Eideard Group
GUARDIANS OF PROSPERITY

Market Commentary

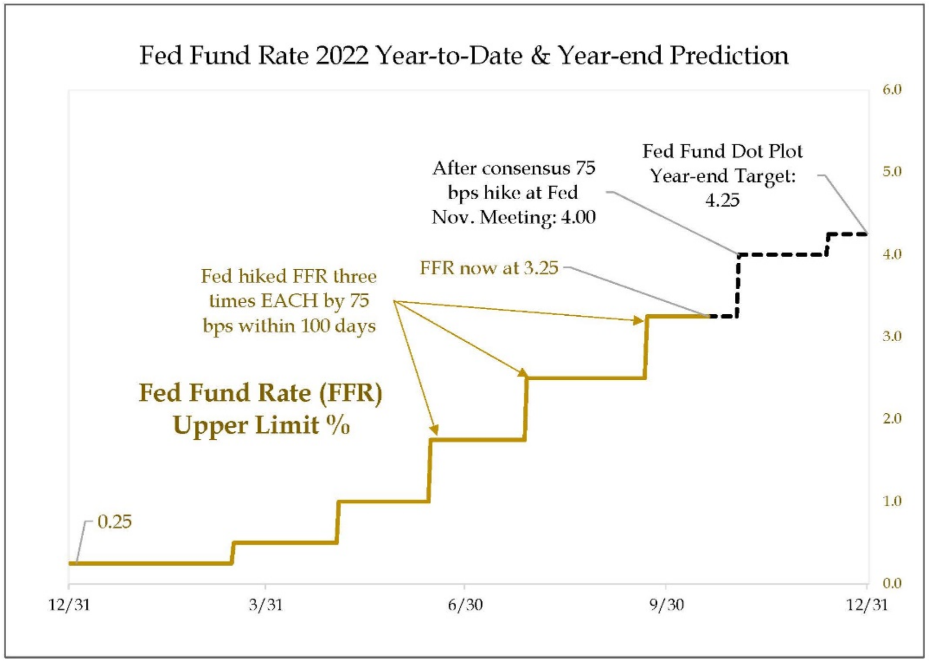
3Q 2022

The Cost of Removing the Punchbowl

All of us who have a stake in the financial markets painfully know that stock and bond price volatility continued to swing wildly through the close of another quarter, leaving returns for the third consecutive three month period and the year-to-date substantially negative and in bear market territory. Not only have the price swings been extreme on a monthly, weekly and daily basis, but often within the trading day itself (from Wall Street's opening bell to the last moments of the trading session). With astounding frequency, we have witnessed single day price swings of between 2-4% across all the major bourses with morning sessions often offering portfolio upside before relinquishing all the gain and more by the end of the trading day. Under these conditions, which were born of an unexpected post-pandemic forty-year high inflation rate and a Federal Reserve crusade to conquer it, our only reasonable recourse is to stay put, read a few good books and wait for the storm to pass; something that always happens in favor of brighter skies.

Meanwhile, focusing more closely on the stock and bond market trends over the course of the year to date, it is clear that both markets have marched in "lock-step". This uncommonly tight correlation is atypical during most periods of stock market instability, most of which arises from financial excess followed by bursting bubbles. During such times (when interest rates are benign) there is always a shift, a "flight to safety" from risk assets to US treasuries and municipal bonds whose prices typically rise on sharp and rapid demand to help preserve overall portfolio values and ease investors' pain.

Unfortunately, this cycle is very different since it is "singularly" due to the Federal Reserve's seismic shift in monetary policy; to remove the punchbowl of loose money in the hope of slowing down consumer demand, cooling off the economy, and subduing price pressure. As the accompanying chart illustrates, US interest rates have never before risen so sharply or as rapidly in history as they have in this cycle. There have been (5) rate increases since May including the (2) most recent and prominent 75bps hikes through September. This has lifted the FED's overnight inter-bank lending rate from near 0 to +3.25% with more hikes on the way. When you consider that interest rates in the US and around the globe had been hovering around zero, or at times even gone "negative" for prolonged periods over the last nearly two decades, the current markets' negative reaction is certainly understandable! The size and acceleration with which these increases have occurred has only supercharged this response, "temporarily" leaving the destruction of significant financial value in its wake!


