

January 12<sup>th</sup>, 2023

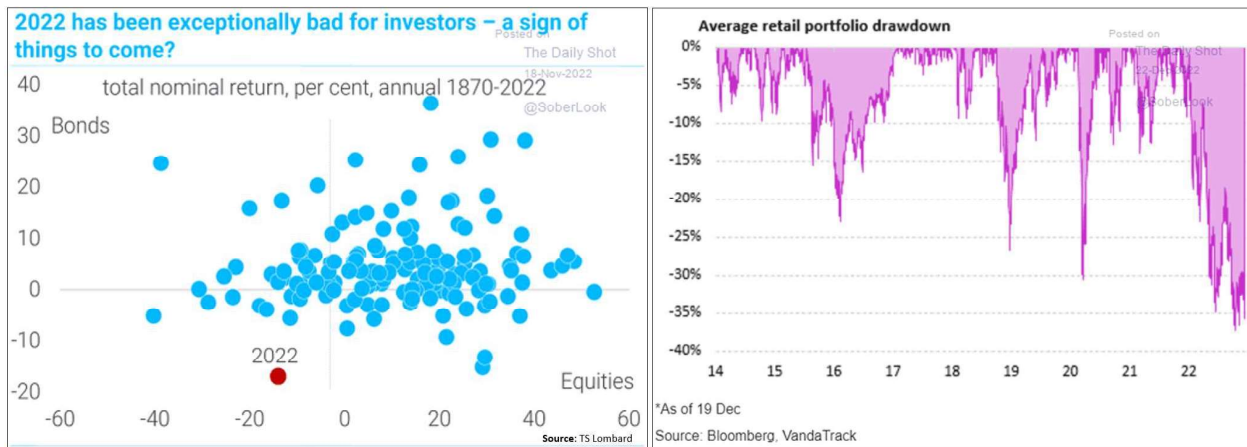
Winter Quarterly Commentary



"Though the storm may rage and the winds may howl, We must keep moving forward and stay true to our goals. For it is in the darkest of days that we find the light, And the courage to keep going through the endless night."

Björn Olafssen  
Explorer of the Svalbard Islands, 1600s

The year 2022 was a punishing one for investors. The S&P 500 Index returned negative eighteen percent and the broad U.S. bond market delivered a total return, including interest, of negative thirteen percent. Dual declines, let alone declines of this magnitude, are exceedingly rare.



There is some good news, however. While virtually all our strategies declined, they by and large outperformed by dropping less than their benchmarks. Cold comfort to be told it could have been worse, but such differentials ultimately make a big difference in the long run.

Despite all the doom and gloom, it is worth noting the stock market bounced back more than eight percent in the fourth quarter. That aggressive pace - the average return for a full year - is an excellent reminder of why one must stay invested when things are ugly.

Even better, this past quarter we collectively received some heartening news which effectively takes some of the worst market scenarios off the table. 2022 owed its plummeting values and dismal attitudes to inflation, and to the Federal Reserve's interest-rate-raising reaction to said inflation. If inflation continued mounting, it is not hard to imagine 2023 following in the footsteps of 2022.

Fortunately, starting in October, inflation all but disappeared. That is, prices stopped rising at their breakneck pace<sup>1</sup>, making the investment outlook much more neutral, if not outright positive. This cessation isn't readily apparent and mainstream media has largely missed the story, but Mr. Market didn't. That's why he perked up in the fourth quarter. The forthcoming explanation is a little technical but please bear with us because it's important. Inflation has been driving everything - and the story has changed<sup>2</sup>.

The first reason the good news inflation story has been somewhat obscured is that it is standard practice to quote inflation at an annual rate, that is, how much prices have changed over a year. Looking at how prices have changed over a year will make it hard to see the change when prices rise for nine months and then start to level off - which is exactly what has happened. In the November report, the annual or year-on-year core inflation rate was six percent, down somewhat, but far above the Federal Reserve's two percent target. However, if you just look at the change in prices from October to November (the month-on-month change), you get a rate that annualizes at just 2.4%, right about at the Fed's target.

