NADLER FINANCIAL GROUP

Investment and Financial Consultants

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THIRD QUARTER 2022 ECONOMIC AND FINANCIAL MARKETS REVIEW

After a dismal first half of this year, the stock market rallied during July and much of August as investors became optimistic that the Federal Reserve Board would stop raising interest rates in the near future. The Fed has been raising interest rates aggressively this year in an attempt to reduce inflation. However, these interest rate increases also slow economic growth and harm corporate earnings and consumer spending, leading to declining stock and bond prices. In late August, the stock market began to decline again when it became apparent that the Fed would not stop raising interest rates in the near term, as they needed to continue raising aggressively to fight excessive inflation. The Fed will likely continue to have a bias toward raising interest rates and keeping them at higher levels until inflation declines much further. As a result, the S&P 500 Index ended the third quarter down 24.77% year-to-date, while the Dow Jones Industrial Average lost 20.95%. The Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index declined 9.62% year-to-date as of September 30, 2022.

The reason the Fed raises interest rates to fight inflation is that it slows down economic growth by reducing demand for borrowing, and thereby spending, which brings prices down. However, investors worry that the Fed will raise rates too much and too fast, resulting in an economic recession. A recession is obviously bad for stock prices because it harms corporate profits. Therefore, each time the Fed indicates that they are going to continue raising interest rates, or that they are going to raise them more frequently than expected, the stock market sells off. Each time the Fed sounds like they will soon be done raising interest rates, the market recovers in hopes that the economy will not slow down as much as feared. The Fed may need to continue raising interest rates throughout the rest of this year to attempt to reduce the inflation rate to an acceptable level. However, once they give any sign that they are near the end of this rate-increasing cycle, the stock market will likely begin to recover.

In the meantime, another problem with the Fed raising interest rates so much this year is that bond prices have declined as well. The reason is that if an investor owns a bond that pays a lower interest rate than a new bond that is issued at a higher rate, the value of the existing bond declines. Much of the time, when the stock market declines, the bond market rallies because bonds are seen as a safe haven during times of stock market turmoil. However, stock and bond values tend to decline simultaneously when interest rates rise as they have this year.

Despite the significant downturn in the financial markets this year, there are many reasons to be optimistic about the future. For example, although the Fed has slowed economic growth with its interest rate increases, thereby reducing stock and bond prices, these increases have led to rising interest rates for new fixed-income securities. This means that investors can now earn a better yield buying bonds, which are trading at a lower valuation than they have been at in a long time. Also, due to this year's stock market decline, stocks are more fairly valued than they have been in a long time. Economic growth will likely pick up again when the Fed is done raising interest rates, leading to increased consumer and business spending and ultimately better corporate earnings growth. Finally, new technological innovations such as electric vehicles and artificial intelligence will likely help the economy and stock market to grow over the coming years. In short, while the short-term trend for stocks may be down this year, the long-term trend is likely still up.

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For this reason, we continue to recommend that investors remain focused on the long term without letting short-term market declines change their overall investment strategy. After many years of favoring large-company stocks over small-company stocks, we may begin to recommend smaller-company stocks for investors with a relatively high risk tolerance. Also, after several years of U.S. stocks outperforming, foreign stocks appear relatively inexpensive. We continue to recommend short-term bonds rather than long-term bonds because short-term bonds are less sensitive to rising interest rates. Finally, if rising interest rates and other geopolitical issues continue to strengthen the U.S. dollar, gold may not be as good of an investment as it has been the past several years.

As always, we will continue to monitor ongoing economic and financial market conditions. In the meantime, please contact us if you have any questions or concerns regarding your portfolio or the financial markets in general.

* *Index returns were obtained from the Wall St. Journal and Bloomberg Barclays on October 3, 2022.*

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