CARMICHAEL CREEL INVESTMENTS

339 Main Street, 2nd Floor | Franklin, TN 37064
(615) 595-5825 | www.CarmichaelCreel.com

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2022 Year-End Review
"Headwinds to Hurricanes"

Last year at this time we cautioned that the headwinds and the high valuations in the investment world caused us much concern. What we saw in the months to follow was a bona fide bear market in both stocks *and* bonds. The S&P 500 Index fell more than 19%, and the NASDAQ Composite fell 33%: the worst performance for those indexes since 2008. Bonds were pummeled as well with the Bloomberg 20+ Year US Treasury Bond Index falling by 31.1% and the US 10-Year Note showing its worst annual performance since the 1960s. So much for the notion that bonds would always provide a "balance" to stocks for an investment portfolio.

As last year began, the consensus was for a continuation of the 2021 market advances spurred by the recovering economy and the unprecedented injection of liquidity into the financial system during the pandemic shutdown. Interest rates were near zero, and money was flooding the economy. Stocks and bonds had done well, and there was more "FOMO" (fear of missing out) than there was fear of loss ("FOLO"?). Then, those headwinds turned into a hurricane. Inflation took off. Interest rates were jacked up. The money supply was tightened at a furious pace. A major war erupted in Ukraine disrupting food and energy markets. The Chinese economy sputtered under the weight of their Covid lockdown policies. The yield curve inverted sharply. Finally, the cryptocurrency bubble burst with some headline-grabbing bankruptcies.

What we are seeing now is a fundamental shift not just in this country, but internationally as well, as we emerge from the largest monetary bubble in modern economic history. As Nobel-prize-winning economist Milton Friedman said, "Inflation is always and everywhere a monetary phenomenon." The explosion of monetary liquidity provided by the Fed and the federal government was understandable given the seriousness of the economic disruption caused by the pandemic. By the time the pandemic hit, however, the Fed had already left interest rates too low for too long in the aftermath of the Great Recession of 2008. Consequently, the Fed was forced to ease further when it was already past time to tighten monetary conditions under normal circumstances. The asset bubble of 2021 was the result. Low interest rates and a flood of liquidity encouraged speculation as well as excess leverage since borrowing was so cheap. Investors and corporations became quite used to "free money" and markets went up.

Then inflation took off in mid-2022. The central banks worldwide had been left with only one remedy to combat rampant inflation: tightened financial conditions. With inflation remaining persistent, the Fed panicked and started raising the Fed funds rate at a historic pace. Short-term interest rates rose from almost zero to 4.5% in a year's time. Money supply contracted at the fastest rate since 1948. Investment markets have taken the brunt of the adjustment to the new and less friendly monetary regime. Market action in 2022 met the text-book definition of a bear market with declines of at least 20% in major market averages.

Bear markets can be brutal on investments but are especially hard on those that are more speculative and trendier. Very popular and high-profile stocks can and will decline dramatically whether they be emerging technology, “de-fi” (decentralized finance, including cryptocurrencies), or “meme” stocks. By keeping our investments concentrated in more financially conservative and higher income-paying positions, we have avoided the worst of the carnage that this bear market has caused.

Currently the prevalent expectation for investment markets in 2023 is for disappointing first quarter corporate profits and a recession within the coming year. The debate rages over whether the predicted recession will bring a “soft” or “hard landing,” but most forecasts include a recession, nonetheless. While we try to bear in mind that conventional wisdom is often wrong, we see the problems that everyone else does. Valuations have not reached the average bear-market lows, corporate profits are coming down, and the Fed appears ready to continue raising rates, perhaps even causing a recession that might have otherwise been avoidable.

One of our challenges this year will be to avoid the fear of missing out and being “whipsawed” in volatile market swings by feeling pressure to buy into rallies and sell into subsequent declines. Investors are often overeager in anticipating a “Fed pivot,” the time when the Fed reverses course and eases monetary conditions that allow for a new bull market. Our dilemma is that these rate increases act with a lag effect and most of the negative effects, including the recessions, usually start *after* the Fed has *stopped* raising rates. Investing aggressively too early can be costly. It may be counterintuitive, but the sharpest rallies often occur in bear markets, i.e., markets that are still headed lower. In the bear market of 2000-2002, there were twelve rallies of 10% or more and four rallies of 28% to 49% as the market continued to slide to its ultimate low in October of 2002.

There is good news. We are at least one year closer to the next bull market, and the Fed is probably closer to the end of their tightening than to the beginning. Inflation numbers are improving, supply chain bottleneck problems have begun to ease, and stock prices have come down closer to bargain levels. Our goal is, as always, to preserve capital while taking reasonable risks to increase your investment returns. With rates moving higher and stocks priced lower, we may soon find increased opportunities to invest in good businesses at great prices.

Please review your portfolio statements and reports at your leisure and call with any questions or suggestions you may have. We appreciate the trust that you have placed in us, and we will continue to work to earn that trust in 2023.

Happy New Year!

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Claude R. Carmichael CFA   Arthur Creel CRPC