



# MANAGED ASSET PORTFOLIOS

MAP VIEWS

MAP QUARTERLY COMMENTARY | JANUARY 2023

# MAP Views

## First Quarter 2023



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After being pressured during the first three quarters of the year, stocks moved higher during the fourth quarter, marking their first quarterly gain in 2022. However, for the year, stocks posted their worst performance since the Great Financial Crisis (GFC), as investors responded negatively to the highest inflation levels in nearly four decades. Bonds posted their worst yearly performance in almost fifty years of record keeping as high inflation diminished the attraction of fixed-income securities as the Federal Reserve (the Fed) engaged in an aggressive cadence of rate hikes. While we believe inflation peaked in June (when it hit an annual rate of 9.1%), it remains elevated relative to history, with November's annual Consumer Price Index (CPI) growing at a rate of 7.1%.

As mentioned, stocks eventually rebounded during the fourth quarter as investors were increasingly hopeful that the Fed would stop raising interest rates or maybe even begin reducing them sometime next year. While we admit our first expectation was that the Fed may start easing during 2023, given the stubborn nature of current inflationary pressures, we now believe the Fed will likely continue to raise rates during the first half of 2023, albeit at a slower pace than in 2022. Ultimately, we anticipate the Fed "hitting the pause button" on rate hikes sometime around mid-year. However, barring a "Black Swan" event, we would be surprised to see the Fed 'pivot' and lower rates next year. As such, we now believe the Fed cutting rates is likely a 2024 phenomenon, which we would note contradicts current Street expectations.

Most noteworthy to us in 2022 is how value stocks outperformed their "expensive," or growth, counterparts by the widest margin since 2000. This outperformance relative to growth was one of the contributors to the global equity strategies' performance outpacing our primary benchmark for the year. We would note that typically such cycles last multiple years, as evidenced by the outperformance that value enjoyed from the bursting of the dot-com bubble leading up to the GFC. It is also worth mentioning that historically, inflation has served as a tailwind for value stocks while creating a headwind for growth stocks. In an upcoming thought piece planned for distribution in the first quarter of 2023, we will discuss in depth the outperformance of value stocks in 2022 and what implications it may have for the markets in the near to intermediate term.

As mentioned above, we believe inflation will likely remain stubbornly elevated in the 4% - 5% level for some time, well above the Fed's current 2% target. While not a complete list, we believe there are three primary reasons supporting this thesis:

1. Much of current inflation is caused by wages. Unlike commodity prices, which can fluctuate greatly, wages do not. Generally, wages only go in one direction: up.
2. The movement toward a greener environment is likely to keep energy prices high; hydrocarbon production declines faster than new sources can be brought online to replace them.
3. The world economy is in the early stages of deglobalization. For years, globalization provided us with many inexpensive goods made in countries with cheap labor. Since COVID and the related supply chain issues, the focus has shifted away from cost and toward dependability/reliability.
4. The geopolitical environment is changing. China is building strategic relationships not only with Russia but with the Middle East (in particular Saudi Arabia). Over the next few years, oil may be invoiced in yuan, not dollars. This would be a negative for the dollar and likely cause inflation to remain problematic for the U.S.

As discussed in previous publications, we believe the Fed is in a challenging position as the economy struggles to find growth. At the same time, excess debt continues to serve as a barrier to prosperity. A large amount of debt also hinders the Fed's ability to raise interest rates to a level sufficient to stifle inflation. For example, in 1980, then Fed Chairman Paul Volker "broke the back of inflation" by taking short-term and long-term rates to close to 20%. In 1980, federal debt stood at one trillion dollars; today, it stands at approximately \$31 trillion. Applying 1980 interest rates to today's federal debt load, annual interest costs would approximate \$4 trillion - about how much the federal government collects in yearly tax receipts.

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Whether or not we officially enter a recession in 2023 is debatable. Still, the yield curve (historically a very accurate indicator of recessions) suggests it is a good possibility. If we do indeed enter a recession, we believe it will be relatively shallow (given the strength of the current job market) but extended. The typical tools the government implements to jump-start a lagging economy do not seem plausible. In other words, they do not have enough tools in their toolbox. Given the amount of the deficit, tax cuts appear unlikely; and with stubborn inflation, we don't believe the Fed will rush to resume Quantitative Easing (QE) or lower (as we mentioned earlier) interest rates.

As a result of these macro-dynamics, we have made several changes to our balanced portfolios over the past few months. We have increased the weighting of bonds, lengthened maturities slightly, and improved credit quality. We continue to favor shorter-term maturities over more extended ones as the risks appear too great relative to potential rewards from holding longer-dated maturities.

Given an uncertain economic backdrop, we think owning economically defensive names in sectors such as Consumer Staples (particularly agricultural names) and Healthcare makes sense. Materials and Energy names should also provide an inflationary hedge. While technology typically tends to underperform during inflationary environments, we believe exposure to specific technology names that benefit from adopting technologically driven solutions to labor shortages and rising wages should perform well over the long term.

In summary, it would be remiss not to mention how volatile markets can be with the dissemination of single economic data points. For example, there have been times when a softer-than-expected inflation number sends stocks soaring one day, while more robust-than-expected inflationary data sends them retreating the next session. We note that seldom does economic data move in a linear direction. We believe the economic scenario discussed above should allow for more favorable market conditions in 2023 relative to 2022. Additionally, as has been our mantra for some time, selectivity will remain essential. Focusing on individual stock selection instead of broad indices whose performance has benefitted from low-interest rates and quantitative easing will be critical to delivering solid risk-adjusted returns for the next decade.

Thank you for allowing us to serve as your investment advisor. It's a responsibility we do not take lightly or for granted. We work diligently to achieve our client's exceptional long-term risk-adjusted returns. We want to take this opportunity to wish everyone a happy, healthy, and peaceful New Year!

### Managed Asset Portfolios Investment Team

Michael Dzialo, Karen Culver, Peter Swan, John Dalton, and Zachary Fellows

### January 2023

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