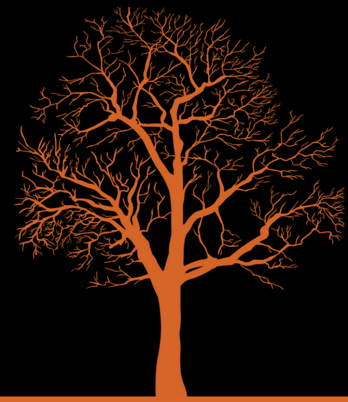
3Q2022

Maclura Investments

3Q22 Review - The Fed Pivots to Pain



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This past quarter marked a significant change in monetary policy throughout the world. Over the past decade, easy monetary policies have been implemented by central banks in an attempt to coax economies to a self-sustaining recovery after the Great Recession of 2008. Not only were short-term interest rates lowered to near or below zero but quantitative easing programs were implemented where central banks purchased securities to help keep interest rates low. While the Federal Reserve has communicated for a while now that interest rates needed to be raised to a more “normalized” level, the expectation by investors was that it would be at a measured pace after reviewing all of the economic data. The Fed pivot to a more “aggressive and prolonged higher interest rates” stance during the quarter to try to get ahead of the inflation curve was more than what the market anticipated.

At the end of the second quarter, our quarterly newsletter explained that if the 2nd quarter GDP estimate released in late July was negative, making it the second consecutive quarter of the GDP contracting, which historically has been defined as a recession. With the estimates for the contraction being just slightly negative and the unemployment rate still strong, it was expected to be a shallow and brief recession. Nonetheless, the expectation was that the two consecutive GDP contractions would slow the Fed’s monetary policy in raising interest rates, allowing the market to rally. Indeed, the GDP estimate for the second quarter was negative, and the Morningstar US Market Index rose by 13% from July 1st through August 16th, recouping nearly half of the market’s negative returns incurred during the first half of the year.

Exhibit 1. Investment-Style Returns

	Morningstar Index Market Returns	2015	2016	2017	2018	2019	2020	2021	2022 1st Qtr.	2022 2nd Qtr.	2022 3rd Qtr.	2022 ytd
Growth	U.S. Growth	5.54%	3.16%	29.52%	0.78%	35.90%	44.65%	24.79%	-11.97%	-25.33%	-3.84%	-36.39%
Growth	Large Growth	7.71%	1.79%	31.15%	2.94%	33.81%	38.86%	21.47%	-13.55%	-29.81%	-2.74%	-40.99%
Growth	Mid Growth	-0.71%	6.46%	25.67%	-3.16%	36.01%	46.17%	14.97%	-16.01%	-21.33%	-2.37%	-35.49%
Growth	Small Growth	-0.18%	9.61%	23.77%	-5.67%	27.60%	43.52%	-1.00%	-13.37%	-22.41%	-2.49%	-34.46%
Value	U.S. Value	-2.16%	20.79%	14.23%	-7.51%	25.09%	-1.31%	23.98%	2.35%	-9.44%	-6.60%	-13.43%
Value	Large Value	-1.43%	18.91%	15.09%	-5.90%	25.70%	-0.62%	21.49%	1.63%	-8.16%	-7.09%	-13.27%
Value	Mid Value	-2.57%	25.21%	13.02%	-10.63%	24.81%	-3.76%	29.02%	4.85%	-12.65%	-5.11%	-12.26%
Value	Small Value	-8.65%	27.96%	8.40%	-16.61%	19.96%	1.01%	31.79%	1.80%	-12.78%	-5.14%	-15.11%

