3rd Quarter 2022 Review

Stocks attempted a mid-summer rally early in the quarter but later faltered as interest rates continued their march higher and inflation remained stubbornly high. The quarterly declines for the major stock averages were: The Dow Jones Industrial Average declined 6.20% (down 19.76% YTD); the S&P 500 was down 4.93% (down 23.93% YTD), the Russell 2000 Small Cap Index was down 2.10% (down 25.13% YTD), the NASDAQ fell 4.10% (down 32.4% YTD). International equities were down as well with emerging market stocks falling 13% on the quarter (down 28% YTD), while the MSCI EAFE Developed International Index fell 10.3% (down 27% YTD). On a relative basis, value stocks continue to outperform growth stocks with S&P 500 Growth down over 30% YTD and S&P 500 Value down over 16% YTD.

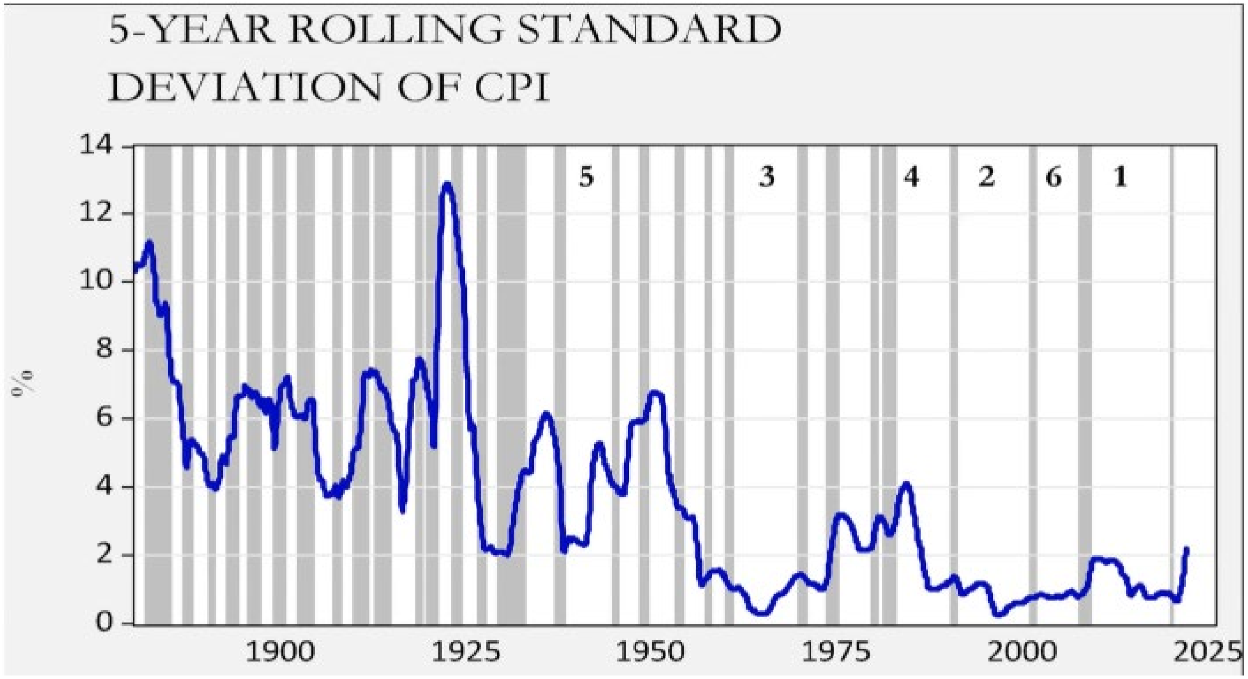
Bond markets, which have historically provided a place of refuge during periods of stock declines, provided no such protection in the quarter. Bond yields rose consistently in August and September, pressuring the prices of bonds. The U.S. Aggregate Bond Index fell 4.70% for the quarter and is now down 14.3% for the year.

We are in the midst of the fastest pace of change in Federal Reserve interest rate policy in modern times. Granted it has been from an extremely low starting level for interest rates, but this also makes us wonder about how well an economy that has grown so accustomed to ultra-low rates can absorb these higher rates and the higher cost of capital that comes with it. Markets are grappling with a Federal Reserve (Fed) that has made it very clear that they intend to bring down the level of inflation even if it causes the economy some pain. That pain could manifest into higher unemployment, and a recession. The Fed is attempting to do just enough to bring down inflation without causing too much damage to the economy (a soft-landing as it is known). Monetary policy by the Fed typically works with a lag- sometimes up to a year lag before the action the Fed has taken becomes fully reflected in economic activity. This poses the possibility that higher levels of rates and inflation and the volatility that comes with this will be with us for some time longer.

The elevated level of volatility that we are seeing in most areas of financial markets (stocks, bonds, currencies) is a result of a regime change that is underway from an era of low rates and low inflation to one of higher rates and higher inflation. Consumers, businesses, and entire economies are dealing with this new reality in various ways. Consumers face high hurdles in housing affordability with the sharp rise in mortgage rates and rapid home price appreciation. Higher current mortgage rates could also reduce the desire for those with the low-rate mortgages to move. A strong housing market has been a big deal for the economy given the multiplier effect of spending that occurs from new household formation or moving to a new existing home. We are watching the trends here as there will be winners and losers from a business standpoint; but overall consumer spending in the economy could suffer in a weakened housing market.

