November 2022

Mid-Quarter Update

Watching and Waiting

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Est. 1980

As we approach the end of a challenging year, “watching and waiting” seems an apt description of the posture of investors. We are watching the Federal Reserve (Fed) raise interest rates in an effort to reduce demand, and we are waiting to see the effect of higher interest rates on inflation, the economy, and corporate profits. The Fed is in firm command of the conversation regarding the economy and markets. Unusually high inflation is THE economic problem, and the Fed is continuously stating their intention to bring inflation under control by raising interest rates to a level that eventually impacts demand, and after that inflation. Investors are forced to wait until evidence emerges that this policy is working. This question of when is uncertain, and since investors dislike uncertainty there is considerable volatility in the markets for both stocks and bonds.

Despite this uncertainty, the stock market has responded favorably thus far in the fourth quarter. Most U.S. stocks are still down for the year, but the stock market has risen approximately 10% over the past seven weeks. Longer term interest rates are about where they were at the beginning of the quarter but down from the peak just a few weeks ago. Despite the respite from dual bear markets in stocks and bonds, we may be in this posture of watching and waiting for some time to come.

It is conventional wisdom among economists that changes in monetary policy require twelve to eighteen months to take full effect in the economy. The Fed made their first upward move on interest rates in March of this year which means we are still pretty early in the process. The Fed has made it clear that there are more interest rate increases to come, but at some point there will be a pause, as they then join us in waiting to see when the desired effect of the higher rates becomes a reality.

The Fed is seeking to engineer a slowdown in consumer spending and business investment. Once this occurs, the labor market will begin to cool down with less hiring, which inevitably leads to slowing wage growth. Slower wage growth is the most important of these facets for it directly affects demand and ultimately exerts a large influence on inflationary pressures. In a perfect world, the Fed could pull off a “soft landing,” meaning they are successful in weakening demand and bringing down inflation without invoking an actual contraction in economic activity. Of course, there are risks involved; the main one being the possibility that the Fed commits a policy error by pushing interest rates too high and reducing demand so much that a recession results.

The possibility of the Fed overdoing it adds to the uncertainty. They too are watching and waiting. The good news is that the economy has a number of strong points working for it. Consumer balance sheets remain strong, unemployment remains low, and importantly, longer-term inflation expectations remain under control. If we do have a recession in 2023 or 2024, we believe it will most likely be a mild one. Deep and protracted recessions usually require the unwinding of major economic imbalances. Aside from inflation, the U.S. economy does not suffer from such imbalances.

As we watch and wait we are supported by the large measure of quality that our portfolios contain. Quality is a sustaining force and has helped preserve value in a difficult environment. We expect quality to continue to serve us well until we see the end of this period of uncertainty. We are confident that it will eventually yield to a more favorable and more certain environment for investment.

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CRA-22-269