PrivateWealth Partners, LLC

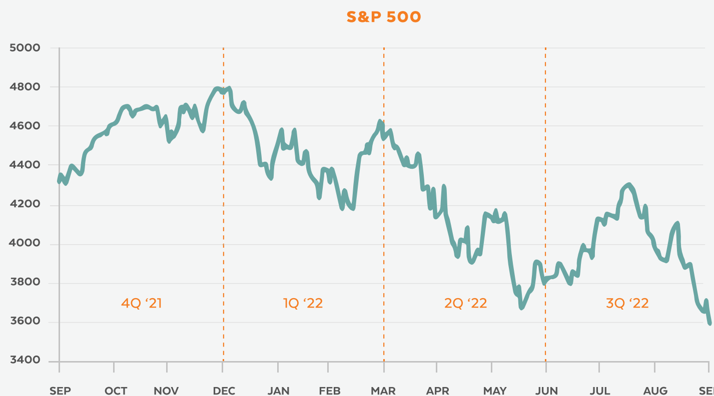
THIRD QUARTER
2022 REVIEW

Dear Friend,

October 14, 2022

Inflation and central bank policy continue to be at the center of investor focus. As detailed in our Q2 letter, Private Wealth Partners sees inflation as stickier than in past cycles. Even though there are growing signs inflation pressures may abate in the coming months, we think risks in the stock and bond markets will remain until inflation comes down meaningfully. That did not happen in July or August, as inflation essentially plateaued at elevated levels while the labor market continued to post relatively strong job and wage gains. The July stock market rally quickly faded, and the S&P 500 index ended the third quarter with a -4.9% loss.

AN EARLY SUMMER RALLY FADED BY AUGUST



Source: Strategas Research

Private Wealth Partners has been active in this volatile period. We reduced equity exposure in the first half of the year, and we continue to view 2022 as a transition year for the stock market—which warrants extra caution. We're looking for signs that economic conditions will facilitate a material reduction in inflation, ultimately closing the gap between the current 4.9%+ personal consumption expenditures (PCE) inflation rate and the 2.8% forty-year inflation average. The Fed's official goal is to average 2.0% inflation over the long-term, so it seems likely the central bank would settle for an inflation rate slightly above that level in the current cycle, which would reduce the risk of overly harsh monetary tightening measures needed to get all the way to 2%. This transition is likely to take some time.

"Set your course by the stars, not by the lights of every passing ship."

\- OMAR N. BRADLEY

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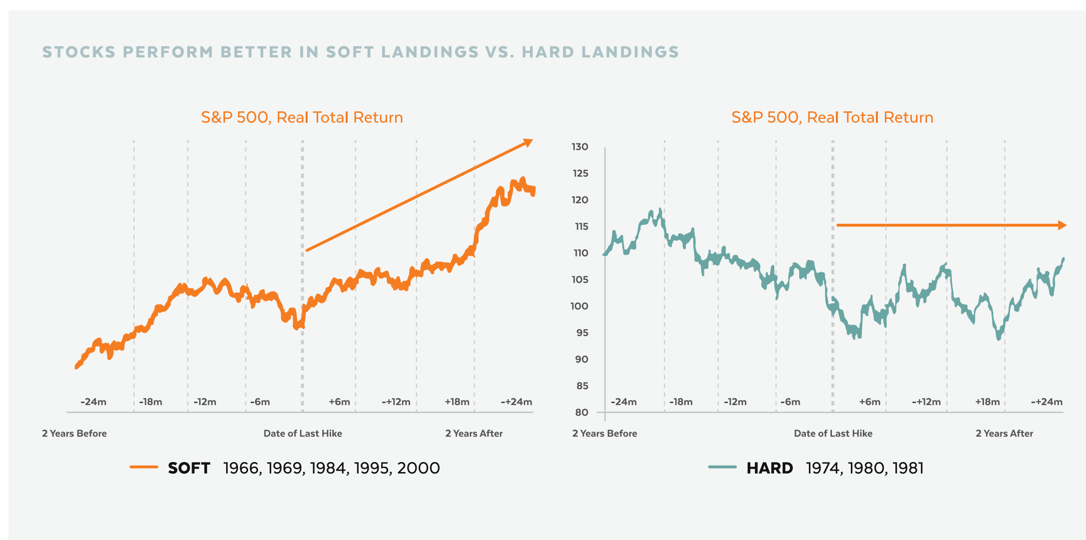
The good news in this environment is that stocks are forward-looking, and the eventual arrival at peak inflation is likely indicative of positive forward returns. Since 1960, the consumer price index (which measures inflation) has gone above 6% on four occasions, in 1970, 1974, 1979, and 1990. In each instance where CPI peaked and started falling, stocks stabilized and rebounded.

