WESTERN PACIFIC
WEALTH MANAGEMENT

Third Quarter 2022
Investor Letter

Global financial markets continued to experience very high levels of volatility in the third quarter. For the period, the Morningstar US Market index declined by 4.6%. The single digit decline was misleading, however, as it masked the offsetting impacts of a 14.6% rally from the end of June through mid-August, followed by a decline of 16.5%. As we pointed out in our special letter in September, the biggest reason for the decline was another bad inflation report for August which made it clear that the Fed will need to continue its series of large rate increases. As we write this letter, the September CPI report also showed broad and higher than expected price increases.

Bonds are also poorly performing this year. The Morningstar Intermediate Core index is down 14.7% year to date, while the Morningstar Long Term Core index is down 29.5%. (Long term bonds are more sensitive to interest rate changes than short or intermediate term bonds.)

Growth stocks have dramatically underperformed value stocks this year. There are several possible explanations for this occurrence. First, as we noted in our first quarter letter, growth stocks were much more highly valued at the beginning of the year, making them more vulnerable to a correction. Second, during periods when interest rates rise rapidly, growth stocks often fall faster than value stocks. We discuss this phenomenon in more detail in the section below.

It is impossible to say how long the current bear market will last. While valuations have fallen substantially and are no longer at the extreme levels seen in January, they have not yet reached the levels generally seen at market lows. As we've stated previously, financial markets have a way of overshooting on both the upside and the downside, so it would not be unusual to see stocks fall further before reaching a low. There may be strong rallies during the bear market, such as the one seen in the first half of the third quarter. What can be said is that this period will end eventually and a new, more positive one will begin.

The string of rate increases in the US, along with the current strength of the US economy, has driven up the value of the US dollar. This has the positive effect of making imports less expensive for US consumers (which should help with inflation) but also has the potential to destabilize the economies of other countries. For example, European economies may be forced to raise their interest rates to protect their currency, even though their economies are relatively weak and would benefit from interest rate decreases.

An example of how fragile the European system was seen recently when the new British conservative government unveiled a series of tax cuts (highly unusual for a government trying to fight inflation) and nearly set off a financial crisis. The pound dropped to record lows and the Bank of England was forced to intervene. Prime Minister Truss was forced to withdraw her proposals and fire her top economic advisor.

There is almost certainly an interest rate level which would slow the US economy enough to reduce inflation. The problem is that nobody knows exactly what that rate is, and the unintended consequences of getting it wrong could be substantial. Among the potential worries for the Fed are much higher unemployment, a falling real estate market, a financial crisis or (as noted) problems overseas related to the strong dollar.

Given the string of rate increases by the Fed and persistent high inflation readings, a reasonable person might ask whether the Fed's strategy is failing to solve the inflation problem. Our view is that it is too early to make this judgement. History has shown that Fed policy acts with a significant lag, so we would not expect to see an impact from the Fed's actions for a few more quarters. (That is why many economists are forecasting an economic slowdown next year.)

Interest Rates and Stocks, a Complicated Relationship

It has been widely reported that 2022 has been an unusual year in that both stocks and bonds have fallen at the same time. This has perplexed investors who believed that bonds were meant to be relatively stable and that their place in a portfolio was to help insulate them from the wide swings often seen in equity markets. Also, bonds were believed to be somewhat of a hedge against stock market exposure. According to this theory, it could be expected that when the economy did well, stocks would perform well, and when the economy did poorly, stocks might fall but bonds would hold up relatively well. This relationship has not held up this year. The most important reason is that bond yields were at record lows at the beginning of the year just as inflation accelerated and interest rates rose. This combination of events created a "perfect storm" and created a large drop in the bond market.

There is another factor which has been important this year, and it has impacted both bond and equity prices: Long-dated bonds have underperformed short-term ones, and growth stocks have underperformed value stocks. While it is not generally understood, these two phenomena are related. The reason long-term bonds are more interest rate sensitive is because, since the payments of interest and principal are further in the future, a change in interest rates impacts those payments over a longer period of time and has a bigger impact on the price.

For example, think of a one-year bond vs. a 30-year bond in a case when interest rates increase by one percent. The value of the one-year bond will be lower because investors will require a higher yield over the one-year period until all the interest and principal comes due. But for the 30-year bond, investors will require the higher yield for a 30-year period. Obviously, this has a much bigger impact on the price. In the above example of a one percent increase in rates, we estimate the decline in price of the one-year bond would be close to 1%, while the decline in the 30-year bond would be as much as 25%! (Details of this example are available on request.)

How does this apply to equities? To put it simply, during a period of large interest rate changes, shares of companies with stable earnings (which includes most value companies) would be expected to act more like medium-term bonds, while companies whose earnings are far in the future (growth stocks) would act more like long term-bonds. The logic for equities is the same as with bonds. When rates rise and analysts look to value a company with stable earnings, they will discount future earnings at a higher rate than before and come up with a new valuation. But because growth stocks have a higher proportion of their earnings farther in the future, the change in the rate at which earnings are discounted will have a bigger impact on their value.

To be clear, there are many other ways in which interest rates impact equities. Companies with lots of debt may be negatively impacted by higher rates. Companies whose customers have lots of debt (such as homebuilders) may also be impacted by changing rates. But in years when rates rise so quickly, companies with earnings far in the future are likely to lag the overall market.

We wanted to go through this analysis because this issue has been in the news recently in a way that can be confusing without some explanation. Analysts on television or in the press often use terms such as "long dated assets" without taking the time to explain the meaning or relevance. One of our goals is to help our clients understand these terms and how they impact financial markets as well as their own portfolios.

Thank you for being a client. Please feel free to call if you would like to discuss any topics in this letter.

Best Regards,

William R. Andersen, CFA
Chief Investment Officer & Partner