INVESTMENT INSIGHTS

THIRD QUARTER 2022

Key Topics

- When Will Stocks Finally Reach a Bottom?
- Why is Today's High Inflation Problematic?
- Inflation Predicted to Remain Elevated Through 2024
- Interest Rates and Corporate Earnings Drive Stock Prices

Pumpkin in Fells Point, Baltimore
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MARKET UPDATE

Persistent Inflation Forces Fed to Accelerate Rate Increases

When Will Stocks Finally Reach a Bottom?

The summer rally was short lived as both stocks and bonds hit new lows in September. Higher-than-expected inflation data in September diminished the hope that monetary tightening would soon end. As a result, the S&P 500 index closed down 4.9% and bonds declined 4.8% in the third quarter.

Persistent inflation has forced the Federal Reserve into an unavoidable trade-off. To lower inflation, the Fed is determined to continue to raise interest rates. The risk remains that going too far will cause a recession. Over the last 80 years, the Fed has implemented 15 interest rate tightening cycles; 60% of these led to a recession.

One challenge the Fed faces is that monetary policy takes time to be fully reflected in the economy. The full impact of rate increases this year will not be felt until well into 2023 and perhaps 2024. This timing delay makes it difficult to determine how much is enough.

Financial markets are seeking a floor and valuations are becoming increasingly attractive. Identifying a bear market bottom is tremendously difficult. In fact, because financial markets tend to be forward-looking, a recession may already be accounted for in stock prices.

Successful investors design portfolios with an appropriate amount of liquidity and diversification to weather market turmoil. They understand that consistently timing the market is not possible. No investor has the ability to accurately predict when to get out and when to get back in. The key challenge is the need to time the markets correctly twice, both upon the sale of an investment and then again when buying back into the market. A far better strategy is to maintain exposure to a broadly diversified portfolio and take advantage of the power of compounding, a phenomenon that Albert Einstein once called the eighth wonder of the world.

Comparative Returns

			Annualized Performance			
	Q3 2022	YTD	1 Year	3 Years	5 Years	10 Years
Large Cap U.S. Stocks[1]	(4.9%)	(23.9%)	(15.5%)	8.2%	9.2%	11.7%
Small Cap U.S. Stocks[2]	(2.2%)	(25.1%)	(23.5%)	4.3%	3.6%	8.6%
International Stocks[3]	(9.9%)	(26.5%)	(25.2%)	(1.5%)	(0.8%)	3.0%
Real Estate[4]	(10.3%)	(28.9%)	(17.5%)	(3.1%)	1.7%	4.9%
U.S. Bonds[5]	(4.8%)	(14.6%)	(14.6%)	(3.3%)	(0.3%)	0.9%

1 S&P 500 index. 2 Russell 2000. 3 MSCI ACWI ex-U.S. index. 4 MSCI U.S. REIT index. 5 Bloomberg Barclays Aggregate Bond index

> *"The arithmetic makes it plain that inflation is a far more devastating tax than anything that has been enacted by our legislatures. The inflation tax has a fantastic ability to simply consume capital. [When inflation is high], the best thing you can do is to be exceptionally good at something."*
> Warren Buffett

Why is Today's High Inflation Problematic?

Inflation is one of the most important and closely watched economic factors. It represents an increase in prices across the entire economy. Policymakers aim for low, and more importantly, stable inflation of approximately 2%. This is necessary for the long-term health of the economy and the labor market.

As prices rise, inflation lowers the purchasing power of money. Savers can outpace the cost of inflation by owning risk assets with returns that exceed the inflation rate. However, one's standard of living declines during inflationary periods if returns on their investments do not keep pace with inflation. Similarly, if wage increases do not keep pace with cost inflation, families can afford less and become poorer. A prime example of an immediate impact is the recent doubling of mortgage rates to 6.8%.

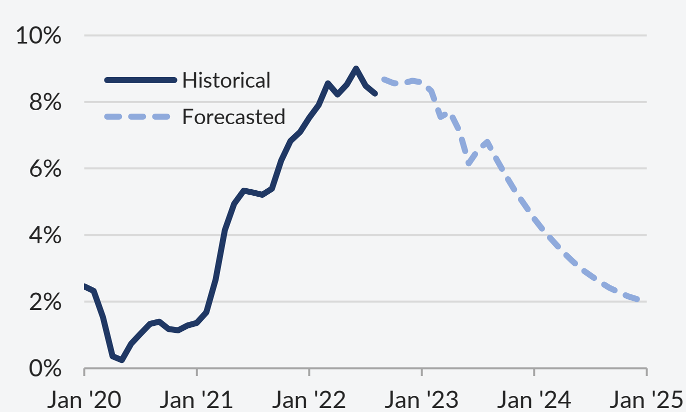
An overheating economy is especially problematic because prices can rise to the point where spending declines. Once spending falls, the economy can easily tumble into a recession.

