October 7, 2022

Are We There Yet?

Dear Investor:

Stocks and Bonds have both delivered the worst returns in 2022 since the 1970's. It's been a very difficult and painful year for all of us. There's really been no place to hide from the declining markets. In the middle of June, the SP500 hit an intraday low of 3636.87 and then went on a summer rally for the next two months. The rally came to a fairly abrupt end when Fed chair Jay Powell spoke at Jackson Hole on August 26th. I listened to his speech and was amazed at the time; it was only 9 minutes long. He made several main points:

- We must have price stability. A failure to restore it will mean even more pain down the road.
- A single month's improvement in the inflation data is welcome, but not adequate.
- They cannot stop raising rates at the estimate of the long run neutral rate.
- The current situation will likely require maintaining a restrictive policy for a longer period of time. It is not desirable to stop too soon.
- They are determined to win the fight against inflation.

It turns out later that Mr. Powell stated he made the speech so short to focus the market on only ONE point, they intend to fight inflation. The market had been rising on some vague idea that the Fed was already in a position to stop raising rates. I genuinely thought there was no case at all for that, and told clients all summer it was a bear market rally, not to get their hopes up. From Powell's speech until the end of September, the market worked its way back down. It just made a new intraday low of 3584.13 on September 30. Thus, we are back where we were in June.

A commentator on CNBC stated "We have chopped a lot of wood, but there's more wood to chop". For some reason the comment stuck with me. I think it's an accurate description of our current situation. The SP500 is down over 1,000 points, more than 20% since the beginning of the year. I'm sure you know that meets the commonly accepted definition of a bear market. Many high-flying stocks are down much more than that. We also know there have been significant interest rate increases, with more likely to come. The speed of these rate increases has slammed the bond market. Bonds usually help us to buffer the stock market's volatility, but that's not happening now. The AGG bond index has been down in the range of 15% for the year, which is huge for that market. As I explained in the past, the Fed should have started to raise rates much sooner than they did.

Looking ahead, there's more wood to chop. The Fed Funds interest rate futures curve is currently predicting that the Fed Funds rate will peak around March or May in the range of 4.5% to 4.75%. This is not set in stone. It can, and likely will, change as new data points emerge each week. However, it does give us an idea of what might be ahead. The bond market is expecting rates to continue to go up into the spring of next year. The purpose of the rate increases is to slow the economy and thus the inflation rate. Interest rates and bond prices move in opposite directions. As long as rates are rising, there will be direct pressure on the bond market and bonds will continue to decline. There's a good chance we have not reached the bottom on our bond positions.

In a slowing economy we have to consider what will happen to company earnings. At the beginning of the year, the market was expecting the SP500 to earn around $223 to $224 in 2022. As of Sept 30th, they are still expecting around $224 according to Factset. What has changed drastically is the P/E ratio that the market is willing to pay for these earnings. At the beginning of the year, the Forward P/E ratio for the SP500 was about 21.3. At the end of September, it had dropped to 15.4. This is over a 27% decline and reflects the sharp drop in the price of stocks. Based on historical data, this is a much better price to pay for the earning power of stocks. The earlier P/E of 21.3 is considered bubble territory and was a result of the massive pandemic stimulus.

Now that we are back to a much more comfortable price level, what can we possibly expect? With the rising rates coming as discussed above, there is a big risk that the economy will slow too much or go into a recession. In that case, we will see analysts lower their earnings expectations for the SP500. This has already begun to a modest degree. In fact, taking a closer look at our current market, it has really been held up by the big move in the energy sector. If you take that out, earnings have already been declining this year. If earnings decline substantially, I would expect the market to move lower. If the Fed is able to make that elusive soft landing, perhaps earnings will hold up. In that case, the bear market could be close to an end.

A year ago, the outlook for US GDP growth for 2022 was 4%. We had negative growth the first two quarters of this year. The Conference Board currently states that due to persistent inflation, and rising hawkishness by the Fed, they expect real GDP growth will come in at 1.4% this year, and 0.3% in 2023. There are already some signs things are beginning to slow. The housing market is the biggest one with mortgage rates close to 7%. Mortgage applications are way down and the refinance market is virtually dead. We also know the Fed is very focused on taking some heat out of the labor market, and there are a few signs on the edges that it may be starting to slow down. On balance, it seems clear to me that this is going to take more time. We aren't there yet, we have more wood to chop, but we are a lot closer to the end of this.

I do think we will have two more rate increases this year and expect Fed funds to be at least 4% by the end of the year. After that, I have to wonder if the rates will go as high as currently expected in the futures market. Things are slowing and the economy is not that strong if you look under the hood. As I mentioned above, earnings for many companies are already declining. If Fed funds get to 4% or more by the end of the year, mortgage rates will be close to 8%. I have a hard time seeing our economy being able to handle that. Rates for autos, and other forms of consumer credit will also be very high. A lot of consumer spending the last year and a half has come from government transfer payments that were handed out during the pandemic. Those programs are over, and most of that money is already spent. According to the big banks, people are using their credit cards again to fill the gap, and they are putting more money in reserves for bad loans. Thus, I think there is some chance that things may slow down faster than currently expected. If that happens, I believe the Fed may pause or end their current rate hike program earlier than expected. If that were the case, we might be able to get the rest of this bear market behind us and start making some money again.

I noticed something in reviewing my information to write this letter that really stuck out to me. Before the pandemic hit, on Feb 19, 2020 the SP500 closed at the former bull market high of 3,386.15. The recent low close on Sept 30, 2022 of 3,585.62 was only 5.9% higher. Why mention this? Here we are over two and a half years later and the market is only up 5.9%. It shows me that all the money printing and government debt that we did to fight the pandemic did not produce real prosperity. It did get us past the pandemic, which is no small thing to be sure, but there's really no lasting value. The whole thing was a big bubble, and now we are forced to let the air out or inflation will do substantial lasting damage, as most people experience a long-term reduction in their standard of living. It's food for thought. There's No Free Lunch.

To pull all this together in a simple statement, I do think the bear market has further to go at this time. If I'm wrong, we will all be much happier as both our stocks and bonds begin to recover. We want to thank all our clients who have been incredibly patient going through this hard time. We have to remember the basic premise of investing: no risk, no reward. We've all taken that risk to make higher returns than cash. This is what we signed up for, but it's been a hard this year. In due season, the bear market will end. They all do, and we will begin to experience reward again. Please contact us anytime to discuss your portfolio or financial goals.

Best Regards,

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