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VIEWPOINTS

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IN THIS ISSUE OF VIEWPOINTS, WE DISCUSS TURBULENT MARKETS AND BLATANT SPECULATION.

For anyone to claim expertise in predicting the stock market, it would take skills that are beyond most mortals. However, history can provide us with some sense of direction if only with the admonition attributed to Mark Twain that history doesn't repeat itself, but it often rhymes. The operative word that may apply to our current time in history refers to the concept of the "superbubble." This is a rare market phenomenon that may occur only a handful of times in an investment career. Jeremy Grantham, the legendary overseer of GMO Capital Management, has defined it this way: *Most of the time (85% or thereabouts) markets behave quite normally. In these periods, investors are happy enough, but alas these periods do not truly matter. It is only the other 15% of the time that matters, when investors get carried away and become irrational.*

Having entered the final quarter of the year, we think we can safely say that 2022 will be remembered as the year that finally got the attention of an entire generation of investors, or perhaps more appropriately speculators, who are too young to have ever experienced a bear market as a consequence of a bursting of a superbubble. This current bear market is destined to punish mass foolishness in everything from FAANG stocks, ever-present glam tech stocks, high price-to-sales newcomers, meme stocks, SPAC/IPOs, cryptocurrencies and the list goes on.

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For the better part of the last two years, we have been writing and speaking about imbalances in the markets and the risks they presented to already over-valued assets due to the ill-conceived programs emanating from the Federal Reserve via monetary policy and the Federal Government via fiscal policy. An entire generation of investors has been conditioned to believe that any disasters in the economy would be mitigated immediately by pro-market actions of the Federal Reserve. This was called the "Fed Put" which convinced investors that any downside risks would be offset by aggressive Fed action in the monetary arena to stanch the drop in share prices and reinstate the bull market. Fed Chairs that included Alan Greenspan, Ben Bernanke, and Janet Yellen, each presided over loose monetary policies more recently defined by the acronym ZIRP, zero interest rate policy, and QE, quantitative easing (another way of describing outright bond purchases for the Fed's portfolio designed to keep interest rates artificially low.) When the cost of money is essentially zero, investors have a free ticket to speculate at their leisure, and if anything untoward happened because of it, the idea had been implanted by prior experience that the Fed was there to bail out the miscreants. The Fed would be the first to admit that this entire panoply of ZIRP and QE was an experiment that had no historical precedent as they tried to offset the festering negative impacts of the Dot.com collapse in 2000 and the real estate disaster of 2008, both of which contributed to the near stall-speed growth rates of US GDP within an over-arching deflationary global economy.

Then the pandemic set in and the Federal Government by way of its fiscal policy really went to town by distributing money directly into bank accounts of its citizens, what Bernanke once called "helicopter money." If there were ever a perfect definition of the cause of inflation, it was too much money from all these cash giveaways chasing too few goods caused by pandemic-related shortages. However, according to the New York Fed, shell-shocked Americans spent only about 25% of those funds and used the rest to repay debts and buy assets such as stocks and single-family houses in the suburbs, trying to escape from the chaotic urban centers.

The perfect storm of "free" money from the Federal Reserve and from the Federal Government caused markets to go ballistic, and an era of blatant speculation ensued defining the final blow-off phase of the bull market that had its roots all the way back in the mid 1980s, the two market crashes of 2000 and 2008 notwithstanding. To battle the hyper-inflation of the 1970s, the Fed Chairman at the time, Paul Volker, went on an aggressive tightening campaign, causing a major recession in 1980 which ultimately broke the back of the embedded inflation. As can be seen on the chart below, from the 1981 peak in interest rates when the 30-year US Treasury bond carried an unimaginable 14.25% coupon, long term interest rates have dropped consistently all the way down to the 1% range in 2020. The market then quickly realized that the new Fed Chairman Powell had changed the landscape with a program of dramatically increasing interest rates to tamp down the current inflation fire to which the Fed had earlier contributed. History certainly does rhyme in economic cycles!

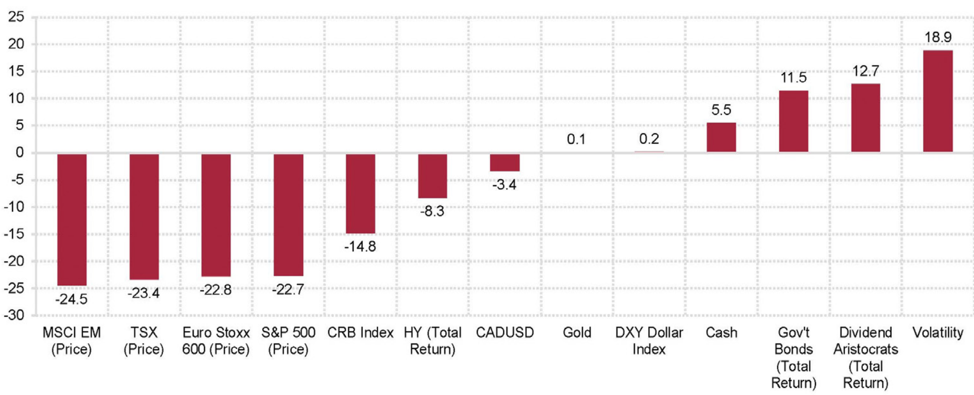
30-YEAR TREASURY BOND RATE YIELD CHART, 2022

SOURCE: MACROTRENDS

The current bear market began as the Fed imposed 75 basis point rate increases per meeting, and investors woke up to the idea that the "Fed Put" was a thing of the past. No more free lunch, and asset prices began their price readjustment to the downside. Much like the 1980-82 bear market where pretty much everything went down in price except cash, there are currently very few places to hide in this environment, and the only thing that one can rely on is time. Eventually, all things pass, including nasty bear markets, but reversion to the mean can take time after a long period of generally increasing share prices.

HOW TO BE POSITIONED IN A RECESSION

United States: Median Return in a Recession by Asset Class
(annualized percent change)



Returns calculated from six months prior to recession to three months before it ends.

SOURCE: BLOOMBERG, ROSENBERG RESEARCH

Portfolios at SG & Co. LLP had been defensively positioned going into this bear market period. An interesting chart at left illustrates the median return from various asset categories in a recession. Our emphasis has clearly been on the right side of this chart, in particular, dividend-paying companies in industries that are traditionally considered recession-resistant. However, when the volatility rate is as high as it has been recently, even defensive stocks can get impacted, but not nearly as much as the vast list of higher-beta (risk) stocks that populate the S&P 500, the NASDAQ and the Russell 2000. And cash which we had previously increased to much higher levels is again king in our portfolios.

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IN CONCLUSION

Markets are by their very nature unpredictable. If they were predictable and without risk, there would be no money to be made. Our job as we define it in our firm's mission statement is to protect and enhance our clients' capital over time in a conservative and prudent manner. We are especially anxious to preserve capital in those periods when the markets are declining, as they are currently. We were early in our cautionary stance prior to this final phase of the superbubble, and at some point down the road we may be early when bargain stocks once again appear as attractive additions to our portfolios. It will seem risky and dangerous to buy anything at that moment, but that is traditionally the period of maximum value and future potential for long-term investors seeking compelling total returns from good dividend-paying companies. Our 44 years in business give us a very good perspective as we take on this challenge.

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