Patience Not Pessimism

Q3 2022 Report

Concord Asset Management

Patience Not Pessimism

Key Observations

- Inflation is proving more stubborn than anticipated, with the Fed getting increasingly hawkish and markets becoming more skeptical of a "soft landing."
- A steady decline in asset values so far this year (i.e., a collapse in growth stocks and a correction in bond prices) has created attractive valuations in many asset classes.
- Higher interest rates are having mixed impacts on the economy (e.g., the housing market has cooled significantly, but savers are now able to actually earn an attractive return on their savings).

Economic Commentary

At the end of the third quarter, inflation was still the hot topic on everyone's mind, especially after the Federal Reserve's decision in September to implement a third consecutive rate hike of 75 basis points. Inflation ticked up in August after declining in July and stubbornly remained above 8% on an annualized basis, despite gasoline prices continuing to fall steadily since the end of June.[1]

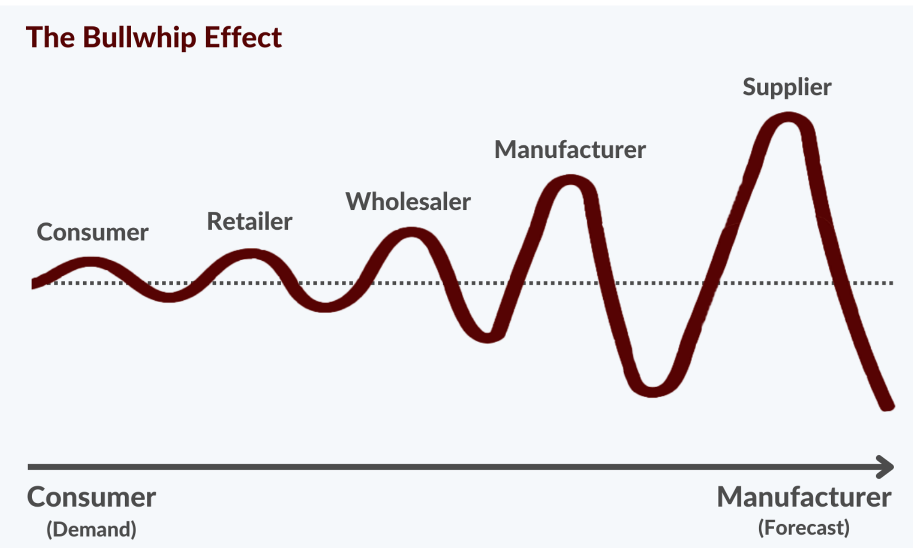
The Fed is determined to get a grip on inflation and is bound to do so eventually. As Fed Chair Jerome Powell said after the group's September meeting, they will "keep at it until the job is done."[2] Fed officials see rate hikes continuing into 2023, not exceeding a "terminal rate" of 4.6%, with the goal of pulling inflation back down to 2% by 2025.[2]

Markets now understand that the Fed's mission, which includes a pull-back on asset purchases, will come with a short-term cost and potentially some economic pain. At a news conference in September, Powell was explicit, "We have got to get inflation behind us. I wish there were a painless way to do that. There isn't." So the question becomes: how painful will it be? No one knows.

Here at CAM, we have been setting expectations for some time that the U.S. will not likely see a V-shaped recovery after any potential recession (i.e., a rapid recovery, nearly to pre-recession levels). But how deep any recession may be—and how long it lasts—will likely depend on how quickly the Fed can end its tightening policies.

This challenging economy is still somewhat of a unicorn, continuing to show many signs of strength.

Typically an economic slowdown is accompanied by rising unemployment, but today's job market remains competitive. As inflation burned hot in August, payrolls continued to expand, with non-farm jobs expanding by 315,000. Unemployment remained below 4%, labor force participation gained, and wages rose. The chief investment strategist at Charles Schwab told CNBC, "This could very likely be a recession where you don't see the kind of carnage in the labor market that you see in most recessions."[3]



Source: Seegrid Corporation, April 20, 2020

Businesses have continued to invest, with capital goods expenditures reaching a seven-month high in August, according to the U.S. Commerce Department[4]— another potential argument against a deep recession.

Furthermore, some of our current economic pain and price inflation can still be chalked up to the "bullwhip" effect of mismatches in supply and demand. COVID disruptions to the supply chain have yet to unwind fully, while consumer demand snapped back more quickly than expected and then slowed toward the end of summer. Such mismatches continue to roil the economy.

Ford announced last month that it has more than 40,000 pick-up trucks it can't finish building for lack of parts.[5] Consumer appliance maker Whirlpool is experiencing component shortages.[6,7] Natural gas is in short supply heading into the winter season, not just because of the war in Ukraine but also because electricity providers had to draw down gas reserves to meet surging demand during an unusually hot summer.[8] Supply shortages, bad weather, war, labor shortages, and high consumer demand are squeezing the markets for everything from tires,[9] to frozen vegetables,[10] to Halloween candy[11] and Christmas trees.[12]

At the same time, some sectors of the economy definitely are showing signs of weakness.

