Fight or Flight? – October 15th, 2022

"You don't have to run faster than the bear to get away. You just have to run faster than the guy next to you."

It has not been a great year for the stock market. Or the bond market. Or the market for digital ape art. If 2021 was the "There Is No Alternative" market for stocks, 2022 is the "There Is Nowhere to Hide" market for everything… So what exactly is going on?

We had been living in a world of low interest rates on sovereign bonds[1] for over a decade, when in March of 2020 things got very strange. COVID lockdowns of the US economy led to a zero-rate policy that the Federal Reserve kept in place for the next two years. Congress shoved trillions of dollars in stimulus spending out the door and into Americans' checking accounts. This permissive monetary and fiscal environment drove stock valuations to elevated levels around 25x S&P 500 earnings that made many "traditionally minded" investors nervous. I would have sold stocks aggressively for myself and clients in late 2021 if bonds offered rates of return in line with post WWII averages, but so long as rates were 0% it made good sense to follow the investing maxim of "Don't Fight the Fed" and skew towards stocks[2].

The Fed maintained the zero-rate policy throughout 2021 despite surprisingly high levels of inflation that began to appear early last year, as they believed the elevated CPI readings were "transitory". While this view was not universally shared, it was nevertheless defensible given the pervasive global supply chain snarls and altered consumption patterns of 2020 & 2021 which saw American consumers switch en masse from spending primarily on services and experiences to physical goods for their homes – or second homes. But from that point forward the Fed's actions got far less defensible.

Take real estate, for example. Anyone paying attention in late 2021 knew that home prices were exploding. Low mortgage interest rates support higher residential real estate prices, so one might have reasonably presumed that Fed officials would have allowed rates to RISE, in order to cool off an increasingly overheated housing market. And yet, perversely, the Fed was *purchasing* mortgage-backed bonds to the tune of $30 billion monthly and continued doing so as recently as March '22. This form of "quantitative easing" acts to keep mortgage rates low and stimulate housing prices, which made some sense coming out of the 2008 housing collapse, but seems like a borderline insane thing to have been doing in early 2022, a time of skyrocketing home prices nationwide.

In short, Fed officials maintained the stimulative zero-rate and quantitative easing policies for at least 6-12 months longer than it should have. This was "great" if you owned stocks, real estate, fine art, imaginary crypto currency, etc. But we are now in the process of ringing these excesses out of the system, and that process is painful. The period following the crash of internet stocks in 2000 was not unlike this current environment, and back then it took a little over 2 years for the market to bottom. The Bear market resulting from the '08 Financial Crisis took 18 months to resolve itself. We

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[1] European and Japanese government bonds had negative yields for long stretches of time in the years following the 2008 Financial Crisis

[2] Fed officials were forecasting precisely ZERO fed funds rate increases at this time last year

are only 9 months into the current downturn, and while there is no telling precisely how long this "reset" will last, it is my opinion that we need to be patient and ride this out a bit longer.

What am I basing this on? Inflation and interest rates. There are no historical examples of which I am aware that saw a central bank tame inflation without raising short-term interest rates above the rate of inflation, and then pausing there for a bit to let the effects of higher rates work through the system. Where are we in that process? Short-term rates are currently 3.25% and inflation has been running around 8.5% - 9%, so I think we potentially have a way to go on rate increases, and stocks are very unlikely to outperform short-term bonds while the Fed is raising rates. It is for this reason that I have been loading you all up with 3 month > 2 year Treasuries since Q1 of this year.

While we are normally "bottom up" investors who look at the fundamentals of individual companies when making equity purchase & sale decisions, we are also quite mindful of the fact that the Fed holds the majority of the cards here. The preponderance of our clients remain at if not slightly above their long-term targets for equity exposure, due to the relatively unattractive arithmetic in 2020-2021 of selling stocks to buy bonds that yield less than 1%. But short-term Treasuries now yield 3.5 % - 4.5% and I am quite content to "park" client funds there for the time being. This marginal conservatism will likely end when stocks are 10% or more lower than they are today, and/or when inflation in the economy has been tamed. I don't know precisely when that will be, but we will get paid while we wait to find out.

Some of you may be feeling blue, reading this letter, but I want to point out that here are Silver Linings in this environment. Lower entry points for stocks and bonds improve prospective forward returns. You can see this most clearly with bonds: since 2020 yields on Vanguard Short-Term Treasury and Corporate ETFs (VGSH &VCSH ~ representative of our core bond holdings) have risen from 0.25% and 0.5% to 4.3% and 5%, respectively. Bonds have been an important component of our typical portfolio for decades, and they are now attractive as an asset class relative to alternatives for the first time in 15 years.

For those in the drawdown phase of life who need to liquidate stocks periodically to fund their cashflow needs in retirement, during the 2000 – 2002 Bear Market the NASDAQ experienced 8 rallies that lasted an average of 33 days and returned 26%. We have had two such significant rallies this year, and there will likely be more to come for those of you who need to sell stocks, assuming historical patterns repeat themselves.

In closing, more than a decade of artificially low rates had distorted asset markets to such a degree in early 2022 that the 40% - 50% bond & cash weightings that we have historically relied upon to blunt equity losses and smooth overall results did no such thing this time.[3] For this reason, I would encourage clients to measure the health of where their portfolios stand against where they stood on January 1st of 2020 – not the 1st of 2022. While this may sound like a convenient misdirect from a portfolio manager during a Bear Market, I honestly believe it's the most logical way to judge your portfolio in light of the unprecedented two & a half years we've just been through.

The path to recovery starts with admitting you have a problem, and I hope we're on our way.

[3] the Bloomberg Aggregate Bond Index has declined 16% in 2022, ytd