Quarterly Market Commentary

Fourth Quarter 2022

Shifting Winds

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> *"I've never been more excited about our future, and I've never been so uncertain about the present."*
>
> \- Gary Friedman, CEO of RH

When Paul Volcker took the helm as Chairman of the Federal Reserve in 1979, he inherited an economy plagued by a decade of upward spiraling inflation. In 1974, following the OPEC Oil Embargo, inflation hit 11.0%. The Consumer Price Index (CPI) receded to high single-digits for four years before jumping back to 11.4% in 1979 and then 13.5% in 1980. To finally extinguish inflation, Volcker raised the Fed Funds rate to 20%(!), which ultimately leveled the CPI to 3.2% by 1983. Volcker's success in establishing a disinflationary environment allowed the Federal Reserve to reduce the Fed Funds rate to high single digits and keep it there for the rest of the 1980s, before eventually reducing it again to the mid-single digits in the 1990s. As we now know, by smothering inflation, Volcker set in place a declining interest rate environment that prevailed for the next forty years.

Tailwind to Headwind

The impact that falling interest rates have had on economic growth and the expansion of asset prices over this period cannot be overstated.

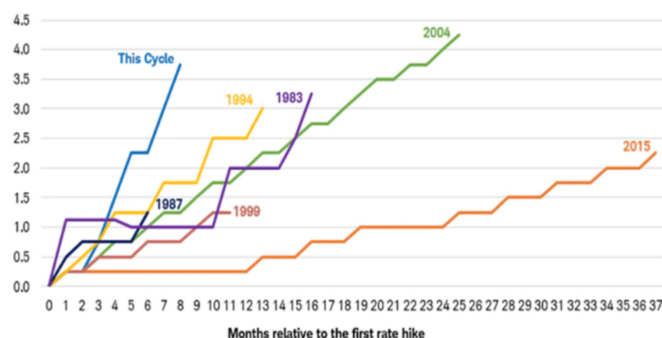
Investors have enjoyed the benefit of major trends since the Volcker years: (a) strong demographic and economic growth as the U.S. continued to gain influence over the global economy; (b) tremendous corporate leadership as the largest companies extended their footprint beyond our borders; (c) technological gains that allowed for the transfer of information at light speed. While these economic tailwinds are significant, falling interest rates may have provided the greatest gift of all to investors. Falling interest rates increase valuations, increase corporate net income margins, and increase the availability of credit and liquidity.

While falling interest rates are no substitute for growth, innovation, or to the trends above, they do amplify the impact for investors. Howard Marks, in his most recent memo to Oaktree clients, used the following analogy to describe the impact of declining interest rates: "At some airports, there's a moving walkway, and standing on it makes life easier for the weary traveler. But if rather than standing still on it, you walk at your normal pace, you move ahead rapidly. That's because your rate of travel over the ground is the sum of the speed at which you're walking plus the speed at which the walkway is moving". Over the past 40 years, investors have enjoyed the growing value of their ownership stakes in the companies that participated in the economy's growth. In addition, as Marks outlined, investors have been on the moving walkway, pushed along faster by falling interest rates. It is reasonable to assume that a significant portion of the returns investors have enjoyed have at least in part been due to the massive decline in interest rates. In 2022, this moving walkway was slammed into reverse.

Inflation, which has been relatively dormant for the past decade, began to rear its head in mid-2021. Our emergence from isolation left piles of unspent money from the pandemic and burned holes in consumers' pockets. Due to inventory shortfalls as a result of lockdowns, too much cash was chasing too few goods and services. Finally, Central Banks across the globe, initially hesitant to quell a surging and rebounding economy - as is so often the case - were slow to use the monetary tools at their disposal to nip inflation in the bud.

As a result, inflation worsened throughout 2021, forcing the Fed to acknowledge that the rapid price increases were not transitory and would ultimately require restrictive monetary policy to regain price stability. Thus, 2022 has been characterized by the most aggressive rate-hiking cycle ever.

Pace of Federal Reserve Rate Hiking Cycles[1]
Change in Fed Funds Rate (%)



For investors, though the economy continued to grow throughout 2022, the abrupt change in monetary policy proved to be one of the greatest headwinds for asset markets in several decades. The market, which had been characterized by easy money, optimistic borrowers, and complacent asset owners, gave way to pessimism and uncertainty. Over $30T of asset value has been lost between Global Equities and Global Bonds in 2022 ($14T in Equities and $16T in Bonds). That is nearly four times the asset destruction of the Great Recession in 2008. While this year has been painful, we do think that the Volcker-era of the early 1980's is a good corollary for what is to come.

2023 Outlook and Beyond

Inflation, the great focus of Central Banks and investors alike in 2022, has finally begun to recede. Peaking in June at 9.1%, CPI has since fallen in consecutive months, most recently to 7.1% in November. Asset markets rejoiced, as the S&P 500 jumped 13.4% from the September bottom. The underlying causes of today's inflation will likely abate as the swollen savings on household balance sheets are spent, supply chains normalize, and increasing supply aligns with moderating demand. Before declaring victory over inflation, the Fed will surely need to achieve a positive real Federal Funds rate (a rate higher than inflation). At present, the Fed Funds rate is at -2.2%. Therefore, even if the Fed stops increasing rates in March (as many investors believe), higher interest rates will likely be with us for a while.

As we look ahead to 2023, inflation fears have been replaced by the potential for economic contraction, or recession. Recession would further challenge corporate earnings, as businesses contend with higher borrowing costs, rising wages, sticky input costs, and slowing demand. For equities, we expect the ride to be bumpy and uneven. In contrast, fixed income investments are as compelling as they have been in over a decade.

Since the Great Financial Crisis of 2008, fixed income investors have been forced into riskier and more volatile assets in search of yield. 2022 served as a dramatic reset, moving us from a low-yield environment to a full-yield world where investors can now potentially receive solid returns from credit investments. Importantly, this means that investors no longer must increase risk to achieve their overall income and return targets. Lenders and bargain hunters face much better prospects in this changed environment than they had become accustomed to.

Despite the past year's challenges, markets enter 2023 from a much healthier starting point. At the beginning of 2022, expected long-term returns were very low relative to history. Bonds yielded less than 2%, high stock prices depressed earnings yields, and credit spreads were near all-time lows. Today, bond yields are near 4%, earnings yields are 50% higher, and dividend yields are 40% higher. This paints a much more robust picture for future asset returns.

Weaning the market from its dependency on cheap money has been challenging and uncomfortable. In many ways, the Fed's aggressive action to quell inflation has been an act of solving a problem that they had created and perpetuated. That said, we believe that we are moving toward a more normal economy with stronger and more stable market conditions. Investment opportunities that did not exist just 12 months ago are now appearing. And a foundation for the next bull market is being formed.

[1] Bloomberg

Markets, like life, are rarely symmetrical or linear. And what worked before may not work in the future. Our mission, as always, is to remain prudent and steady – so that when the winds shift again (and they will), we will be prepared to respond. Until then, we wish you good health and happiness in 2023.

Respectfully,

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The impact of the outbreak of COVID-19 on the economy is highly uncertain. Valuations and economic data may change more rapidly and significantly than under standard market conditions. COVID-19 has and will continue based on economic forecasts to have a material impact on the US and global economy for an unknown period.