AndCo's Monthly Market Update

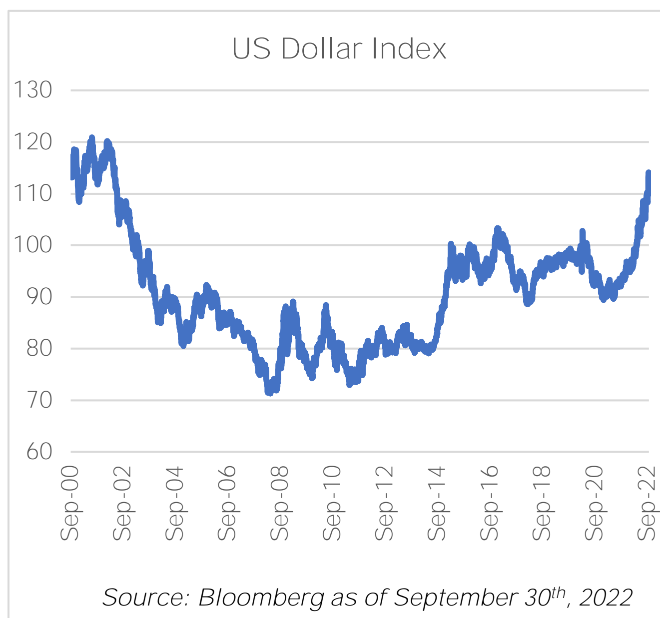
October 2022

THE ECONOMY

"The Federal Reserve Bank is answerable to no one." Ronald Reagan

While we saw several datapoints during the month that confirm our thesis that the economy is slowing, the real story remains actions by the Federal Reserve Bank (the Fed). As expected, Chairman Jerome Powell delivered another 0.75% increase in interest rates, raising the Fed Funds rate to 3.25%. This marks the fifth rate hike this year and the third consecutive 0.75% increase. Importantly, Powell reiterated that the Fed remains committed to fighting inflation and indicated that more increases are likely.

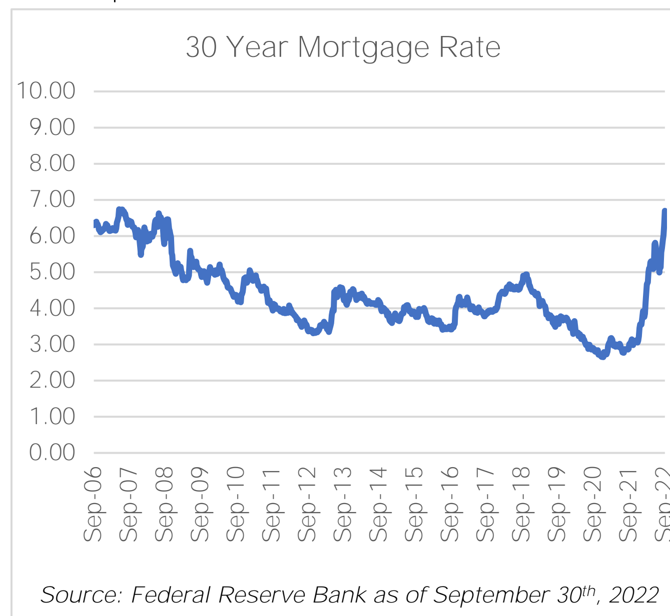
While all markets have experienced volatility in recent periods due to the shift in monetary policy, global currency markets (FX) have exhibited some of the strongest reactions. Year-to-date, the US dollar (USD) has soared by roughly 19.0% to levels not seen since prior to the Great Financial Crisis in 2008.[1] The cause of USD**'s** strength relative to other currencies is twofold: a) **the Fed's** decision to hike interest rates, and b) **investors' fear.** As the Fed hikes interest rates, the spread relative to other currencies becomes more attractive. Similarly, during periods of increased volatility, foreign investors will often flee to the USD **as a "safe haven" asset.** In both cases, there are net inflows which drive the USD higher. While a strong USD may have some near-term benefits to Americans such as lower commodity and import prices, the real concern is over the longer-term. Specifically, many countries finance debt in USD. A weaker domestic currency means the cost of serving the debt



Source: Bloomberg as of September 30th, 2022

increases. To stabilize their currencies, these countries are often forced to raise interest rates to slow the local depreciation, which further slows their local economies. While the full effect of the rate hikes has not been fully felt, it is worth noting that a currency crisis often precedes an economic crisis. To that end, we are watching the USD and FX markets for signs of deteriorating conditions.

