JSB Capital Management, LLC

Pro-active Wealth Management

January 18, 2023

After years of ultra-loose fiscal, monetary, and credit policies, stagflationary pressures are now putting the squeeze on a massive mountain of public- and private-sector debt. The mother of all economic crises looms, and there will be little that policymakers can do about it.

- **Nouriel Roubini Dec. 2022**

This newsletter will look back on a very tumultuous 2022 and attempt to make sense of the current state of the economic environment with the intent to position the portfolios for what lies ahead in 2023.

2022: The Worst Year for Both Stocks and Bonds in History

Last year was the S&P 500's worst year versus the Dow since the S&P 500 was introduced as a broader stock market index in 1957. In terms of total returns (price action plus dividends paid) the S&P 500 index experienced it's the fourth-worst year since 1957 (it was down 38% in 2008 by comparison).

Here's what a one-year chart of the index looked like in terms of just price action:

Significantly, typical investors fared worse than the index performance (mostly due to excessive trading, fear-based decisions and various fees) as the average 401(k) account balance was down 23% from a year ago to $97,200, according to a new report by Fidelity Investments, the nation's largest provider of 401(k) plans which handles more than 35 million retirement accounts.

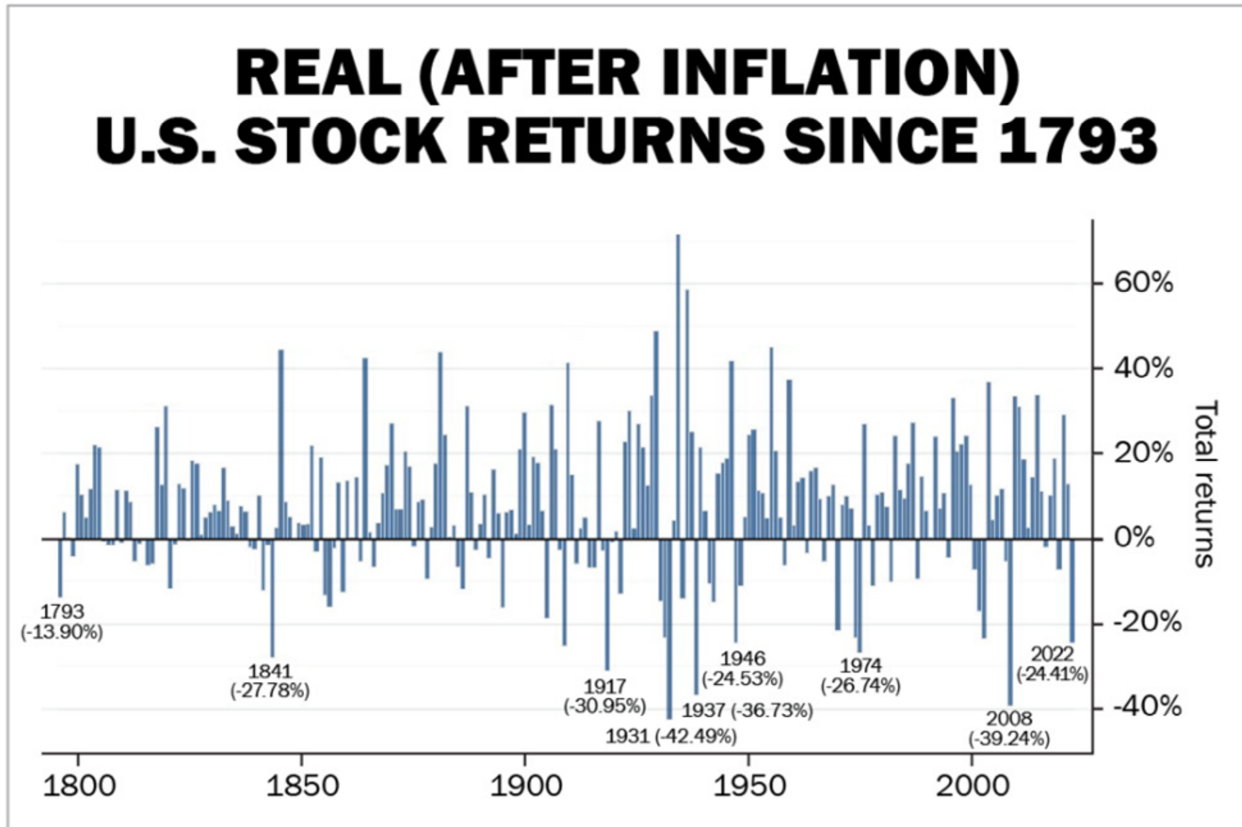
Perceived as a "safe heaven" during stock market declines, the overall bond market **lost 30.2%** in 2022 marking the worst annual return in U.S. bond market history.

