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Investment Market Review
October 2022

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Although the stock market decline over the first nine months of this year seems, and is, dramatic, the valuation of the S&P 500 stock index is now at a level in line with long-run averages. Recall that the long-term average annual return of the U.S. stock market is about 10%. In the few years leading up to 2022, the market experienced far above average returns (18.4% in 2020, and 28.7% in 2021); the stock market was due for a correction. The negative returns we have witnessed thus far in 2022 are, in effect, a reversion to the mean. As unpleasant as it feels, short-term stock market volatility is part of the natural economic cycle and is the price investors pay for long-term wealth generation. This serves as a great reminder that investing should be a patient, long-term endeavor, not to be derailed by short-term deviations.

Inflation and Fed policy continue to be the primary forces driving market volatility. A summer rally in the stock market recouped approximately half of the losses registered over the first half of the year. The rally was fueled, at least in part, by expectations that the Fed may not need to raise rates as high as originally feared, and that they may in fact pivot to rate cuts in early 2023. Those expectations ultimately proved to be fleeting.

At his August speech in Jackson Hole, Wyoming, Fed Chair Jerome Powell made it abundantly clear that the focus of the Fed was to bring inflation down to its target of 2%. Achieving that goal would, in the words of Powell, "require maintaining a restrictive policy stance for some time." He ended the speech by saying, "We will keep at it until we are confident the job is done." The message was clear: any hopes that the pace of interest rate hikes would moderate or that rates would be cut in the near-term were misplaced. The summer rally fizzled and markets retreated.

The Fed went on to raise the interest rate it controls by ¾ of a point at its September meeting, the third consecutive increase of that size and a historically aggressive pace of rate hikes. Over the 6 months between March 2022 and September 2022, the federal funds rate has risen by 3%. The market is currently expecting another ¾ point increase by the Fed at their November meeting.

Bond yields have gone up along with the Fed rate increases. Short-term Treasury bills have gone from yielding almost zero 12 months ago to over 3% on September 30th. The yield on the 10-year Treasury bond has more than doubled over the same period. As of this writing, the yield on both is over 4%, the highest they have been in 15 years. Meanwhile, the interest rate on a 30-year mortgage has doubled over the past year to almost 7%, the highest since the early 2000's.

It is through higher rates across the economy that the Fed intends to cool demand and contain inflation. The Fed has also noted its concerns regarding the imbalances in the labor market, where the demand for workers exceeds the supply of available workers. An increase in the unemployment rate and a reduction in economic growth are the unfortunate costs that Fed policy will have over the coming quarters.

The fight to curtail inflation, and by extension inflation expectations, is a vitally important one, even if it means some short-term pain. Runaway inflation expectations can become a self-fulfilling prophecy. So far, inflation expectations several years out remain relatively well anchored. Lessons learned from the efforts to combat inflation in the 1970's reinforce the importance of remaining committed to this endeavor and avoiding the "stop-and-go" monetary policy of that previous era, which neither contained inflation nor boosted economic growth. It was not until Paul Volcker, chairman of the Federal Reserve from 1979-1987, pushed rates to 20% that inflation finally started to subside.

Corporate earnings have been resilient against a challenging economic backdrop. Furthermore, earnings estimates for next year have held up relatively well so far. The risk that next year's estimates will be revised lower as economic growth cools cannot be overlooked, which could put more downward pressure on stocks. While it seems likely that the market has priced in several additional rate increases, it is less clear that it has accounted for a possible earnings recession.

It is understandable to look toward the market with pessimism. There are a variety of risks on the horizon and investors should be prepared for additional volatility. However, it is important to note that it is often when the outlook for the market and economy appear most dire that upside opportunity awaits. Look no further than March 2009 or 2020, the bottom for the financial/housing crisis and the COVID pandemic, respectively, for recent examples.

Through all the challenges of this year, we remain steadfast in our belief that corporate America is resilient and that stocks offer the most attractive long-term return potential for those with the appropriate risk tolerance. Our commitment to identifying high-quality companies that can weather the economic storm and thrive on the other side is our top priority. Our approach to managing client assets resists the common urge to make investment decisions based on short-term market movements; instead we employ the time-tested strategy of riding through market turbulence with an eye toward the long-term prospects of the economy and stocks we own.

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