

# TWENTY, TWENTY, TWO AND COUNTING

Fall 2022 Newsletter

OCTOBER 2022

*20/20 means normal vision.*

Things are considered clear and discernible at 20/20. Isn't it ironic that the 2020s have been anything but? Of course, what's normal is quite subjective. So goes 2022.

The 5.7% 2-day rally to begin Q4 was the best start to a new quarter for the Stock Market since 1938. It also came on big volume with 90+% advancers. It was a big thrust higher, which is encouraging. It also came after a simply brutal end to September, which has been the theme for 2022. I needn't remind you, the year ain't over yet.

At issue in 2022 have been inflationary pressures not seen since Ronald Reagan first won the White House. The price of pretty much everything has gone up. The drivers were many. It's been driven by supply chain disruptions, high energy prices, hot war in Ukraine, cold war with China, droughts in some regions, flooding in others and free money flowing throughout the financial system. Something had to give.

## The Price of Money – No Longer Cheap

The Federal Reserve embarked on its largest tightening campaign in decades. It took interest rates from near zero to 3%, with plans to clear 4% by the end of the year. Bond yields have spiked, taking down both bond and stock prices in violent fashion. The Dollar hit levels not seen since the 1980s, further denting asset prices. 30-year mortgages eclipsed 7%. They started the year below 3%. Home prices stopped going up; Then they went down.

It's not necessarily the level of interest rates that are impacting the Market and the Economy. They're actually back to somewhat normal levels. It's the speed in which it's happening that has caused the disruption. When you start at zero and are used to zero, then abruptly increase the price of money by 0.75% on average every other month, it creates a bit of a shock. The money supply has shrunk. The system is stressed.



Investors have been addicted to low interest rates and cheap money for years. Asset prices soared. Bubbles were formed. Euphoria permeated sentiment as investors partied like it was 1999. No longer. The cost of whatever it took to prevent a financial calamity from Covid in 2020 is finally being paid. The party came to an abrupt end. Reality set in. Much like the Dot-com days, history will view this recent past period as the Covid bubble. There's no such thing as free.

The result has been higher prices. Supplies were strained early in Covid while demand soared. Supplies for stuff have loosened quite a bit, but still remain quite tight. And here's the thing: The Fed can't control supply. It doesn't make devices. It can't build more houses. It can't produce more energy. It can't grow more food. What the Fed can do is crush demand. They're doing just that.

One of our sources on the Street believes the Fed is embarrassed with their complacency and lack of action last year in getting ahead of inflation, so they are aggressively trying to rescue their credibility and overdo it on the tightening campaign. The clear risk is the Fed going too far, doing too much. There is precedent. The Market has been supremely focused on just that.

### Bear Market Cycle

The Stock Market erased all of its gains for both 2022 and 2021. The Dow went further, having closed out September back at pre-Covid levels. The Dollar hit multi-decade highs, putting increased pressure on stocks. It's been a brutal Bear Market.

The S&P 500 declined 25% through the end of September. That has few comparisons in history. Since World War II, only 1974 and 2002 saw worse starts to a year. It got better. Both those years saw the S&P 500 gain approximately 8% in Q4, to claw back some of the losses.



The damage has not been relegated to stocks. Bonds fell nearly 20% through 3 quarters in 2022. They're on pace for their worst year perhaps ever. This, on the heels of a down year last year marking the first back-to-back Bond decliner ever. To put things in perspective, the Bond Market had only declined 4 times in the last 5 decades. 2022 is extremely rare territory.

The scope and velocity of the moves in the Bond Market and the Currency Market have little precedent either. These are

areas that normally fluctuate little. In 2022, they've fluctuated a lot. The Dollar jumped 18% through September. The 10-Year Treasury yield moved from 4% to under 3.6% back to 3.9% in just the first week of October. It might not seem like it, but these are some really big moves. It speaks to the stress in the system.

### It's Still All About the Fed

Fundamentals take a backseat when monetary policy tightens. It doesn't pay to fight the Fed. Now at full-throttle, the central bank is letting \$60 Billion of Treasury securities and \$35 Billion of mortgage-backed securities roll off its balance sheet. This reduces liquidity in the financial system. The Fed was the big buyer. It's a buyer no longer. Investors finally realized that this time the central bank is serious about removing the punch bowl. It declared war on inflation at seemingly any cost. The Fed Chair said there will be pain. That pain has been felt.



