the BENEDICT *REPORT*

6000 Lake Forrest Drive NW, Suite 550, Atlanta, GA 30328-5901 • 770 671 8228 • 770 671 0232 *fax* • 800 678 8227

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Written by: Mark A Beaver, CFP®

What is happening with the economy and the markets? Is there any good news out there?

To say that 2022 has been a challenging year is an understatement. Starting with the first few days in January, this year has proven to be one of the most difficult in recent memory. We've experienced the terrible tragedy of the war in Ukraine, sky-high inflation figures that have not been seen since the Reagan administration, soaring energy prices around the globe and significant market declines across all major stock indexes.

So, is there any good news out there?

Let's dig a little deeper into what's going on in the economy and in the markets and try to answer that question.

If I had to summarize 2022 in just a few short words, it would be this: "the end of cheap money."

And the end of cheap money has wreaked havoc around the world.

Essentially, cheap money means ultra-low interest rates, not only in this country but across the globe. In fact, in many foreign countries, they even had negative interest rates, meaning you were paid to borrow money! How backwards is that?

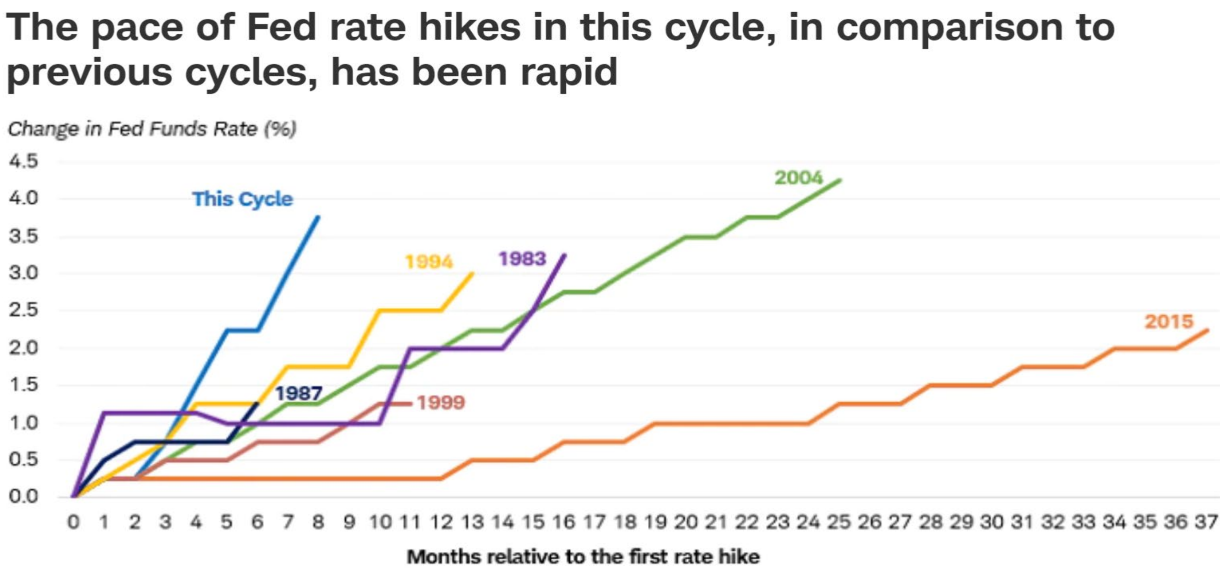
All this cheap money spurred excesses around the world that are now having negative consequences. Cheap money made it too easy for governments, companies, and individuals to borrow and spend excessively. Why not? It was too cheap not to!

Back in 2020, governments around the world increased the money supply and passed massive stimulus bills in response to the pandemic and to boost their economies. These easy-money policies continued throughout 2021 and started stoking inflation figures. But numerous government officials confidently assured the public that it was 'transitory'. Remember that?

In February, Russia invaded Ukraine and the world reacted by implementing sanctions against them. Historically, Russia has been a large energy exporter, especially to Europe. One of those sanctions was to stop importing Russian oil and natural gas. This caused energy prices to skyrocket around the world, especially in Europe and the U.K.

