THE WORLD TURNED UPSIDE DOWN

Written By:
Your First Bankers Trust Team

A few words from your FBT Team

We're very grateful at First Bankers Trust to have a wonderful set of clients and look forward to each meeting. There is always thoughtful discussion, great stories, and plenty of laughs. Even better, we sometimes get the perfect title for our newsletter. In a recent meeting, our client had a list of discussion topics but said he just couldn't get one particular phrase out of his head: "The World Turned Upside Down." The phrase is the title of an English ballad that was allegedly played at Yorktown when the British surrendered to Washington's troops.

Investing is not a matter of life and death or national security, but 2022 certainly felt like a battle. And many investing paradigms were turned upside down.

A Look Back...

Arguably the asset class that had its world turned upside down the most in 2022 was fixed income. Sure, high flying tech stocks were thrown in the woodchipper. But that happens from time to time in those areas of the stock market. What does not happen from time to time is what bond investors experienced in 2022. In fact, research suggests 2022 was the **worst year for bonds in 150 years!** Deutsche Bank published data dating back to 1872 that showed investors in a 10-year Treasury bond suffered the worst total return in history – and by a significant margin. The "risk-free rate of return" asset became the return-free risk asset. The Bloomberg U.S. Aggregate Bond Index, which only dates back to 1976, posted a (13.0)% return, its worst by a margin of 10%!

Bonds aren't the only asset class that loathe the shock of inflation, of course. Stocks had their own struggles as we alluded to above. The S&P 500 sprinted to bear market territory (-20%) at the fourth fastest pace in the index's 94-year history (note the data table only focuses on bear markets coming off fresh all-time highs). However, with some meaningful ups and downs, the index managed to hang around the same level into yearend. Nevertheless, it was still a **bottom 10 finish for the S&P 500.**

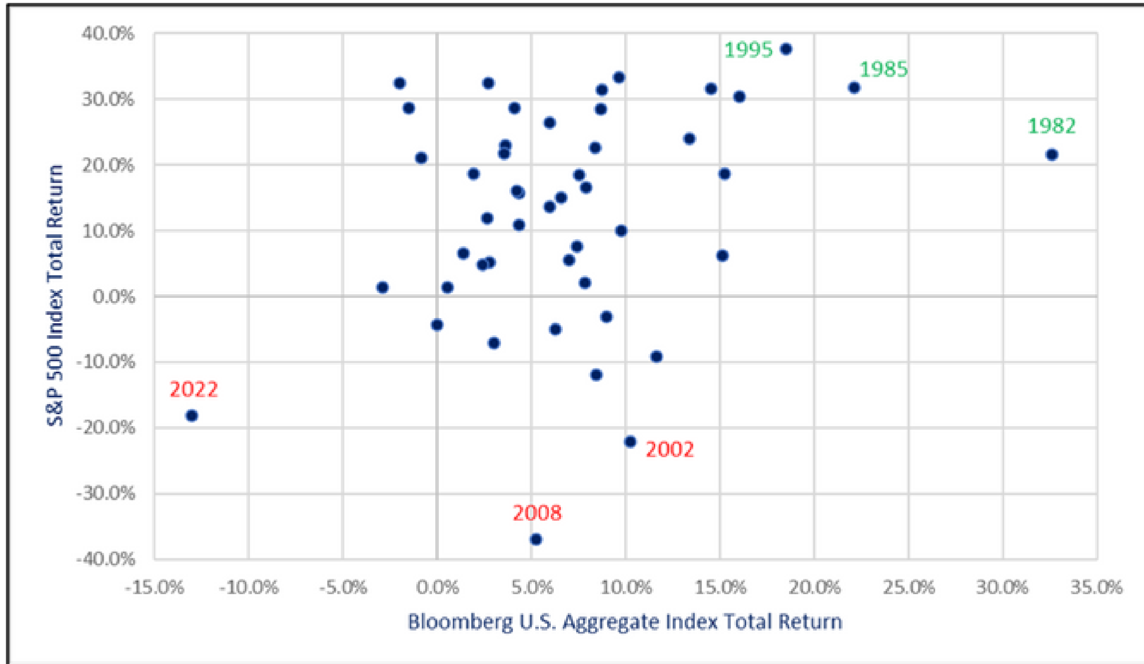
S&P 500 Bear Market Start Date	Days to Reach Bear Market Territory
2/19/2020	22
9/16/1929	42
8/25/1987	55
1/3/2022	**161**
12/12/1961	167
2/9/1966	240
10/9/2007	280
1/11/1973	328
3/24/2000	353
11/29/1968	426

Source: Bloomberg, FBT Research

Total Year	S&P 500 Total Return (price and income)
1931	-47.1%
2008	-37.0%
1937	-34.7%
1930	-28.5%
1974	-26.5%
2002	-22.1%
2022	**-18.1%**
1932	-14.8%
1973	-14.7%
1929	-11.9%

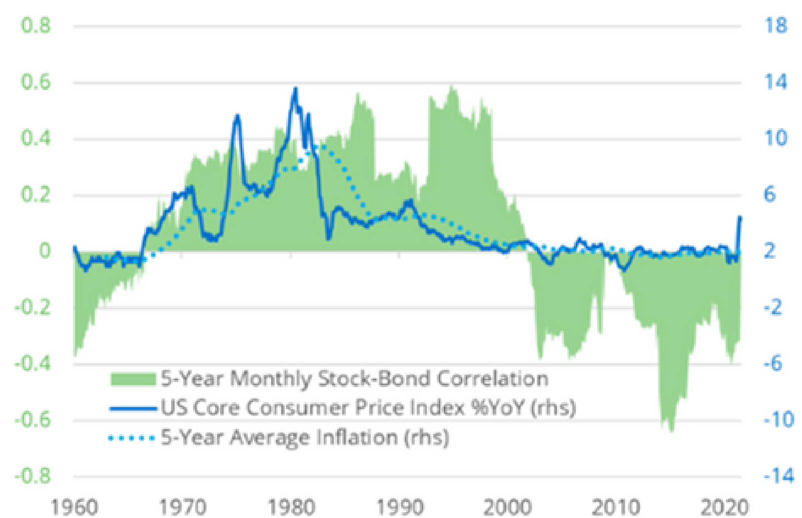
Source: Bloomberg, FBT Research

There have been much worse years in the stock market, in very recent history in fact. For the famous 60/40 (60% stocks, 40% bonds) portfolio, the magnitude of the 2008 stock decline was enough to offset a positive year in bonds that year and remains the worst year for the 60/40 dating back to the start of the Bloomberg Aggregate Index (-20.1% in 2008 vs. -16.1% last year). B**ut a broad market index investor simply had no place to hide in 2022** whereas an overweight to bonds would have at least helped in 2008. Looking at the chart below, a different song comes to mind: "All by Myself."



