INVESTMENT OUTLOOK

A PEAPACK PRIVATE WEALTH MANAGEMENT PUBLICATION

THIRD QUARTER 2022 INVESTMENT OUTLOOK: HAKUNA MATATA?

Hakuna matata, What a wonderful phrase
Hakuna matata, Ain't no passing craze
It means no worries
For the rest of your days
It's our problem-free philosophy
Hakuna Matata!
-Elton John and Tim Rice

In the Walt Disney movie and Broadway play *The Lion King*, there is a song titled "Hakuna Matata," which translates from Swahili as "No worries." After a challenging first half of 2022, investors began to embrace the idea that rate increases being implemented to reduce inflation would be limited. Not only would interest rates not need to be elevated much further, but success in fighting inflation and slower economic growth would induce the Fed to "pivot." That pivot would involve a course correction in which the Fed would begin to reduce rates again.

Markets rallied sharply, beginning in mid-June, in response to this favorable no-worries narrative. Yields fell, lifting bond prices, and equities jumped by double digits. Investors got their mojo back.

Alas, the Fed put the kibosh on this narrative, reminding investors that wishful thinking is not a sound investment foundation. At the Kansas City Fed's annual Jackson Hole symposium in August, Chair Jerome Powell gave an unambiguously hawkish speech in which he asserted the Fed's commitment to slay the inflation dragon with higher rates than markets had been anticipating. And he guided market participants to expect rates to remain high for an extended period of time after rate increases are paused.

The happily-ever-after fairy tale of a pivot to lower interest rates early in 2023 went down the drain. Interest rates resumed their climb, bringing down both stock and bond prices. Investors shifted rapidly from partying to worrying. Investment fairy tales can be hazardous for your portfolio, but the Disney productions featuring the wildlife of the African continent contain nuggets of wisdom from the animal kingdom worthy of our consideration.

HIGHER RATES, LOWER ASSET VALUES

It's always the crocodile you don't see you have to worry about.
-Jeremy Wade

The Nile crocodile is rightly feared for its aggressiveness, its immense bite force, and its tough hide. It also takes practically all of its food by ambush.

The Fed's tough, even aggressive Jackson Hole interest rate message, reinforced at its September press conference, had immense bite force. Investors who had swallowed the pivot-to-lower-rates story felt ambushed.

In response, markets recorded negative returns for the third consecutive quarter.

Asset Class	Index	3rd Quarter Returns	Year to Date Returns
US Large Cap Stocks	S&P 500 Total Return	-4.9%	-23.9%
US Small-Mid Cap Stocks	Russell 2500	-2.8%	-24.0%
International Developed Markets Stocks	MSCI EAFE	-9.4%	-27.1%
Emerging Markets Stocks	MSCI EM	-11.6%	-27.2%
Real Estate Securities	MSCI US Real Estate	-11.6%	-28.3%
Commodities	Bloomberg Commodities Futures	-4.1%	13.6%
Bonds	Bloomberg Barclays US Aggregate	-4.8%	-14.4%
Cash	FTSE USBIG 1 Month Treasury Bill	0.5%	0.6%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

All asset classes, save cash, generated negative returns in the third quarter. And for the year to date, all equity asset classes recorded declines in excess of 20%. International markets were even weaker than domestic markets, in the face of US dollar strength. Only commodities and cash produced positive returns.

BRINGING OUT THE BIG GUNS TO HUNT DOWN INFLATION

Elephants can sense danger. They're able to detect an approaching tsunami or earthquake before it hits.
-Jennifer Richard Jacobson

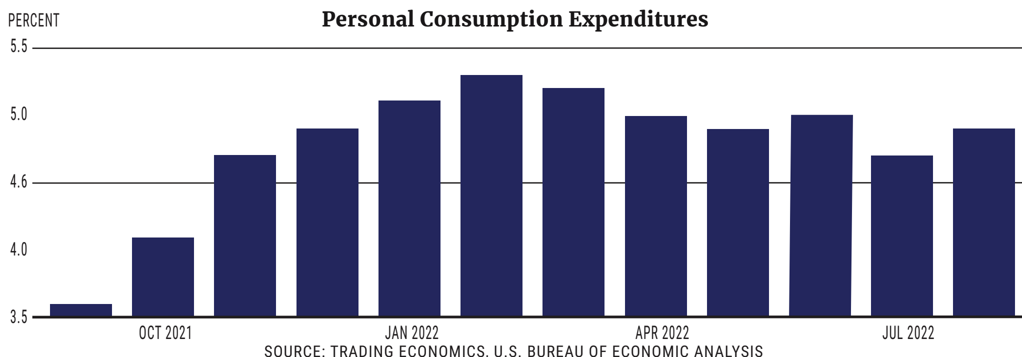
Elephants are widely believed to have excellent memories. It is an important part of their survival skillset, as it helps them avert dangerous situations they encountered in the past.

