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2022 Third Quarter Commentary

The third quarter started off well with the S&P 500 trading up 12.7% by mid-August, only to retreat and finish the quarter down 6.3%. The weakness in the equity market was precipitated by a slightly hotter than expected CPI report for August, followed by an aggressive Federal Reserve (FED) at the September Federal Open Market Committee (FOMC) meeting. The hawkish tone of the FED caused interest rates to increase with the US 10-Year treasury topping 4% for the first time since 2008. In March of 2021, the FED forecasted the Fed Funds Rate to remain at zero at the end of this year. Just seven months ago they were still engaging in quantitative easing. Since then, inflation has likely peaked but has not receded as quickly as the FED would like. This caused the FED to get progressively tighter at each FOMC meeting this year. In May the FED went big, in what, at the time, was thought to be a one time increase of .75% in the Fed Funds Rate. Since then, the FED has raised rates .75% at each of the June, July, and September meetings and is expected to again in November. While monetary policy has a lagged effect, the market is forward looking and is pricing in the future impact of this aggressive tightening policy. The S&P 500 finished the third quarter down ~25% and the US Aggregate bond index finished the quarter down ~14.6%, year-to-date.

Inflation remains at the heart of the economic problem and the FED is determined to beat it. When inflation began to increase during COVID, we wrote about how demand shifted from services to goods at the same time supply chains were breaking down and demand was being fueled by stimulus. Now we are seeing that demand shift back towards services as economies open and society tries to do all the things they put on hold for the past two years. This decrease in demand for goods, along with improvement in supply chains and decreases in commodity prices, has led to a decrease in 'goods inflation.' Headline CPI peaked at 9.1% in June and came down to 8.2% by September. Much of the decrease seen in goods inflation has now been replaced by inflation in services. During COVID, $1.3 trillion of spending on services was put on hold. The service sector tends to be more labor dependent, thus making a weakening of the labor market, to bring down wage inflation, one of the FED's goals. Housing, aka 'shelter,' accounts for roughly one third of the headline CPI and house prices rose 24% in the two years ending November 2021. The Bureau of Labor Statistics (BLS) however, only observes rent for renter-occupied units, which lags home price growth by roughly 18 months. Economists Bolhuis, Cramer, and Summers, along with researchers at the San Francisco Fed project shelter inflation will increase by 7% in 2022 and 2023, boosting headline CPI by about 1.1 percentage points. However, just as rents lagged the surge in home prices, they will lag the stabilizing and/or fall in home prices caused by a doubling of mortgage rates. Overall, inflation has likely peaked and is beginning to recede, though be it not as quickly as the FED (and all of us) would like. While some parts of inflation remain sticky- mainly wages and shelter, those too should ease as tighter monetary policy begins to weaken the labor market and stabilize/decrease home prices. Finally, inflation expectations are not out of control as the FED has feared. Consumers expect inflation to be 2.7%, professional forecasts expect inflation to be 2.9% and the market expects inflation to be 2.4% over the next five years. The Bloomberg Consensus and Cleveland FED nowcast both have headline CPI falling roughly two percentage points by the end of first quarter of 2023.

As we mentioned, home prices rose 24% in the two years ending November 2021. Research from the Federal Reserve Bank of San Francisco attributes more than 60% of that increase to the rise in work-from-home during the pandemic. While there has been an effort to bring people back to the office, 30% of work was still being done at home as of August 2022. This persistence of remote work is likely to support housing demand in the years to come. Since the Great Financial Crisis (GFC), there has been a significant underdevelopment in single family homes. As a result, housing inventories have been below their 30-year average for the past decade and remained 863,000 below the average in August. Too much demand and not enough supply leads to an increase in prices, and as a result, according to Federal Reserve Economic Data, the median price of houses sold in 2022 was $428,700. Now if you factor in a doubling of mortgage rates (from 3.5% to 7%) that would increase the monthly mortgage payment for that house to $2,852 from $1,925 a year ago, or roughly a 48% increase on top of the 24% increase already realized in the price of the home. The housing price affordability index is at its lowest level since 2006, however, once the August and September data is included, it will likely show that housing affordability is the lowest it's been since the early 1980's. This has priced many home buyers out of the market forcing them to rent, which in turn has driven the rental vacancy rate to its lowest levels since the mid-1980's. The positive news is that we do not expect construction to collapse like it did in the GFC. Rather single and multi-family housing starts have been increasing over the past ten years with single-family housing starts near their long-term average and multi-family housing starts well above their long-term average, which, over time should increase supply and stabilize prices.

The labor market has been strong and overheated, which is the primary factor negating the notion that the US could be in recession after two consecutive quarters of negative GDP in Q1 and Q2. Nonfarm payrolls increased 263,000 in September, most of which were in the service sector, and the unemployment rate fell to 3.5%. There were some encouraging reports out in September, raising the prospects for gently reversing labor market overheating without the need for a recession. First, the JOLTS report showed job openings fell 1.1 million or 10% in August. This is the largest one-month drop since April 2020, and before that since July 2009. The ratio of job openings to unemployed people, a metric frequently referenced by FED chair Powell, fell to 1.67 from 1.97. Second, the layoff rate and job-finding rate among the unemployed remained fairly high, signaling the decline in total labor demand has come from a decline in job openings rather than a decline in employment. Finally, average hourly earnings growth remained softer in September with a recent trend rate of around 4.5%. This rate needs to come down to somewhere in the 3.5% range to be consistent with 2% inflation, but for now at least its moving in the right direction.

The FED has embarked on one of the most aggressive rate hiking cycles in its history, and as a result it is looking more likely they will cause the US to go into a recession next year. The NBER looks at six variables when trying to determine if the US is in a recession: real personal income, nonfarm payroll, household survey employment, real consumer spending, real wholesale and retail sales, and industrial production. From where we stand now, the coming recession does not look like the past two where all these variables turned negative in a crisis like manner, causing the FED and fiscal authorities to come to the rescue. Rather, the next recession may be softer and of a rolling nature, where each of these variables move either side of zero resulting in slower growth for longer. The cyclical sectors of the economy remain at or below their long-run averages, so we do not expect a boom to bust type scenario exacerbating the slow down.

The alternative asset classes in the portfolio, comprised of Real Estate and Equity Alternatives, have really demonstrated their value this year as both have achieved positive returns year-to-date. We have allowed the allocation to private real estate to increase naturally due to its growth, while equities and bonds have sold off with the market. We began increasing our exposure to equity alternatives last year and continued to do so this year as their objective is to act as a hedge in a volatile market. We are currently underweight equities, traditional fixed income and internationals while being overweight real estate, alternatives, and cash. Should we see a buying opportunity in equities we will look to put some cash to work, but for now we remain positioned relatively conservatively.

In conclusion, when monetary and fiscal policy change so abruptly, there is the possibility of adverse consequences. Aside from the unknown, the risks to the economy from tighter policy are real but do not yet appear to be too grim. The markets are forward looking and have been pricing in the implication of higher interest rates and chance of a recession in 2023. When the reality of a recession sets in next year, there may be more weakness in the markets but just as the market is pricing in a recession before it occurs, once we are in a recession the market tends to begin pricing in the better days ahead.

Please know we are here to help during this time of uncertainty and are available to answer any questions or concerns you may have.

Take care and be well,

Michael, Michelle Jolie, Nina

The Management Team
Michael, Michelle, Jolie and Nina

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