## Market Commentary

*Alone among the various forms of larceny, fraud has a time parameter. Weeks, months or years may elapse between the commission of the crime and its discovery. This is a period when the fraudster has his gain and the man who has been defrauded… feels no loss. There is a net increase in psychic wealth. At any given time there exists an inventory of undiscovered fraud in …the country's business. – John Kenneth Galbraith (paraphrased)*

Global equity markets ended with a modest fourth quarter rally that reduced the pain somewhat, but still resulted in the **worst calendar year performance since the 2008 Global Financial Crisis**. The S&P 500 returned -18.1%, which outperformed the -20.1% return from Emerging Markets but lagged the -14.5% return of the developed market MSCI EAFE Index. Growth stocks fared the worst, with the Russell 1000 Growth Index returning -29.1% compared to -7.6% for the Russell 1000 Value Index. **However, the declines came after several years of record performance. The two-year return of the S&P 500 remains positive**, and the 3-year annualized return of 7.6% is in line with the average returns we utilize for planning assumptions. While equity markets saw the largest declines in over a decade, the -13.0% return of the Bloomberg US Aggregate Bond Market Index delivered by far the worst performance of the bond market since the inception of the benchmark. The largest negative return of the Bloomberg Aggregate over any 12-month period, prior to 2022, was a comparatively modest -5.1% in 1980. **The record poor performance of the bond market stemmed from the normalization of the ultra-low yields in 2021 and investors are already benefiting from higher yields.** T-bill and money market rates above 4% mean that short term savings can be productively invested without taking undue risk. Over time, the higher yields on intermediate term bond portfolios will offset the valuation declines from last year.

**As the famous quote by John Kenneth Galbraith alludes, boom times enable fraud that subsequently gets exposed at end of a market cycle**. While most fraud can be avoided by following basic due diligence and refusing to invest in schemes that are either too difficult to understand or appear too good to be true, many investors succumb to the pressure when they see the supposed gains that others are receiving. Malinvestment, defined as badly allocated investments driven by cheap capital, behaves similar to outright fraud – investments in wildly overvalued assets create a feeling of prosperity that shatters when capital discipline returns to markets. The 1980s ended with the insider trading scandal of Michael Milkin and Ivan Boesky and the bankruptcies of highly levered private equity investments. Along with the dot-com bubble, the 90s ended with Enron, WorldCom and a host of other accounting scandals. The 2008 Global Financial Crisis exposed Madoff, along with endemic fraud at every part of the supply chain for residential mortgages.

**The frauds at the end of past business cycles spurred reforms that helped protect investors during the next cycle, and investors generally did not repeat the same misallocation mistakes.** The widespread insider trading across investment banks and law firms ceased to exist after the prosecutions of the late 1980s. Leverage in private equity investments declined to more sustainable levels in the 1990s. Similarly, the harsh criminal penalties placed on corporate management by the Sarbanes Oxley act greatly reduced the incidence of accounting fraud in public US companies, and investors became wary of technology hype. Notably, the greatest corporate scandals of the past ten years were either non-US firms (Wirecard in Germany, Canadian-domiciled Valeant or the China-based Luckin Coffee), or in private companies such as Theranos, FTX or WeWork. Given the banking reforms after 2008, the balance sheets of American and European banks remain in pristine shape.

**Over this cycle, the issues appear to be concentrated in crypto and some niches of the public equity markets, such as low-quality technology stocks, meme stocks or SPACs.** While the losses of retail investors in these schemes are real tragedies, the scale of the crypto market (less than the market cap lost by Tesla last year) is too small to impact the broad economy or financial markets. Prices for speculative tech stocks corrected sharply last year. SPACs are a special vehicle allowing private, typically venture-backed companies, to go public with less regulatory scrutiny than a traditional IPO. The SPAC mania of 2020-2021 led to the listing of hundreds of speculative technology companies, many without either revenue or actual products. Predictably, most of these stocks have lost 90% or more of their value.

