

AndCo's Monthly Market Update

September 2022

THE ECONOMY

"Investment success requires sticking with positions made uncomfortable by their variance with popular opinion." David F. Swensen

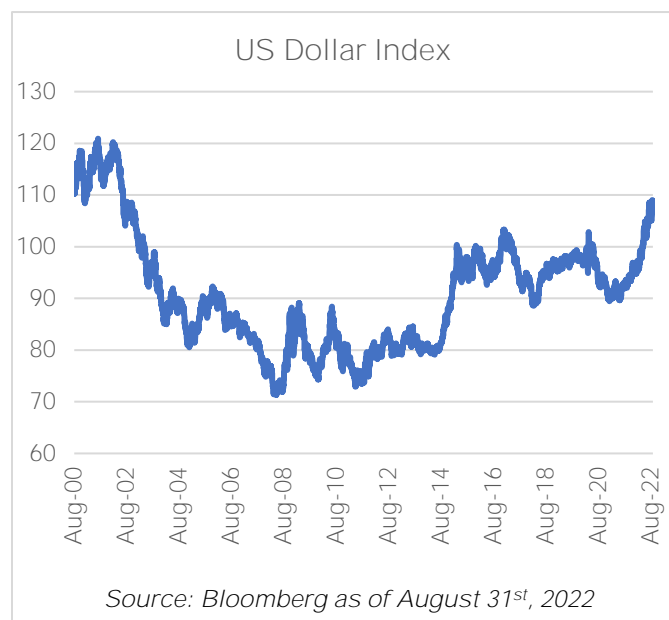
Investors' resolve was tested in August as both broad equity and fixed income markets fell. Globally, the specter of persistent inflation, fueled primarily by rising energy prices, has led to tighter monetary conditions which all contributed to the month's decline. The root cause of these issues lies with global central banks' monetary policies which remained "too loose for too long." The explosion in the monetary base following the onset of the pandemic resulted in significant price increases for such staples as gas, food, and rent. As a result of these increases, global central banks have been forced to raise interest rates at their fastest pace in decades. The Federal Reserve Bank (the Fed), having already hiked interest rates earlier this year by a total of 2.00% (three increases), is poised to raise rates in September with the market anticipating another 0.75% increase.¹ The European Central Bank, which had held interest rates at, or below, 0.0% for nearly a decade, only recently got around to raising interest rates by 0.75%.² So far this year, 40 central banks have increased their interest rates by at least 0.75%.³ Like a wave, the unprecedented amount of money that sloshed into the market in recent years is now beginning to recede. Our concern is that investors have become overly accustomed to low interest rates and easy money, and as a result, may be discounting the reality that as interest rates rise, stress is put on the economic system. Like past rate hike cycles, the Fed was slow to respond to rising inflation, and to correct the policy error, they will likely overshoot with higher-than-expected interest rates. The outcome of this scenario could be significantly slower economic growth than recent years resulting in a reduction in corporate earnings and ultimately, lower asset returns than expectations.

One part of the economy that has been impacted by rising interest rates is real estate. In many parts of the country, residential real estate prices have risen dramatically due to low interest rates and demographic shifts. However, rising mortgage rates have resulted in a significant slowdown in home purchases. The national average 30-year fixed mortgage rate is roughly 5.6% as of the

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end of August, up nearly 2.8% from a year earlier and the highest since 2008.⁴ Not surprisingly, new and existing home sales are down by 29.6% and 20.2%, respectively as of July, on a year-over-year basis.^{5,6} As fewer buyers enter the market, home prices have begun to decline. For the month of July, home prices declined by -0.77%, the largest monthly decline in prices in over a decade.⁷ Importantly, the market is showing signs of stress as delinquencies are starting to edge higher.⁸ So, what does all this mean for investors? For the middle class, the home is one of the greatest stores of wealth. Many people who bought recently may see their equity eroded as home prices decline. While we do not think this is a replay of the Great Financial Crisis in 2007-08, we are mindful of the potential negative impacts to consumers should housing prices decline significantly.

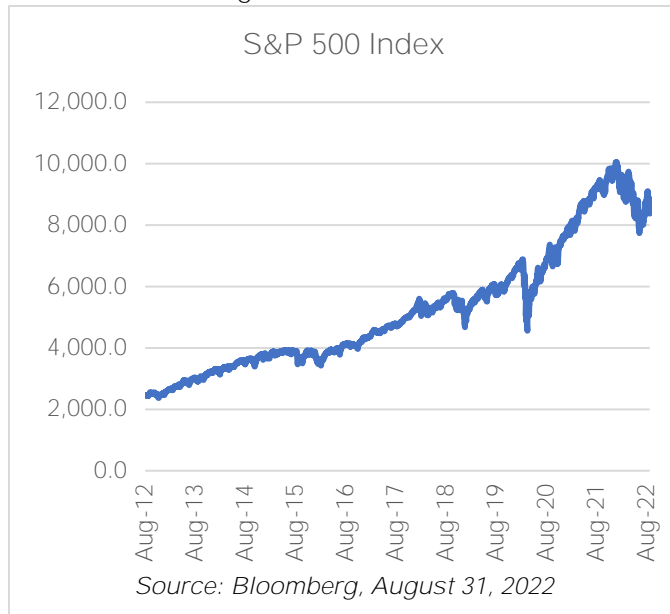
Finally, a byproduct of the rate hikes initiated by the Fed to fight rising inflation is the strength of the US dollar when compared to other world currencies. Year-to-date, the US Dollar Index (DXY) is up roughly 12.9%.⁹ The catalyst for this strength is as US interest rates rise, foreign investors, especially those in low interest rate countries, sell their currencies to buy dollars. This condition can act as a tailwind to the economy since energy and commodity prices tend to fall as the dollar climbs in value, however, this has not been the case this year. The reason that energy prices remain high has much to do with supply issues resulting from sanctions on Russia and the general lack of global production capacity. As a result, a rising dollar most likely will result in lower corporate profits for US companies with significant overseas operations. A rising dollar also puts significant pressure on countries that issue dollar-denominated debt such as emerging market countries. As the local currency falls in value, countries with dollar-denominated debt must devote more of their resources (weaker currency) to paying interest and principal payments. Historically, periods of dollar strength are marked by sovereign defaults, and as a result, we will keep a close eye on currency markets as a leading indicator of potential future market volatility.





