Volatility Continues

Stocks started very strong in the third quarter as hopes of a Federal Reserve (Fed) pivot towards a less aggressive rate posture, drove 10-year treasury rates below 2.6%. At its peak on August 16th the S&P 500 had gained over 14%. Shortly thereafter Fed officials made it clear they do not expect to pivot anytime soon. The 10-year treasury marched straight up to 4%, and stocks turned lower with the S&P 500 finishing the quarter down 4.9%. For the year the S&P 500 has declined by -23.9%, solidly in bear market territory. Investors cannot even find refuge in fixed income, an asset class that usually does well when stocks suffer. The overall bond market has lost about 15% so far this year.

The reason for this carnage is clear – inflation is much too high, causing interest rates to rise dramatically, and stoking fears of a recession. Part of the inflation problem is due to a series of unexpected supply shocks during the Covid lockdowns, constraints on energy supply with the war in Ukraine, and U.S. fiscal policy that was too expansionary. The $1.9 trillion American Rescue Act in 2021 was excessive. For its part the Fed persisted with ultra-loose policies for too long.

What does all this negativity mean for the future? The stock market is a discounting mechanism, usually meaning the best time to invest is when everything looks the worst, and there is a good chance all the negative news is reflected in prices. Both professional and individual investors are extremely pessimistic which is a contrary buy signal. The current expectation is for the economy to enter a recession, hurting corporate profits. If the outcome is less dire, stocks could respond favorably. We also find it encouraging that the most speculative parts of the market have collapsed. Cryptocurrencies, SPAC stocks, meme stocks, and Covid stocks have all cratered. The IPO market is essential closed currently.

One positive from the 2022 carnage is that high-quality, attractive fixed income investments are now available which is something that investors haven't had in over a decade. The 2-year treasury note is yielding over 4% which is up from 0.3% (virtually nothing) in 2021.

We did take advantage of the rally in the quarter to sell some stock positions. In our Diversified strategies we sold some of our international ETFs, an asset class that is down over 26% on the year. After the rally fizzled, we reinvested the proceeds late in the quarter and continue to overweight the Value factor which is the best performing factor in 2022. In fixed income we hold floating rate and short duration ETFs avoiding a large part of the bond market declines.

While our more optimistic outlook doesn't guarantee stock prices won't head lower, we believe there is very good value in the stock market for long term investors. At the same time, we do not expect the market to recover to new highs any time soon. The most likely scenario for stocks is to build a base over the next year or so before another bull market emerges.

There's lots of news so please call us if you'd like to review your portfolio.

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