The Carl / Timpone Group
at
Morgan Stanley

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The Serious Investor's Guide

The End of the Global Pandemic

One might have thought that the end of the shocking global pandemic would bring an accelerated growth phase to the world economy, and perhaps it would have if it were not for the horrific actions of Russia's President Vladimir Putin and his unprovoked war against Ukraine and the West as a whole. This devastating war has called into question the entire concept of globalization and relying on the rest of the world to produce many of our important raw materials and products. China's support of Russia, its desire for the reunification of Taiwan, along with their zero-Covid policy has caused nervousness throughout the world. The current very high level of worldwide inflation is mainly due to the combination of incredibly loose monetary and fiscal policies instituted to get the world through the pandemic, as well as the invasion of Ukraine by Russia. The weaponization of oil and natural gas by Putin, and the massive reduction of producing and exporting of grain along with other raw materials has caused surging prices there as well. The long period of underinvestment in the development of oil and gas and other commodities and raw materials, has kept supplies lower than they should be, and has also helped to rekindle high inflation here in the U.S. as well. However, the real culprit may very well be the massive buildup of debt over the last 20 to 30 years in this country.

Thomas A. Carl
Managing Director-Wealth Management
Senior Portfolio Management Director
Financial Advisor
Tel: (201) 967-6323
Toll Free: (800) 526-0829
Fax: (201) 262-3761
Cell: 201-248-4782
thomas.a.carl@ms.com

The Carl / Timpone Group
61 South Paramus Road
3rd Floor
Paramus, NJ 07652

Edward C. Timpone
Senior Vice President
Senior Portfolio Management Director
Family Wealth Advisor
Financial Advisor
Tel: (201) 967-6349
Toll Free: (800) 526-0829
Fax: (201) 262-3761
Cell: 201-248-8673
edward.timpone@ms.com

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Inflation and the Markets

Due to the extraordinarily high level of inflation of 9% a few months ago, the Federal Reserve Board has raised the Federal Funds rate the fastest in history, from .25% in this past March, up to an expected rate of 3.25% on September 21. This was done in order to attempt to slow the US economy and reduce overall inflation. The Fed is also embarking on quantitative tightening which means instead of buying bonds in the open market they are letting their nearly $9 trillion in holdings of bonds runoff to the tune of $95 billion per month which should put further upward pressure on long term interest rates. The bond market has been anticipating this to a certain point, as the ten year U.S. Treasury Note yields have risen from 1.26% to 3.69% in the last year. This has helped to slow the economy and caused a significant decline in both stocks and bonds so far this year. In addition, the National average of 30 year mortgage rates have risen from the low of 2.98% about a year ago, to currently 6.59%. This along with the big increases in home prices across the country, has dramatically reduced the affordability of housing in the U.S. and around the world. This lack of affordability is causing a 25% drop in the sales of existing homes and a 50% drop in the sales of new homes this year, and it looks like the end of the big increases in home values. This could be the beginning of a more difficult pricing environment ahead for home values.

The stock markets around the world have already dropped as much as 19 to 40% worldwide this year at their recent lows. They have been declining on fears that the aggressive rate increases by the Fed will push the U.S into a recession in order to lower inflation. The European economies are likely in or near recession with the dramatic rise in natural gas prices and the current rationing of natural gas. China, with their sporadic lockdowns of major cities due to their zero-Covid policy, is enduring a severe slowdown as well. The U.S. has registered two quarters of negative GDP, which normally signifies a recession. However, the GDP results were skewed a bit by the unusually large rate of inflation and the unemployment rate actually declined during this period. The current bearish investor sentiment is about as high as it has been in March of 2009, and in our opinion, the market drop has almost fully discounted a mild recession to a great degree.

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Thomas A. Carl
Managing Director- Wealth Management
Senior Portfolio Management Director
Financial Advisor

Edward C. Timpone
Senior Vice President
Senior Portfolio Management Director
Family Wealth Advisor
Financial Advisor

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Peak Inflation?

Our belief is that we may have already seen peak inflation in the commodities market, the housing market, and at retail, due to bulging inventories at many of the Nation's major store chains. Bottlenecks at the various ports have improved and many companies have announced cutbacks in their workforce hiring plans. With 11.2 million total jobs available in the U.S., and a 3.7% unemployment rate, the Fed is going to keep their foot on the brakes by threatening to cause some pain to individuals and businesses in the months ahead. The hope is that they have already burst the bubbles in the real estate, stock, bond, and commodities markets, and that they will not have to do much more tightening. Unfortunately, the past decade of the underinvestment in energy supplies and commodities, may lead to further significant price increases in the commodities market at some point in the future which would help slow the economy down but may cause more concerns about inflation longer term.

Bottom line: We believe the likelihood is that the next 5 to 10 years or so is not likely to produce above average returns in the overall stock and bond markets, due mainly to a somewhat expensive stock market at the index levels, higher inflation, and higher interest rates. Therefore, investors must think outside the box and look for opportunities in mispriced assets that have the chance to produce outsized returns and preserve principal against higher inflation in the months and years ahead.

The Closing of the Casino

In last year's Serious Investor's Guide, we discussed the fact that the U.S. stock market was in a casino-like environment, whereby investors were throwing caution to the wind and speculating in many ways without considering the risks. Thankfully, for the most part this has ended, or at least has been substantially reduced. We believe speculative investors are likely to continue to see significant damage as we move forward. Value investors, on the other hand, have been rewarded as more investors are reallocating their investment dollars into companies that make good economic sense. Companies that are needed and that are priced at a discount to their intrinsic value are what we focus on. We prefer companies that pay good dividends or that have good growth characteristics, and strong balance sheets. Entities that have a good value proposition and excellent management are the ones we typically invest in. By utilizing this conservative approach, we seek to generate good risk adjusted returns for our clients over the very long term and throughout what could be a challenging period ahead for most investors.

*All Newsletter data is from Bloomberg and The Wall Street Journal

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