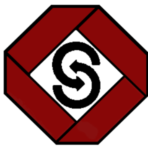

Herbert R. Smith and Company

Investment Advisors

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	3-mo	12-Mo
Dow	-6.16%	-13.40%
S & P	-4.89%	-15.50%
NASDAQ	-3.91%	-26.23%
10-Yr Treasury		3.79%
10-Yr Municipals		3.12%
Fed funds Rate		3.25%
Gold		$ 1660.61
Silver		$ 20.63

Higher Inflation, Fed Rate Hikes and Geopolitical Risks Weigh on Stocks and Bonds in the 3rd Quarter

Global markets declined again in the quarter as inflation remained near multi-decade highs, geopolitical tensions escalated further, and the Federal Reserve continued to aggressively hike interest rates signaling future rate increases will be larger than previously expected.

The third quarter started with a solid rebound in stocks and bonds that was driven by impressively resilient corporate earnings, hopes of a possible peak in inflation, and hints from the Fed that the end of the rate hiking cycle may come sooner than initially expected.

Starting with earnings, corporate results for the second quarter remained strong. Despite high inflation and lingering supply chain issues, the majority of second quarter earnings reports beat estimates, and that solid performance by corporate America encouraged investors in spite of an extraordinarily volatile economic environment.

On inflation, several survey-based economic reports showed price declines in June and offered hope that inflation pressures were peaking. Finally, in late July the Fed raised interest rates by another 75 basis points, *but Fed Chair Powell stated that at some point in the future, it would be necessary for the Fed to slow the pace of interest rate increases.* Investors interpreted that comment as a signal that the end of the rate hike cycle may be closer than previously thought. Hope for a less-aggressive Fed combined with strong earnings and a possible peak in inflation fueled a 9.2 gain in the S&P 500 in July, its best monthly return since November 2020.

Stocks continued higher through the first half of August driven by more proof of a peak in inflation and the growing hope that the Fed would soon pivot to a less-aggressive policy stance. The July CPI report showed clear moderation in price pressures, further entrenching the idea that inflation had peaked. Confirmation of a peak in inflation combined with the hope of a “Fed pivot,” pushed the S&P to nearly 4-month highs by mid-August. But ultimately, the move higher in July and early August was nothing more than a “Bear Market Rally.” As we move into October, the largest 2-day rally since April 2020 of 5.7% confirms we are probably in for more of the same as we work our way through this bear market.

While making remarks at the Jackson Hole Economic Symposium, Fed Chair Powell dismissed the idea of a less-aggressive policy and warned the US economy will likely feel some "pain." The reiteration of continued aggressive policy and historically large rate hikes, combined with the warning of looming economic pain, hit stocks late in the month, and the S&P 500 gave back all the early August gains to end the month down 4%. Selling continued in September as rates were again raised by 75 basis points (as promised) affirming they will continue to rise. At some point, the markets will have to start believing the Fed instead of "hoping" they will change direction.

That being said, it is amazing the Federal Reserve (which is not federal at all but a private entity that prints and lends fiat currency to the government) can impact markets so dramatically. All the while the White House and administration tries to downplay the seriousness of the inflation they actively participated in making worse by spending more money. Reality has a stubborn way of paying no attention to fantasies and make-believe. We all know better.