Today, central bankers are demonstrating that they have long memories, too—particularly for dangerous inflationary situations they've encountered in the past. From 1969 to 1982, the US—beset by Vietnam War expenditures, two oil embargoes, and the abandonment of the gold standard, among others—experienced a dramatic and sustained rise in inflation. At its worst, inflation topped out at 14.8%. The Fed vacillated between policy tightening and loosening, and only succeeded in bringing down prices meaningfully when it raised the fed funds rate to a peak of 20% in 1981.

Fast forward to 2022. The Consumer Price Index (CPI) for August was up 8.3% over the prior year, and above expectations. Excluding volatile food and energy prices, the Core CPI was up 6.3%, an increase from July's 5.9% rise. These readings continue to be in a range that's the highest in 40 years.

YEAR-OVER-YEAR PERCENTAGE CHANGE | SOURCE: U.S. BUREAU OF LABOR STATISTICS

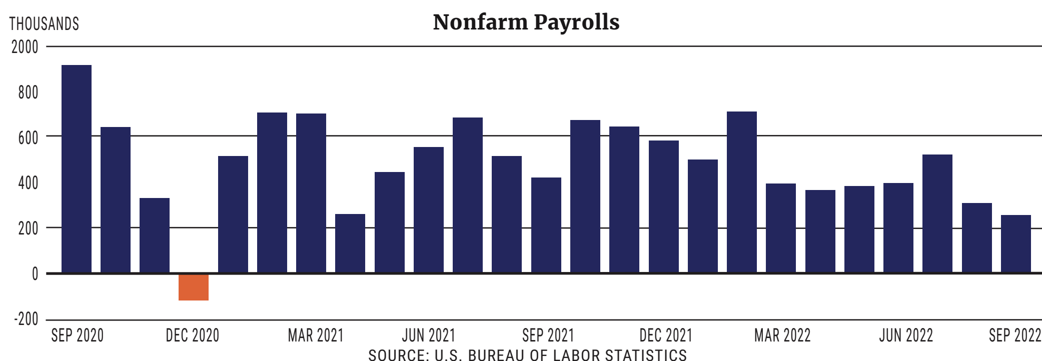
The Fed prefers to utilize the Bureau of Economic Analysis' Personal Consumption Expenditures, as it exhibits less volatility. For the past five months, Core PCE has hovered in a narrow range between 4.7% and 5%—vastly in excess of the Fed's 2% target. The Fed has raised the fed funds rate by 3% thus far this year, to 3.25%. Many market observers believe, however, that the fed funds rate needs to rise above the current inflation rate in order to bring down inflation.



SOURCE: TRADING ECONOMICS, U.S. BUREAU OF ECONOMIC ANALYSIS

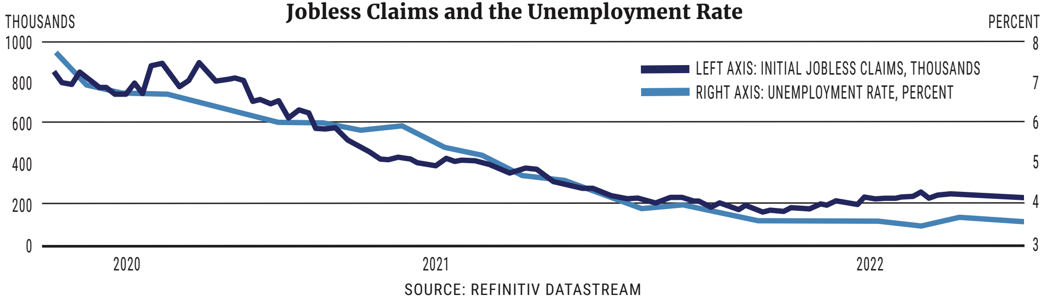
Evidence of inflation is apparent in many areas in the economy. Food prices have risen relentlessly, with food-at-home up 13.5% in the most recent CPI report. Transportation costs are 11.3% higher. New vehicle sales are 11.1% higher. And, importantly, labor costs have escalated sharply. The Federal Reserve Bank of Atlanta estimates that hourly workers who switched jobs in the last three months got a median pay raise of 8.4%. More broadly, average hourly earnings are up 5.2% year on year. It's the logical result of high demand for, and low supply of, labor.