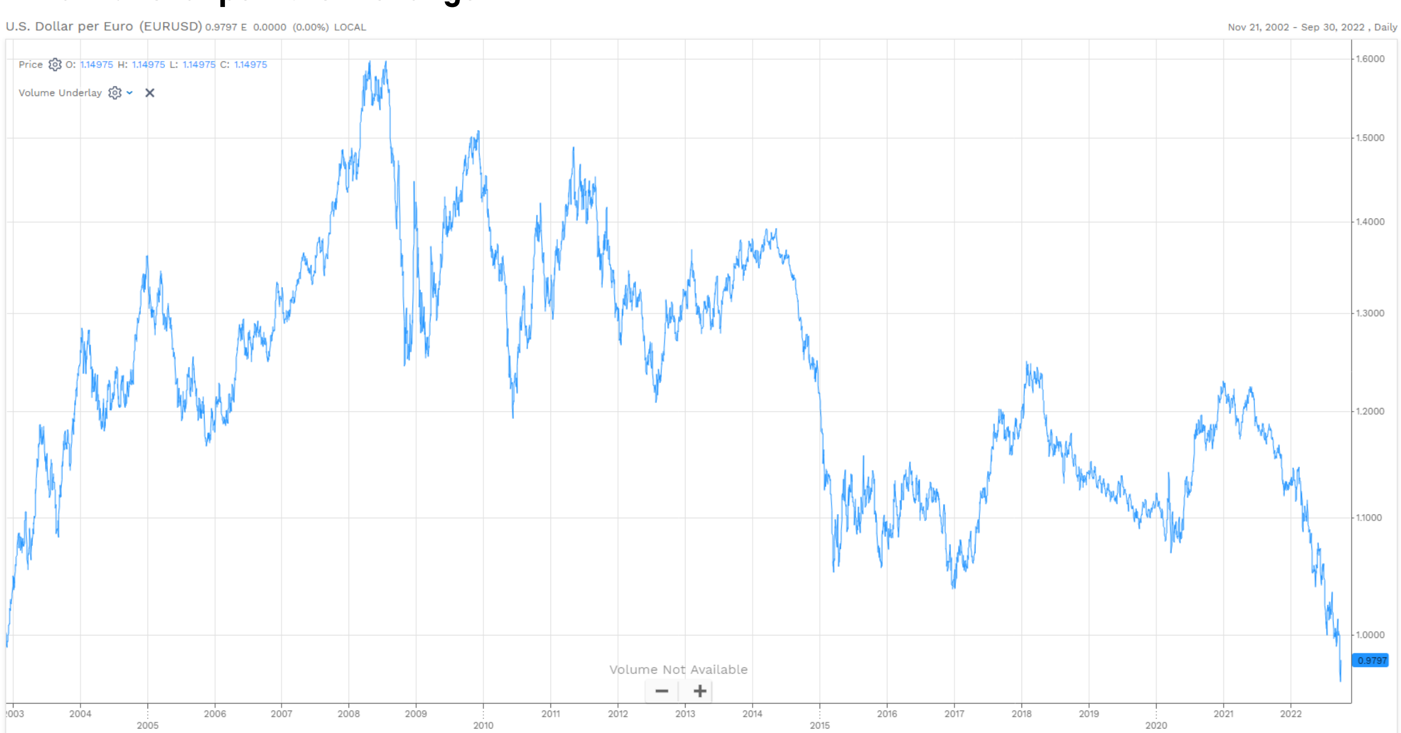
Source: *Morningstar*

Then came Fed Chairman Jerome Powell’s speech in late August warning of “some pain” for the economy as the Fed fights to lower inflation, and by the end of September, the market had given up its mid-quarter gain and then some, with the Morningstar US Market Index ending down 4.6% and 24.9% for the quarter and first nine months, respectively. During Chairman Powell’s press conference in late September after the FOMC committee had decided to raise short-term interest rates by 75 basis points to a range of 3.0% to 3.25%, he communicated that the committee planned to continue to aggressively raise rates, possibly to 4.5% by year-end, if not higher, to address inflation.

Besides the obvious impact this pivot has had on the fixed income and stock markets, there are a number of ramifications to this action, particularly when paired with the ramping up of the monthly reduction of the Fed balance sheet to $95 billion per month starting in September. In our last quarterly, we discussed the impact of rising interest rates to asset values using mortgage rates as an example. At the time, mortgage rates were near 6%, but its persistent rise has recently taken it to over 7% for the average fixed 30-yr mortgage. Part of the monthly $95 billion reduction of the Fed's balance sheet is the redemption of mortgage-backed securities. During the question-and-answer session of Chairman Powell's September press conference, an inquiry was made as to whether the Fed would consider slowing down the mortgage-backed securities reductions to help moderate the rise in mortgage rates. Chairman Powell's surprised expression of being asked the question, followed by his response that the Fed was not even considering it, indicates that the increase in mortgage rates will not end anytime soon and will likely continue to 8% to 9% within the next six months. While this may decrease demand in the housing market, it doesn't do much to lower the overall affordability of housing when considering the additional cost over the life of the loan with the higher interest rates.