Inflation Rears Its Ugly Head in 2022

Years of near-zero interest rates produced the predictable effect of skyrocketing inflation last year. The most well-known gauge of inflation, the Consumer Price Index (CPI), hit 9.1% in June and slowly eased downward to finish the year at an annual rate of just over 8%.

The Federal Reserve Bank aggressively raised their short-term, administered rate (Fed Funds Rate) to a point where it finished the year at just under 5%. Most analysts agree that the Fed will continue to raise this rate at their next several meetings until the effective rate is around 5.5%. This contributed greatly to the slump in stock prices and will continue to influence stock prices lower in 2023. It is likely that the stock market as measured by the S&P 500 Index will find a bottom in late spring to early summer somewhere about 15-20% lower than it began this year.

The chart below shows the very long-term performance of stocks when adjusted for the incredibly detrimental force of inflation:



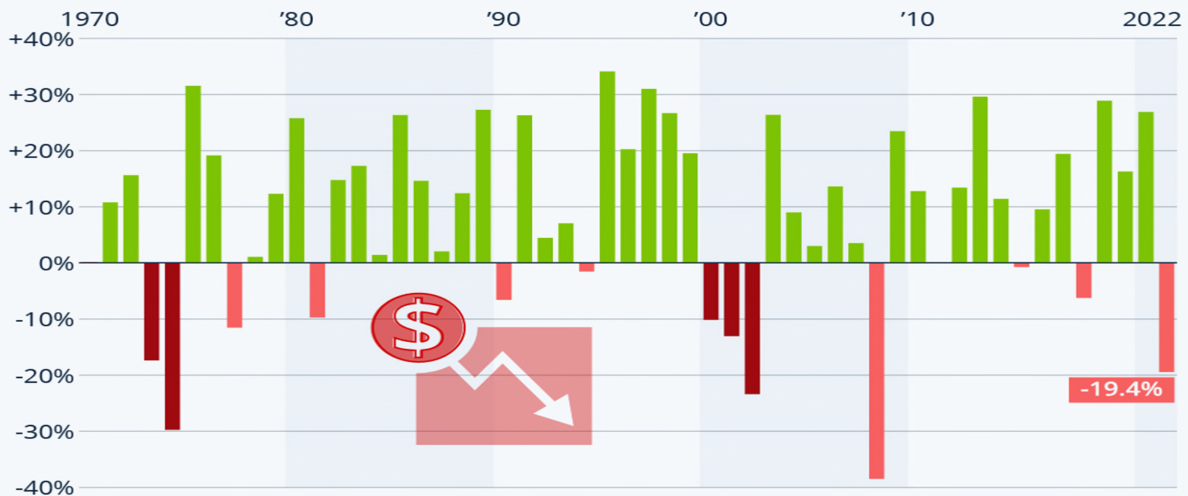
One important thing to notice is that in a persistent inflationary environment, like we are currently experiencing, the inflation-adjusted performance of stocks can be negative for two or three consecutive years. In fact, according to Macrotrends.net, years with consecutive negative returns experienced worse returns in the second (and third) down years on each occasion since 1957.

What is In Store for The Markets in 2023?

While it is true that stock markets rarely experience back-to-back down years as the chart below depicts, 2023 could prove to be an exception:

Back-to-Back Down Years Are Rare for the Stock Market

Annual percentage change of the S&P 500 index



Source: S&P Dow Jones Indices via Macrotrends.net

statista

Various factors are stacked against investors this time. As the war in Ukraine shows no sign of ending, Covid-19 continues to disrupt the increasingly influential Chinese economy and the Federal Reserve is all but certain to keep raising interest rates in the face of persistent inflation, consumer spending and corporate earnings both will be negatively impacted which will likely send stock prices even further down at least for the first half of this year.

Macroeconomic Indicators Forecast Recession

This is the "geeky" economic section of the newsletter. Feel free to skip it if you like!

1. The very important economic indicator known as the Purchasing Managers Index or PMI confirmed in December that the manufacturing side of the US economy is at its weakest since the COVID-lockdown crisis. A worse than expected result combined with the ninth straight decline in ISM Manufacturing Index produced the longest stretch of declines since 1974-1975.

