BECK MACK + OLIVER

Newsletter: October 2022

In our most recent newsletter, we situated the 2022 bear market in equities and bonds within the following framework:

- (i) inflation had become persistently elevated;
- (ii) the Federal Reserve, realizing that it had previously been too complacent, commenced and then accelerated a series of interest rate increases; and
- (iii) short-term interest rates, especially in an economy with significant supply-side inflationary pressures, are a blunt tool with which to fight inflation, heightening the risk of an economic slowdown or outright recession.

During the third quarter, despite some evidence that inflation has begun to move in the right direction, concerns over how aggressive the Fed was likely to be in raising interest rates grew more pronounced. As indicated in the table below on the left, not only did prevailing interest rates move higher during the quarter, but expectations for where interest rates would be in the future also shifted upwards. And as indicated in the table below on the right, the equity market decided that a more aggressive Fed raises the odds of a recession, which means lower corporate earnings, while higher interest rates reduce the market value of a given earnings stream, which means lower valuation multiples (e.g., price-to-earnings ratios).[1]

Federal Funds Rate		
	6/30/22	9/30/22
current rate	1.50 - 1.75%	3.00 - 3.25%
March 2023 rate	3.49%	4.53%

S&P 500 Index		
	6/30/22	9/30/22
index level	3,785	3,586
2023 earnings estimate	249	242
price-to-earnings	15.2x	14.8x

The tables above reflect changes that occurred during the third quarter alone. At the beginning of the year, the federal funds rate was in a range of 0-0.25% and the price-to-earnings ratio for the S&P 500, based on 2023 estimates, was nearly 20x.

<u>As stock-pickers rather than market-timers, we are not inclined to hazard a guess as to when or where the market might bottom, and we certainly do not make investment decisions on that basis</u>. In the context of a market that seems quite sensitive to Fed policy, however, we would note that there are incipient signs of disinflation, including lower commodity prices, softer real estate markets, more smoothly functioning supply chains, reduced tightness in the labor market, and improvements in the inflation indices themselves.[2] Further progress in this direction could pave the way for the Fed, in the not too distant future, to slow and then cease its

[1] The March 2023 federal funds rate is based on pricing in the federal funds futures market. Earnings estimates for the S&P 500 are sourced from Bloomberg and reflect averages of multiple individual estimates.

[2] For instance, year-over-year growth in the Consumer Price Index was 9.1% in June, 8.5% in July, and 8.3% in August.

current sequence of interest rate increases. Such an outcome would remove an important, but hardly the only, source of uncertainty and volatility from the market. Whatever the Fed may or may not do, financial asset valuations remain subject to various economic headwinds, geopolitical risks, and stresses in the financial system.

With the S&P 500 down nearly 24% year-to-date through September 30th, it is tempting, and not necessarily inaccurate, to conclude that every stock one owns is cheap. In the absence of a fresh infusion of capital, however, it is simply not feasible to buy more of everything that one already owns. At the same time, there can be a kind of psychological paralysis in the face of sharp market drawdowns, where one is reluctant to sell anything at a discount to its intrinsic value.

Our approach, in this kind of environment, is to prioritize our highest-quality investments—that is, excellent businesses that can compound their earnings at attractive rates over long periods of time and strengthen their competitive advantages during periods of economic stress. These businesses in turn tend to have exceptional and well-aligned management teams, healthy balance sheets, and a track record of smart capital allocation. Precisely because of these characteristics, such companies only occasionally trade at compelling valuations—prior instances, in recent memory, include the spring of 2020 and the fourth quarter of 2018—and when they do, our preference is to take advantage of the corresponding opportunity. To the extent that this requires us to sell other investments, we would look first to those about which, for one reason or another, we are or have become less enthusiastic, particularly where we can realize a capital loss for tax purposes, if applicable. As uncomfortable as it may be to sell *any* investment for less than what we believe it is worth, if we can then use those proceeds to buy a higher-quality investment for less than what we believe *it* is worth (and perhaps create a tax asset for our clients in the process), then we will have used this current market dislocation to high-grade our clients' portfolios in a tax-efficient manner.

Partners of Beck Mack + Oliver