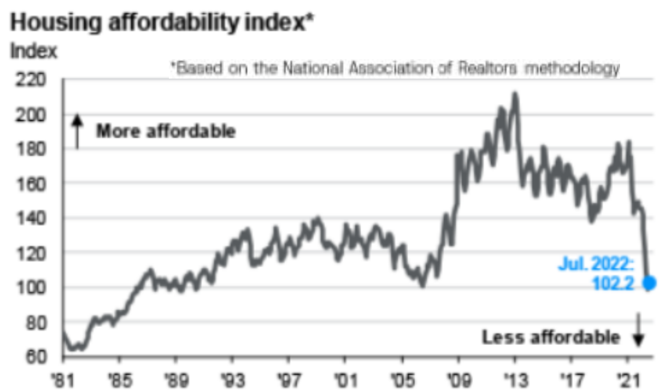
ICR® 3rd Quarter Newsletter – October 2022

After a brief summer rally, markets pulled back in August and September, with the S&P 500 finishing down 5.3% for the quarter. Small cap stocks fared a little better, losing only 2.2% as measured by the Russell 2000 index. Energy (+2.3%) and consumer discretionary (+4.4%) were the only sectors to post positive returns for the quarter, while telecom (-12.7%) and real estate (-11.0%) were the biggest losers.

Foreign stocks lost 10% during the quarter as measured by the MSCI EAFE index for developed nations, but almost six percentage points were attributable to U.S. dollar appreciation. That is, if quoted in local currencies, the index would have only been down 4.3%. Emerging markets were even worse, losing 12.5% (9.1% in local currencies). As Richard Nixon's Treasury Secretary, John Connally, once said, "The dollar is our currency, but it's your problem." Indeed, it has been a problem for other countries that have to import goods denominated in dollars because all of those goods have gotten more expensive with the dollar's recent surge. Most other countries have already been battling inflation like we have in the U.S., so this is effectively adding more inflation on top of an already-difficult situation for them.

Bond yields continued their march higher as the Federal Reserve persisted in raising rates to fight inflation. Amid rising rates, the Bloomberg Aggregate Bond Index fell 4.8% for the quarter, bringing its year-to-date losses to 14.6%. The short end of the yield curve has experienced the most dramatic moves. The two-year treasury note, for example, began the year at 0.73% and finished the third quarter at 4.27%. Ten-year yields have also risen, but more slowly than shorter-dated maturities, causing the yield curve to invert at the beginning of July (as measured by the 2s-10s spread). Historically, an inverted yield curve has been a leading indicator of a recession. In this instance, a recession should come as no surprise, as the Fed has more or less said that's what they are trying to accomplish in order to reduce inflation.



This has also led to much higher mortgage rates than what homebuyers could get just a year ago. The average 30-year mortgage rate has more than doubled since January, now approaching 7%. That means the monthly payment on a new $500,000 mortgage increased from around $2,100 per month to about $3,300 per month. With housing prices only softening a bit, that has led to the lowest housing affordability since the bubble of the mid-2000s. And we all remember what happened when that bubble popped. With so many jobs tied to the housing industry, not to mention the over-securitization of mortgages, the economy fell into a recession and millions of people lost their jobs.

Those who remember the 1980s when 30-year mortgage rates got as high as 18% might question whether 7% is really that bad. And, in historical context, it's really not. But it took about four years for mortgage rates to double from 1977 to 1981. This year, it took about eight months for rates to double. The speed at which things have changed could cause major disruptions in the housing industry and the economy as a whole.

Many are asking whether – or to what degree – the Fed is weighing the negative consequences of what it is doing versus the positives of bringing inflation back down to its 2% target. But the Fed seems committed to the task. Chairman Jerome Powell said, "While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain."

It's worthwhile to stop and ask how we got to this point where the Fed is desperately trying to bring inflation back down. There was a lot of hand-wringing after the Global Financial Crisis (GFC) when trillions of dollars – from both fiscal and monetary sources – were used to try to stop the economic bleeding. Many thought it was certain to cause inflation, but in the subsequent years, core CPI in the U.S. never exceeded 2.5% - until 2021, when it began to spike.

So, what was different this time? First, the magnitude of stimulus was larger. U.S. fiscal stimulus amounted to 27% of GDP to fight the economic impact of the pandemic – about four times the share implemented during the GFC. In addition, the supply chain disruptions and the continued effects of some countries shutting down certain regions have exacerbated the problem by creating supply shortages in the face of demand spikes. And, finally, it feels safe to say at this point that the Fed was too slow to begin tightening monetary policy in response to inflationary pressures. After hitting the gas hard during the worst of the pandemic, they waited too long to ease off the gas and are now having to slam on the brakes. We all remember the Fed's claim that inflation would be "transitory." And in the long run, that may still prove to be somewhat true, but given the Fed's almost-urgent tightening of financial conditions and the impact that has had, it's clear they could have begun a more gradual, less disruptive process earlier.

What does it all mean for markets? When the Fed was easing financial conditions, pundits commonly said, "Don't fight the Fed," and the same thinking could be applied here as they tighten. As we said in our last quarterly newsletter, a recession is the likely outcome (if we're not already in one) and stagflation is on the table. However, markets are forward-looking and tend not to bottom at the end of a recession, but rather at some point in the middle, as they start to see the light at the end of the tunnel. When the Fed starts to indicate any degree of optimism about the direction of inflation, we may see investors interpret that as a signal that we're making our way to better times.

As always, thank you for giving us the opportunity to work with you and for your patience during a frustrating and difficult period in the markets. If you have any questions, concerns, or thoughts, please don't hesitate to reach out to us.

Sincerely,

James A. Heine

James L. Cobb

Market Report (as of 9/30/22)

Index	**2022 YTD (%)**	**3-Year Annualized (%)**	**5-Year Annualized (%)**
S&P 500	-24.8	6.4	7.3
Dow Jones Industrial Average	-21.0	2.2	5.1
U.S. Aggregate Bond Index	-14.6	-3.3	-0.3
MSCI EAFE (Foreign Index)	-28.9	-4.2	-3.4

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