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Investment Newsletter – June 2022

Executive Summary

Investors reacted to changes in interest rate policies, as well as the increased economic uncertainty, by requiring higher future returns on their investments in 2022. Thus, (perhaps counter-intuitively) market securities prices have dropped in order to bring future expected returns up to this new level. High inflation has caused the Federal Reserve to depart from its normal counter-cyclical policies; this has upended standard investment risk mitigation measures. Higher real interest rates are better for investors in the long run, but they, along with increased recession risk, make investing uncomfortable in the near term.

What Falling Market Prices Mean for Long Term Investors

Warren Buffett is a truly long term investor. He famously compared stocks to hamburgers in his 1997 letter to shareholders:

“If you plan to eat hamburgers throughout your life and are not a cattle producer, should you wish for higher or lower prices for beef?” ...

“If you expect to be a net saver during the next five years, should you hope for a higher or lower stock market during that period? Many investors get this one wrong. Even though they are going to be net buyers of stocks for many years to come, they are elated when stock prices rise and depressed when they fall. In effect, they rejoice because prices have risen for the "hamburgers" they will soon be buying. This reaction makes no sense. Only those who will be sellers of equities in the near future should be happy at seeing stocks rise. Prospective purchasers should much prefer sinking prices.

Jason Zweig, the Wall Street Journal’s writer of “The Intelligent Investor” column makes the point in an amusing way:

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“The problem with stocks is that they contain the letter T. If they were called socks instead, people would treat a 20% decline in price not as a selloff but as a sale.”

These sentiments apply even more so to bond investors as I explained in my June 2018 newsletter. This is because bonds pay off at maturity. Therefore, even if you’re not still saving, you’ll be investing in new bonds as the old ones mature.

I’m sharing these quotes to encourage readers to consider the purposes of investing when reacting to changes in market prices. For most people throughout history, wealth was thought of in terms of how much income was produced by what you owned. Before there were stock markets, the wealthy owned land which produced income according to its use for growing crops or other commercial uses. In this world, there was no one quoting a price to buy your land every day to give you a sense of its worth. Instead, the income produced was the measure of wealth.

In modern times frequently observable market prices tend to distract us from this more important aspect of wealth: how much income will it produce to protect us from running out of money in retirement.

With this thought in mind, let’s consider how a rational investor (as opposed to a speculator¹ or trader) can put a value on an investment. My goal here is to explain some key market variables that we care about so as to provide meaning to the current market environment.

In order to value the future cash flows we expect to receive when buying a particular investment, we discount the cash flows by a required rate of return to get a value we would be willing to pay today. For example, if I expect one cash flow of \$100 coming back to me one year from now and my required return for investing in that future cash flow is 10%, then it’s value to me would be $\$100/(1+.10) = \90.91 . At this price, if I do actually get the \$100 cash flow, I earn a return of \$9.09 over a year (ending cash flow – purchase price). My return, as a percentage of the price I paid, is $\$9.09/\$90.91 = 10\%$ - as required.

The valuation formula in the previous paragraph includes the desired return², added to 1, in the denominator. Mathematically, we see that for any positive return on capital, the value of a future dollar is less than \$1 today. Furthermore, we can see that the higher the future return we plug into the denominator, the lower will be the price we’d pay today. This means that market prices and future expected returns move *inversely* to one another. Another way of saying the same thing is, given the expected future cash flows of an investment, the more the price drops, the higher will be

¹ A speculator is someone who buys an asset based on the idea that someone else will buy it for more later, rather than based on any cash flow to be produced by the asset. Bitcoin is the perfect example.

² The 10% required return is represented by the .10 in the denominator term.

