PASI NEWS
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Professional Advisory Services, Inc.
2770 Indian River Blvd. – Suite 204 • Vero Beach, FL 32960
(800) 847-7274 • (772) 778-0552 • fax (772) 770-2979

Market Update – *Singular Focus: Inflation*

by David A. Jaffe, M.D.

It's never this simple. Federal Reserve chair Jerome Powell says "we'll do whatever it takes." The Fed raises interest rates and withdraws liquidity. Economic growth stalls. A looming recession seems inevitable. Corporate earnings will falter. Stock prices tumble.

The S&P 500 ended the quarter with a year-to-date decline of 23.87% *including reinvested dividends*. The PASI composite stock portfolio fared 0.30% better, essentially matching the broad market stance at the end of the quarter.[1] The aggressive action by the Federal Reserve drove interest rates higher, and bond prices (which move in the opposite direction) lower. At the end of the third quarter, total return on the FTSE 1-5 Year Corporate Bond index, closely mirroring our taxable bond portfolio, had declined by 7.56%. The stark drop in both stock and bond markets left the commonly employed 60:40 stock:bond mix with the worst three quarter performance since 1974.

So far, pretty simple, right? But answering the question weighing on all of our minds is far from simple. Where do we go from here?

Contrary to what one might expect, an earnings recession and stock market behavior need not be temporally aligned. While stock returns follow business growth over long periods, investor psychology and emotion have a strong influence on near-term investment decisions, with varying results. While emotion may lead to irrational extremes, investors with patience and

[1] The PASI Stock Return would be reduced by Professional Advisory Services, Inc. fee, which is described in Part II of form ADV, available upon request. Our fee is a maximum of 1% and decreases based on assets under management. As an example of fee impact, over a ten year period a $1,000 investment growing at 10% per year would increase at the end of ten years to $2,512 net of 1% fee versus $2,685 gross return.

confidence work to anticipate future developments and move early to capitalize on perceived opportunities.

In fact, S&P 500 earnings were *up* 5.1% at the end of the third quarter, while stock prices were *down* in excess of 20%. Worried about a coming recession and earnings contraction, investors were simply unwilling to pay as much for a dollar's worth of earnings as they have during times of growth and optimism. At this point, one must ask "is all the (anticipated) bad news already baked into the stock market?"

What we need at this point is a crystal ball, right? Well, maybe not. In a recent review by analyst Ben Carlson looking at annual corporate earnings growth from 1930 to 2021, he demonstrated the problem with the temporal disconnect between earnings growth and stock market appreciation. During that period, earnings were up 61 times and declined 31 times. Using our crystal ball to limit stock investing to the years when earnings were up resulted in a 10.2% average year-over-year return. But … investing only in the years when earnings were down yields a 9.8% average year-over-year return. Looking forward? Looking back? Or just looking at CNBC? Investors make different choices at different points in time.

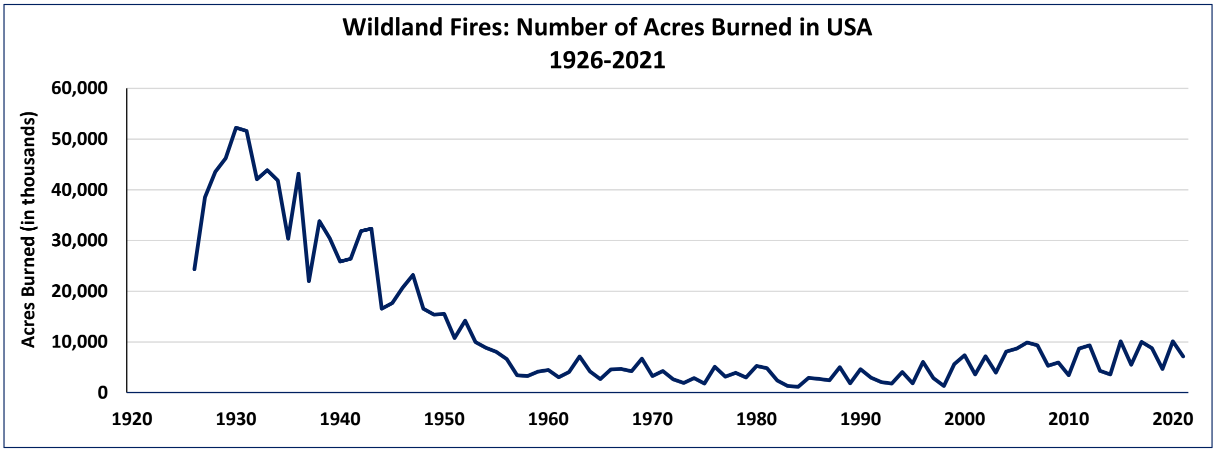
Carlson's study reinforces the futility of trying to *time the market*, jumping in and out of stocks based on short-term market moves. It also reminds us of a Wall Street quip that "financial market predictions are meant to make weather forecasters look good." While we all feel distressed and unsettled in the face of the current bear market drop in asset values, and are eager to know how deep the decline will go and how long it will last, there simply are no credible answers. Diversification, proper preparation, and patience are far more valuable than the elusive crystal ball.