> The US economy will get to this point eventually, and when it does, high-quality US equities will regain their status as attractive holdings in portfolios. Private Wealth Partners will maintain a level of caution to protect capital in the meantime.

INFLATION & THE ECONOMY

As mentioned in the introduction, there are growing signs that inflation is very close to reaching a peak. Rents are falling month-over-month in many major markets, commodities are at a seven-month low and trading far from peaks, retail inventories are soaring which has caused companies like Nike to cut prices, container freight rates are falling sharply, and the US ISM Manufacturing Prices Paid Index is currently at 51.70—down -36.33% from a year ago. All of these factors point to reduced inflationary pressure in the months ahead.

The key for markets is whether reductions in inflation occur before the Fed has gone too far with rates. This would significantly increase the chances of a soft economic landing. As readers can see in the chart below, stocks do much better when an economic soft landing (GDP growth that bottoms at a mild negative number)—follows the last rate hike.



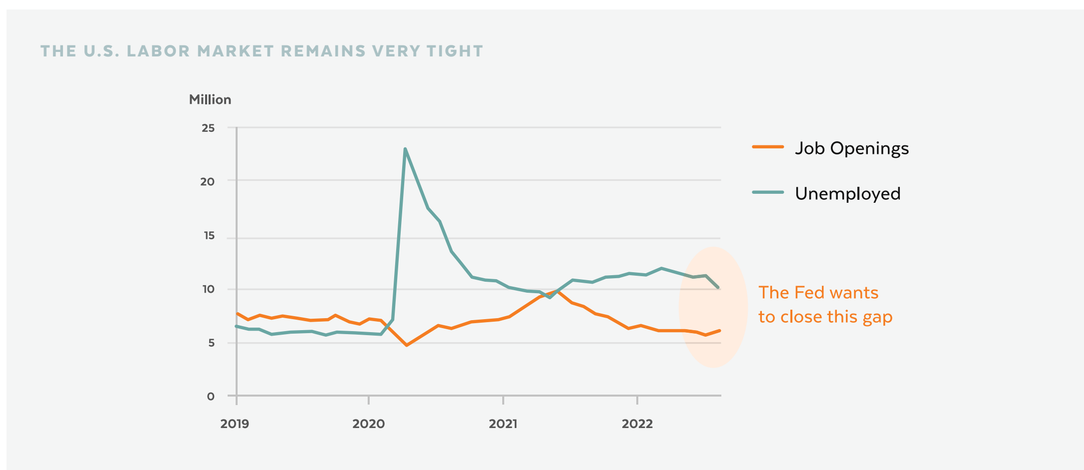
Source: Datastream, Goldman Sachs Global Investment Research

Goldman Sachs sees a narrow path to a soft landing, which will require policymakers to:

i. Slow GDP growth to a below-potential pace in order to...
ii. Re-balance supply and demand in the labor market enough to…
iii. Bring down wage growth and, ultimately, inflation.

Regarding the first point, US economic growth is moderating and earnings estimates are coming down, signaling that the Federal Reserve and other global central bank measures are having at least some effect in reducing demand in the global economy. S&P 500 profit margins have also peaked, which generally implies an economic slowdown is underway or nigh. In the US housing market, 30-year fixed mortgage rates have shot past 7%, which has resulted in seven straight months of declines in existing home sales. Permits for future homebuilding have also plummeted to levels last seen in spring of 2020.

