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Don't Fight The Fed
Environmental Strategy Overview - Third Quarter 2022

October 4, 2022

Although the third quarter got off to a good start from a return perspective, the stock and bond market rallies that persisted for much of the summer proved unsustainable, and we closed the third quarter at new lows for the year. There are myriad reasons for this, and we will explore some of them in this update.

As alluded to above, market volatility has been quite high this year. We started 2022 with domestic equity markets at all-time highs, and valuations that were stretched, as we mentioned in our year-end 2021 letter. Rich valuations can create fragility on their own, but several other factors have contributed to market unrest in 2022. These include lingering supply chain disruptions and related inflation, the ongoing Russia/Ukraine war, concerns for the Chinese economy, and tension over Taiwanese independence. These factors and others affect U.S. markets, but the variable we think most important for the foreseeable future is our own domestic level of inflation.

The current level of inflation is the highest we have experienced since the early 1980s. Consumer and business demand has been persistently high, supported by years of near-zero interest rates, an equity bull market, and unprecedented fiscal stimulus. Making matters worse, supply has been very constrained in key sectors such as housing, autos, chips, oil, and even labor. This imbalance of demand and supply is at the root of the current inflation challenges. As we have highlighted in our recent quarterly updates, the Federal Reserve is very focused on increasing interest rates and tightening financial conditions in an attempt to reign in this unacceptably high level of inflation.

Since the Federal Reserve has little ability to directly affect the supply side of the economy, they are focused on curtailing demand through higher borrowing rates (e.g., 30-year mortgage rates have risen from approximately 3% to 7% since the beginning of this year). This transition from what had been a policy of near-zero interest rates (dating back to the financial crisis of 2008-09) to a more normalized and significantly higher interest rate policy is at the core of the stock market unrest we have been experiencing since the beginning of 2022. While many factors influence bond and equity market outcomes, the actions and rhetoric of the Federal Reserve are currently having an especially meaningful impact. The Fed hopes to engineer an economic soft landing, slowing the economy enough to bring inflation down to their stated target of 2% without causing a full-blown recession. This is a delicate balance that may be difficult to achieve.

An age-old adage of the investment profession is "Don't fight the Fed." This statement acknowledges that, through their policy actions, the Fed can significantly influence the direction of markets. And whether or not one agrees with their intentions, it is often unwise to bet against them. Taking them at their word (as communicated via their most recent mid-September projections), the current higher interest rate environment is likely to persist through at least year-end 2022.

Higher interest rates generally dampen demand at the margin, which in turn can dampen corporate earnings and consequently, equity prices. That relationship is fairly obvious, but higher interest rates can also affect equity prices in a few other ways.

One way to determine a company's equity value is to use an assumed interest rate to discount expected, but unknown, future corporate earnings. The higher the discount rate (which is derived from market rates), the lower the present value of those future earnings. Therefore, higher interest rates are a direct headwind for the equity market. This is one basic reason why the share prices of less profitable (and unprofitable) growth companies have been particularly hard hit this year. The stratospheric valuations of these companies at the start of the year didn't help either.

Another way interest rates can affect equity prices is related to the acronym TINA (There Is No Alternative). In the ultra-low interest rate environment of the last several years, many investors felt "forced" to buy equities because the bond market did not provide a reasonable alternative from a yield perspective. Now that interest rates have risen considerably (e.g., a two-year U.S. Treasury security yields in excess of 4% currently), bonds are again being viewed as a reasonable alternative to stocks. This may continue to attract investors away from the stock market.

Bringing these factors together, we see that the Fed is focused on reducing inflation by raising interest rates, and that higher interest rates have adversely affected equity prices in 2022. What is the end game? When will the Fed consider the "job" to be finished?

