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## **Third Quarter 2022**

The third Quarter of 2022 was much like the Second Quarter – miserable. Earlier this year inflation hit a 40 year high. Then, after holding interest rates too low for far too long, the Federal Reserve has been raising them at an historic pace. The Fed raised its benchmark Federal Funds rate 0.75% on September 21, the fifth increase in a row, to a range of 3%-3.25%. Their benchmark rate is up 3% from 0.0% - 0.25% in March. It is expected to be raised another 1.25% by March 2023, to 4.5%.

Last week Mary Daly, President of the Federal Reserve Bank of San Francisco, poured cold water on the idea that the Fed would soon ‘pivot’ from raising rate to lowering them: “I don’t see that happening at all. I see us raising to a level that we believe is restrictive enough to bring inflation down and then holding it there until we see inflation truly get back close to 2%.” Daly expects that inflation will get back to 3% by the end of 2023 and 2% only a year after that. (Dow Jones Newswire, October 5)

The 10-year U.S. Treasury yield has touched 4% for the first time in over 10 years and has climbed at the fastest pace in 40 years, because of rising expectations of how high the Fed will raise short-term rates. The yield curve – the difference between short-term and long-term interest rates – has inverted. An inverted yield curve has been a reliable indicator of a coming recession. The two-year U.S. Treasury yields 4.26% today, the 10-year 3.92%.

The surge in U.S. interest rates has made the U.S. dollar almighty. It is up 9% against the Loonie, which has done better than most currencies, and is up 14.6% versus the Euro.

The combination of rising bond yields (and falling bond prices) and falling stock prices have been awful for a balanced portfolio. I have seen more than a few bear markets (bears hibernate, bulls charge around) in the past 40 years. There tends to be something of a four-year pattern to them. As I look back now, none seem to have had that same combination of near record low unemployment, sharply rising interest rates, and plunging real estate and stock prices as this one has.

To pick out a few bear markets: 1981-82 was characterized by high unemployment, high and falling interest rates and falling stock prices. Then, like now, there was a Federal Reserve, led by Paul Volcker, determined to crush inflation.

1987-88 was marked by a spectacular stock crash brought on by a misguided confidence in ‘portfolio insurance’ derivatives. On Black Monday, October 19, 1987, you could have heard a pin drop in our office. The expected recession/depression never materialized, and stocks went right back up.



In 2000-2002 the bear market was mostly limited to technology stocks, the NASDAQ tech heavy index lost 86% but other sectors of the stock market were not much affected.

In 2008-09, the Great Financial Crisis began with a collapse of home prices in the U.S. and climaxed with the bankruptcy of Lehman Brothers, a storied investment bank that dated back to the Civil War. Fed Chair Bernanke dropped interest rates to aggressively support the financial system to stave off a financial contagion. For his research on that topic, he was awarded a Nobel Prize for Economics this weekend. Note that in these examples the bear market unfolded over two years.

In late September rumours of financial strain at Credit Suisse led to talk of a 'Lehman moment' that would cause the Fed to pivot to lowering rates, but the financial strain has apparently not been large enough yet.

Often in this letter I like to bring attention to individual stocks. However, this year rising interest rates has led to indiscriminate selling of stocks, such that it hasn't seemed to matter what an individual company's prospects or valuation are – good and bad are suffering now. Undoubtedly individual stock characteristics will matter again one day. The S&P 500 can now be said to be fairly valued at 16 times earnings, which is about the historical average, but we don't know how much a recession, if it comes, will damage corporate profitability.

The Fall has usually been my favourite time of year to be looking for bargains in the stock market, because of capital loss selling and other seasonal factors. I suppose I should be happy that there are so many to choose from this year and that should make for a Happy Thanksgiving. In our household Kristin tested positive for Covid on Thanksgiving Monday which has put a damper on our long weekend. As for me, perhaps feeling gloomy and tired is a symptom of long Covid, or more likely feeling gloomy and tired is a symptom of a bear market. Eventually, wars, against inflation and otherwise, end.

Sincerely,

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Senior Portfolio Manager

Please visit us at [www.georgestedman.com](http://www.georgestedman.com)

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