Inflation figures continued to surge higher and finally the Federal Reserve abandoned the transitory language and started aggressively fighting inflation with their only weapon… interest rate hikes.

So, we are now in a difficult economic cycle of tightening monetary policy in order to reduce economic demand and, in turn, reduce the high inflation rates. The Fed has committed to this plan of action, acknowledging it will cause some short-term pain across the economy. But they must remain focused on breaking the high inflation figures.



Source: Bloomberg. Federal Funds Target Rate - Upper Bound (FDTR Index), using monthly data as of 11/2/2022.

The chart shows how fast the Fed has raised rates compared to previous rate hike cycles. This current rate hike cycle has seen the most rapid increases compared to preceding ones.

Is their plan working?

It seems the Fed's interest rate hikes are starting to trickle down through the economy and have the desired impact, albeit rather slowly. It took over 2 years for inflation to ramp up to these levels, so it's unlikely to suddenly drop back into the desired range. This process will take some time and patience.

The good news is that some of the monthly economic figures that are considered leading indicators (meaning data that may help forecast future economic activity) are showing that the Feds' actions are having an economic impact. This contrasts with the closely watched monthly Consumer Price Index (CPI) figures, which is considered a lagging indicator (meaning data that confirms a longer-term trend). Based on the leading indicators, the Fed's actions could start to impact the CPI figures in the coming months.

Speaking of the Consumer Price Index (CPI), it is an economic indicator measuring the average change in prices paid for a variety of consumer goods and services. The largest weighting by far in the Index is housing costs, which has been a primary driver of the higher inflation figures we have seen. In order to lower the CPI figure, the housing market needs to cool. And with the Fed aggressively raising interest rates, the impact on mortgage rates has been dramatic. Consider this…a borrower that was looking to spend $1,800/mo on a 30-year conventional mortgage payment (excluding taxes & insurance) would have been looking at houses in the $535K range earlier this year when rates were around 3%. Now, with 30-year rates hovering around 7%, that same borrower is shopping for homes in the $340K price range. The rapid increase in mortgage rates has certainly impacted millions of potential homebuyers, as evidenced by the quote below:

> …the increase in mortgage rates has boxed out 24 million households from a $400,000 mortgage.
>
> *Barron's, 10/31/2022*

The Fed is committed to breaking inflation and will continue with their restrictive monetary policy until the data shows them different, which could be soon.

With some potential good news coming up on the economic front, what is going on with the market? Is there any good news there?

The broad market indexes are all down substantially this year, but it doesn't mean everything is all bad. If we go back to the "end of cheap money" concept I mentioned earlier, this has had a major impact on the markets.

The recent cheap money days during 2020-2021 generated excitement for risk assets and high growth companies with no profits. Debt was cheap and it was high growth at any cost. No one cared, and it didn't seem to matter. The speculative craze was on, shown by the pandemic plays, IPO's, SPAC's, Meme stocks, crypto, NFT's, etc.

But then came 2022 and the end of cheap money, and it all suddenly mattered. With interest rates and debt costs rising, the appetite for those speculative assets immediately dropped, along with their share prices or asset values.

Fundamentals came back into focus. Profits and dividends are in vogue. [*Were they ever out of style? Not in our opinion!*]

The darlings of the last couple of years have been punished this year. The quality companies that generate profits, pay dividends, and have manageable debt levels have fared much better than their speculative counterparts.

But this years' market declines have been widespread, and many companies' share prices are down in value. Does that mean the companies are performing poorly or are in trouble? Not exactly. Let's look at two examples:

- A company that designs and manufactures semiconductors and integrated circuits recently reported better than expected earnings, including double digit revenue growth and increasing gross margins. The company generates substantial cash-flow, has zero net debt and recently announced an 8% dividend increase and authorized a $15 billion dollar share buyback plan. But what has the share price done this year? It's down almost -15%.

- An electronic payment processing company recently beat their earnings expectations with double digit sales and earnings growth. The company has wide profit margins, sizable free-cash flow and zero net debt. In addition, the company recently hiked their dividend 20% and approved a new $12 billion dollar share buyback program. And the share price? It's down almost -10% this year.

