April 2023

INVESTMENT REVIEW AND OUTLOOK

Rebalance

If the year 2022 represented a reversal of many of the prior decade's trends, the first quarter of 2023 served to rebalance valuations from the levels reached last year. The S&P 500 posted a total return of 7.5% in the quarter, and growth stocks rebounded, with the Citigroup Growth Index returning 9.6%. In contrast, the Citigroup Value Index returned 5.2%. Bond prices also gained. The Bloomberg Aggregate Bond Index had a total return of 3.0%.

The economic news in the quarter was generally constructive. The economy remained essentially at full employment, and the unemployment rate stood at 3.5% on March 31. Inflation, while still above the levels of the last few years, has begun to show month-to-month moderation. According to the Federal Reserve Bank of Atlanta, real U.S. GDP growth is forecasted to be 1.5% in the first quarter. However, we are watching some developments that serve as cautionary signs for the economy. The effect of higher interest rates continues to work through the economy and is having a dampening effect on consumers and businesses alike. According to data from the Commerce Department, real consumer spending moderated in the first quarter, and according to the Institute for Supply Management, factory activity slowed during the same period.

Following a difficult year in 2022, the first quarter provided much-needed peace of mind for investors: interest rates stabilized, the economy grew modestly, and stock prices rebounded. However, many challenges remain, not the least of which is the ongoing adjustment to the more restrictive monetary policies of central banks and the accompanying increase in interest rates.

The Hangover

We have written frequently about the ultra-easy monetary policies of global central banks. These policies originated in response to the financial crisis of 2008–2009, were carried through the Euro debt crisis of 2015–2016, and then renewed during the COVID-19 pandemic from 2020–2022. For perspective, using the one-year Treasury Bill as a reference for short-term interest rates, the yield on this security was 1.4% at the start of the great financial crisis in 2008. Over the next 13 years, the yield ranged between 0.04% and 2.7%. In eight of the 13 years, the yield was less than 0.30%. Since the initiation of tighter monetary policies in late 2021, the increase in short-term interest rates has been dramatic; in mid-April, the yield on the one-year U.S. Treasury Bill rose to 4.7%.

The consequences of over a decade of ultra-easy monetary policy were many, and we have chronicled them in recent letters. These include stock market speculation in the form of "meme" stocks, inflated valuations for emerging growth companies, and the rise of crypto currencies. While many of these excesses were corrected during the stock market decline of 2022, the longer-term implications of

“easy money” are likely to be felt in the years to come. In essence, global central banks created an artificially low cost of capital for an extended period of time, which impacted borrowing costs for governments, businesses, and individuals. The rise in the inflation rate that began in 2021 is generally thought to be at least partially caused by the overly accommodative monetary policies of recent years.

Beyond the speculative excesses that have received fairly wide recognition, there are less-obvious effects that will only become apparent with the passage of time. For example, borrowing costs for the U.S. Treasury were at 1.6% during fiscal year 2021, and this cost is expected to rise to over 2.1% in the current fiscal year. With a current U.S. federal debt level of nearly $31 trillion, the impact of higher interest rates on the federal budget will be significant in the years ahead. The Congressional Budget Office estimates that the cost of service to U.S. federal debt will double in the coming decade, rising from $640 billion in 2023 to $1.4 trillion in 2033. In the private sector, low interest rates helped to facilitate a boom in venture capital and private equity investments. With the current subdued environment for initial public offerings (there were 181 IPOs in 2022, an 80% decline from 1,035 in 2021) and the higher financing costs for private equity investments, the impact of higher interest rates will likely become more pronounced in these sectors in the months and years ahead. Likewise, in the commercial real estate field, projects that were underwritten during the period when interest rates were extraordinarily low may face challenges if the associated debt needs to be refinanced in the current environment. This will be particularly relevant for projects that may face other challenges, such as reduced occupancy levels due to the rise in hybrid work.

We have recently witnessed the failure of several prominent regional banks. While there will likely be a myriad of postmortems on these failures, there is one inescapable fact: the recent dramatic increase in interest rates has led to a significant decline in the carrying value of government bond holdings across the financial sector. This development is another example of the unintended consequences of the rise and fall of ultra-easy monetary policies.

Given the long duration (2008–2021) of easy money policies by the U.S. and global central banks, it is unlikely that all of the unanticipated side effects have run their course. While we cannot predict the future, borrowing costs for both the public and private sectors are likely to be a focus of attention in the months and years ahead. Likewise, asset values that were previously supported by low borrowing costs may face additional scrutiny in the near future.

A Different Landscape

For the reasons discussed above, and due to the changing economic and geopolitical environment, the years ahead are likely to differ markedly from the decade just past. Notably, given the ongoing central bank policies, global interest rates are unlikely to return to the very low levels that have prevailed for much of the last decade.

One of the unintended consequences of ultra-easy monetary policies was an increase in the wealth gap between the top 1% and the rest of the population. With the increase in the value of public equities, due in part to the low level of interest rates, the top 1% of the U.S. population now owns a record 54% of individually held shares, according to data compiled by the Federal Reserve. While much media attention has been focused on wealth inequality, only recently have tax laws targeting top earners been enacted. During the 2022 election season, Massachusetts passed a referendum implementing a 4% surtax on incomes greater than $1 million. Similarly, Los Angeles voters passed a 4% “mansion tax” on the value of properties that sell for $5 million or more. Various other proposals targeting tax increases for high earners have been circulated at both the federal and state levels in recent years. With the federal

government continuing to record annual budget deficits in excess of $1 trillion, higher tax rates on high incomes appear to be a realistic possibility in the years ahead.

With more modest economic growth and a decline in stock and bond values in 2022, tax collections at both the state and federal levels are lagging behind those of the prior year. In the case of several large states, budget surpluses have quickly turned into deficits. In the state of California, for example, the current fiscal year budget was previously expected to be surplus; however, against the backdrop of declining tax receipts, the state is now projecting a deficit of $22 billion, according to the governor's office. The combination of higher government deficits and higher financing costs will make for some difficult decisions in the years ahead.

Vladimir Lenin was quoted as saying, "There are decades when nothing happens, and there are weeks when decades happen." The spirit of this quote seems appropriate for the current state of world affairs. In the last 18 months, we have witnessed a large land war in Ukraine and a newly assertive Chinese state. The many implications of the Russo-Ukrainian War will only be known in the fullness of time. However, the security situation in Europe has been altered significantly, as has Russia's relationship with the West. In the case of China, "the peaceful rise of China," which has been a catch phrase for much of the last two decades, is surely a subject of debate. China's close ties with Russia, its claim of sovereignty over the South China Sea, and its live-fire naval exercises in and around Taiwan all call into question what type of role the People's Republic will play in the coming decade.

An Evolving Story

In keeping with the changing economic and investment environments, our portfolios have evolved to take advantage of opportunities. Given the significant increase in interest rates, we have recently increased our holdings of U.S. Treasury bonds and high-quality corporate bonds. Given the changing global security picture, we are maintaining our longstanding weighting in the aerospace and defense sector. We are also maintaining a significant position in the healthcare industry due to its resiliency and attractive valuation. We are retaining a position in the Gold iShares as a hedge against inflation and geo-political risks.

As always, we welcome your comments and questions.