MARKET
AND ECONOMIC
UPDATE

3 Investor Insights for Inflationary Markets in Q4

OCTOBER 2022

Investors have navigated a difficult market all year and the third quarter was no exception. Although markets have turned around a bit at the start of October, all major indices ended the last quarter in bear market territory.

The S&P 500, Dow and Nasdaq declined 5.3%, 6.7%, and 4.1%, respectively, from July to September. Interest rates jumped with the 10-year Treasury yield climbing above 4% on an intra-day basis, the highest level since 2008. The challenges of persistently high inflation and slowing growth have continued to impact the expectations of both investors and policymakers. In times like these, investors might naturally prefer to wait until it feels comfortable to invest, and even experienced investors may wonder if markets will ever turn around. This is why it's important to remind ourselves that while bear markets are unpleasant, they also create opportunities for long-term investors. The valuations of major indices, sectors and styles are at their most attractive levels in years, and bond yields are finally at levels that can support portfolio income.

Interest rates are rising after declining for 40 years

Source: Clearnomics, Federal Reserve

A key principle of investing is that achieving long-term returns doesn't just involve risk - it *requires* it. This is true whether markets are down due to the economy, geopolitics, a pandemic, or any of the hundreds of investor concerns over the past few decades. After all, if staying invested were easy, everyone would do it and there would be no opportunities at all. History shows that those investors who have the discipline and fortitude to handle market pullbacks are more often than not rewarded.

At the same time, it's also important to understand what is driving these market dynamics. Below, we highlight three important insights that will continue to affect markets and the economy through the remainder of 2022 and beyond.

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Markets had rallied beginning in June but abruptly reversed course in late August. The turn in the market coincided with Fed Chair Powell's speech at Jackson Hole during which he emphasized that the Fed would continue to fight inflation by keeping interest rates higher for longer. This message was then reiterated at the Fed's September meeting with the third 75 basis point hike in a row and higher projections through 2023.

This jump in both policy and market rates is breaking a 40-year pattern of declining interest rates. It's no wonder that financial markets have been volatile as they adjust to a higher cost of capital and slower economic growth. Regardless, both history and the summer period show that markets can move forward once they digest these new expectations.

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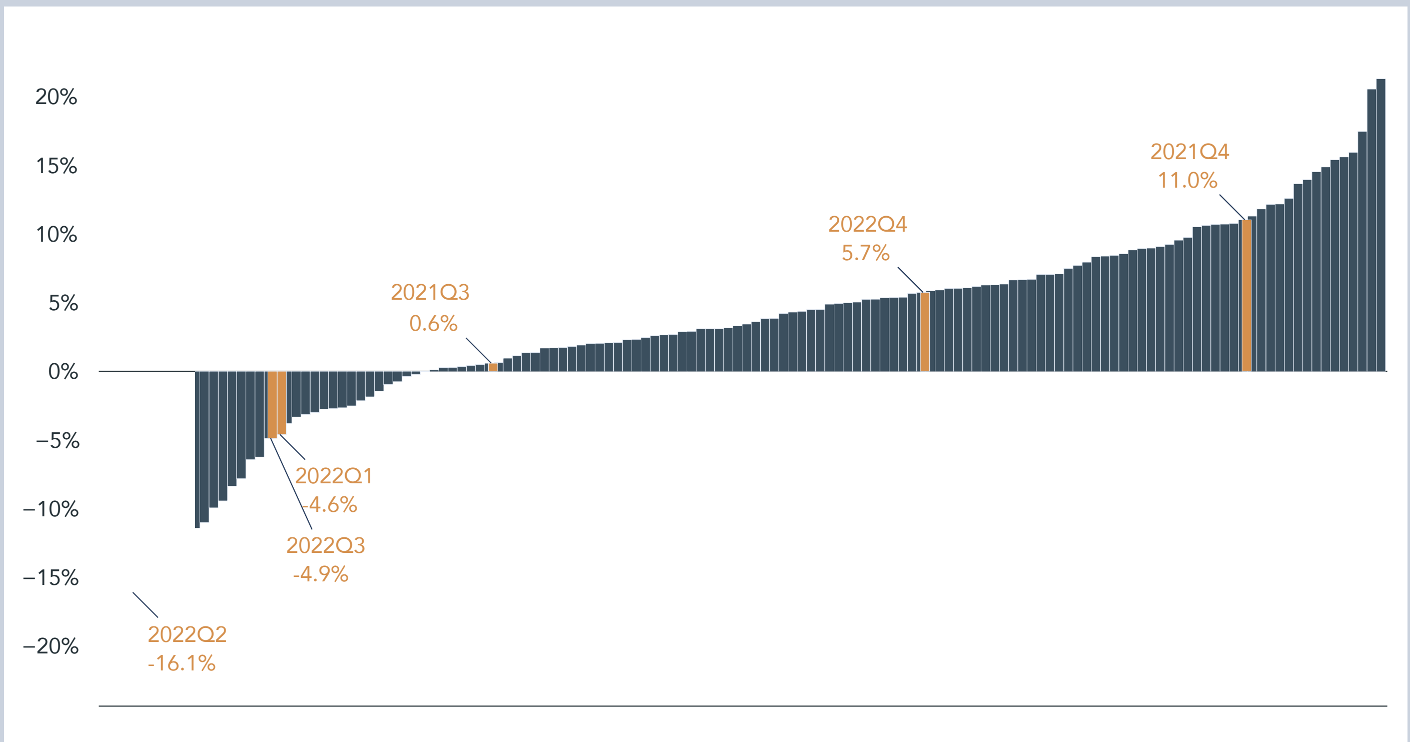
The stock market is adjusting to higher inflation and rising rates