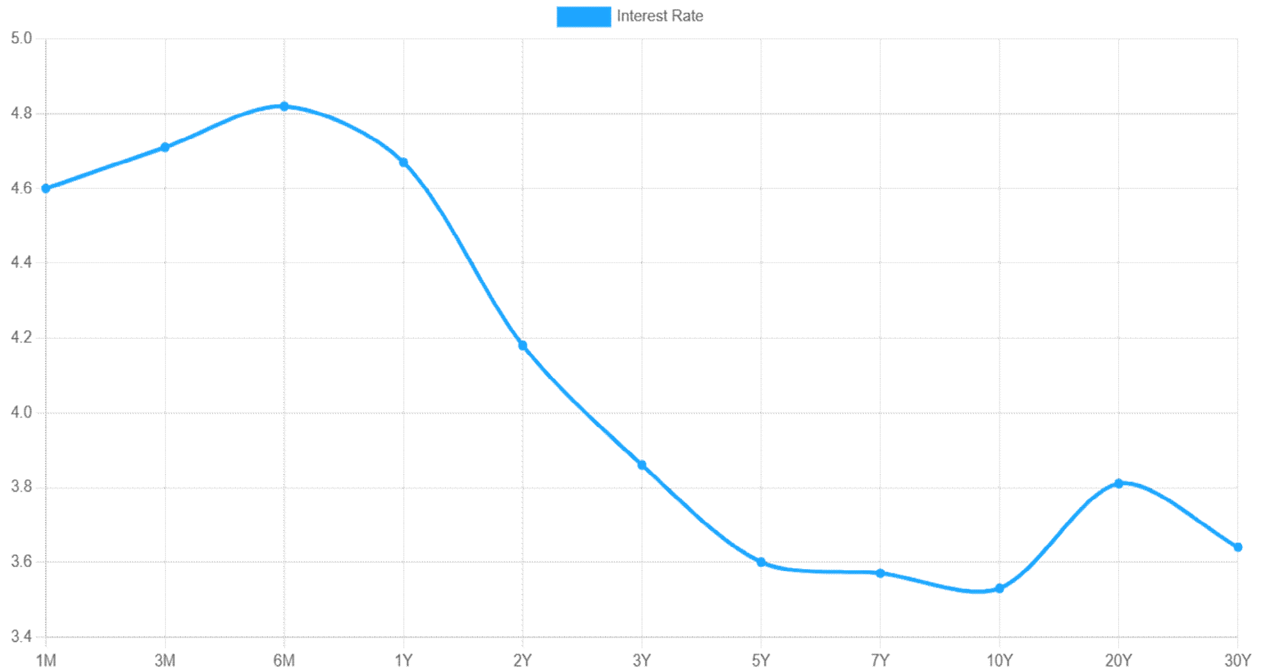
2. Additional very troubling warning signs in the last 30 days:

    a. The NY Federal Reserve Bank's General Business Conditions index crashed nearly 22 points to -32.9 this month (twice as bad as the weakest analyst estimate).
    b. Aside from the trough of COVID lockdowns in May 2020, this is the weakest print for the Business Conditions index since March 2009 and it has been in contraction mode in five of the last six months.
    c. New orders dropped nearly 28 points to minus 31.1, also the lowest since May 2020 and marking the third-straight month of contraction.
    d. New Shipments (orders for durable goods) plunged by a similar amount to the lowest since August.
    e. Factory employment fell to its weakest level in more than two years, indicating that hiring has essentially stalled.