Retailers are finding themselves with too much inventory of the things they can get as consumer spending has slowed. Amazon recently announced its second Prime Day-type sale for 2022, when it normally has only one such event per year. Walmart and Target are planning an early start to their holiday shopping sales. Such efforts, using discounts to reduce inventories, could help bring down prices over the remainder of the year.[13] Overstocked inventories are also causing a ripple effect through the transportation industry, with global shipping beginning to slow as well.[14]

While rent remains high, the market for home purchases has finally begun to soften. Price increases are slowing, home sales dipped half a percent in August,[15] and the senior economist for Realtor.com recently said that “the upward momentum has lost steam, and it is clear that the market peak is now firmly behind us.”[16]

So, when you add it all up, it would be an understatement to say that economic signals are mixed. The Fed’s war on inflation may slow the economy and cause a marginal increase in unemployment, perhaps even a recession. However, many parts of the economy will only be slowing from a white-hot level that we believe is objectively unsustainable, and supply issues will eventually slowly sort themselves out. In sum, we’d argue it’s a time for patience and caution, not pessimism.

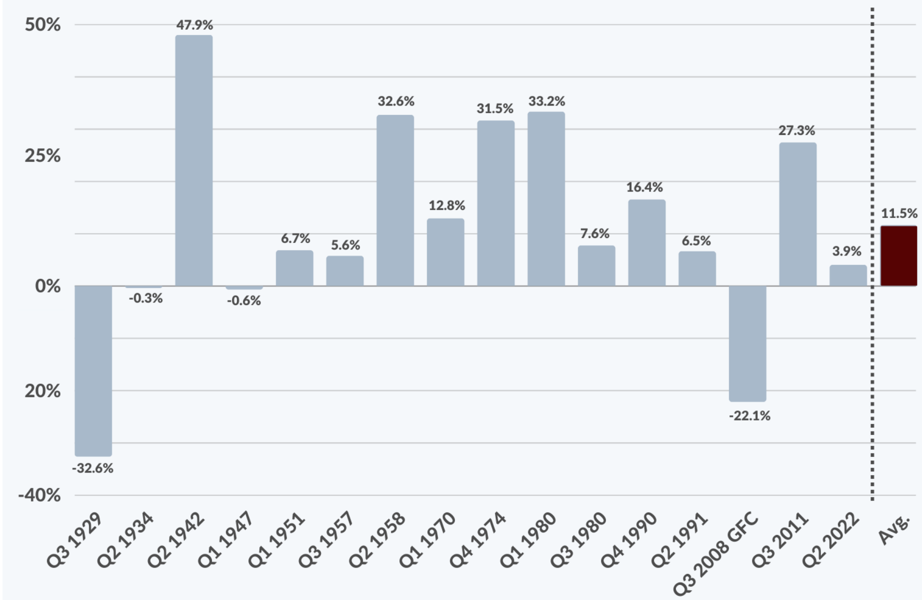
Market Commentary

The thing to remember about securities markets is that assets are priced on a forward-looking basis. Essentially, prices reflect future events and earnings, not current ones.

As such, market retrenchment during the third quarter was likely driven by investors finally coming to terms with the fact that the Fed will not let up any time soon on its inflation fight. Rates will continue to rise, and some sort of recession is more likely than not.

Equity Performance Following Prior Inflation Peaks

S&P 500 return 12 months after peak inflation, 1927-2022



Source: BlackRock Fundamental Equities, with data from Bloomberg and National Bureau of Economic Research (NBER)

Moreover, economic forecasts for the U.S. have come down from 1.7% annual GDP growth to just about zero this year (0.2%) and less than 2% annually through 2025.[17]

So, even though stocks recovered from July through mid-August, they pulled back again through the end of September as a “soft landing” scenario became less and less likely. The S&P 500 peaked on August 16 at just over 4,300 and with the exception of a brief rally in mid-September, slid steadily through the quarter end, even flirting with bear market territory. The S&P 500 is off about 23% from its high in Q4 2021.

The DOW showed a similar pattern, peaking on August 16 and then sliding into bear territory on September 23, with the DOW currently off about 15% from its high in Q4 2021. The biggest losses by far, however, have been seen in the tech-heavy, growth-oriented NASDAQ, which peaked on August 15 and approached bear territory by the end of September. The NASDAQ is down about 32% from its peak in November 2021, as high inflation tends to take a bigger toll on growth stocks compared to other sectors of equity markets.

Bond investors are also feeling the pain in 2022, with longer-term issues (10+ years) getting hit hardest in the third quarter since they are most sensitive to changes in interest rates. According to Morningstar, every one of its taxable bond categories is in the red for 2022, through mid-September. The least-impacted sector of fixed income has been ultra-short bank funds and high-yield has held up better than most, only down about 10% as of mid-September.[18]

The bright spot in all this negative news is that price-earnings ratios for stocks—especially growth stocks—are at some of their most attractive levels in years. In the case of a shallow recession, equities may be positioned for a strong bounce. Bond yields, which tend to overshoot in both a positive and negative direction, may now also offer significant value as the Fed's rate hike regime approaches its finale, likely in the early part of next year.

