withum
WEALTH MANAGEMENT

Fall, 2022

Investment Commentary

Summary of the Quarter

As the nation gears up for winter and the holiday season, markets are not leaving investors much in terms of reasons to be cheerful in 2022. Despite the seemingly constant flow of negative news, we aim to provide clarity for what is going on in stock and bond markets and the economy, what investors can expect moving forward, and how client portfolios are being positioned for long term success.

July and August started off well, with the S&P 500 rallying 17% off the June lows in just about two months. The narrative behind that short-lived rally was that despite a Federal Reserve extremely focused on combating inflation, they would appropriately stop raising rates once inflation was under control and accommodate a soft landing – i.e., avoid a recession. But then came Powell's speech at their annual Jackson Hole event.

Higher for Longer

After numerous speeches by almost every current Federal Reserve member and some former Federal Reserve participants, the message was clear: interest rates need to be higher for longer to stop inflation.

In Chairman Powell's own words, there is no anticipation of easing anytime soon, there will likely be some "pain" for the economy, and the Federal Reserve cannot risk an early-80s-style rebound in inflation by prematurely loosening policy. All of this led to a poor end to the quarter, leaving the S&P 500 down -23.9% on a total return basis for the year, firmly in bear market territory.

Through the summer, anticipation of the not-too-distant easing cycle caused financial conditions to actually get looser (i.e. money and the cost of doing business was getting cheaper) while the Fed was hiking interest rates. In the near term, rates were going up, but the expectations were that there would be rate cuts within 12-18 months.

Jerome Powell's Jackson Hole speech might be referred to as a pivotal moment in this bear market. While there are typically relief rallies during bear markets, this summer's rally was unprecedented. Usually, once a market recoups over half of its losses, it does not go on to set new lows. The Fed has since ramped up its harsh rhetoric in telegraphing a continuation of tight financial conditions. It seems more likely that unemployment will rise and demand will get squashed, as the Fed fights inflation. A soft landing seems less likely and concerns about an economic recession followed by an earnings recession dominated the news headlines and continue to permeate consumer sentiment.

Rates, Dollar & Cracks in the System

A consequence of the Fed raising rates so quickly and so much, is that interest rates in the U.S. are now higher than most other stable, developed economies around the world. Overnight rates are 3.00-3.25%, however the six-month US Treasury Bill, as of this writing yields well north of 4.00%. Because U.S. debt is usually viewed as some of the safest debt in the world, many foreign buyers are purchasing Treasuries which is causing a sustained and meteoric rise in the US Dollar. In the last month of the quarter, we have seen parity with the Euro and nearly the Great British Pound – a historic event.

UK GILTS (their form of Treasuries) saw an incredible spike in yields, forcing the Bank of England to step in and provide liquidity to the bond market. In our view, this was the first instance of obvious cracks in the financial system.

Providing liquidity is counterproductive to the goal of fighting inflation – we know that government assistance via stimulus checks and purchasing Mortgage-Backed Securities via quantitative easing is what spurred a massive overvaluation in numerous asset classes. However, sometimes providing liquidity is necessary to avoid catastrophic failure. For instance, the 2008 Troubled Asset Relief Program (TARP) helped to provide a backstop for failing banks and avoid a much bigger financial crisis.

The Fed's Quandary

So here in lies the rub – the Fed needs to slam on the proverbial "economic" brake to destroy demand. If there is no demand, merchants can't keep raising prices. If retailers can't sell as many goods, forecasted revenues and earnings estimates will come down. Companies will pause hiring, possibly lay off workers, who will, in turn, further reduce spending. The above sequence of events is what typically happens in a recession. The Fed accomplishes this by making the cost of money and doing business more expensive via interest rate hikes.

The Fed, however, has a dual mandate. Their responsibility is to keep price stability (inflation in check) while maximizing full employment (keeping the unemployment rate low). In the current environment, it seems impossible for the Fed to accomplish both of their goals together. Based on recent language from Chairman Powell and other Fed governor speeches, they seem willing to put aside the "maximum employment" tenant in favor of achieving price stability.

Hindsight is 20/20, but it is clear to us now that the Fed was too accommodative for too long. Just as a pendulum swings, gravity will be painful, and we are likely to see the Fed eventually overcompensate and keep monetary policy too tight for longer than is needed.

Where Do We Go From Here?

It has been a challenging year, and we anticipate continued elevated volatility as the Federal Reserve continues its hiking path in its effort to fight inflation. We also share a few observations:

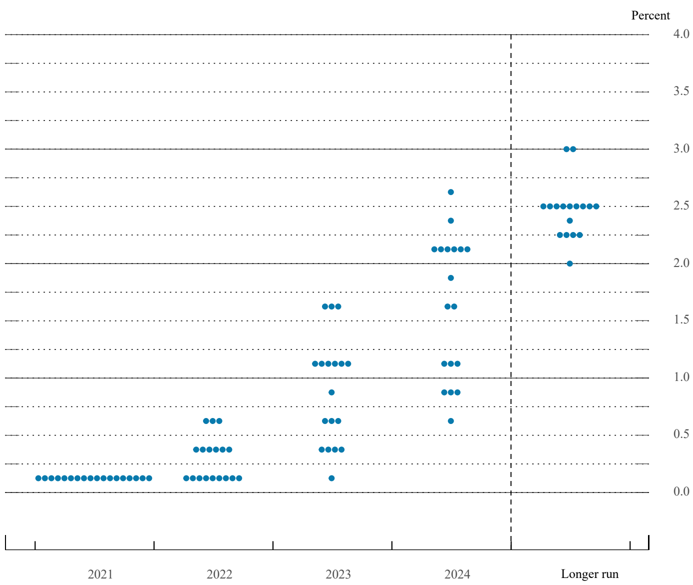
- The economy is likely to get worse, before it gets better
- The market is forward looking, anticipating future earnings of companies and can bottom many months before the recession is over
- The market bottom will likely feel like the worst time to invest
- There are alternatives to traditional stock and bond portfolios
- Stocks will likely remain a good inflation hedge due to their higher, real, long-term returns

The investment landscape, despite all the negative points we have explained in this writing, is much better today than it was a year ago. The stock market was higher then, however forward-looking multiples on earnings were at euphoric levels, not seen since the tech bubble. We all know how that ended. Today, multiples are lower, possibly with more room to contract, but this presents a brighter picture for forward returns and room for optimism to return and send stocks higher in the long run.

