CAUBLE & HARRE
WEALTH MANAGEMENT

Third Quarter 2022 Market Commentary

I happened to catch the live video last week from NASA's mission to crash a rocket into an asteroid. The intent was to see if we could change the orbit of an asteroid if there was one headed toward earth. NASA launched the rocket 10 months ago, and it had been traveling the 7 million miles to the flying rock. From 7 million miles away, it would seem to be a success to get anywhere close, but the intent was to hit the rock directly. I picked up the video feed when the rocket was 1,500 miles away and 5 minutes from impact. Think about that. To make it more impressive, they were sending their last signals to the rocket. The rocket was sending images back (with a 40 second delay……because of the 7 million miles), and the rock grew larger and larger until it filled the screen, and then the screen went blank. Success. I jokingly thought that they should have sent a second rocket to record what happened. The next morning, I learned that they did, but no details on that yet.

The third quarter felt like hitting an asteroid. Stocks fell 7.1% during the quarter (Vanguard Total World Stock Market Index ETF). It felt worse because markets began to rise again in July, so the declines in September had to reverse these gains and fall another 7%. Bonds and Gold continued their losses as well. Year-to-date stocks are down 25%, bonds are down 14% and gold is down 7%.

We entered 2022 with historically expensive markets. The declines through the first six months brought the valuation back down to the 25-year historical average. Investors began bidding up prices again in July hoping that the Federal Reserve would not continue to raise interest rates. One can hardly blame the Buy-The-Dip crowd for its behavior. They have been trained to do so by the Federal Reserve over the last 12 years. The difference today vs. the last 12 years is the high level of inflation present. The Federal Reserve seems committed to fighting it. Rates (the cost of money) are remaining high. That changes a lot of the math that goes into deciding whether to maintain some investment strategies, especially those involving borrowed money.

Interest rates have moved up quickly. The 5-year Treasury rate began the year yielding 1.26%. By June, the yield has risen to 3.0%. It continued rising to 4% by September 30. The U.S. dollar is also gaining strength quickly. Interest rates in other countries are also rising. When things like interest rates and currencies remain low/stable for a long period of time, investors can begin to implement investment strategies that depend on these factors remaining the same. This is poor risk management. They are tempted by the extra returns seemingly available at low risk. Some refer to this as picking up nickels in front of a steam roller. When the steam roller shows up (abrupt changes in interest rates or currencies), these investors become forced sellers, trying to unwind those strategies that seemed to make sense before.

Here are two examples of indicators or sources of instability in the current environment:

Pension funds in the UK just found themselves having to sell assets quickly to meet margin calls on investment products that were blowing up because of the quickly changing interest rates. The pension regulator had been pressuring pension sponsors to adopt these strategies for the extra returns they offered. The Bank of England had to begin buying UK government bonds to help lower interest rates to staunch the need for more asset sales.

There are trillions of dollars of debt held by overseas investors that are denominated in U.S. dollars. Because of this, a strengthening dollar can cause the value of these liabilities to rise for their holders. Liabilities can increase without the means to pay for them. Also, if a country imports food and energy priced in dollars, these items can begin to get quite expensive. This puts pressure on companies and governments.

What about corporate earnings? Are we headed into a recession with lower corporate earnings as a result? Possibly. We do know that a stronger dollar makes the earnings of U.S. companies earned overseas worth less when translated back into dollars. So far, companies have been aggressive in raising prices for customers, which has allowed revenue and earnings to hold up. Can they continue to pass along their higher costs? Will rising labor costs begin to impact profitability? Upcoming third quarter earnings releases over the next few weeks will shed some light on these questions.

The stock market could have more downside if earnings are perceived to be at risk. Also, valuations may suffer further if the Federal Reserve continues to increase rates. There could be more pockets of forced selling if more levered investors are caught by the higher interest rates.

What is the good news? Rising yields do make bond investments more attractive. Some bond investments are offering positive real yields for the first time in years. For stocks, when the recovery occurs is not known, but it is a question of when, not if. Although more volatility would not surprise us, we continue to believe in the adaptive nature of companies and their ability to carve a path forward, and for revenue and earnings to continue their improvement.

We are happy to discuss any specifics with you.

Regards,
Peter B. Harre, CFA