January 13, 2023

One of the Worst Years Ever

Dear Investor:

I think a brief review of how we ended up with such a disappointing year will be helpful. It really does all go back to the pandemic. Government policies that prevented people from going to work caused huge losses in the productivity of GDP. Productivity is the income side of our national balance sheet. To make up for this huge loss, the government borrowed massive amounts of money to give to individuals and businesses to help them survive. More specifically, the Federal budget deficit in 2021 was $3.1 trillion and the deficit in 2022 was $2.7 trillion. If you want to assume that we would have borrowed $1 trillion in each of those years based on the 2019 deficit, that means close to $4 trillion was spent on Covid relief programs. The Fed took rates back to zero as fast as possible, and they reinstated quantitative easing or QE as it's known. This added up to over $4.6 trillion in newly printed money. Expanding the money supply by well over $8 trillion in a short period of time has produced the high inflation we have today. This tidal wave of liquidity rolling through the system lifted asset prices to very high levels. Now we are in the tightening phase in an attempt to bring things back under control. This tightening has brought a dramatic decline in the prices of those very same assets. Stocks, bonds, and real estate have all been hit hard. The very large double-digit drop in bond prices played a major role in the discouraging results. Bonds had one of the worst years of all times, literally. There was an article in the Wall St Journal stating it was the worst bond market since 1842 (that was before the Civil War!) I saw many other items illustrating just how bad the bond market performed in 2022. It's important because bonds usually buffer the stock market declines and make them less painful. Energy did well last year due to the war, while gold and utility stocks managed to hold their own.

As you probably know, CPI, consumer price inflation, hit a high point of 9.1% in June of 2022. Fortunately, since then it has declined each month for the last six months and is currently 6.5% over the last 12 months. This is welcome news, but it's still way too high. As I discussed in my last letter, the Fed has made it very clear that they are serious about this battle with inflation. Their desire is to get back to the target range of 2%. One of the issues we are living with is the lag effect of their interest rate increases. In other words, how long does it take for these to impact the economy? This issue is widely debated by market participants. It's an important one, and I don't think anyone knows for certain. This is one of the main reasons it's very hard to achieve a "soft landing". If the Fed underestimates the effect of the past increases, they will over tighten, and we will head into a recession.

On the other side of the coin, they don't want to stop tightening too soon. Chair Powell has let it be known this is his biggest concern. We know he is keenly aware of what happened in the 70's, the last time we had this kind of inflation. In the early 70's, inflation was running in the 3% - 5% range until the OPEC oil embargo in October 1973. The sharply rising cost of energy pushed inflation up to 11%. At

5788 Widewaters Pkwy | Suite 203 | DeWitt, NY 13214
315-701-5750 | Fax 315-701-5751 | dkeim@keimassetmanagement.com
www.keimassetmanagement.com
Securities and Advisory services offered through Commonwealth Financial Network, Member FINRA/SIPC, a Registered Investment Adviser.

that time, the Fed Chair Arthur Burns pushed rates all the way to 13% in a short period of time. Thinking they won the battle, they lowered rates very substantially over the next two years, and inflation took off again. In fairness to Burns, it was a nasty time. The economy was in recession, unemployment was rising, and inflation was high. There were several years of stagflation, which is very difficult to deal with. By early 1980, inflation had moved all the way up to 14.7%. This is where the legend of Fed Chair Paul Volker comes into play. By December of 1980, he took the Fed Funds rate all the way up to 20%. He lowered it a touch on two occasions to test the market, but brought it back to 20% until May of 1981. This broke the back of inflation, and Mr. Volker is credited with giving us decades of much lower inflation, lower interest rates, and thus a much more prosperous economy. So, going back to Jay Powell, our current Chair, he has made it very clear that his biggest concern is backing off on rate increases too soon and having a repeat of what happened in the 70's. He does not want to be the author of that.

