Please note: This is a transcription so there may be slight grammatical errors.

Mike Vogelzang:

As a kid I remember my Dutch immigrant grandparents using the proverb roses fall, but the thorns remain. [foreign language] For investors in 2022 the markets have grown thorny while the gorgeous pedals have faded on the returns we enjoyed over the past few years.

Coming into this year, investors had enjoyed three years of terrific returns despite a global pandemic. But 2022 has been a far different story with significant losses across most financial assets, leaving investors nowhere to hide. The market gains, those beautiful blooms, came before the economic pain. Today, stocks are down significantly from year end levels. However, the greater unexpected pain comes from the normally quiet and sedate bond market. Through the end of the third quarter, core bonds have fallen by 14%, far outpacing the largest previous drawdown at this time of the year. Put the two together and the Bellwether 60-40 portfolio of stocks and bonds is having its worst year since 1931.

So what's driving this synchronized selloff? There's no shortage of reasons. The lingering effects of the pandemic, companies that can't find workers, turmoil in global currencies and commodity markets, Europe on the brink of recession, and of course levels of inflation across the globe that we haven't seen in decades. But despite these headwinds, the biggest puzzle for markets this year has been the actions and statements of the Federal Reserve as it tries to reign in inflation.

The Fed fund's interest rate impacts financial asset prices like nothing else, and also has a major effect on consumer and business behavior. But the problem now is twofold. One issue is that the Fed may have waited too long to act to stop nascent inflation. The second is that the Fed is most effective at reducing demand driven inflation, but not nearly as impactful when inflation is coming from other places like supply chains and production disruptions, labor shortages, and the war in Ukraine. As a result, the Fed may have to act even more aggressively today to halt the specter of stronger inflation across the global economy.

Through the first three quarters of the year, the Fed raised its target interest rate from 0 to 3% in a period of just six months. That's the fastest pace in the modern era, and their statements have made it clear they plan to continue raising rates until inflation is in check, even if it causes further economic pain. The result has been a repricing of almost all financial assets, with the greatest hit felt in those bond markets we mentioned earlier. Mortgage rates have also risen rapidly, which is leading to a slowdown in the housing market. Put it all together and there's a decent chance that the US enters recession sometime in 2023.

All of these issues represent a thicket of thorns and make it hard to remember the sweet smell of flowers from just a year or two ago. But not all the news is bad and there is room for optimism. Gas prices have come down, supply chains are healing and the US labor market remains very strong. After all, when companies can't find enough workers it makes it harder to cut jobs. Equity valuations have fallen from highly elevated levels to their more normal historic range. Households and businesses are more cash rich than before the pandemic with lower levels of debt and the financial stress tests enacted after the global financial crisis have made the banking system stronger as well. Sustained high levels of inflation could dampen this strength, but it could also mean that any recession might be milder. And finally, US competitiveness has never been stronger, given the unfortunate and challenging crises facing the broader world.

The goldilocks just right scenario of an economic soft landing without a recession is still possible. As the economy slows and inflation fades, the Fed could soften its stance to avoid an economic slowdown, but it will be a very difficult needle to thread given the unpredictable lag on economic activity caused by Fed policy. But as we've said many times, it's important to remember that the economy is not the markets and vice versa. Volatility can certainly continue from here, but markets have already priced in a lot of bad news. So the worst could be behind us. The economy, like the growing season, is cyclical. So we can surely expect roads buds to emerge and bloom once again. But for now, we're still using our gardening gloves.

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