It's important to remember that the US central bank kept buying mortgages and Treasuries while the Housing and Stock Market bubbles were inflating. The Fed kept feeding them oxygen. Now they are letting those securities run off at maturity, effectively tightening while the Economy heads toward recession.

The Federal Reserve's actions to shrink its balance sheet ramped up during the 3rd quarter. It raised its key policy rate by 150 basis points (1.5%) across 2 meetings. This accounted for half of its rate hikes since it started tightening in the Spring. That, and the central bank's insistence that they'll keep rates higher for longer to beat down inflation, has compressed asset prices. The Market reflects that. The Fed is trying to brake the Economy. The Market thinks it's going to break the Economy.

**Something Almost Broke**

The British Pound Sterling fell to \$1.03, its lowest level against the US Dollar in history. The new administration, led by Prime Minister Liz Truss, announced a series of tax cuts and increased spending that sent shockwaves through the system. This was the most aggressive tax-cut plan coming out of London since Margaret Thatcher occupied 10 Downing Street in 1988.



Stocks and bonds sold-off aggressively in response to the tax cuts. Yields soared, taking bond prices down. It created a great deal of stress in the system. The Bond turmoil in the United Kingdom led to the Bank of England (BOE) stepping in and buying bonds in the open market. The jump in rates made government borrowing costs surge. The BOE wanted to put a stop to that.

The British plan was to borrow more in order to pay for the tax cuts. The Market believes a borrow-and-spend plan lacks fiscal discipline. This, as Great Britain and the rest of Europe stare directly in the face of recession with elevated inflation. The controversial British tax plan drew criticism from the IMF (International Monetary Fund), Moody's and the White House. The British government swiftly switched gears and ditched the tax cuts. The Market approved of that decision. The Bond Market proved again what James Carville once said: it can intimidate anyone.

**Something Else Still Might**

There's another systemic concern out there. It's a bank overseas. Credit Suisse is its name and it's drawing some comparisons to Bear Stearns and Lehman of late. The cost to insure the bank's debt against default jumped to its highest level since its 1856 founding. Management has tried to cool Market fears that it has sufficient capital and liquidity to weather the seas of uncertainty and volatility. Credit Suisse is experiencing its darkest hours at a time when everyone is nervous about what comes next. The Swiss bank is being watched ever so closely.

**Earnings Drive Stock Prices**

Earnings Season starts again in October. Estimates keep getting cut. The Street is now looking for S&P 500 earnings to increase by just 2.9%, down from the 9.8% expected at the start of Q3. Bottom-up Earnings Per Share (EPS) estimates fell from \$59.44 to \$55.51, representing a 6.6% decline since Summer started. This is the largest downward reset since the depths of the pandemic. It's really pronounced in Tech. Technology companies were expected to see nearly 9% Q3 earnings growth back in July. Now it's just 1% and sinking.



Revenues are expected to increase 8.7%, down from 9.7% at the start of the quarter. The strong Dollar will hurt sales overseas, though the Market clearly knows that. The Market has moved much faster than Wall Street analysts to price in the slowdown. That's always the case. The Street is known to chase.

It's impossible to interpret fair value in this type of environment. Price to Earnings (P/E) ratios are the most common form of valuation on Wall Street. When there is great unpredictability in the "E" there is guaranteed volatility in the "P." That's indeed what we investors face right now. We will learn a lot in the coming weeks as to how Corporate America is holding in and what they have to say about the year ahead.

**Commodity Prices – Up and Down**

One key sign of economic slowing is falling commodity prices. The price of Copper has been cut by a 1/3 since its highs reached in March. Industrial metals, like steel and iron ore have declined 16% this year. This is a direct reflection of a contraction in manufacturing and construction. Lumber prices have plummeted 70%, back to pre-Covid levels. Prices initially collapsed as everything in the world slowed to a halt in the Spring of 2020 early in the pandemic, but by that Summer, the price of Lumber surged alongside home sales and the remodeling fever. The fever broke.



Other signs that Consumers are being more cautious can be found in the commodity markets. The price of cotton, a key ingredient for clothing, just hit its low on the year. Corn and soybeans fell to 2 ½ month lows. Meat prices have stopped soaring. The price of poultry has remained elevated, while pork and beef seem to be plateauing. The slowing Economy and rising Dollar are the primary drivers here. It will take a while for it to be reflected at restaurants.

