# Market Commentary

Third Quarter 2022

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The third quarter of 2022 was another frustrating period for investors as recessionary fears and stubbornly high inflation reports combined to drag down financial asset prices. For the first time in nearly 40 years, the Federal Reserve is fighting persistent inflation and many investors have not experienced steadily rising interest rates for more than a few months in their investing lifetime. US stocks, as measured by the benchmark S&P 500 Index, decreased by 4.9% on a total return basis during the three-month period. This brought the YTD return on US equities to a sobering -23.9%.

Fixed income yields increased during the quarter, as the Fed continued to raise rates at a far more aggressive pace than most had expected. Although the rapid Fed pace will dramatically shorten the tightening cycle, interest rates flow through the economy with a lag, estimated at anywhere from 6-18 months. This means we are only now seeing some of the effects of the initial hikes in March. The rapid tightening in financial conditions raises the chance of a potential misstep by raising rates too far too fast. The Fed has been scrambling since early this year, trying to get a handle on runaway inflation expectations, which were exacerbated when the Fed stayed static while inflation pressure took hold during 2021. The $1.9 trillion "American Rescue Plan" signed into law in March 2021 added inflationary fuel as it dumped large sums of cash into an economy that was already well beyond crisis mode and on its way to a natural recovery. While other developed countries are seeing higher overall inflation rates than the US, it is mostly due to energy price spikes in those countries. The US has among the highest core inflation growth among OECD nations, which we believe is due to the supply/demand imbalance intensified by the American Rescue Plan. In our last commentary we noted that the Fed, "*can either continue raising rates methodically which will likely slow the economy further, or they can pull back on rate increases which could let inflation take hold*." The Fed has apparently chosen the former, which is far better for the longer-term, although it likely comes with some near-term pain.

## Economic and Market Outlook

The benchmark 10-year US Treasury note ended the quarter at 3.83%, significantly higher than the 2.97% yield on June 30, and more than double the 1.51% at year-end 2021. To say the Federal Reserve has been behind the curve is being charitable. As an example, in late September 2021 (one year ago), there was not a single Fed member that expected the Fed Funds rate to be as high as 1% in December 2022. To be fair, most economists and strategists were wrong but to differing degrees. We had long implored the Fed to move earlier than they did, writing in our 3Q 2021 commentary "*we still believe the Fed risks waiting too long and allowing inflation to remain higher than current forecasts*." This was when inflation was running around 5%. Even we did not see inflation surpassing 9% and the Fed having to push short-term rates towards 4% or higher by late 2022. Aside from interest rate hikes, the Fed is also reducing its bloated balance sheet, allowing $95 billion a month in securities to roll off without reinvesting the proceeds. While nobody knows how long Quantitative Tightening will last, Powell has said it could go on for two or more years. At the current rate, this could reduce the Fed's balance sheet from over $9 trillion to about $6.5 trillion. The combination of rapid large rate hikes and the sale of bonds from the Fed's portfolio increase the chances of a Fed miscalculation. There are three risks in every tightening cycle.

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Historically, the Fed tends to start too late, raise rates too high, and keep rates too high for too long. We know they started too late in this cycle, leaving the last two risks on the table. If they come to fruition, it increases the chances of a deeper or longer recession than currently anticipated. Even though we think a mild recession is likely – or already underway – we are not counseling widespread selling of stocks and bonds. Stocks have declined almost 25% from their peaks and bonds have experienced their worst two-year period in generations. Thus, both asset classes are meaningfully cheaper than they were 12-18 months ago. Looking at markets from a longer-term perspective, we believe a significant part of the speculation and overvaluation (particularly in fixed income) has been removed.

The price for benchmark West Texas Intermediate began July at $105.76 and declined during the quarter, to end September at $79.74. This reduces the YTD price increase to 5% and brings oil to a level below where it was when Russia invaded Ukraine in late Winter. Our estimate for the fair value of oil, absent the current geopolitical tensions, remains in a range of $70-$90 per barrel. However, we expect oil could surpass the higher end of that range while the conflict in Ukraine continues. Also, we would be remiss if we did not point out the effect of the Biden administration releasing significant reserves of oil from the Strategic Petroleum Reserves over the past six months. As of mid-September, the SPR held 427 million barrels, down from 618 million at the end of September 2021, and the lowest level since 1984 when the SPR was initially being built up. If we assume the releases from the SPR will cease shortly - the current authorization expires in October 2022 - and be followed by oil stocks rebuilding, the government will switch from being a seller of oil to a net purchaser. This could tilt the supply/demand curve and push prices higher than they otherwise would be in 2023 and 2024, depending on the rate of oil purchases.

While stocks are currently 25% cheaper than they were at the start of the year, we believe earnings estimates need to decline further reflecting higher input costs, wage hikes, and higher borrowing costs which means stocks may not be as inexpensive as they currently appear. Earnings estimates for the S&P 500 for 2022 have declined in recent months, and we expect 2023 estimates will decline further in coming months as well. As investors reset earnings expectations, we believe the market declines this year already factor much of this into current stock prices. The September 30 valuation of the S&P 500 is approximately 15.4x forward earnings estimates, which is below the 25-year average of 16.85x and significantly below the 22x forward estimates during 2021. However, with our belief that estimated earnings for 2023 are too high by approximately 5-10%, this brings the current valuation close to the historical average if earnings fall short of current expectations next year as we project.