Inflation Predicted to Remain Elevated Through 2024

After more than a decade of subdued inflation around 2% per year, fiscal and monetary stimulus during the pandemic, along with supply chain disruptions, propelled annual inflation to over 8%. This is the highest level since 1982 and well above the Fed's 2% target.

Higher input costs, especially wages, have caused significant downward revisions to corporate earnings, reduced profit margins and lower stock valuations. For bond holders, inflation can be especially destructive. When the inflation rate exceeds fixed bond coupon payments, purchasing power erodes for bondholders.

Wall Street Consensus Inflation Forecast



Source: www.econforecasting.com

To stem inflation and regain price stability, the Fed has responded forcefully this year by effecting the most aggressive rate hikes in decades. Fed actions and supply chain improvements have reduced select commodity prices. However, overall prices are rising faster than the Fed's desired rate. Forecasts suggest that inflation will decline towards the end of this year, but not reach the Fed's 2% target until year-end 2024.

Interest Rates and Corporate Earnings Drive Stock Prices

Over the long-term, stock prices are driven by corporate earnings per share. By definition, equity holders reap the benefits of earnings and dividends during their holding period. At any point in time, investors value the market's future earnings potential to determine its current pricing. An investor's interest rate assumption is a key metric to determine an appropriate valuation. A higher interest rate level, as evident currently, causes investors to apply a higher discount rate to future earnings, leading to a lower valuation today.

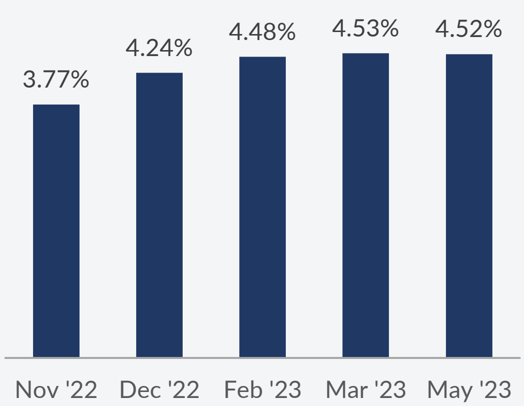
Slowing economic conditions typically lead to lower earnings growth. Second quarter S&P 500 earnings rose 8%, but excluding the energy sector, declined by 2%. Several companies, including FedEx, GE and Ford, issued major earnings warnings in September, which is likely a harbinger of subpar third quarter earnings for U.S. companies. While earnings growth is expected to slow this year, consensus Wall Street estimates continue to predict moderate growth in 2023 and 2024.

Last year, extremely low interest rates helped fuel exceptional earnings growth and strong valuations, as evidenced by above average price-to-earnings, or P/E multiples. As interest rates jumped this year, the P/E multiple of the S&P 500 declined from 21.5x to 14.9x – below the 20-year average of 16.8x.

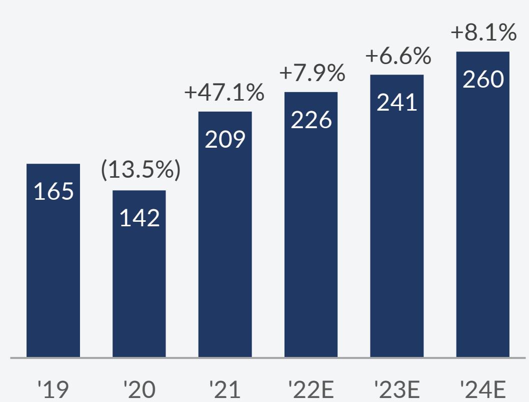
The two keys for stock performance in the near-term are interest rates and corporate earnings, which are both highly dependent on inflation. Once inflation declines, the Fed will likely pivot and gradually reduce interest rates to achieve their steady state goal of 2.5%. As lower interest rates are priced into the market, P/E multiples should increase and bolster stock prices. If the Fed is able to orchestrate a "soft landing" where inflation subsides, economic growth remains positive and earnings estimates are achieved, stocks will rise even with constant earnings multiples that are below the long-term average.

Market Consensus: Rising Rates and Moderate Earnings Growth

Fed Funds Interest Rate Estimates



S&P 500 Earnings Estimates ($)



Source: Left - Factset, Right - Credit Suisse.

BlackDiamond Financial

ABOUT US

Black Diamond Financial, LLC is a fee-only registered investment adviser with a unique and holistic focus on preserving and enhancing wealth. Our mission is to help you achieve your financial goals through the use of low cost, tax-efficient investment strategies. We create individualized investment portfolios for each client that are risk-appropriate, returns optimized, and tax-efficient. Where appropriate, we incorporate institutional quality private investments to capture illiquidity premiums or yield opportunities. Furthermore, we believe cost is a critical factor in any successful investment strategy and therefore offer fully transparent pricing that is well-below industry standard. As an employee-owned firm focused on our fiduciary duty, we make our clients' interests our highest priority.

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