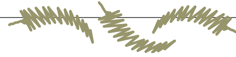
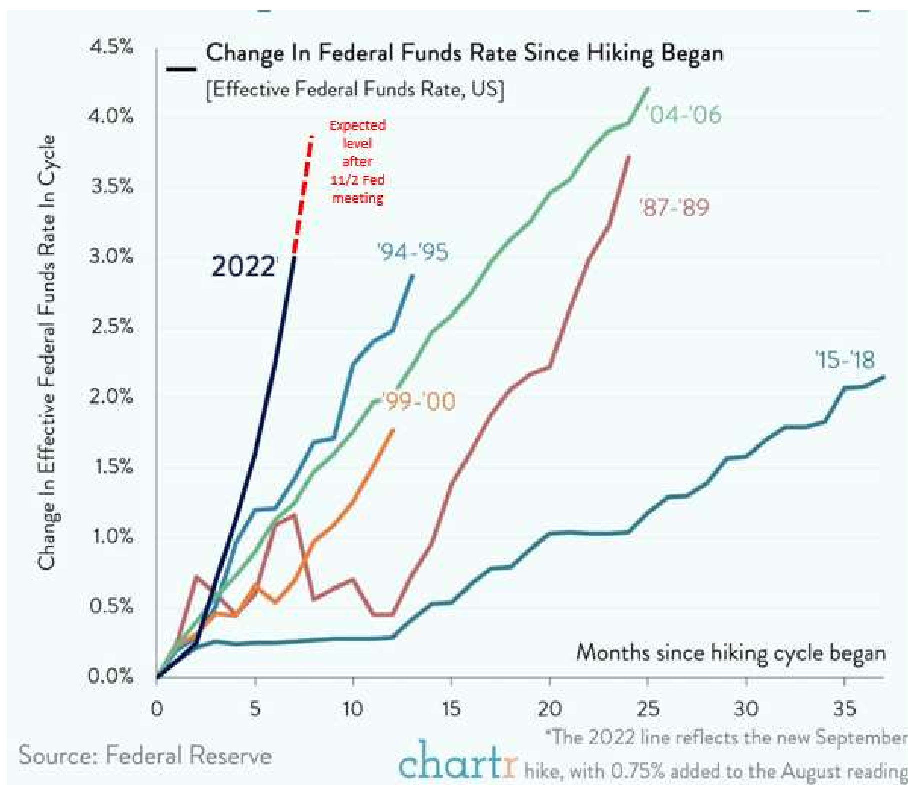
C Y P R E S S

Asset Management, Inc.



MARKET COMMENTARY **October, 2022**

The S&P 500 suffered its third consecutive quarterly decline (-5%) and closed the 3Q2022 in clear bear market territory, down 24.5% YTD. Bonds ***have not*** been a safe haven and have fared even worse than equities. According to BAML research, balanced portfolios (60% stocks/40% bonds) are having their worst year since 1920, down 27% YTD. The Fed has moved aggressively to tighten monetary policy and indicated it will continue to tighten to combat high inflation. In fact, the Fed is hiking rates further and faster than any time in modern history. Against the backdrop of persistent global inflation and rising rates, the U.S. economy continues to slow.



Global Headwinds

The IMF recently cut its global growth forecast for next year to 2.7% but it sees even slower growth in the U.S. (1%) and the Euro Area (.5%). The world economy and financial markets are under considerable stress. The war in Ukraine, persistent high global inflation, fiscal tightening led by the Fed and now European Central Banks and others to combat this inflation, and China's draconian "zero-covid policy" have all combined to produce a significant economic slowdown. The result of all these converging factors is an environment unlike anything we have seen since the 1970s and 1940s. The United States and Europe have probably already entered a recession of unknowable duration and severity. The good

news is that, as the market has been telling us all year, the process and hopefully the cure is well underway and at some point, stocks will begin to reflect or "discount" a better outlook well before it arrives. The old aphorism that "stocks look 6 months out" contains more than a grain of truth, but we also caution that with so many unknowns in the current global environment events could also shift in a more negative direction.

Fed Tightening Cycles and How They End

Monetary policy operates with a one-two year time lag, so Fed tightening is really only starting to impact the real economy. It can, however, more rapidly influence financial markets, and almost every tightening cycle has been associated with a financial shock or crisis. Monetary policy is a blunt instrument and typically the Fed tightens until something "breaks". Here are some examples from past tightening cycles:

	Financial Shock/Crisis	Fed Reaction
October 1987	Black Monday	Eased
1997	Asian Financial Crisis	Eased
1998	Russian Ruble/Long Term Capital	Eased
2007/2008	Housing Bubble/Financial Crisis	Eased & QE
2012	Eurozone Crisis	More QE

This time around two early flash points are the dollar and mortgage rates. The dollar has appreciated almost 20% in 2022 and is at a 20 year high. U.S. 30-year mortgage rates are up 400 basis points from around 3% to 7%, the highest level since early 2002. Consequences are being felt near and far. Fed rate hikes and dollar strength have put additional pressure on the United Kingdom and the pound as it navigates an energy crisis and its own monetary tightening path. The BoE recently said the UK was on "on the brink of financial crisis" as it intervened to stabilize its government bonds (Gilts) and the pound as they experienced a mini crash which threatened the solvency of its pension system. Here at home, soaring mortgage rates are putting the U.S. housing sector under pressure and will pressure property values across the board. Mortgage demand just fell to the lowest level since 1997, as interest rates continued to rise. Demand was 86% lower than the same week one year ago. We will be monitoring these and other market developments in the months to come. But in conclusion, there are signs that a financial crisis or shock may not be long in coming and with it a pivot in Fed policy.

