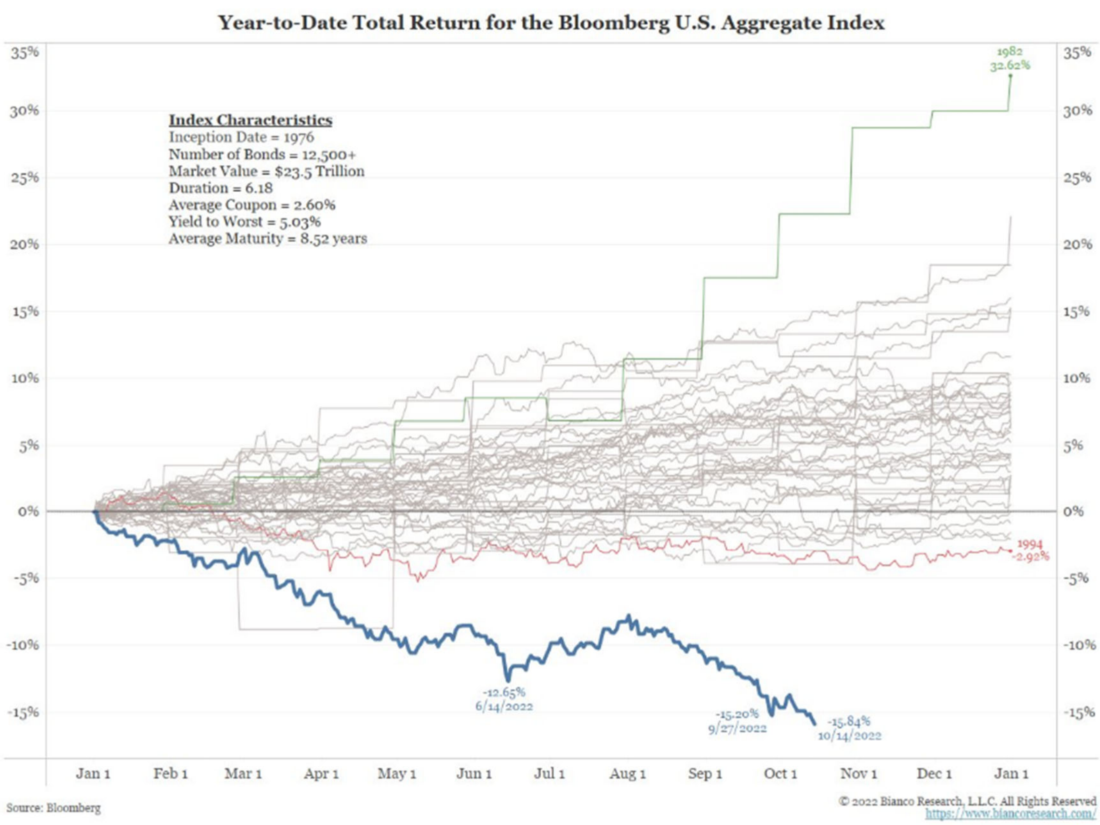
Fall Cleaning

My wife Linda and I spent this past weekend cleaning out the storage room in our basement. After living in our house for 15 years, we have collected quite a few items. It's not that we hoard, but – like my investment style – we like to "buy and hold." We found the usual 3rd grade art projects from our kids and other miscellaneous items, but what caught my eye was a framed picture of Winston Churchill.

The photo featured his memorable phrase: "If you are going through hell, keep going."

The first ten months of 2022 may have indeed felt like hell for investors.

The total drawdown (i.e., loss in value) in US stocks and bonds is estimated at $16.7 trillion—twice the loss experienced in the 2008 / 2009 financial crisis.[1] While all the attention is on the S&P 500 and Nasdaq being down 18% and 25%,[2] respectively, few realize that this has been one of the worst years for bonds (in terms of performance) EVER. The bond market equivalent to the S&P 500 is called the Bloomberg US Aggregate Index which is down almost 16% for the year. The chart below shows its annual performance since 1976. This year's performance is in the blue.[3]



Bond investors' biggest concerns revolve around inflation. If inflation continues to print relatively high numbers, the Federal Reserve ("Fed") will continue to increase the Federal Funds target rate which is now 3.25%.[4] The Fed has two more meetings this year, and the committee is expected to raise the Funds rate by a total of 1.25% (75 basis points on November 2nd and 50 basis points on December 14th). As a reminder, the Fed Funds rate was 0% at the beginning of the year.

Outside of the energy sector, this year's sell-off in stocks has also been brutal. Even "blue-chip" stocks such as Facebook (now known as Meta) and Nvidia are down 60% this year. Meta last traded at this stock price in December 2018.[5] The significantly lower stock prices are because of a few reasons including:

- Higher Interest Rates: A company's current stock price is theoretically the sum of future profits. Those cashflows are discounted or valued today using significantly higher interest rates which decreases the net present value. We believe this is the most important factor in this year's sell-off.
- Valuations: In the low interest rate and inflation environment of the past 15 or so years, companies – especially technology stocks – were priced at higher valuations than previously. The return to more normal interest rates like we currently have has perhaps caused investors to revise what valuation multiple one should give to earnings and growth.
- Income: Since the 2008 crisis, many investors bought stocks for income rather than bonds. You no longer need to do that. With 2-year Treasuries yielding almost 4.5%, there is now a meaningful income alternative. As a matter of fact, we like buying Treasury, municipal and convertible bonds with maturities between 2 and 4 years.
- Earnings and Economy: Investors are worried that corporate earnings will weaken because of either inflation hurting margins or a slowing economy hurting profits. Additionally, the housing market is slowing down and this will impact the economy.
- China and Tech Restrictions: Technology stocks have sold off recently in light of the new export restrictions imposed by the Biden administration.

At the beginning of this year, few predicted how sharply and swiftly the Federal Reserve would raise interest rates or how the geopolitical environment would shift. These unexpected developments have darkened the mood in markets and brought valuations down from unsustainable highs. In that way, market pessimism has created an opportunity for long-term holders that has been scarce in recent history: buying high-quality companies at reasonable valuations. Many companies with solid management teams and compelling long-term growth prospects are now trading at valuations not seen in four or five years. This is especially true for small and mid-cap stocks.

2022 has truly been a hellish year in markets. While losses are never fun, they create an opportunity to reassess portfolios more broadly. Just like now is a good time for Linda and myself to purge items that may no longer be of use to us, it may also be time to let go of holdings that no longer serve our portfolios. In taxable accounts, we are looking at taking losses for tax purposes; in non-taxable accounts we are looking to see if there are opportunities to re-shape portfolios with stocks that may have better outlooks.

Please reach out if you'd like to discuss your portfolio with us.

Sincerely,

Peter Karmin
Managing Member

Citations and Disclosures

[1] Bespoke Investment Group, "Bespoke Report" (October 14, 2022)
[2] Bloomberg Finance (as of October 16, 2022)
[3] James Bianco Twitter (October 15, 2022)
[4] Bloomberg Finance (October 17, 2022)
[5] Bloomberg Finance (October 17, 2022)

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