Highs and Lows – January 2023

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Introduction

Happy New Year! I hope everyone had a wonderful holiday season and wish everyone a healthy and prosperous 2023. Feel free to share with anyone whom you may feel interested. Please e-mail or call with any feedback or questions.

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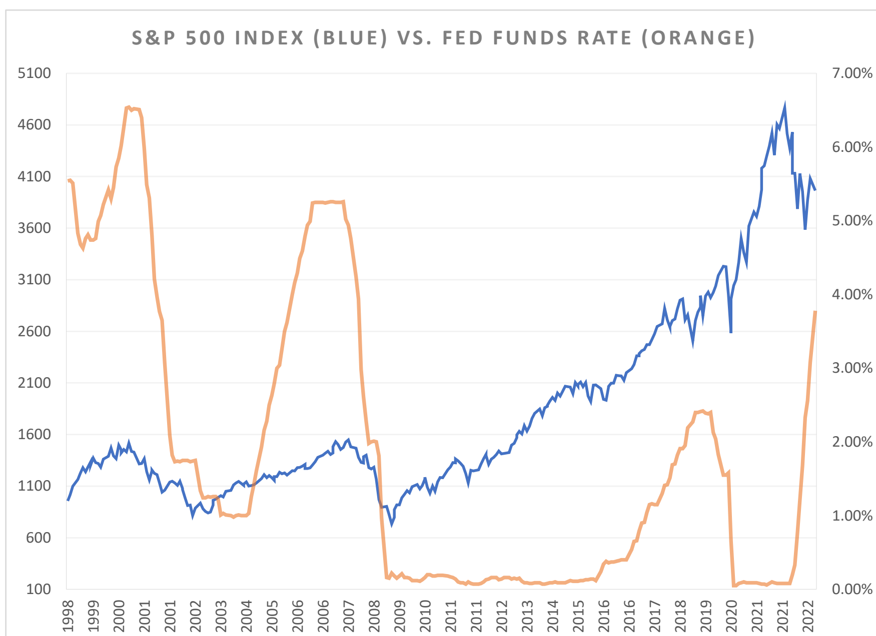
Are We There Yet? The Outlook for 2023

With inflation peaking, or possibly having peaked, the Federal Open Market Committee (FOMC) looks set to have rates top out around 5% -- slightly higher than our previous forecast of 4.5%. A soft form of forward guidance indicates that the FOMC intends to keep policy rates around that level until sustained improvements are shown in both realized and expected measures of inflation. This guidance should continue to keep the interest rate curve broadly inverted with short rates remaining stubbornly high absent an economic slowdown or financial crisis that sufficiently elevates the unemployment rate to replace inflationary concerns. As monetary policy typically operates with a lag, investors are left to ponder whether the worst is indeed behind us in terms of economic, equity and bond market performance.

Inflation does indeed look to have peaked. Commodity prices have subsided while measures of money supply growth have turned negative. Policy changes by the FOMC and other central banks have been at least initially successful in reducing the supply/demand imbalance by reducing the demand side of the equation. While we expect inflation to remain stubbornly elevated, the improvements to inflation dynamics should allow the FOMC to refrain from substantial further increases in policy rates. As such, we remain positive on the prospects for longer dated fixed income barring concerns percolating regarding debt sustainability.



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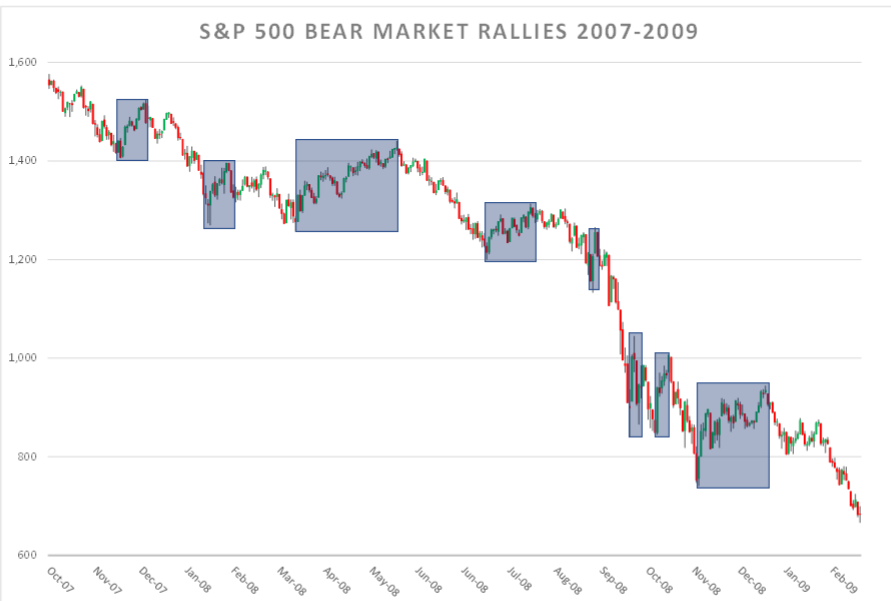
Our bond exposure has taken a more laddered approach due to potential fiscal concerns and the likelihood that next eventual leg of the bond market curve evolution is steepening. Additionally, we like the idea of having some of our fixed income portfolio maturing in the shorter term allowing us to potentially reallocate into higher equity weightings. We are underweight credit, however -- particularly high yield and leveraged loans. The credit spread on offer does not sufficiently compensate investors for the increased risk of default embedded in credit sensitive bonds. We join the voices against easing policy too soon in response to positive inflation developments, however. History has shown that declaring victory prematurely can have dire consequence for future inflation developments. If you come for the king, you best not miss.