Source: Bloomberg, FBT Research; top 3 and bottom 3 years for a 60/40 portfolio are labeled

Investors over the past 40+ years, or roughly the lifetime of the Bloomberg U.S. Aggregate Bond Index, have had the benefit of falling interest rates. Federal Reserve Chairman Paul Volcker's epic fight in the early 1980's against inflation took interest rates to extraordinarily high levels. While there were some counter moves on the way down, bond investors could simply ride the wave of falling rates (and therefore rising bond prices). So yes, bonds and stocks do have a recent history of correlation as the chart below shows. But it has largely been correlation with positive returns. And over the past 20 years, stock and bond investors have benefited from negative correlations.



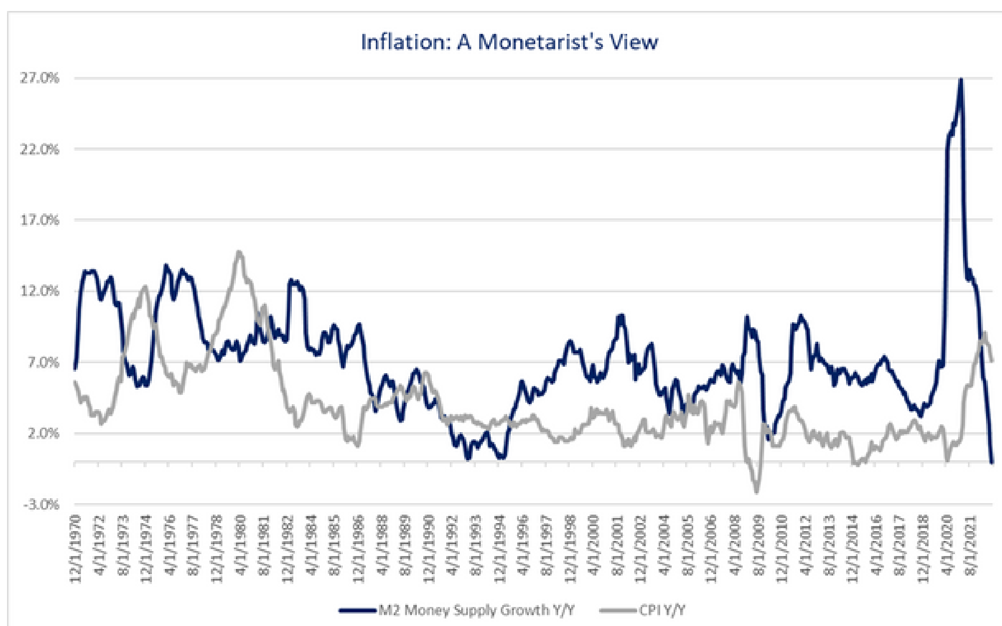
Source: Morningstar Direct, FRED, U.S. Bureau of Labor Statistics, Qontigo

A Look Forward: Inflation

After the shell shock of 2022, many investors fear more pain awaits in 2023. **The direction of bond and stock markets comes down to two incredibly complex and intertwined topics: recession and inflation.** Looking back to our summer of 2021 newsletter "Inflation: How Long is Transitory?", the stars are aligning for the "year or two" expectation of falling inflation to prove prescient. While we are looking prophetic in a directional sense, the magnitude and the cause is now the focus.

Peaking at just over 9% in the summer of 2022, inflation has already receded to 6.5%. It is pretty easy to see a scenario where inflation, as measured by the Consumer Price Index (CPI), falls below 5% with ease and could even flirt with the Federal Reserve's inflation goal of 2%. However, attaining the 2% goal on a sustained basis may come with some pain. Inflation at a 40-year high of 9% isn't generated by just one source; both supply and demand in many sectors of the economy played a significant role.

On the demand side, excessive government stimulus is to blame. There are undoubtedly nuances beyond money printing and artificially low interest rates, such as rapid shifts in consumer spending preferences, but the majority of the demand side inflation was caused by pandemic government policy. Due to both fiscal stimulus and monetary stimulus, **M2 (one of several measures of money supply) has increased over 38% from February 2020 through the end of 2022. For reference, CPI is up 15% since February 2020.** As the chart below shows many times throughout history, money supply growth and inflation aren't perfectly correlated