A Path to Recovery

Challenging as is the current environment, it is possible that stocks are near their low and we are closer to a positive turning point than another major leg down. The bear market has thus far been driven by multiple contraction, making stock valuations more attractive. The S&P500 started the year trading at around 21x forward earnings and currently trades at about 16x times forward earnings. Corporate profits are likely to be up only very modestly, 1%-2%, this year and our outlook is that earnings are unlikely to increase in 2023. If we use as our guide the notion that stocks look 6 months out, there is a pathway to believing that in about 6 months earnings estimates will have troughed and out-year profit estimates will show a resumption in growth. This is predicated on an assumption that corporate earnings hold close to current levels, which would require a few things to go right in an environment where not a lot has gone right for investors or the global economy over the past 9 months. As painful as this Fed tightening has been, the longer-term case for stocks and higher stock valuations depends on the Fed ultimately being

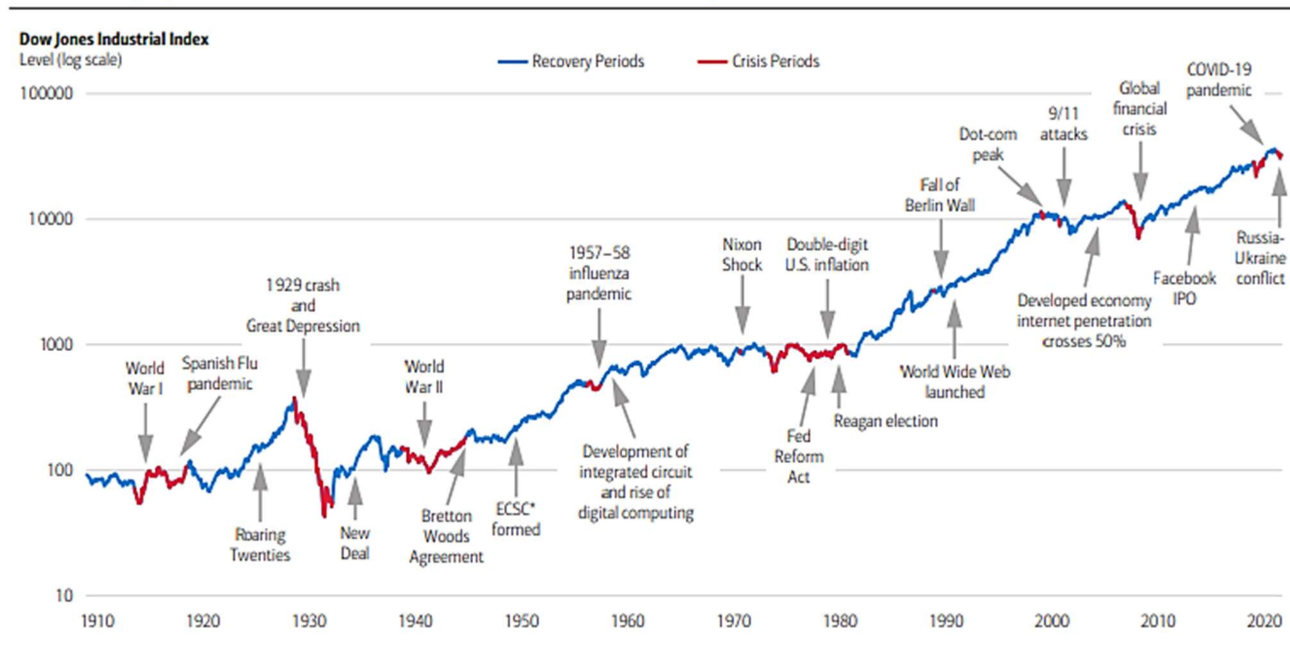
successful in its fight against inflation. Stocks are long duration assets, like real estate, and their value is highest in a low inflation low interest rate environment.

We take a long-term view, are fortunate to have clients who do the same, and believe our portfolios are well positioned to weather these challenging times and prosper when the American economy inevitably returns to growth.

What a Difference a Year Makes

	LAST YEAR	THIS YEAR
COMMODITY PRICES	*Increasing*	*Declining*
GLOBAL GROWTH	*Accelerating*	*Recession Levels*
DOLLAR	*Flat y/y*	*Up*
PRICING POWER	*Surging*	*Plunging*
GOVERNMENT SPENDING	*Surging*	*Slowing*
FED BALANCE SHEET	*Expanding*	*Contracting*
NEW CAR PRICES	*Up*	*Down*
USED CAR PRICES	*Up*	*Down*
CONTAINER FREIGHT RATES	*Up*	*Down*
TRUCKING FREIGHT RATES	*Up*	*Down*
INFLATION EXPECTATIONS	*Straight up*	*Down*
M2 GROWTH (MONEY)	*Almost +30%*	*Less than 2%*
HOUSING MARKET/PRICES	*Expanding/Up*	*Contracting/Coming Down*
CONSUMER NET WORTH	*Increasing*	*Declining*

Exhibit 1: Equity Market and Historical Periods of Crisis and Recovery.



Source: Chief Investment Office, Bloomberg. Data as of July 2022. *European Coal and Steel Community. **Past performance is no guarantee of future results. It is not possible to invest directly in an index.**