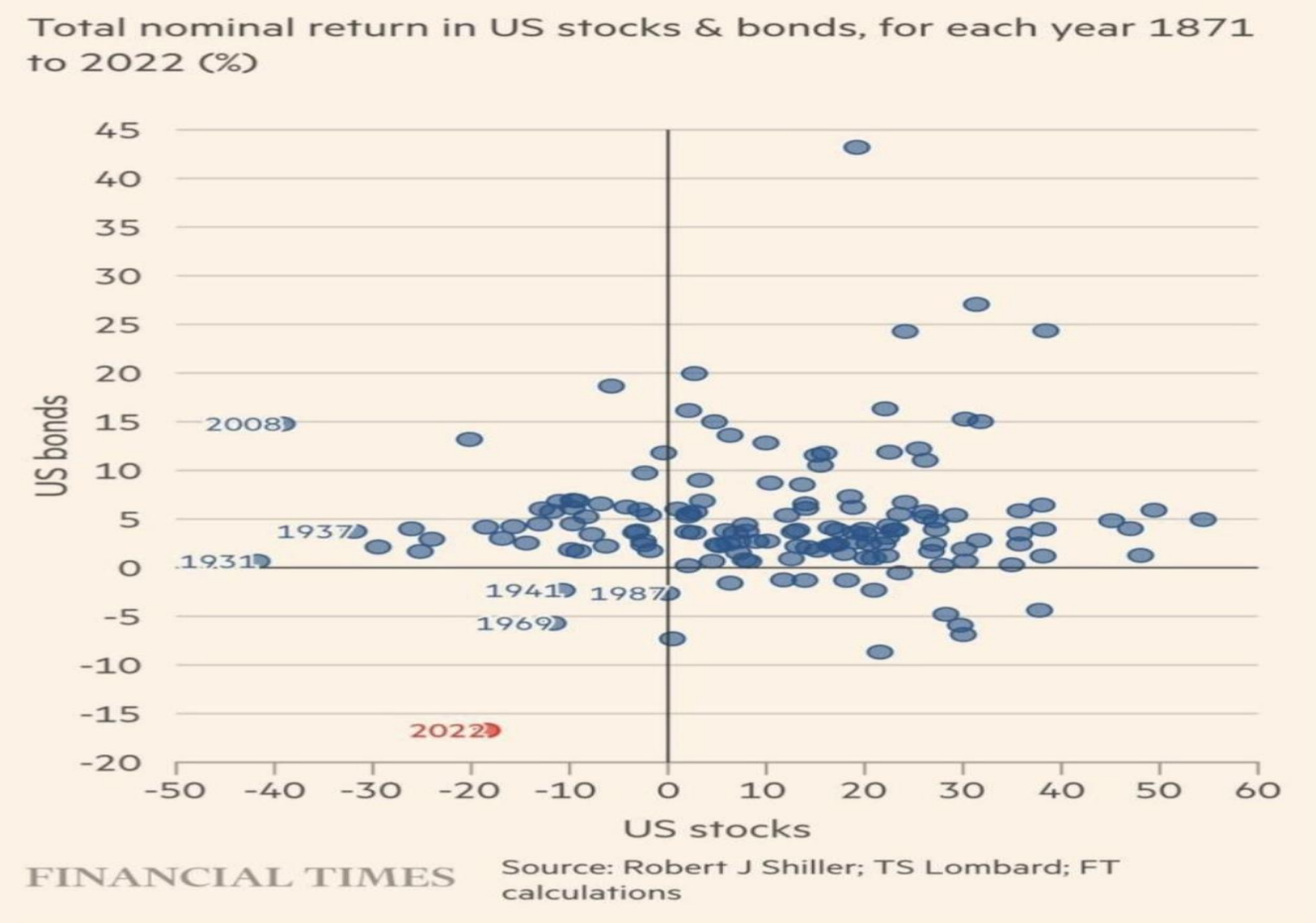
Investment Strategy
January 2023

2022 was a very difficult year for most investors as nearly all major asset classes delivered negative performance. Fixed income investments turned out to be particularly hazardous as long-term U.S. government bonds experienced their biggest drop since 1788. Meanwhile, the traditional 60% stock/40% bond portfolio suffered its worst performance since 1932. To review, the S&P 500 Index declined 19.4%, the tech-heavy Nasdaq fell 33.1%, and the Vanguard intermediate-term corporate bond index was down 16.4%. To give proper historical context, we included the chart below from the *Financial Times* that shows the annual performance for U.S. stocks and bonds since 1871. As you can see, there have been several years of larger stock declines, but the combination of very poor stock and bond returns made last year truely unique.