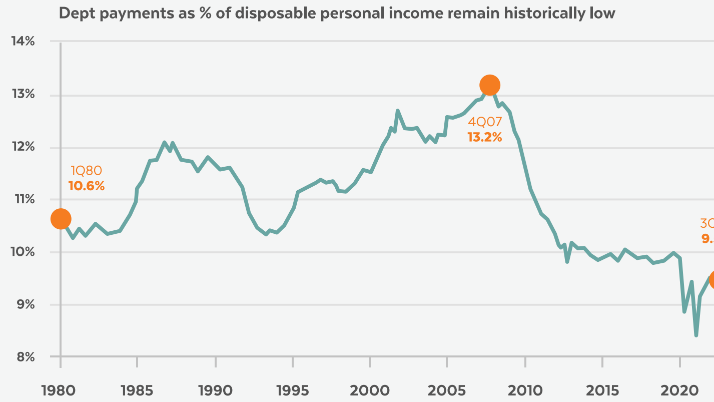
As for Goldman's point regarding the rebalancing of supply and demand in the labor market, the optimistic view is that the Fed could theoretically achieve this goal by reducing the number of job openings instead of slowing the economy to the point of triggering layoffs. August employment data showed an early sign of this possibility, with total job openings falling by 10% to 10.1 million. This figure still far exceeds the 6 million unemployed people looking for work (chart below), but closing the gap could be a ticket to bringing down wage growth—and thus inflation—without causing a severe recession.



Source: Labor Department

Other factors supporting an economic soft landing are strong fundamentals in the private sector and for households. The private-sector has shown few signs that leverage is becoming an issue, and while households have spent down a decent portion of accumulated savings following the pandemic, J.P. Morgan estimates there is still $1 trillion of net excess savings on balance sheets. The legacy of low interest rates is also keeping debt service costs historically low for a majority of Americans (chart on next page).

HOUSEHOLD DEBT SERVICE RATIO



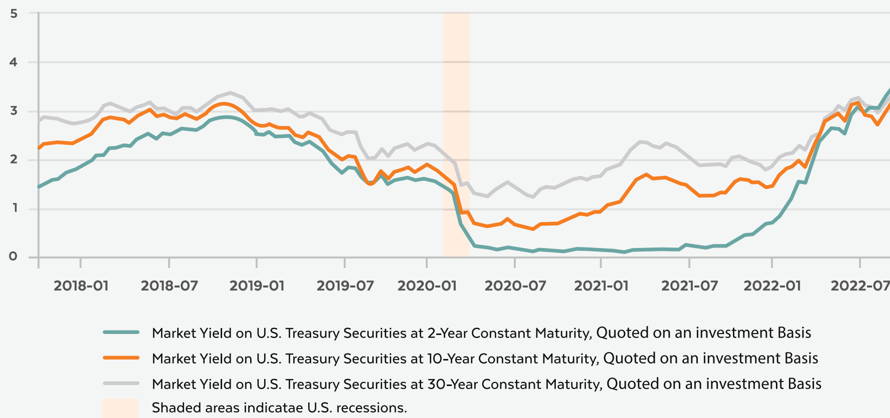
Source: J.P. Morgan Asset Management

While these factors and a historically tight labor market may not prevent a recession, they could help moderate the worst second- and third-round effects of any economic downturn.

