Time is the one asset that gains value when shared.

Spend it with people who care.

Bangor Wealth Management

Key Points

- Strong summer rally in stocks fades away
- Fed Pivot? Don't expect it anytime soon if inflation remains high
- Stock market volatility is likely to remain high in the months ahead
- US Treasury bond yields now offer attractive risk/reward opportunities

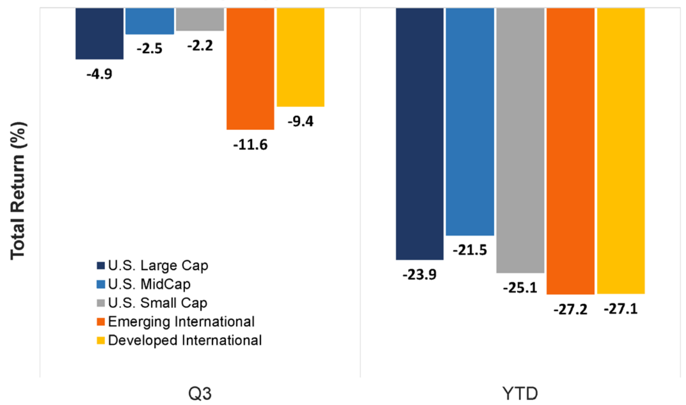
2022 as of September 30th: By the Numbers

Overall, both bond and stock markets continued to struggle in the third quarter as rising interest rates continued to weigh on investor sentiment. As of September 30th, the S&P 500 Index has declined almost 24% in total return in 2022, despite a 13% rally for the index during the first half of the quarter. The index ended the quarter 4.9% lower. Much of summertime rally was being attributed to rising hopes of a year-end pause in interest rate hikes by the Federal Reserve as well as continued strength in the US economy.

Small and mid-sized US companies fared slightly better than their large cap counterparts, but they also struggled in Q3, falling 2.5% and 2.2%, respectively. International developed and emerging market stocks were the worst sub asset class performers in Q3 with negative returns of -9.4% and -11.6%, respectively. The majority of the losses suffered in international stocks were caused by the rising US Dollar. During the quarter, the US Dollar rose over 6%, using the Bloomberg Dollar Index, a broad measure of US Dollar strength or weakness versus major global currencies. The relative hawkishness (tighter monetary policy) of our central bank versus other global central banks can explain much of the US Dollar strength during this period (Fig. 1).

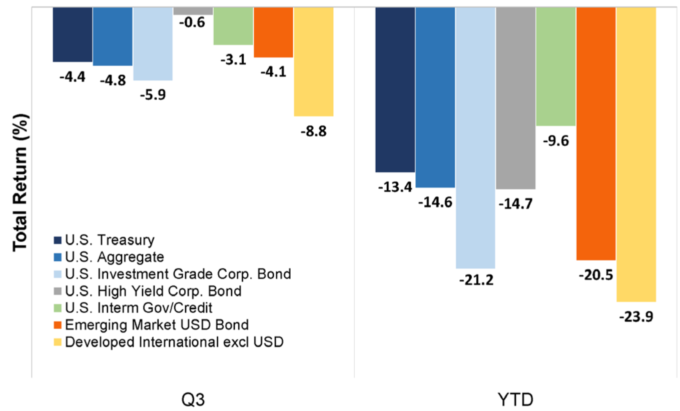
As has been the case throughout 2022, bond markets did not provide any protection against falling stock markets during the third quarter. All major bond sub asset classes were lower for the quarter. Shorter term bonds provided better relative returns due to their lower sensitivity to changes in interest rates (Fig. 2).