Another market negatively impacted by the Fed's rate increases is housing. 30-Year fixed mortgage rates are now at their highest level since prior to the Great Financial Crisis in 2006.[2] Not surprisingly, sales of existing homes slowed precipitously in August, posting a decline of -0.4% month-over-month. This equates to an annual run rate of 4.8 million homes, the slowest pace in more than eight years.[3] The declines represent a -26% change year-to-date.[4] Unfortunately, the housing market's decline in activity has spillover affects into other parts of the economy such as services, finance, and home-related industries. Powell made it clear at his recent press conference that the housing market is out of balance, with home prices having risen significantly since the end of the pandemic. If the Fed persists in raising interest rates further, it is reasonable to expect a further slowing in home sales.



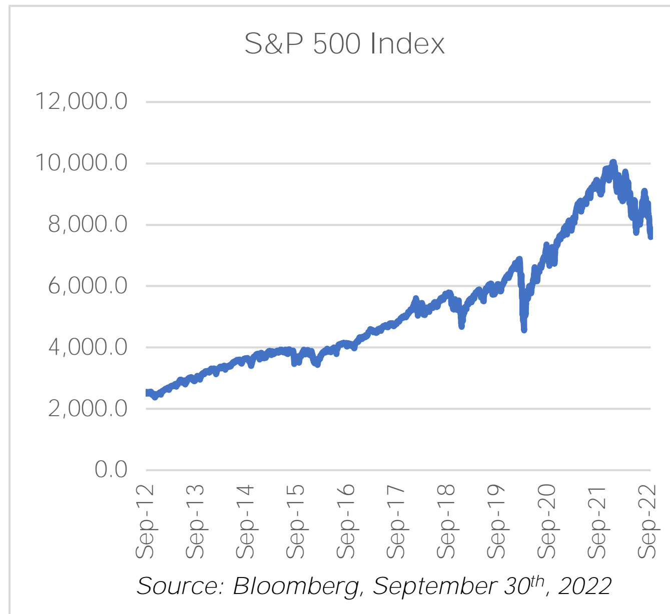
Source: Federal Reserve Bank as of September 30th, 2022

One market that remains resilient is labor. In September, 263,000 new jobs were added.[5] Importantly, the unemployment rate fell to 3.5%, down from 3.7% in August.[6] While there remains a significant number of jobs left unfilled, there appears to be little slack in labor markets which should benefit wage growth. That said, as we move forward and the economy likely continues to slow under the weight of higher interest rates, it is reasonable to expect some softening in the labor market and the unemployment rate will likely move higher.

Finally, we would be remiss if we did not mention the geopolitical events witnessed during the month. The conflict between Russia and Ukraine escalated during the month with an offensive by the Ukraine army resulting in the retaking significant amounts of territory previously captured by Russia. Four Russian-occupied territories held elections to determine if they would join the Russian Federation. The elections were broadly viewed in the West as a way to annex the territories. In an effort to shore up their forces in the region, Russia mobilized 300,000 soldiers to rotate into the theater. Finally, both the Nordstream 1 and 2 pipelines were attacked and disabled. While little natural gas was flowing to Germany from Russia at the time of the event, the effects will be long lasting given Western Europe's reliance on Russia energy. The longer the conflict lasts, the greater the humanitarian and economic costs.

EQUITIES

Global equity markets declined during the month primarily due to persistently higher inflation, tightening monetary policies, and continued geopolitical concerns. September saw the S&P 500 decline by -9.21%, bringing the benchmark's year-to-date decline to -23.87%.[7] September has historically been a challenging month for equities, having averaged -1.03%.[8] However, the recent decline ranks as the worst September since 2002.[9]



Source: Bloomberg, September 30th, 2022

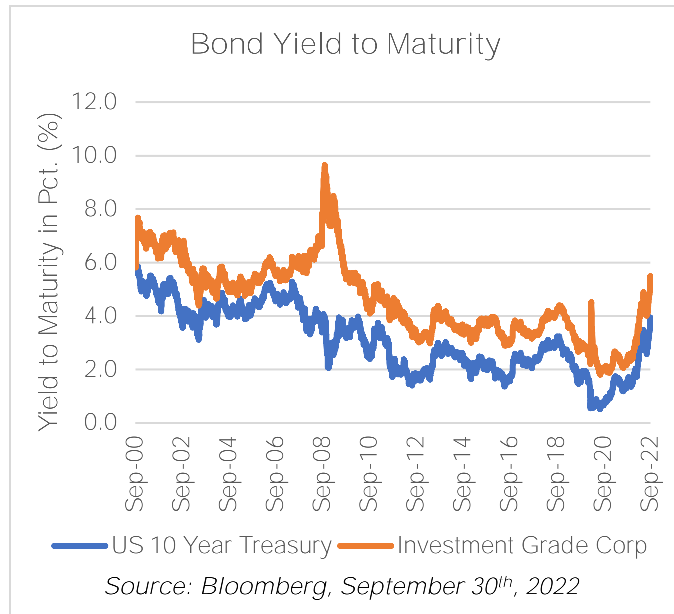
Global developed and emerging markets also suffered during the month, with emerging market equities acting as the laggard. The MSCI EAFE Index fell by -9.35% while the MSCI EM Index dropped by -11.72%.[10] In Europe, the affects from continued energy supply disruptions hampered growth. Additionally, a strong USD acted as a headwind for US investors' foreign investments. In emerging markets, the primary driver of performance was the deterioration of the economy and lower export volume.

