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Inflation, Markets, and Strategy

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The Federal Reserve raised the benchmark Fed Funds rate by 0.75%(75bps) Wednesday, taking the overall range to 3%-3.25%. This is the highest since early 2008. Keep in mind two things: 1. The Fed started the year near zero. 2. The Fed intends to keep raising rates until they hit their 'terminal rate' endpoint of 4.6% in the first part of 2023.

That's a huge move in just over one year. And Powell (Fed Chair) has recently stated: "The FOMC is strongly resolved to bring inflation down to 2%, and we will keep at it until the job is done." Well, right now the posted inflation number is well over 8%, and 2% is a far cry from that.

Full recession risk has gone up significantly – we are already in a technical recession as we have had 2 consecutive quarters of negative GDP growth - and the housing market is getting hit by a collapse in affordability driven by much higher prices and higher mortgage rates (current 6.55% from a low of 2.65%). Keep in mind, the mortgage rates have been as high as 18.63% in 1981 to a low of 2.65% in 2021. The overall average 30-year mortgage rate has been 8%.

The recent driver of the poor market performance was that inflation did not decline further as everyone had hoped for, but instead climbed higher (despite a fall in energy prices). Unfortunately, at this time, inflation has become embedded in services and the labor market, which means the Fed might need more large rate hikes to curb inflation. We have seen outrageous levels of money injection from the federal government, and directly because of this, asset inflation is here for a while.

The S&P500 hit a low in mid-June, and we have recently broken through a support level of 3915. Does this mean we repeat the June low of 3636? That might be the case, but not necessarily; there are many factors to consider, and there have been many times this year where the S&P500 has bounced (even double bounced) off a support level.

Every type of market always overshoots; whether it is the stock market, bond market, job market, etc., and this is somewhat good news. We don't see any market stopping at fair value, they blow through it. Markets overshot up in 2021, and now we are seeing them overshoot down. One thing is a verifiable fact: the US stock markets have never gone down and stayed at the lows, or gone to zero; they always come back and the key is to be in a good position to take advantage of that.

Our strategy: we have been much heavier in cash and one-month Treasury bills than we have in years. Our holdings have vastly improved in quality and most are dividend-paying higher-quality names. Most of our direct S&P500 exposure is hedged within that security (this means it will move significantly less than the overall markets). In general, we continue to hold strong companies as we have been avoiding small capitalization stocks, as well as those with negative interest rate sensitivity.

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Put simply: we continue to hold good names that we would be completely fine holding for many years, and avoiding junk. Now is not the time for gambling, and it has not been for the last year. We continue to hedge the portfolios with either cash, short-term bonds, or those names that we feel confident will act either inverse to the market, or take advantage of the higher inflation expectations.

We will continue to adjust as needed, but at this time, we expect to remain in some part of the markets to take full advantage when the recovery happens. Currently, we don't see the economy fully recovering until well into the second half of 2023 (although the global economic situation is fluid, and estimates may change) – but the stock markets will react much earlier than that in anticipation.

Please reach out should you have additional questions or wish to discuss further.

Thank you,

~ Your SharpePoint Team

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