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VIEWPOINTS

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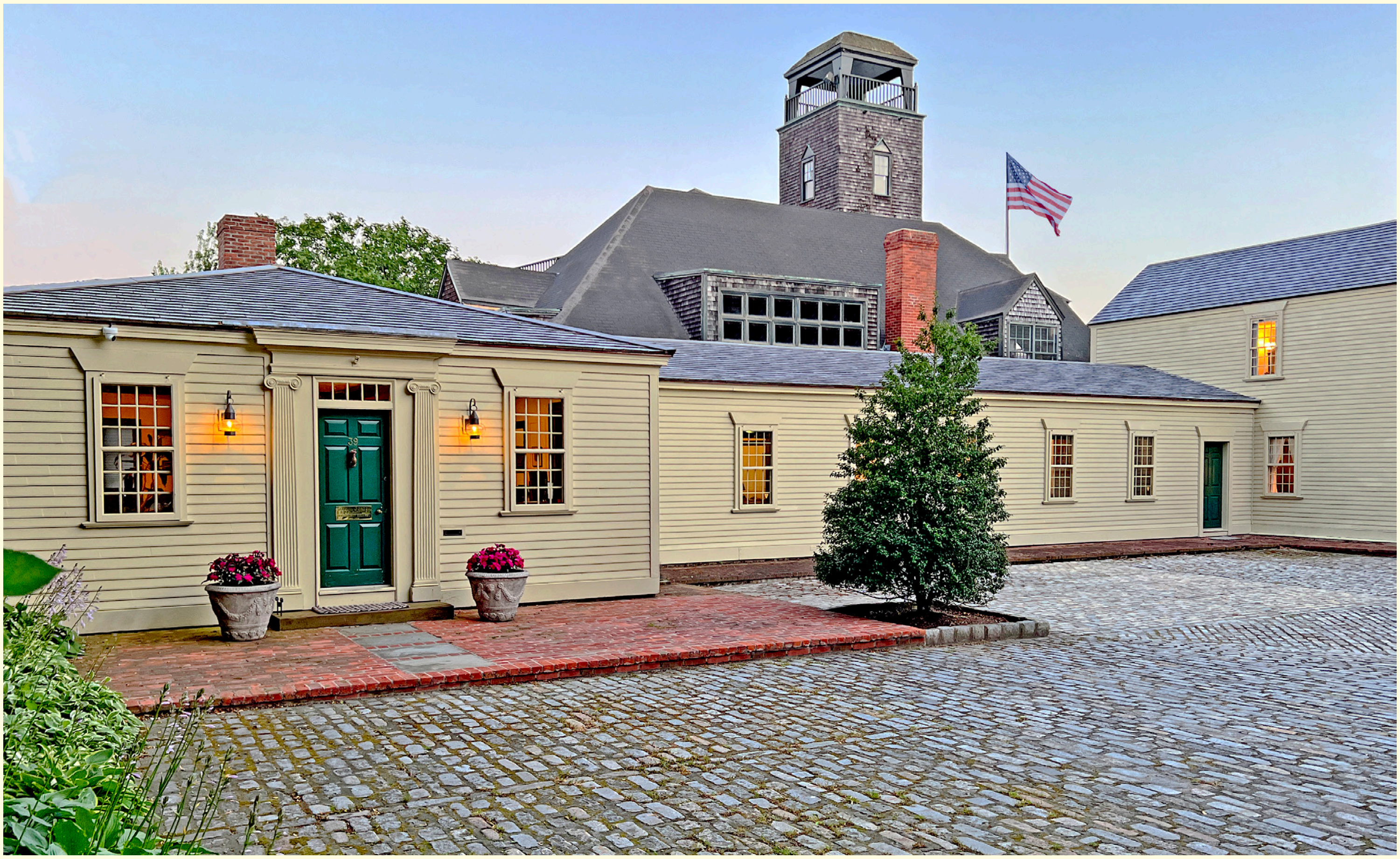
IN THIS ISSUE OF VIEWPOINTS, WE CONSIDER THE HIGHS AND LOWS OF AN UNPREDICTABLE MARKET.

