BEND OR BREAK?

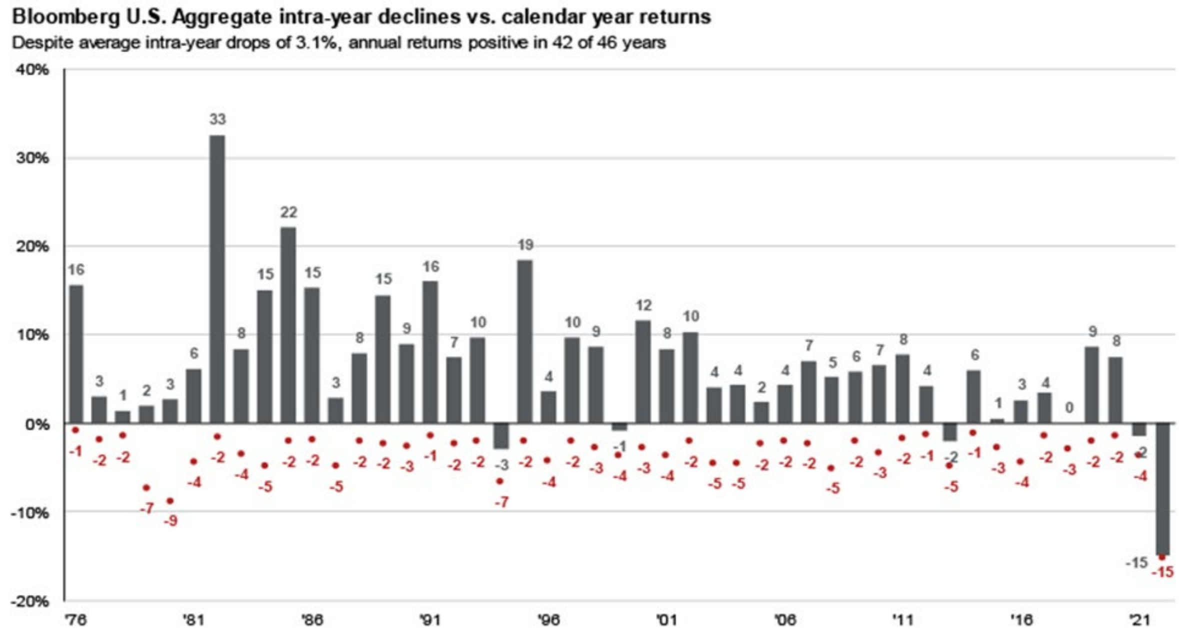
The Federal Reserve is in uncharted territory as it attempts to combat inflation by raising interest rates at the fastest pace in more than 40 years. With higher interest rates, the Fed is aiming to curb business and consumer demand and slow economic growth. Facing criticism for not responding to inflation early enough, the concern is they will now tighten too much and too fast. While higher prices have continued to hurt consumers, a Fed induced recession with much higher unemployment would be worse. The dual mandate of the Fed, which last quarter's market commentary discussed, calls for maximizing employment and promoting price stability. Unfortunately, these mandates are working against each other in this environment, as the unemployment rate is 3.5% but inflation remains persistently high. While low unemployment is a positive for the economy, this puts upward pressure on wages as employers compete to attract and retain talent, thus driving inflation higher. The Fed most recently raised the fed funds rate in September by another 75 bps, to a range of 3.00 – 3.25%, and consensus expectations are for an additional 100 – 125 bps over its November and December meetings. For perspective, the Fed began to take inflation seriously in November 2021, but the fed funds rate was maintained near-zero until March of this year. Put simply, the Fed's challenge is to make the economy bend under the pressure of its tighter monetary policy, without breaking it down into a recession.

As evidenced by the downturn of the equity and fixed income markets this year, markets were quick to react to the Fed's actions and what it's anticipated to do next. The actual impact on consumers and business in the economy, however, can take more than a year to be seen. With both the markets and economy, there are several headwinds due to the Fed's tightening cycle.