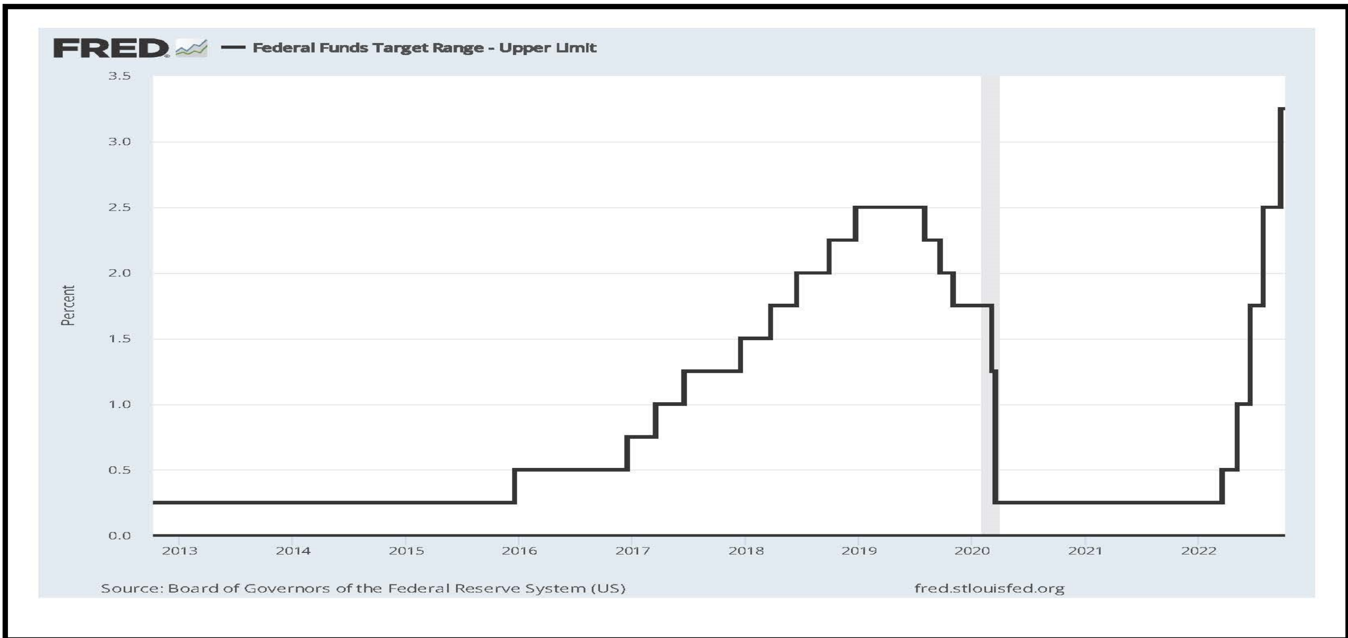
Finally, during the last few days of the month, global currency and bond markets saw a dramatic increase in volatility as the government of the United Kingdom announced a spending package designed to stimulate the economy. But that would also likely add to inflation pressures and the announcement resulted in a spike in global bond yields and the pound collapsed to an all-time low versus the dollar. The combination of sticky inflation, expectations of numerous future rate hikes, rising geopolitical tensions, currency and bond market volatility, all weighed heavily on the markets finishing the quarter near the lows for the year.

All four major stock indices posted negative returns for the third consecutive quarter, although the tech-heavy Nasdaq did not lag other indices as badly as the first two quarters and declines were fairly uniform across the most widely followed indexes. Unlike the first half of 2022, growth outperformed value in the third quarter.

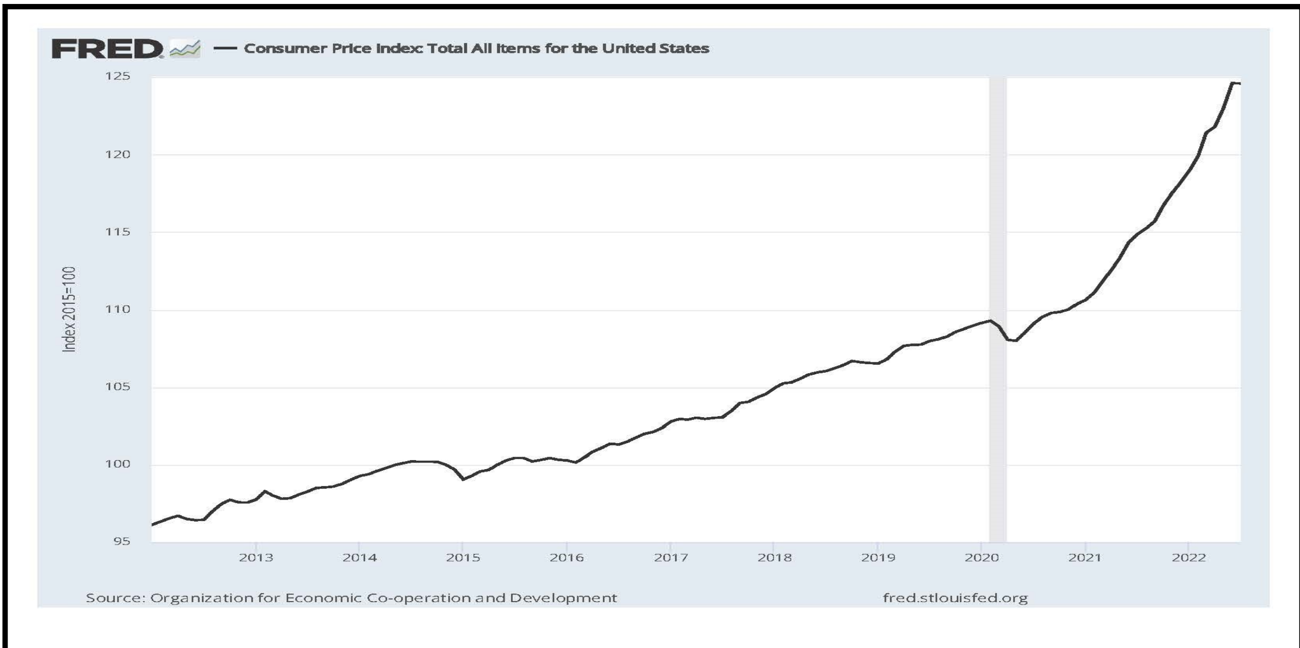
Just one of the eleven S&P sectors finished the quarter with a positive return— consumer discretionary, due to strong consumer spending and still low unemployment. The energy sector finished the quarter with a fractional loss as energy stocks benefitted from solid earnings and strength in natural gas prices. More broadly, defensive sectors (utilities, health care, consumer staples) outperformed over the past three months in anticipation of slower economic growth. Real estate declined in the face of spiking mortgage rates and home price appreciation began to slow. Let's face it, we all knew that was going to happen.

