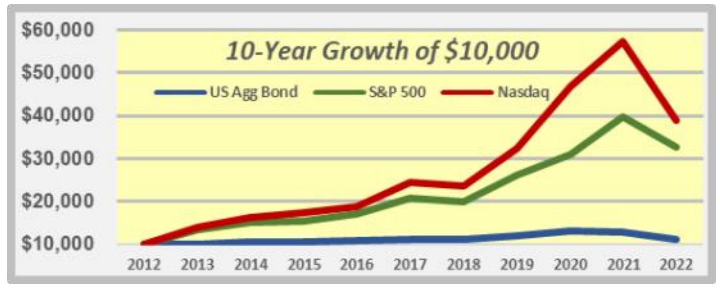
Investment Watch

4th Quarter, 2022

Punch Bowl

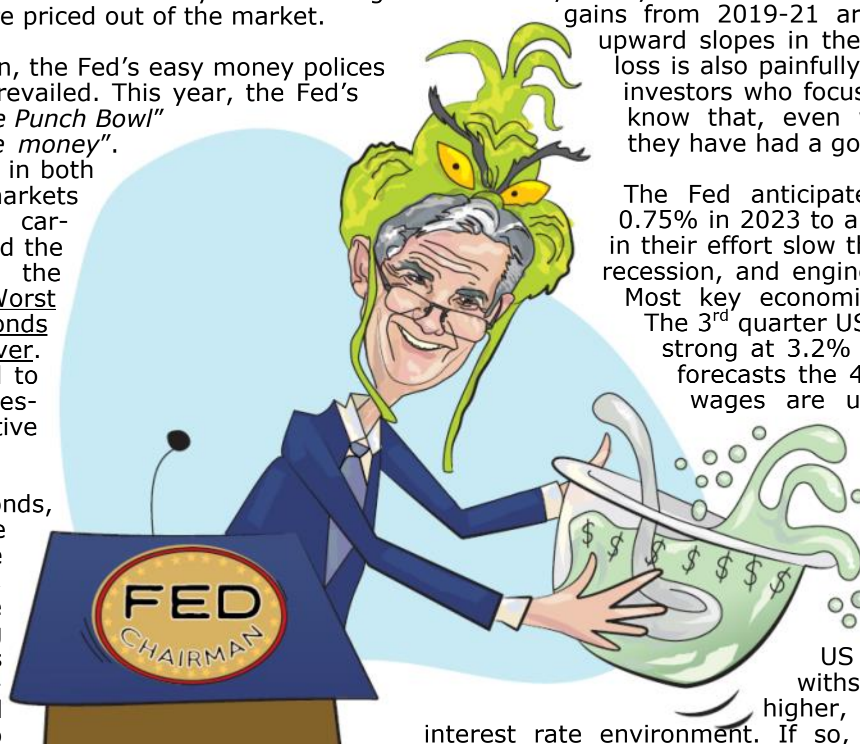


Holiday parties were not so festive this year as Federal Reserve Chairman Jerome Powell took away the **Punch Bowl** by steeply boosting interest rates to curb runaway inflation. At the start of this year, falsely believing the high inflation was transitory, the Fed was behind the curve maintaining *near zero* rates since the pandemic lockdowns. Scrambling to rein in soaring consumer prices, the Fed moved at the most aggressive pace in decades raising interest rates in every meeting since March from *near zero* to 4.25% - 4.50%.

Both policy makers and investors were burned as the soaring inflation of 2021 proved not be transient, then further exacerbated by Putin's war on Ukraine adding to runaway prices with exploding food and energy costs. Back in March of 2020 in response to the global pandemic, the Fed filled the **Punch Bowl** to kick off the "*free money*" party. During two emergency meetings, the Federal Reserve lowered rates to near zero while Congress unleashed $2 trillion in stimulus.

The Fed's action is painful, but necessary to slow the economy. Inflation not only eats away at consumers' purchasing power but also reduces the value of their savings. Although the Fed controls only one interest rate—the *federal funds rate*, its actions have an instant impact on most lending rates including mortgage, car loans and credit card rates, all of which have gotten costlier. Mortgage rates soared to nearly 7.0% halting sales as homebuyers were priced out of the market.

Since the Great Recession, the Fed's easy money polices and low inflation have prevailed. This year, the Fed's rate hikes "*took away the Punch Bowl*" ending the days of "*free money*". The astonishing volatility in both the bond and stock markets stunned investors. The carnage was inescapable and the yearend headlines told the story - Stocks Log the Worst Year Since 2008 while Bonds Had the Worst Year Ever. Stock investors are used to volatility, but Bond investors expect steady positive returns.



In the last 45 years, bonds, as measured by the Bloomberg US Aggregate Bond Index (US Bonds), have fallen only five times with 2.9% being the deepest decline. This year's 13% loss shattered this 45-year old record. There was no place to hide. Ironically, the loss for the S&P 500 which is a broad measure of US equity performance, was not far from the bond losses closing the year down 19.4%. The Nasdaq which lost 33.1% was hit the hardest by rising rates and big tech's fall from glory.

Although difficult to look past last year's devastation, investors should take a long-term view. The chart above shows the growth of a $10,000 investment over the last 10 years in US Bonds and two stock indexes - the S&P 500 and the tech heavy Nasdaq. US Bonds over this 10-year period hardly eked out any gains at all due to abnormally low interest rate environment before 2022 followed by this year's record loss. The outsized stock gains from 2019-21 are depicted by their upward slopes in the chart, while 2022's loss is also painfully apparent. However, investors who focus on the longer-term know that, even with this downturn, they have had a good run.

The Fed anticipates raising rates by 0.75% in 2023 to a range of 5%-5.25% in their effort slow the economy, avoid a recession, and engineer a "*soft landing*". Most key economic factors are solid. The 3rd quarter US GDP was surprising strong at 3.2% and the Atlanta Fed forecasts the 4th quarter at 3.9%., wages are up and employment firm while inflation has subsided during the last six months.

Although the Fed's record to evade a recession is poor, there is hope that the strength of the US economy can withstand the burden of a higher, but more normal, interest rate environment. If so, Bond investors will garner higher future interest payments and 2023 may be less stressful for Stock investors.

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