The equity market currently appears to be thrilled by the idea that lower rates in the future will once again turbocharge asset price growth. However, I caution that lower rates in prior cycles have not been so kind to equity prices especially once an investor considers the still very high valuations relative to history in the market. Valuations have improved somewhat, but not to a degree that the value-minded investor would consider attractive. Indeed, falling policy rates have been typically a negative omen for equity prices. Logically, this makes sense as looser policy is usually employed to fight of an impending recession. As rates fall, so do expectations for future earnings, the latter of which swamp the benefit of higher discounted values for those earnings and therefore act to depress equity prices. While it is imprudent to reduce equity allocations to

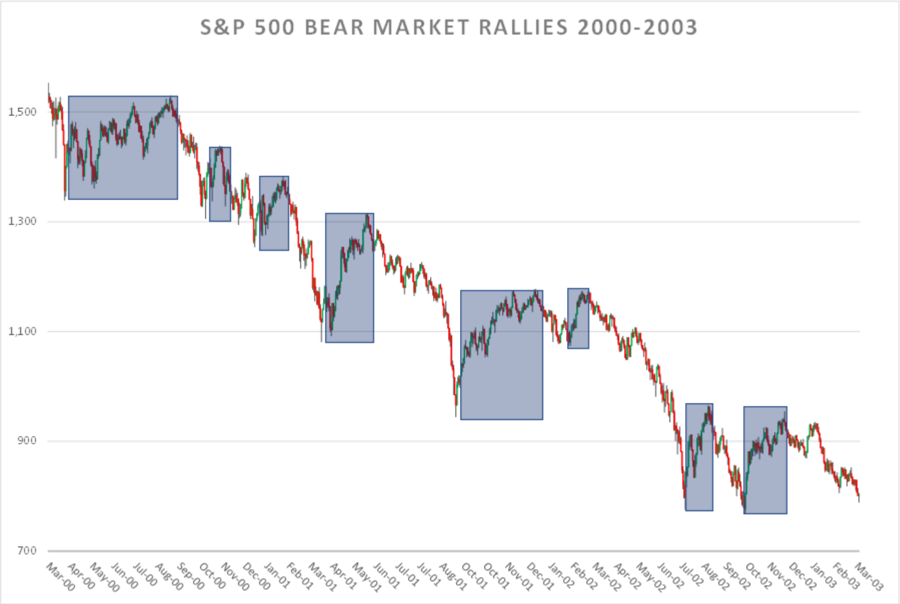
Why Are Bank Deposit Rates So Low?

Inflation is running hot and the FOMC has been raising interest rates – so why are bank deposits rates still so low? The simple answer is that your bank does not want your cash deposits and is purposely trying to make them unattractive.

Oversimplified, banks make money by leveraging short term deposits to make riskier longer-term loans at higher interest rates. With the banking system flush with cash deposits, banks simply cannot make enough prudent loans to take advantage of all the deposits they are holding.

Instead of holding excess cash in your bank account, consider investing it in short-term, risk-free bonds earning higher interest rates. These offer higher rates than most CDs as CDs are just another form of bank deposit. Inflation is already eroding your hard-earned savings, do not let low bank deposit rates make the situation worse.

zero, we have focused our exposures on sectors and companies whose valuations are more reasonable compared to their future earnings potential. Avoiding the markets worst sins has been a consistently effective way to avoid large drawdowns.



In general, our analysis of the equity market indicates an ongoing transition in regimes from inflationary concern to recessionary concern. Where during the inflationary concern regime, lower potential policy rates would indicate positive news for equities, the new recessionary regime will instead indicate that lower potential policy rates are once again negative news. If our analysis is correct, the recent market behavior would be nothing more than yet another bear market rally. A bear market rally is a powerful rally against the bearish trend. Often very convincing, the rallies seem to indicate the worst is over pulling investors back into the market only to be met with disappointment. Our experience as investors has taught us that the best rallies are those met with disbelief, not those met with excitement.

Nevertheless, we should not discount the potential of a soft landing. The roadmap to a soft landing follows the reasoning that higher costs of capital reduce employment in the most speculative areas of the economy but other sectors can absorb the losses preventing employment from deteriorating. Meanwhile, inflationary factors subside and inflation falls back to target promptly allowing the FOMC to ease interest rates moderately. Housing, buoyed by low supply and high home equity, does not materially falter and starts to rebound once interest rates fall. Forward earnings estimates rise amongst the analyst communities which then leads to a durable equity market recovery. While we think the path to this outcome is narrow and unlikely, it is certainly not impossible. Our role is not to predict the future but be prepared to act based on the future that arrives. As such, we continue to monitor for clues that the soft-landing outcome will prevail and are ready to act accordingly with changes to our portfolio.

As always, I'd like to thank all of our clients and wish everyone a happy, healthy and prosperous 2023.

Steven Segarra, CFA

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