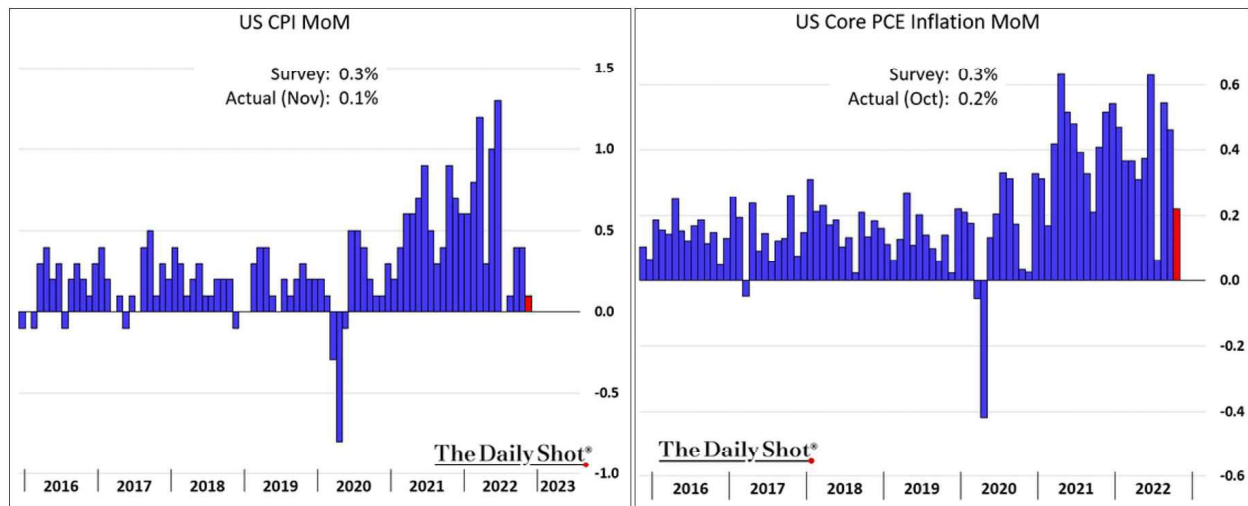
Simply put, even though annual measures of inflation are still elevated, excess inflation has all but disappeared in the last three months. You can see this visually in the following month-on-month charts of two popular measures of inflation: the standard Consumer Price Index (CPI) and the Core (excluding food and energy) Personal Consumption Expenditures Index (PCE). Observe that the recent monthly readings, are

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<sup>1</sup> The end of inflation doesn't mean prices will go back down. The end of inflation simply means that prices stop rising. In practice, this means that prices stop rising faster than the Federal Reserve wants them to - about two percent per year.

<sup>2</sup> For now, at least. It is always possible that inflation re-accelerates in the coming months, but this is not our view at present.

both right about where they were before the pandemic (when inflation was under control).



But wait there's more. The inflation story is even better than that because even the month-on-month measures discussed above drastically overstate recent inflation. Why? Because the way our government measures shelter inflation<sup>3</sup> is hopelessly lagged. When it comes to inflation in home prices and apartment rates, even the month-on-month CPI readings only tell you what happened over the last year, not what is happening now<sup>4</sup>.

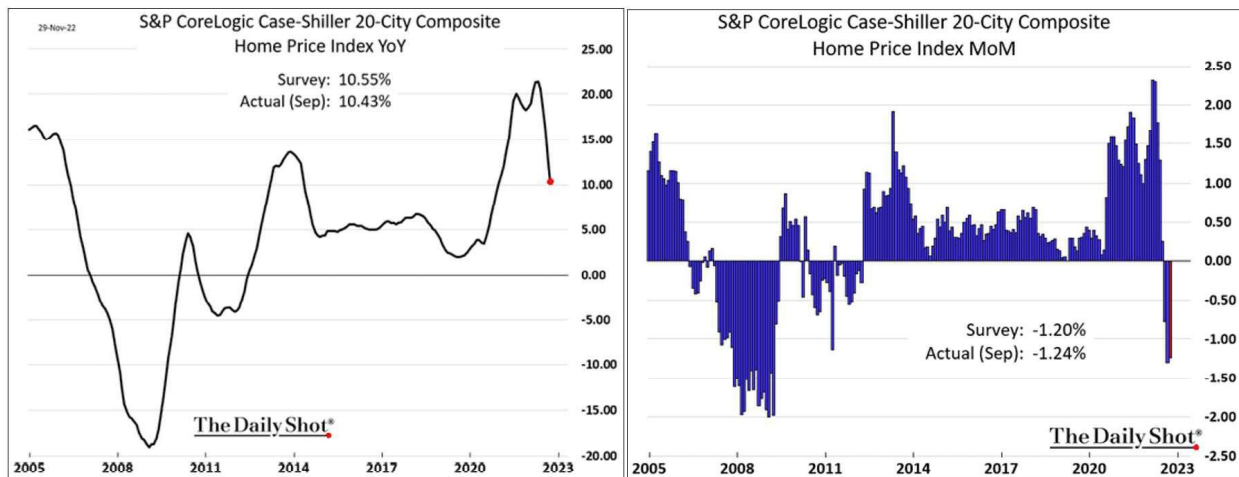
For a more up to date idea of what is happening with home prices, we can look at the recent activity in the Case-Shiller Index. This index of home prices in twenty cities is updated when a home that was previously sold is sold again. It doesn't suffer from the same delay issues that plague the official shelter CPI numbers.

