

Client Letter – January 27th, 2023

Living to Fight Another Day

This past year was a very difficult one for both equity and fixed income investors. The S&P 500 declined 18%, while the Bloomberg Aggregate Bond Index declined 13.1%, which made it the worst year for bonds since they formed and began tracking the index in 1977. The classically moderate risk 60/40 stock-bond portfolio, which mirrors our most common client portfolio allocation, declined 16% in 2022 for its worst year since 2008's similarly putrid 21% decline.¹

It should be noted however that these two skunks took very different paths on their way to the garden party: in 2008 the S&P 500 was down 37% while bonds delivered a 5% gain on the year. That stability in our bond portfolio in 2008 while stock prices collapsed allowed us to rebalance client portfolios towards stocks, which set the stage for what was probably our best year ever in 2009 on a risk adjusted return basis. Conversely, our discipline forced us in 2022 to hunker down in short-term treasuries and take our lumps, as the Federal Reserve's Zero Rate Policy (ZIRP) had distorted our client portfolios nearly as badly as it warped the real estate market. It is impossible for me to know with certainty what's in store for the remainder of this calendar year, but with ZIRP now in the rearview mirror I find myself enjoying getting back to re-balancing basics.

One Door Closes, Another Opens

The main culprit of carnage in the financial markets in 2022 was persistently high inflation that forced the Federal Reserve to engage in aggressive interest rate hikes.² So where are we now in terms of the "healing process" of curbing inflation? The Fed Funds rate currently sits at 4.5%. Inflation as measured by the Consumer Price Index (CPI) came in at 6.5% y/y in December '22 (-0.1% m/m) while Core CPI (ex food and energy prices) was at 5.7% (+0.3% m/m). While this indicates that inflation has peaked and progress has been made in the fight to bring CPI back to the Fed's stated goal of 2%, the job is likely not yet done; each Fed tightening cycle of the past 50 years did not end until the Fed Funds rate was above the rate of inflation³ and we are not there yet.

To be fair, the Fed's rate increases have already depressed the prices of many goods, which is showing up as weakness in the markets for housing, autos, and all manner of "stuff", and that's a good thing. But the stickiest aspect of our current bout of inflation is wages, and with the unemployment rate sitting stubbornly at 3.5% and job openings remaining elevated at 10.5 million we have yet to turn the corner on that key driver of inflation. Bullish investors hope that the Fed can bring the labor market into balance by destroying

¹ "Don't Give up on the 60/40 Portfolio" – *Barron's* (January 10th, 2023)

² Generically speaking, both stocks and bonds respond negatively to increases in interest rates

³ Strategas Q\$ Market Update (January 6th, 2023)

job openings while not causing a spike in unemployment, but I for one doubt they can because the problems for the US labor market are structural and unlikely to respond to interest rates. One must also be mindful of the broad consensus in the post-pandemic era that the US needs to onshore large portions of its supply chains, especially in areas such as semiconductor chips, pharmaceuticals and other key economic inputs deemed essential from a national security perspective. While I think this makes good strategic sense and agree that it should be implemented as a policy, it is also inflationary: US producers didn't shift manufacturing & supply chains to China as a favor to the Chinese, but because the region's low-cost labor lowered the prices of goods for consumers and boosted profits for corporations. The reversal of this multi-decade offshoring trend is likely to have the opposite effect. I hope that I am missing something and will therefore be proven wrong, but I think we should prepare ourselves for a multiyear battle with inflation.

In closing, I have very little confidence that the S&P 500 will enjoy one of its more typical years in 2023, in which it might gain 10%.⁴ With inflation not yet kicked, and the Fed Funds rate likely to remain higher for longer, investors should be prepared for a potentially tough slog. However, it's certainly possible that much of the "hard work" has already been done to curb excesses in financial markets & the economy, and we should not expect the stock market to test new lows. Furthermore, while I enter this year with modest expectations for equities, I'm more positively disposed toward bonds than I have been in some time. The return of meaningful both nominal & real⁵ interest rates on investment grade fixed income securities has returned bonds to their traditional role as a source of income generation and portfolio stability, an element sorely lacking in recent years.

On behalf of myself and our team, we look forward to catching up with you all as the year progresses.

Adam Hamilton, on behalf of the Hamilton Group

⁴ "Over the past twenty years (2001-2021), the average annualized return on the S&P 500 is 9.87" – Investopedia, 8/16/22

⁵ Real interest rate = nominal interest rate – rate of inflation
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