The Long Run

INVESTMENT LETTER
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REYNDERS, MCVEIGH CAPITAL MANAGEMENT, LLC

"You sometimes need to be in dire straits to find out who is loyal to you."
—Jeffrey Fry

Since the onset of COVID-19 , it has been hard to know what normal really is in the world, let alone in the financial markets. By locking down the U.S. economy in 2020, the government intentionally created a recession—which they then helped alleviate by lowering interest rates to zero and issuing $6 trillion in free money for individuals and businesses. Stocks responded by surging to their second best three-year results ever from 2019–2021. In 2022, the Federal Reserve raised interest rates at their fastest rate ever to counter inflation, which was at least partially created by the free money giveaway. Stocks then entered a bear market on fears that we will be entering yet another recession.

Speculative holdings were hit particularly hard, but even the static, conservative portfolio advice of 60% stocks and 40% bonds failed badly. According to Santa Clara University Professor Edward McQuarrie, last year's returns for a 60/40 portfolio were the fourth worst in any 12-month period since 1792. Though the S&P 500 rallied 7.56% in the fourth quarter to finish ahead of where it was at mid-year, it still declined by 18.11% for the year. According to Morningstar, the 60/40 diversified portfolio was down about 20%. (NOTE: We tailor portfolios for individual client needs, so a 60/40 allocation is not meant to be representative of your returns, but indicative of how traditional advice did last year.)

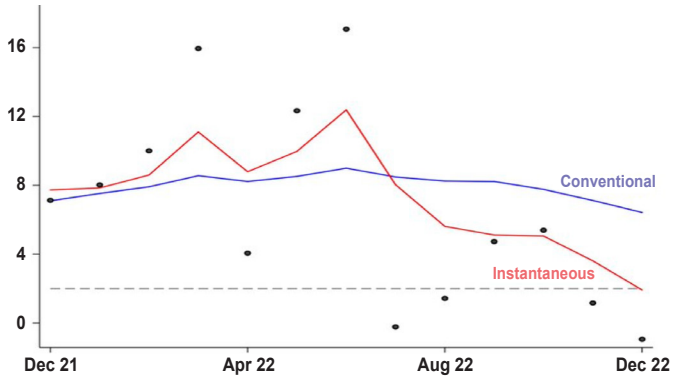
So, where do we go from here? While the past four years have been very positive for stocks, 2022 results have left many feeling they are stuck in dire straits. We lose sight that 2019–2021 was as abnormal as 2022, though for opposite reasons. While the risk of a recession, threats of a government shutdown, and the continuing war between Russia and Ukraine are not to be dismissed, we also see financial markets that are moving closer to normality—where capital has a cost and speculation is not an investment strategy. We believe that our discipline of valuing quality companies based on interest rates and earnings will continue to prove successful over market cycles—and that companies with strong balance sheets and progressive managements will have distinct advantages in the new investment landscape ahead.

MONEY FOR NOTHING

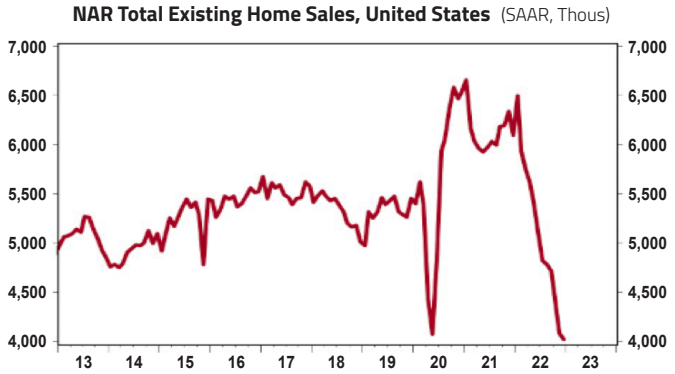
While the Federal Reserve's interest rate policy over the past several years has resulted in extreme moves, you can almost hear the refrain "That's the way you do it" echoing from the halls of Washington, D.C. Exaggerated monetary and fiscal policies have succeeded in achieving their desired results. We did escape the COVID-19 recession with people in much stronger financial shape than is typical post-recession. But free money was not without a cost. It brought about inflation. It encouraged speculation in financial assets. And it created a bubble in home prices.

As quickly as we had instituted an economic program of 0% interest rates—and the fastest monetary growth rate in history—the past year witnessed the most aggressive interest rate hikes in history, and the slowest monetary growth. While there is still debate over how much higher the Federal Reserve will raise rates, it appears to have already achieved its primary intention of reducing inflation and asset bubbles, though again with some side effects.

