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2023 Third Quarter Newsletter and Outlook

BY MICHAEL C. STALKER, CFA

"Chance Fights Ever on the Side of the Prudent"
—Euripides

The world is on fire, fueled by climate change, domestic and international political strife, war, excessive debt, and inflation. For investors, this means becoming far more discerning about risk and investment selection.

Through September 30, 2023 (if MCS clients' investments were treated as one large portfolio including their cash), on average clients gained 2.73%*, after fees. For comparison purposes, the S&P 500 Total Return Stock Index (S&P 500) gained 13.07% YTD, and the Bloomberg Barclays Aggregate Bond Index lost 1.21% YTD. The range of MCS individual client returns was from gains of 6.82% to 0.52%. (Note: returns quoted here are actual, not annualized)

The client with the lowest returns had overweight inherited stock exposure in retail stocks. Clients with the highest returns had stock exposure to specific technology and holding company stocks. Overall MCS client portfolios continue to have much less volatility due to a very large allocation invested in state income tax-exempt US Treasury Bills.

Stay Frosty

In a hot world, keeping a cool head is essential if you wish to successfully navigate rising interest rates, higher inflation, and a likely end to the low-tax era.

* MCS Family Wealth Advisors (MCS) consolidated client returns are dollar-weighted, net of investment management fees unless stated otherwise, include reinvestment of dividends and capital gains and represent all clients with fully discretionary accounts under management for at least one full month in 2023. These accounts represent 99% of MCS's discretionary assets under management as of 09/30/2023 and were invested primarily in US stocks and bonds (1.75% of client assets on 09/30/2023 were invested in tax-exempt municipal bonds). The Stock Index values are based on the S&P 500 Total Return Index, which measures the large-capitalization US equity market (including reinvested dividends). The Bond Index values are based on the Bloomberg US Aggregate Bond Index, which measures the US investment-grade bond market. Index values are for comparison purposes only. The report is for information purposes only and does not consider the specific investment objective, financial situation, or needs of any recipient, nor is it to be construed as an offer to sell or solicit investment management or any other services. Past performance is not indicative of future results.

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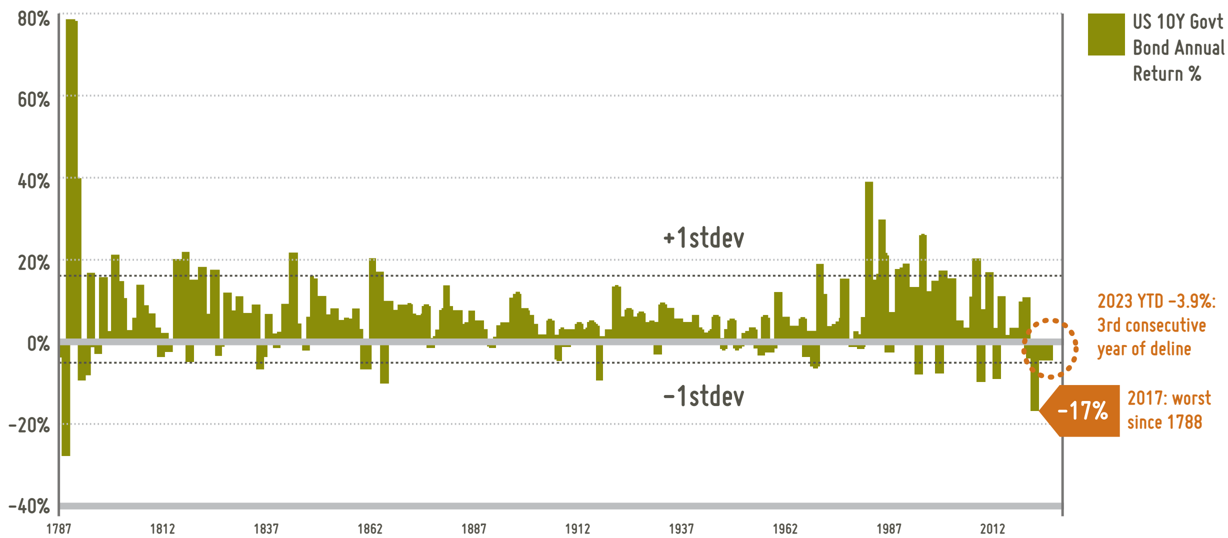
The end of record low interest rates has hammered bond investors

As of September 30, the US Government bond market had recorded the worst cumulative loss streak in its history, according to strategists at Bank of America. Diversified bonds are also down in the last three years.

