



Inflation Highs Meet Unwavering Fed Interest Rate Hikes October 2022

Dear Client:

It's been an up-and-down ride.

July's optimism had many investors proclaiming that the Fed is about to pivot and stop hiking interest rates. This enthusiasm began a powerful rally for most of the period—yet abruptly reversed during 3Q22.

The Fed addressed interest rates to stem inflation in August at the Jackson Hole, Wyoming, meeting and in September after inflation and employment numbers were announced. One by one, the Fed members affirmed no pivot anytime soon, and the market promptly stopped its recovery rally to end with a negative third-quarter return.



For September, the Consumer Price Index came in at 8.2% year over year, and the Producer Price Index came in at 8.5% year over year, showing that the U.S. economy continued to experience higher-than-expected inflation during the third quarter. The two developments of focus by the end of the period were volatility in equity markets and the Treasury yield curve adjusting higher and inverting after the Fed's September rate hike (75bps points).

Financial conditions continued to tighten in the form of higher borrowing costs—which is beginning to stymie demand, notably in the housing market. Meanwhile, China's continued COVID-induced lockdowns, a strong U.S. dollar, Russia's invasion playing havoc with European energy prices, and chaos over the British Prime Minister led the myriad headwinds slowing global economic activity.

A sea of red was again across markets globally in the third quarter: the Dow Industrial (-6.17), every Russell index except one, Barclays Aggregate bond index (-4.75), MSCI world ex-USA (-9.8%), Bloomberg commodity index (-4.1%) and the S&P 500 (-4.9%) were down for the third straight quarter in 2022.

This broad landscape of negative returns for multiple asset classes intensified pundits' predictions of a pending hard economic landing and had many asking, "Has the recession already begun?"

Growth in China has been particularly weak due to multiple factors within and outside the Communist Party's control: the regulatory crackdown last year, the Ukraine war, a collapsing housing market, and an aggressive zero-Covid containment policy. In Europe and the United

Kingdom, economic activity faltered due to higher energy prices and commodity shortages resulting from the war in Ukraine.

Central banks have also adopted more hawkish policy positions to combat sharply rising inflation. At the start of the year, the key policy rates of the European Central Bank and the Bank of England were (-0.50%) and +0.25%, respectively. Today, they have risen to 0.75% and 2.25% and are expected to go higher in the months ahead despite recession concerns.

Labor markets in the U.S continued to stay strong, as available jobs still outnumber workers; the official September unemployment rate was 3.5%, matching its 50-year low last hit in 2019. Consumers are still spending, though definitely not receiving the same amounts of goods or services for their dollar.

The U.S. dollar also exceeded multi-decade highs during the quarter, a trend that is generally bad for U.S multinationals, terrible for international countries, and, with rising interest rates, not good for stocks.

Domestic equity market



The third quarter of 2022 for U.S. markets saw Growth style stocks best Value style in every market cap size. The broad stock market, as measured by the Russell 3000, was down 3.37%. Small stocks, as categorized by the Russell 2000, broadly outperformed large caps. Most notably, Russell 2000 Growth, at 0.24%, was the only positive performer in all equities for the quarter.

Large Growth stocks, as measured by the Russell 1000 growth, were down 3.60% for the quarter, while Value stocks per Russell 1000 value lagged, with a -5.62% third-quarter return.

The market continued its declining trend from the past two quarters. Nine of 11 S&P sectors were in the red for 3Q22. Energy (+1.65%), the lone positive industry last quarter, was joined this quarter in positive territory by Consumer Discretionary at 3.89% in the green.

Communication Services (-11.58) and Real Estate (-11.03%) had the two deepest plunges for the period. Materials (-7.13%), Consumer Staples (-6.95%), and Technology (-6.36%) were the next biggest decliners for the third quarter. Utilities (-6%), followed by Health Care (-5.18%), Industrials (-4.72%) and Financials (-3.1%), were also laggards. Those last few sectors illustrate why value stock indexes both were negative and trailed growth for 3Q22.

While S&P 500 operating earnings per share (EPS) were spectacular in 2021, rising 70%, profits in 2022 are growing much slower. In the first half of this year, operating EPS fell 3.2% year-over-year, and analysts now expect a less than 1% gain for all of 2022. Companies will have difficulty achieving even these modest estimates. Although energy companies are likely to benefit from high margins, rising labor costs, higher interest rates, and slowing sales growth eat into profits everywhere else. After the recent stock market decline, the S&P 500 forward P/E ratio is below its 25-year average of roughly 16.9x.