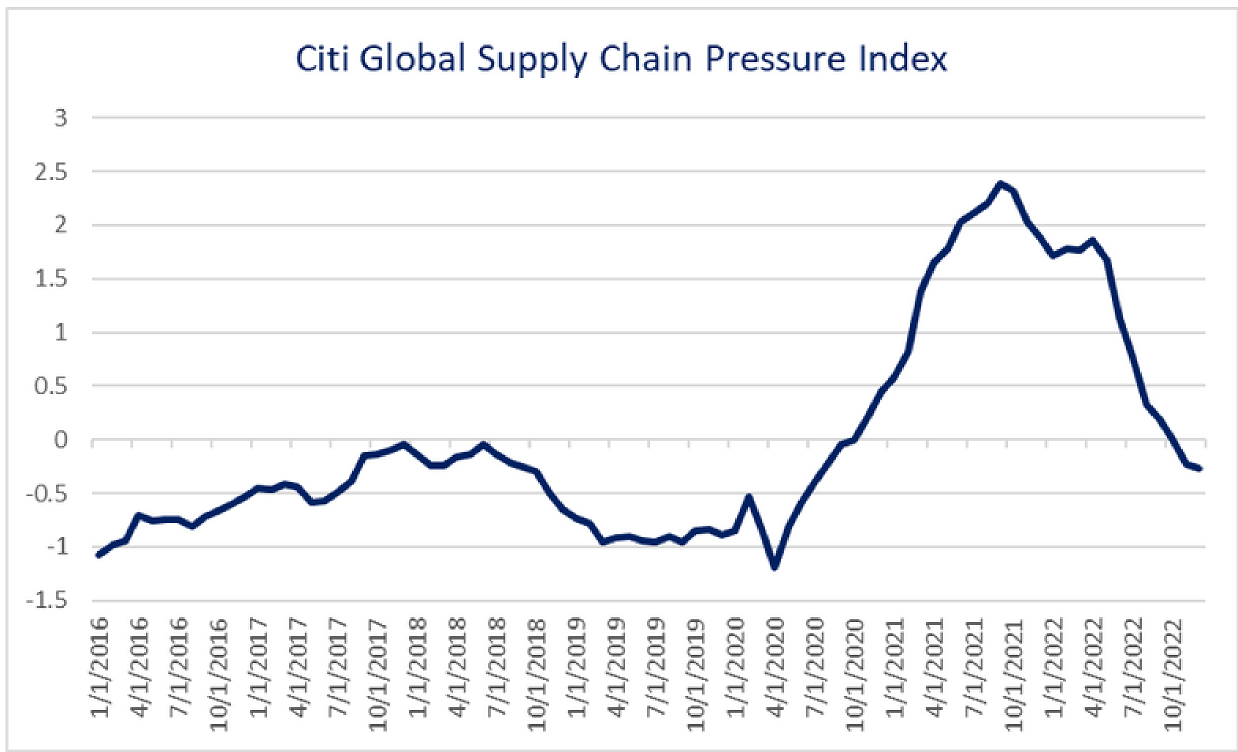


Source: Bloomberg, FBT Research

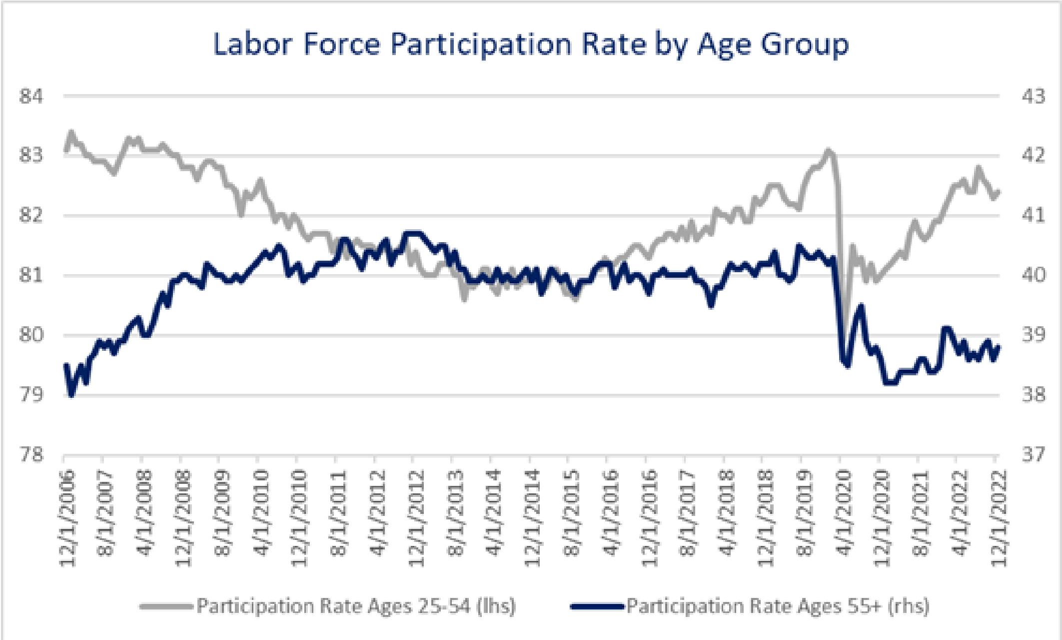
That is the beauty of a capitalist economy responding to price signals: supply of goods and services rise to meet increased money supply and keep inflation at bay. Furthermore, we would argue it is important to consider the rate of change in money supply, not just cumulative increases. And, at the time of this newsletter, M2 is contracting slightly.

We would argue, after serious mistakes, that monetary policy is trying to correct for past sins by eliminating excess demand from the system. Fiscal policy, however, is not quite as restrictive as it should be, but it is much more sober than the pandemic days of free money. A key transmitter of demand-side inflation, in our view, was housing. Housing demand has fallen significantly, and housing inflation looks set to roll over.

On the supply side, the picture is also improving. A key fixation in financial media were the massive supply chain disruptions. We'd argue the supply chain problems were both a demand and supply problem. Consumers rapidly shifted spending from services to goods in the face of lockdowns, while business across the world struggled with labor disruptions from both sick workers and government-mandated lockdowns. While it is hard to parcel out how much of the supply chain price surge (and current normalization) was demand versus supply, the picture is unquestionably improving.



So far, the inflation picture is shaping up to align closely with our initial call. However, we weren't perfect. Both a beauty and necessity of investing is the ability to change your mind when incoming facts differ from your initial thesis. Over the past eighteen months, our view on two elements of inflation have shifted: **labor and commodities. Demand for both will inevitably ebb and flow with economic growth, but the supply side of each may be more hindered** than we initially expected. For domestic labor, it appears the decline in participation rates may be more secular than transitory. Labor markets were destined to shift as baby boomers hit retirement age, but Covid was both an immediate and, we now believe, a permanent change. As the chart below demonstrates, labor supply is unlikely to rebound quickly due to what some estimates suggest to be three million early retirements. Prime age (25-54) work force participation is not terribly far from its pre-pandemic highs but the baby boomer participation rate has not recovered at all. Furthermore, immigration growth has slowed significantly and appears unlikely to deliver needed workers in the near future.



Source: Bloomberg, FBT Research

The commodity production response to a very rapid rise in price post-Covid and another spike following the start of the Russia-Ukraine war has been tepid. That's not to say there hasn't been an increase in supply; for example crude oil production is not terribly far from its pre-Covid levels despite demand still being slightly below pre-Covid levels. However, we believe the war has fundamentally altered the supply outlook for many commodities. Russian oil is still finding its way to market, likely meaning Russian production has not declined meaningfully. As sanctions bite and Russia loses access to external capital and technology, we believe Russian production will decline over the coming years. Furthermore, investment in other key oil producing countries has been lackluster. While this brief discussion focused on oil, there are other key commodities experiencing a similar lack of attention from corporate capital expenditure budgets.