The Tip of the Iceberg

by Nathan Polackwich, CFA

Thanks to the Internet it's never been easier to develop a warped sense of reality, and yet paradoxically it's also never been simpler to access information that can improve our knowledge of the world. Passive news consumers see just the tip of the iceberg of what's known on a subject and can be heavily influenced by the view they see. But a researcher with an open mind will almost always find the iceberg to be magnitudes larger than first thought the deeper they go.

For example, the casual news viewer is probably under the impression that wildfires in the United States have worsened dramatically in recent years due to climate change. Some cursory research, however, shows that while acreage burned in the U.S. has risen modestly since 2000, it remains considerably below levels in the first half of the 20th century.



Source: National Interagency Fire Center

So there's nothing to worry about? Well, not exactly! Further research reveals that the chart above is unreliable, as the earlier data includes intentional, controlled burns while the later years don't. We don't really know whether wildfires are more common today than the distant past. They've certainly gotten worse since 2000, but whether this is due to climate change – and thus a trend we should expect to continue – or other, more temporary causes is hard to say.

The underlying ecology, for instance, has changed. There are factors that have worked to reduce fires like the fragmentation of forests by human settlement and extensive logging leading to the replacement of mature trees with younger, more fire-resistant stands. Conversely, invasive species like cheatgrass in the western U.S. tend to increase wildfires' prevalence and intensity.

Direct human intervention has also played a pivotal role. More human activity means a greater potential for accidental (or purposefully destructive) ignitions to occur. On the other hand, the U.S. Government got serious about wildfire prevention following several severe seasons in the early 1930s, and by the 1950s the policy had become highly effective thanks to new technology like fire suppression chemicals. Unfortunately, this turned out to be counterproductive, as it allowed biomass to accumulate providing fuel for larger and more destructive fires later on.

Climate change is thought to worsen wildfires due to increased heat and associated drought. The problem is that average U.S. precipitation rates are *higher* than historical norms, though there are regional disparities (Western U.S. is drier while the Midwest and Eastern U.S. are wetter). Moreover, drought doesn't always cause more wildfires, as dry conditions can inhibit plant growth, reducing the biomass available to burn.

With incomplete data and so many countervailing factors how can one say with certainty that climate change is causing more wildfires? Certainly, the casual news reader and even amateur researcher cannot. The iceberg keeps getting bigger the deeper you dive.

The author Michael Crichton once coined the term Gell-Mann Amnesia Effect[2] to describe the phenomenon where an expert will "read with exasperation or amusement multiple errors in a story" on the subject of their expertise. "**You read the article and see the journalist has absolutely no understanding of either the facts or the issues…and then turn the page to national or international affairs and read with renewed interest as if the rest of the newspaper was somehow more accurate about far-off Palestine than it was about the story you just read. You turn the page and forget what you know."**

The older I get the less I realize I know, but also the more I realize what others don't know. The world is an infinitely complex place and for many questions there are no easy answers. Worse, the news itself isn't designed to accurately depict reality but rather to grab our attention via our emotions of which fear is the easiest to provoke.

And it seems like there's a lot to be afraid of these days – still uncomfortably high inflation, continued supply chain disruptions from the pandemic, the Federal Reserve aggressively hiking interest rates, and the prospect of an energy crisis and deep recession in Europe due to Russia's invasion of Ukraine. While all legitimate concerns, there are *always* seemingly dire threats hanging over the global economy. And when considering these omnipresent dangers it's important to recognize that 1) Their inherent complexity makes trying to predict their outcome a fool's errand, and 2) The most impactful economic risks are usually unexpected. In just the last three years the financial markets have been shocked by a once-in-a-century pandemic and the Ukraine war – two events that seemingly came out of the blue. Crises in the global economy that everyone already knows about usually turn out to be less of a threat than the next big surprise.

