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Inevitable

INSIDE STORY

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We have wrapped up one of the strangest years in the financial markets in my memory. It feels like we are living in Bizarro World. For those who did not grow up with "Superman" comics, Bizarro World was a planet where everything was bizarre.

We had high inflation, which we (and every other analyst I know) saw coming, yet somehow the Fed did not. We had two quarters in a row of real GDP declines, which has always been the practical definition of a recession, but pundits insist that it wasn't a recession this time. We experienced the worst stock market since 2008, and to add some salt to that wound, the bond market collapsed. The U.S. Aggregate Bond Index goes back to 1977, and in those 45 years, bond prices have been down only five times. The worst decline before 2022 was in 1994 with a 2.9 percent drop; In 2022, bonds dropped 13.01 percent.

The bond market carnage at least makes sense, as the big issue in 2022 was inflation. Inflation causes interest rates to rise, which the Fed's actions accelerated. The stock market, however, is a more nuanced story. It would be easy to relate the drop directly to inflation, and inflation can certainly hurt some companies; however, inflation actually helps more companies than it hurts, at least on paper, as stated earnings get inflated with everything else. Energy companies are a great example of this and were the best place to be last year.

Nature has its seasons, and the economy has the business cycle

Stocks dropped because the majority opinion of market participants is that the Fed raising rates will cause a recession. In the 30-plus years I have been in this business, I do not recall a time when so many were so convinced that a recession was inevitable... which is precisely why I doubt a severe recession will occur this year. Perhaps I am being a bit of a wimp in adding the caveat of "severe" here, but stay with me.

Before I explain our thought process, it would be good to discuss what causes recessions in the first place. The economy flows in a way not dissimilar to nature: There are seasons, and spring leads to summer, which gives way to fall, and eventually winter. Winter, with all of its brutality, gives birth to a new spring. Trees grow, they mature, then fade and die, and in doing so, fertilize the soil for a new tree.

Similarly, a business also has a spring, summer, fall and winter. The four largest companies in America today are Apple, Microsoft, Alphabet, and Amazon. Apple was founded in 1976 and Microsoft in 1975. Alphabet was founded in 2015 as the parent of Google, which was founded in 1998. Amazon was founded in 1994. The four largest companies in the U.S. today did not exist when I was born, and two of those four did not exist when I graduated from college. How about you?

Nature has its seasons, and the economy has the business cycle. The cycle starts with new growth, new ideas, and new products. It grows into a flourishing summer, and when all looks positive, it then matures into fall and finally dies in winter. That death brings forth new life, and the cycle repeats. This is the life of a company, and when we combine all the companies that currently exist, we get an economy. The difference between nature and the business cycle is human psychology.

The great sin of humankind is the thought that we can control things which cannot be controlled. In the Abrahamic traditions, Adam and Eve brought sin into the world when they ate the fruit of the tree of knowledge in order to be like God. In the Eastern traditions, they speak of having to give up the illusion of control. The ancient philosophers warned of hubris. This is a universal truth, and a bedrock of every tradition that has stood the test of time.

This manifests itself in the business cycle as companies experience the summer of their existence. We start our company selling widgets; our widgets are better than any widget that has previously existed, but in our spring we must overcome the newness. We must get our message out, then scale our production to meet the growing demand. If we survive this season, eventually we enter summer. Growth comes easily. We are no longer a startup but the leader of our industry. Demand is sky-high, manufacturing has been optimized, and profits flow.

If we were animals, our instinct would be to know that fall is coming with winter after that. We would prepare for our survival. But we are not animals, we are human beings, and we constantly believe that summer will last forever. At the moment when we should be storing up the fat for winter, we decide to expand instead. We overreach, and this brings on the fall.

Fall is not that bad. The colors are beautiful. It may start to get a little chilly, but it is nothing a sweater won't fix. For our business we become a cash cow. Growth in demand has fallen, but we have become very efficient at making our widgets and they are more profitable than ever. We may be selling fewer of them, but the increased profit keeps our illusion of summer alive. While even the squirrels are wise enough to store all the falling nuts, we convince ourselves that we are still in control.

Then winter hits. In nature the animals hibernate and live off their fat stores, but our business was running very thin. We must take drastic measures. Payrolls slashed and factories shut down. We have brought on a recession. When recessions hit the unprepared, cuts have to be made. Like trees falling in the forest, those cuts lead to new growth.

We had severe recessions in the 1970s, when technology giants like IBM and Hewlitt Packard had to lay off employees – employees who would then take a chance to work for inspired startups named Microsoft and Apple. Twenty years later, a savings and loan crisis caused a recession and companies started trimming the bloat that had built up in the booming 1980s. Those trimmed workers staffed internet startups such as Google and Amazon.

Winter brings forth spring, but with all due respect, there is no cliché about people retiring to Minnesota. People retire to places like Florida because as a whole we prefer summer to winter. Of course, the four seasons take place in one year, while the business cycle historically took place over a five-year period. Macroeconomists have searched for a way to stop winter from coming. John Maynard Keynes theorized that we could stop it by having the government spend more when things began to slow.