A Look Forward: Recession

Falling inflation is not the clear-cut positive one might think. The Federal Reserve has taken an aggressive path to try to reign in inflation, and it is very possible they will push interest rates too high. As a result, demand could not only normalize but over-correct and push the economy into recession. Even supply increases are fraught with risk in this environment; companies and industries racing to increase supply in response to what proves to be transitory surges in demand can create gluts that drive margins lower and lead to layoffs.

It seems like every headline on the economy these days calls for a recession.

It's tempting to smash the contrarian button if everyone is in agreement, but one must note the **bond market certainly concurs a recession is on the way.** While we certainly respect the collective intelligence of the largest, most liquid market in the world (the U.S. Treasury market), we would encourage folks not to lose sight of a couple ideas: this same market also forecast inflation to be running at 2% just two years prior to 2022 versus the 6.5% we experienced. Keep in mind this faulty forecast is after excessive government policies were implemented. While the Treasury market's track record is strong in predicting recessions, no market is perfectly accurate. Secondly, the economy is still very disjointed in its recovery from Covid. These distortions are not healthy, but a silver lining could be that positive normalization in certain sectors of the economy offset recessions in other industries.

Nevertheless, t**he Federal Reserve has a poor track record when it comes to "soft landings," i.e. raising interest rates without causing a recession.** Additionally, the housing market has not found a floor yet. Prices needed to come down, and the pristine credit underlying the Covid housing boom would certainly permit a price correction without pulling the economy into a recession. However, the Fed is teetering on the edge with housing normalization, in our opinion, and mortgage rates meaningfully above 6% appear to push housing from "healthy correction" to "painful contraction." We believe the disjointed nature of the current economy can withstand a healthy correction in housing despite housing's historically significant role in the economic cycle. However, we don't see a scenario in which a painful contraction doesn't drag the whole economy into recession, even if only a mild one.

Should we be proven wrong by the housing sector, or should a rebound in housing activity – not necessarily price – occur quickly enough, we'd be inclined to take the contrarian position of a soft landing. Another key factor for recession avoidance will be consumer spending preferences. Many leading indicators, especially in manufacturing, are in recession territory. However, production has remained robust as companies work through backlogs. That process looks to be nearing completion in many industries and new orders are very low. Consumer spending needs to be strong in 2023 to pull down inventories and send signals up the supply chain to start increasing new orders again. Consumer sentiment may be low at the moment, but income growth will likely exceed inflation in 2023 (barring mass layoffs) and consumer balance sheets are still strong in aggregate. Thus, consumer spending could be a positive surprise, in our opinion. **If housing and new orders can rebound in short order, a recession very well could be avoided. But the window is closing quickly in our opinion.**

What Does This Mean for Portfolios?

What would a recession mean for stocks and bonds? Many point to the poor year stocks had last year as evidence “it is already priced in”. However, last year was simply a normalization of valuations. Corporate earnings typically decline in a recession, and they actually grew last year. In fact, **earnings only missed Wall Street’s starting estimates by 2%.** The rest of the 18% decline was valuation compression. Wall Street expects earnings to grow again in 2023 and 2024 and valuations are, by many measures in relation to earnings expectations and interest rates, reasonable. Thus, unfortunately, more pain in stocks await if a recession is realized. We do believe though that a recession would be a temporary cure for inflation and bonds would perform well.

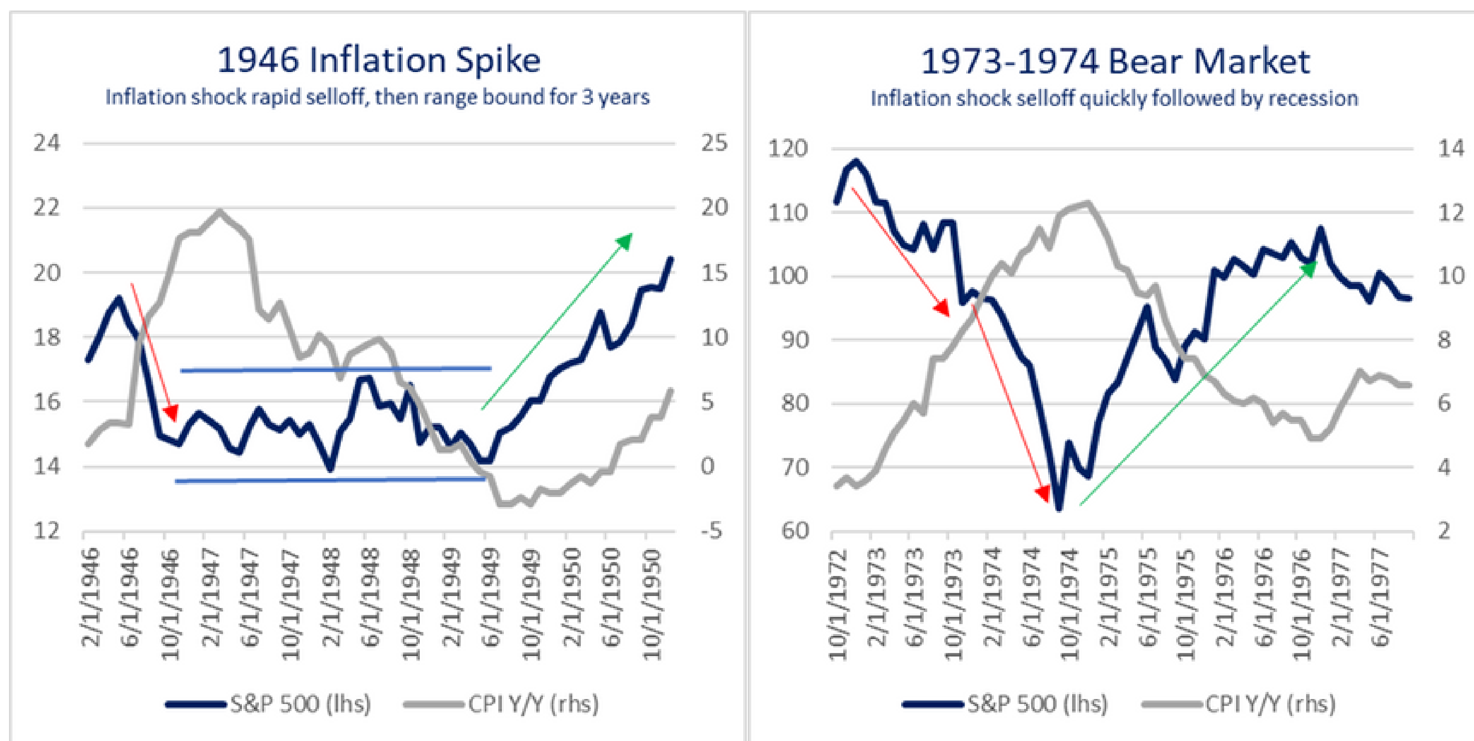
If the economy threads the needle and avoids recession, interest rates will likely go higher and bond prices would decline again. However, the price decline, we believe, will be far less drastic than 2022 and bonds now have higher coupons to help offset the price decline. If recession is avoided, stocks have a solid chance at a positive year. Valuations are normalized and a no-recession scenario could come with another dose of inflation that boosts nominal earnings.

