Mopping up the Money

1st Quarter 2023

We will not wax nostalgic for 2022. In addition to the abject failure of the capital markets, it was a humanitarian disaster for Ukrainians, a natural disaster for much of the U.S. and the erosion of social and civil liberties for the Chinese citizens. Geopolitics were front and center in 2022 and the changing world order that began last year will impact 2023 as well. Territorial flexing by China and Russia will continue to be a destabilizing force. New alliances, "near shoring", new trading patterns and control of commodities will be major influences in the next decade. Covid will continue to be in our vernacular as China ends restrictions and the world deals with the ramifications of the overnight shift from zero Covid to laissez-faire Covid.

Beginning macro and then getting to the bottom line – Disinflation is the goal! The metaphor of money to water is apropos in both the nature of their necessity and the damage that can be done by having too much or not enough. The billions of dollars governments floated out into the world during the height of the pandemic to support vulnerable people and businesses is now being sopped up through the Federal Reserve's interest rate hikes. The consumer price index reached 9.1% at its peak, since subsequently trending lower. The two most important components of inflation – housing and labor – are the battle grounds. Housing has regained a more recognizable balance of power between buyers and sellers with inventory levels and mortgage rates both influencing price. Fear of a recession has similarly slowed rising labor costs that were partly fueled by the lowest unemployment rate in over 50 years.

The Federal Reserve raised interest rates seven times and 400 basis points this year to fight high inflation. The consequences and impact of these unprecedented moves may result in a recession later this year. Increased interest rates have many costs: they dramatically impact the affordability of a home mortgage; they increase borrowing costs for businesses to fund operations or growth and they sometimes make high growth companies less profitable and investable. However, the alternative was equally unpalatable as entrenched and persistent high inflation portends a worse fate for economic well-being. Low inflation and full employment remain the dual mandates guiding the US central bank. Other central banks around the world are taking their cues from us and following suit.[1]

The year was an unmitigated disappointment in the capital markets for virtually every asset class. Producing double digit declines for both stocks and bonds, large and small, foreign and domestic, high grade and high yield.[2]

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However, there is always a bull market somewhere…For 2022 it was energy, commodities and the dollar. Fortunately, your portfolios contain all of those assets and that helped mitigate the decline.[3] After almost a dozen years of high-growth, domestic equity dominance, 2022 went retro to rewarding traditional energy companies, commodities and low growth, high dividend yielding stocks. The near decade long warnings of Bears about impending inflation from low interest rates finally came true. Unfortunately, hiding in bonds provided no shelter for the bears or balanced portfolios.

What does all of this mean for 2023? The backdrop for the global economy has changed. The way to profitable investing will look different over the next decade. Companies that relied on raising capital and borrowing capital to operate and grow have a steep hurdle ahead of them. When money is cheap, growth rewards. When it's not cheap, bonds and dividend yielding stocks return to favor. The underweight of our portfolios to traditional bonds over the last several years helped us in 2022. The rebalancing we did at the end of 2021 to take profits in some of the high growth stocks also contributed to out-performance by reducing our exposure to the hardest hit parts of the stock market. In addition, we held cash that buffered our retirees and buoyed our savers. This faint praise is not meant to distract from the losses we suffered, but to provide context for the small "w" in performing better than the indices.

The risks for 2023 include stubborn inflation, recession and stagflation. The market declined in 2022 as these warnings for the year ahead increased and grew louder.[4] We hope to see the same behavior that negatively impacted 2022 should positively influence markets in 2023 as we begin to anticipate the recovery…The risks that forecasters are too draconian, and that the Fed is able to navigate the economy into a soft landing are reasons not to be too negative. These counter trends warrant positioning for a volatile year. We have exited a low inflation, low interest rate environment and now exist in a high inflation, high interest rate environment. Optimism towards the end of Fed interest rate hikes, low P/E ratios on the major indices to start the year, a declining dollar and the reopening of the second largest economy in the world are valid data points for a constructive market this year.

We are prepared for the changing landscape and the opportunities that lie ahead for investors. The Fed is mopping up the pandemic stimulus money with high interest rates. Money flows like water. It moves and changes shapes but does not disappear, it moves to where it is treated best. Your money is our singular focus. Providing performance, preservation and bespoke advice is our mission and mandate. We look forward to serving you and seeing you in the New Year!

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*Keeping in mind index returns are not fund returns. An index is unmanaged and not available for direct investment. Past performance is no guarantee of future results. All investing involves some degree of risk, whether it is associated with market volatility, purchasing power or a specific security, including the possible loss of principal. Stocks offer long-term growth potential, but may fluctuate more and provide less current income than other investments. The report herein is not a complete analysis of every material fact in respect to any company, industry or security. The opinions expressed here reflect the judgment of the author as of the date of the report and are subject to change without notice. Any market prices are only indications of market values and are subject to change. The material has been prepared or is distributed solely for information purposes and is not a solicitation or an offer to buy any security or instrument or to participate in any trading strategy. Additional information is available upon request.

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1. Daily Equity & Market Analysis, Dorsey Wright, December 28th, 2022
2. Sevens Report, November 29th, 2022
3. State of the Markets, Wells Fargo Investment Institute, December 21st, 2022
4. Top Global Risks of 2023, Charles Schwab, December 19th, 2022

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