### The World Still Runs on Crude

The one area which still remains elevated is the price at the pump. It's likely to stay that way. OPEC+ just announced a production cut of 2 Million barrels per day. The move is designed to stem what had been declining Oil prices. There has been a steady decline since hitting \$120 over the Summer. This marks the Oil cartel's second consecutive monthly cut. It had previously reduced production by 100K barrels in September. The 2 Million barrel cut is the biggest since the early days of the pandemic.

It's important to note that some members have been pumping well below their official targets already. They could automatically be in compliance with the new limits without reducing production. Quite frankly, they would prefer to increase production to capitalize on higher prices. They don't have the clout that the Saudis do. So the actual cut might be closer to 1 Million barrels which is roughly 1% of daily consumption. It's also the approximate amount that the US has been releasing from the Strategic Petroleum Reserve. Coincidence? That's a rhetorical question.



This is a highly unusual cut at an equally unusual time. OPEC is clearly concerned about a hit to energy demand from a rapidly slowing Global Economy. Growth worries are now everywhere, like in China, where Covid-19 lockdowns are hurting demand, as well as other economies that are suffering from the consequences of rapidly rising rates and the surging Dollar. Saudi Arabia's push for a large production cut also reflects its fears that Russian output could fall sharply further as sanctions tighten.

The White House is not happy about this production cut whatsoever. It's important to acknowledge that Russia is, in fact, part of OPEC+. The bigger deal is that Saudi Arabia and Russia are not only willing to work together to prop up crude markets, but they are deepening their ties despite the war in Ukraine. The cut is a big win for Moscow, which has already lost about a Million barrels of production. An EU Oil embargo begins in December. It's also a blow to US efforts of re-engaging with Saudi Arabia. President Biden pushed for production hikes to lower prices. The Saudis are doing the opposite.

The Fed did not rely on the declining gas prices since geopolitics are so influential in the price of energy. The price of Oil jumped 10% ahead of the news, as the cut was leaked. There are fresh fears over what the increase could mean for the US Economy, especially with gas costs having already risen due to Midwest refinery problems and seasonal West Coast maintenance as the Summer blend transitions to Winter blend. This OPEC+ cut exacerbates the issue. We mustn't forget, energy impacts everything.

### Global Trade



A year ago, the global supply chain was completely strained. Cargo ships were stacking up in Long Beach with nowhere to go. That was then. Trans-Pacific shipping rates have plummeted roughly 75% since. October is normally peak shipping ahead of the Holidays. Not so now. The transportation industry is grappling with weaker demand as retailers cancel orders while trying to unload excess inventories built-up this year. Expect lots of sales and markdowns this Holiday season.

The WTO (World Trade Organization) lowered its projection for global goods growth to just 1% next year. That's a big downward revision from its previous estimate for a 2023 expansion of 3.4%. The WTO says, "Major central banks are already raising interest rates in a bid to tame inflation but overshooting on tightening could trigger recessions in some countries, which would weigh on imports." Escalating tensions with China and Russia were also cited as risks to global economic output. Global commerce is contracting.

### Hot War and Cold War

The War in Ukraine entered its 9th month. Peace is showing no sign of arrival anytime soon. In fact, the stakes keep rising. President Biden just warned the risk of nuclear "Armageddon" is at the highest level since the Cuban Missile Crisis. That said, the White House made clear there is no indication Russia is preparing to use nuclear weapons. But the risk of nuclear activity is further from zero than we've seen in a couple generations.



China will hold its Communist Party Congress beginning October 16. Xi Jinping is expected to secure a third leadership term, cementing his place as the country's most powerful leader since Mao Zedong. Xi has ambitious plans for China as a superpower, and clearly has eyes on Taiwan. Being the major producer of global semiconductors, the United States has eyes on Taiwan too. A Cold War is brewing between the world's largest economies. There are no signs of that subsiding.

As if this wasn't enough for geopolitical stress around the globe, North Korea launched missiles over Japan for the first time in years, reminding the world it's a menace and a threat. Russia and China no doubt see this activity as useful. Planet Earth is a complex place.

