Capital Investment Advisors

The Fed Has Pummeled Markets – But Silver Linings Lie Ahead for Income Investors

October 1, 2022

If it feels like it's been a painful year, it's because it has been.

There's no way to sugarcoat a rough 2022. Nearly every investment category is in the red. Growth stocks, value stocks, long term bonds, short term bonds, and even precious metals, have all had significant pullbacks on the year. Even this year's early bright spot, energy and commodities, have fallen 20% since this summer. Put it all together, and even balanced portfolios with stocks and bonds have had their worst year in nearly 80 years.

Again, if it feels like it's been a painful year, it's because it has been.

We also know that much of this value destruction stems from a distinct and dramatic change in policy by the US Federal Reserve. In their battle to bring down record inflation (Consumer Price Index (CPI) of over 9% this past summer), the Fed has embarked on one of the most significant rate hiking campaigns in the past 40 years. The Federal Funds Rate (FFR), which indirectly dictates borrowing costs around the nation, was near zero at the beginning of 2022. Today markets are pricing in a FFR of over 4.5% by early 2023.

However, there are very real potential silver linings as we move forward from here.

1. Stock Market Recoveries – Historically, once stocks are down 20%, there's a more than 70% chance that they will be up over the next 12 months, with an average gain of 15%. Even in recessionary times, once stocks are down 20%, they still have a nearly two-thirds chance of being higher one year later. We know that the past doesn't always predict the future, but we can use it as a guide. See the table on the next page:

Peak	Trough	Max Down	20% Down	% Down on Date	3 Months	6 Months	1 Year	2 Years
9/6/29	6/1/32	(86.2%)	10/28/29	(28.6%)	15.1%	9.1%	(10.1%)	41.3%
7/15/57	10/22/57	(20.7%)	10/21/57	(20.3%)	6.7%	11.9%	36.2%	55.1%
12/12/61	6/26/62	(28.0%)	5/28/62	(23.6%)	6.9%	14.0%	30.7%	54.9%
2/9/66	10/7/66	(22.2%)	8/29/66	(20.8%)	8.9%	18.6%	29.0%	41.5%
11/29/68	5/26/70	(36.1%)	1/29/70	(20.9%)	(3.7%)	(7.1%)	16.5%	30.2%
1/11/73	10/3/74	(48.2%)	11/27/73	(20.4%)	1.3%	(5.9%)	(23.7%)	3.7%
11/28/80	8/12/82	(27.1%)	2/22/82	(20.6%)	4.4%	7.3%	38.0%	52.9%
8/25/87	12/4/87	(33.5%)	10/19/87	(33.2%)	13.2%	17.4%	29.0%	63.4%
3/24/00	10/9/02	(49.1%)	3/12/01	(22.7%)	6.6%	(6.8%)	0.1%	(29.7%)
10/9/07	3/9/09	(56.8%)	7/9/08	(20.5%)	(20.4%)	(26.2%)	(27.2%)	(9.2%)
2/19/20	3/23/20	(33.9%)	3/12/20	(26.7%)	21.6%	35.9%	61.8%	74.8%
1/3/22	9/27/22	(23.9%)	6/13/22	(21.8%)	10.1%	?	?	?
		(38.8%)	Average	(23.3%)	3.9%	6.2%	15.4%	25.6%
			Positive Rate		72.7%	63.6%	72.7%	72.7%
Recession Average		(44.8%)		Average	1.7%	2.2%	10.0%	15.3%
Positive Rate				Positive Rate	62.5%	50.0%	62.5%	62.5%
Non-Recession Average		(27.9%)		Average	9.6%	16.7%	29.6%	53.3%
Positive Rate				Positive Rate	100.0%	100.0%	100.0%	100.0%

Source: CIA Research, Bloomberg data

2. Bond Income Hits 15-Year High - Many bonds now pay more than 4%, or around the highest in 15 years. While the move to higher interest rates has been a headwind to fixed income assets, it does significantly improve the outlook for bond income and overall returns going forward.