Recession or not, investors must stay diligent on inflation, which has turned the financial markets upside down. Remember, money supply is still up 38% while prices in the real world are only up 15%. There is no economic law that mandates this gap must be closed by higher inflation. However, inflation risk will remain high for quite some time. The Federal Reserve might be raising interest rates by the fastest pace in history, but their control over money supply is not omnipotent now that the cat is out of the bag. That printed pandemic money is in the hands of consumers, businesses, investors, and potentially banks in the form of deposit liabilities that can be lent to fund expenditures for which there is not adequate supply.

This inflation risk is arguably most important for bond investors. If recession occurs and inflation subsides, bond investors must be sure they are being adequately compensated for this risk. It is very easy to foresee a scenario in which interest rates fall too far and inflation rears its ugly head again. Thus, we still view the short end of the yield curve as more attractive from a risk/reward standpoint and stick to our call in the previous newsletter that 4% on the 10-year Treasury is respectable compensation for inflation risk.

Equity investors cannot ignore inflation risk, but history actually shows stocks can be attractive investments after the initial shock of inflation. Valuations have reset, and the question for 2023 is whether margins and thus earnings reset as a result of a recession. In other words, is it 1947 (an underdiscussed historical parallel in our opinion) or 1974?

Source: Bloomberg, FBT Research



Regardless of the path of inflation and question of recession, our investment philosophy will not change. We're proud to have delivered significant downside protection for our clients in 2022 and aim to do the same in 2023. It is much easier to compound off higher lows to remain on track to achieve client goals.

