Pain Before Prosperity

It was a dismal quarter. We just have to know that things will get better.

After a terrible first half of the year, it looked as if the markets established some footing and a gradual return to normality in the economy would usher a stock market recovery. These hopes were dashed, however, by strong remarks from the Federal Reserve, which cast a spell on the financial markets. As a result, both stocks and bonds had their worst showing through nine months since 2001.

Do you remember all of those years when the Federal Reserve served to cajole the markets with ever present stimulus measures? Investors were constantly reassured by a dovish Fed. Even as late as this May, Chair Powell said that the recent moves to raise interest rates would result in a “softish landing”.

During the second quarter, stocks even deciphered these remarks by the Fed to be friendly and insinuated a gradual trajectory to interest rate increases. Then in August Chair Powell abruptly reversed his stance and went so far as to prescribe “pain” for all of us to absorb in an effort to fight inflation. This was immediately intolerable to the stock market.

Powell later went on to say “no one knows if this process will lead to a recession”, which in Fed parlance is like saying, “so be it”. It was “game on” following this clear message and the intense selling that followed, washed out the gains for the third quarter.

The Fed’s mandate is to raise rates until inflation is stamped out. At the expense to investors and the overall economy, the course is set. **Pain before prosperity**.

Why is the Fed taking such an apocalyptic approach? Who are they to say where interest rates should be?

Inflation is already waning. Almost every measure is trending lower over the last few months. Signs abound. The cost of shipping a 40 foot container from China has fallen 75% over the past six months and is now at lows last seen in April 2020, after the outbreak of the pandemic.

Companies like Walmart, Target, and Nike are now reporting they have too many bicycles, TVs, and sports apparel.

Meanwhile, substantial wealth has been extracted from the economy. Isn’t that deflationary?

The S&P is down 24% NASDAQ is down 32% for 2022. The combined value of 16 trillion, or just over 20% of all total market value of stocks and bonds is the largest decline in market value ever registered during a calendar year.

The third quarter ended at the lows for the year, reflecting the gloom permeating markets and investing in general. The S&P 500 declined 4.93% in Q3 but it fell 9.24% for the month of September 12.77% in the final 14 agonizing days. One of the most amazing sides of this

contagion is that long term treasuries are down by over 30%, matching the year to date decline on the NASDAQ.

Housing values constitute the largest percentage of household wealth and these values are starting to decline, as well. What if this decline continues as a result of the Fed policies.

Looking back, we can conclude the Fed has been misguided. First, it provided too much fuel after the pandemic which spawned asset bubbles in stocks and real estate. When a three trillion dollar company like Apple can rise by 5% in one day, like happened many times last year, that is the result of a bubble created by our very own Fed, knowingly or not. Soaring home values is another example of a Fed created bubble.

Now comes the crusade against inflation, barring all consequences.

The Fed claims to be "data dependent." Inevitably, this leads to oversteering the economy. It doesn't seem like this is an effective way to run a stable financial system.

What to Look For

What will it take to reverse the fortunes of the stock market?

So far, in 2022, each market rally has given way to fresh lows in the stock market. Everyone wants to know how much further the market will fall and when it will begin to turn around in a more durable way.

Waning inflation is necessary to ease the contagion in the markets. We also look for further evidence of cooling in the job market. Already, large technology firms have announced layoffs, so this might be encouraging.

A pronouncement of a recession would actually indicate the worst is over for the stock market. This is paradoxical since most people view a recession as the enemy for investing. The slack in the economy from a recession will be just the medicine we need. Ultimately, this would be supportive of the stock market and open a more clear path to investing.

Peregrine Strategy

Negotiating sharply rising interest rates became the marching order for investing in the third quarter. For managed accounts, the emphasis has been on capital preservation and capturing rising yields on short term investments, like treasury bills.

There will be a juncture when the market rallies, but so far in 2022, these rallies have only given way to lower lows for the overall market. *Throughout 2022, it has generally not been rewarding to be favorable to stocks.*

The most beneficial investment strategies have been selling or avoiding all areas of the stock market. The bear market has come for market generals, such as the formerly lauded technology stocks but it has also hit market defensive stalwarts , like General Mills and Pepsi.

The overarching principle for Peregrine accounts, currently, is to be more conservative than our competitors, with respect to investing.

Once it becomes definitive that a recession has arrived, should pave the way for a reversal of fortunes for the stock market.

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10/6/2022