Figure 1

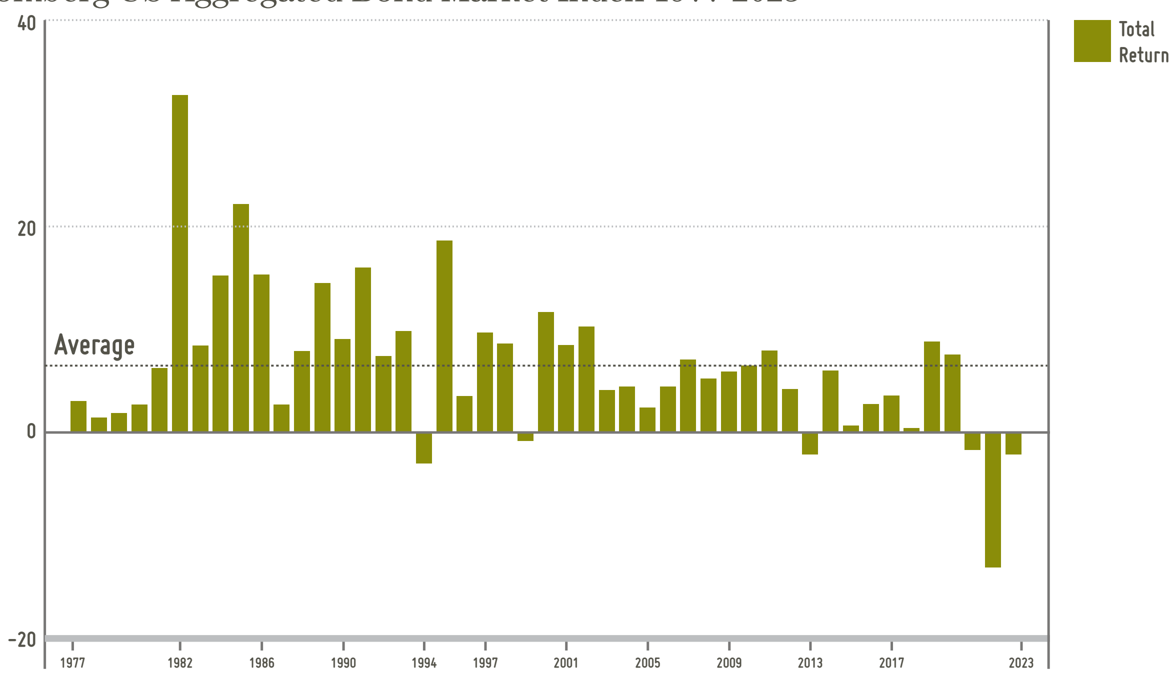
Worst Consecutive US Treasury Returns in History



Source: BofA Global Investment Strategy, Bloomberg, Global Financial Data.

Figure 2

Bloomberg US Aggregated Bond Market Index 1977-2023



Source: Bloomberg. 2023 is year-to-date.

Throughout my career, I used long-term bonds to build clients a secure financial foundation with strong cashflow. None-the-less, as interest rates bottomed out over 3 years ago, I began reducing exposure to long-term bonds–moving to very short-term bonds, CD's, and then T-bills for a simple reason. Interest rates had plummeted to such ridiculously low levels that investors were no longer compensated for the risks inherent in long-term investing.

A book in my library, 'The History of Interest Rates' by Homer and Sylla[1], tracks bond yields over the last 5,000 years. A MarketWatch article from 2016[2] used this research to observe that the then current rates were the 'lowest interest rates in the past 5,000 years,' and this was before the COVID-19 pandemic dropped rates even lower! From March 2019 to December 2022, rates on 10-year government bonds dropped as low as .51% (half of one percent).

My investment career began near the *highest interest rates* in American history. The decline in interest rates from highest on record to lowest on record ended in early 2021, and it was followed with a massive surge in inflation ignited by a globally coordinated effort by central banks to mitigate the economic impact of the pandemic. To be fair, the pandemic was not the only inflationary factor. Deflationary trends, such as cheap and abundant labor from globalization, were ending at about the same time.

It is tempting to conclude that, after such a rare event, it's time to buy. Often buying after an unprecedented drop is a good strategy.

On the other hand, this three-year worst period in US bond market's 236-year history was preceded by the *lowest global yields of the past 5,000 years*, therefore a 236-year comparison is not so persuasive.

Figure 3

Lowest US Government Interest Rate on Record

At the height of the Pandemic, rates went even lower.

