Quarterly Market Commentary

Third Quarter 2022

The Great Unwind

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> *"You can't change the past. You can't even change the future, in the sense that you can only change the present one moment at a time, stubbornly, until the future unwinds itself into the stories of our lives."*
>
> - Larry Wall

For almost 15 years, investors have been obsessed with the Federal Reserve. In the 19th Century, the Federal Reserve System did not exist – its creation in 1913 was in response to the Panic of 1907. Before that event, there was the Panic of 1893, which was widely known at the time as "The Great Depression." When policy makers created the Federal Reserve, the hope, of course, was that a Central Bank with great monetary powers would be able to prevent another Great Depression – a task with which they were successful until the 1930's, when another run on the banks led to the Great Depression, as we know it today. Now, fortunately, we have FDIC insurance, which has changed this dynamic. We also have, as investors are forced to acknowledge, a very active Central Bank that is willing to use their blunt monetary tools to either spur or stifle growth and inflation.

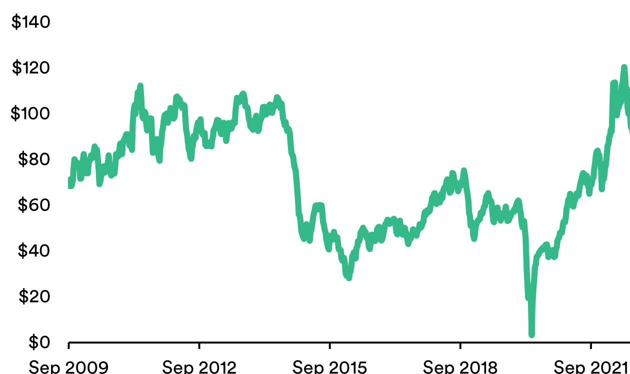
Coming into the year, investors largely expected that the healthy consumer – supported by significant fiscal stimulus during the pandemic – would power the economy at an above-trend pace. After all, this was the experience last year when the bull case for what became a terrific economic and market year was predicated on the convergence of a post-pandemic consumption binge and consumers flush with cash and solid personal balance sheets. After nine long months, we are now embattled in an economic environment where all that had once been a tailwind is evolving into a gathering headwind.

Then & Now

Inflation

Inflation averaged just 2.6% between 2010 and 2020. For ten beautiful years, the world enjoyed a period of low and stable inflation. As we have been schooled this year, oil prices are an extremely important input into every consumable and general inflation expectations. Oil prices from 2011 to 2020 (prior to the pandemic) were nearly halved, from $100 to $58 per barrel, down nearly 60% adjusted for inflation. The same relationship existed with most commodities, like metals and agriculture, allowing for low input costs and lower relative prices to the end consumer. Businesses, meanwhile, enjoyed historically high profit margins and operating leverage as revenues grew and costs remained subdued.

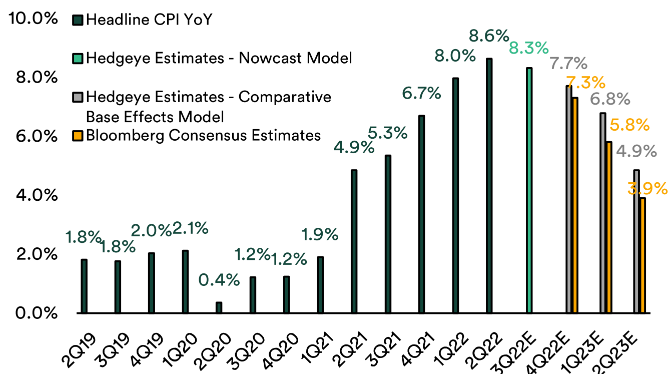
WTI Crude Spot Price ($/bbl)[1]
September 4, 2009 – September 16, 2022 | Weekly Returns