Although conventional CPI inflation has been at a worrisome level of 6.4% over the past 12 months, the following chart from economist Jason Furman illustrates how instantaneous inflation has been decelerating quickly. Six-month inflation is at 1.9%, three-month at 1.8%, and the most recent month at -0.9%.



Asset bubbles have also popped over the previous years and few, if any, remain. While one could argue that it is possible for a speculative asset like Bitcoin to fall further to approach $0, it did decline by 65% last year. Also, the housing market could continue to weaken. But rising mortgage rates have led to existing home sales falling for 11 consecutive months, ending the year at their lowest level in over a decade.



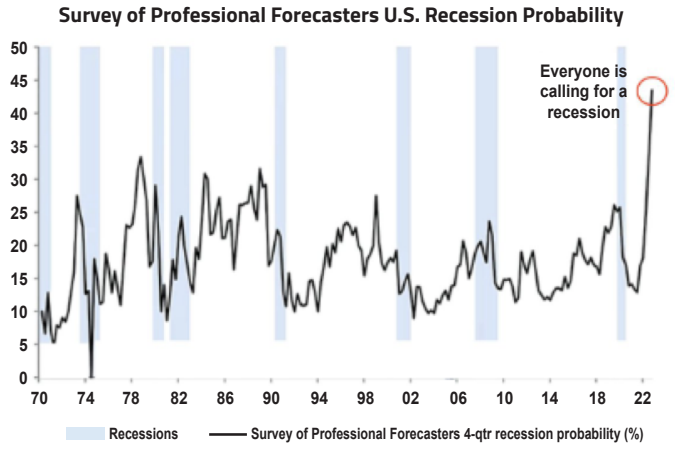
Source: National Association of Realtors/Haver Analytics

Rising interest rates have created this year's concern—will we have a recession?

INDUSTRIAL DISEASE

In an economy loaded with debt, higher interest rates can quickly turn growth into recession. We are seeing that in the housing market and also seeing it in many other sectors. Leading economic indicators have now declined for 10 months in a row and are pointing to a decline in growth. The yield curve has been negative since July and persistent inversion has always led to a recession. Nearly 40% of banks are tightening lending standards, which is a level that generally indicates a slowdown. New manufacturing orders have also turned negative.

If this is handwriting on the wall, it is a script that is increasingly obvious. Warning lights are flashing with professional forecasters, who have never been so certain about the likelihood of an imminent recession.



Source: J.P. Morgan

It is highly likely that the Federal Reserve is looking at the same economic indicators as these professional forecasters, and will begin to curtail their aggressive interest rate hikes. While we are expecting corporations to report lower earnings in the first half of the year, we do understand that these comparisons are versus a period last year when the monetary and economic backdrops were abnormally good. We believe, as the year unfolds, we will be on a path to more normal interest rates and inflation. In this environment, financially strong, high-quality investments should find their footing.

BROTHERS IN ARMS

Within this uncertain environment, we understand that it is easy to become fatalistic about the future of the planet. We would like to close by pointing out a few pieces of good news that illustrate the importance of people working together to make positive change—as well as create long-term investment opportunities.

In a just-released report, the United Nations Environment Program and the World Meteorological Organization found a significant thickening of the ozone layer. Ozone-damaging chlorine declined 11.5% since its peak in 2007, due to the ban on CFCs. Continuing shifts to more environmentally friendly refrigerants, particularly in air conditioners, is seen as the biggest way we can impact climate change. In Europe, during 2022, natural gas usage dropped between 21% and 35%, depending on the country, while solar generation capacity was up 47%. The demand for renewable energy continues to grow. And adoption of electric vehicles is reaching a tipping point. According to the International Energy Agency, emissions-free cars and trucks will likely account for 13% of all new auto sales globally in 2022, up from just 4% two years ago. Electric vehicle sales reached 18% of sales in California, 19% in China, and 20% in Europe (when counting plug-in hybrids). And, in Germany, there were actually more electric vehicles sold in December than conventional cars.

We will continue to look for opportunities to grow your assets and benefit the planet in the year ahead. Please let us know if you have any questions, or would like to discuss your goals in light of world events. RM

Sources:
https://www.winthroppartners.com/what-happened-to-your-60-40-portfolio-in-2022/
Brothers in Arms section:
Information on the ozone hole came from the WSJ, 1/9/2023 "Earth's Ozone Layer Recovers as Airborne Chemicals Decline"
Data on gas usage dropping in Europe and solar increasing came from a Green Alpha Advisors blog post, 1/3/2023, "The Long View: Past Informs Future"
Data on EV sales came from January 17, 2023 WSJ article "EVs Climb to 10% of New Cars Sold"