RADNOR CAPITAL MANAGEMENT

4th Quarter 2022 Commentary

"2022 will likely be remembered as a year when conventional wisdom about a new market and new economy was destroyed, and investors once again learned that it's not different this time. Investors were once again brought back to economic and financial reality, a reality where profits matter, interest rates can go up, inflation can rise, and geopolitical risks are real." – Tom Essaye, Sevens Report Research[1]

The S&P 500 declined 18% in 2022. The manner of the decline was particularly painful for investors who were trained to "buy the dip" in 2021. You may remember that the S&P 500 reached 70 new highs over the course of 2021, all without registering a drop of more than 5%. This was the most in a single year in two decades. 2022, however, saw one record high on January 3rd, the first trading day of the year, and the market then proceeded to fall from that point to finish its worst year since 2008. "Buying the dip" only works if the market recovers and no such recovery was in the cards. The pain, for many, was exacerbated by the underperformance of bonds which are meant to act as a stabilizing force in such volatile markets. Cash, it turns out, was that stabilizing force and finished the year as the best performing asset class.

The decline in the stock and the bond market were brought about by the Federal Reserve's aggressive interest rate policy. Interest rates were raised at a torrid pace to cool inflationary forces which were caused by the rather extraordinary fiscal and monetary stimulus of 2020 and 2021. It suggests that, while we clearly had too much of a good thing for too long, the Federal Reserve has a penchant for overreacting at the wrong time with tools that lack the precision they are believed to have. Unfortunately, Federal Reserve policy is reactive not preventative which means the institution is using tools to solve today's problems, not tomorrow's. The increase in interest rates from 0% at the start of the year to 4.5% by yearend, for instance, is the fastest such increase in interest rates since 1980. Figure 1 shows this year's tightening (solid red) in comparison to the last 9 tightening cycles.

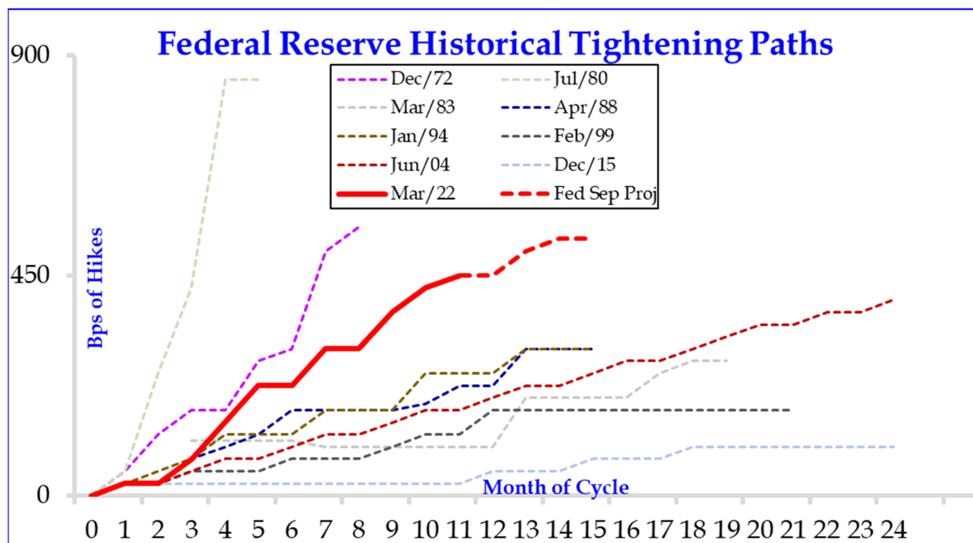

Figure 1:Federal Reserve Historical Tightening Paths (Strategas)

[1] Denton, Jack. What A Crazy Year: A Bear Market, Oil's Pop, and Those Bond Yields. Barron's. December 30, 2022. [What A Crazy Year: A Bear Market, Oil's Pop, and Those Bond Yields]

The Fed is expected to increase interest rates several more times in 2023. Minneapolis Fed President Neel Kashkari recently supported the need to raise rates at the next few meetings until they, the board, are confident inflation has peaked. He went on to say that "wherever the end point is, we won't immediately know if it is high enough to bring inflation back down to 2% in a reasonable period of time. Any sign of slow progress that keeps inflation elevated for longer will warrant, in my view, taking the policy rate potentially much higher."[2]

Despite evidence to the contrary, investors expect interest rates to decline in the second half of the year. The expectation is likely due to the fact that a majority of Wall Street economists are now predicting a recession sometime in 2023.[3] Whether the Fed ends up reducing rates or not, investors would do well to remember that the immediate concern is still inflation at over 7%. Jerome Powell stressed the committee's need to remain committed to bringing down inflation last August. "The Federal Open Market Committee's overarching focus right now is to bring inflation back down to our 2% goal. Price stability is the responsibility of the Federal Reserve and serves as the bedrock of our economy."[4] Regardless of this strong language from Powell and the Federal Reserve Board, many still hold out hope that easing will take place.

