Investor Insights & Outlook

October 2022 3rd Quarter Concorde Investment Management

Domestic Economic Overview

> **A Message from Concorde Investment Management**
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The newest term being used in the economic press is ‘growth recession’. While we’ve never heard anyone use that term it was actually coined in 1972 by an NYU economist. It basically means GDP growth is below trend but not actually collapsing, think flat or slightly negative real GDP growth. Hopefully this ‘growth recession’ does not precede stagflation. While stagflation is not Concorde’s expectation, if the Federal Reserve Chairman and board of governors are to be believed, they will continue to raise interest rates until inflation is brought under control. If they are unsuccessful in getting inflation down, then the only benefit of the rate rises will be an economy in tatters while inflation still eats away at consumers pocketbooks. The Fed has given a couple of metrics that they believe will indicate inflation is easing. One of the metrics is the unemployment rate. Currently approaching 3.5%, the rate is low enough that the only way businesses can attract talent is by offering higher wages than the prospective worker is currently earning at their existing job. While higher wages are positive for the worker, the term used by economists that is a possible outcome of job switching is a “wage price spiral”. That means the conditions for inflation are self-reinforcing, higher wages paid by companies result in higher prices charge for good s and services by those same companies. The rate rises the Fed is undertaking are meant to stop the wage price spiral in its track.

Explaining the current economic environment continues to irritate both the academic class and the business world. On one hand, the Fed has raised interest rates which has brought the housing market, outside of a few pockets, to a screeching halt. Even though housing inventory is close to all time lows, the affordability index has collapsed, driven by increased mortgage rates. On the other hand, the consumer continues to spend discretionary income. The consumers household debt service ratio is still very close to all-time lows, currently at 9.5% (that is debt payments as a percentage of disposable income). The indicator bankers, economists and investors have been holding on to for a hopeful ‘soft landing’ relates to consumers excess savings. Recent data showed that peak savings were revised down approximately $300 billion ($2.1 trillion vs. $2.4T). That same revised data also showed that consumers have spent almost 1/3 of those savings. Meaning the consumer has less runway than previously thought to support the economy. We continue to monitor the consumer and Fed expectations on inflation and interest rates.

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International Economic Overview

Multiple major issues impacted or are going to impact the international economy but the three we are focused on relate to UK pension funds, OPEC+ production cuts, and China. Our lack of discussion on the Ukraine war does not mean it isn't an issue, just that the other three had a more material impact during the quarter.

During the 3rd quarter the United Kingdom's government announced a fiscal plan that included tax cuts (which are stimulative) in contrast to the Bank of England attempting to tighten financial conditions in order to fight inflation. The result was currency weakness and yield spiking that caused some pension funds to almost go bankrupt. The Bank of England had to step back in and buy long dated Gilts (Gilt is the UK equivalent of US Treasury Bonds) and abandon their tightening program. It also caused the Prime Minister, Liz Truss, to resign ending the shortest PM term in UK history. The broader indication is fiscal and monetary policy better be rowing the boat in the same direction for developed economies or risk the market backlash.

OPEC+ announced a 2 million barrel per day production cut in anticipation of a slowing global economy. Stateside, the Biden administration was furious about the Saudi led cartel cutting oil production because of the impact on US inflation numbers from higher oil and gasoline prices right before mid-term elections. The US has been draining its strategic petroleum reserve since the beginning of summer in an effort to bring down energy costs for the US consumer and with one quick decision by OPEC+, all that effort was for not. The Saudi oil minister was quick to address the Administration's concerns and pointed to the US Federal Reserve's projections and goal of reducing consumption as the reason for the production cut, not an effort to undermine US elections. The net result is the Saudi's and the rest of OPEC indicating to the world that they will do everything in their power to maintain higher oil prices going forward, regardless of economic swings.

China has recently announced that going forward they only expect their economy to grow between 2.5% and 3.5% per anum. While this will take some time for the market to digest there are some important conclusions that now need to be revised. First, the Chinese economy won't be equal to the US economy until 2060 (if we take into account that the Chinese population is expected to be cut in half during that time anyone can conclude that they will never catch the US economy in size). Second, the growth numbers mentioned above would be an outlier in all historically middle-income countries. Once a country's working age population starts to decline, which China's did in 2015, they are not able to hit the real growth number China is claiming it will be able to without adding either workers or increased government spending. China, as our readers know, is already massively debt burdened and won't be able to stimulate the economy without other negative effects.

Fixed Income

Fixed income markets continued to have a significant performance impact not only on income investors but also on other risk markets such as public equities. Rising yields across maturities and credit quality had a negative valuation impact on public and private markets. Broad domestic bond aggregate indices were down around 4.5-5.00% for the quarter and even shorter term, high quality index funds had negative total returns of approximately 2.00%. Despite concerns for projected economic growth, persistent inflation and the resolve of the Federal Reserve to reverse this trend via short term rate policy are the easy answers to the higher yields. We agree with this analysis but also believe that we are in a transition from artificially suppressed yield levels of the last ten years to a market that more accurately reflects fundamentals, in addition to the recent surge in inflation. This shift is causing a lot of pain for equity investors through valuation adjustments and for income investors, many of whom had become complacent.

Going forward, shorter term Treasury and investment grade bonds now represent at least fair value and are worth holding or buying. Yields certainly can go higher but our thoughts are that most of the move has likely occurred, especially in the less than five-year maturity area. With the rising risk of additional economic weakness domestically, the above discussed segments along with short to medium term municipals, particularly revenue based, are attractive to hold at this time. See table below for the dramatic yield increases 2022 YTD.

Comparative Yields		
	12/31/21	**09/30/22**
6 Month U.S. Treasury Bill	0.18%	3.90%
10-yr U.S. Treasury Note	1.51%	3.83%
BBB U.S. Corporate	2..60%	6.10%

Source: Fact Set; Morgan Stanley; ICE BofA Corporates

Equity Markets

The domestic stock market continued the negative path that has persisted all year with average negative index returns of 3% to 6% for the quarter. Quarterly returns for the developed international markets dropped around 5% worse than U.S. indices, but are down only slightly more year to date at an average of negative 30% for the year.

With respect to individual sectors and what is holding up better, the energy and consumer discretionary groups did generate positive returns, yet energy is the only sector with gains for the year, exceeding all other groups by a wide margin. Traditionally defensive value sectors such as utilities, financials and communications services have been weak as rising yields in the bond market have caused these stocks with typically significant dividends to face tougher alternatives, especially in short term bonds.

At this point, valuations appear to be reflecting the current higher rates that are a component of fundamental stock analysis, but the risk going forward primarily rests in the potential for much weaker growth over the next year along with the possibility of even higher market interest rates. Stocks of many companies with businesses that typically outperform in weak environments likely already reflect good value for the longer-term investor. Despite the significant outperformance over the past year, energy and commodity equities could be at risk if the economy gets weaker and we have modestly lowered our overexposure in this area. As we have stated in recent quarters, particularly attractive areas for value shopping at this time are in the financials and health care sectors. Overall, many stocks reflect additional modest weakening of growth but not a significant slowdown or hard recession.

09/30 YTD	
S&P 500 (Large Cap)	-23.9%
Nasdaq (Large Growth)	-32.0%
Russell 2000 (Small Cap)	-25.1%
STOXX 50 (Euro proxy)	-31.6%

*Source: Morgan Stanley: Bloomberg