

ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary

January 6, 2023

Dear Clients:

Albert Einstein once said “the only thing more dangerous than ignorance is arrogance.” In surveying the market carnage of 2022, we think the evidence suggests market prices at the beginning of the year were adversely influenced by both ignorance and arrogance. Seemingly, many market participants either chose to ignore (aka arrogance) or were ignorant of capital markets history and valuation relationships among stock prices, bond yields, and inflation. The broad market correction experienced in 2022 presents an effective, if not remedial, educational refresher course for the ignorant. Whether the arrogance factor has been reduced remains to be seen.

Starting with the bond market as the indicator of the price of money over time, the annualized yield on intermediate term US government bonds was about 1.35% at the beginning of the year and finished the year at about 3.9%. Reflective of the mathematics of bond pricing, the total return on this segment of the bond market was a negative -7.7%. The negative return on the broad US bond market (including both corporate and mortgage bonds) was even more severe at a negative -13%, reflecting an end of the year bond yield of about 5%. The US Consumer Price Index (CPI) averaged slightly above 7% for both 2021 and 2022, a level significantly above the nearly 100 year average of 3%. Since 1926, the nominal bond yield has averaged about 2% above the CPI, a perfectly logical relationship if an investor is to maintain the purchasing power of the bond portfolio. The reported CPI for the period 2010-2020 averaged less than 1.7% which “supported” a decline in the annualized intermediate government bond yield from 2.4% to 0.4% despite massive and unprecedented fiscal and monetary stimulus. Negative real yields are unambiguous markers for inflation.

In contrast to the recent bond market action, the period from 1970 through 1981 resulted in an entirely different outcome. CPI during this period averaged above 8% including the peak level of 12.5% in 1980. Bond yields rose steadily from 8.3% at the beginning of 1970 to 14% at the end of 1981. Despite the large rise in bond yields over this period, the total return on US intermediate government bonds remained positive, averaging 7% for the 1970-1979 period, 3.9% for 1980, and 9.5% for 1981. Bond yields adjusted upward to compensate investors for higher inflation and were sufficiently high at the start to absorb the decline in bond prices. Why market participants and monetary officials were complacent about the interaction of 7% CPI and a 0.4% bond yield remains a mystery. Ignorance seems an implausible explanation, leaving only arrogance as the most likely cause.

The rise in CPI, combined with the “prospect” for higher bond yields resulting from monetary tightening, had the predictable impact for equity investors. The S&P 500 Index posted a negative return of -18.1% for 2022. Negative returns were most noticeable from some of the top ten weightings in the index. Significant declines were as follows: Amazon -49.6%, Apple -26.3%. Microsoft -27.9%, Tesla -65%, Alphabet -39.1%, Netflix -51.1%, and Meta Platforms (Facebook) -64.2%. Seemingly, complacency about valuations based on very low interest rates and sustainability of above trend growth rates far into the future caught many investors by surprise in 2022. The total return on the S&P 500 Index averaged 13.6% during the 2010-2019 decade, 18.4% in 2020 and 28.7% in 2021. Following on the -1% annualized average return for the 2000-2009 period, perhaps the recent higher than normal returns were a cyclical reaction to the prior decade. However, we think the unsustainable “fuel” in the form of near zero interest rates and excessive debt issuance by government, business, and households pushed earnings multiples far above rational levels. Looking back to the 1970-1981 period, the average annual total return on the S&P 500 Index was about 7%, a level slightly higher than the average return for 2000-2022. Despite the recent decline in stock prices, price to earnings multiples remain above long term averages and will likely move lower from some combination of rising bond yields and slower revenue and earnings growth.

The special case of crypto currencies added some toxic (in our view) ignorant and arrogant behaviors to the financial landscape in recent years. Although almost certainly motivated by poor execution of fiscal and monetary policy by the world's more developed and less developed societies, the fundamental logic behind these software creations lacked a believable foundation of trust necessary to justify true value. But like tulips in the 1600's, combining ignorance, arrogance, and leverage creates a potentially explosive result.

When it comes to investing other people's money, neither ignorance nor arrogance is a desirable characteristic of an investment advisor, business manager, or government official. Investing clients and their investment advisors must contend with the noise of a 24/7 media with talking heads providing mostly entertainment rather than sound investment insights. The basic rules of valuation, whether for stocks, bonds, or currencies, have not changed since the earliest history of capitalistic-oriented societies. Yet, based on observed pricing activities through the end of 2021, one might have concluded that the price of money over time (aka interest rates) had now become essentially zero without any regard for the cost of currency debasement (aka inflation). Similarly, the required investment return through owning a share of uncertain future enterprise earnings (aka stock investing) was driven down both by near zero interest rates and an unwavering confidence in the expectation of sustainable revenue and profit growth far above historical norms. Warren Buffett is quoted as having said, "Price is what you pay; value is what you get." When value is denominated in real return terms, nominally higher CPI leads to higher bond yields and lower bond and stock prices, as evidenced by the realized returns for 2022.

Our View Going Forward

Current market pricing factors suggest to us an evolution back toward a rational forward return relationship of say 10%+/- for stocks and 5%+/- for bonds. This relationship is the foundation for the classic 60/40 stock/bond portfolio. If our intuition is roughly correct, the path forward will be bumpy and heavily influenced by the future level of CPI. Recent measured inflation in the US has been around 7%, which if that continues would suggest bond yields approaching 9%. We think a lower level of inflation is more likely and in the range of the Federal Reserve Board's 2% target and the long term average of 3%. Current pricing of intermediate and longer term government bonds imply a 2.5%+/- sustainable inflation rate. Given this background, stocks remain susceptible to further price reductions due to some combination of higher bond yields and earnings decline due to recessionary conditions in the economy. Investors will need to maintain a sense that lower stock and bond prices generally lead to higher future returns. Having sufficient "dry powder" for future deployment is a rational approach for today's investing environment.

Our most significant concern for the future is the level of government intervention into the workings of the private economy. These interventions are particularly susceptible to the adverse consequences of applied ignorance and arrogance. As Alexis de Tocqueville so eloquently observed – "The American Republic will endure until the day Congress discovers that it can bribe the public with the public's money." Investors and their advisors need to be diligent in remaining unemotionally informed about the risks and opportunities signaled by market pricing and be prepared to act consistently and contrarily in a "buy low and sell high" manner in implementing investment guidelines.

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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