Readers of *Viewpoints* and viewers of *Our View from Mill Street* over the last few years must be familiar by now with our consistent caution about risk. In every market cycle, there are times when it makes sense to "stretch" a little by increasing (relative) risk to take advantage of potential returns that fit within our macro-economic and corporate profitability expectations. This is the more normal and enduring investment climate that has propelled equities higher over the very long term. A quick look at the overall direction of stock prices on the Dow Jones or S & P 500 averages over the last 100 years will prove that point: corporate profits (and stock prices) normally grow along with GDP at the national level.

Conversely, there are times when recognizing the limitations of the broader cycle, it makes sense to "hunker down" and reduce risk to preserve capital. These periods, while fewer and farther apart, can be enormously destructive because it takes time to run the full gamut of emotions in a bear market. A little like the seven stages of grief, only time allows for market participants to finally recognize the disruptive end of a stock mania and the ensuing painful liquidation phase of stock losses that ultimately leads to utter disgust in investing in anything at all. When this appears, the sellers are exhausted and it is finally the bottom!



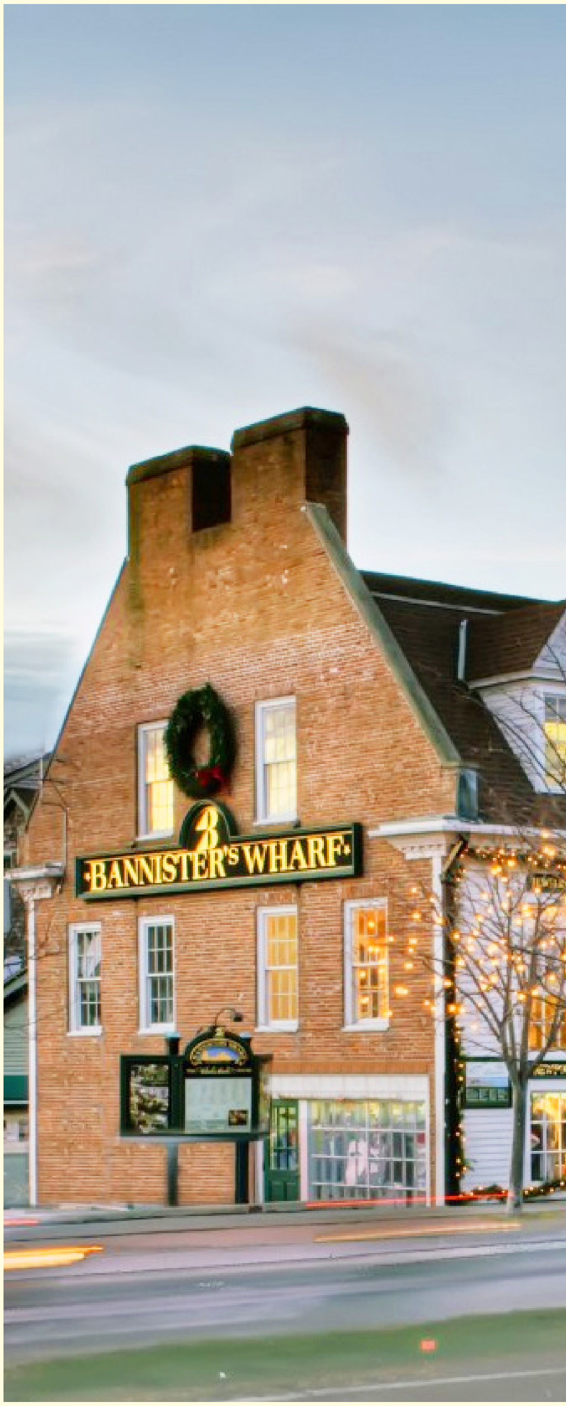
We think we are in this latter phase that may take time to play out, and not without some pain as well. Heading into 2023, there is an increasingly negative set up and lengthy downhill path remaining as we slog through this economic contraction. The consumer is cutting back, overwhelmed by a serious burst of inflation, the likes of which very few people today can recall because it last occurred in the 1970s. Nearly all core consumer cost centers are impacted with higher prices, and what makes it more painful is that nominal wage growth is trailing behind. Consumers have largely spent their pandemic "helicopter" money from the government, proof of which can now be seen in higher credit card balances.

