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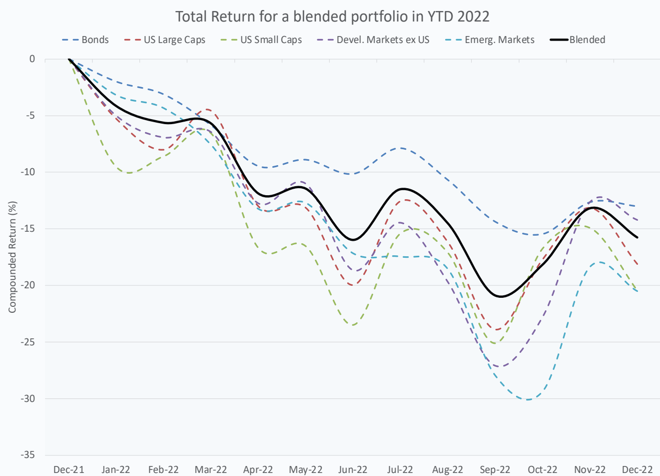
WHERE WE STAND – Q4 2022

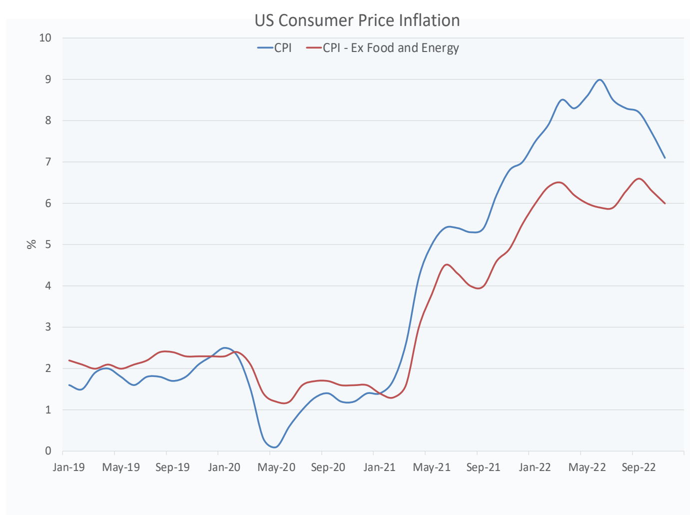
A blended portfolio* of equities and bonds was up 6.5% (on a total return basis) in Q4 2022. For the year, down 15.8%. See the black solid line in the chart below. Although most asset classes attempted a rebound in the 4th quarter, renewed weakness in December left all on the backfoot for the year. Leading declines were Emerging Markets and US Small Cap stocks (both -20.5% for the year). US Large Caps were down 18.1%, Developed Markets ex USA (-14.2%) and US Investment Grade Bonds down 13.0%. See the colored broken lines in the chart.



*A typical blended portfolio would be comprised of 60% equities and 40% bonds. For a benchmark, such a portfolio would arguably be 30% large cap US stocks, 10% US small caps, 10% developed markets ex-US, 10% emerging market stocks and 40% US government, investment grade corporate and GSE bonds.

So called long-duration-assets were the worst performers on the year owing to the effect that higher discount interest rates have on expected investment returns. For example, in equities, the Nasdaq 100 was down 36% in 2022 because many of its constituents project cash returns to investors further in the future. Whereas the Dow Industrial Average, comprising of more mature companies with high free cash flow (and many with dividends being paid now) was only down 8.8% on the year. And in fixed income investments like bonds, the long-dated government bond fund was down over 32% on the year (!), providing none of the diversification benefits that it usually does to a typical investment portfolio. A very rare occurrence: usually when equities collapse, bonds provide a counterbalancing positive effect. On the other hand, shorter dated fixed income bonds like 1–3 year government bonds were 'only' down 5% in 2022.

In response to inflationary pressures, the Federal Reserve hiked its benchmark short-term Fed Funds rate twice during the Q4, by 0.75% in November and again by 0.50% in December. For the year the rate has risen by an extremely aggressive 4.25% from 0%. As mentioned in previous reports, the consensus of both the Federal Reserve and the investment community, entering 2022, was that inflation pressure were 'transitory'. In fact, in December 2021 no Federal Reserve members saw the base rate rising above 1% by end 2022. (As an aside no members see the same rate below 5% - another 0.75% higher than it is now - by end 2023.) This, not surprisingly, proving that macro economic forecasting is proving to be an extremely inexact science.