While the decline in stock prices has negatively impacted portfolios, from a valuation perspective, stocks look to be more reasonably priced at current levels than at their previous highs. As of September 30th, the SPX trailing 12-month price-to-earnings multiple is roughly 18x, far below the 26x in January this year.[11] Our concern is that valuations may decline further as corporate earnings slow in tandem with the economy. If earnings were to decline, stock prices would need to decline further in order to remain "fairly valued."

FIXED INCOME

Correlations between stocks and bonds remained high in September as evidenced by the broad decline in fixed income markets. For the period, the Bloomberg US Aggregate Bond Index fell by -4.32%.[12] Year-to-date, the benchmark is down -14.61%, having suffered three consecutive quarters of negative performance.[13] Similar to higher quality bonds, the Bloomberg US Corporate Bond Index and Corporate High Yield Index fell -5.26% and -3.97%, respectively, during September.[14]

Bond market yields moved higher during the month as the Fed delivered another rate hike and hinted at additional tightening. For September, the 10-Year US Treasury yield increased by more than 60 basis points (0.60%) while investment grade credit increased by roughly 80 basis points.[15] Despite the move higher, the US Treasury curve remained inverted, meaning short-term rates were higher than long-term. The spread between the US 2-Year and 10-Year Treasury Bond was -39 basis points to end the month.[16] A negative spread such as this has been used as a leading indicator of future recession. As evidence of this, investors are betting that inflation will eventually decline as the economy slows. The 10-Year US inflation break-even rate fell to 2.15%, suggesting that investors believe that future inflation will be lower.[17]



Source: Bloomberg, September 30th, 2022

Finally, volatility was the story in global bonds during the month. The UK experienced a significant sell off in rates to start the month as the newly formed government recommended a package of tax cuts that was deemed to be fiscally unsound. The 10-Year UK Gilt bond increased by more than 130 basis points to roughly 4.0%.[18] Concerns about the UK mortgage market and pension solvency increased, resulting in the Bank of England initiating another round of quantitative easing, or bond buying, to support the market. For the month, the Bloomberg Global Aggregate Bond Index declined by -5.14%.[19]

The remainder of this page left blank intentionally

APPENDIX

1. https://am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/guide-to-the-markets/economic-and-market-update/
2. https://fred.stlouisfed.org/series/MORTGAGE30US
3. https://www.hsh.com/trends.html
4. https://www.hsh.com/trends.html
5. https://www.bls.gov/news.release/empsit.nr0.htm
6. https://www.bls.gov/news.release/pdf/empsit.pdf
7. Morningstar, September 2022
8. https://www.spglobal.com/spdji/en/documents/commentary/market-attributes-us-equities-202209.pdf
9. https://www.spglobal.com/spdji/en/documents/commentary/market-attributes-us-equities-202209.pdf
10. Morningstar, September 2022
11. https://olui2.fs.ml.com/publish/content/application/pdf/gwmol/me-cio-weekly-letter.pdf
12. Morningstar, September 2022
13. Morningstar, September 2022
14. Morningstar, September 2022
15. Bloomberg, September 2022
16. https://fred.stlouisfed.org/series/T10Y2Y
17. Bloomberg, September 2022
18. Bloomberg, September 2022
19. Morningstar, September 2022

Important Disclosure Information

This document is being provided solely for informational and educational purposes and should not be regarded as investment advice or as a recommendation regarding any particular course of action and additionally is not intended to provide, and should not be relied upon, for legal, tax, or accounting advice.

Any securities cited are for illustrative purposes only. References herein do not constitute a recommendation to buy, sell or hold such securities.

The material provided herein is valid as of the date of distribution and not as of any future date, and will not be updated or otherwise revised to reflect information that subsequently becomes available, or circumstances existing or changes occurring after such date. This document may contain opinions, observations, projections or forward-looking statements which are subject to various uncertainties whereby the actual outcomes or results could differ from those indicated.

Certain information is based on sources and data believed to be reliable, but AndCo cannot guarantee the accuracy, adequacy, or completeness of the information. The source for all data, charts and graphs is AndCo Consulting unless otherwise stated.

AndCo Consulting is an investment adviser registered with the U.S. Securities and Exchange Commission ("SEC"). Registration as an investment adviser does not constitute an endorsement for the firm by securities regulators nor does it indicate that the adviser has attained a particular level of skill or ability.