It is more than challenging to bring inflation to heel when the labor market is so robust. New job creation has been resilient this year, consistently above 250,000. Employment now exceeds its pre-pandemic level.



SOURCE: U.S. BUREAU OF LABOR STATISTICS

Lay-offs also indicate sustained strength in the labor market. New filings for unemployment claims remain extraordinarily low by historical standards, indicating that employers are retaining workers. High demand for employees is also apparent from the most recent JOLTS report from the Bureau of Labor Statistics, indicating that there are 10 million unfilled jobs. The unemployment rate has barely budged, at an historically low 3.5%. Many of these data points are the strongest they've been in 50 years.



All in, this has the look and feel of a wage-price spiral. And of a Fed that is almost as far from achieving its price stability mandate as the asteroid Dimorphos (the one whose path was redirected by a spacecraft) is from earth.

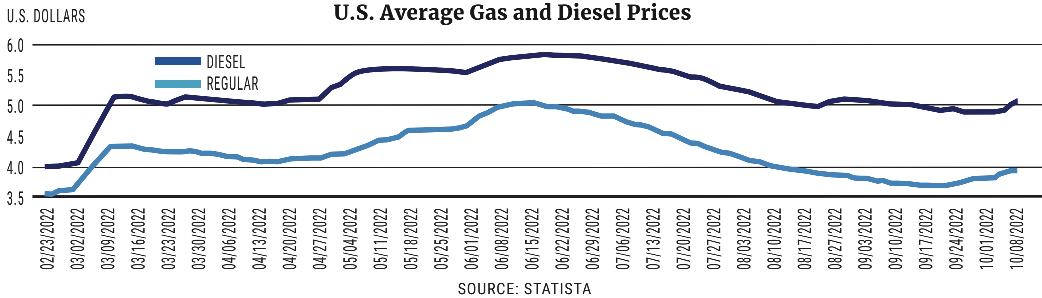
RECESSION WATCH: BINOCULARS NOT NEEDED

Sometimes facing opportunity is like staring at the knees of a giraffe.
-Laurie Beth Jones

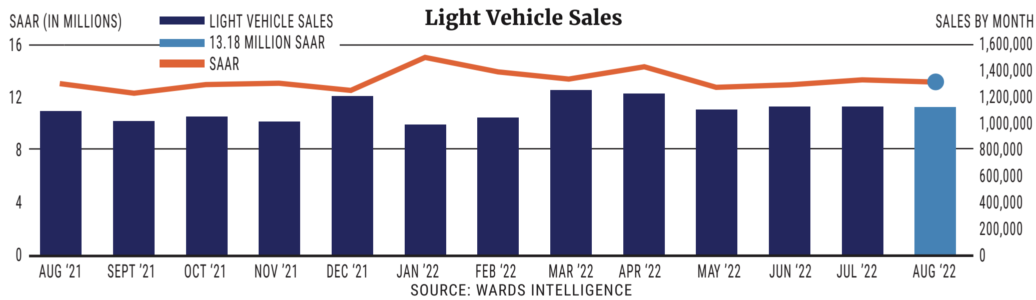
To the untrained eye, giraffes look a lot alike. But the distinctive spot pattern on each giraffe is unique–coat markings are more complex and variable than we recognize. The spots are important as camouflage, and the unique pattern helps giraffes recognize family members.

Business cycles, similarly, look alike on the surface, but each one is unique. And this one has a peculiar dynamic in which some inflation data are seemingly spinning out of control, while in other cases prices are dropping precipitously. Indeed, there is some relief in prices, or a slowdown in growth, in three areas of the economy.

