Investment Review and Outlook **October 2022**

After a difficult first half of 2022, both the equity and fixed income markets got off to a reasonably good start in the third quarter. Interest rates began to head lower and the stock market recouped about half its losses by the mid-August. But just when it seemed to many in the investment community as if the equity market rout of 2022 had made a bottom, Federal Reserve Board Chairman Powell threw a torrent of cold water onto the markets. In a terse address at the annual Jackson Hole conclave in late August, Powell clearly set the near-term agenda of Federal Reserve policy. Powell emphatically stated that fighting inflation will be its main focus and the Fed is planning to do whatever it takes to drive the inflation rate lower. The reaction from Wall Street was swift and the stock market went on to make new lows for the year toward the end of the quarter.

In the past, we have warned that the Fed was playing with fire by artificially suppressing short term interest rates. Just a year ago the Fed underplayed the simmering inflation problem and emphatically asserted that inflation was “transitory.” Moreover, Powell had set the Fed’s goal as driving the unemployment rate to pre-Covid levels. And that would be the primary objective of its easy monetary policy. To say that more than a few seasoned economists and investment professionals have lost confidence in the Federal Reserve is not earth shattering. But the continued missteps by the Fed is making the investment climate and its attendant risks increasingly parlous. We have some concerns that the Fed risks sending the economy into recession which could result in lower corporate earnings and stock prices.

The elevated uncertainty regarding Federal Reserve policy and the growing likelihood of an economic slowdown should give investors pause. We would like to remind our clients that economic downturns and bear markets ultimately sow the seeds of the bull market that normally follows. In our judgment, the global economy will be challenged by much higher interest rates. For example, the dramatic rise in mortgage interest rates has severely exacerbated the affordability of housing for many more Americans. Thus, we believe that further interest rate hikes will only exacerbate economic conditions to the point of a potential recession. As a result, we are anticipating a possible peak in interest rates sooner rather than later. But an earnings recession that we envision needs to be discounted before considering the stock market cheap. Therefore, rigorous and disciplined stock selection will continue to be an important driver of returns in these uncertain times.

R.I.P. T.I.N.A.

We have no friends named Tina that recently passed away! But one of the main investment mantras on Wall Street for the past decade of near zero interest rates has been TINA – or “There Is No Alternative.” What was meant is that investors need to favor stocks over bonds because returns on fixed income was too low, and in some cases, non-existent. Just as an example, 1-2 year Treasury securities offered interest rates late last year that were well below 1%, and below the average yield of the S&P 500 basket of stocks. More recently, those same securities now yield over 4%, a rate more than double the dividend yield of the S&P 500. Thus, the relative attractiveness of fixed income has clearly changed dramatically in the past year.

Now some could argue that since interest rates are still well below the inflation rate as measured by the Consumer Price Index (CPI), investing in T-Bills will still result in a loss of purchasing power. But if interest rates continue to normalize and the inflation rate heads lower as the economy slows, we believe that fixed income securities will once again earn an important place in portfolios for diversification and income generation. There are a number of near-term risks in the fixed income market. But we have become increasingly more sanguine regarding the asset class. While we remain bullish on long term prospects for equities, we are no longer shunning the fixed income asset class and are paying attention to the emerging opportunities.