Fed Fund Rate 2022 Year-to-Date & Year-end Prediction

For US corporations, the inflationary cost of doing business has risen sharply, eroding profit margins and net earnings per share. This is already becoming evident in the emerging revenue numbers in 3Q's reporting season just underway where only 72% of companies having reported met or exceeded analyst expectations. That number has typically been closer to 80% over the previous 5 years. Even if a corporation exceeds expectations but its forward guidance is off in any way, its stock is immediately punished. Lastly, rising US rates have supercharged the US dollar whose year over year strength has increased by as much as 18-20%. A strong dollar only serves to diminish the value of foreign revenues when they are translated back into US currency for reporting purposes. This is significant given that a majority of US companies now generate material revenues from overseas operations.

As to corporate stock itself, rising interest rates also serve to discount the value of its future cash flows thereby painfully eroding stock price. Sadly, the more growth oriented a stock is or for that matter the smaller its market size, the more likely it is at least in the near term, to be beaten up relative to larger high dividend payers whose long term capital growth potential is generally less rewarding.

As for the bond market, when new higher interest rates are introduced and captured in new bond issues, the market value of older (secondary market) bonds paying lower coupons quickly adjusts to the downside so as to equalize value between "old and new". That is the simple math of bonds. But unlike stocks saddled by the inherent risk of loss, however remote, bond prices by their nature are self-healing. The closer they get to maturity the more rapidly they price to par.

Notwithstanding, the impact of rising rates on bonds so far this year can no better be seen than in their YTD total returns across the markets. The "risk-free" US Treasury market closed down (13%), while municipal bonds fell on average by as much as (12%). Corporate investment-grade bonds on average fell by as much as (18%), while high yield bonds, the riskiest of the bunch, somehow skidded by with only (15%). Until most recently there really have been no "safe harbors" in which to hide but perhaps for real estate investments, commodities like oil and gas and MLP infrastructure, and of course cash which seems to be enjoying a new coronation.

All this said, it was instructive however to observe that shortly after the mid-year trough, around about July through mid-August, stocks and bonds enjoyed a brief but startling rally! And again, they moved in lock-step! It was occasioned by a growing market consensus that the FED would soon pause or at least pivot away from additional immediate hikes in order to assess its policy impact on what appeared to be flagging energy prices and inflationary pressure. Unfortunately, the notion was quickly dispelled in August's inflation and employment data. Likely distraught by the numbers, Chairman Powell in his mid-September pronouncement made it "perfectly clear" that the FED was determined to remain as aggressive as necessary "irrespective of the financial and economic consequences that may ensue" and ending on the note that some pain would likely have to be endured. Of course these were the harshest words yet from the Central Bank which today places the markets precisely where they are. Notwithstanding the dim forecast, we perceived there may have been a hint of silver lining when the FED cautiously projected that a 4.3% rate could be its anticipated "terminal rate" and further that it may be achieved by as early as next February-March. While the jury is certainly out on this plausible forecast, we'll be keeping our fingers crossed!

Looking Forward

Despite we are very aware that this bear market has left everyone feeling less confident in our immediate economic future and individually less wealthy in just a matter of the past several months, it is very much worth remembering that global finance has been transacting in an intentionally engineered, artificially low interest rate environment arguably for way too long! It is also fact that low interest rates combined with excessive liquidity, we'll call it (L&L) have always been both a culprit which preceded, groomed and invariably ignited financial calamity only to then become the medicinal prescription in its aftermath. History is replete with such events. In most recent memory, such outcomes can be seen from the 2002 Dot.Com bust to the extraordinary Financial Collapse of 2008 and the Great Recession that followed and even the post–COVID economy where two years of pent up consumer demand and supply chain disruption was met with trillions of government relief money. One might appropriately conclude that the S&P 500's extraordinary 200% cumulative total return performance from 2019-2021 was in some full measure, the result of excessively low interest rates and too much liquidity on the street. Despite the euphoric growth we all enjoyed over those three years, we think that conclusion is absolutely correct. How high and rapidly can a market grow unscathed before its legs give out?

We all know very well that private investors of all ilk, the young and old, the most risk oriented and even the most risk averse among us have been "driven" to the equity markets for years now (regardless of the risk inherent in stocks) for returns that simply could not be found elsewhere. Certainly not in bonds or other interest bearing investments. In that very fact lies an implicit and dangerous imbalance!

We therefore are and remain confident in the belief that once the FED has corralled inflation, a nominal interest rate, if left to itself, will find its own natural level. Let's agree to call it a "rate re-set" or the "new normal" to which we further believe the base for a new bull market will be established along with a healthy financial balance between the stock and bond markets. To that end, investors will enjoy expanded investment opportunities that are more consistent with their risk tolerance and less reliant on a blind need for income wherever it may be found regardless of the associated risk.

At the end of the day, when that day comes, all of us along with the US and world financial markets will acclimate, repair and successfully carry on! For now it's just a matter of time!

Best Regards,

Eideard Group

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