FIXED INCOME MARKETS

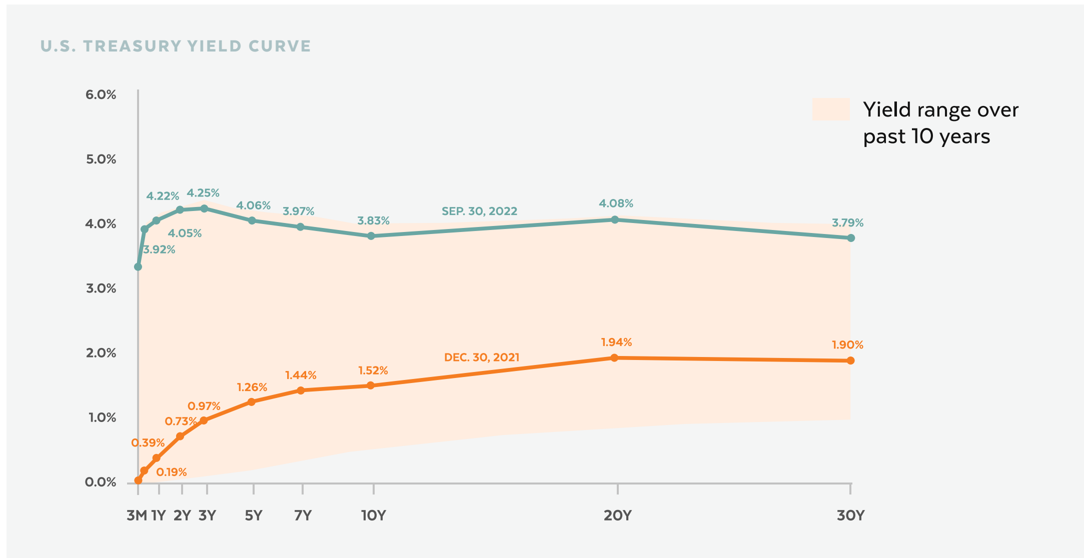
Normally, investors would be able to find refuge from equity market volatility in the fixed income markets. Not so in 2022. US Treasury bond yields have risen sharply across all maturities, leading to a -15% year-to-date decline of the Bloomberg US Aggregate bond index. The yield on the 2-year US Treasury bond (blue line below) finished September at 4.21%, having posted its steepest rise to start a year since 1981.

BOND YIELDS ACROSS THE YIELD CURVE HAVE PUSHED HIGHER



Source: Federal Reserve Bank of St. Louis

With the yield on 2-year US Treasury bonds notably above the yield on 10-year US Treasury bonds, the yield curve is inverted—signaling that November and December rate hikes are likely priced into the short-end of the curve, while intermediate and long maturities are sending stronger signals of the possibility of recession.



Source: J.P. Morgan Asset Management

CONCLUSION

Every time markets have tried to price-in a peak in the interest rate cycle, some combination of strong labor market data, stubbornly high inflation, and central bank comments and policy decisions have pulled them back.

There are many layers to the current economic and market outlook, but at the end of the day, it is inflation that matters above all. No relief from price pressures came in the first three quarters of 2022. In August, the personal-consumption expenditures (PCE) price index rose 0.3% from July and 6.2% year-over-year. The core PCE-price index, which excludes food and energy, rose at an even brisker month-over-month pace, increasing 0.6% from July. This data suggested that inflation had become more broad-based.

There are many meaningful signs, however, that inflation pressures are easing and will come down in the coming months. Trends in commodities, inventories, freight rates, producer prices, and even a stronger dollar all seem likely to contribute to fewer price pressures in the short term. But it is also true that the US labor market has been pushing in the opposite direction, with strong levels of new jobs being added in every month year-to-date.

In a speech given in Atlanta last week, Fed governor Phillip Jefferson said “in a market with more job openings than workers, the competition to fill vacancies is leading to rapid wage gains now, and the resulting salary compression may lead to further upward wage pressures in the future.” Clearly the Fed is still worried about labor market strength. The hope is that reducing the number of job openings—versus triggering outright layoffs—is the remedy that can ease wage pressures and ultimately, inflation.

Looking out to Q4 and beyond, the risk of recession has clearly risen with falling profit margins, a weakening housing market, and an inverted yield curve. Nevertheless, investors should keep in mind that bull markets typically start during a recession, around 6-9 months before a trough in earnings. Equity markets have also done very well once CPI peaks and comes down, and also when growth is weak but improving (rather than when it is strong but slowing). In our view, we may be closer to reaching these conditions than most appreciate.

In company news, we would like to announce the retirement of our long-time Chief Financial Officer and Chief Compliance Officer, David Wong. David has been an outstanding leader, colleague and friend. We wish him happiness in retirement. With David’s retirement, we have brought on Michael B. Yongue to assume the role of Chief Operating Officer. In addition, we would like to welcome Ashley Saia who will be taking over a number of the Chief Financial Officer responsibilities, as well as working in client services.

If you have any questions about this review or your portfolio, please do not hesitate to reach out to us. In the meantime, we wish you a colorful and relaxing fall season.

Kenneth F. Siebel
William F. Dagley
Chris Greene
Elyse Gottschalk
Richard G. Kuchen
James Lenczowski
Jason M. Saxon
Vickie Marinovich
Katrina Sutherland
Michael Yongue
Ashley Saia

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