The higher cost of money, the result of the Fed's recent dramatic interest rate increases, means that companies, especially unprofitable tech companies, are facing layoffs to preserve capital. As the slowdown broadens out, the corporate profit recession will claim more victims in the form of lower earnings and layoffs.

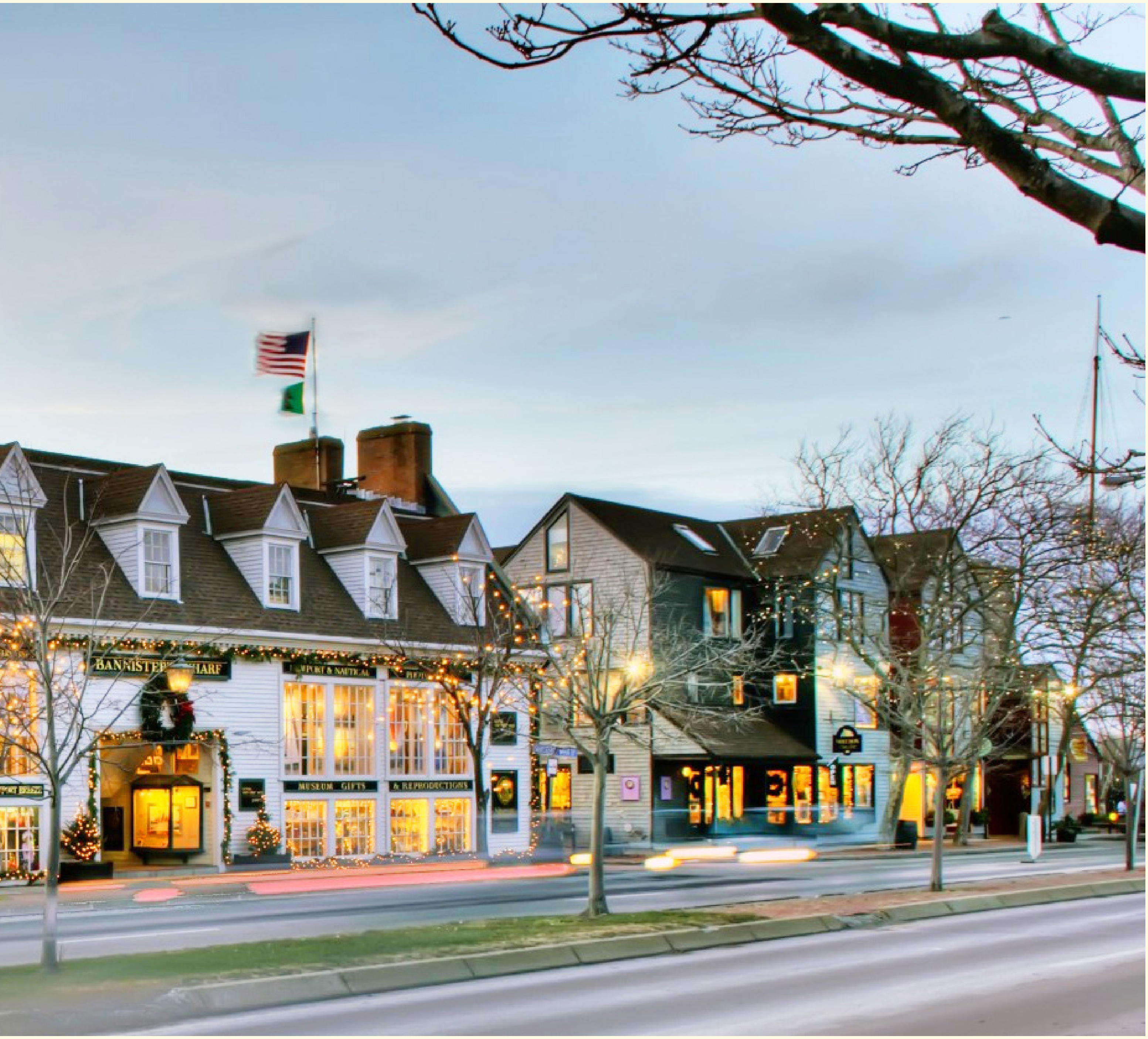
While a case can be made that a slowing economy will ultimately slow inflation, there are other factors impacting the macro picture that suggest a new, higher inflation regime may be sticky for longer: deglobalization, mis-guided energy policies, the Russian war, political uncertainty, and an amazing disregard for any semblance of fiscal prudence given the enormity of the US government debt. Inflation is one of those things that can feed on itself, in some cases, by economics and in other cases, by psychology. Time will tell what the verdict will be this time around as compared to the 1970s.