As we warned a year ago, there were very few places to hide in 2022. Luckily, our portfolios significantly outperformed the indexes last year (most roughly broke even in 2022). Client portfolios were boosted by large holdings in the energy sector which was the one asset class to provide a large positive return in 2022. We also dodged the calamity in the bond market

last year by holding a sizable portion of client portfolios in cash. While this positioning was very unusual and unconventional, it made sense to avoid the most richly priced bond market in human history at a time when inflationary pressures were raging. As interest rates moved sharply higher over the summer, we shifted client cash into short-term U.S. Treasury bonds to generate safe income.

Looking forward to 2023

We were lucky to avoid most of the trouble in 2022 as clearly overvalued, speculative stocks (and other assets) took the brunt of the losses[1]. A year ago, we believed a period of euphoria would end as surging inflation caused the central banks to tighten financial conditions. In retrospect, the U.S. Federal Reserve was more aggressive than we anticipated as they boosted short-term rates from essentially 0% in March to 4.25% by the end the year. The sharp increase in interest rates acted like gravity on asset valuations, leading to broad declines across nearly all types of investments. While last year was largely a story of deflating asset bubbles, 2023 returns will be more driven by slowing global growth and deteriorating company profitability.

The "rule of thumb" is that an interest rate increase takes 9 months to make its way into the real economy. Based on this **debatable** approximation, the initial interest rate increase last March is only beginning to have its full impact today. This means that we might experience a rapidly slowing global economy in the first half of 2023 as tightening financial conditions work through the system. Importantly, all major central banks around the world have boosted interest rates in unison over the past 9 months. As a result, we could suffer the first synchronized global recession since 1981-1982[2]. Unironically, the deep recession of the early 1980's was triggered the last time the Federal Reserve sharply increased interest rates to fight inflation.

Corporate profitability will suffer in 2023 as margins are compressed. As the economy slows, businesses will be faced with slowing or declining revenues. At the same time, companies will continue to experience cost pressures from several different sources. For example, companies are struggling with Russian material shortages due to the war, Chinese supply chain problems as geopolitical relationships deteriorate, and surging U.S. labor costs as workers demand higher pay following the recent burst of inflation. Further, higher interest rates increase the cost of carrying debt, subtracting from profits. In short, there is a confluence of factors that are now pressuring corporate profitability and none of them are likely to go away soon. Keep in mind that several unusual circumstances have been boosting profit margins to the highest levels since the early 1950's. We point these things out because investors are underestimating the potential decline in earnings. Put differently, investors are misjudging how expensive the stock market remains despite the declines in 2022.

[1] Highly Speculative stocks fell 50-90% in 2022
[2] An idea promoted by Lakshman Ackuthan of Economic Cycle Research Institute (ECRI)

Tesla is the easy example because the stock embodies the current mania where people suspended disbelief and will suffer the consequences. In 2022, Tesla's stock declined 65.5%[3] and the carnage has continued in early 2023. Investors may now assume that Tesla is quite the bargain at a market cap of $350 billion. Unfortunately, the stock would need to shed at least another $300 billion in value to be priced in-line with established automakers. This would represent an 85% loss from here and a 96% loss from its peak. While this case is particularly egregious, many blue-chip consumer staple, healthcare, and utility companies are exchanging hands at 25x earnings or more. Most of these companies are very mature and haven't been able to significantly grow revenues for the past 5-8 years. Given a lack of growth, these stocks should be trading at much lower valuations. As these examples illustrate, there are still plenty of overpriced areas of the market that are likely to suffer in the year ahead.

Our overriding strategy for 2023 is to try to avoid various pitfalls by remaining defensively positioned. We have recently been trimming back our richly priced consumer staple and healthcare stocks that were pushed up to new all-time highs. At current prices, a short-term U.S. Treasury bond yielding 4% is far more attractive than a richly priced, mature company offering a dividend of less than 2.5%. We have also maintained our large allocation to cash/short-term U.S. Treasury bonds across client accounts. There will be a time to deploy this cash aggressively into new investments and that opportunity may present itself later this year. However, it is very difficult to predict the timing of any such investment. We have retained our large allocation to energy stocks and gold mining companies. While oil stocks are up sizably from a year ago, they are still trading at a significant valuation discount to the overall market. The energy companies we own are generating loads of excess cash at current oil prices. This is allowing them to pay down debt and significantly ramp up dividend payments to shareholders. Meanwhile, gold mining companies have been highly profitable for several years. As a result, they have already paid down most of their debt and have boosted their dividends several times over the past two years. Additionally, the price of gold has behaved much better at the end of the year as foreign central banks accumulate gold at the fastest pace in decades. We believe this allocation adequately protects client nest eggs while positioning portfolios to pivot to a more aggressive stance when investment opportunities become irresistible.

Sincerely,

Keating Investment Counselors, Inc

[3] 70.3% decline from peak on November 7, 2021

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