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"Slow down… You're moving too fast!"

Dear Clients and Friends: October 19, 2022

It might be hard to remember, but the third quarter began on a reasonably optimistic note. Inflation appeared to be peaking evidenced most notably by gasoline prices retreating from $5 a gallon to below $3. Hope spread that inflation would continue to moderate quickly, appeasing the Federal Reserve and avoiding a recession. From July to mid-August, we saw bond yields retreat and equity markets rally 15%, mitigating much of the negative returns witnessed in the first half of the year.

Then came Federal Reserve chairman Powell's annual speech from Jackson Hole. He emphasized their goal of bringing inflation back down to 2%, even at the cost of a recession. The clarity of his message brought this calm to a halt. August's Consumer Price Index (CPI) then followed and was more elevated than expected. Markets across the world reversed course immediately. Realization that inflation was not yet in the rear-view mirror and Powell's clear message began to sink in.

The results for the third quarter added to the year-to-date losses already experienced across the board. U.S. large cap stocks were down another -5%, now down -24% on the year. U.S. small cap, developed international, and emerging markets were all similar with year-to-date losses in the -25% to -27% range.

As discussed in last quarter's letter, the most disappointing market has been fixed income. The U.S. Aggregate Bond Index was down -5% for the quarter and is now down -15% for the year. Bond investors have seen interest rates across the yield curve rise both directly as the Fed has raised the Fed Funds rate, and indirectly as markets priced in the strong inflation fighting rhetoric.

Inflation

Inflation is the result of an imbalance between supply and demand. If there is too much demand relative to supply, prices rise and you get inflation. If there is too much supply relative to demand, prices fall and you get deflation. Central banks have historically tried to manage inflation by raising and lowering interest rates to either promote or discourage economic activity. Their success can be argued.

Subtly, inflation can have a significant impact on how participants in an economy make decisions. Deflation tends to cause delays in consumer consumption and business investment as participants wait as long as they can to get the lowest price they can. These actions slow economic growth and can cause recessions as demand wanes. Since the Great Financial Crisis, economies have been battling many deflationary tendencies. The Fed's zero-interest rate policies and quantitative easing programs have been their weapons to promote growth in this fight.

On the other hand, high inflation can promote a quickening in activity as participants want to purchase before prices rise even further. This scenario can lead to a self-fulfilling inflationary spiral where prices consistently and uncontrollably rise. The Fed's often stated inflation goal of 2% seeks to find a middle ground that allows price increases, but in a stable and predictable manner.

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However, the supply/demand situation we currently find ourselves in is a bit unique. Much of the inflation we are seeing today is the result of a shortfall in supply relative to **normal** demand. The war in Ukraine and sanctions against Russia have significantly reduced the available supply of oil, gas, wheat and other commodities relative to normal demand. While the rest of the world has opened back up, China's Zero COVID policy continues to shutter major cities and ports. This has led to shortages and supply chain disruptions everywhere. Following the Great Financial Crisis, construction of new housing has been curtailed. Estimates suggest the U.S. has a shortage of 3-4 million homes relative to the current need, putting upward pressure on house prices and rents. Additionally, a combination of retiring baby boomers and falling legal immigration has created a shortage of workers relative to available jobs. This is exacerbated by an evolving economy where needed skillsets are in even shorter supply, creating upward pressure on wages.

These are examples of some of the nuanced causes of the inflation we are seeing today. Many are also structural in nature. Affordable housing, old and inefficient infrastructure, and a lack of available and qualified workers are issues our political leaders should be tackling and not be left to the overseers of monetary policy to solve. Even with proper leadership, these problems cannot be fixed quickly but still need to be addressed.

Another interesting theory on inflationary sources has been termed "Revenge Vacations". Consumers amassed $3 trillion in extra savings during the COVID lockdowns. Now that the world has opened back up, they are determined to [Reader: *Fill in the thing you still want to do*] regardless of the cost. They essentially have become "price insensitive" purchasers, contributing to the inflation problem by paying higher prices without consideration. Estimates are that excess savings are now down to $1.3 trillion, still a substantial amount.

Unfortunately, the Fed is attacking all this inflation with the very blunt instrument of higher interest rates. The Fed can't fix these problems or tame the "Revenge Vacation" cohort with monetary policy. Instead, they are hoping to create demand destruction, bringing it more in line with available supply. Investors fear this cannot be done without a recession.

Bonds

The blunt attack of rising interest rates is wreaking havoc on markets around the world, but none more important than the U.S. bond market. Bonds are usually less volatile than stocks while also uncorrelated. Normally, when investors worry about an economic slowdown, bonds rise in price while equities fall and vice versa when anticipating economic recoveries. So, holding bonds along with stocks usually results in a less volatile portfolio.

Bonds have not been their usual ballast. It is an understatement to call 2022 an outlier. With rates still near zero to start the year, there was very little income to offset the price declines seen from the rise in rates. Since 1980, the current -15% decline in the Aggregate Bond Index is far and away the worst year on record. The prior worst year was 1994's -2.9% decline. As detailed in the last quarterly letter, we have protected clients from the bulk of this negative return by concentrating on shorter maturity bonds. Longer maturity bonds have faired significantly worse. A Treasury bond maturing in 20 years has had a price decline of over -30% this year, even worse than equities!

The worst may not be over, but we believe we are getting close. The Fed has raised their Funds Rate from zero to 3.25% over their last five meetings. Markets have priced in additional increases to around 4.75%, probably concluding in the first quarter of 2023.