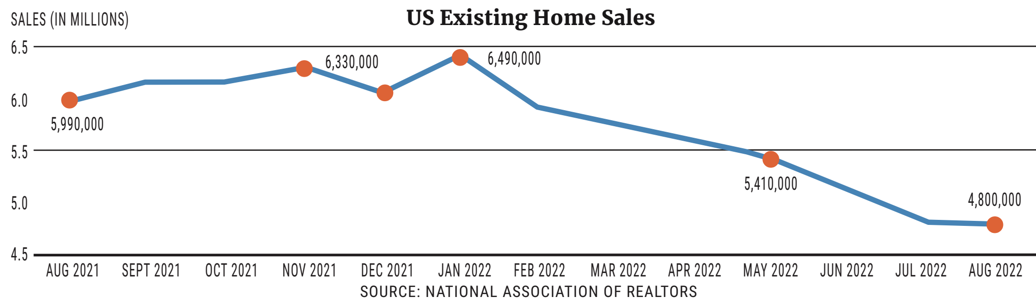
Perhaps most visibly, commodity prices—and particularly gasoline—have been in a multi-month downtrend. According to the World Bank, global energy prices fell 8.1% in September, industrial metals dropped 5.6%, and precious metals declined 4.6%.



A second area softness is automotive sales. As seen in the following chart, a combination of higher prices, limited supply, and higher financing costs has constrained new vehicle sales to an expected 13.5 million annual run rate. This compares to pre-pandemic yearly sales of 17 million vehicles.

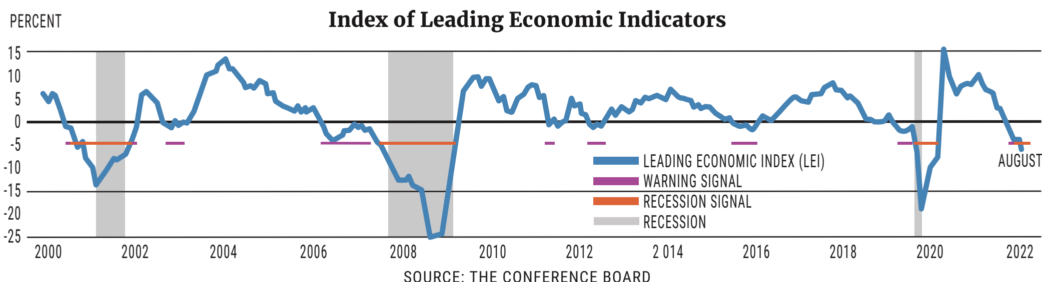


Housing is a third area with the effects of higher interest rates—combined with two years of rapid price appreciation—have so reduced home affordability that both sales and prices are declining. With mortgage rates having more than doubled to 6.7% recently, existing home sales fell 19% in August from a year ago. Home prices edged down 0.4% from the prior month.



The August CPI report also indicated that prices softened for airfares, used cars, and hotels, amongst others. In addition, ocean shipping rates have plummeted, as some supply chain issues have eased—the cost to ship a 40-foot container from China is down 60% from January. Thus, it would appear that the Fed's interest rate moves are already affecting interest rate-sensitive areas of the economy. Perhaps, as some investors hope, the Fed will not need to raise rates as much as anticipated. But that is not the current posture of the Fed, and while inflation may have peaked, it remains so much higher than acceptable levels that the Fed's stated determination to bring it down substantially and sustainably should not be ignored.

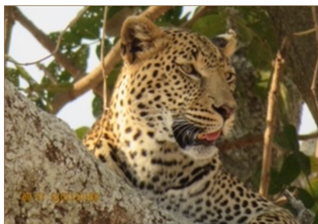
So that brings us to the question of whether the Fed's hawkish positioning—a restrictive monetary policy in order to reduce demand—will overachieve its inflation fighting objective, slowing the economy so much that recession is the result. When the Fed first spoke about fostering demand destruction to bring down prices, it was optimistic that it could achieve a soft landing in which economic growth is reduced enough to curb inflation but not so much as to induce a recession. With time, the rhetoric has changed; a less optimistic Fed began to speak of a soft-*ish* landing. And then, more recently, Chair Powell has noted that some households may encounter "pain", as the price to be paid for stamping out sustained, elevated inflation. One might be forgiven for supposing that pain is a euphemism for recession.



We think that the risk of pain (okay, let's call it recession) is mounting. The Index of Leading Economic Indicators has been falling for many months, and resides in negative territory. The labor market continues to be overheated, and the policy prescription for that is higher rates. Those higher rates, in turn, are likely to suppress economic growth. The Fed's most recent Summary of Economic Projections—historically an over-optimistic forecast—sees real GDP growth of 0.5-1.5% for 2023. Private economic forecasters are penciling in lower numbers: The Conference Board is looking at 0.3%, Toronto Dominion has 0.7%, Fannie Mae has -0.5%, Goldman Sachs has 1.1%. It seems not imprudent to take the under.

