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December 2022 Crescent Commentary

Happy New Year! If you're like most investors, 2022 has you wondering, what the heck happened last year? And where do we go from here? Let's start with what happened last year. Last year the U.S. experienced an inflationary spike which brought inflation to the highest level in forty years. The inflation came about as a result of COVID-19: sick workers stayed home and many workers looked for new careers, disrupting manufacturing and transport of goods. At the same time, the U.S. government provided our economy with excessive stimulus, which led to excessive demand for goods. This scenario of demand exceeding supply led to a spike in inflation.(1)

The problem with inflation is it can spiral out of control and lead to social unrest if left unchecked. So the Federal Reserve stepped in and started to reverse the excessive COVID economic stimulus by increasing interest rates and taking some other measures. It turns out that the Fed didn't just reverse the COVID stimulus – it has actually reversed the stimulus of the past fifteen years by increasing interest rates to the highest level since 2007.(2)

Just as eating or drinking too much can lead to a stomachache or hangover (no doubt an experience of the recent holidays), indulging in excessive financial stimulus and irrational exuberance can lead to a financial hangover. And that's exactly what we're going through right now. There's no question that by keeping interest rates artificially low for the past fifteen years, the Fed artificially boosted the values of all financial assets. And now we're working through the correction of that stimulus. As a result, in 2022 we saw bond prices deflate, cryptocurrencies crash, speculative and popular stocks crash, and the beginning of a real estate correction.(3)(4)

So that's the bad news. The good news is that our nation has been through far worse problems in the past and always moves on to brighter days ahead. This time is no different. Over the past few months, we've seen signs that inflation has peaked. That's especially good news in that it appears we are avoiding the adverse scenario of a return to the double-digit inflation that wreaked havoc on our economy in the 1970s.(5)

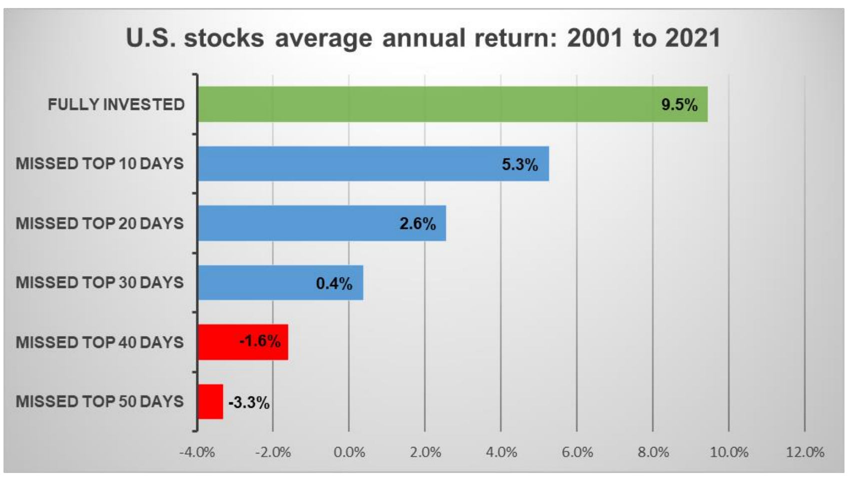
Regular readers of our commentaries know that in 2021, we warned of trouble ahead for speculative and popular assets (see our August 2021 Commentary). At that time, we counseled our investors to avoid such assets and stick to sound, if not boring investments that earned stable cash flows and paid steady dividends. Such investments have historically shown resilience during times of high inflation and economic hardship.

It turns out that over the long term, mundane investments end up doing better than exciting, high-growth investments because they grow continuously and steadily, avoiding technological disruption. Professor Jeremy Siegel of the University of Pennsylvania looked at current surviving members of the largest U.S. companies from 1957 (many are now gone). He found that 17 of the top 20 performing companies since 1957 were brand-owning consumer staple or healthcare companies. Those two sectors were the U.S. stock market's best performing sectors by a wide margin. We've all heard the fable of the tortoise and the hare. It turns out that when it comes to investing, it's more fact than fable.[6]

So that's what happened in 2022. And now the moment everyone's been waiting for: where do we go from here? We've often warned about the uselessness of specific predictions. In 2021, we predicted trouble ahead for popular and speculative assets, and trouble has arrived. But we never predicted specific levels of decline. At the end of 2019, no one predicted the 35% COVID crash and swift recovery to new high levels for stocks. Similarly, the forecasts for 2023 will be overwhelmingly wrong with the exception of a few people who simply get lucky. As Warren Buffett has said, "forecasts may tell you a great deal about the forecaster. They tell you nothing about the future."[7]

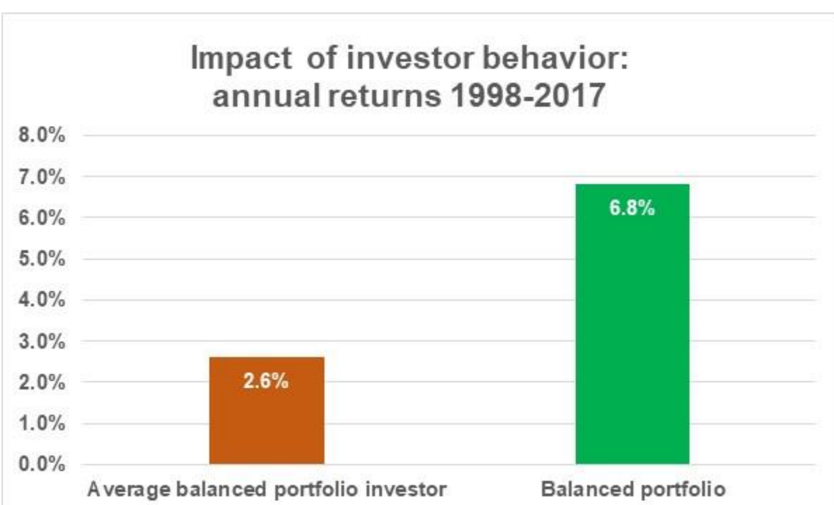
If you are fully invested in a sound allocation that's appropriate for your risk tolerance and financial goals, then you should remain invested. If you're not fully invested and you have concerns about the potential for asset prices to fall further over the short-term, then you should work with us to come up with a plan to invest your funds over a defined time period, also known as dollar cost averaging.

