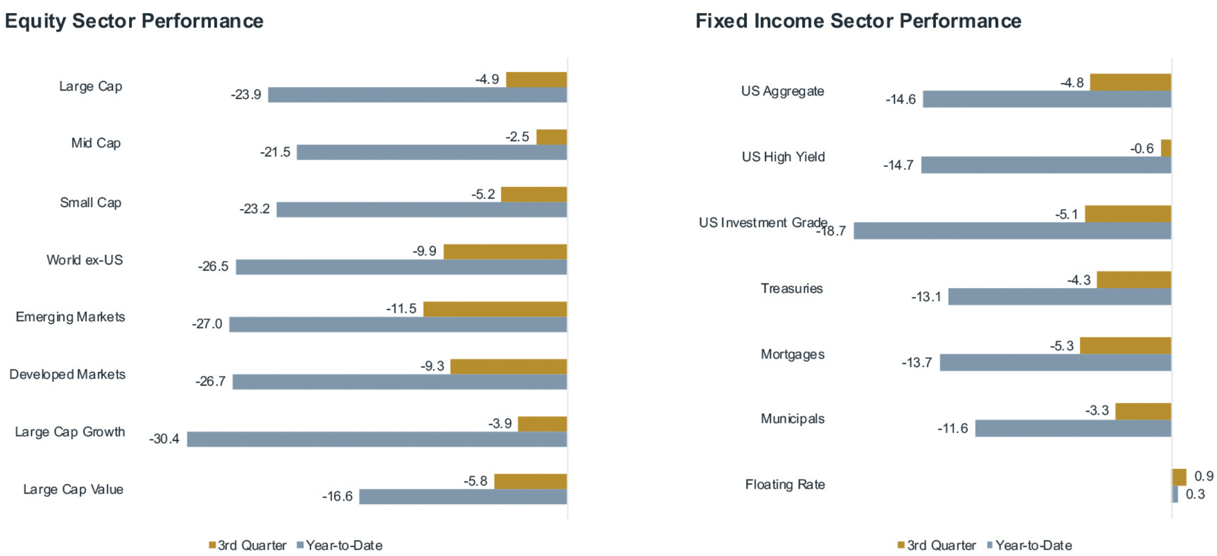
Fall 2022 Market Commentary

Global financial asset prices have tumbled this year as the positive tailwind momentum from more than a decade of ultra-low interest rates has reversed course, with interest rates now rising sharply higher and creating a challenging headwind for stock and bond investments. The US benchmark equity index S&P 500 today trades close to where it did at the end of 2020. Recall that at that time, global central banks and sovereign governments were flooding the markets with stimulus intended to support a "Main Street" economy in the throes of a pandemic. Instead, much of the stimulus money found its way into "Wall Street". Rock bottom (even negative) interest rates and plentiful liquidity lulled investors into a complacent state where simply buying an index fund or consistently buying every dip in the market yielded handsome returns. Today these same governing entities are attempting to rein in the price inflation that their stimulus programs engendered. The bond market has seen valuations collapse thus far this year as interest rates have risen with tightening Central Bank monetary policy. The result has been extreme price volatility in both stock and bond markets and an increasing correlation between these two asset classes with prices declining simultaneously.

