HFG
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Market Commentary
January 2023

Well, here we are at that time of the year when we must stop everything, tally up the scores and see who got it right. After all, what's the point of going through all this effort, grinding out the past 365 days, (and it has been a grind) if we are unwilling to look back, see where we got it right and if we got it wrong, admit the mistake, learn, and avoid future mistakes?

With the humility that comes from hard lessons learned, managing money over more than 20 years during the most dynamic market period (Tech Bubble-2022) possibly ever, upon deep reflection, I'm proud to say we did not get a lot wrong in 2022. 2022 was a relatively straightforward equation. If an investor, individual or professional, got inflation wrong, nothing else mattered. Fortunately, we got inflation right, and for the first time in the 17-year history of HFG, every single household for whom HFG manages money outperformed their respective index. Yes, it was a down year, but the defense played in 2022, and likely to continue in 2023, laid the foundation for strong growth in coming years when the time comes to rotate from defense to offense. In January 2022, I wrote:

> *"Persistent inflation is the biggest risk facing investors. By this, I mean that persistently high inflation is increasingly likely to result in reduced Fed accommodation for the markets."*

In January 2022, the accommodative Fed Funds rate was 0.00%-0.25% and a 30-year mortgage was roughly 3%. Fast forward 365 days and the Fed Funds rate is 4.25% - 4.50% and a 30-year mortgage recently breached 7%, increasing the payment on a $500,000 home by more than $1,200 *per month!*

As recently as 13 months ago the Federal reserve projected 2-3 rate hikes bringing the fed funds rate to 1.00% by the end of 2022. By December we experienced 7 hikes, and the Fed funds rate had risen to 4.5%. The Federal Reserve is exceedingly powerful and those of us who have been around a while are familiar with the old Wall Street axiom, "Don't fight the Fed." This sage advice applies in a rising rate environment just as it did in recent periods of declining rates.

It is a fact most banking executives, investors, and economists entering the field in the past 14 years have never worked within a financial environment without direct monetary intervention by central banks, i.e., free money, from the Federal Reserve. Those professionals can't even comprehend a world where the Federal Reserve does not artificially support equities, bonds, and other elements of the system. Without basic comprehension they have no concept of the consequences when the free money disappears.

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Market commentators, many of whom are also relative newbies, breathlessly wait for the "Fed Pivot." "The Fed will step in," they say, because the Fed has always stepped in, and nothing will ever change. But a defining feature of the market is change, and the notion that the Fed cares about the longevity of a bull market run is naïve and demonstrates a lack of historical market/economic understanding. Fed press conference after press conference has created a rather predictable set of reactions - the Fed suggests hikes will continue, and the mainstream freaks out. The Fed then suggests that "one day" the hikes might stop, maybe sooner maybe later. The mainstream rejoices and interprets the comments to mean that the Fed is about to pivot, and markets rocket higher. Then, the Fed does not pivot, and down the market goes.

No one is asking the question that really matters here: Why should the Fed exist? The very existence of the need for central bank intervention at various points of the business cycle ***is an overt admission of the Fed's failure to maintain stable prices and employment***. Perhaps we should consider the Fed is not the cure, but instead the cause of extreme market and economic swings.

At the risk of sounding repetitive, the US economy is addicted to cheap money that people thought the central bankers, our resident drug dealers, would never stop providing. But the easy money drug has diminished returns and the economy is acclimated.

Stagflation has arrived

The circumstances surrounding stagflation are chaotic. Certain sectors of the economy will go into steep decline while others will appear to remain resilient. Commodities in the 1970's were up in the hundreds of percentage points while the bond market declined and the stock market moved sideways for 17 years, 1964-1981.

It might be confusing – why are there better-than-expected employment numbers and in some cases retail sales numbers, while there is also a major contraction across the board in multiple other areas of the economy? That's what happens when a central bank pumps over $8 trillion into the veins of the system in only two years, on top of tens of trillions of dollars over the past decade. That money is circulating rapidly and wearing down the gears of the machine. Some parts break while others still function.

These are the effects of stagflation, as well as the effects of a central bank that is now abandoning the inflation game and actively seeking to create a deflationary event. Without the endless trillions of free money which kept the system on life support since 2008/2009, the Fed will get what they want eventually, but it will take time. Don't fight the Fed.

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Inflation is declining but will prove sticky: More rate hikes incoming

I expect the Fed is going to continue with rate hikes well into 2023 until there is a hard landing. There will be no "soft landing" and Jerome Powell knows this. Raising rates into economic weakness runs a very high risk of creating an economic crisis and this, too, Powell understands.

