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VIEWPOINTS

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IN THIS ISSUE OF VIEWPOINTS, CHARTS IN SUPPORT OF A CAUTIOUS VIEW.

At a recent investment conference we attended, the noted investor, Howard Marks from Oaktree Capital, posed a question that we thought was very provocative. *What was the most important single event in the financial world in the last 40 years?* Some answers could include the Great Financial Crisis, the Lehman bankruptcy, the bursting of the ".com" bubble, the pandemic… Actually, none of the above. It was the epic decline in interest rates where Fed funds went from 20 to virtually zero over that stretch of years. Chart 1 shows the 30-year Treasury which is even more remarkable starting at over 15% and going all the way down to one-and-a-fraction % over that same period, and that single phenomenon dominated the financial environment and its performance. Forty years is a long period of time, and constantly expanding return expectations from persistently declining interest rates where the Fed was always coming to the rescue became embedded in investors' thinking.

CHART 1: 30-YEAR TREASURY YIELD

Then, as a consequence of endlessly easy money and the onset of Covid, inflation, a word not heard for decades, came back with a vengeance. Once the Fed figured out that it was not transitory, they raised interest rates dramatically, in fact at the fastest rate in 40 years, and ended the experimental market giveaway of Quantitative Easing (QE).

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So, now with higher interest rates, we are experiencing a slowing economy with the expected tougher access to credit and capital, although the equity market has seemed to ignore this–for the moment.

The current yield curve is the most inverted (short term rates are higher than long term rates) in 40 years: Chart 2 shows the spread between the 10 and 2-year Treasuries which, when this chart was created, was 82 basis points. The lead time of an inverted yield curve to the beginning of the recession is historically about nine to 12 months. When the banking industry tightens lending standards, as it is now, it usually accelerates the weakening of the economy, and defaults and bankruptcies typically follow, and the currently narrowing stock market, too, will feel these effects.

CHART 2

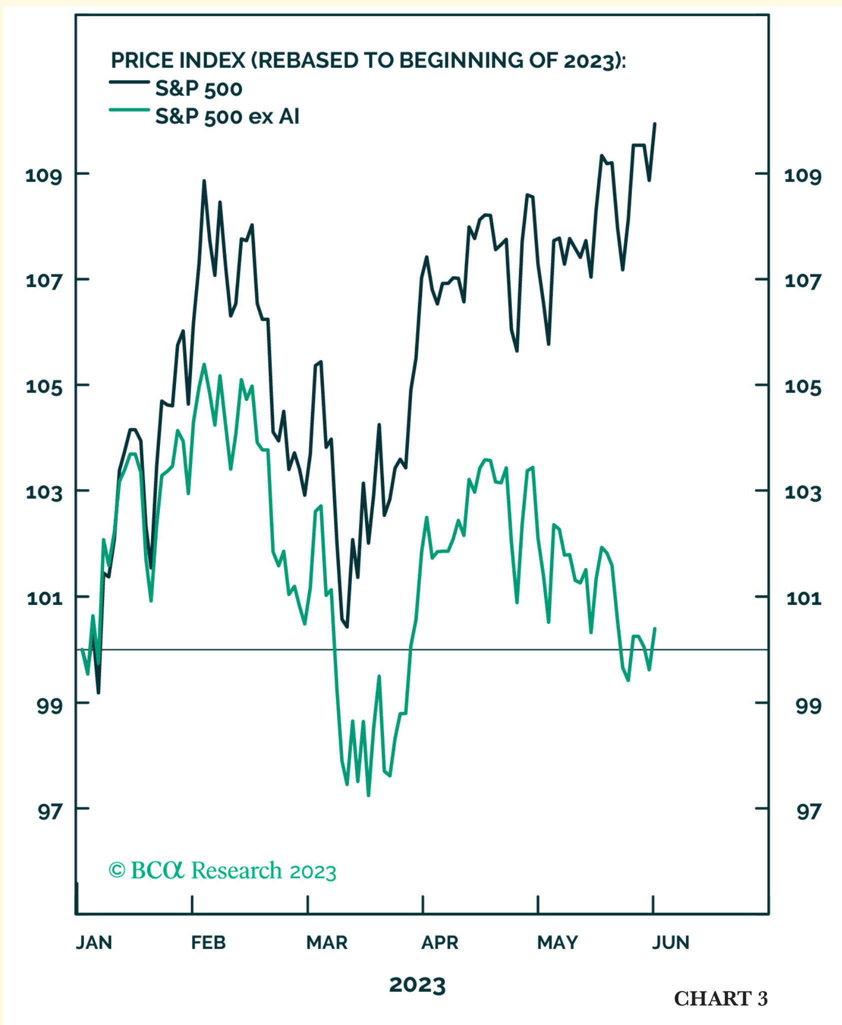

CHART 3

A few charts paint the picture of our description of a narrowing stock market. On Chart 3, while the S&P 500 (BLACK LINE) is up significantly so far this year, if you take out the 7 stocks that are leading the current artificial intelligence (AI) frenzy, the remaining S&P index (GREEN LINE) is struggling. There continues to be damage in the broader market as illustrated in Chart 4 (facing page) which is a composite of the Russell 2000, S&P 500 Banks, S&P 500 Real Estate, and S&P 500 Transports, just to name a few. The numbers are less important than the slope of the lines on the graphs.

