Highs and Lows – October 2022

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Introduction

Welcome to the first edition of our quarterly markets newsletter. This is a work in progress and feedback is appreciated! Feel free to share with anyone whom you may feel interested. Please e-mail or call with any feedback or questions.

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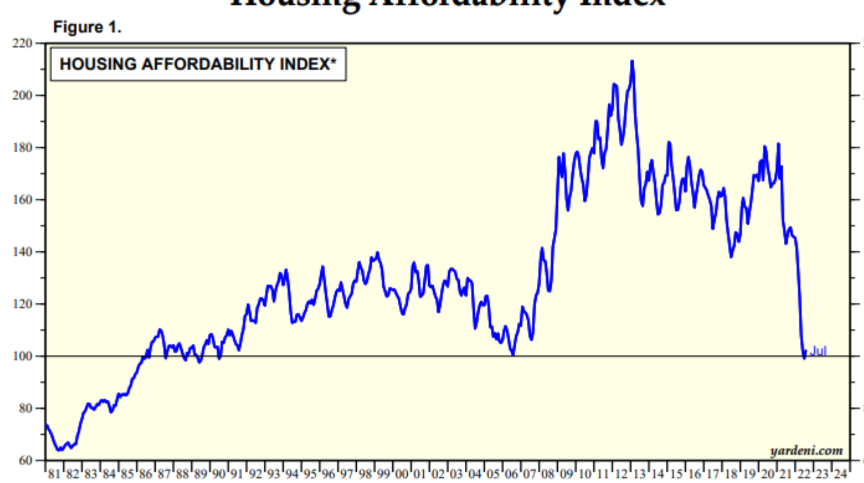
We Reap What We Sow…

Global asset markets continue to trade on their back foot as the central banking community seeks to undue the effects of nearly a decade's worth of irresponsible monetary policy. Global central banks are now forced to remain steadfast in their committment to reign in high inflation levels by reducing liquidity, reducing aggregate demand, and removing their implicit backstop from equity markets. While falling paper wealth levels can be a painful experience, it is important to remember that inflation is a scourge and must be defeated. A well functioning and growing economy requires a low and predictable rate of inflation. Losing the battle with inflation could have dire consequences on the long run trajectory of potential growth and we should not doubt the central banking communities' resolve.

As such, we presently expect the Federal Open Market Committee (FOMC) to raise rates to 4.5% by early next year then hold rates at that level for much of 2024. Our analysis indicates a 4.5% policy rate is consistent with a sufficiently restrictive level that the FOMC has publicly stated as its goal. However, actual measures of inflation and economic activity will ultimately decide if that is the case. Monetary policy is a blunt instrument with long lags so the FOMC would be prudent to observe realized inflation measures in the coming months before tightening beyond the 4.5% level. The era of inexpensive capital has passed.

Policy is already having a material impact on interest rate sensitive sectors and assets. The housing market is undergoing a period of extreme unaffordability for non-cash buyers as mortgage rates peak above 7.0% and home prices are still elevated from the COVID buying rush.

Housing Affordability Index



* Based on 30-year fixed rate mortgage.
Source: National Association of Realtors.

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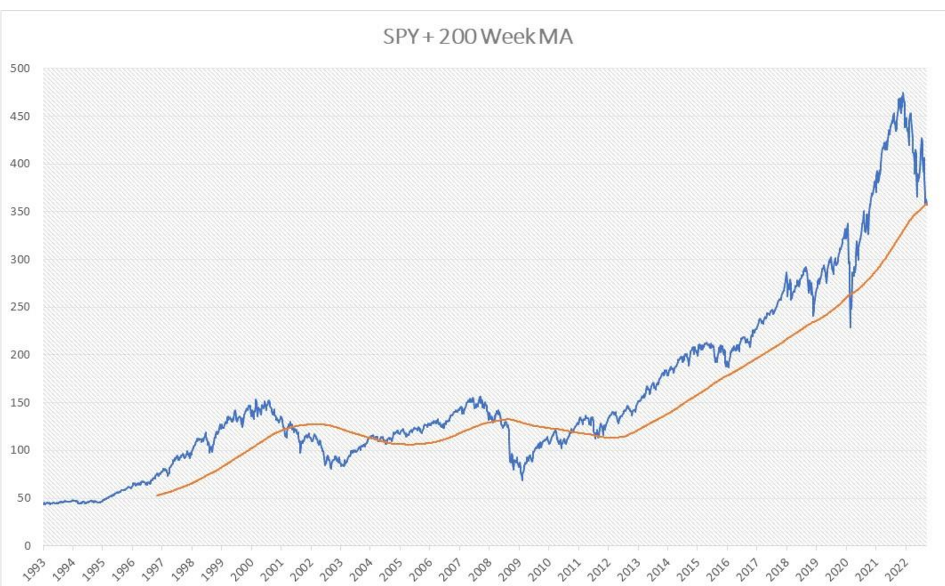
However, supply will likely remain well below levels typically associated with normal absent a material increase in unemployment or some other shock due to high equity levels and the "lock-in" effect. Few will be willing to sell their homes to potentially double their mortgage rate. In our view, the low level of supply will dull the impact on house prices from higher rates but we still think we could see a drop of 10-20% in nominal house prices in the coming years with larger falls possible in areas that overheated during the COVID boom. Activity, however, could crater leaving sectors exposed to housing activity with a long road to recovery.