We present two graphs showing what is going on with home prices in the U.S. The first is a year-on-year graph that shows, yes, home prices are certainly higher than they were a year ago. However, the second month-on-month graph shows that over the last few months home prices have started to decline. Like our example with inflation, it will take a while for these recent monthly changes to show up in annual numbers. Unlike

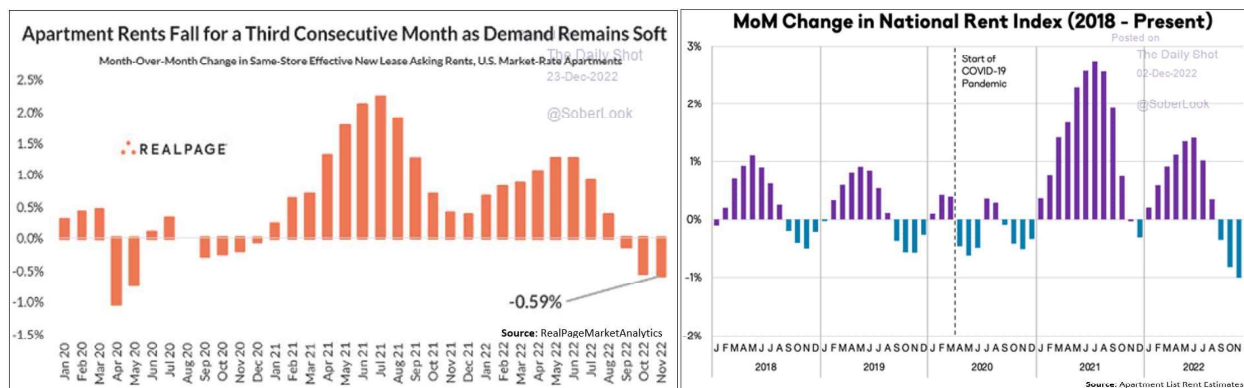
<sup>3</sup> Shelter inflation encompasses the implied expenses of living in owned homes as well as renting living space.

<sup>4</sup> Shelter CPI lags conditions on the ground for a few reasons. Firstly, when rent starts going up, most people don't pay more until their previous lease expires. CPI measures what most people are paying now, not what is happening with new leases. Secondly, the Bureau of Labor Statistics, which maintains the Consumer Price Index (CPI), only goes out and samples rents every six months. When they do find an increase, they don't reflect it immediately, but rather slowly phase it into their statistics over six months until their next measurement. Put these factors together and you get a substantial lag in the shelter inflation being reflected in CPI.

inflation, when it comes to homes, it appears that prices are actually *falling*.

