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asset management

January 2023

"The oak fought the wind and was broken,
the willow bent when it must and survived."
-Robert Jordan

The year 2022 will be remembered as an unusual period in investment history when both stock and bond indices declined in value. Typically, stocks and bonds perform inversely to each other. A confluence of events created a "perfect storm" that led to the negative performance returns across both asset classes. The exceptionally low US inflation rate that had been persistent for the past twenty years reversed its course. The current higher rate of inflation was ignited when stocks were trading at historically high valuations. Investors rationalized high stock price-earnings ratios when the level of interest rates was zero but could no longer do so as interest rates began to rise. To reduce inflation, the Federal Reserve raised interest rates which led to a decline in bond prices. As investors grew increasingly concerned about the persistence of higher inflation, a bear market ensued.

Inflation and Interest Rates

During the year, world economies began to awaken from the pandemic slowdown. The increase in economic activity, ongoing supply chain constraints, a surge in commodity pricing, and stimulus fiscal spending were significant factors that resulted in a higher inflation rate. The Federal Reserve responded by raising interest rates to the highest level in fifteen years, from zero percent to 4.25%-4.5% between March and December. The recent peak in the inflation rate of 9.1% in June has moderated to an annualized rate of 7.1% reported in December. Yet, it is still far away from the Feds target inflation rate of 2%. The hope for US investors is that higher interest rates will gently slow economic growth enough to quell inflation. Historically, this strategy has been successful for controlling inflation. However, it does not take into consideration the structural changes in the US economy that have occurred over the past few decades.

Today, approximately 75% of US GDP is comprised of the service sector. Meanwhile, manufacturing has steadily declined to 10%. Manufacturing companies require investment in large capital-intensive projects including expanding physical plants and new equipment to add capacity for growth. To fund such expansion, manufacturers require financing which is offered at the prevailing interest rate. Conversely, service companies provide services performed by employees and/or technology such as software that is not capital intensive. Furthermore, new technological advancements have increased opportunities for additional income and expanded the "gig" economy. The "gig" economy, a factor in the structural change which contributed to higher consumer spending, relies heavily on temporary and part-time positions filled by independent contractors and freelancers. The magnitude of such structural change in the US economy should be considered when evaluating the potential impact of higher interest rates on the inflationary environment.

Finally, economic statistics continue to show resilience in the US economy. Third quarter US GDP increased 2.9%, the unemployment rate remains low at 3.7% and recent inflation data included a wage rate increase 5.1%. There are global factors that support a higher rate of inflation, such as the Ukraine war and recent actions taken by the US to reduce its dependence on China. Fiscal spending, such as the CHIPS Act, and the Inflation Reduction Act, provide support for business infrastructure spending, in turn sustaining both economic growth and the labor market. Based on the recent economic reports, it appears there is no guarantee that higher interest rates will cause an economic contraction or reduce inflation to 2%. In fact, the Chairman of the Federal Reserve has expressed that interest rates may be higher for a longer period to wrest inflation rate from the current rate of 7%.

Despite the current economic reports, the bond market's inverted yield curve is forecasting an US recession. Today, the 2-year US Treasury yield is 4.7% compared to the US 10-year Treasury yield of 3.89%. The inverted curve is hopeful that future reports will evidence a slowing economy and bring a lower inflation rate.

How should investors position portfolios during this transitional period?

The tumultuous investment experience of 2022 has amplified the importance of a risk-adjusted return strategy. AHB portfolios have been buffered from the severe declines in both stock and bond markets. Beginning in 2021 and continuing through early 2022, we reduced portfolio exposure to information technology companies and added positions in energy, financial services, and bio-pharmaceutical sectors. These sectors of the economy are opportune to increase earnings growth despite higher rates of inflation and interest rates. Additionally, these companies have higher dividend yields and lower price-earnings ratios to provide additional downside risk protection from equity valuation contraction. We anticipate 2023 to be another year of transition toward a normalized economy whereby inflation may be approximately 2-3% per year, interest rates approximately 2% over the inflation rate, with equity valuations returning to historic averages and commensurate with the rate of future earnings growth potential.

The zero percent inflation and very low interest rates allowed for unlimited expansion of equity valuations for companies with no profits and merely the prediction of future earnings potential. It also pushed fixed income investors to stretch for yield in significantly longer dated maturities or junk rated paper. These higher risk investments are those that experienced the greatest declines for investors in 2022.

Bond prices declined in 2022 and will be under continued pressure until there is more evidence of a decline in the inflation rate. Beginning in 2021 and continuing through 2022, AHB prepared portfolios for an environment with higher inflation. Taxable and municipal bond portfolios were repositioned with shorter maturities and a lower target duration, providing some protection from the decline in bond prices.

Actively laddered bond portfolios continue to be reinvested at shorter maturities to take advantage of the higher returns and preserve principal. Over time, we would expect the yield curve to transition to the normal curve where the longer dated bonds will provide a greater return.

AHB client portfolios are fortified with stocks and bonds that are well positioned for this transitional period in capital markets. We look forward with cautious optimism to a lower rate of inflation that will reduce uncertainty and volatility in the capital markets.

Best wishes for a happy and healthy New Year.

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