Source: Bloomberg

Few investors want to contemplate the rude math that a sustained period of higher interest rates can inflict on investments: prices go down and stay down.

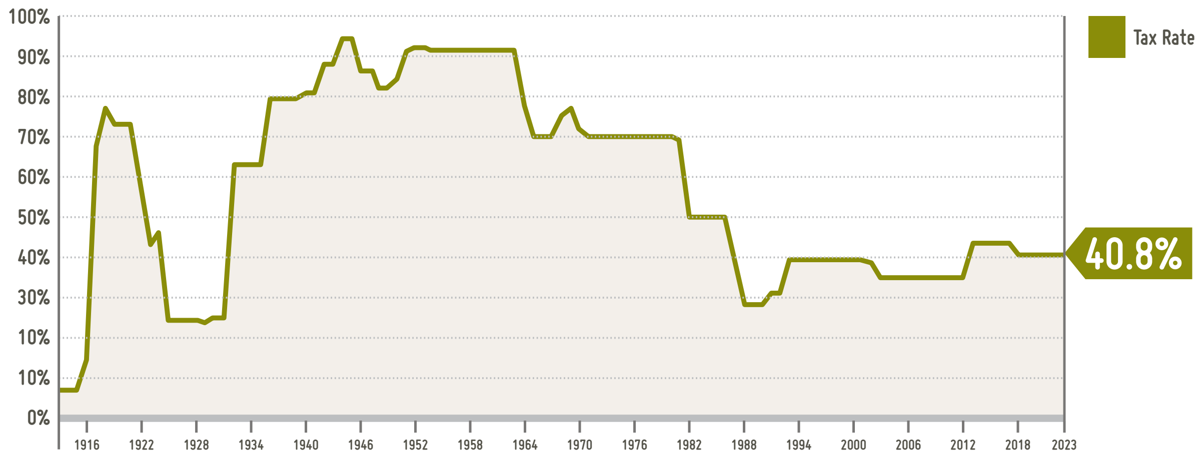
Worse for consumers seeking financial advice, retirement planning programs all too often use only the last 10 or 20 years of investment data to calculate the probability of a successful retirement. These assumptions are very misleading when viewed in a historical context, but they sure make retirees feel good about their future. I ditched these planning program assumptions long ago.

Declining tax rates since 1981 are likely to reverse

The top federal income tax rate prior to 1981 was 70%. Lower tax rates over the past 40 years, like lower interest rates and inflation, have been a big tailwind for investment prices. Lower tax rates made more money available for consumer spending and personal investment.

Figure 4

Top Individual Federal Tax Rates, 1913-2023



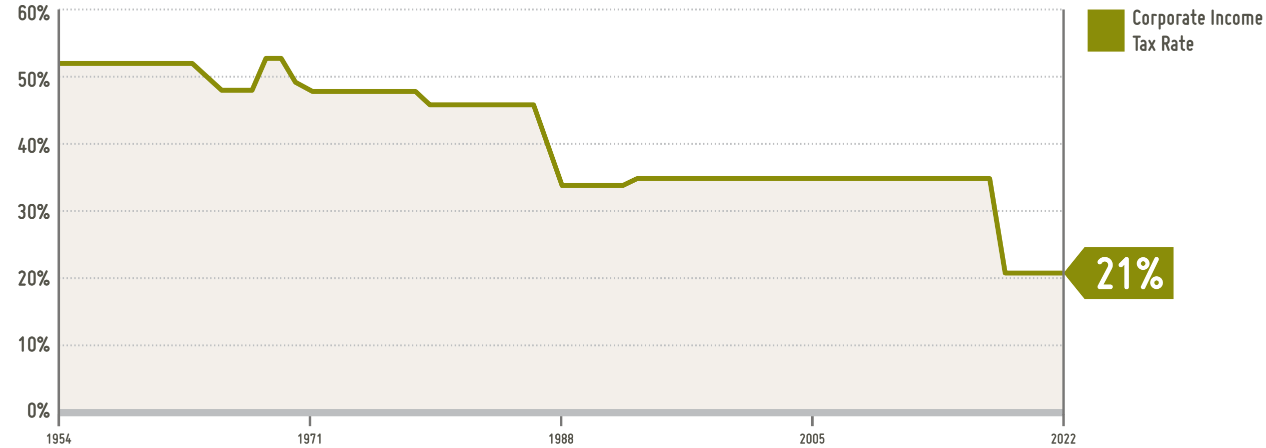
Source: Bradford Tax Institute

Corporate tax rates declined over 50%

Note that the statutory rate isn't the rate actually paid. For example, in 2018 corporations paid an average effective tax rate of 9%. Lower corporate tax rates made more income available to shareholders, boosting the value of stocks.