When will the Fed stop? Most economists currently feel that 4.75% will be high enough for the Fed to pause and assess their actions on financial conditions. Longer-term, they will need to see inflation is headed lower and making real progress toward their target. An unemployment rate moving above 4.0% with fewer job openings would demonstrate their actions are working and could also give them reason to pause. Lastly, any dislocations in the "plumbing" of the financial markets, while unfortunate, would force a halt prematurely to their goals. At present, the economy is just too strong for any of these conditions.

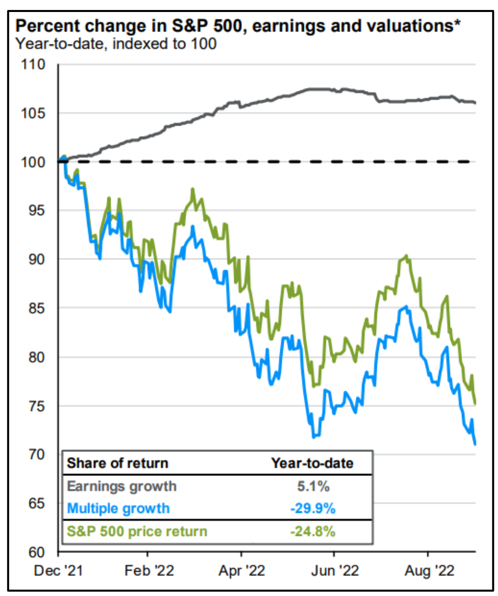
These market moves have set the bond market up for future opportunity. We have been able to reposition portions of fixed income portfolios to take advantage of 5.0%+ yields on investment grade corporate bonds and are seeing yields of 9.0%+ in more aggressive areas. Yields at these levels have not been available since the mid-2000s.

Equity Performance

We've seen how rising interest rates have affected the fixed income markets, but many clients are asking why the higher rates are also having such an impact on equity markets. The level of rates can influence stock prices in different ways, affecting both earnings and the valuation multiples. If Fed actions have the desired effect of demand destruction and slower growth, this will mean a lower level of overall economic activity. A less robust economy generally leads to lower earnings for most companies. Companies often combat this environment with cost cuts, mergers and acquisitions, and other methods to increase earnings when the general winds of economic growth are not at their backs.

For companies that use debt, the cost can become more expensive as they either refinance old debt coming due or issue new debt going forward. In both cases, the higher interest expense reduces their current earnings. Any reduction in earnings makes a company less attractive to investors.

Lastly, what investors are willing to pay for a company's earnings is partially dependent on their other investment options. When interest rates are low, fixed income investments present less competition for an investor's dollar. They will pay a higher price for a stock's growth and dividends. However, as interest rates and income rise on safer investments, investors become less interested in equities. So, as the Fed raises rates, they make the earnings environment more challenging and increase the competition for investment; both can lead to lower stock prices.



To date, all the negative return experienced by the S&P 500 has come from valuation contraction. Through the third quarter of the year, earnings are up +5.1%. Yet, the price investors are willing to pay for those earnings has come down -29.9%, netting the -24.8% year-to-date loss.

Outlook

To be sure, we recognize the current environment is challenging. While inflation seems to be concern number one, other worries are certainly present. Recent Ukrainian gains in the war with Russia appear to have backed President

Putin into a corner. Further escalation, heightened aggression, and even threats of a nuclear retaliation have become more likely. How the winter plays out in Europe due to its dependency on Russian oil and gas is still not fully understood. Even the United Kingdom's recent Prime Minister change has ushered in unexpected new policies, roiling global currency and bond markets even further.

The Fed's aggressive posture has had secondary effects at home as well. Mortgage rates are up dramatically, from below 3% to almost 7%. While most of us "older folks" would consider a 7% mortgage a gift, rates have not been this high since the 1990s. With the rise in house prices and higher rates, younger generations are suddenly getting sticker shock on monthly payments. Higher interest rates have also caused the value of the U.S. dollar to soar to 20+ year highs. A strong dollar has helped from an inflation standpoint but will dampen corporate earnings over the next several quarters.

We are also seeing global economies start to slow. This was inevitable after the torrid pace of COVID reopenings, but Central Bank interest rate policies are now having an effect. The threat of recession is top of mind. In the U.S., while we believe recession likelihood is increasing, we also believe it will be mild. Painful recessions usually stem from working off major excesses in the economy. This often includes an overbuilt housing sector, too much business investment, or an inventory overhang that must be brought down. As has been mentioned, the current inflation problem is due to shortages, not excesses. Recessions are also a normal and regular occurrence and do serve a useful purpose. They can flush out speculative behavior and restore balance between prices and fundamentals, creating a stronger foundation upon which to build the next cycle of economic growth.

The abundance of issues has created very negative investor sentiment. That negative sentiment does not mean a bottom has been reached but does mean a lot has been incorporated into current market prices and the outlook for the near future. In the past 77 years, there have been 11 times that the stock market has fallen by over 20%. The median decline after falling 20% was another 10% decline with the ultimate bottom occurring a median of 117 days later. Based on recent performance, we have already endured most of the time and the decline of a "normal" bear market. Of course, it could get worse. However, any look at a long-term chart of the market shows it has always recovered and moved to new highs over time. Current low prices often reflect better future returns.

We also know that most of our clients don't like to hear the words "patience" or "long term". However, these are the times when we must emphasize those words and remember how both created the investment successes of the past. We can also take comfort that the investments we hold are in real companies, doing real business, and should recover in time. We must stick to our plans, making opportunistic changes when possible.

Thank you again for your continued confidence and trust as we work through these extraordinary times. We welcome your comments, questions, and referrals. Please don't hesitate to contact us. Please stay safe and well.

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