FIXED INCOME: A BULL MARKET IN YIELD?

What does the leopard teach us? Not to be intimidated
by animals that outweigh him. To be fearless and daring.
-J. D. Jacobs

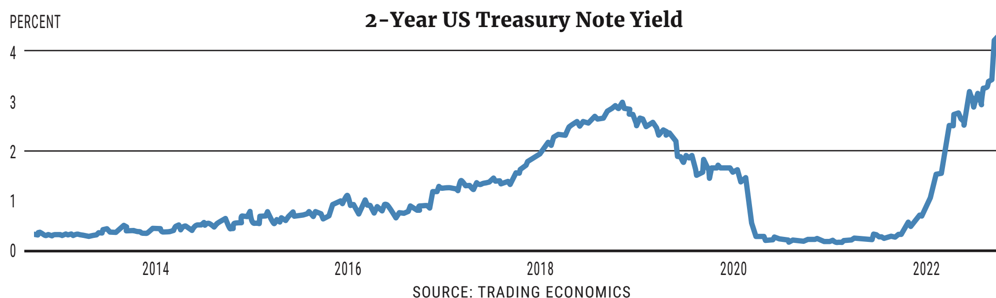


The leopard cannot change its spots, and the Fed cannot change its interest rate increase regime without calling into question its inflation fighting credibility. And the Fed has done more than sharpen its messaging. It acted, boldly—and fearlessly—raising interest rates by three quarters of a percent at both its July and September meetings, and promised further increases to come.

So we have clarity on this issue: interest rates are going higher. And the post-global financial crisis mantra of lower (interest rates) for longer has been replaced with higher for longer.

Bond prices have tumbled this year, in the face of the Fed's aggressive interest rate hikes. By at least one measure, this has been the most difficult year for bond investors since 1926. While there have been other periods when rates have risen sharply, the uniquely low level of interest rates at the start of this year factors into how sensitive bond prices have been.

While it might be accurate to label this a bond bear market, due to how much bond prices have fallen, it's important to understand that lower prices are a function of higher yields. Focusing on these higher yields, investors should manifest some enthusiasm—maybe, even, some daring—for bonds, going forward. Put simply, there's more income in fixed income today than there's been in many years.

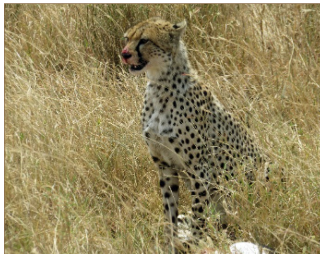


SOURCE: TRADING ECONOMICS

While interest rates are below the rate of inflation—that is to say, real (inflation adjusted) yields are negative—bonds have become significantly more attractive at these interest rate levels. We expect the Fed's restrictive monetary policy to be effective in time to bring down inflation. And, as that begins to be apparent, rates will come down. Thus, it may be advisable to gradually, modestly extend duration into intermediate term holdings. At the same time, given slower global growth and non-negligible recession prospects, we are uninclined to trade down in credit quality to sub-investment grade issues—there is sufficient yield in higher quality instruments.

EQUITIES: RETIRING TINA

To me, fast food is when a cheetah eats an antelope.
-George Carlin

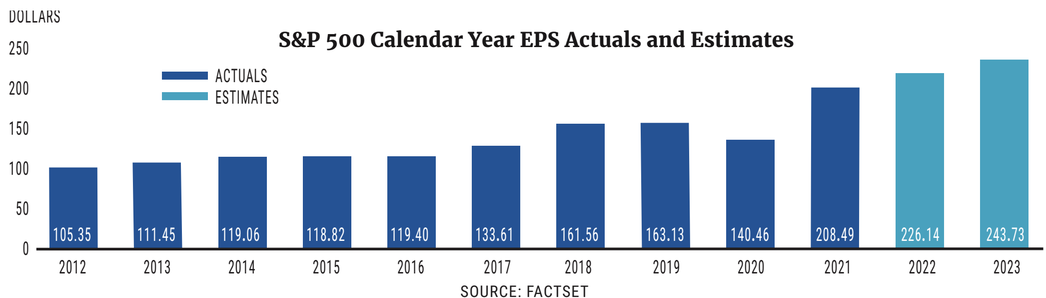


The cheetah is the fastest animal on earth. In 2020, we experienced the fastest recession ever, and along with it a rapid bear market descent in equities. This year, the bear market has been more of a steady grind down.

