Pinney&Scofield

Building long-term relationships with long-term investors

October 14, 2022

Dear Client,

We started our January 2021 letter by quoting the opening lines of Charles Dickens' *A Tale of Two Cities* to illustrate the duality of the economy and markets and the difficulty of forecasting. We were interested to see recently that Jamie Dimon, the outspoken chief of JPMorgan, took a page from our playbook when in mid-September he said:

> "The US economy today is a classic tale of two cities, there are headwinds and tailwinds making it challenging to predict the future. While these storm clouds build on the horizon, even the best and brightest economists are split as to whether these could evolve into a major economic storm or something much less severe."

Slowing down the economy is not a pleasant process. It is very disruptive in the short-term and not even the "best and the brightest" know what's going to happen. Since 1946, the Fed has had 13 rate hike cycles. Ten of those were followed by a recession. Fed Chair Jerome Powell has been quoted as saying they are prepared to face "unfortunate costs" to their actions of raising rates to cool the economy. Part of their objective after all is to increase unemployment and to reduce wage growth. And the Fed's actions have obviously had a negative impact on the markets, especially bonds. We are experiencing the worst bond market ever.

The fed has raised interest rates by .75% three times this year and .50% before that to get the Fed Funds rate up to the 3.0% to 3.25% range. Rates are rising faster than any other time in recent history. And with the September inflation report showing inflation still at 8.2%, higher than expected, another .75% rise seems likely. The rapid rise in rates has had a devastating effect on bond prices which move inversely to interest rates. The longer the bond, the greater the impact rate changes have on pricing. Look at the Bloomberg US Treasury Bond Index Long. It is down 28.84% through September 30th. Compare that to the S&P 500 which is down 23.87%. That's right, long-term bonds, issued and backed by the US government and considered among the safest investments available are down more than stocks.

Bonds typically help to hold up your portfolio when stocks fall. During the financial crisis in 2008 and the beginning of the pandemic in 2020, stocks plummeted while bonds did a much better job in maintaining their value. Stocks zigged and bonds zagged. That is what we are accustomed to seeing. This created rebalancing opportunities for us. We followed our investment policy and trimmed from bonds that were doing relatively well and bought the falling stock. So far this year, with both stocks and bonds falling by double digits, there has not been as many rebalancing opportunities because they have been falling proportionally so your portfolio has not come out of tolerance as often as we have seen in prior market corrections. There have been some loss harvesting opportunities though. Where possible, we have been selling positions at a loss and reinvesting the proceeds in a similar fund which will help come tax time.

How much higher will rates go? That is the big question that not even the Fed is good at predicting. Just look at past Fed "dot plots". At each Fed meeting, all the governors are asked to plot where they think rates will be in a year. Past dot plots show they are not able to predict where the rate will be, and they are the ones setting the rate! There are just too many variables that are out of their control.

Our bond strategy to manage these variables is to maintain an equal weighting in four bond categories within your portfolio – short-term bonds, long-term bonds, high yield bonds and inflation protected bonds. It was not a secret that the Fed would be raising rates this year and long-term bonds would take a hit as a result. Many active investors adjusted their portfolios into short-term bonds so they would not be impacted as much by the rise in rates. Once the Fed stops raising rates, they plan to transition back to long-term bonds. The problem with this strategy is once the Fed ends their increases, the yield on long-term bonds will have already decreased. Active investors will miss out on the higher yields being offered by long-term bonds now. Yes, their portfolio might go down less in the short-term but the total return of their portfolio will go down in the long-term as they miss purchasing bonds with higher yields. As a point of reference, one of the funds in many of our clients' portfolios is the Vanguard Long Term Investment Grade, symbol VWETX. Vanguard reports the dividend yield on this fund has increased from 3.22% in January to 4.57% in September, an increase of 41.9%

We are indeed still facing a lot of headwinds with the persistent high inflation, high energy prices and war in Ukraine. This storm is far from over. But there are also signs of some tailwinds on the horizon. Foreign countries who started raising rates earlier than the US are starting to taper their hikes. This could mean they will start their recovery earlier. International stocks have underperformed over the last several years. Their valuations remain far below their long-term averages so this could provide good future returns for investors. In the US, the S&P 500 P/E (price to earnings) ratio is now below its 25-year average. Of course, the P/E might go even lower as we continue to stumble through the slowdown of the economy, but a lower P/E should help provide better returns in the long-term.

Despite the inflation news, Social Security and Medicare recipients were met with good news. The Social Security Administration has announced the 2023 cost of living adjustment is 8.7% and Medicare announced a reduction in the standard Medicare B premiums for next year.

We do have some sad news to report. Ryan's dog Sierra has recently been laid to rest. Over the last 14 years Sierra has greeted our clients as they walked through the door. In the later years she would do so with a simple head nod from the comfort of her bed. She was always up for a game of fetch in the hallways and was a great stress reliever for the office. Sierra was a fantastic companion to Ryan, and she is greatly missed.

John, Richard, Mary, and Ryan

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