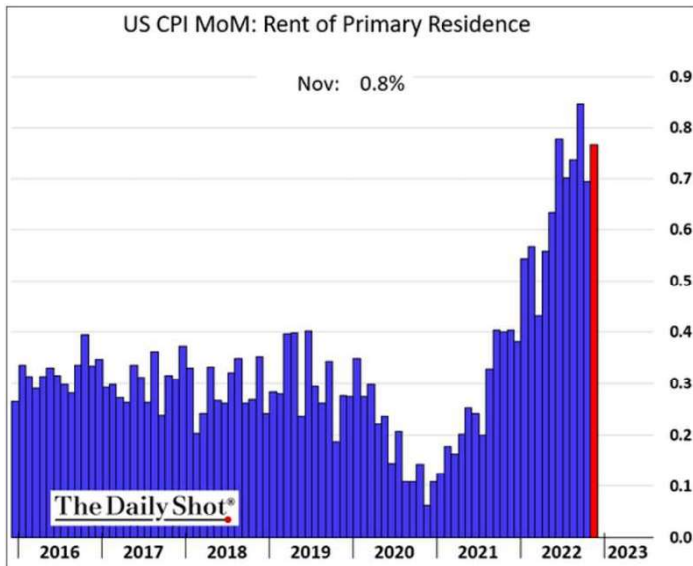


The story is the same with apartment rents. Real time measures show rents falling for the last three months, after rising for the nine months before that.

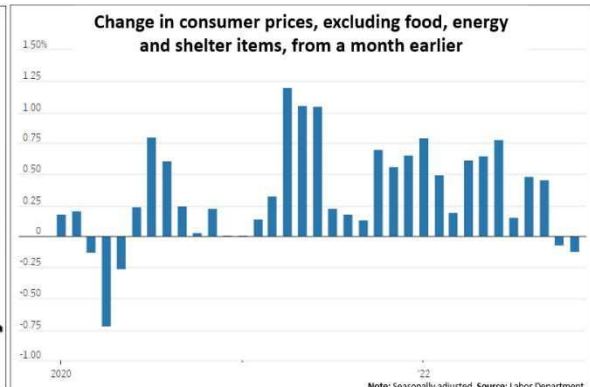
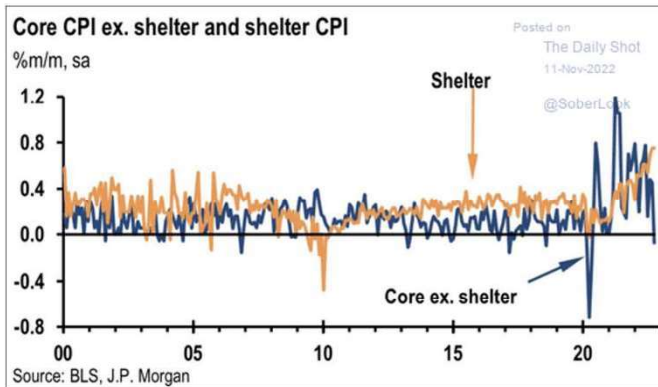


The graphs above show us what we probably know from our own communities: home prices and rents went bananas through most of 2021 and 2022, and only recently started to ease off. Now let's compare what we know actual shelter inflation to be with the official statistics shown below. The figures below would have us believe that shelter inflation is now higher than ever. Why? Because as noted earlier the official statistics are hopelessly out of date<sup>5</sup>. (Note that the monthly figure of 0.8% shown below annualizes to about ten percent.)

<sup>5</sup> Sadly, we believe these lags in shelter inflation were what caused the Federal Reserve to miss rising inflation until it was too late. These same lags are now helping them make the same mistake in the opposite direction - they are missing that things have changed.

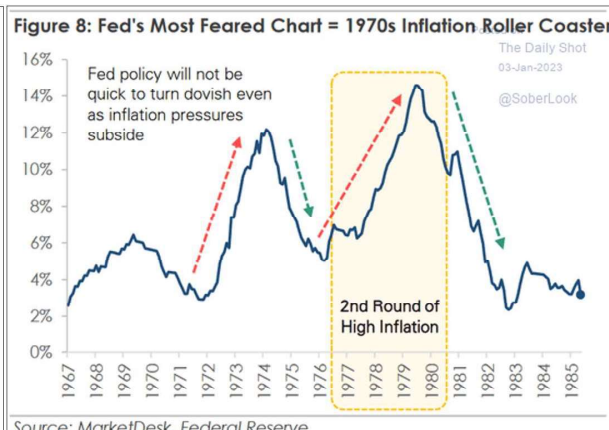
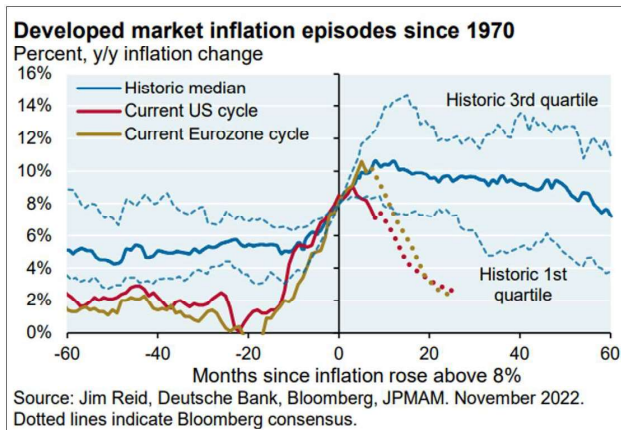


