Q3 2022 Commentary

Hurricane Ian or Powell?

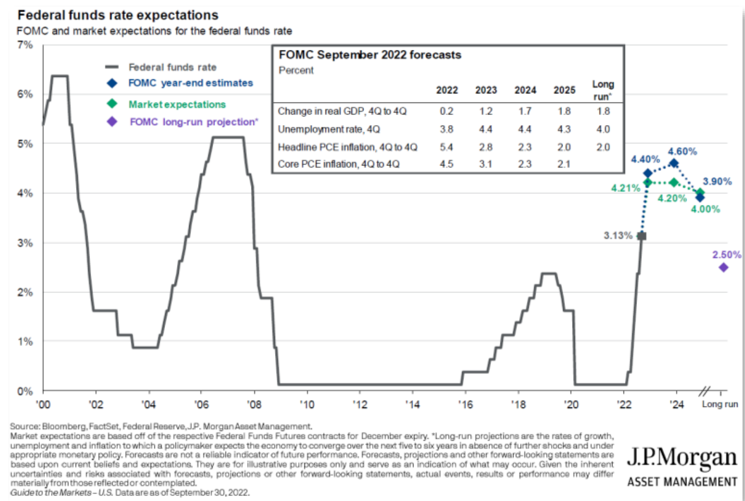
Hurricane Ian made landfall September 28th, with winds reported over 150 mph in some areas and storm surge up to 12 feet. This will prove to be one of the most costly storms to ever hit Florida, and our hearts go out to those affected. The far-reaching impact will go beyond the initial tragedy of life and property. The insurance industry, already in bad shape for Floridians, will be further devastated, which will make obtaining coverage difficult to impossible for coastal communities.

Source: dw.com

Likewise, excessive economic stimulus, energy policy, fiscal spending, and the ensuing inflation have a far-reaching impact that has been on our radar for some time. The Federal Reserve response to dampen out the 40-year record inflation with historic rate hikes and tapering of their bond purchases has resulted in a storm of its own in the financial markets.

We have been living in a period of abnormally high stock market returns, far exceeding the 50-year average on the S&P 500 of 10.3%. With interest rates artificially kept low by the Federal Reserve through 2021, the term **TINA (There Is No Alternative)** helped contribute to stocks' above-average returns as investors recognized that equities were the only game in town. Fixed income allocations were less volatile, but added nearly zero to returns in client portfolios.

TINA has left the building! The Federal Reserve, as shown by the vertical gray solid line below, has raised the overnight bank lending rate from nearly zero to over 3% this year. The dotted line indicates the anticipated further rise into next year. The longer bond rates have had precipitous rise as well with the 10-year US Treasury rising from 0.60% in mid-2020 to more than 4% recently. There suddenly is an alternative to stocks with bond yields on corporates, fixed annuities, and CDs becoming very viable return producers.



The additional pressure on equity valuations and capital costs have brought the overbought valuation of stocks down nearly 25% through the third quarter for the Standard and Poor's 500 index, and far worse for the more aggressive Nasdaq index. As the chart below shows, the volatility in the Standard and Poor's index ran from the beginning of 2022 through June. The S&P 500 had a bounce in late June through mid-August of nearly

The Brechnitz Group of Raymond James
101 S. Main St., Suite 301·Decatur, IL 62523·217-423-1388

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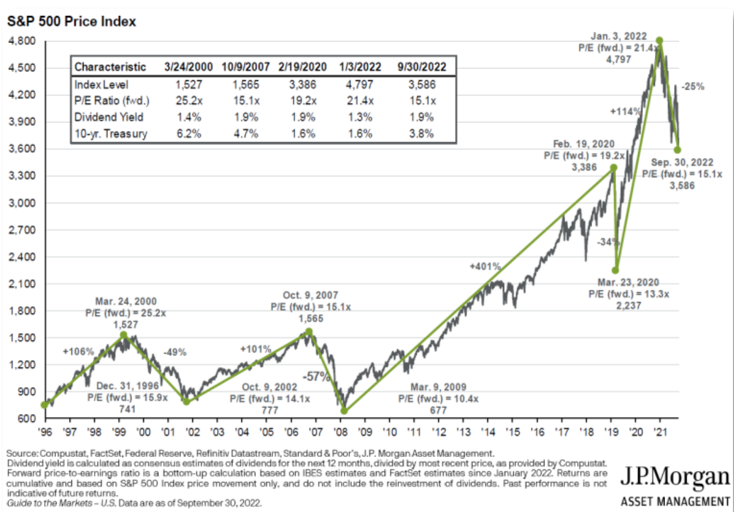
14% before heading back lower to re-test the June lows. This process of retesting the previous low is common, and may occur many times.



