Schroeder | Capital Management, LLC

Global Investment

Investment Review and Outlook – Fall 2022

The Pulse of the U.S Economy – Weakening:

This past week, the Commerce Department reported that Gross Domestic Product (GDP) expanded at a modest 2.6% annual rate during the recently concluded third quarter, largely due to exports under previous contracts and consumer services. Although this was an improvement over the decline in the overall economy in the first half of the year, the report also showed that there were troubling signs of a broad slowdown as consumer durable spending and business investment stumbled under high inflation and rising interest rates.

Most important, recent economic data indicated that growth in the U.S. is slowing. According to the Institute for Supply Management, a trade group, manufacturing activity slowed to a 36-month low in September. The housing market is also declining rapidly. Housing starts, a leading economic indicator, slumped 8.1% in September from August. In mid-October, weekly mortgage applications fell to a 25-year low and a 30-year fixed mortgage exceeded 7% for the first time in 20 years.

Earnings Season – Third Quarter 2022 Results Shows Slowing Profits:

Third-quarter earnings season is in full swing. This is not only providing investors with an important reading on how Corporate America did during the recent quarter, dealing with the current level of inflation and supply chain disruptions, but what they see in their forecasts for the balance of 2022 and into next year.

The reporting season got off to a mixed start with most of the big banks beating expectations due to higher net interest income fueled by higher lending rates. However, those same financial institutions cited mounting economic concerns as they look out to 2023. A case in point is FedEx, a barometer of the overall health of the economy, issuing a dour outlook for global shipping. They cited weakness in China and Europe and a growing concern about the health of the U.S. consumer.

Both the number and magnitude of positive earnings surprises are below their 5-year and 10-year averages. Also, year-over-year, the S&P 500 is reporting its lowest earnings growth since Q3 2020. In general, third-quarter earnings season to date suggests the U.S. economy is slowing.

Inflation – Troublesome Numbers Continue:

Inflation remains elevated and has shown minimal signs of easing. This was again evident in the September reports on producer (wholesale) and consumer prices. The Producer and Consumer Price Indices rose 8.5% and 8.2%, year-over-year, respectively. Importantly, core consumer prices that exclude the more-volatile food and energy components remain troubling. The annual consumer core inflation rate accelerated to 6.6% in September, up from 6.3% in August and the highest since 1982.

Another inflationary concern is that the U.S. labor market continues to be very tight. In September, 263,000 jobs were added, bringing the increase in nonfarm positions to over 3.75 million during the first nine months of 2022. The unemployment rate also declined to 3.5%, down from 3.7% in August, matching the pre-pandemic level recorded in February 2020.

3620 Happy Valley Road, Suite 203, Lafayette, California 94549 | Main Line 800.930.7913 | Facsimile 925.283.7916

The Federal Reserve – Current Posture and Future Interest Rates Hikes:

The Federal Reserve's highest priority is to stabilize prices within the overall economy. The combination of stubbornly high inflation, reflected in the September consumer and producer pricing data, along with a tight labor market, is not giving the central bank any reason to pause on instituting additional rate hikes. The inflation and labor market numbers reported in September were not what the Fed wanted to see at this stage of the monetary policy tightening cycle.

The wide-spread expectation by economists and Fed watchers is that the central bank will hike the benchmark short-term interest rate by another 0.75%, in a range of 3.75%-4.00%, at its next Federal Open Market Committee (FOMC) meeting next week, the fourth-consecutive 0.75% increase. The economy is now facing the most aggressive monetary tightening period since the 1980s. The Fed has suggested another increase by year end, and the betting is only a 0.50% hike.

Increased borrowing costs will make it more expensive for business investment and for consumers to secure loans which is key to the Fed's goal of lowering the money supply, reducing demand for goods and services and eventually putting downward pressure on prices. However, investors are concerned that the central bank will raise interest rates too much and too quickly in an attempt to combat inflation, and that its increasingly restrictive monetary policy may push the economy toward a recession.

While the Fed's restrictive monetary policy is designed to slow growth and inflationary pressures in the U.S., economic conditions overseas are quite dire. Growth is slowing in both China and the euro zone economies. In addition to very high inflation, the euro zone is also facing an energy crunch this winter, with reduced oil and gas shipments from Russia and other traditional sources.

Investment Strategy – Remaining Cautious:

The stock market has been on a decent run since mid-October, assisted by a growing sense that the Federal Reserve might soften its aggressive rate-hiking early next year. It now appears the central bank's plan to reduce demand and dampen inflationary pressures is starting to work. Higher borrowing costs have reduced housing affordability and manufacturing activity is slowing.

While the stock market is starting to anticipate positive developments that appear plausible as we look toward 2023, we should expect continuing volatility in the securities markets along with possible disappointments. This is especially appropriate now as the results of our nation's mid-term elections could possibly result in some meaningful changes in governmental policies that impact our economy, perhaps more stubborn inflationary pressures than expected and the Fed's reaction. In addition, continuing supply chain dislocations resulting from the war in Ukraine and global energy supply disruption could have unforeseen economic consequences. Recent geopolitical concerns could also impact our global trading activity, especially with China.

There is a lot to digest right now and caution continues to be Schroeder Capital's stance in the securities markets. We continue to favor very high-quality companies with strong balance sheets, superior dividends, and importantly, pricing power during this period of unusually high inflation.

G. Frederick Schroeder, CFA
President and Chief Investment Officer

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