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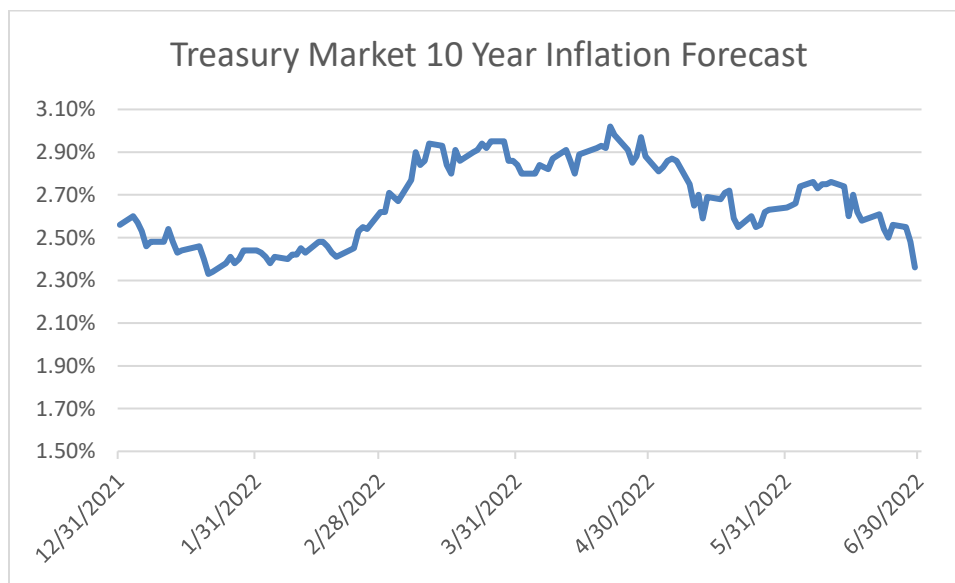
future returns on that investment. This is a VERY important point to keep in mind.

So far, so good, but where does the 10% required return come from? The short answer is: this is a judgement call for the investor. That judgement should be made by considering the market environment and other opportunities. To be specific, we should incorporate three components:

1. Compensation for inflation - meaning the lower purchasing power of money received in the future.
2. The after-inflation real rate of return we can earn on risk free government bonds – meaning Treasury Inflation Protected bonds³ (TIPs).
3. An additional risk premium (relative to item #2 above) to compensate the investor for the risks that cash flows or timing of cash flows from a particular investment deviate adversely from expected.

There are many layers of analysis you can do beyond this, but this framework is adequate for understanding what recent market moves mean for us as long term investors.

We can observe the market wide changes in investor requirements for these three, though of course risk premiums vary greatly across types of investments. Here's the bond market's implied change in forward inflation expectations:

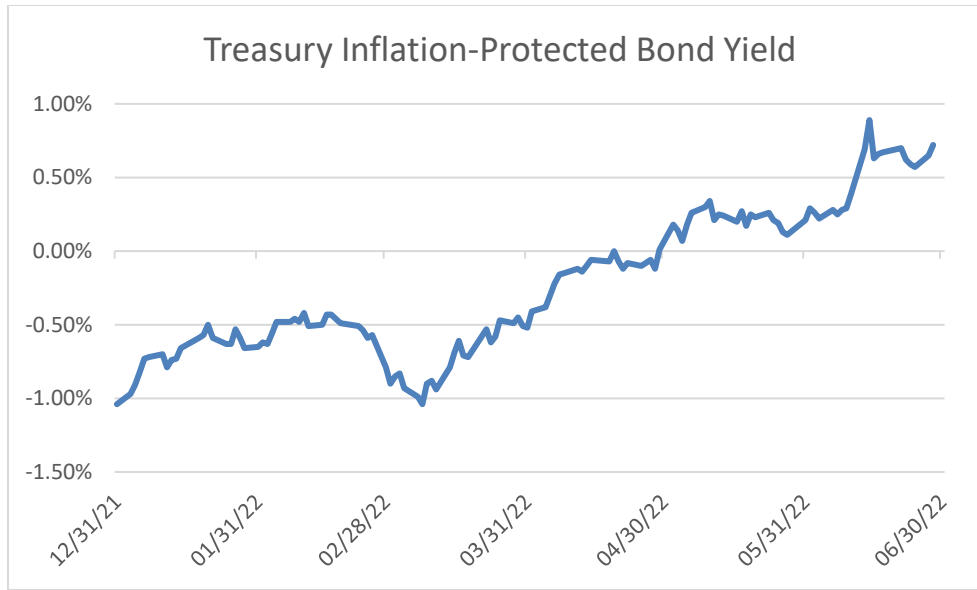


³ The underlying principal to be received at maturity for TIPs bonds is adjusted in line with inflation.