And the stickiest part of the picture is illustrated in Chart 5: the epic drop in the money supply (BLUE LINE) and the lagged industrial production (RED LINE), and finally, Chart 6, the ultimate grease that lubricates the entire economy, bank credit. Banks are not lending these days: it would appear they are more concerned about the return **of** their capital than the return **on** their capital.

CHART 4

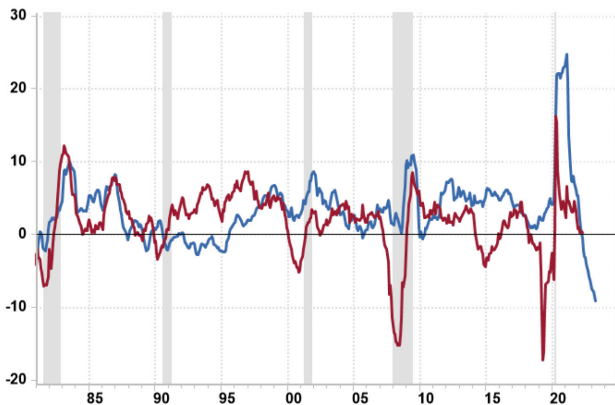

CHART 5

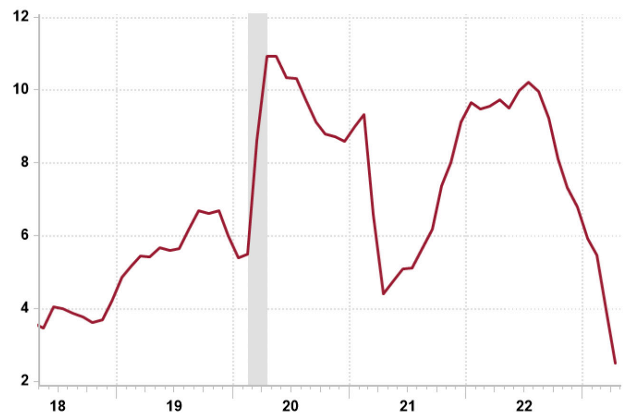

CHART 6

> “The essence of investment management is the management of risks, not the management of returns.”

Our current asset allocation reflects our approach to this sketchy economic scenario. First, our exposure to equities is on the lower end of our normal range, and has an overweighting in the defensive, recession-resistant categories of consumer staples, pharmaceuticals, and utilities, all classic places to be in a recessionary environment, with an average dividend yield in excess of 4%. Second, we have maximized the cash reserves which are now yielding 5%. And third, we have minimal exposure to bonds with very short maturities until we see more evidence that the Fed rate increases are having the desired effect, in which case we may consider increasing the bond portion when it seems appropriate.

Our investment style has always emphasized companies that have a long history of paying dividends. There is a blurred line within that cohort of companies between value and growth, and we are agnostic to those distinctions, but Chart 7 supports our theory that in the long run, companies that pay good dividends and increase them regularly outperform those companies that are stingy with their dividends. Over the last 30 years, the annualized total return on the former of 10.3% exceeds that of the latter's return of 9.6%.

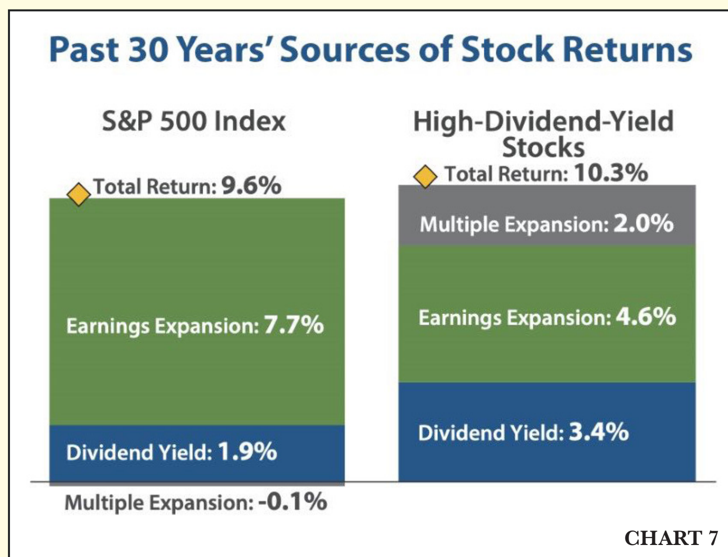

CHART 7

IN CONCLUSION

Our conclusion is the same as Howard Marks': we are in a completely different environment for investors than we have seen for an entire career for most investment professionals who have never been in a world where we didn't have either falling or near-zero interest rates. And the bottom line is that's now over.

Benjamin Graham once wrote, “The essence of investment management is the management of risks, not the management of returns.” While a universal truth, that advice seems even more fitting for the stock market and economic environment we are now experiencing. Patient investors always win the race over the long term.

Jeffrey L. Gordon
Managing Partner

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