EQUITIES

Equity market volatility increased markedly in August and investors tried to balance the hawkish statements made by Fed Chair Powell and continued strength in US labor markets. Prior to **Powell’s speech at Jackson Hole, the S&P 500** was up more than 4.5%.¹⁰ However, after it was revealed that the Fed would remain vigilant in its fight against inflation, the market quickly reversed direction closing down -4.08% on the month.¹¹ Investors were expecting the Fed to pivot towards a more dovish stance, perhaps only raising interest rates by 0.50% in September with the potential to remain on hold as inflation slowly declines. Now that **the Fed is committed to “using our tools forcefully” and “for some time,” investors** are expecting the Fed to continue raising rates well into the first quarter of next year.¹²



Overseas markets performed largely in lockstep with US results, suffering significant declines during the month. Eurozone markets fell in August as ongoing concerns related to the continuing conflict between Russia and Ukraine, surging energy prices, and soaring inflation acted as headwinds. For the month, the MSCI ACWI ex US Index declined -3.22%.¹³ The lone performance bright spot was emerging markets where the MSCI Emerging Market Index rose by a marginal 0.42% during the period.¹⁴ China, which has been a headwind in recent months and represents the benchmark's largest weight, was positive in August. While further lockdowns related to Covid-19 are impediments to growth, the country and central bank enacted several fiscal and monetary stimulus policies designed to boost output.¹⁵ Turkey was the best performing emerging country, delivering double-digit returns as the central bank surprised the market with a cut in interest rates, despite near hyper-inflation which recently topping 80%.¹⁶

FIXED INCOME

Bond markets were whipsawed in August as investors’ expectations shifted from a moderating Fed towards tighter monetary policy. Returns for both US and global government bonds were broadly negative during the month, driven by expectations for higher future interest rates and inflationary concerns. The yield on the US Treasury 10-Year bond rose by 55 basis points during the month, from a low of 2.60% to 3.15%.¹⁷ While the additional income is welcome by investors who have become accustomed to low bond yields, **it’s** not much consolation for the current poor



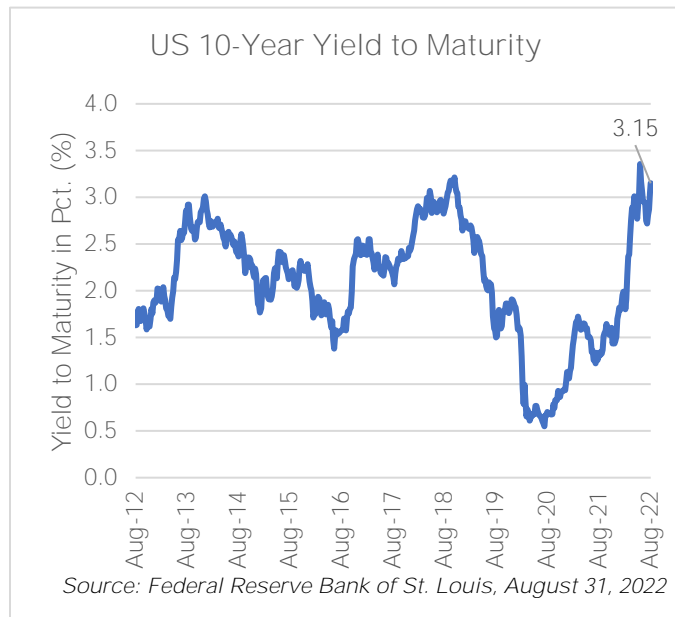
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performance of the asset class. The higher quality Bloomberg US Aggregate Bond Index returned -2.83% for the month.¹⁸

Corporate bonds fared similarly for the period with spreads widened slightly on concerns that a slowing economic backdrop could potentially increase credit risk. For the month, the Bloomberg US Corporate Bond Index fell by -2.93%, while the shorter duration, lower quality Bloomberg US Corporate High Yield Index declined by -2.30%.¹⁹

Similar to the US bond market, global government bonds fell sharply in August as central banks reacted to higher inflation. In the UK, the inflation rate officially hit 10.1% during the month,

prompting the Bank of England to raise interest rates by 50 basis points to 1.75%, the largest single increase in more than 27-years.²⁰ Rising energy prices resulting from sanctions on Russia related to the ongoing conflict in Ukraine have led to higher-than-expected inflation across Europe. As a result, it is anticipated that the European Central Bank will deliver a large rate increase in September to dampen inflation and business activity. For the month, the Bloomberg Global Aggregate Bond Index declined by -3.95%.²¹



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APPENDIX

1. Bloomberg, September 8, 2022
2. <https://www.reuters.com/markets/europe/ecb-poised-another-big-rate-hike-inflation-soars-2022-09-07/>
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