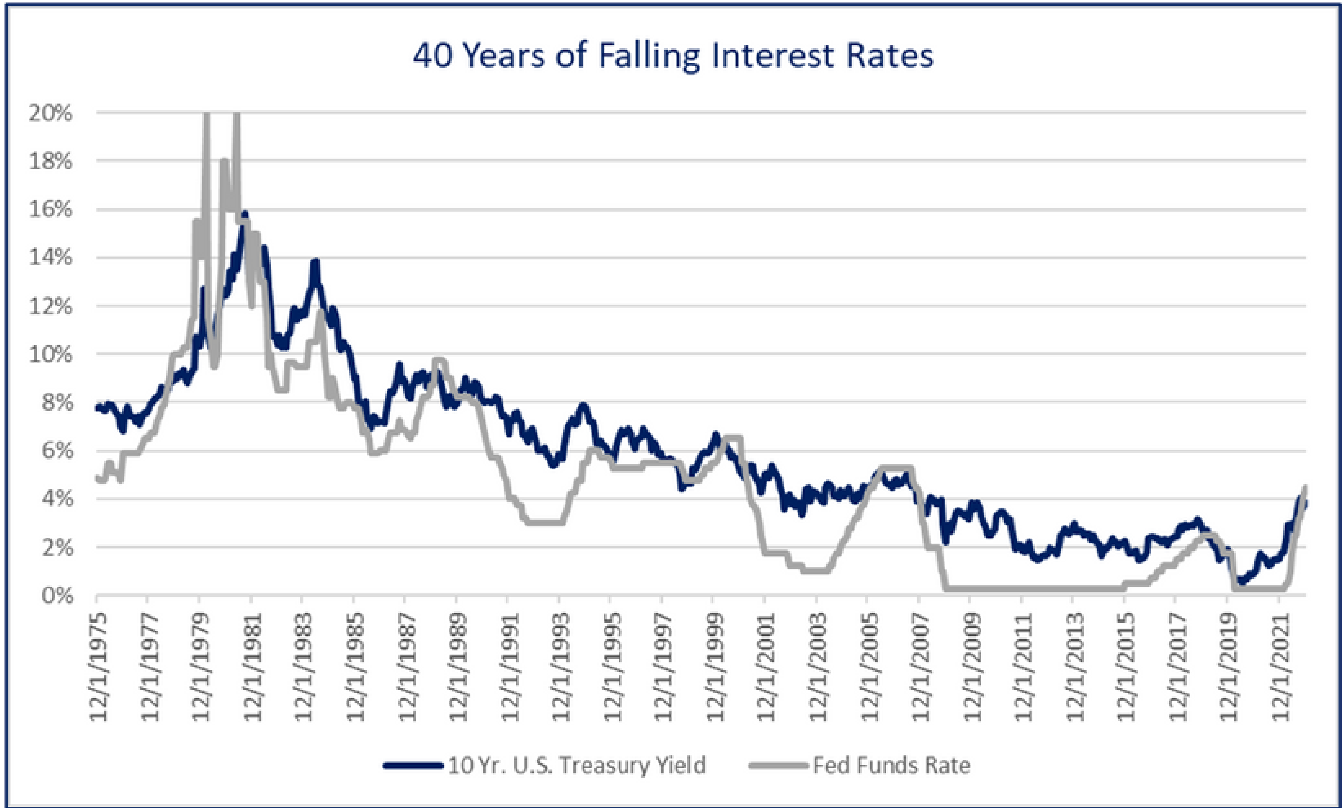
Sincerely,

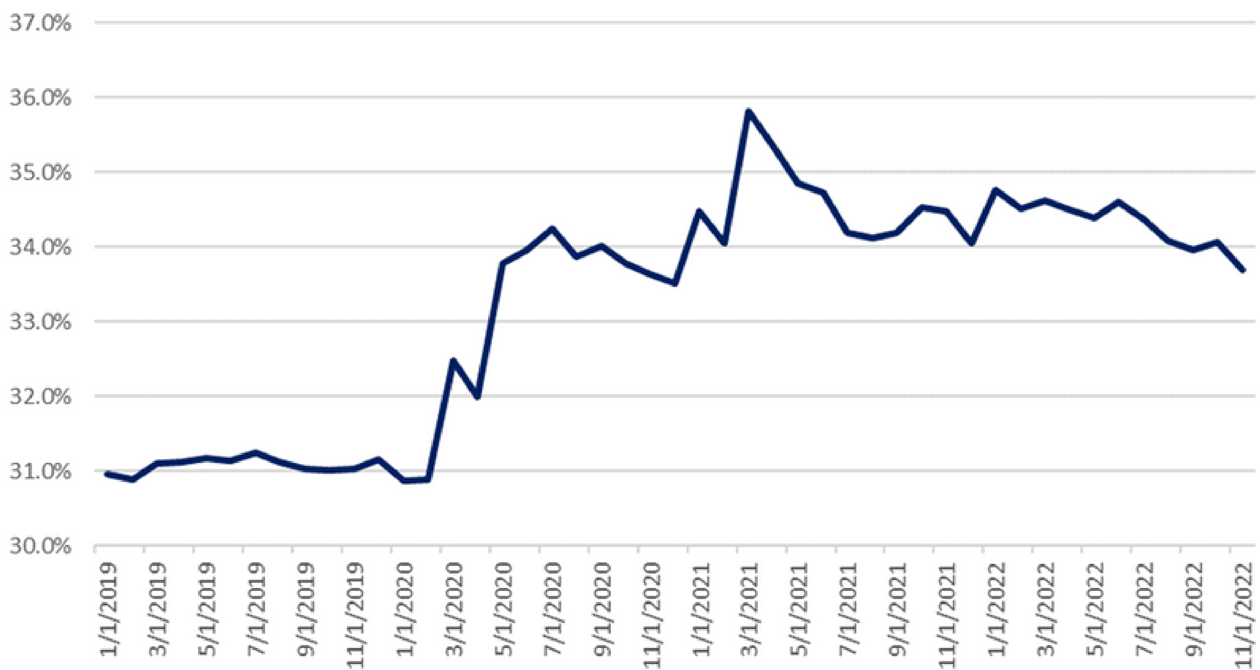
Your First Bankers Trust Team

Investment products are not FDIC insured, not guaranteed by the bank, and may lose value

Chart Appendix

Sources: Bloomberg, First Bankers Trust Research, Arbor Research LLC, Baker Hughes, Morgan Stanley Investment Research, Haver Analytics, Bank of America Global Research, EPB Macro Research




% of Consumer Spending on Physical Goods
37.0%
36.0%
35.0%
34.0%
33.0%
32.0%
31.0%
30.0%
1/1/2019
3/1/2019
5/1/2019
7/1/2019
9/1/2019
11/1/2019
1/1/2020
3/1/2020
5/1/2020
7/1/2020
9/1/2020
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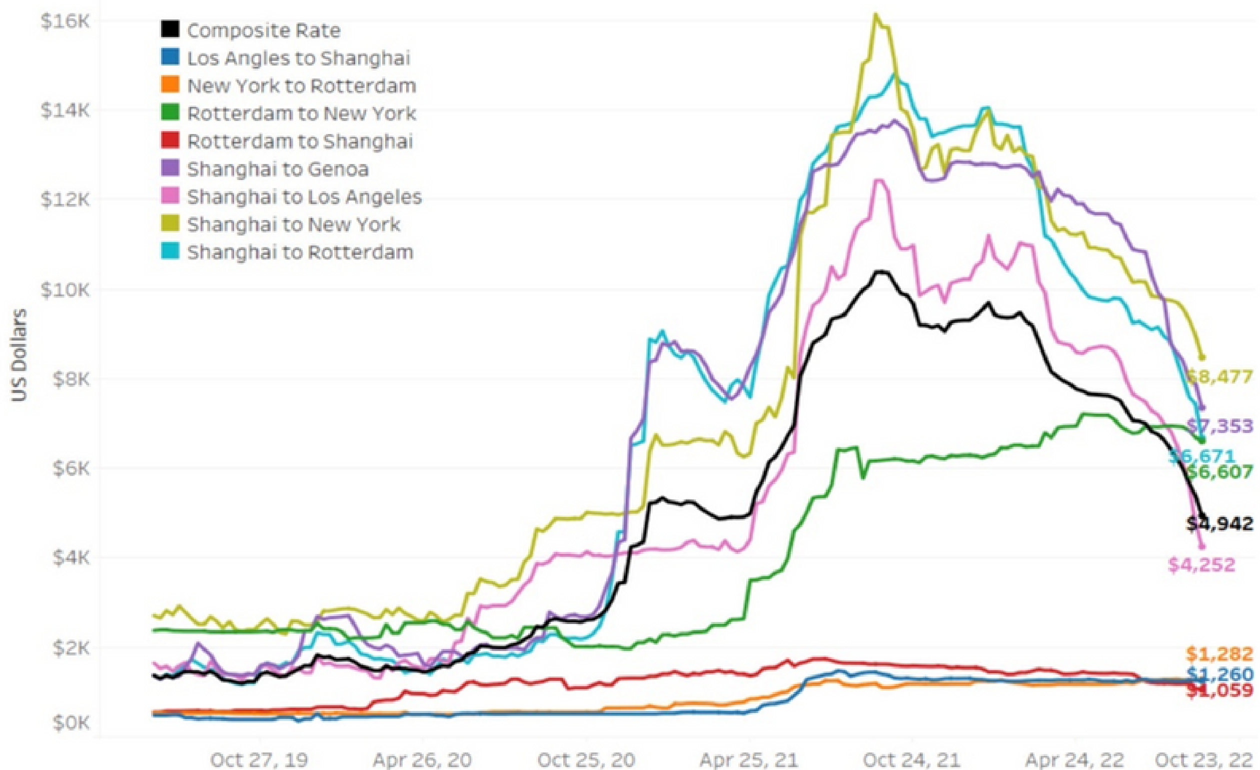
9/1/2022
11/1/2022