On the topic of recession, I receive forecasts on this subject every day from multiple sources. I think forecasts are very similar to our weather reports. Sometimes, they will be right on, and other times they miss by a mile. Yet, almost everyone checks the weather reports. We feel better if we think we know how the day or week is going to go. Right now, the number of people who think we are headed into a recession is well over 50%, and may be as high as 65%. That's a large number of people with a negative outlook. What are some of the things they are looking at? The Treasury yield curve is one. When short-term rates are higher than long term rates, it's known as an inverted yield curve. This situation has had a very strong track record of predicting recessions. Most economists and money managers put a lot of weight on it. It's been inverted for many months now by different measures. Another item is the ISM Manufacturing and ISM Services reports. The Manufacturing report is down for the second month in a row, and the Services report turned down in December for the first time since the beginning of the pandemic. This shows us things are slowing down. Everyone knows mortgage rates have doubled since early in the year and car loan rates have also gone way up. These increases have hit affordability quite hard and sales have declined sharply. The US Savings rate has declined dramatically and is close to where it was before the Great Recession. With the end of the pandemic relief programs and the current high prices, it's much harder for people to save money. This has also led to a significant increase in credit card usage as people have tried to maintain their lifestyle. The Consumer Sentiment Index is also quite low, reflecting these difficult conditions. These are some of the signs that things are turning down. If these trends will lead us into a recession is unclear.

To use a football analogy, I think we are going into the 4th quarter of the game. Most of the hard work is behind us at this point. The signs of a slowdown mentioned above are actually good news in our current situation. The Fed wants to see things slow down. The market is expecting that after a few more rate increases in the first half of 2023, they will be done with this tightening program. The futures market is currently predicting a 96% chance of just a 0.25% increase at the Feb 1 Fed meeting, followed by two more 0.25% increases in March and May. Rates are expected to top out in the range of 5% - 5.25%. At the same time, some strategists think inflation could be as low as 4% by the middle of the year. If they are right, there would be no reason to keep on hiking. How long rates will need to stay high will depend on our GDP, the unemployment rate, and if inflation is expected to continue dropping. A "soft landing" is slowing the economy and lowering the inflation rate without going into a recession. If

5788 Widewaters Pkwy | Suite 203 | DeWitt, NY 13214
315-701-5750 | Fax 315-701-5751 | dkeim@keimassetmanagement.com
www.keimassetmanagement.com
Securities and Advisory services offered through Commonwealth Financial Network, Member FINRA/SIPC, a Registered Investment Adviser.

they can achieve it, that would be very good news. As I mentioned earlier, many people don't think they can do it, and expect us to enter recession territory. If we do, the Fed now has a lot of room to stimulate by lowering rates. This is why most that do expect a recession are talking about a short and shallow decline. In either scenario, I believe we are late in the game. I think that the rest of this adjustment from the extreme pandemic stimulus will play out this year. The market is a forward-looking animal and as soon as an improved scenario can be foreseen with some amount of certainty, the bear market will draw to a close. The buyers will come in as they are convinced the bottom is in, and they will likely be right.

No one can predict the future with certainty; however, I do think we have reason to be optimistic. The bond market will definitely do better as soon as interest rates stop rising. It's a direct mathematical relationship and bond principal will generally stop declining. The interest coming in on many of the bonds will be much higher than we have seen in many years. Thus, that part of our portfolios should clearly improve. As for the stock market, it will depend on the recession scenario. If we do enter recession, earnings of many companies, but not necessarily all, will decline. How much will depend on the slowdown, but as I mentioned above, the Fed now has a lot of room to stimulate the economy by lowering rates. As the economy improves, earnings will go back up.

We want to thank all our clients for their patience and courage in hanging on tight through one of the worst years in the markets in a very long time. I know it can be very discouraging to see those asset values go down. Be encouraged, bear markets do not last forever, and in fact, up years outnumber down years by a wide margin. I'm convinced that a large part of the correction is now behind us, and we will do better soon. Please contact us anytime to review your portfolio.

Best Regards,

David E. Keim

5788 Widewaters Pkwy | Suite 203 | DeWitt, NY 13214
315-701-5750 | Fax 315-701-5751 | dkeim@keimassetmanagement.com
www.keimassetmanagement.com
Securities and Advisory services offered through Commonwealth Financial Network, Member FINRA/SIPC, a Registered Investment Adviser.