Figure 5

Statutory Federal Corporate Tax Rate Has Declined



Source: Peter G. Peterson Foundation.
www.pgpf.org/blog/2023/04/six-charts-that-show-how-low-corporate-tax-revenues-are-in-the-united-states-right-now

Exploding government debt

The level of government debt is higher than its peak in WWII. Compare this to the tax rates in the above charts needed to pay down that debt. It took high tax rates to pay down the government debt incurred during WWII. Current tax rates do not support shrinking the Federal debt.

Figure 6

US Government Debt as a Percentage of GDP[3]

Source: www.longtermtrends.net/us-debt-to-gdp/

40-years of interest rate, inflation and tax reductions has ended

To summarize, this combination of decreasing interest rates, inflation, and tax rates has supported increasing asset valuations[4] and prices since the 1980s. As these trends reverse and those tailwinds become headwinds, the investment environment changes drastically.

Based on these conditions, my best guess is that the following outcomes have over a 50% probability of occurring:

- Higher inflation – an upward not downward bias
- Higher interest rates (no return to lows of the past decade)
  - Long term interest rates that are higher than short-term interest rates
- Higher taxes – cutting government spending can't balance the budget
- Lower prices for stocks and bonds

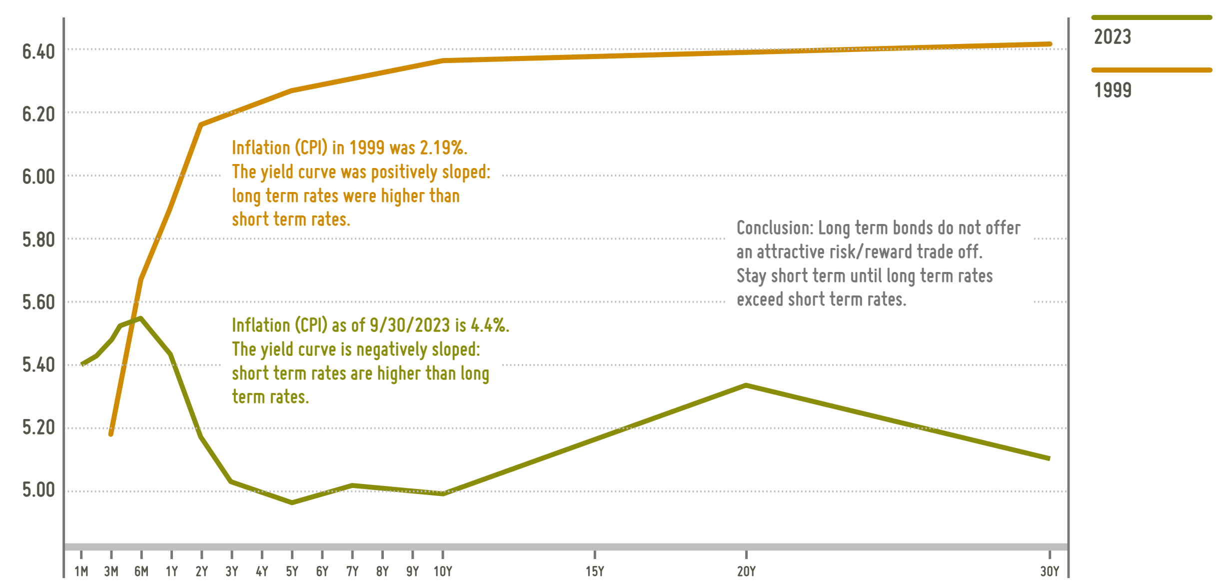
Investment Strategy

My investment strategy is to stay in short-term bonds. Finally, MCS clients are getting a pay-off for their patience! When will I invest longer term to lock in higher rates? I explain below.

The chart below illustrates the difference between a positively sloped yield curve in 1999 and today's negatively sloped yield curve.

Figure 7

Comparison of positively and negatively sloped yield curves, 1999 and 2023



Source: Bloomberg, MCS, https://www.inflation.eu/en/inflation-rates/united-states/historic-inflation/cpi-inflation-united-states-2023.aspx

Most of the time, long-term interest rates are higher than short-term rates. This is to compensate investors for the extra risk and uncertainty of lending money for a longer period.