We have just shown how the official shelter inflation is greatly overstated. What makes this interesting is that this overstated measure of shelter inflation is currently making up the majority of *all* reported inflation. If you remove shelter inflation from CPI (which you should because it's wrong), you are left with little or even negative inflation! Note the below charts showing no inflation when shelter is removed.

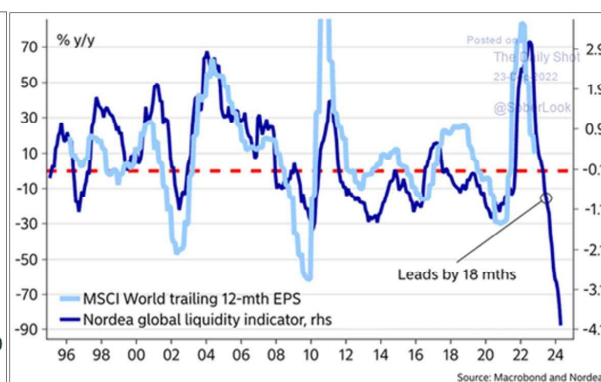
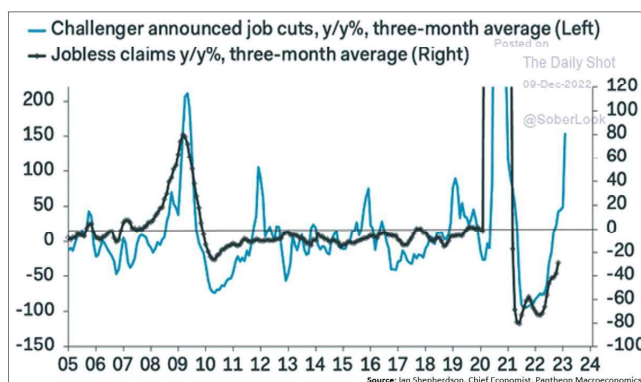


The story that real-time measures of inflation have ground to a halt (or have even gone negative) recently is a big one, and underreported, but as usual comes with a few caveats. The biggest of which is that inflation has been tame for only a few months and could re-emerge. A second, and one that particularly worries the Federal Reserve, is that wage inflation remains high. Another is that it would be an anomaly if inflation has truly declined this quickly for good. Historically it has taken a lot longer for inflation to subside once it gets elevated. Thus, it is possible that annual measures of inflation will drop to, say, four percent but then remain stubbornly there, as has happened in the past. We are willing to believe that the current inflationary episode represents an anomaly, mostly induced by COVID and its repercussions, and thus inflation will drop faster than usual.



