Convergence Commentary

September 2022 Market Recap

Quick Hits:

- Markets remained volatile through the month of September, as the economy continues to face headwinds.
- Inflation continued its moderation process, with rate hikes having varying success on different components of CPI.
- The Fed continues to be challenged in its fight against inflation and balancing economic growth with inflationary pressures.

Market-Moving Highlights

The Consumer Price Index came in above expectations in August at 8.3% on an annual basis and rose .1% on a month-to-month basis. The expectation going in was that it would decline again as it did in the month prior but rising prices in the core inflation measure kept market prices from continuing to fall. Core inflation removes prices of more volatile CPI components like food and energy. Important components of core inflation include shelter, medical care, household furnishings, and new vehicles, among others. Core CPI tends to be stickier, meaning it's more difficult to force prices back down once they increase.

Another high inflation report increased the likelihood that the Fed needs to continue to raise rates. The report was not all bad news as there were some positive signs in the August CPI report, with certain components like energy, used cars, and airline fares continuing to decline. Outside of these, the increasing rates have had minimal impact on other components of inflation, but there is a lag in how long it takes for interest rates to impact the real economy.

On September 21st, the Fed raised interest rates again by 75 basis points. The market was hopeful the Fed would only increase rates by 50 basis points at the meeting, but after the hotter-than-expected CPI report, it became likely the Fed would decide to go with a 75-point hike. Upon the announcement and a more hawkish tone than anticipated, the markets continued their descent from the mid-August highs. As we have alluded to in past market commentaries, increasing interest rates works against inflation by decreasing demand. However, decreasing demand too much can cause economic contraction.

The 2-year treasury yield has continued to surge, rising above 4% for the first time since 2007. The yield has been steadily rising since the beginning of the year. However, in September, the increase in yield accelerated. Rising bond yields have adverse effects on both stocks and bonds. Treasury yields are used as a discount rate to price stocks, rising yields can interest rate sensitive stocks and bonds to be impacted. The Fed has stated that their target rate is 4.6% on the federal funds rate by the end of 2023. The federal funds rate is set by the Fed and is the rate at which banks can borrow from each other. It acts as the "base" interest rate in the economy. In a scenario where the Fed achieves its goal, the 2-year yield would likely be higher than 4.6%. The 2-year treasury yield can be used as a proxy for the market's view on the Fed being able to continue to increase rates. It can be watched closely to get a better understanding of how the market views the outlook of the economy.

On September 28th, the Bank of England announced they would begin to buy bonds to stabilize the British pound, which tumbled against the U.S. dollar. Most of the world's central banks have watched as the U.S. Federal Reserve has aggressively hiked rates, which has led to a sharp increase in the value of the U.S. dollar. This action by the Bank of England is the first significant step a foreign central bank has taken to stabilize a currency against the U.S. dollar.

Index Performance

Index	1 Month	YTD	1 Year	5 Year
S&P 500	(9.90%)	(23.87%)	(15.47%)	9.24%
Nasdaq Composite	(10.94%)	(32.00%)	(26.25%)	11.25%
Russell 2000	(10.13%)	(25.10%)	(23.50%)	3.55%
MSCI ACWI ex US	(10.20%)	(26.18%)	(24.79%)	(0.34%)
S&P US Aggregate Bond	(4.69%)	(14.61%)	(14.60%)	(0.27%)

All the major indexes had difficult months in response to the Fed's hawkishness. The S&P 500 had its worst month since March of 2020. Both the S&P 500 and the Nasdaq broke below their June lows, which were previously thought to be lows for the current bear market. While we acknowledged this as a possibility last month, we also cautioned that the market certainly could break down below these levels again. There are several factors in the market right now that are causing the major declines, but the market is largely being driven by the Fed. Until the Fed slows down the pace of interest rate hikes, stocks (and bonds) may continue to be volatile.

S&P 500 Sector Highlights & Commentary

Best Performing Sectors		**Worst Performing Sectors**	
Health Care	(2.32%)	Real Estate	(13.48%)
Financials	(8.36%)	Technology	(12.83%)
Consumer Staples	(8.70%)	Utilities	(11.87%)

Health Care was easily the best-performing sector in September after being the second-worst performer in August, reflecting the continued defensive sentiment in the market. While Health Care held up reasonably well, other defensive sectors were not as fortunate. While the Consumer Staples sector was a top three performer in September, it was still down 8.7%, and another defensive sector, Utilities, was among the worst performers of the month. Utility companies are interest rate sensitive because they tend to be highly leveraged. This means that they use high amounts of debt to fund their operations compared to other sectors. Using debt to finance a company increases the risk of rising interest rates negatively affecting profitability.