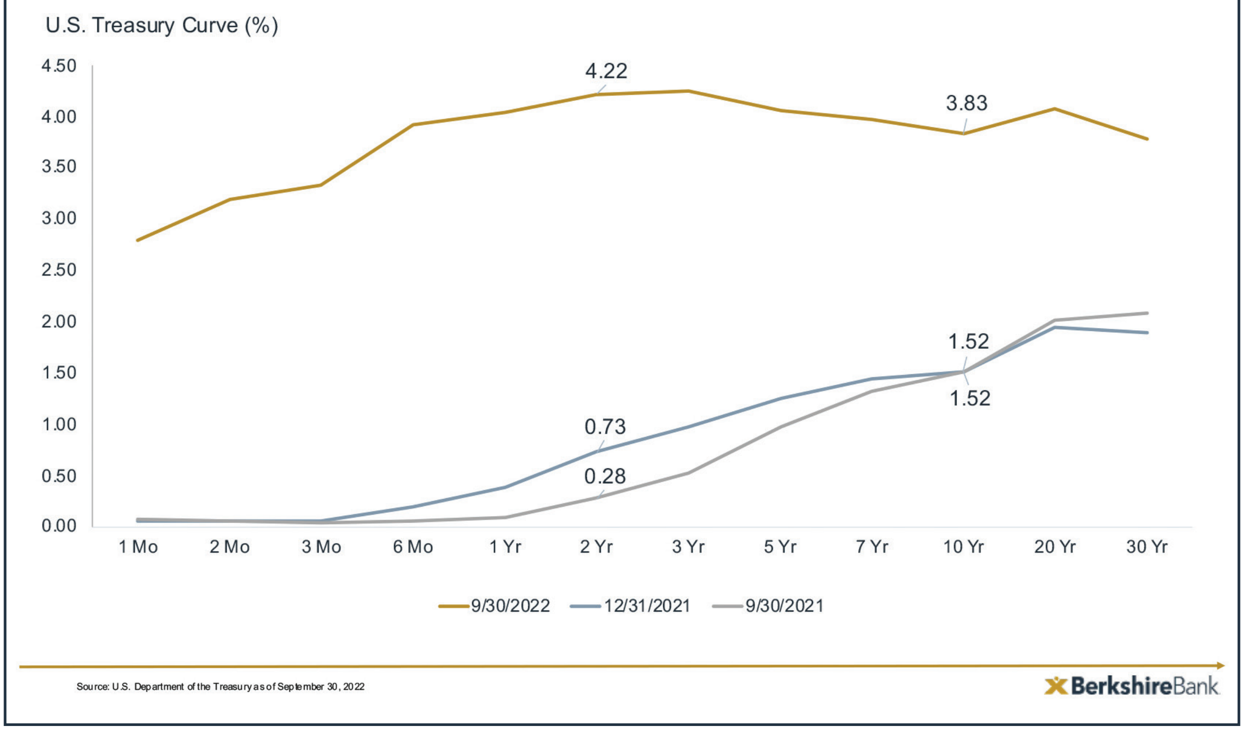
ASSET CLASS PERFORMANCE



Source: Bloomberg as of September 30, 2022

In an effort to fight inflation, the Fed began to tighten credit conditions in March and has since hiked short term interest rates by 3% in just six months with more tightening likely to come. Rising short-term interest rates capture most of the public's attention as higher mortgage rates for new home purchases and increased borrowing rates for the financing of capital projects can be easily observed. Not as much attention is paid to the fact that the Fed is also reducing the size of its $9 Trillion balance sheet by removing itself as the largest buyer of US debt securities. Higher interest rates and lower liquidity in fixed income markets has led to extreme volatility in bond prices, a sector long regarded as being dull with bonds typically serving as stabilizers in portfolios.

YIELD CURVE



This year has been terrible for fixed income investments as prices have broadly collapsed with rising interest rates. Falling bond prices are causing headaches for institutional investors that primarily invest in fixed income such as pension funds and insurance companies, many of whom also used leverage in their portfolios to compensate for the ultra-low interest rates of the past. Monetary authorities are closely watching and providing support to some of these non-bank participants to avert any contagion to the global financial system. Another unintended consequence of the hawkish Federal Reserve policy is this year's stunning rise in the value of the US dollar. The dollar has risen ~18% versus a basket of currencies like the Euro and the Japanese Yen and is the best performing asset class thus far in 2022. A stronger dollar is very inflationary to the rest of the world given that oil and many other key commodities are priced in dollars. Emerging market economies that issue debt denominated in dollars are especially concerned with this trend as they watch their debt burdens balloon.

These various dynamics have caused obvious problems for equities, particularly for nascent unprofitable growth companies that rely on cheap capital to sustain future growth. As economic growth begins to slow due to the dampening effect of higher capital costs, corporate earnings projections are being revised lower and layoffs are being announced. This is happening even for some of the largest and most successful companies that had been steadily expanding operations over the past decade. Not surprisingly, large, well-capitalized "value" oriented companies have performed better this year on a relative basis but even for this group, the rising US dollar is proving to be a headwind to earnings that originate from business operations outside of the U.S.

As in all normal business and market cycles, this one will eventually find a bottom and the seeds for the next economic expansion will take root. Patience is key, especially as many investors have been long conditioned by years of supportive Central Bank intervention in markets. With some luck, inflation will eventually abate, and interest rates will plateau. In the meantime, there are ample opportunities to capitalize on today. Here are some potential action steps for investors to consider:

Fixed income securities now feature attractive coupons and yields to maturity and this higher cash flow may offset any further price declines should interest rates continue to increase. At some point, the risk of a severe recession or credit event will prompt the Fed to pause or even reverse some of its short-term rate hikes. In that event, fixed income investments should do well. Attractive opportunities exist in higher quality fixed securities like US Treasury Bills and Notes and bank Certificates of Deposit. Cash-equivalent money market funds now pay attractive rates of interest and can serve as safe-haven for excess cash balances. The short-term debt of highly rated corporations and/or municipalities with a strong and growing tax base should also be evaluated for potential investment.

Individual investors can use this year's capital losses to offset any capital gains in their accounts to minimize 2022 tax liabilities. Finally, charitable donations and directed donations of required minimum distributions from retirement accounts to qualified non-profit entities can also be used to minimize tax liabilities. We recommend that clients check with their tax professional for specific advice on year-end tax planning strategies.