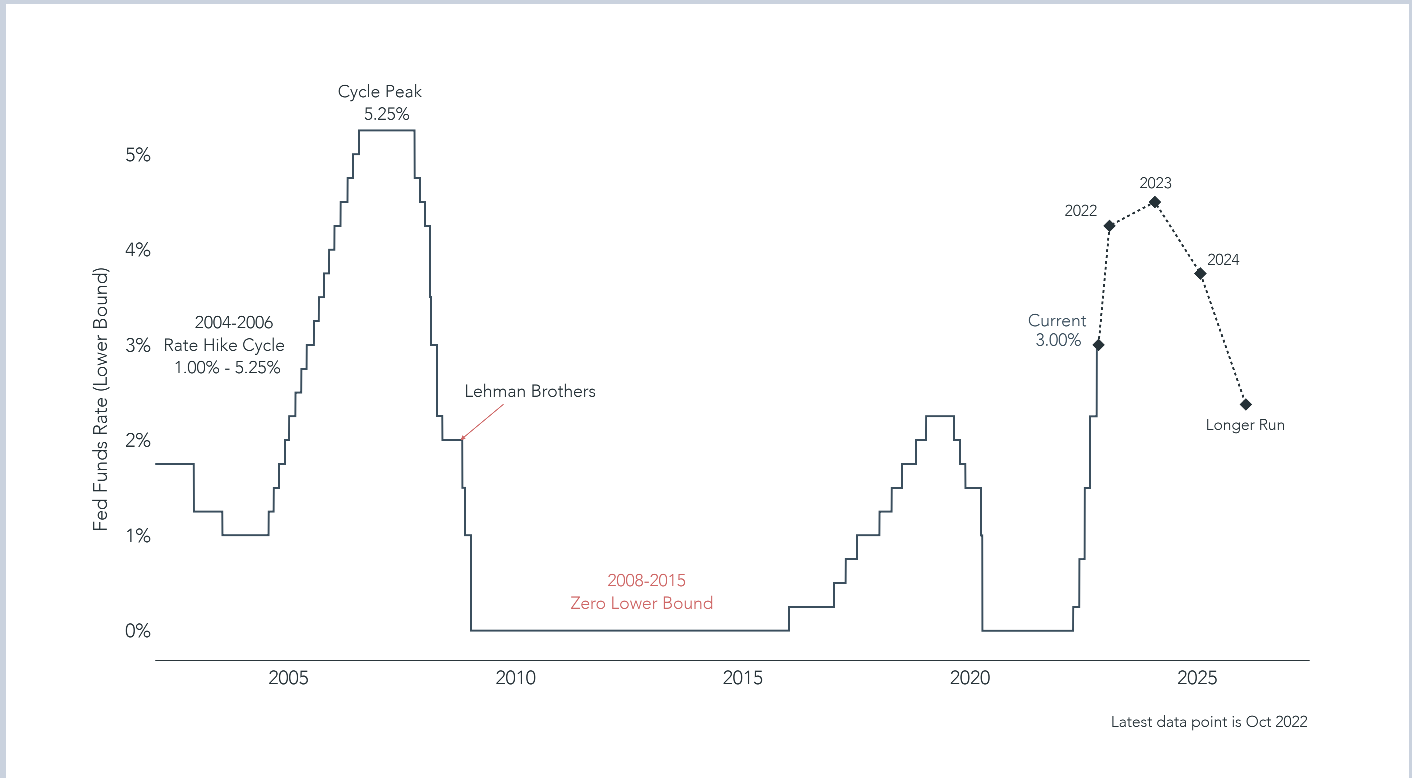
Source: Clearnomics, Standar & Poor's

While the first three quarters of this year have experienced poor returns, it's important to maintain perspective on the past few years. Last year experienced some of the best returns as the world emerged from the pandemic. In all, markets are still quite positive since 2020 and the S&P 500 has gained over 40% since the beginning of 2019. Since markets never move in a straight line, it's important for investors to take the good with the bad in order to not overreact to short-term events.

There is also some good news among the poor economic numbers. Energy prices plummeted throughout the third quarter, reversing much of the effect of Russia's invasion of Ukraine on oil and gas markets. This helped to bring gasoline prices down, although they are still higher than during any other period over the past decade. Headline inflation - which includes food and energy - has eased as a result.

Economists and policymakers continue to focus on "core" inflation which re-accelerated in August, a sign that price pressures have broadened and continue to hurt consumer pocketbooks. This is a key reason the Fed has doubled down on its inflation fight.

The Fed expects to keep rates higher for longer



Source: Clearnomics, Standar & Poor's

The Fed has communicated that it will keep interest rates higher for longer. This has raised investor concerns over whether the Fed can bring down inflation without creating a deep recession - a so-called "soft landing" versus a "hard landing." This is a difficult balancing act for the Fed as they try to achieve their dual mandate of both price stability and maximum employment. The markets will continue to adjust to these new expectations in the coming months.

One of the main effects of higher interest rates is rising mortgage costs. The average rate on a 30-year fixed rate mortgage is now 6.7% - the highest since the mid-2000s and far above the average of 4% since the last housing bubble. Housing activity is slowing across the board from building permits to housing starts, and from refinancing activity to existing home sales.

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Staying Invested in Q4

If history teaches us anything, it's that fighting the urge to overreact to short-term events is one of the keys to long-term investor success. Since the Great Depression nearly a century ago, the market has trended upward over time, following the path of economic growth. Along the way, there have been countless major historical challenges to overcome from wars to bear markets. When zoomed out, these look like blips compared to the gains investors achieved over years and decades.

The ongoing bear market is challenging and unpleasant. However, it is no reason for investors to lose sight of their financial goals. In fact, those investors with the discipline and patience to take advantage of opportunities will likely be rewarded in the long run.

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