WESTBOURNE
INVESTMENT ADVISORS

INVESTMENT PERSPECTIVE — FOURTH QUARTER 2022

"Wise are those who keep asking questions when everyone around them think they know the answers."- J. Bartell

The stock market declined slightly in 3Q following a brutal 2Q, and is down substantially in 2022, largely offsetting the significant gains of 2021. Given that the economy remains robust, the market sell-off is puzzling to many. We have received numerous questions on current stock market dynamics and wanted to step back and discuss the current market sell-off in the face of a strong economy, via a series of frequently asked questions.

The last report of inflation was over 8%...why is it so high? Pre-pandemic the economy was running very well with low unemployment, strong GDP growth, and all-time highs in the stock market. Fearing economic collapse from pandemic shutdowns, global governments stoked the economic fires with many Trillions in fiscal spending and liberal monetary policies, including a policy of near-zero interest rates adopted by the US Federal Reserve (the Fed). Easy money, combined with labor shortages, supply-chain disruptions, and a strong economic recovery resulted in too many dollars chasing too few products. This supply/demand imbalance created high inflation in nearly every segment of the economy, including the labor market.

Why is the Fed increasing rates? The Federal Reserve has two main mandates – 1) Economic growth coupled with low unemployment, and 2) Low inflation. In the wake of the pandemic, the Fed's expansionary monetary policies and government stimulus worked as intended, insofar as they staved-off a long-term economic downturn. However, these polices overstimulated an already fundamentally sound economy.

A major tool used by the Fed to cool an overheated economy is to raise interest rates, effectively increasing the cost of borrowing, and removing liquidity (money supply) from the economy. This increase in rates will correct the supply/demand imbalance by slowing economic activity. Interest rates have increased at a faster pace than any time in the last 50 years, e.g., mortgage rates are now over 7%, vs. sub-3% last year. Between the increase in housing prices and the increase in mortgage rates, the effective cost of housing has doubled in two years.

When will the Fed stop increasing rates? The Fed will stop increasing rates when they perceive that inflation is dropping from the current 8+% inflation rate towards their target range of 2%-3%.

If the Economy is so strong, with record earnings and low unemployment, why is the market selling off so dramatically? The S&P 500 index, through the end of 3Q, is down 25% YTD. The NASDAQ index is down 32% YTD. The market always looks forward and is currently reflecting two worries: 1) Since the Fed is trying to cool a red-hot economy by "slamming on the brakes" via higher interest rates, there is a real potential of a "hard landing" (recession) where corporate earnings slow or recede, and 2) In a rising interest rate environment, there's lower willingness to pay high price-multiples for corporate earnings, which has depressed stock prices. As we move from a near-zero rate environment into a higher interest rate, bonds become a more attractive alternative source of investment - with bonds now yielding 4% to 5%, investment dollars are moving away from stocks and into bonds.

Wait, what?... Are you saying bad news for the economy is good news for the stock market? In the near-term, yes - as bizarre as that may seem. This is atypical, but so are rapid inflation rates, which we have not witnessed since the 1970s. We are in an overheated economy…and metaphorically, the Fed is trying to throw a wet blanket on it. So, signs of a slowing economy mean that factors driving inflation are abating, and the Fed will be less apt to continue rate increases. Evidence: in August, as the market was anticipating that July inflation figures would show progress towards lowering inflation, the market was up over 12% at one point – only to be disappointed and sink back when figures were released showing continued inflation. Alternatively, a jobs report came out last week which implied a slowing economy (the "JOLTS report"), and the market rocketed up over 6% in two days.

410 Severn Avenue, Bldg C, suite 216 Annapolis, MD 21403 Tel: 301-656-9035 Fax: 301-656-9037

When will the stock market sell-off stop, and will it bounce back like in 2008 or 2020? We do not know when inflation will be brought under control, but we are witnessing indications that the Fed interest rate increases are slowing the Economy. A debate among market participants: How long will rates remain high? The answer is complicated and driven by numerous factors, but suffice it to say, when the economy is growing, and inflation is under control, great companies will add economic value and the markets should eventually continue their historical growth.

As we enter a period of higher interest rates, how does that affect investment returns -- especially equity vs. debt securities – and what is a reasonable strategy during this period of increasingly restrictive global monetary policy? We posit that long-term returns for Equities will produce returns at the higher end of the historical 5%-8% range, over the cycle, while long-term returns for Bonds, over the cycle, will produce low single-digit returns, and perhaps negative relative to inflation. However, normalized bond markets and normalized stock markets are wholly contingent on reducing inflation to normal levels. For those with a long time-horizon, stay invested in quality equities.

What about the fall election cycle? What happens if the GOP wins and splits the government? What if the Dems win and keep control of both houses and the presidency? While the political blame-game might be a favorite past-time at American families' Thanksgiving gatherings, equity markets tend to be politically agnostic over the long run. Historically, capital markets create wealth over the long run, despite who is in power. A business maxim applies to politics and business – *"Capital flows where it is invited, and stays where it is made to feel welcome."* History shows that good management teams with strong business models will navigate their way around party politics and will identify the best returns on capital.

Should we run for the hills? Aren't I better off losing 5%/year in purchasing power from inflation by remaining in cash than 20%+ in the equities markets? This might appear wise in the short run (*"recency bias"*), particularly if we possessed the ability to time markets. However, even at normal inflation rates, over a longer time-period of say 20 years, the steady drip of inflation would erode $0.50 cents on each dollar on purchasing power while Equities, applying historical returns of the last 100 years, would enhance purchasing power and exceed inflation. As an example, even with the recent bear market correction, equity returns of the last ten years have been over 150%, or $250 for each $100 invested, while cash returns have been negligible and have destroyed purchasing power.

Over the long run, purchasing power losses in cash holdings are likely permanent, while losses in a diversified basket of quality equities tend to be temporary.

Stay the course and please call with any additional questions,

Scot E. Labin

Scot Labin, CFA - Director of Research
David Cunningham - Founder, Senior Advisor

Joseph C. Wilkinson - Managing Director
Bruce Kromminga - Director of Operations

410 Severn Avenue, Bldg C, suite 216 Annapolis, MD 21403 Tel: 301-656-9035 Fax: 301-656-9037