Financial Markets Perspective

October 2022

Deflating the Great Self-Induced Bubble

Background

When we stepped back and reviewed our second quarter Financial Markets Perspective, penned in July, we considered just changing the title and sending it out for this quarter due to the value of the information and views provided. Unfortunately, the factors that have thrown financial markets into turmoil this year continued during the third quarter, sending stocks back into bear market territory. The equity market rally was terminated by a combination of two 75 basis point increases in the federal funds rate by the Federal Reserve which put the range to 3.00%-3.25%. These rate increases indirectly drive other interest rates higher, such as the prime rate upon which mortgage and credit card rates are based. With interest rates rising, the bond market had equally dismal results for the first nine months of the year.

Let us go back to March of 2020 when the Covid-19 pandemic became a reality. The government's knee-jerk response to shut down the economy had terrible economic consequences. Millions of workers lost their jobs and entire sectors of the economy were disrupted. The federal government's response was to take its foot off the brake and then turn around and hit the accelerator without any further investigation. The combination of fiscal and monetary policy ballooned the federal government's assistance to more than $7 trillion. This enormous injection of liquidity was made on top of a collapse in the supply of goods and services due to the pandemic. The Federal Reserve took the fed funds rate to zero and accommodated the payments explosion by financing the federal government's spending spree.

This historic government response to the pandemic temporarily worked. The economy bounced back to near pre-pandemic levels but not in all sectors. However, the spending spree altered the relationship between the supply and demand for goods and services. The excess injection of funds created enormous speculation in financial markets, especially in those securities that were reliant on far-fetched theories of "value". Many of the companies that experienced tremendous demand on the back of the pandemic flourished, then subsequently cratered as the Covid situation moderated. Many of these stocks have since lost 60-90% of their value.

The Federal Reserve was forced to confront the surge in inflation to 40-year highs and the reaction was swift. Chairman Powell shifted from an attitude that inflation was "transitory" to a policy of raising interest rates until they see inflation back at the 2% target. These swings in standpoints and the resulting policy responses introduced vast distortions in the economy. One example is home mortgage rates, rising by over 100% in just six months. Such shifts can impair the housing industry as buyers suddenly have to pay twice as much for a mortgage loan. Higher mortgage rates also knock many buyers out of the market and pressures home prices lower – a situation we are witnessing today.

As we continue to monitor the current level of commodity prices, we see that the tide has turned somewhat. Many commodities have been heading lower from elevated levels. During the third quarter, oil prices dropped below $80 per barrel from a high of nearly $124! Gold declined by more than 9% to less than $1,700 per troy ounce. Additionally, used car prices have dropped as have rents, which are a very large part of the PCE-Deflator – the Fed's preferred measure of inflation. Global shipping costs have also collapsed. As of this writing, both producer price inflation and consumer price inflation came in higher than anticipated. We suspect that rents have not declined as much as some had hoped. Despite the negative news on inflation, the economy is growing at an estimated 2.5% to 3% rate. Unemployment is at record lows with a rate of 3.5% -- a rate not seen since 1969. Additionally, both the ISM Manufacturing and ISM Services data point to a very healthy economy.

Investors are beginning to see the fundamental impact of this government shift to slow the economy which is a major fall in demand. Companies are beginning to revise earnings estimates downward, with semiconductor companies being hit hardest and many of these stocks are down by 30-50%. The challenge is recognizing when these collapsing prices will shift the inflation number down and how fast the Fed reacts to a changing inflationary environment. In late 2018, the Fed was on a tear to raise interest rates only to have to pivot to take those interest rates back down in early 2019. Today, some knowledgeable economic prognosticators fear some sort of financial meltdown in the banking sector if the Fed continues this rapid course of raising interest rates. However, considering all the current and anticipated metrics contributing to inflation, the worst may be over, and the clear danger is that the government does not recognize that this inflation was a self-induced phenomenon, not an imaginary gremlin.

The International Economy

When we wrote about the war in Ukraine throughout the year, our major concern was the stability of both Ukraine and Russia and what actions countries would take as the war expanded. The conflict's amplification affected both energy and food exports in the region. The result of fewer exports had a profound impact on dependent importers. Today there is a growing threat of a European energy crisis this winter and an impending global food shortage for countries already running short of basic nutrition. While recession threatens many nations both in Europe and the third world, bankers are raising interest rates to slow economic activity. The collision of such policies undoubtedly will slow global growth or even push the world into a recession. Restrictions on the use of fuel during the coming winter will also reduce the standard of living in Europe. The latest acts by Russia to annex parts of Ukraine takes us further into the realm of not knowing when or how the war will end. Financial markets incorporate that uncertainty into the long-term investment outlook and falling equity prices partly reflect the potential for a long, drawn-out war with uncertain consequences.

King Dollar

In the face of global turmoil, investors have turned to the U.S. dollar for safety. In the old days, gold was the haven of choice for investors, but is not playing this role anymore. Gold prices are down this year, while the dollar is having one of its best years ever and has risen by more than 16% through the end of September (as measured by the Wall Street Journal Dollar index). The strength of the dollar is understandable considering the global financial turmoil and the

perspective of foreign investors who see higher yields and elevated currency values as an attractive and stable investment.

The strong dollar is also good news for foreign manufacturers who have become competitive with their U.S. counterparts. On the other hand, U.S. multinational companies suffer for two reasons; their exports become more expensive, and the stronger currency requires a translation to lower earnings. Domestic companies that import parts have seen their manufacturing costs fall while companies that export have seen the demand for their goods fall – both affecting the bottom line in different ways. A wide range of companies will likely cite the greenback's rise as a headwind to their bottom lines as corporate earnings season kicks into gear this month. A stronger dollar makes U.S. exporters' products less competitive abroad while hurting U.S. multinationals that need to exchange their foreign earnings into dollars.

November Elections

The upcoming elections could have an important impact on the financial markets as there is a wide disparity as to how the government will deal with our current economic problems. On the one side is inflation and interest rates and on the other is a strong economy with rising employment and a strong dollar. While social issues impact voters, inflation and the overall economy may play an outsized role in who wins and who loses this November. Elections have consequences and this one could be critical to affecting the outlook for the economy and financial markets.

Conclusions

The problems we identified earlier this year continue to undermine financial markets. Fortunately, the self-induced stimulative bubble launched by the federal government in 2020 is gradually deflating. Fiscal policy continues to withdraw funds, through a massive increase in tax collections, and the Federal Reserve is collapsing money supply growth.

Although financial markets are in turmoil, the American economy is still in decent shape. Corporate profits are being revised downwards but the gains in those profits over the past few years have been impressive. Cash on corporate balance sheets is at healthy levels by historical standards and financial conditions are favorable.

Consumers are also in decent shape, but the wealthy have taken a hit as both stock and high-end home prices have fallen. As restrictions related to Covid continue to wind down, consumers have been increasing their consumption of dining out, traveling and taking vacations. This spending should be a good omen for a variety of industries hit hardest by the pandemic.

Globally we continue to walk on eggshells when it comes to the war in Ukraine. Unfortunately, if the war continues with the escalation of hostilities, financial markets will remain in the doldrums. As a result, the investment outlook remains cloudy for all asset classes until we get a favorable breakthrough in either interest rate policy or the war in Ukraine.