THE DANA VIEWPOINT

September 28, 2022
Dow: 29,684

The Beatings Will Continue Until Morale Improves

Ok Jerome Powell and other members of the Federal Open Market Committee, we get it: you are serious about raising rates. Back in July and August, we (the market) suspected that their work might be done by the end of the year. As outlined in our July Viewpoint, many price indices were falling after the 75 basis point rate increase in June, followed by another 75 basis point increase in July. At that time, another 50-75 basis points were expected at the September meeting. The Fed did their best to talk down the market as it rallied, but maybe there were doubters about the resolve of the Fed. Well there is no doubt now, and the pendulum of Fed resolve may now have swung too far in the opposite direction.

We said in July that if the Fed recognized the easing price pressures in widely recognized market indicators, we may have seen the low in stock prices and the highs in longer term bond yields. Since the July Fed meeting, the broad commodities index is down 7%, crude oil down 15%, gold down 6%, and the dollar index up 6%. Commodities down while the value of the dollar is increasing are classical economic signs of deflation, not inflation. Our hope would be that Powell learned something about these relationships as an undergraduate student, but alas, his undergraduate degree is in political science.

Higher rates are certainly creating opportunities in the fixed income market. Treasury yields have moved above 4% across virtually all maturities. Yield spreads have widened on corporate bonds, moving yields close to 5% on intermediate maturity portfolios. Tax adjusted yields on our municipal bond strategy are even higher. We do believe we are getting close to the end of the Fed tightening cycle, and bond prices usually firm up and move higher when the end of the cycle is near.

Based on Jerome Powell's comments after the latest Fed meeting, the beatings will continue. One economic positive has been the low unemployment rate, and Fed Chairman Powell has now explicitly stated that the low unemployment rate must also be beaten into submission and driven higher. As of 9/27, the S&P 500 Index is down 9% since the July meeting, and most other equity indexes are down more than 10%. Powell has told us this is mostly irrelevant to the Fed; he has said the unemployment rate must go up for the Fed to be satisfied, regardless of what other market and price indicators are foreshadowing. Investors in U.S. inflation-protected securities indicate future expectations for inflation have moved into the mid-2% range or lower across the curve, from two years all the way out to thirty years.

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Another portion of the economy that has turned from tailwind to headwind is the residential housing market. The annualized sales rate for existing homes has fallen for seven months in a row, from 5.75 million in January to 4.28 million in August. This is below the roughly 4.7 million sales rate that existed pre-pandemic. New mortgage rates have skyrocketed this year, and the housing market is slowing even though, or due to, home prices being up 60% in the last three years. The housing market provides a key barometer of capital investment and consumer confidence, and it is one more concurrent price signal that the Fed should heed.

It seems Jerome Powell and the Fed have a both a tin ear and a blind spot for market price indicators. They are also receiving warning signs from global economic activity and exchange rates. The dollar has skyrocketed versus many other currencies. Dollar strength adds a strain to foreign economies in multiple ways. It makes imported goods that are produced in the U.S. more expensive, and it makes debts that are denominated in dollars more difficult to repay. These risks are evident in foreign developed and emerging stock markets that have underperformed U.S. markets.

These are some of the many signs of decelerating economic activity and lower prices to come. We have to believe that they will be recognized by the Fed in the near future. If this happens, there will be strong rallies in both bonds and equities. The price earnings ratio for the S&P 500 Index is now below 17 times 2022 earnings. The last instances of a ratio at this level were briefly during the market correction in December of 2018 and at the beginning of the COVID crisis in 2020. When the bounce in stock prices happens, the P/E ratio of the market goes up because it takes time for the earnings recovery to manifest itself. As the P/E goes up in these situations, deniers who claim there is still too much uncertainty and that prices are not justified by earnings miss these major market moves. While 2022 has certainly been challenging for stock and bond investors, we encourage investors to recognize the long-term opportunities lower stock valuations create and the fact that short US Treasury securities now yield over 4% - the highest levels in 15 years.

Random thought: "Life starts all over again when it gets crisp in the fall."

- F. Scott Fitzgerald, *The Great Gatsby*

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