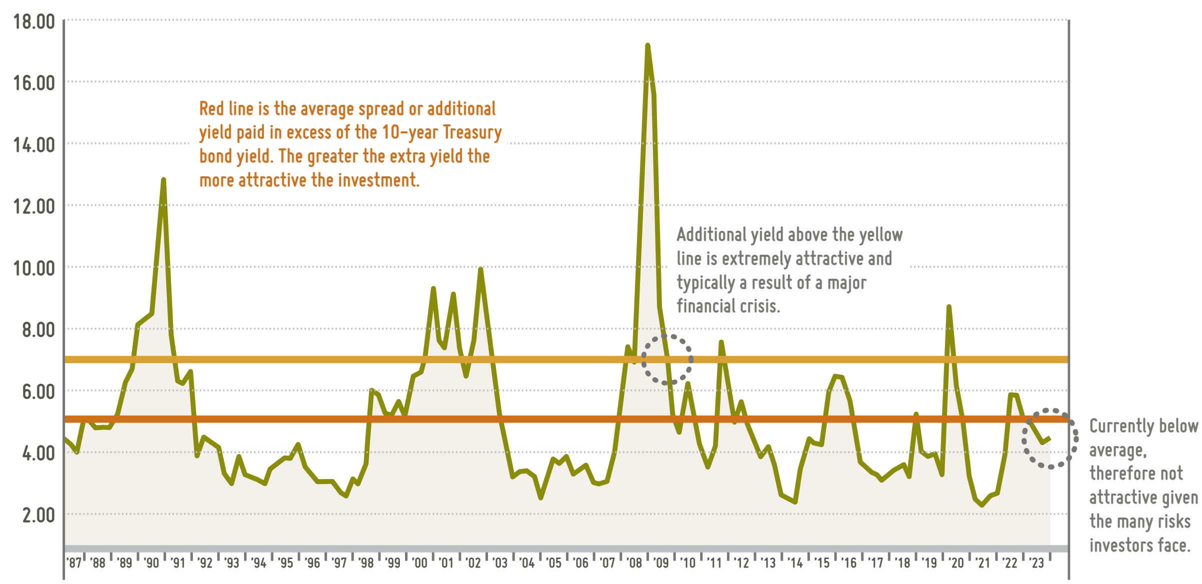
Long-term rates are lower now because investors hope a mild recession will force short-term rates and long-term rates lower. That theme is breaking down, because the economy has remained far more resilient than most investors thought. The market is shifting toward a more normal risk / reward relationship with long-term rates higher than short-term rates, but it has a way to go. The shift means that long-term bonds would decline in price due to higher yields. Stocks could also be under selling pressure as bond yields offer a better risk / reward trade off.

It's also too early to buy lower credit quality, despite what seems like good yields compared to the recent past.

High yield bond prices are still too high because the interest paid is not above the average spread of the past 36 years.

Figure 8

US Corporate High Yield 10-Year Bond Spread



Source: Bloomberg

Bottom Line

Interest rates are increasing, and we are well positioned to take advantage of the change. By not desperately chasing yield when there was none (unlike banks), clients are not stuck with long-term, low-yield investments. I have positioned your portfolios to quickly take advantage of higher yields and volatility while maintaining stability. Chance fights ever on the side of the prudent; those best prepared get the best opportunities.

If you have any comments or questions please contact me at michael@mcsfwa.com.

Endnotes

1. Homer, Sidney and Sylla, Richard; A History of Interest Rates (Fourth Edition), Wiley Finance, 2005

2. https://www.marketwatch.com/story/charting-the-lowest-interest-rates-in-5000-years-worst-commodity-returns-in-80-years-2016-06-14

3. (GDP) GDP is the value of the final goods and services produced in the US (without counting intermediate goods and services used to produce them).

4. Note: Asset 'valuation' means the price in relationship to another variable. For example, the P/E is a price to earnings ratio. If the Price is $10 per share and the Earnings are $1.00 per share, the P/E is 10/1 or 10x earnings. If the earnings stay the same, $1.00 but the price goes up to $20 per share, the price / earnings ratio is 20x earnings. Price earnings ratios increase when interest rates decline and vice versa. Therefore, higher interest rates will, in the long run, lower price /earnings ratios on stocks and potential future stock prices regardless of the earnings per share. See our Q2 2002 Newsletter (https://mcsfa.com/2022-second-quarter-newsletter-outlook/) for a deeper discussion of ratios.

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