Market Commentary
September 16, 2022

Broad Market Selloff Follows Bad Report on Inflation

Equity markets were weak on September 13 following a disappointing report on inflation which was released prior to the market open. We wanted to update you on our take on inflation and financial markets generally.

In our letter at the end of the second quarter we cited inflation as the primary reason for market weakness this year. That hasn't changed. We also noted that the Federal Reserve, which by its own admission was late to act on inflation, was now fully committed to seeing it decline as fast as possible. The Fed's primary tool for impacting inflation is to raise interest rates, which in turn is supposed to slow the economy, reduce overall demand and eventually reduce inflation.

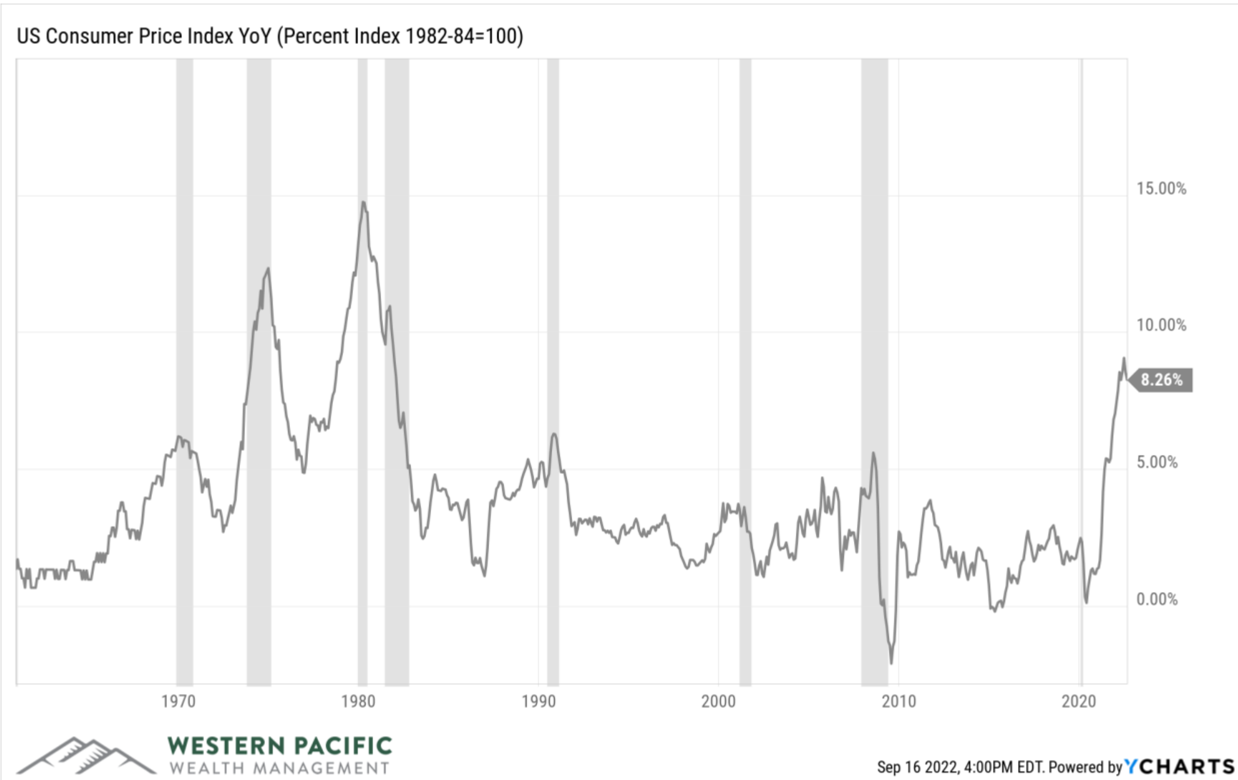
In recent months there had been hope that some of the initial causes of inflation (such as the rising price of gasoline and other commodities) were starting to decline, and that inflation might start to come down. Last month's encouraging CPI report gave further credence to this idea. The report on September 13, however, told a different story. Despite a continuing drop in gasoline prices, inflation rose more than expected. More importantly, the increase in prices was broad based, with rapid increases in the cost of food, rent, health care and electricity. The "core" CPI (which excludes volatile food and energy prices) rose 0.6% in just one month. Clearly the inflation problem will take longer and require more action by the Fed to solve.

In our letter from the fourth quarter of 2021, we stated that the biggest concern around inflation was that it would transition from being perceived as the result of one-off spikes in the cost of various commodities, to being perceived by workers and investors as a more systemic problem in the economy. The reason for this concern is that it has the potential to create a self-reinforcing spiral of higher prices. Workers demand higher wages which cause prices to rise. Higher prices lead to more wage demands and so on. An example of what can happen when inflationary expectations kick in is the current situation with railroad workers who were ready to strike this week despite being offered a 24% raise over five years. (It now appears that the strike will be averted.)

In the short run, it is very likely that the Fed will raise interest rates by at least 75 basis points when it meets next week, and markets are already predicting another big increase at the meeting after that. This increase could create a difficult environment for financial instruments in the months ahead.

We also said at the end of last quarter that the Fed was looking to see several months of positive news on inflation before it would consider slowing its rate increases. This week's inflation report demonstrates why a single positive reading isn't enough for the Fed to change directions. More patience and more action by the Fed will be required to slow the very strong US economy.

Hopefully a reduction in the inflation rate will be accomplished without triggering a recession, but of course that can't be assured. In fact, history suggests otherwise. The graph below shows the history of inflation spikes in the US. The shaded areas are recessions. As you can see, every inflation peak since 1970 was accompanied by a recession. For this reason, investors should not be surprised if there is a recession in the next year or two. It should be noted that not all the recessions were particularly long or deep, but a few of them were.



Our recommendation continues to be to hold current positions and to not time the market. We've held substantial cash positions this year because of the possibility of the sort of events we've seen in recent months. If history teaches us anything it is that conditions will improve eventually, and our goal is to be ready to take advantage of the improved outlook (including better valuations) when it arrives.

If you have any comments, please feel free to call us.

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