How, then, can we get a reasonably accurate view of the world given the shallow and error-laden news media we consume? Moreover, how can we protect ourselves from economic downside when the biggest risks can't be foreseen? The answer in both cases is the same – diversification.

The stock market is an incredible wealth-building machine. In many respects it represents the "score" of progress, which has increased at an accelerating rate since the Industrial Revolution. In the long run it *never* pays to bet against human ingenuity. In the short run, of course, things go wrong, which stock prices inevitably though temporarily reflect. But successful investors effectively arbitrage time – they get paid over the long run for their capacity to absorb short-term setbacks. That capability, in turn, is determined by their relative exposure to poorly performing investments. So long as a portfolio is adequately diversified, its vulnerability will be manageable.

Diversification is an acknowledgement that the future is inherently unpredictable, that we know there's a lot we don't know. It's also an expression of an open mind, a willingness to

[2] Crichton called it this because he once discussed the anomaly with the Nobel Prize winning physicist Murray Gell-Mann, "and by dropping a famous name I imply greater importance to myself, and to the effect, than it would otherwise have."

consider alternative – *diverse* – viewpoints. Only those overconfident in their predictive skill would put all their investment eggs in one basket.

There's a phenomenon where the average of a group of people's guesses tends to be more accurate than those of any one individual. As an example, many years ago at a family reunion we played a game where you guess the number jellybeans in a jar, which the person who comes closest wins. My strategy was to wait until everyone had gone and then use a calculator to find the average. I don't remember the number, but I came within three jellybeans and won the jar. The following year I wasn't allowed to use a calculator.

Why did my strategy work? It turns out everyone approaches the problem from a slightly different perspective. You can think of their guesses as consisting of both *information* and an *error factor*. By taking the average of all the guesses you effectively combine everyone's information while canceling out their errors!

This method of averaging the viewpoints of others to arrive at the best forecasts/solutions has been used successfully for everything from predicting election outcomes to pinpointing the location of a lost U.S. nuclear submarine (the *USS Scorpion*) that went missing in the North Atlantic in 1968. The strategy also works with investment decision-making.

The key is to not allow your view to be dominated – for instance, on inflation, or stock valuations, or the prospect of a recession – by the opinion of one or a few individuals no matter how respected their reputation and compelling their arguments. You want to cast your net as widely as possible for a variety of informed perspectives, which you'll then blend together to construct the most complete view of the economic and financial "iceberg" as possible.

The main benefit of incorporating more views is that your outlook on the future will become less extreme – that is, <u>you'll be less likely to predict radical change (and perhaps make extreme changes in your investment portfolio</u>). That's a good thing because the highest probability bet most of the time is a continuation of the status quo. Revolutionary changes in the economy and financial markets are rare events, and if you're predicting one, most years you'll be wrong.

PASI's long-term economic outlook has changed but not substantially in response to the higher inflation and interest rates experienced by the U.S. economy over the last year. Our perception is that the pandemic's impact on global supply chains and labor markets has reduced our ability to absorb other shocks like Russia's invasion of Ukraine. A world that for the last four decades has been characterized by *abundance* as developing nations like China joined the global economy and women entered the workforce has suddenly become susceptible to *scarcity*.

But we don't see this is as a permanent state of affairs. For one thing the pandemic seems to have run its course, as the virus is now less dangerous thanks to effective vaccines and immunity from prior infections. With COVID lockdowns – outside of China anyway – mostly over, supply chains are healing and the labor force participation rate is approaching pre-pandemic levels. Moreover, the Federal Reserve's campaign of interest rate hikes is likely to be effective (possibly too much so) in slowing the economy and relieving inflationary pressures by reducing the demand for goods and services to be more in line with supply.

Right now Federal Reserve policy represents a stiff headwind for the financial markets, and we probably have a volatile period ahead of us until inflation moderates. But when it does and the Fed pivots to a more accommodative stance (which I expect sometime within the next twelve months), that headwind will quickly become a powerful tailwind.

One might reasonably ask, "Why can't I just sell out of the market now and buy back in once the Fed starts cutting interest rates?" The answer is that the financial markets will have anticipated a shift in Fed policy many months in advance, and those who wait for the "all clear" signal are likely to miss much of a robust stock market recovery. This is the essence of successful investing – the acceptance of short-term uncertainty for the achievement of long-term gains.