We have often written about how as investors we are “macro-aware,” but “micro-focused” when making our investments. This means that we pay attention to big picture forces that can act on financial markets such as the level and rate of change in interest rates and inflation, and overall measures of economic health in the economy. The micro part comes into play when digging into the individual merits of a specific business to determine if we are buying into a quality business at an attractive price. These are the things that we grind out every day in our research efforts. For more on our stock process with a quality and value discipline, we will point back to our 1st and 2nd quarter reviews which are archived on our website and in client portal reports. For now, we want to step back and look at the big picture.

One macro force that is worth highlighting is the chart below from Haver Analytics, which despite its fancy title, is simply the long-term volatility in the rate of inflation.



The chart shows that not only are we starting to experience higher inflation that we have not seen in decades, the volatility in the level of inflation is starting to accelerate as well. This can have important implications for financial markets. One of the major tailwinds for how well financial markets have performed over the last 30 years has been the low level of inflation and the level of inflation's volatility. The bold numbers at the top of the chart represent the lengths of business expansions between recessions. When the volatility of inflation is 2% or less, the lengths of business expansions tend to be longer. If inflation volatility becomes more persistent, we could expect more volatility in the economy (a higher frequency of downturns, or shorter periods of expansion). This type of analysis goes into how we think about portfolio construction, risk management, active management, and making sure we are being adequately compensated in the market for the risks we take.

If we are moving into a period of structurally higher interest rates, and it takes more time for the Fed's actions to bring inflation down (and inflation volatility rises), then it is important for investors to realize that what worked for portfolios over the last 10 years may look very different from what works over the next 10 years. When inflation was stubbornly low, the Fed did not worry about keeping rates pinned at ultra-low levels to support growth. This easy money environment supported speculation and the dramatic overshoot in valuations of growth companies that derive much of their value from the prospect of earnings and cash flows expected far in the future. Projects that would never have been funded in times of a normal cost of capital were routinely funded with cheap access to credit. Speculative excesses built up and asset price inflation took over as the main source of inflation in the U.S. This environment is now changing. The Fed is fighting an inflation fight that it has not had to in years. Assets across financial markets are repricing to reflect the new era and the higher costs of capital.

The U.S. wealth management industry of assets under advisement by financial advisors is over $40 trillion today, representing one of the largest pools of capital globally. Based on data from a private investment platform, CAIS, the allocation to alternative investments within this pool is somewhere between 2-5% collectively on average. When comparing this allocation percentage to those of institutional investors like pension funds and endowments, which are closer to 30% or more, we see a potential for large shifts in the future allocation of capital. We mention this for a couple reasons. First, we have been proponents of using alternative investments in portfolios where appropriate. We view them from multiple lenses depending on the specific use case for client needs. They can be used as a lower volatility contributor of return, where we are seeking to participate in a portion of the market's upside yet protect more on the downside. Alternatives can also be used as a source of higher risk/higher return as a replacement for some allocation to public equity and high yield credit. When properly constructed, they can be sources of differentiated return streams that are less correlated to traditional investments in a typical 60/40 stock/bond portfolio.

The second reason for mentioning this topic is related to the prior discussion of an expectation for higher volatility and potentially shorter economic cycles. The environment of the past decade accelerated many investors' embracement of passive index strategies for both stocks and bonds, at the detriment of active management strategies. There is no valuation filter on such strategies; they simply own more of the highest weighted securities in the index as more dollars flow into them. Such strategies could be at greater risk of outflows as more advisors and investors embrace higher allocations to alternative investments and active strategies.

When the risks come roaring back, it pays to know what you own and why you own it. Owning quality assets at attractive prices has worked for us through decades of market and economic cycles, and we feel no less confident today that it will continue to work for us in the future.

Stock prices are cheaper, and the list of new opportunities to own great businesses at attractive prices has grown. Bond yields have risen, giving investors the first opportunity in many years to earn a decent yield in fixed income. Active strategies in both liquid and private alternative investments have the potential to smooth out the ride for investors and provide unique, less correlated sources of yield, protection and growth depending on the objective, risk and liquidity needs.

These tools in our toolbox and our steadfast commitment of discipline over emotion guide us in both the good times and the bad times. While attentive to the risks, we are surveying the opportunities that arise from periods of high volatility. We thank you and appreciate the trust and confidence that you place in us.

Justin B. Whelan III, CFP
President
jbw3@biechele-royce.com

Matthew C. Sanchez, CFP, CEPA
Senior Investment Advisor
msanchez@biechele-royce.com

J. Anthony (Tony) Milburn
Senior Investment Advisor
tmilburn@biechele-royce.com

Thomas A. Barrett, AAMS
Chief Investment Officer
tbarrett@biechele-royce.com

Stephen R. Allen, CPA, PFS
Senior Investment Advisor
steve@allen.cpa

Rachel A. Rhiver, CFP
Director of Operations
Senior Investment Advisor
rrhiver@biechele-royce.com

George S. Sparks Jr., CPA, PFS
Barnes Dennig – Director
gsparks@barnesdennig.com

Andrew J. Bertke, CPA, PFS, MBA
Barnes Dennig – Director
abertke@barnesdennig.com