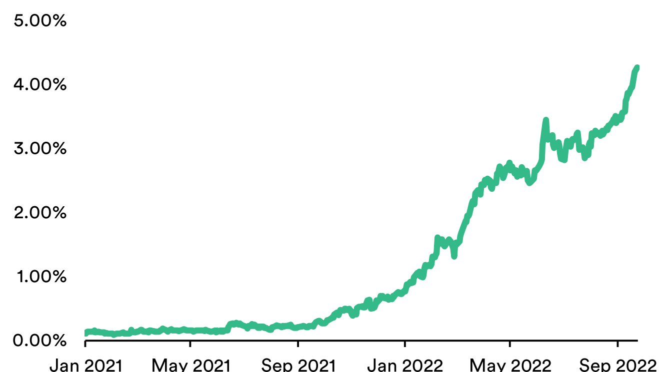
Today, inflation is at a 40-year high of 8.3%. The July CPI reading, which many investors expected would represent inflation's peak, proved to be a false dawn as CPI accelerated by 0.1% in August. It was at that moment when central bankers and investors acknowledged the reality that inflation is not transitory, as they had long believed, but has changed structurally. The story remains the same: supply chain issues, energy shortages, and labor shortages that drive wage increases are all problems that Federal Reserve economists suggest will persist through the end of this year, and likely beyond. With higher inflation comes stretched consumers, lower consumption, and narrowing corporate profit margins. There are, of course, levers that businesses will be able to pull to deal with these higher costs, but growth – by businesses, consumers, and the economy at large – will be challenged.

[1] U.S. Bureau of Labor Statistics

US Inflation: Actual & Estimates[2]
2Q 2019A – 2Q 2023E



2-Year US Treasury Yield[3]
January 4, 2021 – September 26, 2022 | Daily Returns



Interest Rates

Since Alan Greenspan's tenure as Fed Chair, the world has grown accustomed to low interest rates, cheap capital, and liquid financial markets. During a time when corporate debt levels were low, national deficits were manageable, and the economic landscape was stable, cutting interest rates was an "innocent" way of juicing the economy. Since the mid- to late-1990's, this monetary largesse made anything purchased with credit cheaper: houses, cars, vendor-financed equipment, etc. This helped an already robust economy grow even faster. It was also one of several catalysts that drove equity market prices higher. However, the emphasis on monetary policy over fiscal measures caused many dislocations: excessive monetary stimulus overweighted financial assets, devalued labor, created a wide gap between asset owners and wage earners, and sustained many poorly functioning business models.

After touching a bottom of 0.09% in February 2021, the 2-year Treasury has now eclipsed 4.00% for the first time since 2007. The 2-year Treasury rose an astounding 0.60% in September 2022 alone(!). For context, at the beginning of 2021 the 2-year Treasury yield was just 0.10%.

[2] Hedgeye Risk Management

From an economic perspective, this short-term rate serves as a key input for many asset prices and growth drivers. When interest rates were effectively zero, homes were affordable (aided by low mortgage rates), carrying costs for businesses fueling growth were low, and equities could reasonably be assigned elevated valuations. Having hiked interest rates a rapid 12 times (300 bps) in six months, and with more on the way, the Fed has flipped the math upside down. Mortgage rates have soared to nearly 7%, employment gains have slowed to a crawl, and equities around the globe are in bear markets.

To be clear, higher interest rates aren't *all* bad. In fact, higher interest rates are normal, and provide investors numerous advantages. For example, savers begin to earn a return on their bank deposits again. As bonds mature, investors will be able to replace paper that was issued at low interest rates with higher yielding securities. A higher cost of capital for businesses portends higher prospective returns for investors. Furthermore, zombie companies with limited earnings, growth, or prospects that have been kept running by cheap capital will falter, providing capital for new and better innovations that improve customer experiences, lower costs, and increase productivity.

Eventually, the seemingly endless rise in interest rates will subside and a higher yielding era will be upon us. The dangerous hunt for yield and the period of sky-high valuations of 2020-2021 has passed, forcing investors to recalibrate the return they expect to receive per unit of risk. A painful process, yes, but one that should sow the seeds for a healthier economic environment and higher prospective returns for investors moving forward.