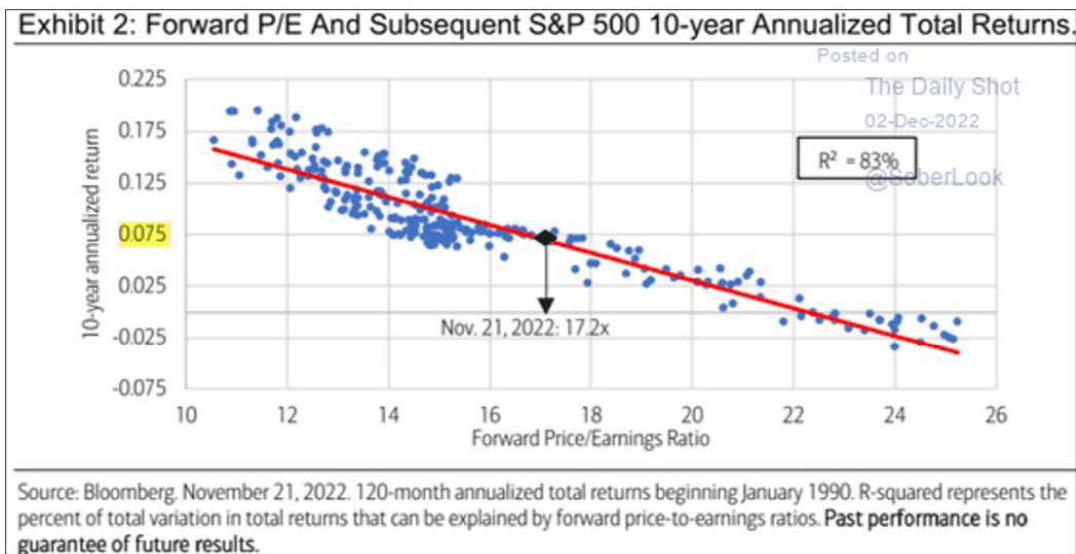
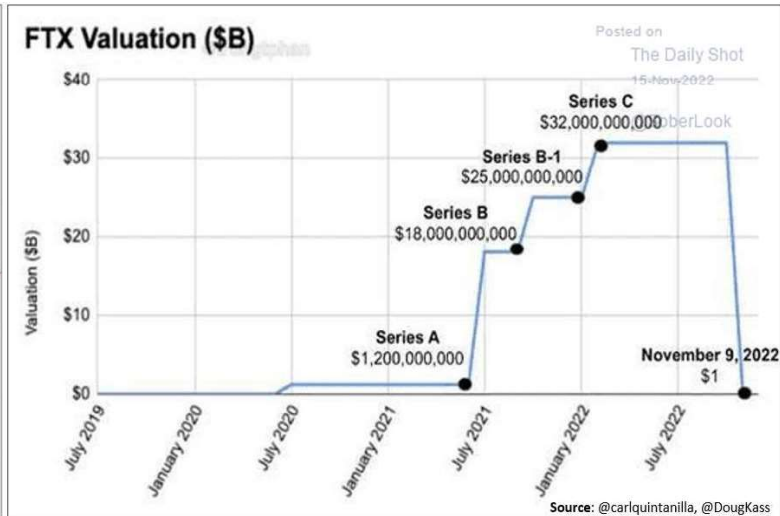
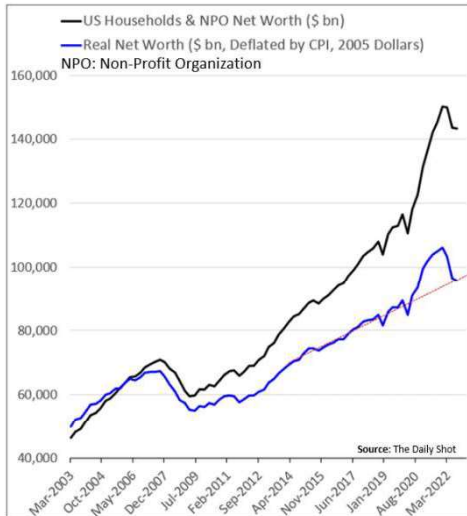


Unfortunately, the Federal Reserve, which sets interest rates in this country, is not willing to believe the inflation monster will be so easily tamed. They are likely worried about the 1970s experience shown in the second chart above, where inflation seemed defeated but came roaring back. Thus, they are preparing to raise short-term rates further toward five percent. This, in our opinion, is overdoing it and will cause a recession. Leading indicators continue to indicate as much.



But not all is lost! Markets tend to bottom around the start of recessions, not their end. The stock market *already* declined 25% into last Fall, in recognition of economic risks, a selloff consistent with a moderate recession. We also know, probabilistically, most years the market rises and periodic market declines are regularly recovered.