- Corporate earnings, the denominator in the forward P/E multiple discussed below, are expected to face greater pressure in coming quarters. While S&P 500 companies saw record profit margins last year, these have begun to contract and will likely continue to do so. Margins will come under pressure as corporations face sticky inflation costs, like an elevated cost of labor as wage growth persists, and eventually higher costs of capital, as higher interest rates increase borrowing costs.

- A stronger U.S. dollar is also expected to weigh on corporate earnings, as S&P 500 companies earn about 40% of revenue abroad. These multinational companies that earn revenue in foreign currencies lose money when converting into a much stronger U.S. dollar. The dollar has surged this year versus foreign currencies as investors sought it as a safe haven, but also for comparably higher yield as the Fed raised rates. While higher interest rates and a stronger dollar combats domestic inflationary pressures, that inflation is essentially exported to other countries, further inhibiting other central banks actions to curb inflation in their countries. This could force other central banks to move rates higher, and for developing counties, destabilize their economies as debt repayments in dollars becomes more difficult. The contagion effect of a global recession impacting U.S. companies cannot be ignored.

- The S&P 500 declined -9.3% in September, its worst month since March 2020, and has lost nearly 25% this year through September 30. Most of the negative return has come from multiple compression, as the S&P 500's forward P/E has come down from 21.4x to 15.1x this year. While a downturn is certainly priced in, further multiple compression is possible, as the S&P forward P/E troughed at around 13x on average in past recessions. The chart below visually depicts the impact on bond prices from the Fed's unprecedented pace of rate increases. Bond prices move inversely to interest rates, thus as rates have been rising rapidly, bond prices have moved lower as well. The Bloomberg U.S. Aggregate is a broad index of intermediate-term investment grade bonds frequently used to measure the performance of the U.S. bond market. As shown, it is typically stable with average intra-year drops of just 3.2% and positive returns in 42 of 46 years, however, the index has had its worst performance so far this year, pulling back 15% through September 30. [i]



Given the new interest rate environment, it is worth revisiting RMC's approach in constructing fixed income allocations. Utilizing a laddered bond strategy, rising rates should not impact an investor's ability to meet the objectives of a bond allocation: providing preservation of principal and predictable cash flow. Bonds are purchased with the intent of being held to maturity, thus despite swings in market prices, will be redeemed at par value. As part of a laddered bond portfolio, interest rate risk is spread across the yield curve and individual bond maturities are staggered over several years. With an inverted yield curve (as measured by the 10 / 2-year treasury spread of -39 bps, as of 09/30/22) and in period of rising interest rates, a shorter-term ladder (under five years, for example) allows the principal of maturing bonds to be reinvested at higher rates upon maturity. In addition to other reinvestment strategies, a bond ladder can also be used to address ongoing liquidity needs, a retiree's RMD requirements, or an endowment's planned capital expenditures. Constructing the maturities of the ladder to correspond with these cash flow needs allows for a predictable return of principal. This is advantageous versus potentially selling equities into a market downturn or selling appreciated equities and generating unnecessary taxable capital gains.

Regarding equity allocations, bear markets do eventually end, and patience is required until further clarity allows markets to move higher. It's important to note that the Federal Reserve is not the only investor focus, as Russia's war in Ukraine, Europe's energy crisis and China's stalled reopening are all forces in the inflation and recession narrative. For those macroeconomic reasons and others previously explained, there is a possibility for further downside, and attempting to time when to get out and back in or trying to find the bottom of the bear market, is not a sustainable way to invest. Some stocks hold up well during these times and some have traded considerably lower, yet maintaining diversification is critical as the latter will have considerably more upside when markets recover. Dollar cost averaging into new or existing positions in a downturn keeps you invested as perfectly timing the swing upwards for individual stocks is not possible. RMC is not trading but investing on your behalf for the future, built around your objectives and rooted in your risk parameters, whether for one's retirement or an organization's long-term viability.

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[i] J.P. Morgan Asset Management Guide to the Markets (as of 09/30/2022)