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INVESTMENT ADVISORS

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INVESTMENT REVIEW AND OUTLOOK

The Weight of Gravity

The third quarter began on an encouraging note: the Consumer Price Index (CPI) report for June came in below consensus expectations, interest rates were broadly stable for the months of June and July, and the economic news was generally positive during the summer. The stock market, as measured by the S&P 500 Index, rallied over 12% from mid-June to mid-August. Thereafter, the force of gravity exerted itself in the form of a higher CPI report for the month of August, hawkish remarks from Federal Reserve Chairman Powell, and a significant increase in short-term interest rates (the yield on the 2-year U.S. Treasury Bond rose from 2.8% in late July to over 4% on September 30). As the quarter progressed, the impact of these developments began to take a toll on the earnings results in different segments of the economy, including the automotive, housing and retail sectors.

The cumulative effect of higher interest rates, an elevated CPI, and corporate earnings disappointments weighed on stock prices in the second half of the quarter, and the S&P 500 gave up its early gains and then some, finishing the quarter with a total return of -4.9%. Due to the sharp increase in interest rates, bond prices fared equally poorly, and the Bloomberg Aggregate Bond Index had a return of -4.7%. The occurrence of negative returns for both stocks *and* bonds in a quarter is relatively rare, and having three consecutive quarters of negative returns for both assets, as we have just experienced, is extremely rare, having never happened over the last 45 years, according to Strategas Research.

Some Consequential Developments

The recent quarter was an eventful one and served to highlight some important developments that deserve further discussion. The rise in interest rates has been well covered in the media and in our recent letters. However, it is worth emphasizing the nearly unprecedented pace at which rates have increased. For example, the 2-year U.S. Treasury note, which today yields 4.3%, had a yield of 0.15% as recently as May of 2021. The reasons for the steep increase are several-fold. The end of ultra-easy monetary policies by U.S. and foreign central banks is a prominent cause; however, the increase in inflationary pressures during 2021 precipitated a rise in interest rates in advance of central bank tightening, which commenced earlier this year. Additional pressure on interest rates arose from corporate and individual borrowing.

Recent data from the housing and automobile sectors indicate that higher interest rates are having an impact on consumer demand: the index of mortgage applications for the month of September declined

29% from the prior year, while automobile sales for September declined by 2.8% from the previous month.

While higher interest rates are beginning to have an impact on economic activity, we need to be aware of the broader impact of higher rates. Recent reports from the United Kingdom indicate difficulties in the U.K. pension sector as a result of derivative contracts impacted by the rapid increase in interest rates. Another area of concern is the cost of borrowing for the U.S. government. As referenced above, borrowing costs for the U.S. Treasury have been extremely low in recent years. During the peak of the COVID pandemic in 2020, the yield on 10-year Treasury bonds reached a low of 0.57%; in contrast, today's yield is over 3.7%. To place this increase in perspective, the total outstanding U.S. government debt is currently estimated at $24 trillion. A 1% increase in borrowing costs on federal debt translates into an additional annual expenditure of $240 billion.

Another development has been the strength of the U.S. dollar. Since the beginning of 2022 the dollar has appreciated over 25% against the Japanese yen and over 13% against the euro. Many factors drive the relative value of currencies, but in the current environment monetary policies play a prominent role. In the case of the United States versus our major trading partners, U.S. monetary policy has accelerated at a faster pace, and this has been reflected in interest rates, which are generally higher in the U.S. than in Europe or Japan. The strong dollar benefits U.S. consumers as the price of imported goods is lower when translated into dollars. However, similar to the rise in interest rates, the rapid appreciation of the dollar poses challenges to the global economy and there are a number of implications. For example, the price of crude oil is priced in dollars and so non-U.S. buyers are paying an additional premium against the backdrop of already elevated energy prices. The stronger dollar also disadvantages our trading partners as sales in dollars translate into lower revenues in local currencies. The same is true for U.S. multinational corporations with significant operations overseas, and a similar dynamic operates for the debt obligations of foreign borrowers whose loans are based in dollars.