Global Container Rates
Weekly Benchmark Cost per 40 Ft Container (thru 9/15/2022)
ARBOR DATA SCIENCE
Composite Rate
Los Angles to Shanghai
New York to Rotterdam
Rotterdam to New York
Rotterdam to Shanghai
Shanghai to Genoa
Shanghai to Los Angeles
Shanghai to New York
Shanghai to Rotterdam
US Dollars
$16K
$14K
$12K
$10K
$8K
$6K
$4K
$2K
$0K
$8,477
$7,353
$6,671
$6,607
$4,942
$4,252
$1,282
$1,260
$1,059
Oct 27, 19
Apr 26, 20
Oct 25, 20
Apr 25, 21
Oct 24, 21
Apr 24, 22
Oct 23, 22
Data Source: Drewry World Container Index
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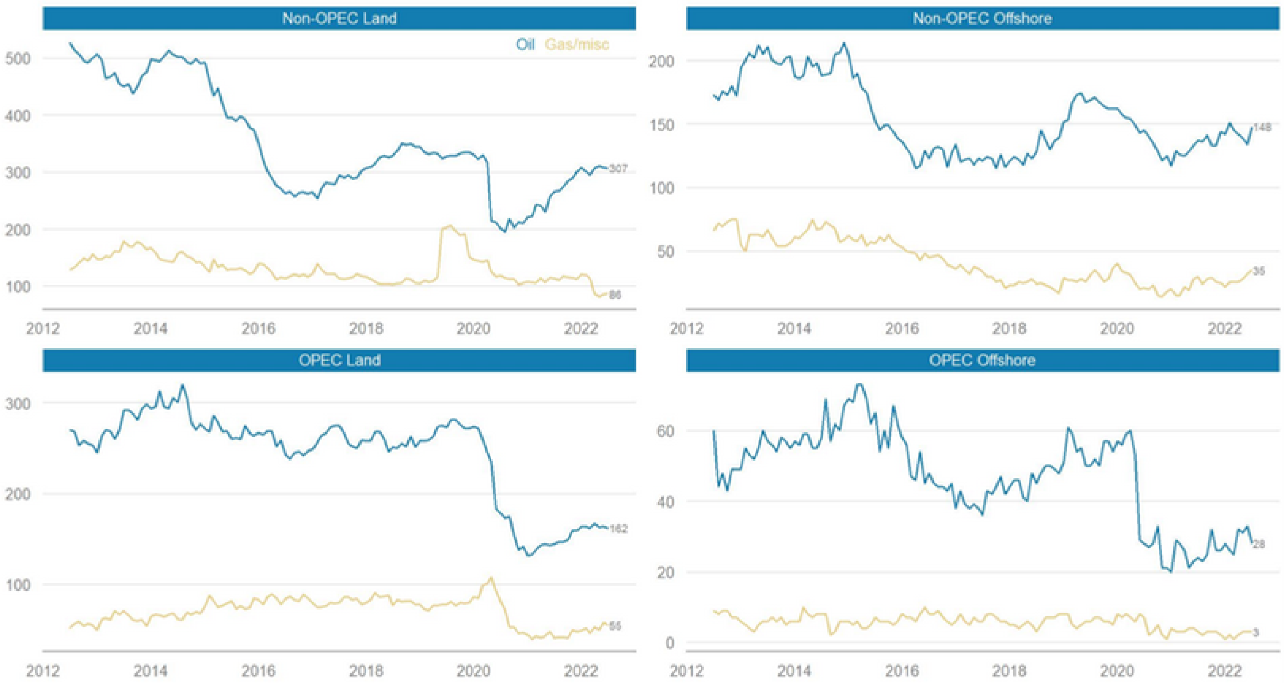
datascience.arborresearch.com


Rig count outside the United States
OPEC vs non-OPEC; land vs offshore
Non-OPEC Land
Oil
Gas/misc
500
400
300
200
100
307
86
2012
2014
2016
2018
2020
2022
Non-OPEC Offshore
200
150
100
50
148
35
OPEC Land
300
200
100
162
55
OPEC Offshore
60
40
20
0
28
3
Note: rigs drilling in inland waters included in 'offshore'

