Making Sense of Finance

Karagosian Financial Services | 10/20/2022 | Volume 25, Issue 4

Third Quarter 2022 Review

STOCK MARKET

The third quarter began on a positive note with gains in the stock market in the month of July. However, by the middle of August with reported inflation rates still high, and amid formidable comments by the Federal Reserve Chairman on the effects of addressing this elevated inflation, the market responded dramatically to the downside. This sell-off continued through September which was an especially turbulent month for both stocks and bonds. The S&P 500 finished the quarter with a loss of 5.2%. Other major indexes posted similar losses, the Nasdaq Composite declined 4.1% and the Dow Jones Industrial Average dropped 6.6% last quarter. Three consecutive quarterly losses in the stock market have not happened since 2008. Stock markets do turn quickly, usually sooner than the economy. Earnings are still expected to grow in aggregate in 2022 and 2023 for the S&P 500 index, however what investors are willing to pay for these earnings has dropped significantly. The 150 basis points increase in the Fed Funds rate last quarter has increased interest rates substantially enough that now there is an alternative to investing in stocks (albeit still receiving a negative inflation adjusted return on most fixed income and cash).

Two stock sectors managed to buck the trend and had positive returns for the third quarter. Consumer discretionary stocks fared best with a gain of over 4%, rebounding after being among the worst performing groups in the second quarter. The other category showing a positive return last quarter were energy stocks. Energy is the only sector showing a positive year to date return at the end of September. Although the price of oil is way off its March high of $124, the current price is still higher than the start of the year and energy companies currently are very profitable. The worst performing stock sectors last quarter were reits (real estate investment trusts) and communication services with losses of 11% and 12% respectively. Reits are highly sensitive to changes in interest rates due to the highly leveraged nature of their businesses but also from an investor point of view, the attractiveness of their yields (or lack thereof) versus alternative investments.

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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Foreign stock markets performed worse than US stocks last quarter when measured in US dollars. The MSCI EAFE Index of developed markets declined 10% in the third quarter, measured in US dollar terms. The strong dollar continues to affect the returns US investors receive from their foreign owned securities. If priced in their local currencies, the same index would have "only" lost 4.2% in the third quarter. The US dollar index has had its strongest year so far since 1967 rising 17%, as the Japanese Yen, the Euro, and the British Pound all have significant declines in 2022. European economies are suffering more from the war in the Ukraine than the United States due to their greater dependence on energy and grain from Russia and Ukraine. Emerging markets also posted losses in their stocks last quarter. A few exceptions were in Brazil and India which had positive returns in their stock markets in the third quarter.

BOND MARKET

Bonds have not provided a benign investment alternative this year. As previously mentioned, the Federal Reserve raised the Fed Fund rate target in the third quarter, and it now stands at 3.00-3.25%. In turn, Treasury yields across the range of maturities increased. Most notably, the yield on a Two-Year Treasury rose from 2.92% at the end of June to 4.22% by the end of last quarter. The Ten-Year yield increased from 2.98% to 3.83% in the same time frame. The Ten-Year yield is meaningful as it has a bearing on the direction and magnitude of mortgage rates (which continued to climb last quarter). The substantial rise in yields means large bond price declines. The Bloomberg Aggregate Bond Index, an index of domestic investment grade bonds, returned a negative 4.6% in the third quarter (not too different from the major stock indexes). The worst performing bond sectors were corporates and mortgage bonds. The longer the maturity of the bond, the worse it did.

In addition to the Federal Reserve raising the Fed Fund rate, yields are also rising due to the fact that the Fed will be reducing its balance sheet (over $9 trillion) by approximately $100 billion per month. This huge stockpile of bonds is the result of massive Fed buying of Treasuries and mortgage-backed government securities (quantitative easing, QE) initiated in 2020 in response to the Covid pandemic devastating the economy. The Fed balance sheet more than doubled in size in the past two years. Eliminating the elements of the "free money" environment of the last couple of years has resulted in the sizable fall in bond prices in 2022.

OUTLOOK

We are big proponents of stocks. Historically, stocks have been a great way to build wealth, offering tax advantages compared to regular income, liquid markets, and are a great inflation hedge; the downside, of course, are large bouts of volatility. But the intelligent investor uses volatility as its friend. If the long-term fundamentals of a company remain the same, wouldn't you rather buy the same stock at $10 vs $20? As Warren Buffet says, "Be fearful when others are greedy, and be greedy when others are fearful". The trick is to have the ability to see beyond one or two years; difficult in an age of instant gratification.

The positives from the Fed increasing interest rates are, for the first time in over a decade, that bonds are a legitimate alternative investment now. Retirees who are not looking to maximize returns can get a "safe" 4% return on a 1-year Treasury bill. If we assume inflation will eventually cool down soon, this is a decent return for the risk.

Anecdotally, we have seen some evidence of consumer prices cooling. Mortgage applications are slowing and the common "sold for all cash over asking within a week" for houses seems to have waned. Used car prices seem to be falling from stratospheric levels too. While the cascade effect from the Fed's interest rate increases hurt like a quickly torn bandage, in the long run, we think its healthier for the world to revert back to a more rational pricing environment.

Inflation will take a while to come down. The Fed has raised interest rates to control demand, but we think supply is the major culprit. Russia's invasion of Ukraine and the Oil and Gas Industry's reaction towards the Biden administration provide hurdles for the economy. Furthermore, China has been slow to open up its borders. Again, the west was very short-sighted to move production to China for the quick cost savings. Some companies have reversed this practice somewhat, but it will take years to get production in the USA up to speed and the reality is it will likely still be more expensive producing products domestically. Our advice remains unwavering; stay the course.

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