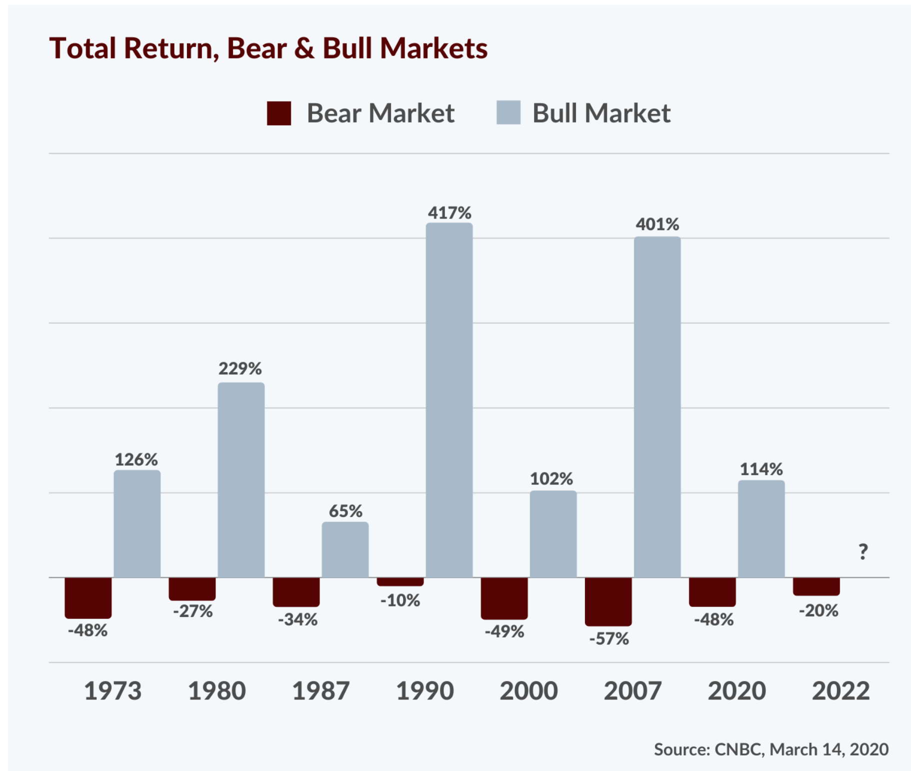
Final Thoughts

In principle, we believe that long-term investors should remain invested across market cycles and that trying to time the ups and downs of market cycles is a fool's errand.

This time around, the Fed has embarked on an important task. While we don't want to underestimate the challenges of a recession, like many investors we believe that the perils of high inflation are worse. Remember that those of us under the legal retirement age have never lived through a prolonged period of high inflation. We have never seen firsthand the destruction of it. Also, remember that while inflation is high in the U.S., relative to recent history, it remains higher around the world.

We believe that the U.S. will come out of this difficult period with a stronger economy and more rational valuations across a wide range of asset classes. This may set the stage for strong investment returns:

- The average S&P 500 return in the 12 months following an inflation crest was 11.5%[19]
- The average 12-month [equity] return immediately following a 15% or greater decline is 55%.[20]
- Bear markets average 14 months in length with an average return of -33%, a relatively short time compared to bull markets that average 71 months and an average total return of 263%.[20]



Rather than seeing this as a time for pessimism, we see it as a time for cautious opportunism, particularly around financial planning work. For example, with interest rates on CDs creeping toward 4%,[21] one can finally earn an attractive return on savings. Many Americans have hesitated to even save an emergency fund given the dearth of return on savings, but now may be the time to reassess one's allocation to cash savings, which is likely an under-invested portion of their financial plan.

Now may also be a good time for tax planning, such as exiting legacy positions that may have been difficult to liquidate when asset values were higher. Given where asset values are today, there may be an attractive opportunity to execute any pending Roth IRA conversion.

In short, we believe in staying on the long-term course. Investors are experiencing the end of the longest bull run in American history. Markets have been and will likely remain choppy. Growth is expected to be tepid. We may see a recession. Global supply issues may take longer than we'd like to work themselves out.

Recessions and market corrections are the anomalies. Recoveries, however, often happen faster than anyone expects, so steadiness and patience are key to riding out any coming storm.

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Concord Wealth Partners built Concord Asset Management (CAM) to bring institutional quality service to their clients and financial advisors.

CAM's service goes beyond simply providing institutional quality investment management; our team brings deep industry knowledge, proprietary research, investment due diligence, and real-time market analysis to help clients and advisors make better and more informed decisions about their financial future.

Our core belief is that clients should always be put first and that everyone's financial goals are unique; that means their investment strategy should be too.

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