We've shown these data before, and we'll show them again:



As this chart shows, missing the ten best days in financial markets over the past twenty years has cut investor returns nearly in half. Many of the best days occur during a recovery from depressed markets, like the bear market we currently find ourselves in. This emphasizes the importance of remaining invested if you are already invested, or coming up with a defined timeline to invest if you aren't fully invested.[8]

Source: Franklin Templeton



The chart to the left depicts the results of a different study by DALBAR research, which shows that the average investor in a balanced portfolio of stocks and bonds earned a 2.6% annual return for the twenty years ending 2017, compared to a 6.8% return for a balanced portfolio of stocks and bonds. DALBAR found that investors underperformed their buy-and-hold allocations due to decision making: investors tended to buy investments during periods of optimism when markets were high and sold during periods of fear when

Source: DALBAR

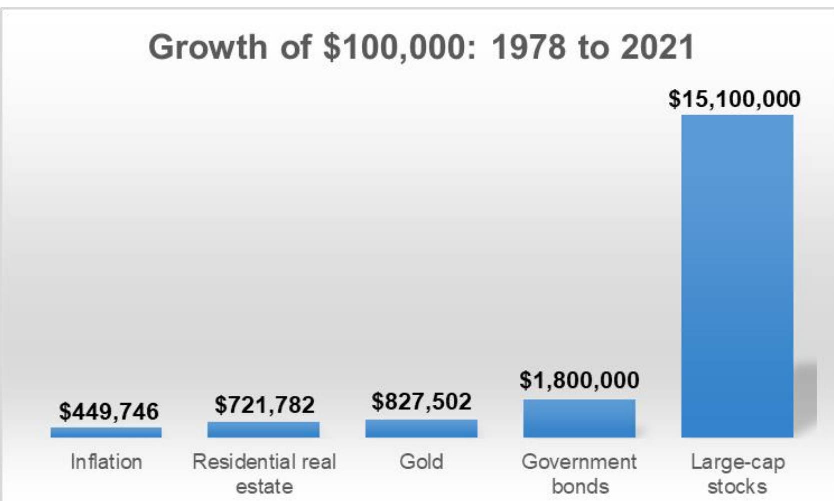
markets were low. This again reinforces the fact that investors should remain invested when times are tough, rather than trying to sell and then buy back in at a time of more clarity.[9]

We continue to recommend owning a high allocation to sound investments paying increasing dividends to shareholders. Such investments have shown resilience during times of elevated inflation, as well as during periods of economic hardship. For example, during the 1970s – the last time the U.S. experienced an inflationary spike – the Dow Jones stock index was flat from 1972 to 1982 as a result of high inflation and multiple recessions. Yet investors who reinvested their dividends earned a 69% return over that decade instead of the 0% return of the index.[10]

More recently, we can look to the 1999 to 2009 decade. All of you know the U.S. went through the bursting of a technology stock bubble and then a home price bubble during that time period. Over those ten years, U.S. stocks as a whole declined 9%. Yet individual sectors generated gains over that period, with Consumer Staples increasing 66%, Health Care increasing 30%, and Industrials increasing 8%.[11]

At the same time that we recommend owning a high allocation to slow and steady investments, we think the carnage in so-called "growth" investments has reached the point where it makes sense to start adding measured amounts of such investments to client portfolios.

After all the talk of how bad things were in 2022, we want to end this commentary with a message of optimism. 2022 was the 7th worst year on record for stocks over the past 94 years. That means a year as bad as 2022 only occurs every 13 years on average. It turns out that calculation holds remarkably true for recent history: 2022 was the worst year for stocks since 2008, or 14 years ago. Investors should take comfort in knowing that turmoil like 2022's only occurs every 13 years or so. As the chart below shows, stocks are the best game in town for compounding your wealth, and corrections like we experienced in 2022 are worth putting up with to get the result depicted below.[12]



Source: Franklin Templeton

As you can see from this chart, for the 43 years ended 2021, stocks of large companies outperformed all other major asset classes. We expect a similar result over the next 40 years. Our economy will get past the current bear market and move on to greener pastures. The key to your long-term success is to be invested or have a plan to get invested so that you can participate in the process depicted in this chart. Amidst the current financial market turmoil, we are reminded of Warren Buffett's op-ed piece published in 2008 during the worst financial market crash since the Great Depression:[13]

"I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be higher or lower a month or a year from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over." – Warren Buffett, October 2008[14]

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Sources:

(1) U.S. Bureau of Labor Statistics
(2) CNBC
(3) Fortune
(4) Yahoo Finance
(5) The Wall Street Journal
(6) Lindsell Train
(7) Berkshire Hathaway
(8) Franklin Templeton
(9) RBC
(10) Roger Thomas
(11) Richard Bernstein Advisors
(12) A Wealth of Common Sense
(13) Invesco
(14) New York Times