Real Estate was the worst-performing sector and it comes as no surprise in a market environment where the Fed is attempting to realign demand with supply. Real estate struggles in such an environment because rising rates lead to increasing mortgage rates, which makes it more expensive for consumers to purchase new homes, ultimately limiting demand for new housing. When demand for new housing is reduced, real estate companies can see their revenues decline. Meanwhile, technology continues to be challenged by the rising interest rate environment. However, we do believe technology is still going to be a major contributor to economic growth in the long term.

What to Watch in October

October tends to be a volatile month – especially in election years. Over the next couple of weeks, there will likely be an increasing amount of political chatter surrounding the markets, which could add some volatility to an already volatile market. However, post-midterm election market performance tends to be very strong.

Treasury yields, especially the 2-year, have made aggressive moves higher over the past few months.

CPI for the month of September will be released on October 13th. Once again, the market will be looking for signs of cooling, especially in areas outside of energy. Any potential CPI moves to the downside would be a welcome sign for a market that is focused on inflation and how the Fed will respond to it.

September marked the end of the 3rd quarter. In October, companies will begin reporting their earnings. While the earnings results will be important, company guidance regarding future earnings will likely tell us more about where the economy may be headed.

Market Wrap

This year continues to be a unique year for financial markets. For the first time ever, both bonds and stocks have produced negative returns for three quarters in a row, and now inflation fears are transforming into recession fears. It is important to keep in mind that this is within the normal flow of the business cycle. The business cycle is the trend of economic growth that flows from an expansion to a peak, followed by a contractionary phase until the cycle hits its trough.

The low interest rate environment since the 2008 Financial Crisis has aided economic growth. This was amplified in response to the pandemic when the Fed moved interest rates to zero, meaning the cost of capital was ultra-low. A low cost of capital for companies, fiscal stimulus to keep the economy afloat through the pandemic, constrained supply chains resulting from Covid restrictions worldwide, and a reduction in labor force participation led to an opportunity for threatening inflation to emerge for the first time in years. All these things were necessary to combat the pandemic's effect, and in some ways, it worked better than we could have hoped. However, it now appears that the Fed maintained a loose monetary policy for far too long, and only recently have they acknowledged they were wrong through their aggressive hawkish actions. After the year we have had, it is hard to remember that in late 2021 the Fed referred to inflation as “transitory” and did not think serious interest rate hikes would be necessary. Fast forward to now and the Fed has reversed course and is now hawkish. They do have a mandate to maintain price stability and it is very important for the long-term well-being of the economy. When the Fed changes the federal fund rates, it takes time for the impact of the change in interest rates to take effect on the real economy. The impact of the first rate hikes back in March have only started to impact the economy. This can help us understand how the Fed could overtighten their policy because they have stated time and again that they will be “data-driven” even though the data may not be reflecting the already increased rates.

The month of September was a difficult time for financial markets. With that said, historically, the larger the drawdown, the better the outlook for the stock market in the months and years to come. In the chart below, we can see how this trend has played out dating back to 1950. We have alluded to this time and again over the course of 2022, but it is very important for investors to understand the economy moves in cycles, meaning a long-term mindset is essential to achieve financial goals.

The Larger the Drawdown the Better the Outlook

S&P 500 Index Returns After Different Drawdowns (1950-2021)

Drawdown	% of Time	Next 3 Months	Next 6 Months	Next Year
One-Year High	10.0%	1.9%	4.4%	9.4%
0% to -5%	50.9%	2.2%	4.3%	8.1%
-5% to -10%	18.1%	2.6%	4.1%	7.9%
-10% to -15%	8.7%	3.0%	4.6%	7.7%
-15% to -20%	5.6%	0.0%	1.3%	10.7%
-20% to -25%	3.4%	0.7%	3.8%	11.5%
-25% to -30%	1.5%	7.2%	10.6%	19.7%
-30% to -35%	0.7%	13.6%	20.4%	22.0%
-35% to -40%	0.5%	-0.1%	12.3%	23.1%
-40% to -45%	0.5%	2.0%	16.8%	32.6%
-45% to -50%	0.1%	14.9%	31.1%	46.4%
-50% to -55%	0.0%	30.6%	42.5%	60.7%
	Overall Average	2.3%	4.4%	9.0%

Source: LPL Research, FactSet 9/28/2022

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

Drawdowns are from the highest level in the past year.

Sources

How Markets Respond to Drawdowns | LPL Financial Research (lplresearch.com)

Your Investment and Research Team

Travis Cook, CFP®, CMFC®

CEO, Financial Advisor

Tyler Hoffmann, MBA

Vice President, Financial Advisor

Dr. John Stansfield, CFA

Director of Investments

Logan Clark

Assistant Investment Research Analyst

Convergence Financial
Investing. Planning. Service.

3919 S Providence Rd, Columbia, MO 65203
573.818.2264
www.convergence-financial.com