[3] Federal Reserve Bank of St. Louis

A Look Back and A Way Forward

It is an understatement to say that this has been a difficult market environment. As is well documented, nearly all asset classes – from stocks, to bonds, to real estate, to private assets – have endured significant capital losses. Certainly, seeing equities fall 20% to 30% is startling. But it is not uncommon. The S&P 500 has fallen, on an annual basis, by 20% or more 10 times in the last 40 years (or 25% of the time). What has caused this year to shift from startling to frightening is the breadth and severity of declines across normally uncorrelated assets. Only commodities have generated a positive rate of return so far in 2022, and even the GSCI Commodity Index has fallen by 30% in the last few months. Therefore, even in a well-constructed, diversified portfolio, there has simply been no place to hide.

As it stands today, a 60/40 portfolio of US stocks and bonds is down 20.4% (as of 9/26/22022), which is on pace to become the second worst year in history, trailing only 1931.

Annual Returns: 60/40 Portfolio[4]
1928 – 2022 YTD (September 26, 2022) | S&P 500 / 10-Year US Treasuries

Year	Return	Year	Return	Year	Return	Year	Return	Year	Return
1928	26.6%	1947	3.5%	1966	-4.8%	1985	29.0%	2004	8.2%
1929	-3.3%	1948	4.2%	1967	13.6%	1986	20.8%	2005	4.0%
1930	-13.3%	1949	12.8%	1968	7.8%	1987	1.5%	2006	10.2%
1931	-27.3%	1950	18.7%	1969	-7.0%	1988	13.2%	2007	7.4%
1932	-1.7%	1951	14.1%	1970	8.8%	1989	26.0%	2008	-13.9%
1933	30.7%	1952	11.8%	1971	12.4%	1990	0.7%	2009	11.1%
1934	2.5%	1953	0.9%	1972	12.4%	1991	24.1%	2010	12.3%
1935	29.8%	1954	32.9%	1973	-7.1%	1992	8.2%	2011	7.7%
1936	21.2%	1955	19.0%	1974	-14.7%	1993	11.7%	2012	10.7%
1937	-20.7%	1956	3.6%	1975	23.6%	1994	-2.4%	2013	15.6%
1938	19.3%	1957	-3.6%	1976	20.7%	1995	31.7%	2014	12.4%
1939	1.1%	1958	25.4%	1977	-3.7%	1996	14.2%	2015	1.3%
1940	-4.2%	1959	6.2%	1978	3.6%	1997	23.8%	2016	7.3%
1941	-8.5%	1960	4.9%	1979	11.4%	1998	23.0%	2017	14.1%
1942	12.4%	1961	16.8%	1980	17.8%	1999	9.2%	2018	-2.5%
1943	16.0%	1962	-3.0%	1981	0.5%	2000	1.2%	2019	22.6%
1944	12.4%	1963	14.2%	1982	25.4%	2001	-4.9%	2020	15.3%
1945	23.0%	1964	11.3%	1983	14.7%	2002	-7.1%	2021	15.3%
1946	-3.8%	1965	7.7%	1984	9.2%	2003	17.2%	2022	-20.4%

Returning to a regime of higher inflation and more normal monetary policy is a difficult and painful transition. Without greater visibility into how much higher, and for how much longer, the Fed (and other global Central Banks) plan to hike interest rates, more pain in asset markets is likely. In his September press conference, Fed Chair Jerome Powell essentially said, "the beatings will continue until morale improves." We have prepared to weather this storm by allocating assets to our most defensive positioning. The double-digit decline in fixed income – a traditionally less volatile asset class – provides little solace at present. However, for those willing and able to expand their time horizons, it is important to acknowledge that long-term wealth creation opportunities are often born during bear markets. The previous chart shows that if investors with diversified portfolios were willing to withstand the 27.3% drop in 1931, then they could generate a 107% cumulative return (15.6% annualized) over the subsequent five years.

When the dust settles from this Great Unwind, our hope is that renewed economic prosperity will propel us forward. For now, we urge caution and patience. And as always, as questions or concerns arise, please do not hesitate to lean on our team and your advisors for answers. We sincerely appreciate being your partner in your financial journey.

Wishing you good health and peace of mind as we close out 2022.

Respectfully,

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The impact of the outbreak of COVID-19 on the economy is highly uncertain. Valuations and economic data may change more rapidly and significantly than under standard market conditions. COVID-19 has and will continue based on economic forecasts to have a material impact on the US and global economy for an unknown period.