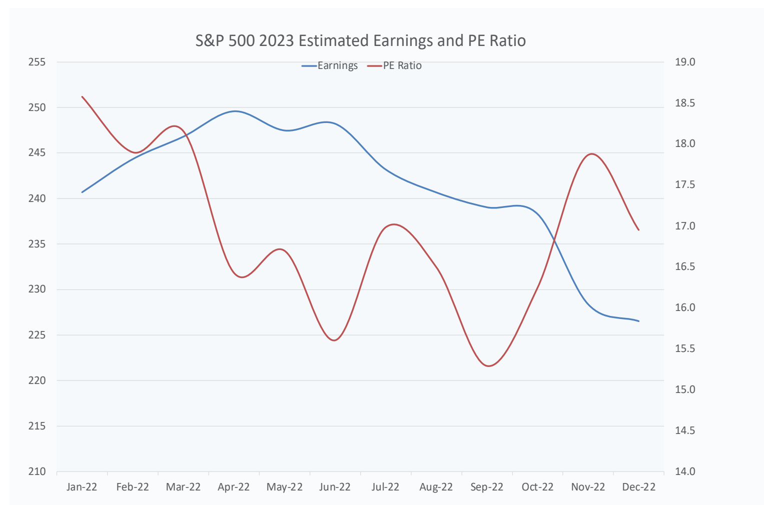
As can be gleaned from the above chart, both the overall CPI (blue) and Core CPI (red) began to moderate in the latter part of 2022 and this fact accounted for the recovery of securities markets in the third quarter. The

belief was that the Fed will end rate hikes sooner rather than later, and in fact possibly signify a 'pivot, from a more hawkish (tight monetary policy) to a more dovish stance in response to this moderation. But by December the Fed continued to express its hawkishness even in the face of a distinct slowdown in the economy (in sectors such as housing). The Fed is apparently concerned about inordinate strength in the labor market and the possibility of a wage price spiral which they do not want to see because this would lead to an endemic and more permanent rise in inflation. The Fed's task is not an easy one given the difficulty in macro forecasting, and in this instance, they are erring on the side of doing whatever it takes to beat inflation, even if it means engineering a recession, because the alternative (trying to engineer a soft economic landing and in so doing risking an inflation spiral) is more difficult for them to extricate the economy from in the future. As an aside, for investors with the long term in mind, this is the more favorable position for the Fed to take…for them to be soft on inflation could lead to bad outcomes for investors in years to come.

In Q4 the short term 3-month T-bill rate rose a further 1.1% to 4.35% (in response to the change in the base or Fed Funds rate mentioned above), yet the Ten-Year Treasury note rate was largely unchanged at 3.85%. This was an intensification in the so-called inversion of the Treasury yield curve and, in effect, the market's expression of its expectation for future economic growth. If the longer dated yield falls relative to the shorter dated yield, the yield curve is emitting a signal that the Federal Reserve may be engineering an aggressive economic slowdown. Investors are willing to forsake the higher yield for 3 months in favor of the lower yield for 10 years, because they feel the 3-month yield will be lower in the future as the Fed responds to lower economic activity by again dropping its base rate.

By late December there was a marginal shift in the market narrative: a shift in the growth/inflation expectation continuum from excessively-tight-labor-markets-and-high-inflation-pressures to the-Fed-is-tightening-too-much-and-could-cause-a-meaningful-recession. This accounted for the weakness in equity markets (aside from the perhaps over-hyped 'tax selling' explanation) in December and sets us up for a need for the resolution of these narratives one way or another as we head into 2023.

As 2022 progressed, the expectation for S&P 500 earnings had fallen from a high of almost $250 per share to, currently around $225 per share (blue line in the next chart), which would be an increase of 12.5% from the



roughly $200 per share in 2022. For some (the bear camp), $225 is considered optimistic given the possibility of a recession in 2023. For the more optimistic, it is achievable given that even in a recession, nominal GDP growth will still be firmly positive (Nominal GDP growth = Real GDP growth + inflation). Therefore, for many corporations, given sales growth is in nominal terms and given positive operating and financial leverage (even as interest rates have normalized), $225 is a possibility. At current levels of the S&P 500, the implied forward PE ratio, based on $225 of earnings, is (3839/225) 17 times (red line).