Fig. 1 All major stock markets experienced significant declines, and international suffered more damages due to the rapid appreciation of US dollars



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

Fig. 2 The fastest rate hiking adopted by the Federal Reserve to defuse muti-decade high inflation has inflicted historical record losses for major fixed-income markets in 2022



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

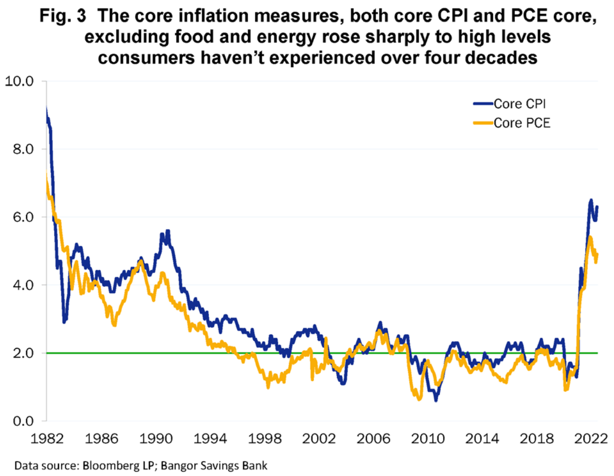
Fed Pivot? Not until Inflation Falls Considerably

In 2022, the US has experienced the fastest increase in interest rates in 42 years. This large move in interest rates will cause a further slowdown in the US economy. The extent of the slowdown still remains unknown, as it takes months for the tightening of credit (caused by increases in interest rates) to filter through the economy. The effects of this tightening of credit has already has shown up in areas of the economy such as housing and capital financing.

So, if the effects of higher interest rates are already starting to show up in the real economy, many investors might be asking why the Fed is continuing to add pressure to a slowing economy with continued interest rates increases. Or otherwise stated in the financial media is – when is the Fed going to pivot?

Investors have become accustomed to a Federal Reserve that is willing to stop hiking interest rates and then, soon after, start to cut rates when economic or capital market indicators begin to fall. These pivots (the switch from raising interest rates to cutting then) have provided support to falling stock markets in the past as investors look forward to easier money conditions ahead.

The environment for quick Fed pivots has dramatically changed since inflation spiked after the demand led consumption boom and monetary stimulus following the Covid shutdowns. The Fed does not have the room to pivot given inflation sits at such high levels that haven't been seen in the US in over 40 years (Fig. 3).



Source: Bloomberg LLP

The Fed attempts to target an inflation rate of 2%. Their preferred measure of inflation is the Personal Consumption Expenditure Core Price Index (how's that for a mouthful), or much easier stated the PCE Core Price Index. This Index currently sits at 4.9% as of the latest reading. The 4.9% is much lower than the often quoted CPI Index, which stands at 8.3%. The Fed prefers the PCE Index over CPI Index due to the index's lower volatility and the broader basket of prices that the index measures. Even using a much lower number of 4.9% for their inflation measure, the level of inflation still sits at a much higher level than their 2% target. Until that number begins to trend lower over a persistent timeframe, investors should not expect the Fed to pivot anytime soon.

Just for reference, over the last fifty years, the timeframe between the last rate hike and the first rate cut has varied between 2 to 15 months. The driving factors behind how quick the pivot was tended to depend on the level of inflation and the extent of the economic slowdown.

When dissecting the current inflation drivers, it is likely that inflation may stay higher for longer due to a strong median consumer (higher levels of cash held by higher income consumers) and higher wages, which are being supported by a strong labor market. However, as we discussed in our summer newsletter, the median US consumer may have more cash than they did a couple of years ago, but that doesn't mean the negative wealth effect (caused by falling home prices and financial portfolios) won't eventually cause them to tighten up their spending.

Market View and Portfolio Considerations

As we mentioned in our previous newsletter, the Bangor Wealth Management Team expects volatility to remain high until a slowdown in inflation becomes more apparent. We may have seen the peak in inflation during the third quarter, but as mentioned above, the drop in inflation will need to be on a more persistent trend lower before the Federal Reserve begins to signal an end to this interest rate hiking cycle.

As always, the Portfolio Management Team is paying close attention to forward looking economic indicators, capital market indicators and signals coming from corporate earnings guidance. We do expect a slowdown in economic growth as well as a slowdown in corporate earnings. However, the stock market has already priced in a material slowdown in growth. As conditions warrant, we will make adjustments to our asset allocation to take advantage of long term mispricing opportunities. We continue to weight our bond allocations towards US treasuries, as yields have risen to levels not seen in 15 years. US Treasury bonds now offer attractive risk/reward opportunities that haven't been available in over a decade.

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