Inflation is currently running between 5% and 8%, depending on the measure. The Fed considers roughly 2% annualized inflation to be normal, so there is significant room for improvement. As a result, they have already voiced their intent to keep raising the overnight Fed Funds rate in the near term, likely into early 2023 at least. In a recent appearance on CNBC,[1] Loretta Mester, President of the Federal Reserve Bank of Cleveland, stated that a Fed Funds rate of 4-4.5% by early next year is likely. This is well-aligned with the projections released after the Fed's September meeting.[2] If that projection becomes reality, the worst may be over for now, as the Fed Funds rate has already increased to 3.25% from 0% at the beginning of 2022.

Further, the Fed is charged with a dual mandate—enforcing price stability (i.e., maintaining inflation at the 2% long-term target) and maximizing sustainable employment. The U.S. labor market remains quite tight currently, at only 3.7% unemployment, giving the Fed leeway to continue raising rates to slow the economy and reduce inflation. So, if the Fed is likely to keep raising interest rates for a bit longer, and we don't want to "fight the Fed," how should portfolios be positioned for the long run?

Outlook and positioning

Consistent with the discussion above, we believe short-term interest rates will continue to increase through the end of 2022 and potentially into 2023. Interestingly, longer maturity Treasury bonds are actually yielding quite a bit less than shorter maturities. As of this writing, the two-year Treasury is yielding 4.21% and the ten-year Treasury is yielding 3.81%. Historically, this type of "inverted" yield curve has signaled a pending recession. Perhaps the Fed will manage the soft landing mentioned above and any recession we experience will be mild. Only time will tell.

As all are aware, the equity markets have declined significantly this year, and the third quarter was no exception. Stocks did manage to rally significantly in July alongside temporarily lower interest rates. However, the Fed vocalized their resolve to continue to raise rates, killing the rally in mid-August and leading to major stock indexes closing the third quarter at new lows for the year.

As of the end of September, the S&P 500 is down 23.9% for the year and 4.9% for the 3rd quarter. Our favored equity benchmark, the Russell 3000 is down 24.6% and 4.5% for the year and 3rd quarter, respectively. Using the returns on our preferred ETFs as a proxy, large cap growth outpaced large cap value at -3.8% vs -6.0% respectively, but growth still trails value by a considerable margin (almost 20%) year-to-date. For many of the reasons cited at the beginning of this letter, the broad international sectors, developed markets (-10.6%) and emerging markets (-11.2%), underperformed our domestic equity markets by a wide margin in the third quarter.[3]

In spite of falling oil prices, traditional Energy remained among the better-performing sectors during the third quarter, joining Consumer Discretionary as the only sectors to post a positive return. Over the last 12 months, Energy's outperformance remains massive at approximately 60%. The other high-carbon sectors (Utilities and Materials) fared less well in the most recent quarter, underperforming the overall market by more than 1%.[4]

As discussed earlier, interest rates were quite volatile during the period, settling materially higher by the end of September. The ten-year Treasury began the third quarter yielding 2.97%, rallied to a yield of 2.6% (remember, bond prices move inversely with bond yields), but ended September yielding 3.8%. Two-year Treasuries ended June yielding 2.93%, were relatively stable until the beginning of August, and then sold off dramatically to end September yielding 4.21%. As a result, the U.S. investment-grade bond market, as proxied by the iShares Core U.S. Aggregate Bond ETF (ticker AGG), fell by approximately 4.6% during the quarter.[5]

We believe uncertainty and volatility will likely be with us for a while longer. Some critics of Fed policy believe they have already tightened enough to bring inflation down, citing the significant lag between the rate increases and ultimate effect they have on the prices of goods and services. Regardless, the Fed has stated their intention to rely on actual price data for their decision, and we have had very little relief in the price data thus far. Remember, "Don't fight the Fed!"

Equity markets have already corrected significantly, but remain slightly rich relative to historical norms on a price to earnings basis. We also do not believe that pricing fully reflects the potential for significantly lower corporate earnings in the future if the economy slows more dramatically and we experience a significant recession. Pockets of the growth economy, such as electric vehicles, social media and certain technologies, remain extremely rich, and we believe their equity valuations may continue to be challenged as we transition from lower to higher interest rates and the economy slows.

