WESPAC Advisors Market Comment August 22, 2022

We hope this letter finds you well and enjoying the summer. Accounting for losses in both stocks and bonds, the first half of 2022 was perhaps the worst first half for financial markets in history. However, since mid-June, stocks have rallied sharply, with the S&P 500 rising more than 15% since its June 14th low, retracing more than 50% of its losses since its January 3rd all-time high as of August 16. The optimism stems from the perception that 2nd quarter earnings were better than feared, coupled with expectations that the Fed will successfully engineer an economic soft landing in its bid to bring down inflation by hiking interest rates. Finally, many investors believe, or at least hope, that even though the Fed is hawkish and hiking rates now, it will soon pivot (or at least pause) from its current policy trajectory.

Beginning with the financial crisis of 2008-2009, the Fed became much more interventionist in the economy, even more so than it was during the Alan Greenspan era (Fed chair, 1987-2006). It was December 2008 when the Fed lowered and then kept short-term rates at zero for years and embarked on its "quantitative easing" program by purchasing trillions in Treasury bonds. This was all done to suppress interest rates and stimulate business activity. The Fed further expanded this program and added mortgage agency bonds to its balance sheet to support the economy and markets during the COVID pandemic.

This long period of interventionism has trained investors, both retail and institutional, to "buy the dip" because the Fed "has your back," meaning that if financial assets begin to sell off, investors can expect the Fed to step in and loosen monetary policy to prop up markets. "TINA", *There Is No Alternative*, is an acronym used in the financial press recently to describe this same behavior. It means there is no viable alternative to investing in stocks if you want to enjoy real wealth building returns, especially with fixed bonds and other yield-based financial instruments paying so little.

Naturally, the recent rally has sparked the age-old debate over whether this is a bear market rally or if the first half sell-off was simply a cyclical bear within an ongoing bull market that has now resumed. In the past, if the economy were softening and financial markets weak, the Fed playbook would dictate loosening monetary policy to help spur business activity. However, ultra-loose monetary policy is one of the main reasons we find ourselves in the current predicament with inflation at 40-year highs. With inflation raging, the Fed has no choice but to hike rates. Moreover, the rate hikes since March have been implemented more rapidly and are of greater magnitude than any the Fed has implemented in its 109-year existence. Given the amount of debt – government, corporate, and personal – in the system, the economic effect the magnitude of these rate hikes has will be key to how this cycle unfolds.

As of this morning, the market is still pricing in 4-5 rate hikes between now and the end of the year. Despite that, the market was also pricing in 0.50% of rate *cuts* next year as recently as a week ago. Last week, San Francisco Fed president Mary Daly pushed back on the idea of rate cuts next year, saying inflation is too high and that she could see the hikes continuing into 2023. While she does not speak for the entire Fed, nearly all recent public comments from various Fed officials have been supportive of more rate hikes. Finally, the Fed's plans to begin drawing down its balance sheet – something that is supposedly already happening – will have the same monetary effects as rate hikes and will further tighten financial conditions.

We believe the market is focusing too much on a potential Fed pause/pivot and not enough on what the Fed has already done and the rate hikes yet to happen. Changes in interest rates normally take time to influence the economy, with lag times spanning anywhere from nine months to two years. However, the effects can be felt much sooner in some sectors. Take housing for instance, where mortgage rates have mostly risen in concert with the Fed hikes. Mortgage rates peaked 8 weeks ago at 5.8% (up from 3.8% at the end of last year) and have backed off slightly to ~5.1%. Still, asset manager Robeco released a note last week stating "homes have become less affordable in the US. Taking out a 30-year mortgage to buy a median-priced home in the US now sets one back $3,155 per

month compared to $1,943 two years ago, an increase of 62%." Existing home sales are down for six straight months and are now 20% below February levels. While housing prices are not in decline, depending on the magnitude and duration of the current slowdown, some analysts say price drops are not out of the question given the unprecedented price increases in the prior two years.

It is true that economic data in the US since the June market low has been mixed rather than uniformly bad. For example, US industrial production increased in August by 0.6% month over month vs. estimates of a 0.3% increase. It has also increased in 5 of 7 months this year. In addition, the recent U.S. retail sales report was not bad, coming in flat compared to last month and up +10.3% vs. a year ago. The caveat on the year-over-year numbers is that gasoline sales were up +40% from last year, accounting for much of the increase. Also, when factoring in inflation, retail volumes were somewhat anemic – if not negative – compared to last year. Finally, the July jobs payroll report was much stronger than expected, with 528,000 jobs created, more than twice analysts' estimates. The problem is that the payroll report is one of the least reliable economic statistics and prone to some of the largest revisions, with significant changes often made months later. The Bureau of Labor Statistics has admitted as much, stating that in any given month, the actual number of jobs created has a margin of error 120,000 above or below the reported figure.

One glaring problem for Fed policy and its forecasts is that by focusing almost solely on inflation and employment, it is looking in the rear-view mirror since these are lagging indicators. There are components of the employment data that are coincident indicators, but the official payroll report itself is a lagging indicator. Most high frequency employment data is trending negative, and we are already seeing numerous articles about hiring freezes and layoffs in the business press. Furthermore, the Leading Economic Index in the US has now contracted for five consecutive months, a rare historical occurrence outside of a recession. Putting aside whether a recession is defined as two consecutive quarters of GDP contraction – something that has already happened – recession risks are rising if one weighs the evidence.

There are signs that inflation may have peaked in the US as gasoline and various commodity prices have come down. Certainly, the recent stock rally was buoyed by the July inflation report falling to 8.5% from 9.1% in June. That was despite the drop in gas prices being responsible for nearly all the decline. Unfortunately, some stickier components of inflation, such as shelter and services, continue to exhibit upward price pressure. While the markets seem to be betting that inflation will come down aggressively, investors need to understand that even if there is <u>no</u> inflation between now and 2023 – something unlikely to happen – the inflation rate would still be 5.4% at year-end, far above the Fed's 2% target. Right now (the odds change almost daily), the market is pricing in roughly equal odds of the Fed raising rates by another 0.50% or 0.75% at next month's FOMC meeting and 1.25% by year-end.

Arguably, there are four historical instances when the Fed successfully engineered a "soft landing." However, in each of those instances, inflation was much lower than it is now. As interest rates are an imprecise monetary tool, Fed rate hike cycles have more often ended up tipping the economy into recession, i.e., a "hard landing." Verily, the last time inflation was this high in the US (1979-1981), Fed chair Paul Volcker was forced to raise rates such that it caused a double-dip recession that at the time, was the worst downturn since the Great Depression.

Today's Fed faces a similar challenge, and ultimately, we believe these rate increases will filter through the economy, leading to slower growth and lower corporate profits. In turn, lower corporate profits almost always mean lower stock prices. Of course, stock prices have already come down, but stock valuations still rival some of the richest in history. We plan to maintain our current defensive posture as we believe risk skews to the downside, but if it makes sense to gain exposure to certain assets or asset classes based on our indicators, we aim to take advantage. *<u>Please contact us if you would like to discuss if you have any questions or would like to discuss your account.</u>*