INVESTMENT COUNSEL

The string that connects the Federal Reserve to the bond market and the stock market drew a little tighter as we closed out the first quarter of the year. Raising rates lowers equity valuations and bond portfolio returns, and higher rates eventually slow the economy's rate of growth. Lowering rates reverses that direction, but usually after a difficult period in the economy and the markets. It is difficult to determine with certainty which is the independent variable in this equation, but investors tend to focus on the Fed.

Having pushed short-term interest rates higher, as in from one-quarter of a percent to over four-and-a-half percent, the Fed was committed to knocking down the inflation rate that was no longer "transitory." That sharp rise in short-term rates cut into the net interest margin that banks earn on the spread between their lending rate on loans and their interest rate on deposits. A couple of banks got crosswise due to what appears to be insufficient risk controls, and those banks were taken over by the regulators. Those actions triggered a widespread but brief panic in the overall banking sector in which depositors sought reassurance they did have access to their money. And, almost as quickly, the Wall Street talking heads concluded that the Federal Reserve would stop raising rates and soon start cutting them.

We are glad the banks we own and the bank custodians we use are financially stable and strong. But we are still concerned about the eventual impact on the market of current interest rates. The forecast remains cloudy skies ahead. We are sure we are not through the complete cycle of the economy or the market.

In a developed economy, access to debt – whether for just a few days or a long-term mortgage – is the oil that keeps everything moving smoothly. The cost of debt, which is the interest rate charged by the lender, drives the viscosity of that oil: lower rates means lower cost of money and easier access to funding. The central bank has extra-market means to increase the availability of funding, too. In addition to setting its overnight rate lower or higher, it engages in the buying and selling of fixed income securities to inject or withdraw liquidity into the financial system. After a long period of low rates and monetary injection, the Federal Reserve changed direction last year and tried to slow the economy with higher rates and quantitative tightening.

Economic data is notoriously late, and sometimes the signals we see in our daily lives are well ahead of the official data reported by the government. Official inflation rates have been slow to react to the change in central bank direction. Other signs of economic activity, from job openings to housing prices, seem to be unresponsive to the Fed's signals.

We believe the Federal Reserve's plan is working, but the reported data is slow to capture its success. We think the normal cycle is still in force: after a period of high inflation, the central bank tightens, and the economy slows in reaction. Amid low reported unemployment figures, there are numerous reports of corporate layoffs planned. These layoffs are not limited to one economic sector, and many come from technology companies, which have been among the strongest performers in the economy.

Companies that are growing strongly do not announce layoffs. From these news reports we can conclude that sales rates must be slowing and costs must be rising. That would suggest we should see estimates of 2023 and 2024 earnings to be cut, as reluctant as Wall Street is to do so. Reduced earnings paired with higher interest rates would indicate stocks are valued too richly, and we expect more market weakness as stock prices find an equilibrium with their companies' reduced circumstances.

Continued on Next Page ☞

The Federal Reserve's policy direction remains an open question. Inflation remains higher than the Fed wants, but Wall Street wants the Fed to stop raising rates. If inflation remains stubbornly high, we risk slipping into something akin to the stagflation of the 1970s. If interest rates remain stubbornly high, we risk slipping into a deep recession like the early 1980s. Nobody wants either. So the Fed is trying to effect a soft landing: stop raising rates just before they would push us into a deep recession but not before inflation is beaten back to an acceptable level. Historically, the Fed has not been able to make a soft landing; in the mid-1990s we did have a mild pause, but almost every other time the economy has experienced a recession.

That is our outlook: a recession and a market reaction that results from the Fed's policy of higher rates longer. Higher costs – first from inflation raising costs and then from rates raising interest expense – and slower revenues will result in lower earnings, which will be re-priced by the market, and we will have another step down in the equity markets.

What to do about this? We have a strategic response and a tactical response. First, the tactical response: take advantage of currently high short term interest rates and use cash reserves as an acceptable part of the asset allocation pie chart. Whereas for years it made little sense to have cash on the sidelines, it does now. First of all, cash does not go down; it's always a dollar. (Admittedly, the effect of inflation means real purchasing power goes down over the long term, but this is a tactical response.) Trimming one position no longer requires a paired trade; one can just hold the cash in a money market fund earning approximately four percent. There will come a day to spend that accumulated cash on securities, so we need to keep it handy.

The strategic response is to remain independent. Our firm does not outsource its thinking or deciding functions to anyone. We own the firm and we make the calls. If we identify a good candidate for investment, we do not fret over its weight in an index that somebody else constructed. We construct our client portfolios individually and in light of the client's circumstances, so the fact that two stocks (Microsoft and Apple) account for 25% of the QQQ (Nasdaq 100 Index) is interesting but not a factor in how much of those two wonderful companies we own in a client's account.

Financial flexibility is another aspect of independence, and we are constantly scrubbing our holdings to be sure the securities in client accounts are financially stable and able to ride through some economic difficulties. Quantitative tightening and earnings recessions are like the tide going out of the bay: not every ship can stay afloat in that shallow water. We seek to avoid those situations through regular reviews of our holdings.

Since the employees own the company, ZWJ is able to focus exclusively on our clients and their needs. In uncertain times, we want to reassure our clients that we do have our eyes on both the long-term strategy and the short-term tactics that mean they can be confident about their financial future.

.

Charles L. Abney III, CFA • Tres R. Carpenter, CFA, CFP® • Krista L. Cosgrove CFA
Stacey D. Ewing, CFA • Casey J. Flanagan, CFA • Emilie D. Hill, CFA • Clayton F. Jackson CFA
William B. Miller • Geoffrey Neville Jr., CFA • Kevin C. H. Yang, CFA • Bradford S. J. Young, CFA

ZWJ is an SEC registered investment advisor dedicated to serving the investment needs of individuals, families, foundations, and institutions. Every investment account is separately managed and individually tailored with stocks and bonds, in response to a client's unique financial objectives, income requirements, risk tolerance, and tax situation. Inquiries and referrals are always encouraged. This market outlook represents ZWJ opinions. This outlook is subject to change and neither constitutes a recommendation to purchase or sell any security nor engage in any particular investment strategy. The information contained herein has been obtained from sources believed to be reliable but cannot be guaranteed for accuracy.