The strengthening of the U.S. Dollar to other currencies throughout the world will have a significant impact on businesses that operate internationally. Additionally, foreign central banks are being pressured to intervene to slow their currency depreciation against the dollar either by raising interest rates or resuming quantitative easing. During the last week of September, Nike (NKE) reported their quarterly financial results and gave guidance that after converting their revenues for the strengthening dollar, fiscal year 2023 sales are now expected to grow mid-single digits after the 8% currency headwind. On a constant currency basis, sales were expected to be in the low double-digits. This will be a reoccurring disclaimer for large companies with businesses overseas. The chart below represents the exchange rate of the U.S. Dollar to the Euro over the past 20 years (currently it takes 97 cents to exchange into 1 euro). The stronger dollar also exacerbates inflation throughout the world, since a large portion of commodities are traded in the dollar.

Exhibit 2. Dollar per Euro Exchange



Source: FactSet

From a geopolitical perspective, the Ukraine – Russia situation continues to worsen. Though social media and media outlets have been highlighting Russia's partial mobilization of 300,000 troops as a failure, it is doubtful to be the failure that is currently being portrayed. Anytime Russia mobilizes troops, it doesn't bode well for Europe. Ideally, it would have been preferred to have a negotiated settlement to have peace prevail, but that looks unlikely at the moment. The weaponizing of energy by Russia against Europe continues to drastically increase costs for manufacturers in the region. And though oil and gas prices have dropped from their highs earlier this year, it will become a delicate balancing act to replenish inventories that helped to bring prices down and not over produce as the global economy enters into a recession.

While there are still a number of additional factors that are being monitored and worthy of discussing, the core question on everyone's mind is what to do now. There haven't been a lot of options in this environment for investors. Core bond indices are down year-to-date anywhere from the short duration Morningstar 1 – 5 Year Core Bond Index down 6.8% to the long duration Morningstar 10 Year Plus Core Bond Index down 29.0% year-to-date. Historically, bonds have helped dampen the effect of a slowing economy as interest rates were dropped to help support the economy, but in the new era of starting with zero interest rates, bonds and stocks have moved in tandem. The market reaction in July favored growth stocks significantly over value stocks, and that provides the blueprint of how to be positioned once the Fed starts to slow down its rate increases, which is likely six to nine months away. Maclura Investments portfolios currently have higher cash levels than would be in a more "normalized" market, and will be using the cash to dollar cost average over the next several months to position portfolios for this scenario.

The wildcard has always been the impact of quantitative tightening (reducing the central banks' balance sheet) and how that was going to impact the markets. As we are a couple of months into the Federal Reserve plan to reduce its balance sheet by nearly $1.1 trillion per year, its unintended consequence is becoming clearer. The bond market is returning to the environment of a real market without the artificial buying (the Fed) skewing the market by buying its own bonds back.

In United States classrooms, it is taught that the government has three branches that balance each other out in power and oversight. In actuality, there is a fourth force: the bond vigilantes. This was a term popularized in the 90's when bond investors sold bonds because of concerns about federal spending during the Clinton Administration. It wasn't until the Clinton Administration and Congress made an effort to reduce the deficit that interest rates started to decline again. This term was recently brought back out of the history books when the United Kingdom announced in late September its plan for tax cuts on top of an energy bill bailout, all funded by a huge increase in government borrowing, causing its bond market to nearly collapse. In order to stop the pain, the Bank of England announced that it would buy up to $5.31 billion a day worth of British government bonds of at least 20 year's maturity. Additionally, caving to the currency and bond market turmoil because of proposal, the UK Government adjusted its tax cuts to exclude cutting the top income tax rate as proposed previously.

This is an example of what is to come to policy makers throughout the world. Without the Fed's bottomless bucket of cash buying bonds and manipulating interest rates, the market is returning to the evaluation of risk versus return analysis, which will force fiscal discipline upon the government. This is actually a good thing. From a stock market perspective, companies have operated before in an environment of higher interest rates, and going forward, projects will have a higher hurdle rate to consider whether the return is beneficial to the shareholders. The first sign that the Fed is concerned about their actions will be them slowing down the pace or halting the quantitative tightening program (balance sheet reduction) to help stabilize the markets. The markets will view this as a positive pivot in policy and likely rally.

In my thirty plus years in the investment industry, this year has been one of the most challenging and frustrating, particularly since most of the pain the market has inflicted on investors has been non-fundamental reasons such as mandatory covid shutdowns of the economy and geopolitical posturing. But this too will pass, and while it is painful to go through what the market has done so far this year, being well-diversified in companies that have strong balance sheets, with solid competitive positioning will benefit investors when the market stabilizes. This is the type of companies sought by Maclura Investments to build client's individual portfolios. While in the short-term the markets will fluctuate, investing in the right companies for the long-term should get you to your wealth destination.