Commercial real estate is another area which could suffer as a result of two separate factors. Cap rates have risen materially due to higher interest rates while occupancy continues to remain subdued on account from Work From Home (WFH) policies. We expect the WFH policies to largely be reversed as the economy slows which should mitigate the issue somewhat. This is an area we will be observing closely for signs of further stress in the coming months.

The war in Ukraine continues to be a tragedy in terms of human suffering and hardship and something that we do not unfortunately see going away anytime soon. The conflict continues to present tail risk scenarios to all asset prices but the economic impact remains limited for now.

Equity markets continue to suffer from quite elevated valuation measures based on our analysis. Periods of overvaluation could persist for long periods of time as no known force exists that causes mean reversion to lower valuation mutliples. However, given the macroeconomic uncertainty we continue to believe an underweight in equity markets is appropriate. On a technical basis, the S&P 500 is resting against its 200 week moving average while the Nasdaq is already below. Breaches of this level do not occur often historically and in



Before Your Turn in a Leased Car…

With elevated used car prices, be sure to compare the residual value on your lease with the current market value of your car. Use a car website like Kelley Blue Book (http://www.kbb.com) to look up how much your car is worth. Then check the residual on your lease. The residual is the predetermined car value at lease end set by the manufacturer when you originally leased your car. The difference between the current market value and the residual is your equity.

That equity can be maintained by purchasing the car in a lease buyout. The only fees should be any applicable taxes and registration fees paid to the state. Financed buyouts are usually available, as well. The equity could also be used towards another lease or a purchase of a new vehicle.

Since turning in a lease typically involves a disposition fee, you may be paying the dealer to take your equity if you turn in your lease without doing your homework first!

the past have been associated with larger falls in market indices. Nothing is certain and this could instead be a level of major support for market indices so this remains an area for observation.

Given the overall macro situation, we are becoming increasingly comfortable with the notion that long term yields are approaching a peak. An inverted yield curve with policy rates peaking at 4.5% would likely have 10-year yields between 3.75% and 4.25%. Current market levels are already consistent with this observation and indeed the pace of rises in yields appears to be slowing. Certainly inflation could continue to prove more stubborn or economic growth more resilient and rates will have to rise further. However, current levels are starting to look attractive. One-year US Treasury Bill yields are approaching 4.50% and are guaranteed by the full faith and credit of the US Government. If held to maturity, these returns are available essentially risk free. Already we are seeing signs that the high level of rates is mopping up excess liquidty by drawing capital out of equity markets and into shorter dated holdings. This is FOMC policy at work.

To end on a positive note, we would like to highlight that those who proclaim loudest that the FOMC is making a mistake by setting policy too tight often have livelihoods that are based on the persistence of extremely low rates and the availability of abundant capital. The economy itself remains stubbornly resilient with increases in hiring every month of this year. To retirement savers, the ability to generate a living yield on their savings without taking large amounts of financial risk is an undeniably positive development. Forcing companies and individuals to act prudently when borrowing funds should be a feature of our economy, not a cause for fear. Risks are certainly associated with the transition from a cheap and abundant capital economy to something more reserved. We believe it is prudent to act accordingly and set aside more savings in anticipation of a possible recession. All this said, recessions and bear markets historically provide opportunities for prudent savers and investors to allocate capital at discount prices. We are not here to say the situation will not get worse, we are here to say that if it does, we will be ready.

As always, I'd like to thank all of clients and wish everyone a healthy and prosperous upcoming quarter.

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