
# 3Q 2022
# Market Commentary

U.S. financial markets posted another round of negative returns for the third quarter of 2022. With the S&P 500 down over 5% and the 30-year Treasury Bond return even worse, down over 16%, there weren't many places to hide. The rise in interest rates hurt prices and returns for inflation-hedges as well, including many commodities and gold. Cash was King!

The quarter didn't start out this way. From the June 15th lows, stocks, particularly the NASDAQ, rallied significantly into early August, regaining nearly half of the first half losses. But by quarter end, broad market indices gave back all of these gains and then some to hit new year-to-date lows. Here are the ugly year-to-date results through September 30th: S&P 500 fell nearly 24% and the 30-year Treasury Bond over 30%. Investors should have called the intra-quarter rally, "the little engine that couldn't." We remained skeptical as economic headwinds stiffened, particularly in September.

The drop in the JOLTS report in early October (from approximately 11 million jobs to 10 million jobs available) seems to indicate the job market is weakening somewhat, even while overall labor demand in the broader economy remains relatively strong. Statements from large S&P 500 companies about hiring freezes and pending employment reductions seem to support this.

Yet, in its public statements, the Federal Reserve Board and Chairman Powell appear to be holding firm to their policy of continued increases in the Fed Funds Rate. Their goal is to dampen the job market and therefore the price inflation pressures they believe come from the strong growth in new jobs and wages. As the quarter came to an end, much of the coming economic pain appeared to be discounted in the market along with renewed hope that the Fed will turn away from its plan to raise the Fed Funds Rate to 4.6% by March of 2023.

We find it very interesting that the United Nations stated its concerns regarding coordinated central bank rate increases. We would not disagree that such swift and extensive rate increases are likely to create problems for most emerging economies. We are of the opinion that just as their past actions resulted in perverse risk taking, central banks may once again overshoot in the other direction and be responsible for many unintended consequences. With the strength in the exchange rate of the U.S. dollar, foreign central banks are being forced to follow suit with the Fed's rate increase plans. While moving away from negative interest rates will be a long-term positive for the U.S. and world economies, the shock of the massive rate increases is likely to create near-term economic pain.

Furthermore, the Fed is attacking the wrong problem in focusing on slowing employment growth and reducing jobs as a way to reduce aggregate demand. New jobs create more supply not less and should reduce supply chain bottlenecks. Yet, the Fed doesn't have many other levers but to cause employment to go down in order to cool the economy and weaken price pressures. It's a blunt tool with the wrong focus. Unfortunately, Chairman Powell gets no help from federal government policy to reduce its deficit spending spree that contributes to aggregate demand and instead stimulate the supply side of the private economy. Thus, in our view, it will be tough to bring price inflation down to the Fed's 2% target. We believe the Fed is likely to eventually drop this 2% target and may be forced to accept a higher target as it recognizes that reaching 2% would inflict unbearable economic pain.

Oil prices are well below the level that existed prior to the start of the war. With U.S. oil inventories continuing to shrink, energy price weakness over the summer still appears to be a temporary respite. We are currently in the shoulder months, a time when inventories typically build due to somewhat slower seasonal energy demand. As we approach winter months, however, shortfalls and distribution bottlenecks tied to the energy infrastructure are likely to overwhelm any recent benefits reached by attempting to reduce global dependence on Russian oil and gas supplies. Therefore, unless a major change occurs in Russia's war with Ukraine, energy prices are likely to remain elevated or even increase over the winter.

We are likely to see continued volatility in supply chain prices for some time to come, something that will be reflected in cost-push inflationary forces. This informs our conclusions on higher normal rates of inflation going forward. All of these forces are likely to display themselves in stagflation with global growth below 2% and inflation above it. Such an environment will not be beneficial to the maintenance of high multiple equities. Rather, we are much more likely to continue to see a gradual erosion in terminal valuation multiples. The most highly valued stocks are likely to see the greatest declines over the next few years. Thus, regardless of interim market rallies, we have not abandoned our caution about the outlook for financial markets over the balance of 2022.

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