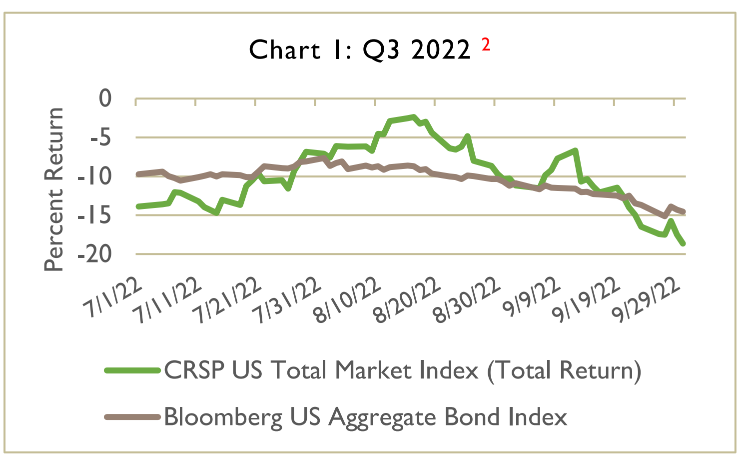
Index Performance Data
Total Return as of 9/30/2022

Indices[1]	Q3 2022	Trailing 12 Months
CRSP U.S. Total Stock Market Index	-4.44%	-17.98%
MSCI Global ex-U.S. Total Stock Market Index	-9.62%	-27.79%
Bloomberg Barclays U.S. Aggregate Bond Index	-4.75%	-14.60%

Concerns about inflation have pushed the Federal Reserve to increase interest rates. The Federal Funds rate is now between 3% and 3.25%, up from zero this spring. Having rates go up that much that fast, and not knowing how high they might go, has presented serious challenges for both stocks and bonds. The Fed's preferred measures of inflation still show price increases over 6% per year. Knowing how destructive inflation can be if it gets embedded into expectations (wage contracts, etc.), the Fed is raising interest rates to slow the economy. They want to make it so people want to consume less, invest less, and negotiate lower wages, with the hope it will ultimately bring inflation back to their target of 2%.

We've seen this before. In the 1980s, the chair of the Federal Reserve, Paul Volker, raised interest rates to bring inflation under control. He succeeded, but the cost was a significant recession. And it is worth noting that his willingness to push the U.S. economy into a recession is viewed in heroic terms within monetary policy circles. Paul Volker's legacy gives Jerome Powell, the current chair, and others who set monetary policy a certain type of permission to push the economy into recession.

The longer the data suggests that inflation is persistent, the more the Fed thinks it has to push interest rates up, meaning that a recession is more likely to occur. And therein lies the real discussion. What data should be considered, and how should we define "persistent"? If we focus on certain data series (like residential rental rates), we are likely to conclude that inflation is persistent, and the Fed will likely need to push the Federal Funds rate up to at least 4.5%. If we focus on other data series and indicators (like commodities and shipping costs), we could conclude that inflation is already slowing, and that the Fed really does not need to do much more tightening at all.



The Blue Chip Consensus forecast for the U.S. economy from August called for the Federal Funds rate to peak at 4%, and for the U.S. economy to slow noticeably, but indicated no recession. That forecast was based on, among other things, very little inflation from June to July, and from July to August. Unfortunately, inflation measures in September were stronger, leading many to believe the Fed would have to be more aggressive, and that a recession in early 2023 was more likely. Our view is that price growth is already slowing because of improvements in supply chains and reduced demand for consumer goods. Container costs and the cost of building materials like 2x4s have come back to pre-pandemic levels, and stores have inventories they need to sell. But the Fed looks at particular measures of inflation, and some of those are heavily influenced by things like rent. The problem isn't so much that asking rents are increasing rapidly, but that the 'rent equivalent' value based on home prices and higher mortgage rates continues to rise, making those particular measures of inflation seem problematic. So, we think inflation is slowing, but worry that the Fed is going to continue to raise rates more than they really need to, because of the metrics they favor, and the idea that a recession may be necessary.

In Focus

One item we think is relevant to discuss are the key differences between now and the 1980s, when Paul Volker took the steps needed to bring down inflation. When he was appointed chair of the Fed, high inflation had been a problem for more than a decade. In particular, there was a strong wage increase cycle in place due to higher levels of unionization. Today, we have been dealing with high inflation for less than two years, and most people expect inflation to fall back to normal/acceptable levels in fairly short order. We do not have embedded inflation expectations that require a large shock to the economy to change. Moreover, some of the imbalances today that are causing inflation bear little resemblance to what we saw in the 1980s. High energy costs play a role today, as they did in the 80s. But the situation in Ukraine seems different; there is a global shift to renewable energy sources, and the U.S. has become a major oil producer itself. The imbalances in housing are also different today. Since the Great Recession of 2008, the U.S. has not been building houses at the rate it used to. Supply is very constrained in many areas, helping to push prices up. Unless household formation slows dramatically, it's hard to imagine the type of recession needed to bring down home prices, when part of the problem is a lack of supply, not just elevated demand. And our supply chains, savings, and money supply are still distorted from COVID and related policies. The amount of money pushed into the economy to deal with COVID and the way people used that money was inflationary, but maybe not in a way that will last for years and years. There are also signs that some prices have been dropping. Commodity prices are falling, home prices are dropping in many markets, and shipping costs have fallen. However, these falling prices have yet to sway the data that the Fed weighs most.

Global markets are also important to consider. As the Fed raises interest rates and U.S. bonds become relatively more attractive, the U.S. dollar increases in value. The Fed needs to consider the influence of their actions on economies and people in other parts of the world. For example, a higher U.S. dollar makes it much harder for foreign countries and companies to pay off U.S. dollar denominated debt. Another consideration is that demographics and changes in immigration policy have affected the labor market. A tight labor market is often a worry in terms of inflation. In this case, we believe that better immigration policy, not higher interest rates, may be a better remedy.

How do we translate all of this into our portfolio management? For fixed income, we remain invested mostly in high quality, shorter term bonds. And for equities, we continue to be underweighted in foreign/global stocks due to economic stress in Europe (high energy costs/Ukraine) and China (zero-COVID policy and a troubled real estate market). We remain cautious, but look forward to more positive signals to move the cash we hold back into the market.

1. Index performance data provided by ICE Data Services, and calculated by Black Diamond, an SS&C Advent company.
2. Index performance data provided by YCharts.