Internationally, foreign markets badly underperformed U.S. markets as surging electricity prices in Europe and the United Kingdom, interest rate hikes by the European Central Bank and Bank of England, and continued geopolitical risks weighed heavily on foreign developed markets. In the face of a surging US dollar, emerging markets performed even worse. Never doubt, we live in a global economy. As the largest and strongest economy (even in a world-wide recession) we have the ability to lead the world out of this. The question is, do we have the will to lead. China certainly does.

Commodities dropped sharply in the third quarter as a combination of multi-decade high in the US dollar, growing fears of a global recession, and sharply rising real interest rates weighed on industrial commodities as well as traditional safe havens like precious metals. Oil prices fell in the quarter as concerns about future demand offset geopolitically based worries about supply. This will reverse as OPEC starts cutting supply, thus increasing prices around the globe.



Because Fed Funds have gone up so sharply (see above), it's easy to understand the market "hopes" it will come down just as quickly. We believe the Fed will continue to raise rates until at least the Q1 of 2023 and will not reduce rates for the foreseeable future.



If only the Fed had started to tighten in 2020 when consumer prices were clearly beginning to surge. The correlation between the two charts is clear. We truly could have experienced a soft landing and a mild recession.

Geopolitical concerns pressured stocks in September as Russia escalated the war in Ukraine by announcing a 300,000 person mobilization from the general Russian population. The risk of a broader conflict simply can't be ruled out. But most Western countries remain united in their opposition to the Russian invasion and that will continue to be a powerful deterrent to Putin. Additionally, even some of Russia's most important allies, including China and India, have voiced concerns about the escalation of the war further isolating Russia from the global community. However, if our government continues down the path of increasing world oil prices by supporting our enemies in producing more and pressuring our own companies to produce less, it will only enrich our enemies and finance Russia's war in Ukraine and further punish our European allies as they suffer through a very cold winter.

Bottom line, the outlook for markets and the economy remains challenging but markets have priced in a lot of "bad"news already with valuations now at levels that are historically attractive. Additionally, sentiment is as pessimistic as it was during the depths of the financial crisis, and if inflation suddenly decelerates quickly, the Fed signals a clear end to rate hikes, or there's positive geopolitical news, the potential is there for a powerful rally in both stocks and bonds. This is a difficult market and a complicated moment for the world, but history is clear: positive surprises can and have occurred even in similar times of turmoil and markets have recouped the losses and moved to meaningful new highs. There is no reason to think this time will be any different.

We understand the risks facing both the markets and the economy. After the mid-term elections, we expect much of the "dust" to settle and provide a clearer view of the economic horizon. Successful investing is a marathon, not a sprint, and bouts of volatility like we're experiencing will not alter our diversified approach to meet long-term investment goals. It's critical to stay invested, remain patient, and stick to the plan.

Herbert R. Smith & Company has been providing investment advice to institutional and wealth-management clients for 50 years. Our expertise in managing assets has assisted our clients in meeting their financial goals without moving beyond reasonable risk guidelines. Our mission statement is:

To provide professional investment advisory services helping clients accumulate and maintain financial wealth through conservative long-term investment strategies.

Please call us if you have any questions or concerns:

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