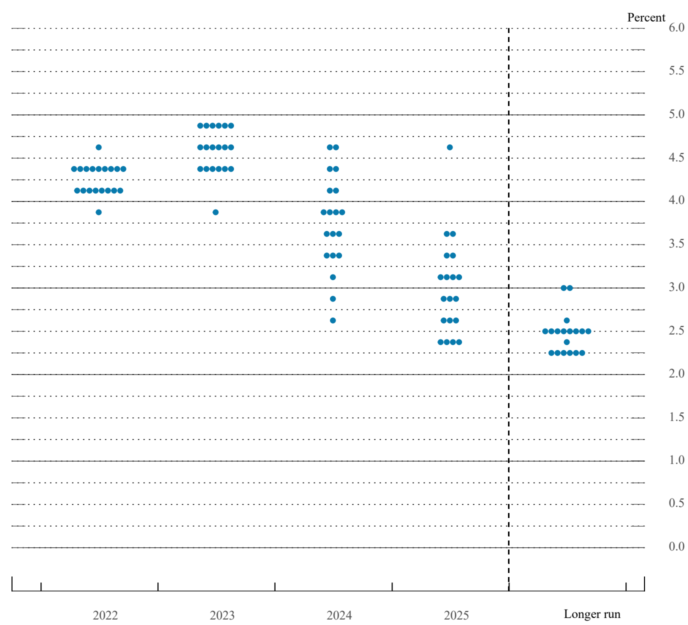
A year ago, the yield on cash was virtually zero. Amazingly, as you can see in the left chart below, the Fed only forecasted three, 0.25% rate hikes in all of 2022 at most. In fact, half of the Federal Reserve voting members envisioned rates ending 2022 still at 0%. Today, depicted by the chart below, overnight rates are expected to be between 4.00 and 4.50% by the end of this year. This means that cash yields are much better, versus next to nothing a year ago. Finding corporate debt yielding more than 4% last year was difficult and required investors to pay a premium, now we can have a cash equivalent, backed by the full faith and credit of our government, that yields nearly 4.50% for a year.

FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level or federal funds rate

For release at 2:00p.m., EDT, September 22, 2021



For release at 2:00p.m., EDT, September 21, 2022



Note: Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. One participant did not submit longer-run projections for the federal funds rate.

Source: Federal Open Market Committee

There is no question that current interest rates are slowing economic growth, but investors can utilize the rise in rates to position their portfolios to help achieve their goals. Understanding your goals and sticking to your financial plan is imperative and we can currently receive healthy returns while taking on less risk than we needed to in the not-so-distant past.

To be clear, we are not advocating for selling stocks at this point, but rather to remain disciplined and maintain a long-term perspective. As we just discussed, any time earnings multiples are at or below historic norms, this suggests positive and favorable returns for the years ahead. The chart below shows some recent time periods where the S&P 500 was down -25% from the highs like we find ourselves at quarter end. While the average decline was ultimately more than -25%, possibly implying more downside to come in the near term, the forward returns over the next several time periods were significant.

When the S&P 500 is Down 25% or Worse Since 1950

Peak	Trough	% Decline	+1 Year	+3 Years	+5 Years	+10 Years
12/12/1961	6/26/1962	-28.0%	31.2%	69.2%	94.8%	171.1%
11/29/1968	5/26/1970	-36.1%	32.2%	44.3%	27.9%	97.5%
1/11/1973	10/3/1974	-48.2%	1.4%	23.8%	42.0%	188.4%
11/28/1980	8/12/1982	-27.1%	43.9%	81.2%	238.6%	403.9%
8/25/1987	12/4/1987	-33.5%	14.7%	34.1%	96.8%	387.1%
3/24/2000	10/9/2002	-49.1%	0.2%	1.9%	21.5%	38.3%
10/9/2007	3/9/2009	-56.8%	-6.9%	3.7%	61.2%	209.6%
2/19/2020	3/23/2020	-33.9%	56.4%	???	???	???
1/3/2022	9/30/2022	-25.2%	???	???	???	???
Averages		**-37.6%**	**21.6%**	**36.9%**	**83.3%**	**213.7%**

Data Source: Ycharts

Closing Thoughts

In closing, we understand the risks facing both the markets and the economy, and we are committed to helping you effectively navigate this challenging investment environment. Successful investing is a marathon, not a sprint, and even extended bouts of volatility like we've experienced over the past nine months are unlikely to alter a diversified approach set up to meet your long-term investment goals.

Therefore, it's critical for clients to stay invested, remain patient, and stick to the plan, as we've worked with you to establish a unique, personal allocation target based on your financial position, risk tolerance, and investment timeline.

Rest assured that our entire team will remain dedicated to helping you successfully navigate this market environment.

Please do not hesitate to contact us with any questions, or comments, or to schedule a portfolio review.

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WEALTH MANAGEMENT

Need More Information? Please do not hesitate to contact a member of the Withum Wealth Management team with any questions or concerns:

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