CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

January 4, 2023

Farewell to a Grim Year...
...Looking Ahead to 2023

In asset markets, 2022 was a year for the record books. It was one of the worst in the last century and more.

It is highly unusual for bonds and for stocks both to be down significantly, but that is what happened.

For investors, 2022 is a not a year to be remembered with fondness. The unusual combination of sharply lower stocks and sharply lower bonds left investors with few places to hide. First the figures, then a discussion of how I made investment decisions during the year. The stock market, as measured by the S&P 500, reached its peak on the first trading day of the year; by year end, it had fallen by more than 19%. As measured by the Nasdaq 100, the stock market's decline was a whopping 33%. Bonds suffered as well. The broad measure of all US tradable bonds fell by nearly 15%. Thus, a typical measure of balanced portfolios comprised of 60% S&P 500 and 40% bonds fell by 17.5%. According to Berenberg, an old German banking and investment firm, there have been only five years in the last one hundred fifty years that both bonds and stocks have had negative returns and 2022 is the worst of these five. In only two years of the last 150 have returns for a traditional 60/40 balanced portfolio been worse than 2022, both during the Great Depression.

In this carnage, the portfolios managed by Core did badly, although better than the benchmark returns. Losses for a typical portfolio were about 13%, the worst for any year for Core's investing. In hindsight, of course, everything is clear and one knows precisely what one should have done, namely to have sold everything on the first day of January and wait in cash.

Bonds and Cash. We entered the year with large positions in long-term Treasury bonds and high-grade US corporate bonds. Starting in February, Core began to sell those positions in stages. But, as the Federal Reserve raised interest rates beginning in March, the prices of bonds fell, causing declines in the positions we still held. The significant mistake I made during the year was to hold these bonds after the beginning of March when the Federal Reserve began to tighten monetary policy in its quest to lower inflation rates. I thought, wrongly as it turns out, that Fed tightening would slow the economy and that the slowing economy would keep long-term rates from rising much.

It is my judgment now that the worst in the bond market is behind us. In the context of the Fed's very aggressive monetary tightening, the rate of inflation is decelerating and the economy shows signs of weakening. Accordingly, in the latter part of November, I began to build another position in long-term bonds, on the expectation that higher prices are ahead. In addition to the long-term bonds, we continue to hold a large position in short-term Treasuries. These are much steadier in price than the long-term bonds, and will provide stability and income to our portfolios. We continue to have large positions in money market funds,

By

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We recently changed our post office box in Sausalito to PO Box 866.

which, because the Fed has raised interest rates so sharply, now provide some real income themselves. During most of the last decade, the Fed had interest rates pegged close to zero and money market funds offered essentially nothing. Now the yield on money funds is about 4% and the yield will rise in the months ahead. Thus, we earn income as we wait for better opportunities to present themselves.

Stocks. By contrast, Core reduced stock positions quite early in the year. Core retained positions in utilities and consumer staples; these tend to perform well in weakening economies of the kind we experienced throughout the year. Beginning in May, I built a position in exchange-traded funds that appreciate as stocks decline. These holdings have made money for us this year and I retain them as we enter 2023, on the notion that we have not yet seen the bottom in this bear market in stocks.

Core portfolios also hold a position in a fund that holds energy infrastructure in the US, including oil and gas pipelines. It pays a large dividend and has been stable throughout this difficult year. It too is a holding I expect to retain in the year ahead.

Fed governors insist that the Fed will keep raising rates and will keep rates high throughout 2023.

A serious recession or some now unknown circumstance may cause the Fed to reverse course.

Time will tell.

Looking forward. As the year begins, I expect that the actions of the Federal Reserve will likely continue to be a primary determinant of the pathway for the stock and bond markets and for the economy as a whole. Inflation remains high, although by most measures the rate of price increases is lessening. However, the Fed, having misjudged inflation through 2021, is very likely to continue its tight monetary policy throughout the year. The Fed's actions are designed to restrain economic activity, thereby causing the rate of inflation to fall. As discussed in previous *Core Comments*, the Fed risks 'breaking something' in its quest. If the 'broken something' is consequential, the Fed may, as it has in the past, reverse its course. Such a change may well upset the direction of asset markets.

Similarly, events in the external world will intrude. In 2020 came Covid. In 2022, Russia invaded Ukraine. The war that continues to unfold has caused inflation to rise and has curtailed grain shipments from Ukraine, causing shortages and hunger in other parts of the world. What will the war bring to the world this year? And what will be the new, hitherto unexpected events to transform markets this year?

I shall be vigilant and cautious in 2023, but alert for opportunity. We have ground to make up after the dismal 2022; our work continues.

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