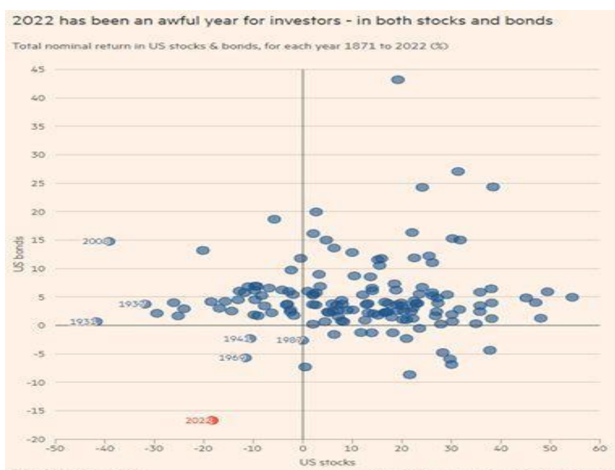
2022: Lessons from a Year to Remember

I want to take a moment to wish everyone a very Happy Holiday season. It is a joy and an honor to continue to be of service to you, regardless of the investment climate we face together. There is a major positive to take away from 2022: the importance of keeping expectations in check and staying grounded.

First the good news: Bond yields have improved substantially in recent months. In fact, the rise in yields during 2022 is truly unprecedented. As you probably know, we have been able to invest in quality bonds (and CDs) at rates which are higher than they've been in many years. This offers a potentially solid foundation for 2023. Investing in bonds in 2019-20-21 was a genuinely bad idea; by the middle of this year, though, that began to change. Many quality bonds are yielding above 4%. We should avoid 'chasing yield', though. Sometimes, attractive yields simply means greater risk.

The odds of a recession in 2023 are fairly high. There is ample evidence to support this, most notably an inverted yield curve, which is a stellar predictor of recessions. Inverted means that short-term rates are higher than long-term rates. The Federal Reserve has indicated they are committed to fighting inflation by raising short-term rates. They may succeed to a point, but they risk crashing the economy if they go too far. Raising rates may pressure profit margins, lead to higher unemployment, and lessen economic activity. Thus the risk of recession. Some experts think we can avert a recession. Though that is possible, my concern is that a recession might be deeper than many think. If so, 2023 stock prices might look a lot like 2022. Too early to say, and I remain open.

Stocks are down this year, yes, but the *Bond* market decline has been even more painful for many. Check out this chart below- it shows annual returns of stocks (horizontal axis) and Bonds (vertical axis) going back to 1871. Note the RED dot in the lower left is 2022. We can call this one of the worst years ever for stocks and bonds taken together.



Our approach at FCM has paid great dividends in 2022: while most returns have not been positive in nominal terms this year, we have added great value in *relative* terms (refer to the dot plot above- that's the average investor). This is not a coincidence. I have done the homework, and continue to learn. My hope is that you continue to walk with the notion that your money is in very solid hands.

Despite the obvious outlier 2022 has been, asset prices may *still* reflect the overvalued levels brought on by many years of ultra-low interest rates and the ability of so many to borrow with impunity. Some are expecting inflation to decline meaningfully in 2023, which could serve as a positive catalyst. That could be the case. I think inflation will be volatile. While it may have peaked, inflation can remain stubbornly high and eat into corporate profits.

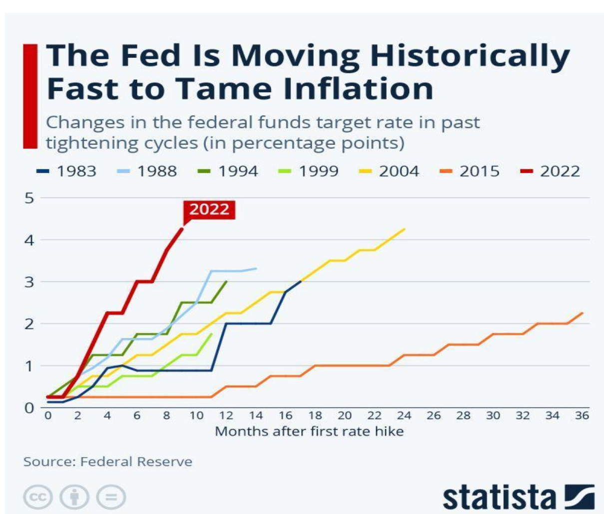
At the heart of this bear market is our system of unsound money. Without the continued and increased issuance of credit (by the Fed), our system might just collapse. Government officials and Wall Street will not speak to this, because their livelihood depends entirely on keeping those credit plates spinning. To be clear, I don't work for them. I work for you. And I repeat: what was once Bedford Falls is now Pottersville. One way or another, a system 'reset' is increasingly likely, whether it be via inflation, currency devaluation, or digital money.

Reliance on credit, or borrowed money, means we no longer operate in a system of Capitalism in the true sense. We actually live in a system of *Extractionism*- where tens of $ trillions borrowed money has been allocated to the top, using government largely as a conduit, while everyone else pays for that debt in the form of inflation. This is known as the *Cantillon Effect*. If you would like a further explanation of this, please let me know. It is an enormous advantage to understand and accept what is going on. It does require thinking outside the box, and challenging existing beliefs.

Stock market rallies, when they do occur, are hard to trust. Rallies can often create the *appearance* of a new bull market forming. While that is possible, I do not view a new bull market as likely. We need to get well into a recession first. Markets tend to rally about halfway into a recession, not sooner. That means no earlier than mid-2023 (my best guess).

There are three paths forward for the Federal Reserve in setting monetary policy. I have alluded to them several times in the past. They all carry significant investment implications:

1. Let asset prices fall- wring out excesses from the system through tighter policies, higher interest rates, and a return to sound money (much like 2022's approach);
2. Print an awful lot of money via the Treasury- much like what the Fed has done up until this year. This involves Inflating the debt away and would imply a Fed 'Pivot'. The market would probably like this initially, as it is supportive of asset prices. But it is also inflationary;
3. A combination of #1 and #2- The Fed fights inflation to a point so it does not run away from us, but stays high, while they expand their Balance sheet to absorb bad assets.



As steward of your money, I will approach 2023 much like 2022, as stock prices adjust to recessionary and profit margin pressures. There may be rallies, some potentially lasting weeks or even a couple of months. They may offer trading opportunities. The process of getting through the excesses and returning to sound money involves vigilance, risk minimization, and reduced expectations. This is not a market for passive investing!!

As you know, I monitor portfolios of Advisory (fee-based) accounts constantly. Several times through the year, I have personally gone into deeper dives to assess risk and exposure to various asset classes for each and every account. I always ask the question "How are we positioned for a potential bear market?" Take care of the downside first; the upside should eventually take care of itself. That approach is paying dividends. We will continue with an allocation to precious metals, commodities (small), and to principal protection strategies. We may enter 2023 underweight stocks and overweight short-term and intermediate-term bonds.