Finally on our list, but by no means a comprehensive list, is the impact of the Fed. Withdrawing the excess liquidity of the past decade that fueled the mania in the first place will require draconian measures that may take years. Rate hikes are one tool to control that liquidity by shrinking the money supply (current M2 readings year-over-year have decelerated to a 60-year low!), but the other is unwinding the Fed's obese balance sheet that was created when their policy was called *quantitative easing* (buying all manner of bonds to keep interest rates low… in fact, near zero) and replacing it with *quantitative tightening* (selling off those bonds to reduce their balance sheet). This reduction in liquidity will be a nightmare for today's historically financialized and over-leveraged economy.

Where the rubber meets the road in this analysis is in the US Treasury market stability. With so much outstanding government debt and ever-increasing deficit spending, and the rising cost of servicing that debt, there may be a diminished appetite for foreign buyers to fund our cash needs at the Treasury desk. Once again, time will tell as we are clearly in uncharted waters in these complex matters.



Market participants are gradually coming to grips with these phenomena, and stock prices last year certainly reflected that exponential rise in uncertainty, and markets hate uncertainty. The current highly inverted yield curve (short term interest rates are higher than long term rates) is normally a dead-giveaway of a slowing economy, and the market, here too, is slowly recognizing this fact.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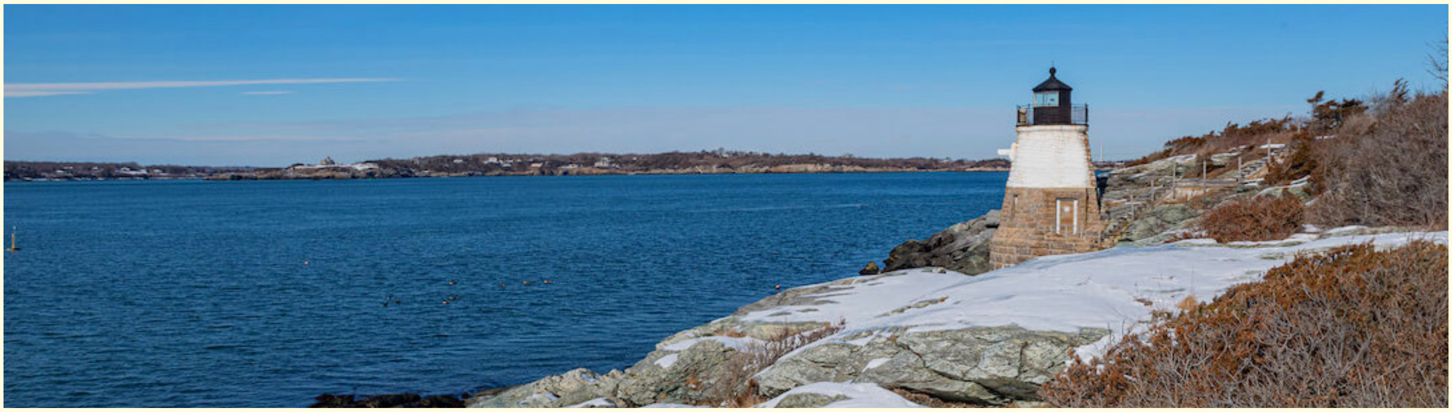

Seemingly intractable problems may linger for longer keeping us ever mindful of the nasty effects of risk.

IN CONCLUSION

So, as we have been contemplating these issues for some time, we feel that we are in a very good position to continue to dodge the bullets as we did successfully last year. Liquidity in our portfolios is up and now earning a compelling rate of return, our bond portfolios had been reduced anticipating this difficult environment for bonds, and our equities are for the most part what one would want to own in a recessionary environment. As mentioned in a recent video, at some point in 2023, the exhausted bear will be replaced by a timid bull, and we will be on the lookout for this, but some of these seemingly intractable problems may linger for longer keeping us ever mindful of the nasty effects of risk.

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