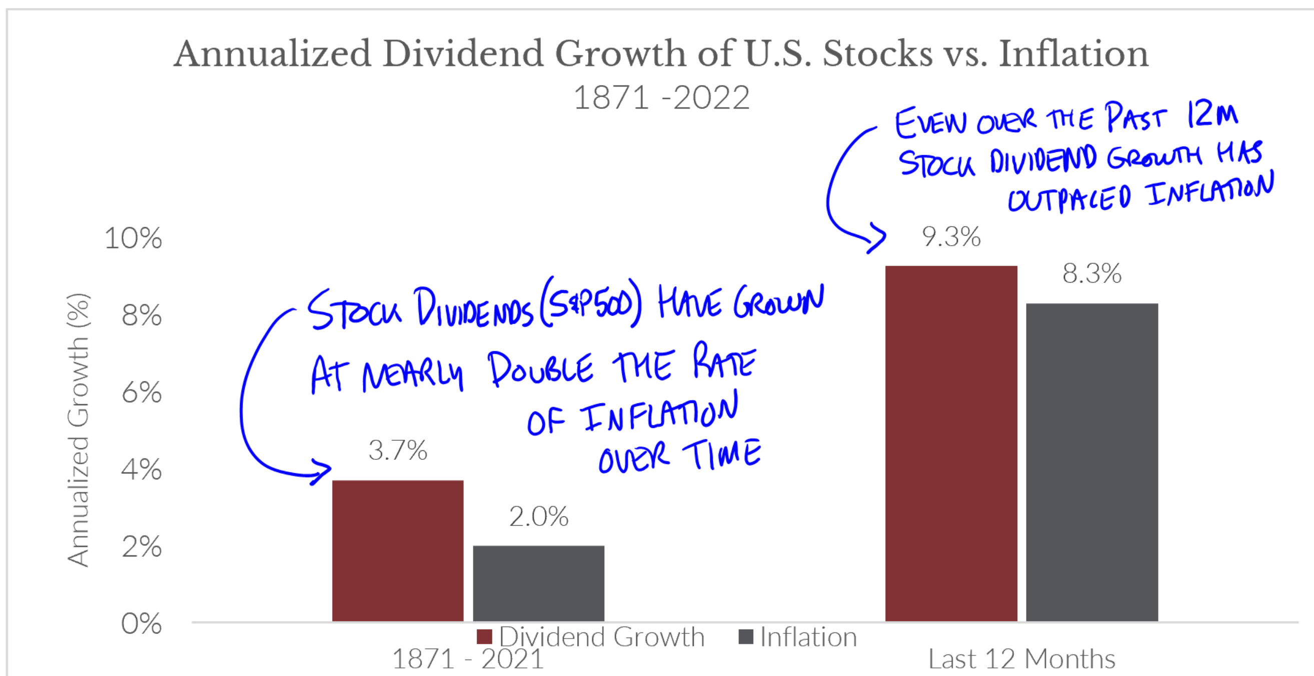
Source: Bloomberg

3. Inflation Pressures May Already Be Easing – Once the Fed feels like inflation is coming back down to earth, global markets will likely breathe a sigh of relief. With the stern and hawkish tone from the Fed so far in 2022 that hasn't happened yet. However, we have started to see some of inflation's most important categories begin to ease. Just this week, the US Case Shiller Home Price Index declined by nearly half of one percent on a month over month basis, or an annualized rate near -6%. This doesn't mean that housing is cheap, but a cooling of prices for both homes and rent is welcome news and could lead to lower CPI reports in the future, as housing accounts for roughly one-third of the index.

Where Do We Go from Here? A Continued Focus on Income.

None of this means we are out of the woods yet… but some of what we believe to be the most important portfolio characteristics we embrace, continue to work well – despite difficult markets. We would like to point out three of these very important items.

1. Dividends Continue to Rise. Stock dividends, which have risen at nearly twice the pace of inflation over the last 150 years (3.7% vs. 2.0%), have continued to do so during 2022's inflation spike. Inflation has run at 8.3% and stock dividends have risen by 9.3% over this same period of time. It's difficult to find a better protector of purchasing power than rising dividends over time. See the chart below.



