By the Way

Monthly commentary from Jack Way

December 2022

"Don't look back, something might be gaining on you"

There is no inherent reason that flipping over the calendar opens up a bright new world; most of the issues that plagued us in 2022 are still around and of concern. I'm reminded of standing on the 10th tee trying to convince myself the back 9 will be a new game and me a better golfer. It just doesn't work that way. At least for the foreseeable future (there's an oxymoron) we will continue to have to deal with slowing global economies, high inflation, war and other geopolitical tensions around the world. If, however, there was ever a new year that did bring in new markets, it was January 2022. The great baseball pitcher Satchel Page famously said; "Don't look back, something might be gaining on you". Well, 2022 was the year it caught up to us. The great markets of 2021 actually peaked on January 1, 2022 and never looked that good again. Like Satchel, I'm not much of a fan of rehashing the recent past, but the stark difference between the markets of 2021 and 2022 make for a worthwhile trek. I want to thank the researchers at Goldman Sachs for most of the following information.

Markets	2022	2021
S&P 500	*-19%*	*27%*
Nasdaq 100	*-32%*	*28%*
US 10 yr. Bonds	*-16%*	*-4%*

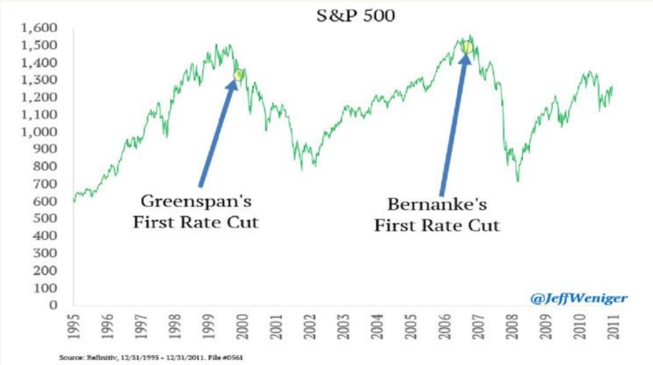
2022 was only the third year since 1926 when both bonds and stocks were down together; (1931 and 1969 were the other two). Energy was the best performing sector in both years. The worst performing sector in 2022 was Communication Services (includes the parent companies of Google and Facebook); the worst in 2021 was Utilities, still up 18%; a sure sign of a strong bull market.

Inflation has certainly not gone away, but there are at least signs we've seen the worst. The Consumer Price Index in November rose 7.1% year-over-year; better than 7.7% reported in October and September's 8.2% reading. Hopefully the trend is our friend. Watch for the next release scheduled for January 12th to see a continuation. It's no time to celebrate just yet as food prices

Source: Bloomberg, Mulvihill Capital

increased 10.2% over the same period and "sticky" wage inflation, which is reported quarterly, continued to rise. On that note, despite being a card-carrying capitalist, it seems appropriate to me that workers experience some catch up. That may well be difficult given one of the Fed's major objectives is to increase the unemployment rate. I'm more optimistic about the rate of inflation than many others I talk to, in part because of reversals in areas that had been experiencing the most aggressive price increases. If you look at charts of things like lumber, used cars, and most recently "pending home sales" they top out for awhile and then just collapse. Someone asked me to explain, given the high vacancy rate in San Francisco, why haven't prices declined more. My answer was that there has been no trade to speak of. Buyers have pulled their bids in anticipation of further declines, and sellers aren't lowering their offerings, expecting prices to recover. As a result, there are very few transactions to set a new price level. If it's like the used car market, when it finally happens it will be sudden and painful for homeowners. In 2000, Martin Gladwell wrote a book called "The Tipping Point" that promoted the theory that ideas, behaviors, products grow until they reach a critical mass and then they explode (or in this case implode). I think that's what we're seeing these days, with the added proviso that with the internet and social media the time to reach that critical mass is compressed. If I'm correct, as inflation and the economy move lower, at some point consumer psychology will reverse (fear is *contagious) and demand will collapse. Democrats used the "lame duck" session of Congress to pass the Consolidated Appropriations Act of 2023 before having to cede control of the House to Republicans when the newly elected members are seated this year. The $1.7 trillion bill will finance the Federal Government through September, and is also meant to provide various inducements and incentives to the general population to mitigate the effects of high inflation. The stimulating fallout from more money in the pockets of Americans should help the economy, but will make the Fed's fight against inflation more difficult.*

The Federal Reserve Board claims to be "data dependent" which is fine, but by the time data is available it might be too late for the Board to grab the wheel and get things back on track. Its current policies, which we all know, centre on slowing the economy in an effort to fight inflation, but given the U.S. economy is so massive and feeds on psychology and momentum, it is no small feat to turn it around once it gets headed in the wrong direction. As we've said before, historically Fed efforts to tighten monetary policy have most often remained in place until something breaks, and here we are again. The Board will need to be exceptionally prescient to perfectly time a move to a more dovish stance before serious damage has been done to the economy. The track record of this, or any other Fed, does not instill confidence. Despite everyone waiting anxiously for the Fed to make a pivot and lower rates, it is important to remember that the S&P 500 declined for several years after Greenspan and Bernanke made their respective first rate cuts. Namely because, for the reason referenced above; something broke.



Source: Refinitiv, 12/31/1995 - 12/31/2011. File #0561

As a senior citizen myself, I have to applaud the Fed policy to raise interest rates and hence my income. This holds true for many groups of so-called "savers", such as pension funds and endowments, as opposed to "borrowers". The acronym TINA, which stands for There Is No Alternative, forced investors out the risk curve in search of needed returns not available in more traditional investments. Given the returns now obtainable in fixed income markets, TINA is no longer as relevant. This is no time to be smug even if the catch phrase "OK Boomer" no longer has the same bite as a few years ago. Many people are suffering from those high rates as houses and cars are no longer worth the debt attached to them and inflation eats into their disposable income. We all may well be dealing with the same issues before this is over.

Consensus remains gloomy for markets and a recession is the accepted outlook for this year. This letter places me solidly in that consensus, where I would rather not be. However, the possibility the recession will be deeper than expected and the risk of a Federal Reserve policy mistake keeps me from trying to put a more positive spin on the outlook.

Day one of the new Congress is foreshadowing the next 2 years as Republicans can't get together to elect a new Speaker of the House, let alone talk to Democrats.

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