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Here we see inflation expectations actually dropped 0.2% from the beginning of the year to June 29th. Inflation expectations are creating volatility but they have not had a significant impact on year-to-date returns.

Below is a graph of the Treasury Inflation-Protected bond yield which is the real (inflation-adjusted) bond yield.



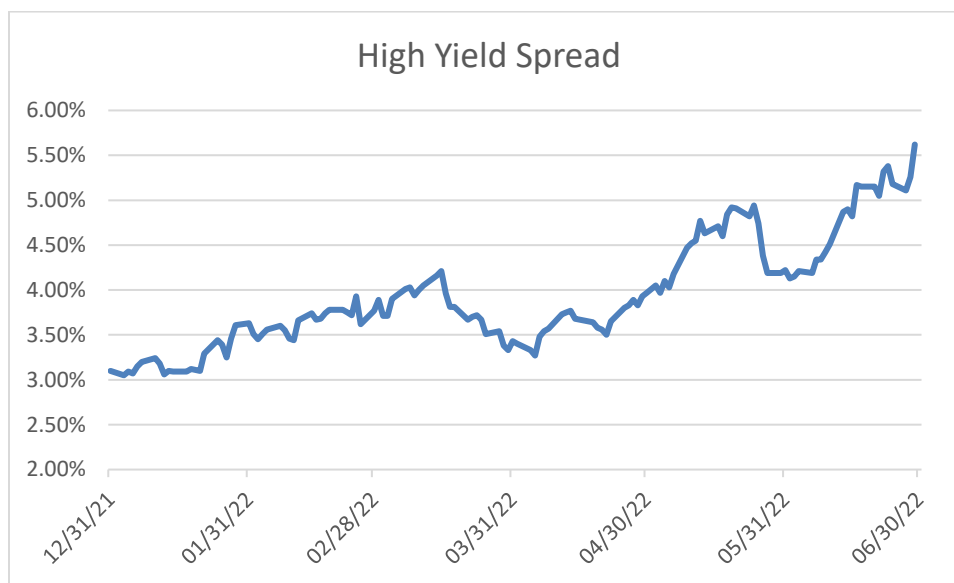
The real (after-inflation) return shown in the graph started the year at -1.04% - meaning investors were willing to lose money after adjusting for inflation on these long term government bonds. This yield has been negative since March 2020 as the Federal Reserve Bank suppressed interest rates. When real rates are negative, investors tend to seek out riskier investments to compensate for the lack of return available. Hence we saw a speculative frenzy during the pandemic which resulted in hugely inflated tech stock values. This year's rise in the real yield to .72% (at 6/28) is deflating that speculative bubble.

For long term investors, the increase in the real yield is unambiguously good – for the same reason that cheaper hamburgers (or socks) are for consumers. It is way overdue for this country to start compensating investors rather than penalizing them with negative real returns. As a country, I expect there will be serious problems for retirees and much of this is a direct result of monetary policy. Rates turning positive will help.

At this moment, however, you will see your bond portfolio value is lower. This reflects the new higher discount rate – i.e. the higher returns on current value that you can expect going forward. Risk premiums also went up.

On the next page I've graphed the high yield spread index which is an average risk premium in the U.S. non-investment grade bond market.

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This shows that compensation for risk of investing in high yield bonds rose from 3.10% to 5.62%. There is a good news, bad news aspect here. The good news is new purchases of high yield bonds offer higher risk compensation. The bad news is that these spreads are rising because the probability of default losses is rising, meaning expected cash flows are moving against us. Except in retrospect, there is no way to disentangle which part relates to actual cash flows to be received versus a simple increase in discount rates which will increase future returns.

Given an investment horizons longer than 3 years we should assume we are going to see shifts in these underlying factors that determine current securities prices and the future returns for newly bought securities. The key in setting our strategy is to choose investments such that you can withstand shifts in required returns which may lower the current value of your holdings. That way, we can benefit from the higher future returns implied by these rises in discount rates.