A Vicious Cycle: *Inflation, Debt, and the Dollar*

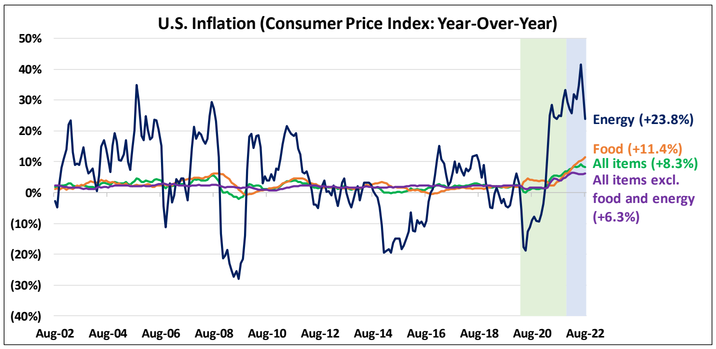
by Jeremy Goldberg, CFA, CFP®

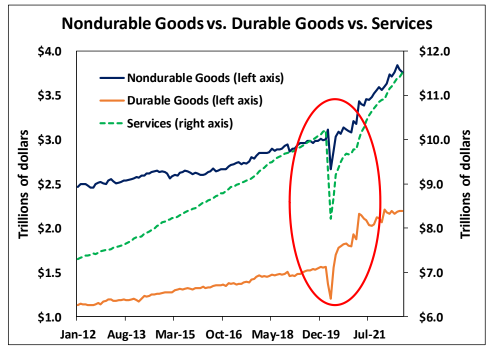
The COVID-19 pandemic led to major segments of our economy shutting down. An unprecedented halt to the global markets, pundits agreed a recession would surely follow. Congress, the U.S. Treasury, and the Federal Reserve (the Fed) acted expeditiously to ensure any imminent recession would be short-lived. At only three months long, it stands as the shortest on record! The Fed, the nation's central bank, cut interest rates to 0% and purchased approximately $4.7 trillion of assets ("quantitative easing"). Meanwhile, Congress and the U.S. Treasury distributed over $4 trillion of stimulus checks and other assistance to individuals, families, businesses, state and local governments, and healthcare providers. Since then, U.S. debt has increased by $7.2 trillion and currently sits at $30.9 trillion.[3] "Money printing" and ballooning national debt are often blamed for inflation ripping through our economy. In an already delicate climate, Russia's invasion of Ukraine on February 22 further exacerbated global inflation. The horizon is cloudy, but there are reasons to be hopeful relief will come within the next 12 months.

COVID created supply chain disruptions, labor shortages, and shifts in consumer preferences. Mandatory lockdowns impacted businesses and schools globally. Sporting events were canceled, and travel was halted. Consumers stopped spending on services (like going out to restaurants) and instead spent on durable goods (like upgrading their kitchens). As we entered 2022, supply chains were normalizing, *except energy*. Energy prices initially cratered from lack of demand, and U.S. crude oil production – what refineries turn into transportation fuel like gasoline and diesel – fell from 400 million barrels/month at the end of 2019 to 300 million barrels/month by May 2020. While only accounting for 3% of U.S. crude oil imports,

[3] Bureau of the Fiscal Service (fiscal.treasury.gov). $24.3 trillion is public debt and $6.7 trillion is intergovernmental debt.

Russia is the world's largest exporter of crude oil, and the Russia/Ukraine War is putting more upward pressure on global energy prices. Positively, U.S. production is back to approximately 360 million barrels/month. Food prices increased modestly during COVID but began to return to normal until February of this year. Since then, global food supply chains have been under pressure as Ukraine is a leading exporter of sunflower oil and corn, Russia is a major exporter of fertilizers (impacting crop yields), and both countries account for 25% of the world's wheat.