In recent years we have used the phrase "geopolitical tensions" to describe a variety of developments ranging from trade barriers to low-intensity conflicts (such as those that occurred in Syria and North Africa), cyber-attacks, and the increased military activity in the South China Sea. The Russian invasion of Ukraine, and China's recent actions around Taiwan have re-cast the dynamic of these tensions into actual or near conflict and this is an important change from the recent past.

The World is Changing

The world is continuously evolving. However, it is human nature to sometimes lose perspective on the pace of change. As an example, little more than a decade has passed since the introduction of the smart phone, yet almost every aspect of our lives has been transformed by this device, which has only recently been widely adopted. We wish to highlight several ongoing changes that are likely to impact our investment positioning in the months and years ahead.

We have often written about the global monetary policies that have been largely in place since the financial crisis of 2008-2009. In Europe, Japan, and the United States, central banks have, by and large, kept benchmark interest rates low while also conducting significant open market purchases of government and mortgage securities. The recent actions of the U.S. and European central banks have made it very clear that the era of "cheap money" has ended. While the full implications of this policy change will only be known in the fullness of time, investment and business decisions that are reliant upon very low interest rates are likely to be challenged as interest rates begin to normalize.

Similar to the pattern of contemporary monetary policies, the fiscal policies of developed countries have been less restrained in recent years. This pattern began in the wake of the 2008-2009 financial crisis, continued with the eurozone debt crisis last decade, and culminated with extraordinary budget deficits during the COVID pandemic. Years of deficit spending, and the accompanying borrowing, have increased the level of sovereign debt to gross domestic product (GDP) to near or above 100% for many developed economies, including the United States. For perspective, the U.S. public debt to GDP ratio has risen from 54% at year-end 2000 to 121% in the second quarter of this year, according to the St. Louis Fed. The trends in Europe and Japan are similar. The near-term impact of these higher debt levels has been muted by the low cost of borrowing. Looking into the future, the financing burden is likely to grow and, at a minimum, will limit the budget flexibility of sovereign governments in developed regions. The recent market response to the proposed budget in the United Kingdom may be a harbinger.

As discussed earlier, simmering global tensions have evolved into a very real conflict in Europe. In Asia, the tempo of China's air and naval activities has increased in tandem with the government's rhetoric over Taiwan. While we do not know the future course of events, one conclusion can be reached: the lull in great power competition that characterized the post-Cold War period is over. The implications of this development are wide-ranging and will affect global trade, immigration and, importantly, the government spending priorities of many of our Western and Asian allies.

In summary, the economic and geopolitical conditions for the decade ahead are likely to be markedly different from those of the recent past, and we are taking steps to adapt our client portfolios to these emerging conditions.

The Path Forward

As we consider investment opportunities in the current setting, flexibility in thinking is paramount. It is rare for the stock market leaders of one decade to maintain that position in the following decade. For example, the early leaders of the Internet era (America Online, Yahoo and Sun Microsystems) were spectacular performers in the period 1990-2000. However, a combination of intense competition, technological change and over-valuation created very difficult conditions for these companies in the following decade. We bear this phenomenon in mind as we position our clients' portfolios; over the last 18 months, we have trimmed a number of strong performing names that experienced a deterioration in fundamentals and/or were trading at excessive valuations.

Our stock selection strategy continues to emphasize cash-generating businesses trading at reasonable valuations with particular emphasis on companies that can achieve resilient earnings growth in a more challenging economic environment. In fixed income, the picture has changed significantly over the past year, and we now find opportunities in shorter maturity U.S. Treasury securities yielding in excess of 4%. Given the more challenging economic and geopolitical environments, our cash levels are above average, and we are maintaining a position in the iShares Gold ETF for our balanced accounts.

As always, we welcome your comments and questions.