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Q3 2022 Newsletter

Economy & Market Valuation

The US stock market as measured by the S&P 500 dropped by around 5% in Q3'2022. The US Federal Reserve (Fed) has been raising interest rates to bring the inflation down to their target of 2%. The US economy is still far away from the Fed's inflation target of 2%. Last month inflation as measured by the Consumer Price Index (CPI) was 8.3% y-o-y. The Fed is expected to increase interest rates further in their November'22 and December'22 meetings. The Fed's own forecast of interest rates is at 4.6% by end of 2023. The interest rates now are at 3.1%. The impact of higher interest rates is a slowing US economy. The US economy is not in recession but is likely moving to a recession. US GDP growth and job growth has been slowing. Mortgage rates are touching 7% reducing the house prices and related housing activity. The US has seen its first house price drop last month after a long time. Housing construction and sales are slowing. Slowing US economy is part of the Fed's play book to bring inflation down. The Fed's priority is to bring inflation down and they are ready to sacrifice the US economy for that. The Fed's view is that lower inflation is beneficial for US economy in the long term and if the US economy has to go through short term pain for long term gain, it is worth taking the risk.

From the stock market's perspective, the question is when the Fed will stop raising rates and when they will start cutting interest rates. It depends on how fast inflation comes down. Everybody connected to the US economy and the stock market is watching inflation with a magnifying glass. There are signs that inflation is cooling but the pace of drop is uncertain. One scenario is that the Fed raises rates to 4.6% and then stops to see the impact on the US economy. If inflation rate shows a material drop, even if still not at 2%, the Fed may pause. Other scenarios are that the US economy goes into a recession or there is a market breakdown and the Fed is forced to stop raising interest rates.

2022 investment strategy:

Our view that teh stock market will remain volatile till the time the Fed is raising rates. As a result, we want to stay defensive in our portfolio. We have raised the cash percentage of our core portfolio to almost 30%. Our positions in the portfolio are defensive and we are staying away from high growth names. We will wait for an inflexion point in inflation and the Fed interest rate cycle to go back all-in to the market.