CAPITAL INVESTMENT COUNSEL

The Columns

October 2023

I thought October was supposed to be easy. History says that after a rough August and September, the market finished October higher 90% of the time. Not in 2023. We were on track for a solid return until October 18th. Since then, a 2% market gain turned into a 4% loss – a 6% drop in a flash. Ten-year US Treasury rates skyrocketing from 4.5% to 5% over that time might have had something to do with that.

When it comes to inflation and high prices, I wish the government would look to increase supply instead of choking off demand. Unfortunately, the Federal Reserve feels differently. Their approach is to kill growth as opposed to increasing abundance, and home buyers are probably the biggest casualties of the Fed's rate shenanigans this year. Currently, the Fed Funds Rate sits 1.6% above inflation making this the tightest conditions we've seen in 16 years. *(Source: Charlie Biello)*

In 2014, 70% of homes in Raleigh were considered affordable. This ratio looks at the average home price versus average income, and today, only 40% of Raleigh homes are affordable. I purchased my first home in 1989 for $90,000 and an interest rate of 10.5%(!!!!). I recently saw it on Zillow for $925,000. Talk about missed opportunities. Also, this home was only 1100 square feet. What a world! Ironically, the cure for high home prices might end up being high prices. Think back to 2008 when oil prices were $140 a barrel. Oil was high and the potential profits encouraged oil companies to find profitable ways to extract oil. It took time but by 2016, the new technologies increased supply and oil plummeted to $16 a barrel. Abundance is good for everyone.

Housing might be seeing a similar development, and like oil, this too will take time. Three years ago, the average US home sold for $380,000 with mortgage rates at 2.75%. By 2022, the average home sold for $470,000. Rates have popped over the last 18 months and sit at 7.6% currently. That put the brakes on home prices and the average home actually *dropped* $38,000. With many homeowners locked into lower rates, there isn't much for sale. The good news is that builders are stepping in and adding new homes. Attracted by higher prices, they can make a solid return, even with rates at 7%.

The shock for most of us is not the absolute interest rate itself. It's more about how quickly rates changed. It's easier to prepare for change when things move at a manageable pace but interest rates tripling over 3 years isn't manageable – it's like getting into the ring with prime Mike Tyson. Higher rates will force better investment choices from everyone. Businesses are like the rest of us and are simply adjusting to the "new normal" rates. Maybe the Fed needs to remember that price stability is their mandate. Over to you Jerome Powell.

The interest rate spike is the visible threat to stock prices. Hidden beneath the surface, the big drop in money supply is having a big effect. Sure, the Fed dumped money in record amounts during Covid, but they've pulled it out of the system quickly as well. M2 money supply just endured the largest 2-year drop in history and fell by nearly 4% over the last year alone. Imagine your car engine running low on oil and you'll get the picture of M2's role in the economy. This explains why stocks are stumbling but what I want to know is what happens next.

The timing is excellent as we've entered a potential great stretch for market seasonality: the last 50 trading days of the year. Since 1980, the last 50 days have had a positive bias and stocks were higher 77% of the time with a median gain of 3.3%. *(Source: S&P)* Remember the market doesn't have to be doing well going into the last 50 days to turn higher. The potential return is higher if the market is negative going into this stretch: a median gain of 4% versus 3% for a positive year-to-date market. Either way, the odds may mean stock prices turn higher soon.

I'm digging deep into history with this gem from Jay Kaeppel at Sentiment Trader. Over the last 123 years, if the S&P is up 10% through October, the market closes the year higher 36 out of 41 times. The average gain is 5% and the worst drop was only 2%. I like the risk reward here and remind you that we need the S&P to close at 4223 or better on Halloween to set this in motion. As I write this, the S&P is trading at 4114 so it needs to get a move on if it wants to trigger this scenario. If you have any comments, feel free to contact me at heddins@capital-invest.com or call at 919-656-0836.