We have previously addressed our belief in why it makes sense to own fixed income and we have not altered our views. The precipitous spikes in interest rates across the maturity spectrum has functioned as shock therapy to investors. As an example, two-year Treasury Notes ended 2021 yielding 0.73%. On September 30, the two-year note was yielding 4.27%, a nearly sixfold increase! While not diminishing the declines bond investors have experienced over the past 12-15 months, we counsel perspective. The same investors who had no issue buying 10-year bonds with rates below 2% a year ago, are now balking at buying shorter-term bonds with rates over 4%, when they are much more reasonably priced. Real GDP growth declined again during the second quarter of 2022, falling by 0.6% after a 1.6% decline in the first quarter. Although most economists define a recession as two consecutive quarters of declining real GDP, the jury is out on whether we are currently in a recession. Tandem's view is that if we are not already in a recession, we likely will be within a few months, although expectations are for a shallow and short recession. Few of the excesses that are historically present at the start of recessions can be seen today.

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It is difficult to see a deep recession with the very strong employment situation we currently enjoy. When Fed Chair Powell spoke in late August, he said, "*Reducing inflation is likely to require a sustained period of below-trend growth. Moreover, there will very likely be some softening of labor market conditions. While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses.*"

We believe current Fed forecasts for unemployment remain too rosy and the unemployment rate will likely move above their projections. However, coming from the current generational lows, a modest increase should be expected as the Fed leans heavily towards the price control side of its dual mandate. Looking at the current components of inflation, we believe that continued stability in energy and commodity prices alone could bring the inflation rate down towards 5-6% by year-end. Further improvements in the supply chain could knock another percentage point off the inflation rate. However, getting the rate down from 4-5% to the Fed's 2% target will require time and some economic pain – particularly in the job market. At its September meeting, the Federal Reserve released its updates for economic growth. They cut expectations for real US GDP to rise by a meager 0.2% in 2022, down significantly from 1.7% at their June meeting. 2023 estimates decline from 1.7% to 1.2%. Surprisingly to us, the Fed still does not expect the unemployment rate to surpass 4.4% during the next three years which if true, limits the depth of any recession we may experience. Whether or not we are in an official recession, it is clear the economy is at stall speed. The "dot plot" of expected future rates now show the Fed expecting to raise rates by 75 basis points in November, 50 basis points in December, and an additional 25 basis points in the first quarter of 2023. We continue to believe the Fed remains too optimistic regarding its growth and unemployment forecasts if they stick to their interest rate hike forecasts.

**Portfolio Positioning**

Tandem has continued to reduce relative valuations in portfolios throughout 2022, focusing more on dividend yield, cash flows, and quality as measured by financial strength. With earnings estimates for many companies likely to come down, it is critical to preserve and protect capital as much as possible. Companies and investments with the ability to continue to grow despite the headwinds currently present in the economy should be favored. While acutely aware that nobody likes to see the value of their investment portfolio decline, we have long counseled against market timing. Markets can turn on a dime with investor sentiment bouncing between fear and greed several times over the past few months. We remind you of the Wall Street proverb, "Nobody rings a bell at the bottom." Instead, we advocate prudent, risk-aware investing. This style of asset preservation and protection investing will allow portfolios to decline less than market indices during market pullbacks, which is one of the primary factors in building long-term wealth.

**Conclusion**

While many may lament the Fed's aggressive moves thus far in 2022, we believe they are on the correct path. We think they waited far too long to increase rates which led to asset prices getting frothy – particularly in the housing market – but agree with their current stance. We detected a meaningful change in the Fed's commitment to price stability earlier in the summer. It began with the June FOMC meeting, where everybody was prepared for a 50-basis point increase and the Fed surprised us by hiking

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75 basis points following a hot inflation report days earlier. The Jackson Hole speech by Powell in late August was a second event that convinced us of the Fed's dedication to price stability. Powell has told insiders that he had a different speech prepared, but markets had been running higher in anticipation of a "Fed pivot" towards rate cuts. To quash this behavior, Powell delivered a blunt and simple message – the Fed was willing to accept a recession as the price of getting inflation under control. These two events, along with the press conference following the September FOMC meeting, give us confidence the Fed remains committed to getting inflation under control. While there will be some economic pain involved, it will be mild compared to what could happen if price increases become embedded in the economy. One only needs to look back to the 1972-1982 period to see what long-term, high inflation does to financial markets.

We understand that emotions can run high during volatile periods. Emotions interfere with investment strategy as investors watch daily market movements and get caught up in the news headlines. We strongly advise ignoring the day-to-day movements and focus on where the economy is going over the next 18 to 24 months. The stock market is a discounting mechanism and investors will price in 2023 and eventually 2024 earnings over the coming months. What is occurring today was priced in months ago. Conviction in a risk-aware investment strategy helps investors stay focused during times of angst. We are still playing defense by protecting the downside until we believe the risk-reward outlook has improved. By retaining perspective and focusing on where the economy and companies can likely be in the future, investors can position themselves for the upcoming rally. Although we do not know when it will begin, we are certain that better times for investors will follow this bleak period as the excesses of the past few years are worked off. While we believe the chances of a recession in the next 12 months are extremely high, we again reiterate our conviction that barring a major misstep by the Federal Reserve, the recession will be short and shallow. We believe the declines in both stock and bond prices since late in 2021 have put more favorable conditions in place when considering a three-to-five-year investment time horizon.

As always, we request that you inform us of any significant changes in your financial situation. Please let us know if you have any specific questions or concerns about your investments.

September 30, 2022

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