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FFG Market Pulse Newsletter, Q3 2022

Through the third quarter of 2022, the markets have experienced the worst year to date performance in over 20 years. This historic level of volatility was not confined to just the stock market. Bonds, Interest rates and currency markets have also experienced historic years. With such a dismal start to the year you may think it would be difficult to discuss anything positive. However, at FFG we are optimistic about the future for several reasons. I will discuss these further down but thought it would be beneficial to first review some of the reasons for the poor start of the year.

In general, it seems the historic downside volatility is due the irreconcilable difference between the need to aggressively tame inflation by raising interest rates without causing an economic slowdown and potentially a global recession. Although this theme has been with us throughout the entire year, it's the ability of market participants to contend with this dichotomy that has been in constant flux. Markets are driven in the short term by the changing perception of current events and their potential effects on the future. In psychology there is a concept called Recency Bias which states that humans tend to favor and overweight the most current events over historic ones. This leads to a very short-term focus where the recent trends are overweighted, and investors end up projecting the current events ad infinitum into the future. When the current events change, especially when the change is drastic, it is accompanied by a significant reweighting of the market towards the latest data points with little regard for historic precedent.

In the beginning of the year, it was believed that the Federal Reserve ("Fed") was unrealistic regarding inflation's permanence and was therefore too timid in its approach to reduce it. During the second quarter the Fed began to acknowledge that inflation was no longer transitory and signaled its preparedness to act and bring inflation under control. As the summer progressed the market became more comfortable with the Fed's approach to aggressively bring down inflation in a "controlled" manner which led to a significant market rally in July. This comfort was later abandoned when it was perceived that the Fed was becoming too aggressive in its approach, would raise rates beyond what was necessary to reduce inflation and plunge the world into a recession. Anyone else dizzy yet?

In reality, the topics discussed above are extremely difficult to manage, control and forecast. There are many factors that contribute to economic growth, inflation and interest rates being the two receiving the most attention at the moment. Furthermore, interest rates are a crude tool at best to manage inflation. There are considerable second order effects that arise from such significant changes in monetary policy, many of which are so loosely related, that it would be difficult to predict them ahead of time. Therefore, to peg one's investment philosophy solely on the outcomes of Fed policy seems unrealistic and frankly irresponsible.

When the market is so hyper focused, opportunities tend to present themselves to those who are willing to pay attention to them. One of the benefits of the Fed's aggressive tightening is that fixed income has finally become attractive again. Interest rates have not been this high in over a decade. Although high interest rates are a negative for borrowers, as a lender they are phenomenal. The ability to lock in 5-6% returns over many years by investing in high quality fixed income is a welcome alternative to the equity only environment we've been in since the Great Recession. It is possible that this dynamic may not last very long and could be a current opportunity to position the portfolios for future growth. This is especially true if the forecast of a recession comes to pass, and rates begin to move downward again to stimulate growth.

In addition, many high-quality companies have seen their share prices decimated. Over time, extraordinary returns come from purchasing these types of companies at significant discounts to their true worth. Contrary to popular belief, these companies become less risky as their share prices fall. This leads to a compelling dynamic where potential returns increase, and risk decreases as share prices fall. Over the past three years it has been difficult to purchase almost any company at a wide enough discount that would provide sufficient risk-adjusted returns over the long term. At some point these investment opportunities will be too good to pass up and investors will begin purchasing them again.

Lastly, although it may be difficult to endure a prolonged downturn in stocks there is a critical element to keep in mind before bailing out into cash, dividends. For many investors it is challenging to appreciate the true benefit of dividends as they see their portfolios continue to drop in value. However, the subtle power of dividends and their impact on investment returns are nothing short of magical. By reinvesting dividends investment returns can be supercharged due to the nature of compounding. As dividends reinvest, more shares are purchased which leads to more dividend income which leads to even more shares being purchased, etc. This virtuous circle of reinvestment is accentuated when share prices decline due to the simple fact that the purchasing power of the dividends increases as the share price falls. Most investors never reap the full benefit of dividends because they are more worried about the current quoted price of their stocks instead of allowing dividends to reinvest when it is most powerful. So next time you get nervous and feel like selling out of your portfolio, remember the power of dividends and their affect on your future net worth.

At FFG we try to assess the current environment to understand what opportunities might arise from the dislocation of current events as opposed to them dictating our investment approach. Although it is difficult to go through a market downturn, especially one this severe, we believe there are both short and long-term opportunities being created and we are positioning the portfolios accordingly.

Yours Truly,



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