**The Aftermath of Government Covid Stimulus:
Risk Mitigation Short-Circuited**

Traditionally investment grade bonds play a risk mitigation role in a portfolio because most of the time their prices move opposite to more risky assets (i.e. stocks). When I construct client portfolios, I take advantage of this negative correlation so as to reduce the potential draw-downs for clients. That way, they can better tolerate holding at least some portion of higher return/risk securities. This method of risk mitigation was explained at length in the June 2019 newsletter.

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As one of my clients pointed out in a recent email, this strategy has stopped working in 2022 as both low risk bonds, and riskier assets, move lower in price together. Let's consider what has changed to cause this breakdown, so as to better understand the current market environment.

Most of the time (in the last 40 years after inflation came down in the early 1980's) the Federal Reserve responds counter-cyclically to economic growth. That is, they raise short term interest rates as the economy grows faster, and they lower rates as the economy slows down.

A fast growing economy is good for stocks. So much so that it's generally more than enough to offset the downward pressure on valuations exerted by interest rate increases. On the other hand, rising rates must reduce bond prices since they don't fully participate in the upside of growth. Higher economic growth (as well as inflation) does reduce credit losses and therefore help credit risky bonds, but it often won't be enough to offset big rate rises.

A slowing economy that looks headed for recession is bad for stocks as earnings will decline. The impact on prices eventually overwhelms the upward pressure on valuations from decreasing interest rates and stocks drop. Bonds, on the other hand, could go either way depending on whether lower rates push prices up more than a poor economy increases credit losses for the credit quality of the particular bond and its interest rate sensitivity. Higher investment rated bonds will generally rise in value as the Fed lowers rates.

That is how it usually works so that stocks and bonds move opposite to one another. Thus we generally want some of each to mitigate overall draw-down risk.

The current situation is different. The Federal Reserve is saying we are going to raise rates even if it pushes the economy into recession and we'll keep them high till inflation abates. So the Fed is saying the counter-cyclical rules no longer apply. Therefore, the market sees increasing recession risk and higher rates coming simultaneously. This implies both stock and bond prices must adjust to both higher rates and slower (or negative) growth.

Most of the time long term rates do not react so much to changes in short term rates because expectations for what the Fed will do are already baked into the long rates. Things are very different this year because, apparently, investors did not expect such an aggressive tightening by the Fed. And that is because the Fed itself is no longer a reliable indicator of its own policy path. Last year, they consistently signaled a leisurely rise in rates that had no chance of stopping inflation. That remains the case even now but they are sowing doubts about how long they'll stick with their short term negative real interest rate policies.

Recession Coming?

The Federal Reserve now talks openly about the possibility that their policies may need to induce a recession to bring inflation down to their 2% target. Meanwhile the stimulus money flowing into the economy is drying up. The housing market has already slowed, as predicted in the March newsletter, and I expect an even bigger impact now that mortgage rates are nearing 6%. First quarter gross national product growth was negative and the second quarter is likely to show 0 growth. On average, economists see a 50% chance of recession in the next 12 months.

I put the odds a bit higher, but I think it will be 2023 before we see a downturn. The job market is still extremely strong and consumers still have a large amount of accumulated savings because of the government stimulus payments and because people stopped going out for so long. I think that gives us momentum for the rest of 2022. Inflation is, however, eroding our purchasing power, and at some point, once excess savings are used up, that leads to falling demand and growth.

Rising estimates of recession probability are likely to temper market expectations for how high the Fed will need to raise interest rates to get control of inflation. This explains why we are seeing long term interest rates pull back a bit even as the Fed raises short term rates. This scenario could result in a reversion to the traditional pattern where investment grade bonds move opposite to stocks.

Conclusion

This is a very uncertain environment with various possible outcomes. There is no strategy which can be optimum for all possible scenarios. Instead, we must calibrate risk taking based on assessments of the probabilities of various outcomes, while focusing on the end goal of generating the income needed to fund retirement spending.

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