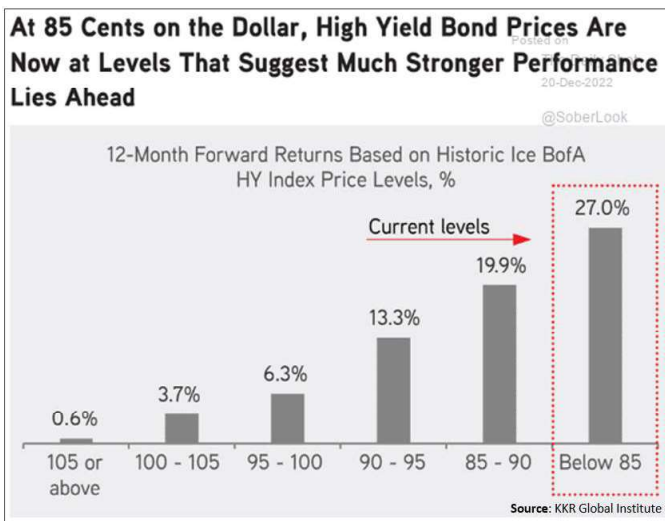
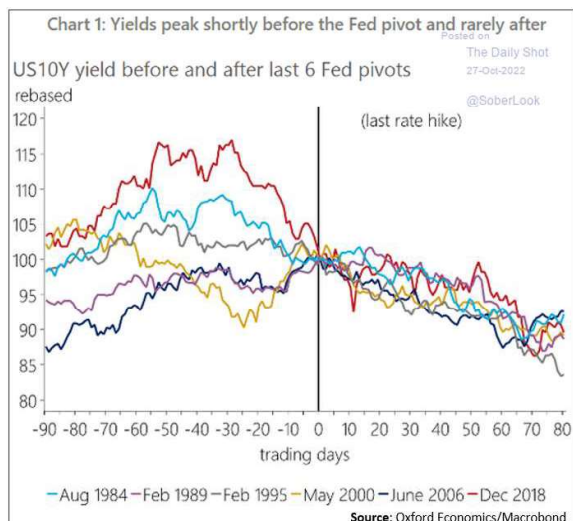
In fact, drawdowns like this are a necessary pre-condition for good forward returns (outside of a bubble scenario). We have written before about the "Illusion of Prosperity" brought about by low rates and excessive government spending. Too many people were getting rich too quickly; it wasn't sustainable and it worried us. In the past year the Illusion was mostly swept away, as shown in the following graph demonstrating that U.S. household wealth has returned to its pre-pandemic trend when adjusted for inflation. An illusion like the "wealth" created by now bankrupt cryptocurrency brokerage FTX needed to be swept away. And now it has been.



More concretely, stock valuations have retreated enough to where the forward ten-year annual expected return of equities is again in the normal range of about eight percent. Previously, high valuations had indicated less sanguine returns, but the selloff has reset the table, and the long term looks solid once again.

The future looks brighter not only for equities but for fixed income as well. While higher rates have hurt fixed income investors over the last year, going forward they unambiguously help. We are now able to buy solid quality corporate bonds yielding in the five percent range, roughly twice the prevailing rate a year ago. For high income tax bracket investors, we can find municipal bonds in the three and a half percent interest rate range, which is equivalent to seven percent return on a tax-equivalent basis. For those with long time horizons and the ability to stomach some volatility, U.S. stocks still probably represent the best bet. However, for those with shorter horizons or who wish for a more tranquil experience, you now get a more meaningful return from fixed income.

Before long, rates may fall back down if the Fed ends up causing a recession as we predict. We believe the fed will "pivot" to lowering rates, probably in 2023. The following chart shows how longer-term rates have declined in the past after the Fed pivots. If this happens again it will make bonds purchased today more valuable.



Prospects also appear promising for high yield bonds, which we selectively employ in our Managed Income strategy<sup>6</sup>. 2022 was a rare losing year for us, with a six percent loss versus an eleven percent drawdown for the asset class<sup>7</sup>. However, as the chart above shows, with high yield bonds now trading at 85 cents on the dollar, forward returns could easily creep into double digits.

Even going to cash (as we sometimes do) no longer means completely missing out on investment returns... as long as you don't keep that cash at the bank. We make sure any cash in your brokerage account earns the maximum safely available, currently about four and a quarter percent annually. (In taxable accounts we take your approximate bracket into account and often invest in municipal money funds which generally have a lower rate but effectively return more on an after-tax basis.) If you've been keeping cash at the bank, give us a call so we can tell you how to earn more by keeping your cash in a (virtually) risk-free money market mutual fund in your brokerage account.

Despite the higher returns available in cash today, we recommend remaining invested in the stock market, as this is the best way to benefit from the progress of the country and world in general. And despite grim headlines, rest assured there is progress. In just the last few months there appear to have been amazing strides in the world of artificial intelligence (AI), especially large language model chatbots.

