October 2022

After experiencing our first extended reprieve in the markets from mid-June through the beginning of August, volatility has returned to close the third quarter. In the following paragraphs, we will explore what transpired and how market expectations evolved during the second half of the quarter.

Third Quarter Whipsaw

As we have mentioned in prior newsletters, the Federal Reserve has prioritized reducing inflation expectations and remains less concerned with any secondary effects. Jerome Powell, the chair of the Federal Reserve, is well aware of the recurring inflation during the 1970s, which resulted from the intermittent monetary tightening and easing. This ultimately ended with Paul Volcker raising the Federal Funds rate to 20% at the end of the decade. Powell does not want to repeat this mistake.

During the summer months, the market began building in a lower terminal Federal Funds rate, and a higher probability of a soft landing, in which inflation quickly falls and consumers' earnings power remains elevated relative to inflation. This eventually leads to increased purchasing power and real economic growth.

Two primary events changed these expectations. First, during Powell's Jackson Hole speech, he succinctly ended any expectations for a pause in tightening. A few weeks later, the September inflation report (for August) came in materially higher than expectations. This combination effectively closed the door on any hopes for a shorter-term soft landing.

Historical Perspective

This combination of declining growth, sticky inflation, and aggressive tightening by global central banks has led to negative returns for both stocks and bonds. Similar to slowing down a train or a car on a highway, the pace of the rate of change in monetary policy often is more impactful than the absolute level (See *Figure 1*).

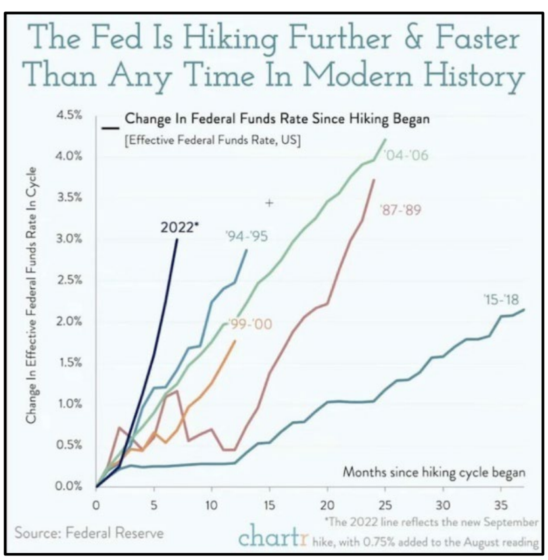

Figure 1 – The Fed is Hiking Further & Faster Than Any Time in Modern History
Source: www.chartr.co/

The current tightening cycle has unfolded at an unprecedented pace. This has had secondary effects on financial markets and the U.S. dollar, which significantly strains global economies, given its status as the reserve currency.

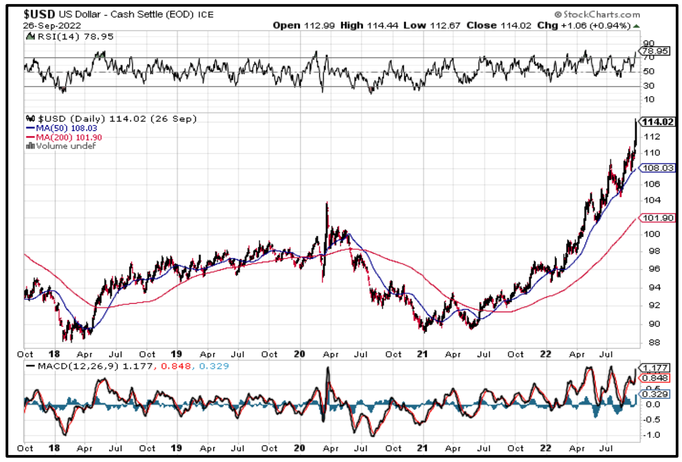

Figure 2 – US Dollar
Source: www.stockcharts.com

While we are only three quarters through the year, one would need to go back to the 1930s to match the current annual losses for a traditional balanced portfolio of 60% equities and 40% fixed income.

Looking Ahead

Equity performance tends to correlate strongly with the liquidity cycle. Over the coming months, we believe headlines will transition from an inflation story to a declining growth and earnings narrative as the accelerated tightening over the past six months funnels into the economy with a lag.

Eventually, the liquidity cycle will turn positive due to falling inflation or elevated economic stress, leading to lower real rates and a tailwind for risk assets. In aggregate, household balance sheets are much healthier following the 15-year deleveraging cycle following the 2008 recession. This has helped prop up the economy thus far and could be a tailwind in the coming years. Further, while many growth stocks have experienced 50%+ declines due to their lofty valuations amid suppressed interest rates, technological innovation continues to advance within many of these transformational segments of the economy. Once the liquidity cycle turns, these companies will likely take leadership as the market recovers.

Our primary focus remains on transparency and communication with the families with whom we work. Our conversations over the past several years around various market outcomes and stress-testing financial plans have been effective in these volatile times. We look forward to connecting soon and will communicate any customized year-end planning opportunities as they arise.

- Jason, Micah, Tim, & Victoria