That Consumer Discretionary had the best performance in Q3 is consistent with consumers coming out of their two-year COVID cocoon and spending with gusto. Yet look closely at this spending, and you find that consumer debt hit a record \$4.2 trillion for the bottom 90% of Americans—while staying flat/unchanged for the top 10%!

As reported by Bloomberg, “Consumer debt, including credit cards, student loans, car loans, and personal loans, rose to an all-time high for the 118 million U.S. households among the bottom 90%, according to the Federal Reserve’s latest data on the distribution of household wealth. The group’s debt soared by \$300 billion over the last year—the largest annual gain on record—as households deal with higher prices for everything from food to clothing and rents.”

If everyone except the top 10% is already increasing their debt level before interest rates have fully kicked in on their credit balances, the declines in corporate profits are coming very soon.

International markets

The U.S. dollar continued its rally above 20-plus-year highs, pushing the Euro and other currencies around. Factors roiling the global economy explain why the dollar has become much stronger this year. Despite rising recessionary fears, the U.S. looks comparatively better off than much of the world.

International stock returns fell sharply in the third quarter as the Ukraine conflict dragged on and threatened European energy access. The MSCI EAFE index of international stocks declined 9.4% in the quarter. China’s growth has slowed due to continued zero-Covid policy shutdowns and a housing crisis. For 2022, for the first time since 1990, China will have



slower growth than the rest of the Asia-Pacific region (according to the World Bank), weighing down the MSCI Emerging Markets Index, which declined 11.42% for the quarter.

To say the United Kingdom is in turmoil is an understatement. The resignation (ousting) of Boris Johnson as Prime Minister after the recent death of Queen Elizabeth amplified governing and economic anxiety for the world's sixth-largest economy. (Next quarter, I'll talk about the economic impact that was the debacle of his replacement Liz Truss and her administration.)

Policymakers in Europe are also facing a difficult challenge: trying to bring down inflation and facing an energy crisis that threatens to cause a recession. Some are already predicting recessions for Germany, Italy, and Europe. The majority opinion inside the ECB is that more interest rate hikes must be implemented to tame inflation despite the already fragile economic state.

While the third quarter saw poor performance for emerging-markets investments overall, a few countries bucked the downward trend. Turkey, whose central bank continued lowering interest rates despite 80% inflation, and Brazil and India saw positive gains in the down 3Q22. Our colleagues at JP Morgan Asset Management state, "It is worth noting that the dollar is now at a near 40-year high in real terms relative to our major trading partners and should eventually decline. In addition, equity valuations outside the United States remain far below their U.S. counterparts and their long-term averages."

The near-term outlook on economic growth seems grim. The U.S., Europe, and China represent roughly two-thirds of global output; if all three regions slow down, it will be hard for any country to remain insulated from the fallout.

Bond markets



Interest rates increased across all maturities in the U.S. Treasury market for the quarter. As measured by the Bloomberg US Aggregate bond index, the bond market fell 4.75% for the quarter, increasing *its all-time low in any year* (-14.61%) YTD.

Like a rerun of last quarter, bonds had negative returns in every style, both domestically and abroad. Rising global bond yields and a surging U.S. dollar driven by a Federal Reserve bank focused on inflation were still the stories. For the third consecutive meeting, the Fed hiked its policy rate by 75 bps and reiterated its resolve to fight inflation until the "job is done," even if means below-trend growth. Median FOMC Fed Funds

projections for 2022-year end rose sharply, from 3.38% after the June meeting to 4.38% following the September one.



Headline CPI inflation in the U.S. fell to 8.3%, its second consecutive decline from the 9.06% June peak but still well above Fed's 2% target, justifying their hawkish stance. Employment data (+315,000 jobs) remained strong and a challenge to the Fed's inflation fight. Yet, in other areas, the Fed's impact is taking hold. For example, 30-year mortgage rates have climbed to 6.70%, impacting affordability.

Bond market volatility abroad was even more apparent as other central banks fought inflation. UK 5-year sovereign debt (Gilts) yields, 248 bps higher in the quarter, rose more than 100 bps in just three days after the release of surprise fiscal stimulus plans. The Bank of England, aiming to calm investors and support prices, announced a temporary Gilt purchasing program while also delaying the start of their planned balance sheet reduction in October. This was an emergency intervention, as UK pension funds became distressed bondholders after PM Truss and her short-tenured Finance Minister Kwarteng proposed tax cuts in the stimulus plan so extreme that he was forced to resign (preceding her by a few weeks).