The revaluation of equities is a function of high inflation and the Fed's response in the form of higher rates. This necessarily leads to a lower valuation placed on companies' future earnings. The multiple investors pay today for those earnings has fallen to 15 times, from 21 times at the start of the year.

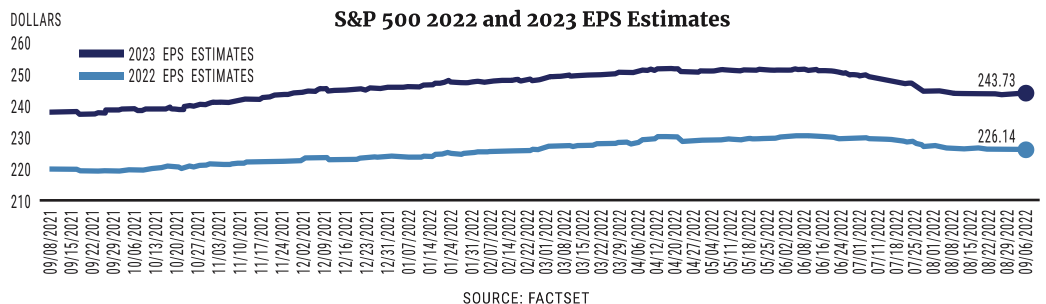
As investors begin to incorporate the probability of a recession into their forecasts, they are necessarily revising 2023 earnings estimates downwards. While we are on the cusp of receiving third quarter earnings reports, a look back at second quarter earnings reports reminds us that companies generally exceeded revenue and earnings expectations. (This almost always happens, as companies are understandably reluctant to provide optimistic forecasts for fear of failing to meet them.) A deeper dive into those earnings reports, however, indicates a few areas of concern. While companies recorded higher sales, volumes were lower—in other words, companies sold fewer products or services but at higher prices. That would indicate that inflation is beginning to affect demand. We also can observe that, overall, profit growth lagged revenue growth. This implies that companies have had to absorb some higher costs—labor, shipping, inputs—rather than passing them along to customers.

This is particularly important as we look at forward earnings expectations. With expected S&P 500 earnings this year of $226.14—an increase of 8% versus 2021—stocks are trading at a multiple of 15.9 times those earnings. Peering into 2023, investors are anticipating earnings of $243.73, a further increase of 7.8%.



SOURCE: FACTSET

Profit growth of this magnitude exceeds long-term averages. But how credible are these earnings estimates? Earnings estimates peaked around mid-year, and have begun to be adjusted downward. We believe the process of downward revisions has further to play out and, if estimates are indeed lowered, stock prices could remain volatile for some months to come.



SOURCE: FACTSET

Over the past decade, investors were introduced to, and got to know, TINA well. TINA is an acronym for a yield-free world in which bonds are unattractive and There Is No Alternative to stocks. In light of the large run-up in interest rates this year, it would appear that TINA needs to take a rest.

While equity prices have fallen significantly, overall valuations are neither elevated nor depressed. Domestic small cap stocks, however, trade at levels well below their historical averages. International equities have also cheapened, but the economic outlook in Europe is more bleak than in the US.

WALK, DON'T RUN

Wisdom is like a baobob tree; no one individual can embrace it.
-David Lloyd George

Baobab trees are said to be among the most long-lived vascular plants. They can grow to over 100 feet tall, 150 feet wide in circumference, and live up to 3,000 years. They have been in existence for perhaps 200 million years.

When markets are as challenging as they have been this year, investors are well served to remember time-tested investment principles and long-term goals and objectives. Prudent portfolio management entails not just anticipating and reacting to economic and market developments but also holding to sound, durable strategies.

In the vast Serengeti (Swahili for "endless plain"), travelers on a walking safari are instructed to proceed slowly when danger (predators) is nearby. The old saw is "only food runs." Similarly, investors should not react with panic when confronted by bear markets.

Rather, turbulent markets can serve as an opportunity to reaffirm goals and objectives. Difficult market conditions can act as a gut check, to give investors deeper insight into their true risk tolerance. In turn, a more complete understanding of market volatility can help investors and their advisors confirm the appropriateness of their asset allocation strategy. It's a privilege for us to do this work for clients, and so we say *asante sana*.

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