Understanding Recent Market Volatility

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As we begin the Fall season in the Midwest, we're also enduring the frigid cold of an economic Winter. We are paying our penance for the economic shutdown during the pandemic, and the subsequent printing of money to numb its impact. Essentially, we voluntarily broke our economy's leg then pumped morphine into it to make it feel better. For a while, the morphine worked, and we could walk around without pain. Now the high has worn off and we find ourselves in the middle of a hurt and healing economy and, correspondingly, a bear market. Volatility and tensions are equally high as we watch our grocery bills rise while our investment values fall. Even bonds – which tend to be less volatile – have been tossed around due to the heavy interest rate hikes. During these times, it's easy to feel discouraged, angry, frightened, and even hopeless. However, this is a normal part of a healthy economic cycle. If we can see past the surface, a look at the data suggests these trying times will not last.

Inflation has been a major player in the economic turbulence we have seen this year. After a small summer rally, September saw us fall back towards market lows for the year. This was in large part due to inflation numbers, as August CPI came in higher than expected (+0.1% vs expected -0.1%).[1] In response, the Fed unanimously voted to raise rates another 75bps during their September FOMC meeting and increased their rate expectations above what was previously anticipated by the market. The narrative is the Fed believes they will have to raise rates higher, stay there for longer, and hurt economic growth more than originally thought to bring inflation down. While the news wasn't great, it was certainly a more realistic evaluation of inflation's impact and the effort it will take to resolve.

How high must we raise interest rates to bring inflation back to normal? Unfortunately, nobody knows. The unprecedented printing of dollars and increase of money supply has led to unprecedented quantitative tightening efforts. We believe finding a clearer path to normalization involves a basic supply and demand economics approach. As we said in our Midyear Review, M2 money supply has the greatest effect on inflation. M2 money supply increased an enormous 42% from January 2020 to March 2022.[2] More dollars circulating equals greater demand. Without an equivalent increase in supply, prices increase. To work towards equilibrium, the Fed and government need to let supply catch up to this increased demand. This involves slowing government spending and letting America do what it does best: produce. The USA is the most productive nation in world history. While bigger government and more spending slows the process, there is more than enough growth and innovation to guide us back to a thriving economy.

A look at data leads us to believe inflationary moderation is ahead. Inflation peaked in early summer and started decelerating in recent months. July showcased the first decline in CPI since May of 2020. Core CPI has declined four consecutive months. The PCE, an index reflecting the change in prices of goods and services purchased by US consumers, rose in July at its slowest rate in 21 months.[3] Restaurant labor numbers are healing; inventories are working towards normal levels; and prices of food, energy, commodities, and goods are all decelerating. The US dollar is stronger than it has been in many years, making imports cheaper and helping our inflationary pressure. All this suggests that inflation, although still high, is headed in the right direction. Better days are ahead, but the path is bumpier and longer than the Fed initially expected.

The rest of this year and next, anticipate continued volatility during the Fed's fight to temper inflation. We expect inflation to continue to decelerate but more slowly than anticipated. While lagging indicators such as inflation showcase grim data, leading indicators point towards brighter days ahead, though timing remains unknown. We will continue to keep an eye on money supply and mid-term elections as well. While politics has had little effect on market performance historically, gridlock within the White House can make government spending and raising taxes more difficult.

For equities, we suspect the next 12-24 months will be turbulent as we continue to work back to normalcy. Until inflation is under control, we could see some bear market rallies that come and go. We believe the bear market could continue a little longer and there is potential for economic contraction that leads to a recession, though much of the negative news has likely already been priced into the markets. Despite this, our long-term outlook remains very positive. Many corporate balance sheets are solid, companies are still paying dividends, banks are well-capitalized, the dollar is strong, innovation is dynamic, and data suggests improvement. The fundamentals do not point towards a bear market as prolonged as that of the tech bubble or Great Recession of 2008.