Keynes's theories dominated the period that led to the high inflation, high unemployment, and low growth of the 1970s. It was a disaster. Milton Friedman thought it better to use monetary policy – the Fed could keep us from recession by manipulating interest rates. As a result, we have successfully lengthened the business cycle from five years to a decade or more. The good news is that winter takes longer to come; the bad news is that the winters have become severe – the tech bubble, real estate bubble, and financial crisis. The more people become convinced that "this time it is different" and winter won't come after all, the worse the impact of the inevitable change of season will be.

Why is that? Winter is fairly mild here in Atlanta, but those who have experienced a Southern winter often speak of it feeling colder. I blame the humidity. Years ago, I mentioned this to my boss at the time. He was from Detroit and knew a thing or two about winters. He just looked at me and said, "That is because you people don't wear coats." He was right, and I have forsaken my Southern roots ever since and brought out the coats anytime it gets cool outside.

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REVIEW *of* ECONOMY

The 3nd quarter 2022 GDP growth came in up 3.2 percent, which was a slight recovery from two negative quarters previously. Most expect 4th quarter to be positive as well but less than 1 percent. This may prove overly pessimistic.

The official unemployment rate dropped to 3.5 percent through December. The labor market remains tight, and participation is growing. This is occurring while inflation is coming down, so it will be interesting to see when this good news is treated as good news by the market.

Inflation is 7.1 percent based on the latest consumer price index report. While still high the level has been consistently dropping for several months. The producer price index, which tracks wholesale prices, is up 7.4 percent over the last 12 months. +

REVIEW *of* MARKET

The market finally rallied. For the quarter the S&P 500 finished up 7.56 percent, and small company stocks represented by the Russell 2000 index were up 6.23 percent. Value outperformed with the Russell 1000 Value index up 12.42 percent while the Growth index was up 2.20 percent. For small companies the value index was up 8.42 percent, and the growth index was up 4.13 percent.

Bonds also provided positive results. The Barclays U.S. Aggregate Bond index ended up 1.87 percent. High yield bonds rose 3.8 percent. Bond yields remain attractive.

International stocks were the best place to be. The EAFE index finished up 17.40 percent and the MSCI Emerging Markets index ended the quarter up 9.79 percent. +

MARKET *forecast*

Pessimism remains very high, and results are likely to be better than expected. This should bode well for the market in 2023. Having said that we would not be surprised if markets get worse before getting better. Caution is still in order.

In the longer-term value stocks and small company stocks still look more attractive. International stocks look more attractive than domestic, and the currency situation seems to be normalizing. This bodes well.

Bonds are actually looking worthwhile and behaving like bonds should. This allows investors to be patient with the stock market as bonds are now a reasonable alternative to stocks in the short run. +

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This brings me back to my somewhat gutless prediction: I believe we may escape a recession in 2023, or if we do not escape entirely, that the recession will be very mild. I say this because everyone seems so convinced that winter is coming that they are actually preparing for it. Recessions happen, especially severe ones, because we constantly believe they won't come and therefore overextend ourselves.

We are not overextended; this may be the silver lining in the very dark cloud which was our reaction to the COVID-19 pandemic. We had not had a recession since the financial crisis of 2008, so we were overdue, but as we entered 2020, all was well economically speaking. We were experiencing the best economy we had seen since the 1980s and 1990s, then we decided to shut the world down in an effort to control the path of a virus. (There is that control thing again.) So, recession started.

We were rebounding from that self-inflicted recession when we decided to reverse course on the lessons of the 1970s and once again embrace the inflation-causing Keynesian fiscal policies of the past, which has landed us where we are today. We are less than three years removed from the last recession, and we are nowhere near the end of a new business cycle; if anything, we are closer to the beginning. This is not the environment which leads to severe recessions.

That doesn't mean we might not have a slowdown or even mild recession. This can simply be a self-fulfilling prophecy: If everyone slows down to stock up for winter, then economic activity will decrease. Additionally, when we speak of recession, we are referring to the economy as a whole. There are always exceptions. Energy companies have been going gangbusters, but they did horribly for the decade before when technology companies thrived.

Today the economy as a whole may be hanging in there, but the mortgage business is hurting severely and certainly experiencing a recession-like environment. Any industry that is tied to interest rates or financial markets has been hurt. This is balanced, however, with others doing well. One tree falling does not mean the forest is dying.

Critics of capitalism never seem to grasp this. There is a growing movement among some today who suggest that our society is too focused on growth; this is incredibly misguided. There are only two states of being: growth and decay. If we stop growing, then we are decaying. The capitalism critics fundamentally misunderstand what growth of the economy means; they seemingly think of the economy as a tree and even use analogies of trees not being able to grow to the sky. The economy is not a tree, but a forest. The forest can grow forever without ever getting bigger or using up more resources, because the forest hosts new growth along with decay.

The four largest companies today did not exist when I was born. Two of them didn't exist when I graduated from college. The four largest when I was born were General Motors, Exxon, Ford, and General Electric. They all still exist today, although General Motors wouldn't if the government had not bailed them out during the financial crisis. All are mere shadows of what they once were, all in the fall of their existence. Who knows what the largest companies will be years from now. Change is inevitable. Recessions are as natural as winter itself; perhaps we would be better off if we stopped trying to control them out of existence.

Warm regards,

Chuck Osborne

CHUCK OSBORNE, CFA *Managing Director*