Source: Shiller Data Library, CIA Research, Bloomberg data

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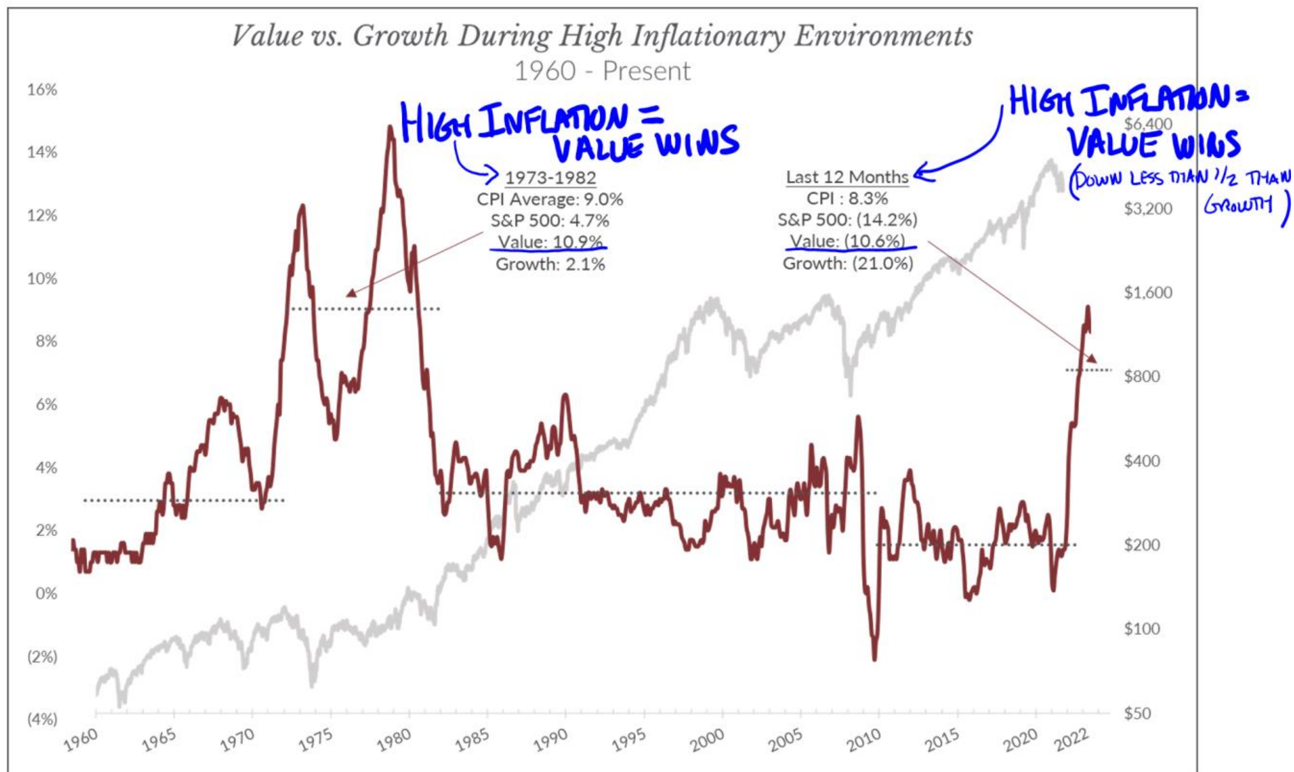
2. Bond Interest Rates Have Quickly Gone from *Nothing*… To *Something*. The following table shows that in September of 2020, interest rates for Treasury bonds were near the zero bound. As of last week, many of these rates are approaching or exceed 4%. For some added context, the 1-year Treasury rate has increased a whopping 34x.

U.S. Treasury Term	Interest Rate	
	September 2020	September 2022
3-Month	0.09%	3.20%
6-Month	0.10%	3.88%
1-Year	0.12%	4.10%
3-Year	0.16%	4.22%
5-Year	0.27%	3.97%

Source: CIA Research, Bloomberg data

3. Value/Dividend Stocks Have Outperformed During Periods of Higher-Than-Normal Inflation. On a relative basis Value/Dividend Stocks continue to hold up well in 2022 and have been a relative safe haven during times of higher-than-normal inflation. From a historical perspective, simply put, during high inflation Value/Dividend Stocks will generally outperform. We will continue to focus on this area of the market.



Source: CIA Research, Bloomberg data

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Bottom Line

When markets are at their most difficult, it is often the case that better days lie ahead. While we think there are still pockets of excess in some areas of the stock market, we continue to focus in on companies and ETFs that provide strong relative value and consistent dividend income. From a bond perspective, rates moving from near zero to above 4% almost overnight, can be a game changer for many retirees. Bonds are finally providing income levels that are decidedly helpful to retirement plans. One year ago, a $1 million bond portfolio would have typically yielded less than $10,000 in annual income. Today, that same portfolio could comfortably see over $40,000 in interest income. Combine the new higher bond yields with the steadiness of quality dividend paying stock dividends, and portfolio income levels are seeing their first real tailwind in over 15 years. We'll take this as positive news in a year where good news has been relatively hard to find.

Very sincerely,

CIA's Investment Committee

P.S. We would be remiss not to mention the upcoming **midterm elections**. While we know there are much larger drivers to equity and bond markets than who sits in Washington, the data around midterm elections is interesting. In the last 70 years, markets have been higher 100% of time in the 12 months following midterm elections. Time will tell what happens in 2022/23.

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