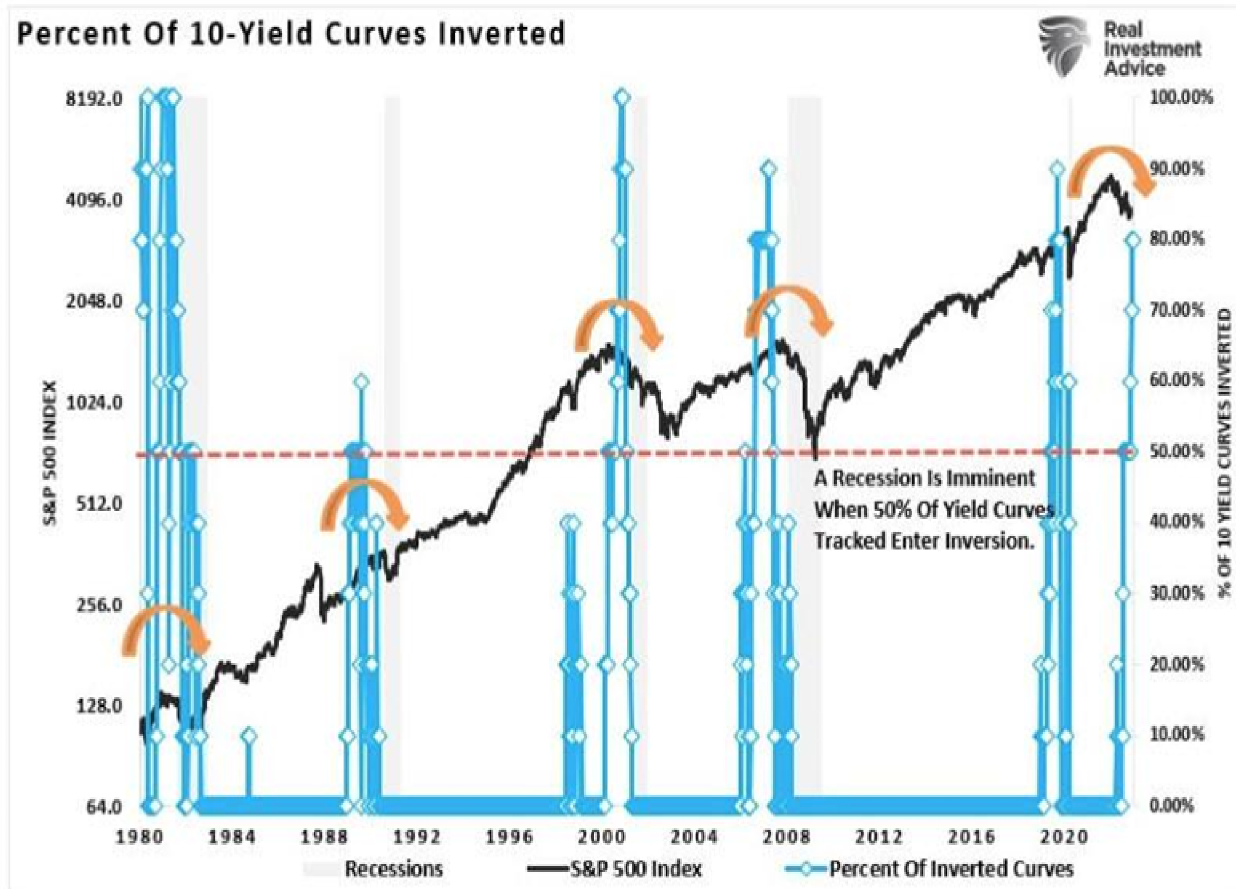
3. The chart below shows General Business Conditions in the highly influential Empire State Survey which clearly looks like the disastrous situation in 2008:

History's Best Predictor of Recession

The chart below depicts the current situation between short and long-term U.S. Treasury interest rates known as the "Yield Curve." Most noticeably, the interest rate an investor receives from the shortest maturing Treasury debt (4.6 to 4.8%) is much higher than the interest received from the longer term debt (the ten-year debt being the benchmark at 3.5%). This condition is known as an "Inverted Yield Curve," and it forecasts very negative economic conditions ahead. A normal yield curve slopes steadily upward from short-term to longer-term as investors demand higher interest income to compensate for the greater risk of longer time. You can see below how distorted the current environment is.

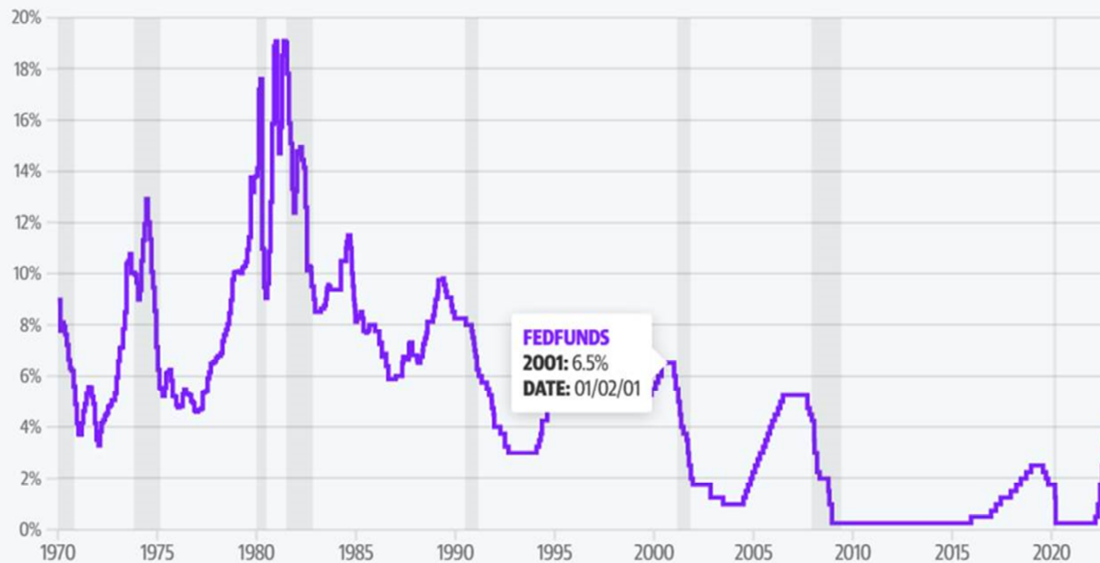


Since 1980 the Yield Curve has inverted 6 times and all six times a recession followed rather quickly thereafter, usually 6 to 12 months after. The current Yield Curve has been inverted for about 6 months now.