<sup>6</sup> This strategy, in which we use a momentum model to buy and sell high yield bond mutual funds in an effort to capture upside and avoid downside, is a material component of all our fixed income strategies.

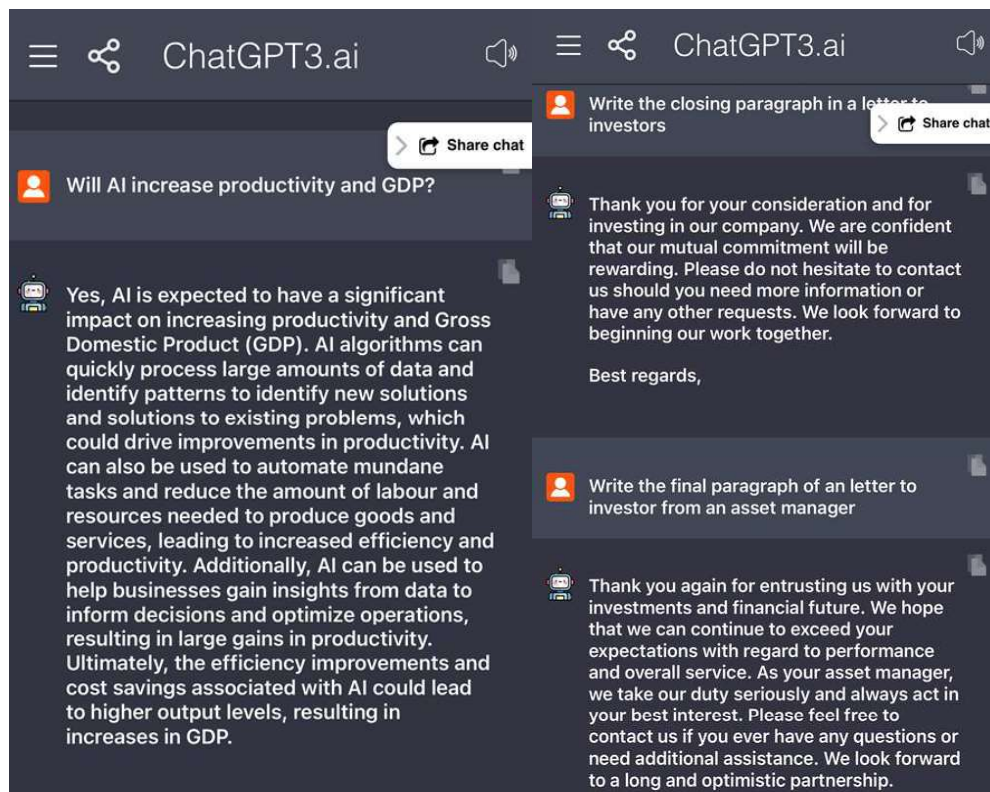
<sup>7</sup> It was even worse for the broad U.S. bond market, which suffered a historic thirteen percent loss for the year.



The recently released Chat GPT3 has been astounding the internet with its ability to respond coherently to complex prompts.

AI is expected to have a significant impact on increasing productivity and Gross Domestic Product (GDP). AI algorithms can quickly process large amounts of data and identify patterns to identify new solutions and solutions to existing problems, which could drive improvements in productivity. AI can be used to automate mundane tasks and reduce the amount of labour and resources needed to produce goods and services, leading to increased efficiency and productivity. Additionally, AI can be used to help businesses gain insights from data to inform decisions and optimize operations, resulting in large gains in productivity. Ultimately, the efficiency improvements and cost savings associated with AI could lead to higher output levels, resulting in increases in GDP.

You don't have to take our word for it. In fact, those weren't our words at all because the previous paragraph was written by a chatbot. Fictional Björn Olafssen's quote and image at the beginning of this letter were also generated by artificial technology. How can you benefit from this technology? Two ways. The first is easy: be a member of society. The second is: have an ownership stake in society, that is, own stocks.



After a tough year, we cannot say for certain whether the next year will be bright. The next handful of years taken together however, will certainly be so.

Thank you for the continued trust you place in us.

Sincerely,



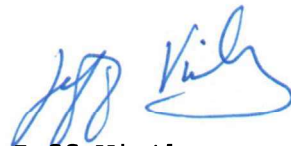
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