4Q 2022
Market Commentary

Newsflash: “*Free Money Is No Longer Free!”*

If there’s any one event or transition that highlights what happened to financial markets in 2022, the Federal Reserve Board’s abandonment of its zero interest rate policy (ZIRP) takes top billing. Starting in 2009, ZIRP held sway at the Fed through 2021, with the exception of the 2016-18 period. Obviously, having seen the Fed Funds rate hike from 0% in March of 2022 to near 4.50% today, one can easily say “Free Money” is gone – for good!

Despite the tumultuous market created in part by Fed actions, we are quite pleased with the way our client portfolios held up during 2022.

Fed Chairman Powell didn’t finally end the Fed’s ZIRP policy out of the blue. The jolt of rapidly rising price inflation proved the policies pursued under Modern Monetary Theory (MMT) did eventually unleash a wave of price inflation. We were not surprised by this result. Given that federal government spending ballooned during the pandemic, with neither political party willing to control it, all of the effort to contain price inflation fell on the Fed. We don’t think it will be easy to contain nor will it be easy to bring back down to the Fed’s 2% target. Our view is interest rates will stay “higher for longer” than financial markets desire or expect. Even if price inflation has peaked, getting it below the 3-4% range will be a struggle for the Fed and the 2% target will remain elusive.

Free money (in terms of low or negative interest rates) distorts capital markets and purchasing decisions. With a low cost of capital, even low return capital projects suddenly look attractive when they wouldn’t be sustainable at higher borrowing costs. Artificially suppressed interest rates also encourage speculation in all kinds of investments in financial securities, as investors look for places to earn income. Non-investment-grade or “junk” bonds with higher than Treasury yields attracted lots of capital, funding many a company with poor business models. Finally, low rates pushed up the price-to-earnings (P/E) ratio of the overall stock market to ultimately unsustainable levels.

Who benefited the most from this decade-plus experiment with ZIRP in the equity markets? Why, a wide range of “growth stocks”, of course, with particular focus on mega-cap information technology and media stocks sporting P/Es in the stratosphere, much like those in the late 1990s. But just as tech spending accelerated in the second half of the 1990s to solve the Y2K problem (shifting from 2-digit years to 4-digit years at the turn of the century), the pandemic pulled forward into 2020 and 2021 a significant amount of tech spending, subscription growth, and consumer durables purchases out of future years. We think the companies that ‘won’ the pandemic are also those most likely to have the toughest comparisons for fundamental growth. SKBA anticipated the inevitable disappointment and slowdown. The combination of falling P/E ratios for the most highly-valued stocks along with falling earnings and growth estimates created the impetus for the plunge in the market for such stocks. We do not believe we have yet reached the end of this process.

The loss of wealth in 2022 was monumental, amounting to trillions of dollars. At the end of 2021, the largest securities in the Russell 1000 Growth Index were Apple, Microsoft, Amazon, Alphabet, Tesla, and Meta, in that order. The 2022 returns for each were approximately -26%, -28%, -50%, -40%, -65%, and -65%, respectively. Although these declines were significant, we estimate it might still take another two to three years to unwind all of the overvaluation and unsustainable growth built up over a decade over a broad range of growth stocks. After such long-lasting excesses, stock prices rarely go from overvalued to fairly valued and then stop declining; rather, overshoots are more common.

An economic boom was created following the economic shutdown of the COVID pandemic from a massive amount of pent up demand along with federal government fiscal stimulus. SKBA defines a "Boom" as the combination of high real GDP growth and high price inflation. With CPI inflation peaking near 10% in the summer, the Boom of 2021 turned into the "Stagflation" of 2022. Our definition of "Stagflation" is subpar economic growth but for which price inflation still remains high. We believe this is one of the worst-of-all scenarios as high interest rates and inflation rates put downward pressure on P/E ratios while at the same time margin pressure hurts corporate profits. Although January of 2023 might see stock prices rebound from the tax loss selling in late 2022, in our view, nothing has suddenly changed enough to warrant a sustained rebound in the market.

Yet stagflation doesn't treat all companies equally. With nominal GDP growth recently near 8%, even with falling price inflation, companies that are able to pass along sufficient price increases to cover cost increases are likely to sustain better margins and profits. It isn't just commodity companies that are able to do this, but certainly they are relative beneficiaries in this environment. Many companies may not have discretion to raise prices in the same amount as occurs with employee and other costs. Yet other companies may see high nominal revenue growth rates driven by inflation in the prices of goods and services translate into less downward pressure on P/E ratios or even increases while the overall market flounders.

The question the market debates now is: Will today's stagflation turn into a recession in 2023? Nearly everyone believes this, and housing is certainly already in recession. In our view, housing this time around can't deliver the blow to the financial system that occurred in 2008. What we think the market wants is evidence of recessionary pressure that cools price inflation for more than a month or two and that causes the Fed to halt its upward march toward higher and higher rates. SKBA believes the overall financial system appears more secure than in 2007, but cracks are evident with excess leverage creating problems for the likes of cryptocurrency, buy now pay later consumer lending, SPACs, commercial real estate deals, leveraged IPOs, and the negative wealth effect of the market's decline. The risks seem to be more in tune with moderate recession risk with price inflation remaining above 2%.

Therefore, we think investors should expect continued market volatility in 2023 from numerous sources.

China could be one of these sources. Chairman Xi established himself as the absolute ruler, having won reelection to a 3rd five-year term, having suppressed or purged all dissenting voices in the Communist party, and having established surveillance systems and controls over the entire population with COVID lockdown measures. Now responding to the population's uprising over lockdown measures by eliminating COVID restrictions, he promises to eventually enable all of China to reopen, at least two years behind the rest of the world. Yet, "ripping off the band aid" as more than one news anchor described it, is finally allowing COVID to take its long-standing inevitable course. With near zero immunity, the disease is spreading like wildfire, and with millions of lives at risk, the COVID pandemic should delay the real reopening by six months or more. Companies relying on Chinese manufacturers to fill their supply chains or add demand for their products may be dismayed at this outcome.

With no end in sight for the Russia/Ukraine war, shortages of agricultural commodities, like wheat, the depletion of defense munitions inventories, the decline in Russian oil supply to the West, and the destruction of Ukraine's infrastructure will continue to be one source of upward pressure on prices. We believe the latest budget bill out of Congress, however, does finally add enough money to the defense budget to restart or accelerate production of defense goods, particularly munitions that are badly needed on the home front and in action in Ukraine. If and when a resolution is reached, the West will further need a "Marshall Plan" for Ukraine, and vast quantities of capital goods will be needed to rebuild the region.

With the radical shift in the investment landscape from the rising cost of capital, the jazziest of the market winners of the last decade aren't likely to be the winners in the next. Companies that can demonstrate that their cash flows are real and their balance sheets strong with rising dividends are likely to come back in favor. Maybe they're viewed as boring businesses, but *boring can be beautiful* – particularly in face of economic and market uncertainty!

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