### There's an Election in November

The next big complication for monetary policy could come from politicians. The midterm elections are fast approaching, and candidates are pointing to inflation and the economic slow-down as a rallying cry. What used to be a unified approach in both fiscal and monetary policy to support economic and financial stability has deviated sharply.

High inflation and rising rates are crushing Congressional constituencies, i.e. the American People. Mortgages, interest on credit cards, the cost of food and other daily expenses have gone through the roof. Incumbents in Washington have felt the heat for months. It hasn't stopped there. The Fed has drawn the ire everywhere across America.



The consensus of Washington insiders indicates a high probability for the Republicans to re-take the House but Democrats to keep the Senate. We all know the questionable relationship between polling and actuals, but our Washington sources tend to agree with that outcome. At least for now. What was looking like a red wave earlier in the year has lost significant momentum. A split decision would likely be welcomed by the Market. That would curb aggressive spending, which would help the inflation fight. That said, there aren't the deficit Hawks in Washington like there once were. That's an issue beyond the now. It's one of which we are well aware.

### What's Next for the Market?

Oversold conditions have become widespread and Bearish sentiment has reached historic levels. Sentiment has seldom been this sour. It's never been this sour for this long. The AAII (American Association of Individual Investors) Bearish index finished above 60% for consecutive weeks to end September for the first time ever. It could be considered peak pessimism. That's generally a contrarian sign which is quite Bullish. Bear Markets usually don't go down in a straight line.

The Market is forward-looking. It anticipates and prices things in ahead of time. A recession in 2023 looks highly probable. The Market historically declines the year before a recession and flattens out while economic data worsens. Rallies ensue when data becomes less bad. It's almost always a bumpy process. Bear Markets are a necessary part of the process. We are in the heart of that process in 2022.



New lows were set in June. A powerful Bear Market rally followed, with an abrupt end in August. A re-test seemed likely and necessary. It's part of the process to form and reinforce a bottom. The test came in September. In fact, it undercut the June low to close out September. Sometimes that's necessary to shake out the final weak hands and trap them as an oversold rally takes shape. It just might have happened. That's the Bull case.

Initial jobless claims rose faster than expected for the final week in September. The Market has been searching for signs of labor-market softening. The September Job report didn't bring many. It was stronger than expected. Unemployment fell back to 3.5%. That is a 5-decade low. The Labor Market is still extremely tight, indicating the United States is far from a recession. And inflation has been stubbornly persistent.

We are at the point where good news is bad news and bad news is good news. It's backwards thinking, but bad news is what will get the Fed to pause. This is all rear-view mirror data and time is required for the Fed tightening to work its way through the system. But this report indicates the Fed will keep applying the brakes, running the risk that something breaks.



Getting the unemployment rate over 5% appears to be the Fed's goal. It's a rather dubious objective to want to increase the number of Americans out of work, but that's a byproduct of the tools they use.

Some on the Street might be a little too optimistic about the potential for a central bank policy pivot. This seems highly improbable. We definitely don't see a rate cut on the horizon. The Fed would lose even more credibility if it switched gears now. In fact, it would most likely spook the Market, suggesting things are far worse than thought.

Our sense is a pause would be the most likely best outcome from an investment standpoint. Another 1% lift to rates by year-end would almost certainly be celebrated with a more sustainable rally. Conversely, a continuation of this aggressive tightening campaign would be considered a hard brake that could lead to a break. It's that in which the Market is most concerned.



The Market is trying to sniff out a less Hawkish Fed. It's now pricing the peak Fed funds rate down to 4.35% next year from the 4.8% priced in just a month ago. Further evidence of sliding inflation and economic slowdown would likely be met with rallies.

We do see a path for both higher stock prices and bond prices into year-end. We really like the Bond Market right now, something we haven't said for going on 4 years. Recession still looks a ways away, but the slowdown is undeniable. We expect more volatility ahead and plan to stay active. The strong start to October could gain some seasonal momentum as a whole lot of bad stuff has already been priced in.

Times like these sure do test investor mettle. Bear Markets are part of the deal. Survival is the key. So many questions. So few answers still. But we study clues. We learn from yesterday so we can apply it to tomorrow. As the Danish philosopher Soren Kierkegaard said: "Life can only be understood backwards but must be lived forward."

Onward we go. Twenty, Twenty, Two and counting. You can count on Bedell Frazier to be there.