**The relatively minor scale of fraud and malinvestment this cycle speaks to a less severe correction than the bear markets of the 2000s.** While valuations have declined to more reasonable levels, corporate earnings remain at risk should the economy slow further. This recessionary risk consumes the focus of pundits and the financial press. As short term economic and market movements remain unpredictable, worrying about a recession is unproductive. Prognosticators a year ago failed to predict either the record inflation or market declines in 2023. Perhaps biased by recent experience, outlooks for 2023 tend to the gloomy side. The primary risk, from our point of view, would be that potential weakness in corporate earnings leads markets to retest the lows of the September – October period, which would be a 10-15% decline from current levels. The equity markets offer comparable upside potential should the economy avoid a recession and corporate earnings remain at reasonable levels. We tend to believe that a recession can be avoided, but a slowdown remains a strong possibility.

**After the pain of last year, bonds now offer reasonable rates of return.** In addition to 4%+ yields on T-bills, intermediate-term municipal bonds offer tax-equivalent yields of around 6% and intermediate-term, A-rated corporate bonds yield over 5%. This normalization of interest rates, while a difficult adjustment from the record low yields of 2021, creates a healthier long-term environment for investors assuming inflation moderates, which we believe it will. The peak year over year inflation rate was recorded in June at 9.1%, which declined to 7.7% for the 12 month period ending November 30. As commodity prices continue to weaken and COVID-related supply bottlenecks abate, inflation should continue to fall. However, it is unlikely that we will experience a return to the sub-2% inflation rates of the 2010s. The move to diversify and re-shore supply chains, the long-term trend of decarbonization and greater political influence for populists on both ends of the political spectrum will lead to higher base levels of inflation.

As the brunt of the correction last year fell on the technology sector, large cap value outperformed growth for only the second time in the past ten years. This ended five consecutive years of large cap growth outperforming all other segments of the US stock market. Value outperformed growth by nearly 25 percentage points, the widest margin since the bursting of the dot-com bubble in 2000. Despite this, large cap value stocks still trade at a large discount to growth stocks and growth stocks still have outperformed value over the past three- and five-year periods. **Given the change in economic trends, which include the move to on-shoring, increased investment in infrastructure and higher prices for natural resources, a strong possibility exists of a sustained period of outperformance by value stocks.** The outperformance of growth during the 2010s began with the valuations of growth stocks trading at an actual discount to value stocks, then recovering to a premium nearly to the levels of the 1999 dot-com bubble. The relative cheapness of value stocks today makes a repeat of the 2010s unlikely.

**A portfolio of companies that can reliably generate free cash flow through volatile economic environments will serve investors through any potential recession.** Given the unreliable track record of economic forecasters, investors should not attempt to reposition portfolios according to their views. With volatile markets likely to persist, we continue to look to income and the safe liquidity portion of the portfolio to meet distribution requirements. The normalization of valuations and yields this year translates into better forward-looking return prospects, and your portfolios are well positioned to take advantage of this. Rebalancing to maintain exposure to value and non-US stocks was difficult during the long run of large cap growth stocks over the past decade, but the value of this diversified approach became evident in 2023 and should continue to add value in coming years. We continue to review positioning of portfolios to best take advantage of opportunities for long-term growth and diversification.

**- Stephen C. Browne, CFA**
Chief Investment Officer
Chief Compliance Officer

## Smart Investing Webinar

Tuesday, January 17, 2023 at 11:30 Central on Zoom

We invite you to join Steve Browne, CFA, CIO and Alison Moss, CEO, for a discussion on the current market and economic conditions.

**Link to join the webinar**
https://us02web.zoom.us/j/82618953825?pwd=Skc2V0x4WUV6MFd1OURacE1DaTVRZz09

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**February 20, 2023 Office Closed**
In Observance of President's Day

**April 11th at 11:30 AM Central**
Smart Investing Webinar—First Quarter Market Review

**July 18th at 11:30 AM Central**
Smart Investing Webinar—Second Quarter Market Review

**October 11th at 11:30 AM Central**
Smart Investing Webinar—Third Quarter Market Review