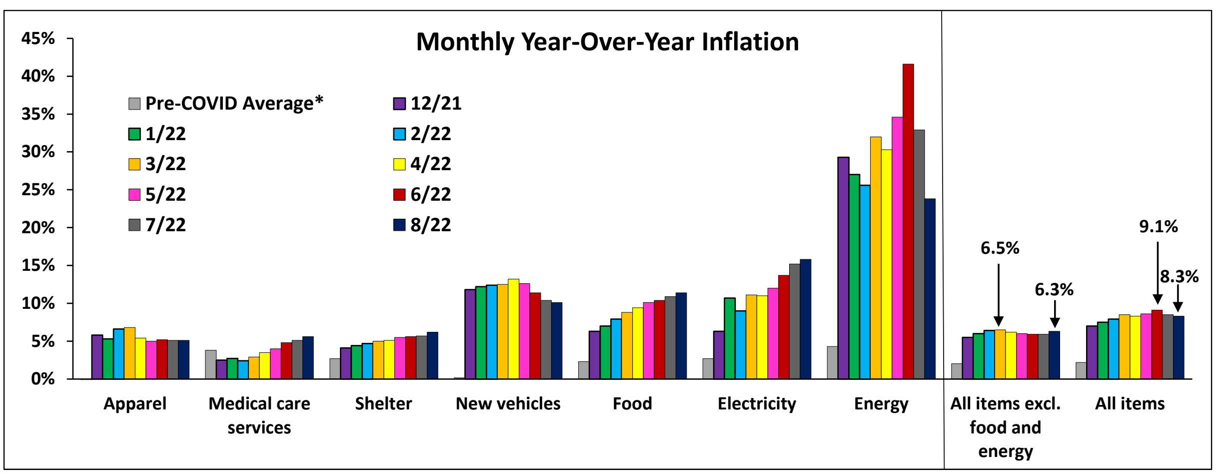




Source: U.S. Bureau of Labor Statistics

Inflation has been hardest felt in food and energy, but there are some positive developments. The most recent CPI print in August showed an 8.3% change in consumer prices year-over-year and 6.3% excluding food and energy ("core" inflation). Both have decelerated over the past few months.

The table below displays year-over-year inflation by category on a monthly basis vs. average inflation before COVID. Apparel, medical care, and new vehicles are drifting towards pre-COVID levels – positive signs that inflation will moderate as supply chain pressures ease.



*Pre-COVID average includes monthly year-over-year data from January 2000 through March 2020.
Source: Bureau of Labor Statistics

The Fed plays an important role in fighting U.S. inflation per its "dual mandate" to promote maximum sustainable employment and stable prices.[4] One of the Fed's governing bodies, the Federal Open Markets Committee (FOMC), is tasked with determining the appropriate target range for the **federal funds rate**, the overnight rate at which commercial banks borrow and lend excess reserves. Changes in the fed funds rate can influence spending, investment, production, employment, and inflation. Higher rates *in theory* reduce employment and inflation by incentivizing saving (higher rates) and discouraging spending (higher cost to borrow). To move rates to its target range, the FOMC conducts **open market operations** (purchases/sales of U.S guaranteed securities).

To combat current inflation, the Fed conducted its first fed funds rate increase this March. Since then, it has increased rates another five times and the target range now sits at 3.0% to 3.25% (up 1200% this year). To the Fed's dismay, September unemployment (released on 10/7/2022) reflected the lowest rate in 53 years – an impressive 3.5% – with wages growing at a faster pace than the prior two decades for all categories of employees, led by those paid hourly and without college degrees! This incredibly strong labor market suggests further rate hikes will be required to moderate inflationary pressure, which is why the market expects the Fed to raise rates to 4.0% to 4.25% by year-end.

The Fed has more control over interest-rate sensitive sectors like housing and financials than it does over business investment, evidenced by soaring mortgage rates (currently 7% vs. 3% in October 2021) and falling home prices. Since housing is a fundamental expense for consumers, it impacts overall GDP growth. It is important to note, however, that the Fed can only influence demand. It has no control over the supply of food, energy, or any other goods or services. This leads to two important points:

1) **Should the Fed keep raising rates?** The Fed's first mandate – to promote maximum sustainable employment – is satisfied. In fact, labor markets may be *too* strong with the unemployment rate at only 3.5%. Focus will remain on the Fed's second mandate, to promote stable prices. Until inflation cools down, the Fed will likely keep raising rates.

2) **There is evidence of progress.** For example, in addition to the real estate market slowdown, S&P Global's Chief Business Economist said earlier this month that falling demand for raw materials has taken pressure off supply chains and manufacturers are reducing their selling prices to drive sales, which "should help to bring consumer price inflation down in the coming months."