Rent is high, food is high, energy prices fell due to Biden's SPR market manipulation, but are still high, home prices are high, vehicle prices are high, and everything is incessantly expensive for the average consumer. While it's true some inputs have come down, a stabilized inflation rate of 5%-6% is far too high for most American consumers, 55% of whom live paycheck to paycheck.

Prices will not come down quickly enough to save the consumer. Unfortunately, just last week Alan Jope, the CEO of Unilever, the world's largest consumer goods company said, "We know for sure there's more inflationary pressure coming through in our input costs…we might be, at the moment, around peak inflation, but probably not peak prices…there's further pricing to come through, but the rate of price increases is probably peaking." So, in other words, yes, your Dove soap costs 100% more than last year and though it probably will not be another 100% higher next year, the price isn't coming down.

Employment

When job numbers hit the wall - and they will - costs will still be suffocating the public. If the goal is truly an engineered deflation event that reduces money velocity and drags down prices, a significant increase in the unemployment rate must also occur to drive down wage growth, a primary and sticky contributor to inflation. Those hoping for an immediate pivot should understand that the rate hike beatings will continue until morale declines and the contraction has fully pummeled the jobs market.

A small sampling of recently announced layoffs:

Microsoft	10,000	Amazon	18,000
Credit Suisse	9,000	Goldman Sachs	3,000+
Alphabet (Google)	12,000	Hewlett Packard	6,000
Cisco	4,000	Morgan Stanley	1,600
Twitter	4,000	Meta (Facebook)	11,000
Goldman Sachs	3,000+	Salesforce	8,000
Ford	3,000	Federal Government	*Hiring*

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These layoffs indicate corporate America sees something both Wall Street and the American consumer are either missing or refusing to acknowledge. Corporations are taking significant actions to defend profits. If the velocity of interest rate hikes was the surprise story of 2022, the surprise of 2023 may be the speed of job market degradation.

Defend and Rotate

When compared to previous challenging periods, the data set was different as we entered 2022, but I anticipated market pricing behavior would be similar. After dusting off the playbook we executed successfully during 2000-2002 and 2007-2008, I initiated the strategy most effective during periods of extreme market volatility. Stage 1; Defend.

We don't celebrate down years, even if our clients experience declines significantly less than their peers, as occurred in 2022. I do get excited as I look out 2-3 years and consider the opportunities the defend and rotate strategy provides to our clients.

We played defense throughout 2022, adding even more defense in December with hedged positions that allow defense without taking away the opportunity for growth should the market pivot more quickly than anticipated. For many clients, the addition of hedged positions ranged from 5% of the portfolio to upwards of 40%, depending on specific circumstances. Clients can find this data point on page 2 of their reviews under portfolio allocation.

At a minimum, I anticipate a defensive posture throughout the first half of 2023. Along with hedging, we are building bond ladders, maintaining overweight positioning in energy, aerospace & defense, and cash (currently yielding 4.21% APY 7-day average). Of course, all allocation decisions and specific investment selections are made on a client-by-client basis.

There may come a time mid-year, not unlike 2009, when the market gets flushed. The average market decline from peak to trough during moderate recessionary periods is 38%. The market was roughly 20% off the peak at the end of 2022 so it would not be unreasonable if we experience a garden variety recession, to expect the market to experience an additional 20% decline from the start of 2023.

During market drawdowns individual opportunities often sell off far greater than the market averages. The S&P lost 19.64% in 2022 and, during the same period, Microsoft lost (30%), Nvidia (48%), Amazon (51%), Tesla (64%), Disney (43.9%), etc. If 2022 was the end of the market cycle, we would be rotating clients with single-digit losses into companies down many multiples of that number.

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The defend and rotate strategy is a long game that has historically provided a window to transition from defense to growth of 18 months during the 2000 correction and 24 months during the 2008 correction, respectively. I do not expect a rotation opportunity to come along in the coming quarter or two, but it may, and if it does, we will begin to rotate from our defensive positions into growth-focused positions, layering in investments over several quarters. Some of our investments may catch the bottom, and others certainly will not, but catching the bottom is not our objective. We will establish a very nice average cost of investments over a period of 6-18 months, planting the seeds of portfolio growth to be realized in the following 3-5 years.

HFG clients are in position for a very challenging 2023 but have retained the opportunity to participate should the market prove to be more resilient than expected. 2022, though relatively successful, was perhaps the most challenging of my career, a strategically complex year with a fair amount of trading activity as we removed long-held positions better suited for times past and replaced them with new positions with which many of our clients have very little experience. Should you have any questions, desire to discuss the strategy for your portfolio in more depth, or would like to come in for an in-person meeting, please don't hesitate to reach out to our office.

It is our privilege to serve you and I wish you and your family the best in 2023. Thank you for allowing us the opportunity to work for you.

Michael R. Harding, CFP®