The 10-year Treasury yield set a new YTD closing high at 3.95% on September 27 before falling to 3.84%, up 64 bps for the month and 82 bps for the quarter. Treasury yields rose somewhat uniformly across the curve in September, while quarterly increases were largest among short maturities, including a 132-bps increase in the 2-year yield. This increase for the 2-year yield furthered the 2- to 7-year part of the curve becoming inverted – a signal to most market participants of a coming recession. *This is the most inverted it has been since the summer of 2000.*

Plus, housing is in a massive slowdown. Interest rates in the quarter hovered near 7%, surpassing the closing level of 3.22% in January. The national Case-Shiller index rose more than 1.0% every month from August 2020 through May 2022. Prices continued that torrid pace in the first five months of this year, rising 8.9% thru May 2022.

June saw the first impact of an interest rate increase when home prices rose a modest 0.3% and then fell 0.33% in July. Private residential construction climbed higher for 24 straight months into May; now, it's declined for two straight months. After reaching a rate of 1.805 million homes annually in April, housing starts fell almost 20% to a 1.446 million rate in July. Fewer housing starts today will lead to less overall construction and home completions later this year and next. Further, when housing slows or stops, so too goes spending associated with setting up new households. Only the country starting from a 10yr + period of massive underbuilding prevents us from having a repeat of 2008.

Still seems like taming inflation is harder than we were led to believe.

A Look Ahead

Inflation is still near an all-time high. The 2- to 7-year bond curve is inverted, comparable to the summer of 2000. The UK and Europe are in bad shape, and the USD's 20-plus-year high is hammering Emerging and International equities as well as U.S. multinational companies. For years, the Fed has been both a hero and a part of the economic problem. It is finally stopping and slowly undoing its *Quantitative Easing* lab experiment and raising interest rates to fight the inflation it helped cause. (The Fed also has the advantage of making these efforts with unemployment at record lows and more available jobs than citizens to fill them.)



No wonder volatility has been intense this year in a declining stock market. In the past 40 years, only 2008 was more volatile than 2022 based on the number of days where the markets moved 1% up or down. Yet the groan from most investors is that the Fed should stop because it's driving stock prices down or because it's going to make a policy error or inflation will self-correct in a few quarters. Also, a Fed pivot is imminent, and each short, violent rally starts a new bull market. *In the past 50 years, the Federal Reserve Board has never concluded a tightening cycle before the CPI was below the level of its nominal interest rate hikes.*

My portfolio recommendations for your asset allocation remain unchanged from last quarter. Maintain a risk-balanced focus and multi-asset class approach, evaluate opportunities and be ready to invest when larger short-term declines occur—and declines are occurring, as are asset allocation adjustments.

Consider:

- Rebalancing overall asset allocation to target ranges—and when assets aren't cheap, cash inside your portfolio is still a good idea until assets get cheap;
- Reducing overall U.S. equity allocation to mid-range of portfolio targets; tilt towards Value over Growth and Small over Large;
- Increasing cash by reducing U.S. Large Cap growth stocks and keeping Private Equity distributions on hand;
- Continuing to increase allocations to Small Cap value, core and Mid Cap value, core, emerging, and international stocks to the bottom range of portfolio targets;
- Maintaining high-quality fixed-income holdings with short-duration (1-year to 5-year), paired with proven opportunistic private credit strategies for yield; reducing high-yield bonds;



- Patiently reviewing niche alternatives, including early-stage venture capital and co-investments, as well as opportunistic strategies and secondary private investments (don't pay premium prices);
- Using cash to invest in cashflow generating Real Estate and Real Asset investments, both equity and debt, in private and public space (logistics, warehouses, data centers, infrastructure, commodities/natural resources, multi-family and farmland).

You must maintain a disciplined focus on your investment strategies – especially during volatile periods. Many investors' interests in the “E” for the environment (as well as in “S” for social and “G” for governance) of ESG continue to grow. Please know that this has and always will be a deeply embedded part of our firm's philosophy that we can happily discuss at length.

It is a pleasure to serve you, and I look forward to continuing our work together. Stay safe and healthy.

With appreciation,

A handwritten signature in black ink that reads 'Walid L. Petiri'. The signature is written in a cursive, flowing style.

Walid L. Petiri

Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board, Bloomberg online, 4Q 2022 J.P. Morgan Asset Management Guide to Markets.