Additionally, the *Wall Street Journal* reported in October that cargo ships are canceling dozens of sailings ahead of peak shipping season. At this time last year, Walmart and Home Depot were forced to charter their own ships to work around supply chain bottlenecks. Now, there are too many ships and not enough orders! Trans-Pacific shipping rates are down 75%. Darden Restaurants said in September that it believes inflation peaked in the most recent

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[4] Board of Governors of the Federal Reserve System (federalreserve.gov). Congress provides general guidance for the Federal Reserve System, but the Fed operates and makes its decisions independently to accomplish Congress's mandates.

quarter. Nike recently announced it was sitting on 65% more inventory than this time last year and anticipates markdowns. Hormel Foods (producer of durable and non-durable food products) believes it no longer needs to hike prices. Positive commentary from industry experts regarding inflation relief gives me confidence that today's high prices will go away soon enough. Furthermore, while the market implied inflation expectation over the next year is approximately 5.5%, <u>three-year inflation expectations plunge to 2.75% and five-year expectations are down to 2%</u>.[5]

Rate hikes *appear* to be working for the U.S., but actions undertaken by the Fed must be viewed in the context of global markets. This is because the U.S. dollar is the world's reserve currency and is overwhelmingly preferred for international trade. When the Fed acts, other central banks must follow. Higher rates in the U.S. attract foreign investors seeking more yield. As foreign investors purchase dollar-denominated assets, the U.S. dollar strengthens relative to other currencies. This makes imports cheaper for U.S. consumers and businesses, but consequently, makes U.S. exports more expensive to other countries. To remain competitive, foreign central banks are then forced to increase their rates because of their own currency's weakness relative to the U.S. dollar. This creates a vicious cycle of global rate hikes and requires the Fed to consider the second and third order impacts rate hikes cause in foreign markets. There is good news! The World Bank and Oxford Economics estimates that global inflation will moderate through 2023 and into 2024 – significant indication that global inflation is slowing.

What about our ballooning national debt? National debt is <u>only</u> created by Congress and has nothing to do with the Fed. If Congress needs more money, it can just run a budget deficit. Critics argue this is another vicious cycle that ultimately exacerbates inflation, but the argument is not applicable because the inflation we're experiencing today is driven by supply-side constraints that will ease, not structural changes in demand.

At this time last year, short-term high-quality fixed income investments were earning a paltry 1.0% annually (measured by yield to maturity). Now, these same instruments are earning a respectable 5.0%. The stock market has been temporarily hurt, but fundamentals are intact for long-term growth. A number of companies across our investment universe trade at pre-COVID valuations despite higher recurring revenues, stronger balance sheets, and improved growth prospects. Meta (formerly Facebook) is one of my favorite examples. In 2018, Meta generated $56 billion of revenue and $15 billion of free cash flow. Today it generates $119 billion and $36 billion, respectively. In 2018, the market valued it at an incredibly reasonable $375 billion, and today it is valued at $340 billion. We can't ask for much more than great fundamentals and an attractive valuation, and this current market environment justifies our excitement about the future for long-term stock returns.

[5] Survey of Consumer Expectations, Federal Reserve Bank of New York.

Account Transactions and "Tax Lot Trading"

We were asked recently about the elevated level of trading activity in 2022. Taking a bit of the sting out of this year's stock and bond market declines, we are making every effort to minimize the tax consequences for clients owning "custodial" or after-tax accounts. One option we often employ is to sell high-cost shares (tax lots), converting *unrealized* losses to *realized* losses. The latter can be deducted against realized gains to reduce taxes. Excess losses can offset $3,000 of ordinary income annually; unused losses can be carried forward for use in future years. Compliance with IRS requirements as well as maintenance of planned investment structure and diversification has led to greater than average trading volume in 2022, but the very modest increase in transaction expenses will be easily offset by the resultant tax savings.

As an aside, if you have had large realized capital gains in recent years, it is possible that current estimated tax deposits can be reduced. Your portfolio manager can provide current 2022 realized gains information, which should then be discussed with your accountant.

FA 100: *CNBC Ranks the Top-rated Financial Advisory Firms of 2022*

Professional Advisory Services was founded in 1977 by Ron Jaffe and Ken Ligon with "four green notebooks on the kitchen table". How proud and amazed they would be to learn that their brainchild was just named to CNBC's 4th annual ***Financial Advisor 100*** list, ranking #15 in the country and #2 in the State of Florida. The list is based on a proprietary methodology developed by CNBC in partnership with data provider AccuPoint Solutions, taking into consideration data that's culled from more than 39,000 RIAs (Registered Investment Advisers). To learn more about the methodology and the other firms on this year's list, go to: http://CNBC.com/fa100 .

We can't emphasize enough how critical our client base has been to our growth and ongoing success. We thank you all for your confidence and support, especially in the face of financial market turmoil and difficult times such as we are experiencing today.

Disclosure