Global unrest and unstable global economies will continue to make non-U.S. investment a tenuous proposition. The war in Ukraine and its economic ramifications for the Eurozone and China's juggling act around its grossly overleveraged real estate sector are just a couple of our concerns.

Regarding interest rates and the bond market, we obviously believe overnight rates will continue to rise as the Fed continues to tighten policy. How much more of an increase to expect is somewhat harder to gauge. At this point, we have little reason to doubt the Fed's own projections of a 4-4.5% Fed Funds range by the end of the year. What longer dated bond maturities will do with that is even less certain. As stated, the two-year Treasury already yields in excess of 4%, while the ten-year Treasury yield is significantly lower than that despite very clear Fed intentions. The evolution of fourth quarter inflation and employment data will clearly be critical in the Fed's ongoing evaluation of monetary policy and the impact that policy has on bond yields across the maturity spectrum.

Our current positioning reflects the expectations and understanding outlined in this quarterly update. On the equity side, we remain overweight value relative to growth. The value bias results in higher dividends, as well as a greater exposure to dividend growth sectors. Regarding industry sectors, we are overweight sectors generally deemed to be defensive, such as health care and consumer staples. To offset those, we are underweight the technology, communications, and consumer discretionary sectors.

Our fixed income portfolio average maturity is very short relative to the U.S. bond market and, as always, investment grade only with the largest concentration in U.S. Treasuries. To that point, we own Treasury bonds maturing in less than two years in most of our portfolios. Although short rates have risen considerably more than long rates, the prices of short bonds are less reactive to that increase, somewhat limiting the damage.

To that last point, despite the move to higher rates, we believe bonds have a place in all but the most aggressive portfolios. Although down in price for the year, short bonds in particular are down far less than equities, dampening portfolio volatility. The rise in interest rates has led to significant increases in current yields. When compounded and combined with higher dividends on the equity side, this can add significantly to portfolio returns over time. Lastly, in the event of an adverse black swan event, such as dramatic escalation of the war in Ukraine or significant recession, we will all be glad to have some bonds in our portfolios, especially the Treasuries!

Environmental Characteristics

The weighted average carbon intensity and fossil fuel exposure of our environmental equity strategy remains roughly unchanged since last quarter. Carbon intensity (tons of CO_2 equivalent emissions per million dollars of sales) is less than half that of the overall U.S. stock market,[6] while exposure to companies that own fossil fuel reserves is about 80% lower.

That's it for this quarter. Please do reach out if you are nervous about markets, have questions, or just want to talk about your portfolio. We are here and we love talking to or meeting with our clients.

All the best,

Frank, Josh and Keith

Notes and Disclosures

1. https://www.cnbc.com/video/2022/09/29/cleveland-fed-president-loretta-mester-interest-rates-are-not-yet-restrictive.html
2. https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20220921.pdf
3. S&P 500 return sourced from Yahoo Finance. Russell 3000 return sourced from FTSE Russell. ETF returns sourced via Portfolio Visualizer for growth (Vanguard Growth ETF, ticker VUG), value (Vanguard High Dividend Yield ETF – VYM), developed markets (Vanguard FTSE Developed Markets ETF - VEA), and emerging markets (Vanguard FTSE Emerging Markets ETF – VWO).
4. Sector performance is proxied using the returns on Vanguard's suite of sector specific ETFs.
5. Treasury yield data sourced from the St. Louis Federal Reserve (fred.stlouisfed.org). iShares Core U.S. Aggregate Bond ETF sourced from Portfolio Visualizer.
6. U.S. stock market is proxied using the iShares Russell 3000 ETF (IWV) and the Vanguard S&P 500 ETF (VOO). Carbon intensity and fossil fuel data for ODIJ's environmental holdings and for the above ETFs utilizes the most recent available data as of the end of the quarter. Data is sourced from MSCI, Inc. via ETF Database.com.