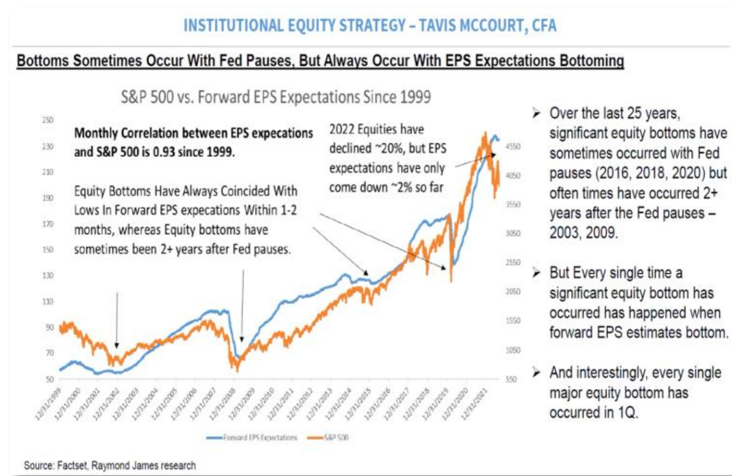
The first few days in October have seen the index undercut the previous June lows, and we anticipate more volatility into next year.

The question that we are asked often is, "When will the volatility in stocks end?" The market is really focused on Federal Reserve Chairman Powell's messages and economic data. Any hint of an end to the Fed's hawkish rate rise bias has been met with dramatic market rallies.

The more important question should be: When will the economic slowdown that the Fed is trying to manage occur, and how severe will it be? We have discussed the dangerous game the Federal Reserve is playing of slowing the economic engine enough that inflation is tamed without stalling out that engine (the economy).

We entered the calendar year with exuberance for earnings growth (maybe irrational levels) that is now being tempered. Many corporate earnings are missing on the downside, and many are revising estimates to lower.

Historically, the market bottom coincides with the end of Federal Reserve rate hikes about half of the time. The better indicator is when earnings bottom (see the blue line below).



The earnings this year are just beginning to rollover, and we need to see them bottom out. This process could take months, and this is the reason that we believe volatility will continue into next year. This does not imply that we feel further dramatic downside is in the cards, but a lot of false rallies are likely, with re-tests of previous lows similar to what we are doing now with the June low.

One of the most surprising aspects of this volatility for investors has been the precipitous decline in bond prices. A principle of bonds is that when interest rates rise, bond prices decline (and vice versa). It happens in all bonds, just like the law of gravity.

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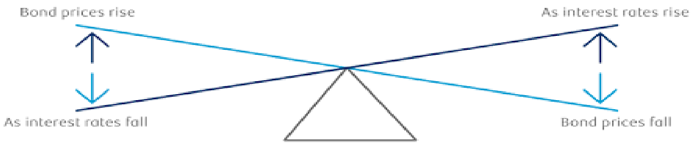

For decades, interest rates have been declining, and although investors have not received much in the way of income, their principal was less volatile (even appreciating). With this momentous rise in rates, we have seen the largest decline in bond prices since the 1970s. This component of your portfolio that has generally been less volatile and is, at worst, now down in value along with stock declines (Aggregate Bond Index down -14% through Q3 2022). This has even resulted in client portfolios with very conservative allocations experiencing significant declines. Just as I could not walk on the beach with a ray of sunshine on me alone in Ft. Myers during Hurricane Ian, most everyone is experiencing this storm, and we believe ensuring you are in high quality, sustainable positions is the best defense to ride it out.

We appreciate your continued confidence and trust!

The Brechnitz Group

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