The Role of The Federal Reserve Bank in Causing a Recession

As shown on the chart below, the Federal Reserve Bank's Open Market Committee (FOMC) manipulates the Federal Funds Rate or short-term rate that their member banks pay to borrow overnight in response to their view on inflation.



The gray areas above indicate periods of recession, and they correlate quite well with the aggressive raising of interest rates by The Fed for the Federal Funds Rate. The reason for this correlation is mainly that the Fed historically has stepped too aggressively on the economy by making the cost of money too expensive through their interest rate policy.

What is the Chance that The Fed Might Raise Rates Too Aggressively this Time?

Some insight can be gleaned from the minutes of the most recent Fed meeting which were released on January 4th. To quote the minutes: “Participants generally observed that a restrictive policy stance would need to be maintained until the incoming data provided confidence that inflation was on a sustained downward path to 2%, which was likely to take some time." The minutes added: "In view of the persistent and unacceptably high level of inflation, several participants commented that historical experience cautioned against prematurely loosening monetary policy."

Many Fed officials see the central bank needing to be able to balance two risks:

1. That monetary policy isn’t tight enough to bring inflation down and
2. That the lag effect of monetary policy could push the Fed to overtighten more than needed.

Some participants concluded that the risks to economic outlook were weighted to the downside, noting the potential for more persistent inflation that could mean higher rates.

Once again, the probability is that the aggressive Fed will cause a looming recession by their own words.

Forecast for 2023

The end of the highly accommodative interest rate policy after more than a decade of near zero interest rates will produce serious problems in the economy. Higher interest rates are starting to create problems across every economic sector because of the unprecedented level of debt much of which was taken on precisely because of low interest rates.

A. In the private sector, the mountain of debt includes that of **households** (such as mortgages, credit cards, auto loans, student loans, personal loans),
B. **Businesses** and corporations (bank loans, bond debt, and private debt),
C. The **financial** sector (liabilities of bank and nonbank institutions),
D. In the **public sector**, it includes central, provincial, and local government bonds and other formal liabilities, as well as implicit debts such as unfunded liabilities from pay-as-you-go pension schemes and healthcare systems,
E. **Globally**, total public and private debt as a share of Gross Domestic Product (GDP) rose from 200% in 1999 to 350% in 2021. The ratio is now 420% across advanced economies, and 330% in China. In the United States, it is 420%, which is higher than during the Great Depression and after World War II.

The above-described mountain of global debt will stifle the economy as increasing levels of interest rates across the board mean higher costs of living for families, higher refinancing costs for mortgages, credit cards, public debt, municipal debt and on and on.

A good portion of this debt particularly government shorter-term debt is usually rolled over at maturity and not actually paid off so essentially only the interest is paid. However, U.S. gross interest payments in 2022 totaled $724 Billion, up from $575 Billion in 2021. As the debt continues to grow along with interest rates, this becomes unsustainable.

Since our March of 2022 newsletter was written, the then forecasted conditions in the financial and interest rate markets have played out as predicted. The first half of this year will be a difficult one for financial assets as the momentum to the downside continues owing to the conditions described herein. The strategy is to continue to protect to the downside by:

1. Continuing the program of buying high paying U.S. Treasury bills of the 3, 6 and 9-month maturities (currently averaging about 4.75% interest annualized),
2. Continuing to hold and augment, when possible, an exchange traded fund that protects the portfolios from precipitous stock market declines,
3. Holding and adding to several preferred stock holdings that are relatively stable in price (historically) and that pay 7% plus dividends, particularly those preferreds that have an adjustment mechanism to higher interest rates,

4. Hold high quality exchange traded funds (ETFs) that pay high single-digit annual dividends and that also offer some downside protection with provisions for adjustments in dividends with higher interest rates,
5. Maintain an allocation to precious metals and possibly increase that percentage,
6. Selectively purchase or hold high quality, blue-chip companies that also pay above market dividends.

As history reflects, all bull markets and bear markets come to an end. This current bear market will likely end late this year or early next and we are prepared to take advantage of the high-quality companies that will be selling at deep discounts to their historical value when the bottom is near.