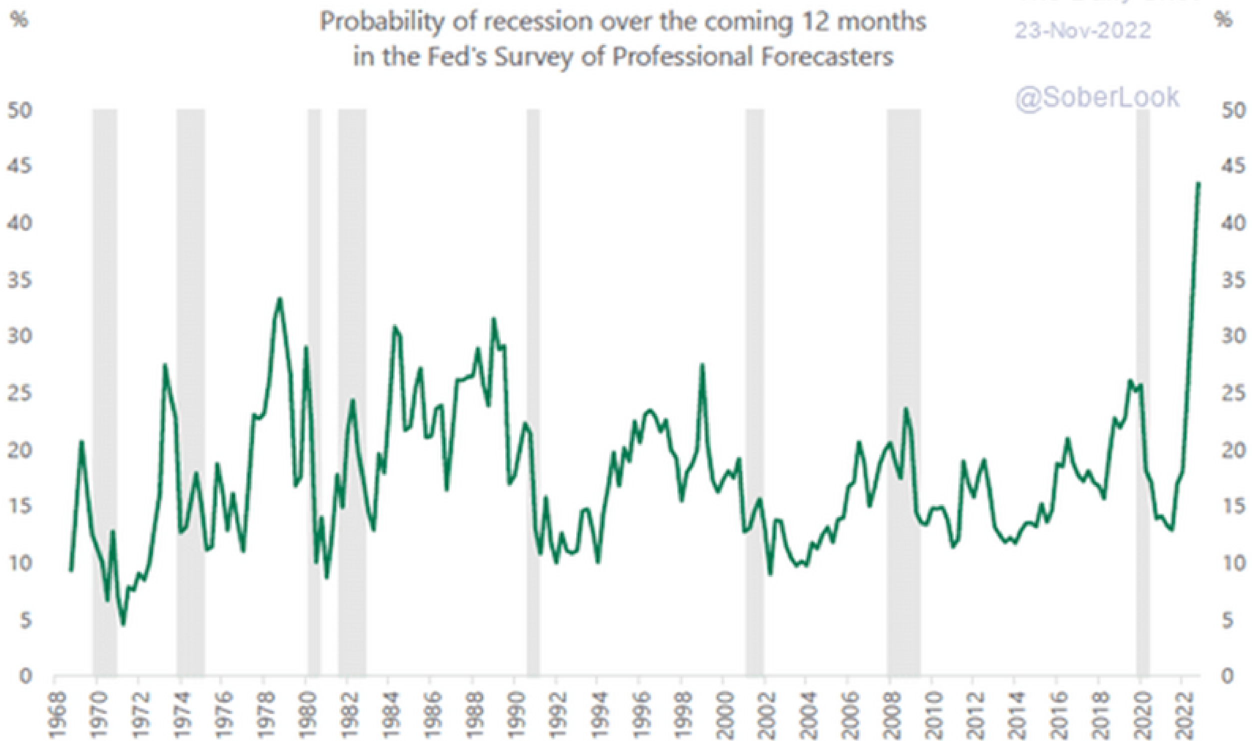
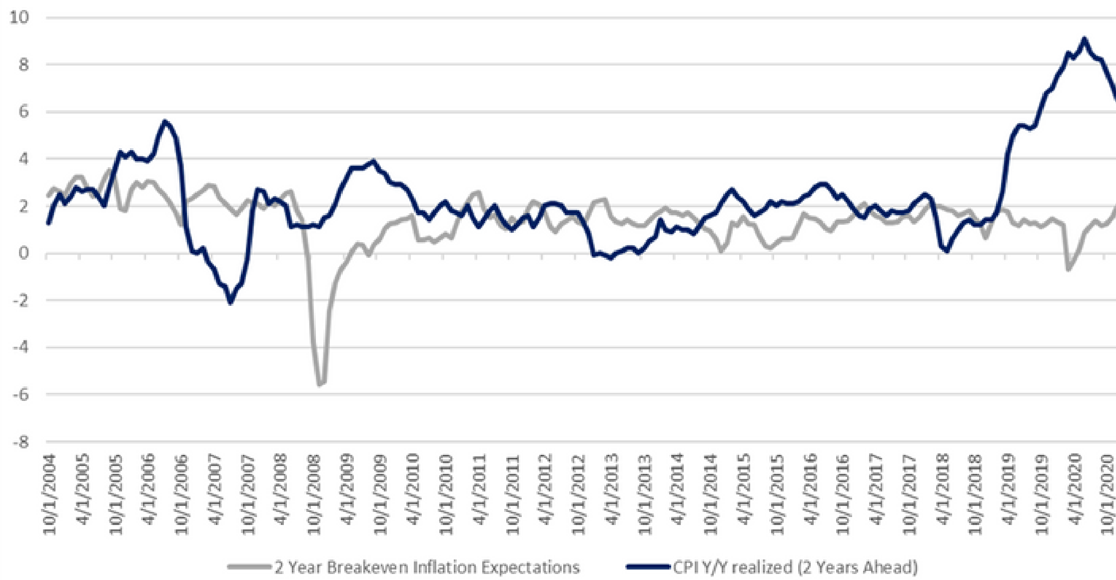
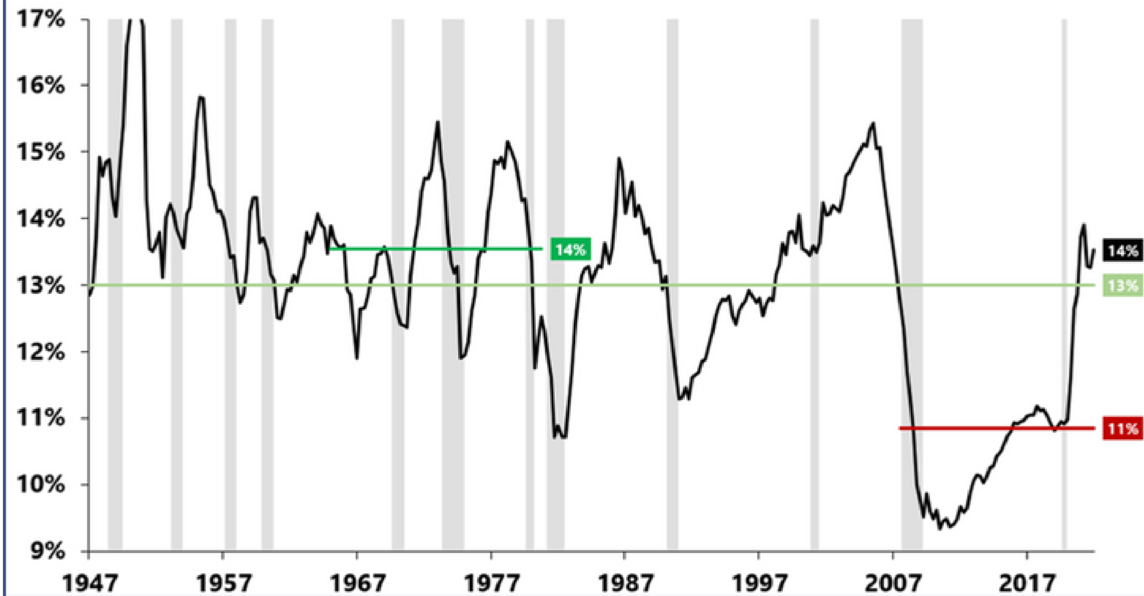

The most anticipated recession ever
Posted on
The Daily Shot
23-Nov-2022
@SoberLook
Probability of recession over the coming 12 months
in the Fed's Survey of Professional Forecasters
%
%
50
45
40
35
30
25
20
15
10
5
0
1968
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012
2014
2016
2018
2020
2022
Source: Federal Reserve Bank of Philadelphia, Haver Analytics, Apollo Chief Economist
APOLLO
4

Chart 3: Yield curve steepening best indicator recession has begun
US 2s10s yield curve and recessions
350
250
150
50
-50
-150
-250
'70
'73
'76
'79
'82
'85
'88
'91
'94
'97
'00
'03
'06
'09
'12
'15
'18
'21
'24
Recession
US 2s10s YC (bps)
Source: BofA Global Investment Strategy, Bloomberg
BofA GLOBAL RESEARCH



Treasury Market Isn't Always Right
10
8
6
4
2
0
-2
-4
-6
-8
2 Year Breakeven Inflation Expectations
CPI Y/Y realized (2 Years Ahead)



USRECD
Cyclical Component of GDP (Housing + Durable Goods)
LT Average
1965-1980 Average
Past 15 Years
17%
16%
15%
14%
13%
12%
11%
10%
9%
14%
14%
13%
11%
1947
1957
1967
1977
1987
1997
2007
2017