Bottom line? If inflation stops moderating in the coming months or the US economy does in fact slow sharply, then current valuations of the equity market will be vulnerable and equity markets could test or take out the lows experienced in 2022 which is 10% below current levels. On the other hand, if inflation moderates further and the Fed is given the luxury of taking its foot of the monetary break, setting the stage for economic resurgence, these are not particularly pricey equity levels with a medium-term investment horizon in mind.

The above 'top-down' analysis looks at the equity market as a whole and on average, but as our own proprietary models show, individual equities are showing very different current values and therefore prospective risk adjusted returns. Intra sector, for example, take two semiconductor manufacturers: QUALCOMM, trades at a 10x PE whereas Nvidia, trades at 33x PE. Buying one vs the other involves a complex decision, based on their respective business prospects, but for the astute stock picker a competitive advantage may exist in how this choice is analyzed and executed. The same differences exist inter-sector like say Software vs Pharmaceuticals.

Until this year, over the last decade, the stock and sector analysis and allocation decision, to equities and bonds,

has been overshadowed by an environment of very low interest rates and the so called Fed Put: that is the luxury the low inflation environment gave to the Fed, in that the moment asset prices came under pressure, the Fed would lower interest rates to stave off the effect that a negative wealth effect would have on economic growth. The Fed did not have to fear that they may cause inflation to rise.

The more aggressive investors, with increasing intensity, ignored valuations, chose assets with the longest duration and leveraged up as much as possible. 2023 was the year of reckoning for these investors: Rivian Automotive (EV Manufacturer) down 82%; Snap Inc. (Internet Content and Information) -81%; Shopify (Software) -75%; Zoom Communications (Telecom Services) -63% and many more. All these companies (and there are hundreds of them) still have valuations well in excess of $10bn, so you get an idea of the wealth destruction in 2022.

The point here is that there has been a fundamental change in the investment landscape: whereas in the last 10 years an inferior balance sheet (assets vs liabilities; cash on hand) and no profitability or free cash flow was ignored in favor of so-called promise-of-growth. This can no longer be the case in a normalized interest rate environment. And that is why companies that have high quality balance sheets and good free cash flow (to finance dividends, share buybacks and research and development) have prevailed in 2023: Merck (Drug Manufacturer) up 50%; Northrop Grumman (Aerospace and Defense) +44%; Archer-Daniels (Farm Products) +38%; The Travelers (Insurance) +19%.

There is a third group of companies that have, as is inevitable, succumbed to general market pressure, but fit into the category of solid balance sheets and solid free cash flow. That pay dividends and/or buy back stock and give investors time to wait for the balance of economic growth and inflation to be restored and for a better investment environment to materialize Target Corp; Ford Motor; Charter Communications; Intel Corp; Verizon; 3m Co; CVS; DOW Inc; Goldman Sachs; Pfizer Inc; PayPal Holdings and AP Moller – Maersk to mention some. And various domestic and international funds that invest in stocks with these profiles: S&P 500 Value; Australian Equities; Euro stocks. There are special situations like gold, uranium, certain preferred stocks, high yield bonds all providing opportunities for growth and income that this bear market has promulgated.

Where We Stand

As strategized, we have treated 2022 as an opportunity to rebuild our portfolios with the next investment cycle in mind. In the process our portfolios have had no more than single digit declines this year and are well positioned to enjoy better times ahead.

We eschewed over-valued securities coming into the year and had high amounts of cash which we have now effectively deployed. With some cash in reserve should we find more buying opportunities if the bear market intensifies. We have completely avoided any existential issues that have resulted in a devastating outcome from which there is no recovery. Many have not in 2022.

All our portfolios are now generating higher levels of income and all our investments fit the mould of solid balance sheet and healthy free cash flows. Our portfolios are highly diversified so any existential risk to them is effectively non-existent. And even if intense recession ensues, the income generation of the portfolios will remain unthreatened given the high quality of the underlying investments. We have staying power to wait out the inevitable time when our portfolios enjoy capital appreciation in addition to the income they generate.