

## ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary

October 3, 2022

### Dear Clients:

A speech was given in 1955 by William Martin, former chairman of the Federal Reserve Board, to a group of bankers about the role central banks play to help manage economic fluctuations. He compared actions taken by the Fed (increasing interest rates) to slow down the economy to “a chaperone who has ordered the punch bowl removed just when the party was really warming up.” That speech was given at a time when the US debt totaled roughly \$275 billion. Fast forward to 2022 and the gross US debt load has ballooned to \$31 + trillion, a staggering 112 times larger. The punchbowl is no longer an appropriate comparison. The punchbowl has morphed into an Olympic-sized swimming pool. The pool has grown from two separate but connected sources: 1) super-sized monetary expansion through zero short term interest rates and the Fed’s unprecedented direct purchase of longer term government and mortgage-backed debt securities; (2) enormous increases in federal budget deficits.

The policy of direct purchases of US government debt by the Fed, known as Quantitative Easing (QE), has resulted in the “creation” of new money supply of nearly \$7 trillion since the end of 2008, effectively eliminating the market discipline on such new issuance. The current Fed chair, Jerome Powell, is leading the attempt to both reverse QE by reducing the Fed’s bond holdings from \$8.9 trillion to a level needed to conduct open market operations while simultaneously raising interest rates to dampen inflation. Our analysis is that the Fed’s bond holdings need to be reduced to \$2 trillion or less to achieve historically normal market conditions. If successful, Mr. Powell may have another career in walking tightropes. There is little history of unwinding an \$8.9 trillion balance sheet held at the Federal Reserve. The stakes are high for a policy misstep as it was only 11 months ago that Powell described inflation as transitory. The US central bank is hiking interest rates at a swift pace. Since the start of 2022, the federal funds rate has been raised by 3%, with large individual increases of 0.75% in June, July, and September. The US bond market is expecting additional rate hikes by year end; initially, yields were slow to change as markets were not convinced the central bank was fully committed to slowing the economy down. Price stability is currently the primary focus of the Fed; only time will tell whether the Fed’s resolve to finish this task can withstand the political firestorm brought on by recessionary conditions.

The debt of the US government has accumulated through continuing budget deficits including expanding government programs, wars, and stimulus payments. A recent WSJ op-ed referred to the growing debt as a “doom loop” – a vicious circle in which the government’s borrowing to pay interest generates yet more interest and yet more borrowing. Complacency about the debt became the norm while both interest rates and “reported” inflation remained low. It can no longer be ignored as most American citizens feel the consequences of printing too much money. Consider this: higher rates could add more than \$1 trillion in additional interest expense to the annual federal budget, which stands at \$6 trillion, by the end of this decade. If interest payments remain elevated or continue rising, interest expense could be ranked higher than Medicare or defense spending.

The strong relationship of asset prices and interest rates cannot be ignored; hence the saying, “Don’t fight the Fed.” The effects are being felt immediately by the housing market as affordability becomes a challenge for home buyers. The effects will be slower in other areas of the economy such as labor markets as a shortage of workers has forced businesses to do more with less. The odds of achieving a “soft landing” seem low. Caution is warranted as we enter the next phase of earnings reports with lofty headwinds tied to a strengthening dollar and the impacts to non-US earnings for global companies, higher operating cost due to logistics/supply chain management, and slowing consumer demand.

Through the first 188 trading days of the year, this is the fourth worst start to a year for US stocks. The only other years with lower returns through the first nine months are:

1. 1974 – (-33.4%) market was experiencing oil shocks, the collapse of Bretton Woods (gold standard) and Watergate scandal
2. 1931 – (-31.6%) Great Depression, excess margin
3. 2002 – (-29.0%) bursting of the Dot Com Bubble

While painful to experience, eventually stocks recovered and the following 5 and 10 year returns were strong in all cases. We expect this time to be no different. We remain committed to holding high quality businesses that can adapt to changing economic environments. We have reduced exposure to emerging markets indices. While the return opportunities appear high, so do the risks as tensions among nations grow and commodity prices remain highly volatile.

Stocks aren't the only asset class garnering attention from investors. The US bond market hasn't fared much better and has returned -14.6% YTD, which is setting up to be the worst one-year return for US bonds in history. The effects of duration risk have moved bond prices down swiftly. On the bright side, income opportunities are starting to look more attractive, a welcomed situation to yield-starved savers. Maintaining a fixed income portfolio with lower duration than the broad US bond market has helped cushion the price declines. As bond yields continue to move up, the opportunity for extending duration is becoming more appealing.

An argument could be made that the Fed has accomplished its mission as retirement accounts are down, the housing market has rolled over, and the overall speculation in non-traditional investments (cryptocurrencies, meme stocks, SPAC investing, venture capital, non-fungible tokens) has dissipated. The big question today is whether the Fed can complete the task of reducing inflation to an acceptable level while enduring the public pushback from the painful impact of recessionary conditions. We expect the pressure to rise on the Fed's actions as mid-term elections approach.

Cash and short-term Treasuries hold their value in all market conditions. Keeping enough on hand to manage the uncertainty of markets is a bedrock principle of financial planning.

### **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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