



**BLUE GRANITE CAPITAL, LLC**

## **INVESTMENT COMMENTARY, OCTOBER 2022**

September lived up to its historic reputation as the worst month of the year for stock market performance, falling 9.21%, and the past quarter was its third drop in a row. In fact, this was the worst monthly performance since March 2020, and we all know what happened then. Stocks are back to June 2020 levels, eliminating 2 years' worth of investment gains.

The capital markets are at a crossroad. Stock and bond action during the last week of September sure felt like classic capitulation – indiscriminate selling across all asset classes with little spared and no place to hide. That is unwelcome news for portfolio performance, though it implies good news in the form of an approaching market bottom and a potential turn in investor sentiment from which we can rally, albeit slowly.

From where we stand, the Fed has done too much to “shock the system” with the most aggressive series of rate hikes since the 1980’s, and now it must step back and let its policy trickle down through the economy to slow growth, suppress demand, and lower inflation. Many Wall Street pundits have recently mentioned the “Fed Pivot”—the point where the Fed stops raising rates and moves to a more accommodative monetary policy stance which could be a catalyst for a renewed stock market rally. Unfortunately, that pivot seems off in the distance with inflation still running hotter than forecasts.

By raising interest rates from near zero, the Fed has produced a historic selloff in bonds. The selloff in bonds has led to a bear market for stocks with the major indices all down over 20% year-to-date and the technology-heavy Nasdaq down more than 30%. More rate hikes are imminent as the Fed has expressed a willingness to compromise economic growth and raise unemployment to bring inflation down.

The rapid rise in interest rates has directly affected the housing market. Mortgage rates are at 20-year highs causing the industry dynamic to become decidedly negative. The housing market has experienced a tremendous pullback from last year’s record levels which should play a role in lowering inflation. That said, food, energy, and rent prices (30% of CPI) remain the leading inflationary issues and do not seem to be abating anytime soon. With home prices still elevated after a 2-year industry run, affordability has declined. This is pushing many prospective home buyers into renting. Therein lies the problem: rents have a long way to go to catch up to the rise in home prices which further adds to inflationary pressures. Property owners and apartment builders know this and continue to raise rents, thus pinching consumers further along with rising prices in food, medical services, and the automobile sector. From a consumer perspective, heightened inflation is exacerbated by the fact that wages (although rising on average) are not keeping pace with CPI, further limiting everyday buying power.

With the equity market selloff, stock valuations have become far more compelling and supply a basis for a more bullish outlook. We will need to see a meaningful drop in the inflation rate from a recent 8% which will confirm the Fed's interest rate hikes are working. The real question—has the bear market selloff in stocks compressed valuations enough to reflect an economic slowdown or do stocks have further to fall to adjust to weaker corporate profitability? While we would all like to know when this bear market will end, it is important to remember that the stock market is a discounting mechanism. In lay terms, this means that the stock market will often form a trough and begin a sustainable rally before a clear catalyst surfaces.

Corporate third quarter earnings reporting has just begun, and investor concerns are elevated regarding growth and profitability. Inflation has certainly hurt businesses while impacting consumers as we have described. Supply chain issues still linger, and several bellwether companies have warned that business is contracting while reducing their respective revenue and earnings guidance. One positive in the current economic environment is that job growth has consistently been cited as one of the reasons the U.S. economy is not in a recession. However, cost-cutting and employee layoffs may materialize at a level which raises the risks of a pending recession though ultimately may serve to drive down inflation, which is of primary importance.

Americans are heading to the polls for midterm elections in a few weeks. If political pundits are correct, the result may be a change in control of the House and Senate. The markets may interpret this as a positive from a fiscal and inflationary policy perspective, but we shall see.

Portfolio positioning is key to weathering any market volatility—get it right and desirable long-term performance can be maintained. Owning high quality, financially stable defensive stocks that pay dividends to its shareholders is a good recipe for success, especially in these uncertain times.

We hope you all enjoyed your summer and as always thank you for your patronage.

Please give us a call should you have anything you would like to discuss.

Warmest regards,

Scott, John, Dave, Richard, & John