

ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary

July 6, 2022

Dear Clients:

Albert Einstein is considered the source of many famous quotes, including “In theory, theory and practice are the same. In practice, they are not.” Yogi Berra also borrowed this theme to describe the frequent disconnects between baseball players’ expected and actual performance on the field. Disconnects between theory and practice occur with regular frequency in all aspects of our daily lives. In a democratic capitalistic society such as the US, perhaps the greatest tension and unease relates to disconnects at the governmental level since market discipline appears more effective at the individual level versus what is seen on a collective basis. In light of this year’s trends in prices of stocks, bonds, commodities, and most, if not all, consumer goods, we think a short review of the multiple disconnects between economic theory and practice collectively affecting our daily existence is due.

In terms of broad economic activity, traditional economic theory has focused on the interaction of governmental activities administering monetary and fiscal policies. In theory, a predictable and steady growth rate in monetary aggregates (aka, money supply) tied to the natural growth rate of a nation’s economy would be sufficient to facilitate growth and price stability. We can thank the late Milton Friedman for this conceptual framework and supporting historical data analysis. In the case of governmental fiscal policy (tax revenue and spending), economic theory has leaned heavily on the work of the late John Maynard Keynes. Keynes developed the conceptual framework justifying the use of government budget deficits to “soften” the adverse impact of contractions in economic activity (aka recessions/depressions) **COMBINED** with the allocation of budget surpluses in good times to pay back the deficit.

In practice, all manner of “anomalies” (think war, depression, financial panics, pandemics, etc.) drive governmental “authorities” to introduce actions that seem justified by current circumstances but run counter to theory. A review of monetary and fiscal policy history reveals numerous deviations from sound theory that made conditions actually worse, requiring more painful corrective actions. The high inflation and slow growth experience of the 1970’s followed by the historically high “therapeutic” interest rates in the early 1980’s resulted from significant government deficit spending combined with excess monetary expansion in the two decades leading up to 1980. The therapy worked as the US economy and investment market returns were almost uniformly strong for the two decades ending in the year 1999. During this period, monetary policy remained neutral while fiscal policy remained modestly stimulative. Note that the duration of the therapy was much less than that of the pain, something akin to taking your medicine being better than enduring the disease.

Beginning in the year 2000, periods of economic/financial stress in the 2000-2002 period, 2007-2008 period, and 2020-2021 period have motivated government activism in conflict with theoretically sound policies. The war on terror, unsound mortgage underwriting schemes, and the COVID pandemic encouraged government activism in an attempt to “enhance” our collective well-being. As a consequence, government debt now stands at \$30+ trillion, having risen from around \$23 trillion in 2019, \$8.5 trillion in 2006, and \$5.7 trillion in 1999. As a percentage of annual gross domestic product, government debt is now approaching 130%, compared to 57% in 2000 and 53% in 1960. Monetary policy since 2008 has become very stimulative. In addition to the perverse action known as “zero interest rate policy,” the Federal Reserve Bank (FED) has directly purchased essentially all of the increase in government debt since 2008. Prior to 2008, the FED maintained direct ownership of government debt of about \$800 billion in the normal course of open market operations. Today, this holding is \$8.5 trillion, having been funded by the “creation” of deposits to the US Treasury. Again, the FED’s actions (quaintly known as Quantitative Easing) has distorted the natural market discipline resulting from private buyers setting the prices of these securities. This combination of simultaneous and rapid debt issuance and money supply creation has ignited a blast of consumer price inflation unseen since the early 1980’s. As a result, monetary policy in the US has flipped from accommodative to tightening in a matter of a few months. In short, theory is out the window as practice is made up on the fly.

Investment Theory and Practice

Modern portfolio theory suggests investors will pursue portfolios constructed with specific allocations to stocks and bonds to generate a blended return sufficient to meet the investor's long-term spending needs. Historically, stocks and bonds have generated total returns of around 10% and 5%, respectively, with counter-balancing periodic return patterns. Given a sufficient forward time horizon (say 20+ years), average forward returns are likely to revert toward the historical averages.

In our opinion, the drawdown in both stock and bond prices since yearend 2021 reflects a natural recalibration of forward investment returns toward historical norms. At times during 2021, the price to trailing annual earnings multiple on the S&P 500 Index was above 30x, compared to a nearly 100 year average of about 16x. Today, that multiple is about 19.5x based on very strong trailing twelve month earnings through March 31, 2022. The path of the broad stock indices over the next couple of years will depend on the level of expected future earnings and the expected rate of return on stocks. We suspect the probabilities are slightly higher for a continued decline in stock prices given market signals suggesting an economic slowdown has either already begun or will do so in the near term.

The forward path for bond yields will depend largely on the expected rate of annual price inflation. The FED seems focused on the current reported annual inflation rate of nearly 8% and is pursuing an accelerated upward adjustment to short-term rates. This trend combined with the expectation of reduced support of the broad bond market through direct purchases would normally lead to a meaningful increase in bond yields across the maturity spectrum. Time will tell how bond yields respond to this renewed faith in monetary theory. We think the imbedded inflation factor in US Treasury Inflation Protected bonds, currently at 2.5%+/-, is a better predictor of future inflation. Stay tuned for updates.

As you review the quarterly report of your investment results, you should observe stock (equity) returns that are modestly less negative than the comparative market indices. We have attempted to underweight the sectors with higher price multiples to achieve this "benefit." Similarly, total returns for the bond segments should reflect the benefit of shorter durations versus the market benchmark but still show the adverse impact of rising yields on bond prices. Allocations between stocks and bonds largely remain in sync with your longer-term objective. Over the last couple of quarters, we have taken steps to reduce volatility for clients with less capacity to absorb market volatility and valuation drawdowns.

Note on Media Noise

The popular news media is primarily an entertainment enterprise; truth is a flexible prop. We are particularly bemused by the aversion to talk about economic recessions (aka, the dreaded R word). Economic recessions are necessary therapeutic episodes to correct capital allocation imbalances that build in capitalistic societies. Most importantly, recessions and market drawdowns almost always provide opportunities for improved investment results.

In Closing

We look forward to visiting with each of you about your investment results and expectations for the future and to make sure your portfolios are aligned with your specific circumstances. We greatly appreciate the opportunity to serve as your investment adviser and pledge our best efforts to meet your expectations.

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