

Market Commentary – September 30, 2022

Autumn is typically my favorite time of year. In my part of the world, the blue of the sky is almost surreal, the leaves begin to blaze with intense color and sunlight turns to gold. The nights get chilly enough for comfy sweaters and cozy fires, and the holidays beckon. Unfortunately, this time of year is also, historically, the most difficult for markets and it can become downright nasty when there is a meandering, hungry bear on the loose.

This particular bear market has recently hit its stride after a remarkable “relief rally” that many had hoped marked the beginning of another long hibernation. Such volatility is the hallmark of bear markets, however, as prices rarely, if ever, move in a straight line – up or down. And despite better-than-expected earnings last quarter, the conditions that prompted the initial declines earlier this year are fundamentally unchanged. So, while we enjoyed some respite over the summer, the bear is back on the move.

While understanding the reasons for its return doesn’t make dealing with a bear market any less frightening, it can help clarify our thinking and allow our decisions to remain unclouded by that fear. And the reasons are myriad and interrelated, but all lead eventually to the same economic phenomenon – inflation.

There are two types of inflation – “demand-pull” and “cost-push.” The first type is a fairly common occurrence – parents run into it every year, as the most desirable toys are twice or three times the price they were over the summer once holiday shopping season starts. High fashion and sporting events are susceptible to the same dynamic, and anyone who has tried to get home repairs done during the pandemic is keenly aware of what surging demand can do to prices.

That is where our current inflation story started, and arguably loose monetary policy, coupled with high levels of fiscal spending via pandemic stimulus, had a lot to do with it. But demand-pull inflation is sensitive to the cost of credit, as most western consumption is credit-based – from mortgages to car loans to credit cards. That cost has risen sharply so far this year as central banks around the world have engaged in radically aggressive tightening.

This has implications beyond demand, as anyone who is currently traveling overseas may attest. The exchange rate is in shambles as US dollars out-bid every other currency for investors attention. Higher yields make the US dollar extremely attractive, especially given the geopolitical situation and the very real energy and food crises facing Europe and the Middle East. That dynamic, however, does real damage to US exporters as well as foreign economies, and so continued rate increases are, at this point, untenable from a global trade perspective.

And yet continued rate increases are likely, because inflation has not abated very much despite the soaring cost of credit. The reason is two-fold: first, monetary policy changes take time to work their way through the economy, and second, we are no longer dealing with demand-pull inflation.

Cost-push inflation – a type of inflation that the western world has not experienced in over 30 years thanks in no small part to globalization – is back, due to sustained damage to the global supply chain as a result of both the pandemic and, more recently, the war in Ukraine. Not since the late 1970's/early 1980's have western economies had to face an actual shortage of raw materials and labor. But now, the base cost of production has grown high enough to spur business into significantly raising the price of what they produce. This, we feel, is why the bear is back.

Just as the inflation story has changed over the course of the year, the market story has similarly shifted. Currently, at about 16.5 x earnings for the companies listed on the S&P 500 (on average), valuations are within their historical norms of 14 to 18 x earnings. That would indicate that bear is about spent - having frightened off the “weak hands” and pulled valuations out of speculative orbit, the beast may be ready to relax as winter approaches. But there is a chance that the bear may have a little time left before hibernating once more.

That is because what was a valuation adjustment may become, potentially, an earnings adjustment. This was what we anticipated happening during the last earnings seasons, when earnings forecasts were cut – and the relative resilience of earnings after such low expectations is what sparked the summer rally.

Now however, the increase in costs looks more entrenched, as monetary policy can only do so much to curb the cost of goods that originate overseas and can do nothing at all to increase the global supply of either labor or food. The flood of cash from the vaunted “savings glut” on both corporate and household balance sheets was enough to delay an earnings recession, but we again expect further cuts to guidance in the coming reporting season. This, in turn, will mean that some stock valuations are still too high and thus we have another episode of repricing that, in our opinion, is not quite finished.

The reality of the kind of inflation we are dealing with can make even the most routine, every-day financial decisions feel fraught – especially in light of falling portfolio values. Human beings are prone to filter all things through their most recent experiences, and as our day-to-day experiences become more distressing (both financially and otherwise) that recency bias can lead us to feel a need for action. To take back control, as it were, of a situation that feels very much out of our control.

But as I noted at the start, clarity of thought can help guide us toward good decision making. We cannot know for sure when the cuts to earnings, and the fall in market pricing, has reached “enough” but we can take some clues from our history and our own inclination toward improvement.

Since 1950, across the Korean War, the Vietnamese War, the Oil Embargo, the S&L crisis, the first Gulf war, Kosovo, 9/11, Afghanistan, Iraq, Katrina, the Great Financial Crisis, Sandy, and a global pandemic, among many other gut-wrenching crises, bear markets thrashed for about for an average of 14 months at a time, resulting in losses of about 33%, on average. And in every instance, no matter the environment that called the bear out of its cave, it ultimately went back into hiding.

During that same time period, the Bulls have run 6 years and returned 279% - on average! A list of positive developments during that time to go along with that statistic is truly outside the scope of

these pages, but it includes numerous advances in technology and medicine that have improved and extended our lives in ways that were literally unimaginable in 1950. History suggests that we are good at recovering from a crisis.

We don't know what the next recovery will look like, or when it will start, but history suggests that a significant portion of the recovery in stock prices accrues in the first few months of a new market rally. During the first year following the 5 biggest bear markets since the Great Depression, stocks averaged a 71% return – highlighting the importance of sticking to the plan and staying invested as those early recovery days are incredibly important to reappreciation of declined assets.

Having been involved in the financial markets for past 25 years, and having experienced multiple bear markets and the crises that bring them about, I remain resolute in the fact that they don't last forever - and that new growth cycles always begin again, bringing about new market highs. Its why successful investing is about time, having a plan for our financial life, ensuring we have less risky assets on hand to fund distributions while the markets are down, and not letting emotion dictate our decision making no matter how rocky things get.

Please do not hesitate to reach out to Steve or myself during this period. We often find that walking through the nuances of the economy and markets, and how they relate to your portfolio, can ease a lot of minds during bear markets, and we are here to help do just that.

Best regards,

Julia Randall, Advisor

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