What's going on? If the company is performing well, why is the stock down? Well, that's just how markets work, at least in the short-term. Share prices tend to be influenced by headlines, market sentiment, and general noise in the short-term, but share prices tend to reflect the company fundamentals over the long-term. This disconnect is what presents us with opportunities during difficult market cycles.

This disconnect is also why you have heard us say, 'pay attention to the company, not the stock'. The company has some control over their sales, profits, expenses and debts, but zero control over the short-term swings in their share price.

Given the declines in the broad market indexes, it can be difficult to see any good news. The good news is quality companies have been through difficult economic cycles before and have managed their way through them. History shows that long-term equity investors have been rewarded by owning these types of companies through good and bad times.

Q&A

We thought it may be helpful to cover a few of the frequently asked questions we have been receiving.

I've heard a lot about I-Bonds. What are they all about?

I-Bonds are savings bonds that can protect from inflation. The bonds offer a low fixed rate plus an inflation rate that changes every 6 months, based on the Consumer Price Index (CPI). I-Bonds are 30-year bonds but can be redeemed after 12 months. However, if you cash in the bond in less than 5 years, you lose 3 months of interest. I-Bonds can only be purchased through the TreasuryDirect website. In a calendar year, the maximum purchase of I-Bonds is up to $10,000 per Social Security number (a couple could purchase up to $20,000 of I-Bonds in a calendar year).

With interest rates going up, can I earn more on my safe money at the bank?

In theory, yes. The traditional big banks should pay more interest on your normal checking or savings accounts. In reality, traditional big banks tend to be very slow in raising interest rates on their regular accounts. In many cases, a credit union or an on-line bank money market may have higher current rates than traditional bank accounts.

What about regular Government bonds?

Yields on shorter-term Government bonds have increased substantially since the beginning of the year and are at the highest level we have seen in over a decade. Treasury bills, notes and bonds can also be purchased directly through the TreasuryDirect website. The maturities can range from as little as 4 weeks up to 30 years.

In our client portfolios, we have started exploring and implementing short-term treasuries as part of our fixed income component and replacing some of our existing lower-yielding bond holdings.

OFFICE NEWS!

After a long pandemic hiatus, we are planning on hosting a Lunch with Benedict in February 2023 for our local clients. Please watch for an invitation with details in the new year.

It's hard to believe we're approaching the end of the year already! From all of us here at Benedict Financial, we wish you a happy and healthy holiday season.

Benedict Financial Advisors, Inc.

Philip C Benedict, CFP®
Travis M James, CFP®
Mark A Beaver, CFP®
Jim Senkbeil, CIMA®
Ashley A Thompson, CFP®
Robert J. Hamill, CFP®, ChFC®, APMA®
Jackie Thompson
Fredda B Schwartz

WHAT WE DO...

We prepare retirement income plans, which are essentially blueprints to help our clients pursue their long-term retirement goals.

We manage our clients' investment accounts on a fee basis with discretionary authority focusing on meeting their objectives rather than focusing on what the financial markets may be doing.

Benedict Financial Advisors, Inc., a registered investment advisor, publishes The Benedict Report. All opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investments may be appropriate for you, please consult your financial advisor. Remember that international investing involves additional risk, such as currency fluctuation and political instability. Also, any time an index is mentioned, please remember that it is an unmanaged index that cannot be invested into directly. And, of course, past performance, in the investment world, is no guarantee of future results. Stock investing involves risk including loss of principle. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds are subject to availability and change in price. No strategy assures success or protects against loss. The payment of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time.

The primary author of this issue of The Benedict Report is Mark A Beaver, CFP®. Philip C Benedict, CFP®, Travis M James, CFP®, Jim Senkbeil, CIMA®, Ashley A Thompson, CFP® and Robert J. Hamill, CFP®, ChFC®, APMA® provide technical assistance. Fredda B Schwartz and Jackie Thompson handle the layout and editing of the newsletter.

Investment advice offered through Benedict Financial Advisors, Inc., a registered investment advisor.

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6000 Lake Forrest Drive, Suite 550
Atlanta, GA 30328-5901
770.671.8228
www.benedictfinancial.com

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