SLOAN INVESTMENT MANAGEMENT, LLC

2022 Year End Letter

This past year, equity and fixed income markets experienced sustained volatility not seen in some time. The stock market posted its worst year since 2008 and the bond market posted its worst year on record. The list of factors that drove negative sentiment throughout the year seemed to be endless. From Russia's invasion of Ukraine, surging global inflation, the collapse of crypto, to major protests against China's zero-covid policy; the hits just kept coming. Fortunately for our clients, we positioned portfolios going into the year to protect from many of the factors that contributed to the downside volatility.

As we mentioned in last year's letter (sloanim.com/newsletters), we anticipated that our Federal Reserve (Fed) would begin tightening monetary policy in 2022, so we tactically reduced or eliminated exposure to sectors with heightened sensitivity to a rise in interest rates, such as homebuilders and technology. We also increased allocations to energy and financials; sectors that traditionally serve as a hedge against inflation. We continued our transition of rotating clients' portfolios towards value stocks over growth, favoring high quality, dividend paying companies over high multiple technology stocks. On the fixed income side of the portfolios, we reduced duration / maturities and increased our allocation to bonds with the ability to increase their distributions. In addition to positioning portfolios to protect and benefit from higher interest rates, we also took advantage of the volatility by selectively putting cash to work throughout the year and harvesting available losses in taxable accounts to offset future capital gains. Last year was certainly one that reinforced our belief in the importance of thoughtful, active, and tactical portfolio management.

Inflation Moving In The Right Direction:

A surge in demand for goods and services brought on by loose monetary policy and strong employment was met with a supply chain still recovering from disruptions rooted in the pandemic and exacerbated by Russia's invasion of Ukraine and China's zero-covid policy. The result was stubbornly high global inflation that ultimately exceeded 9% here in the US, a level that we have not seen in more than 40 years. In response, central banks around the world embarked on a tightening cycle that resulted in the fastest pace of interest rate increases since the early 1980's.

As the Fed recognized the trajectory of inflation far exceeded their comfort level, Chairman Powell shifted away from describing the pricing environment as "transitory". The Fed accelerated its tightening plan, raising benchmark interest rates seven times in 2022, by an unprecedented 4.25%. This resulted in significantly higher borrowing costs for consumers and businesses, effectively slowing the economy enough to get inflation moving in the right direction.

The incoming data over the last several months has been promising, and we believe the peak in global inflation is behind us. We have seen key components of the consumer price index (CPI) rolling over, such as energy, housing, food, transportation, and medical care. Couple that with improved supply chains and elevated retail inventories that will ultimately lead to discounting, and we have reason to be optimistic that inflation can continue to moderate in the coming quarters. This should allow the Fed to pause the current tightening cycle sometime in the first half of 2023. Typically, there is a lag between when monetary policy is implemented, and the effects of the higher interest rates are fully felt in the economy. A pause will allow the Fed to assess the cumulative effect of their aggressive tightening cycle. Depending on the data, it is possible they could shift their approach to bringing interest rates back down if appropriate later in 2023 or in 2024.

Plenty of Reasons for Optimism:

Given many of the economic issues described above were brought on by supply chain disruptions, it is our view that inflation can continue to subside without a meaningful increase in the unemployment rate. This should allow us to avoid the repercussions of an overly hawkish Fed like we experienced in the 1970s. A resilient labor market and modestly rising wages (5.1% in November) should support consumer spending and allow for an economic slowdown to be less severe, considering consumer spending makes up 70% of GDP.

Consumer balance sheets remain strong as debt was paid down or refinanced over the last couple of years. More than a quarter of all homeowners across the US refinanced their mortgages in the wake of the pandemic, locking in historically low interest rates and hedging that portion of their monthly budget from inflation. While the pace of growth in home prices has leveled off in much of the country from the dramatic increase over the last several years, we do not anticipate a material decline in home values as inventory remains tight, the labor market remains strong, and home equity remains at the highest level on record.

Much like consumers, corporate balance sheets remain well positioned. Corporations took advantage of the low interest rate environment to refinance debt and strengthen their financial position. While earnings growth is projected to slow in the coming months, earnings are decidedly still positive, and cash flow remains strong. Corporations paid a record $561 billion in dividends to shareholders in 2022 and are expected to exceed that total this year.

A major headwind that large U.S. based multinational corporations have faced over the last year has been a strong dollar, driven primarily by higher interest rates in the U.S. This has dampened corporate profits generated overseas. In our view, the dollar has peaked along with inflation and should continue to move lower, creating a tailwind for earnings moving forward.

China recently relaxed their zero-Covid policy and began to open their economy. This should lead to greater balance in the global economy and while the surge in pent up demand coming from Chinese consumers could be viewed as a negative in the fight against inflation, the mending of damaged supply chains offsets that concern in our view.

Volatility is Here to Stay:

Despite the volatility we experienced this past year, we believe some sanity has actually returned to the markets. Valuations on unproven technology stocks reached levels reminiscent of the dot-com era and the market shifted to rewarding stocks of mature, well-established companies with stable cash flows and dividends with long track records of earnings growth.

We do expect volatility to remain elevated as the effects of higher interest rates continue to work their way through the economy. Much has been said about a looming recession. If it occurs, it would be the most anticipated and publicized recession in history. We believe it would be shallow and short, nothing like the recessions we went through in 2001, 2008 and 2020. From a corporate fundamentals and earnings perspective, whether or not the economy enters a recession or narrowly avoids one is mostly semantics. The market is forward looking and, in our opinion, has already discounted much of the anticipated economic slowdown. In that same sense, the market will price in an anticipated recovery in the economy long before we see it in the numbers.

We wish you and your family peace, health, and happiness in 2023.

The Sloan Portfolio Management Team