A return to the fundamentals of investing is important during these times. It is vital to remember that sticking to a financial blueprint is

[1] *https://www.bls.gov/cpi/*
[2] *https://fred.stlouisfed.org/series/M2SL*
[3] *https://www.bea.gov/data/personal-consumption-expenditures-price-index*

imperative to working towards financial goals. While stock prices are low, quantity of shares owned remains the same until sold. If you owned a home, the worst time to sell would be in a bad housing market. In the same light, high quality stocks shouldn't be sold just because of a period of poor market performance. In fact, it is more disadvantageous to sell now than selling when the market is flourishing! Hunkering down during the storms and holding tight might sound boring or passive, but it's one of the best things investors can do. To accelerate recovery, purchasing quality stocks during bear markets helps lower the average cost per share and can help work towards financial goals more quickly and efficiently. For many, these times can act as a gift for their 401(k)s, IRAs, and investment accounts when new money is coming in. Turbulent and trying times are when it is most important to remember we are *investors* and not *traders.*

Growth out of recessionary bear markets has historically resulted in robust 3–5-year returns, especially to those who purchased additional high-quality stocks during the bear. Predicting a bottom to the market is nearly impossible, especially in high volatility. Knowing this, long-term investors should view low enough as good enough when investing. Raymond James portfolio strategy team says: *"Regardless of potential downside over the coming months, the long-term risk/reward from current prices skews heavily in investors' favor. Applying historical averages of earnings and P/E growth out of recessionary bear markets results in a 5-year potential S&P 500 value of ~6,000, or ~10% compounded annual growth before dividends from current prices. So while we expect equities to remain volatile for now…we encourage long-term investors to keep their focus. Picking a bottom is a challenge when volatility is high; but even in further downside, investors are still looking at strong returns over the next several years."*[4]

For investments that are down with the market this year, holding tight and weathering the storm is prudent. Waiting out the winter, reinvesting dividends, and awaiting recovery can often be the best solution to the question of "*What should I do*?". We encourage you to follow the truth, look at the underlying data, and stay focused on the end goal. Yes, things are tough, but it is distorted because we have taken unprecedented actions these last couple years. Do not let fear keep you from continuing the course towards accomplishing your most important financial goals. As Mission Financial owner Janssen Longenecker puts it, "Just because we can't see the sun through the storm clouds doesn't mean it's not shining. In the same way, there is light in this stormy time. We can't feel or see much of it right now, but there is a way forward that leads to better days in the economy and market to come".

[4] *raymondjames.com/missionfinancial/resources/2022/09/23/weekly-market-guide*

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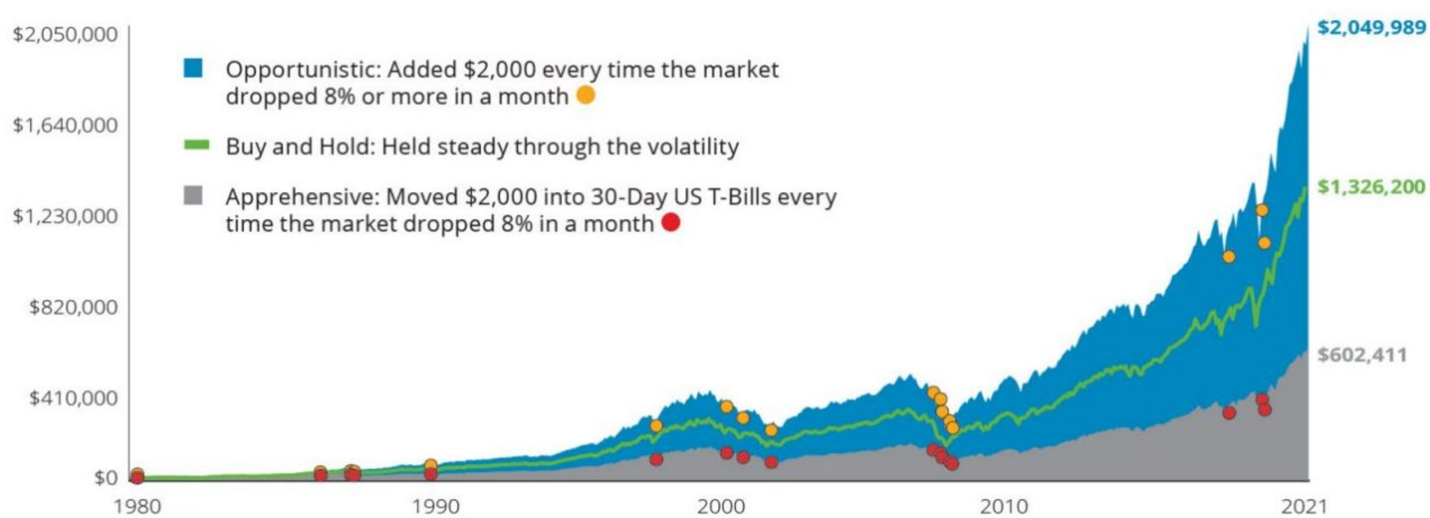

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