This hope may be due to the rather immediate impact of higher interest rates on mortgage rates, auto loans, and personal lines of credit last year. The costs to consumers increased dramatically and transaction volume in each area slowed as a result. In other words, the punch bowl was taken away and the music is starting to slow.

Cracks in Corporate America are also starting to appear. Many management teams have lowered future growth expectations and delayed investment projects until visibility improves. More recently, investors have been peppered almost weekly with headlines of layoffs in Corporate America. Despite these cracks, earnings expectations have proven to be somewhat resilient, and the labor market remains healthy.

Still, the market's reaction to interest rate policy last year lends credence to the notion that investors should not fight the Fed. The board has been quite clear on their intent. Further, it took nearly two years for inflation to work its way into the economy. It stands to reason that it may take longer than 12 months for inflation to work its way out of the economy, particularly now that it is anchored in the labor market. Businesses and other organizations are already planning with higher wages in mind. The probability seems high therefore that rates will remain higher for longer regardless of the unintended consequences (higher unemployment and recession).

Finally, history suggests that interest rates peak when they are above the current rate of inflation. Figure 2 illustrates this relationship and shows that we have some way to go.

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[2] Timiraos, Nick. Fed's Kaskari Sees Rates Rising to 5.4%. WSJ. January 4, 2023. Fed's Kaskari Sees Rates Rising to 5.4%

[3] Rabouin, Dion. Big Banks Predict Recession, Fed Pivot in 2023. January 2, 2023. WSJ. Big Banks Predict Recession, Fed Pivot in 2023

[4] Powell, Jerome. Jackson Hole. August 26, 2022

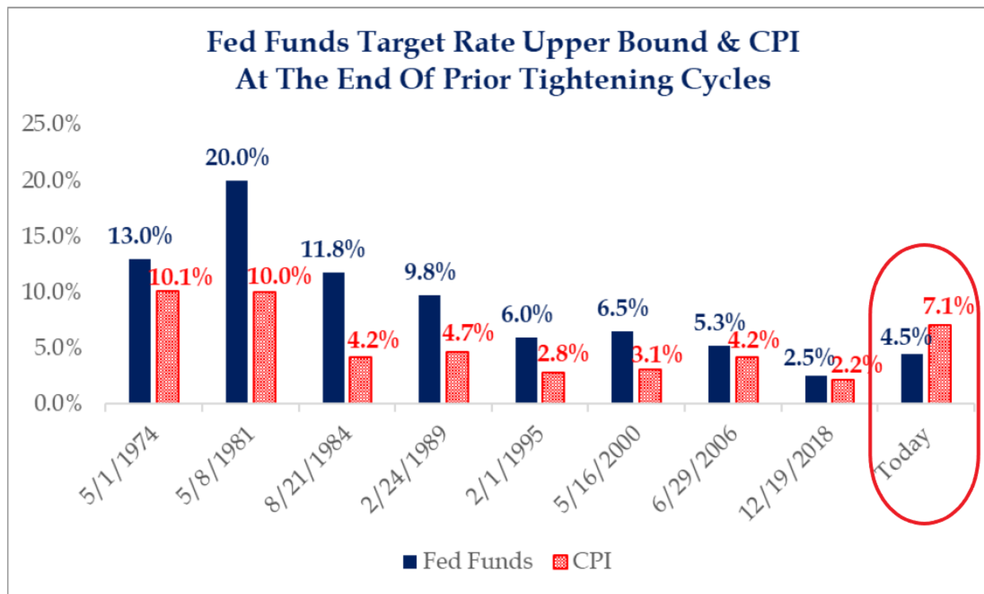

Figure 2: Fed Funds Target Rate & CPI at the End of Prior Tightening Cycles (Strategas)

What does all this mean for markets in 2023?

It means that, even though valuations have declined to parity with long-term averages, the broader stock market will likely continue to face headwinds from higher rates. Growth stocks, which fueled much of the market advance in 2020 and 2021, are likely to present the greatest headwind since they not only trade at a significant premium to the market but because they are also still a disproportionately large percentage of the overall market. Remember, higher rates act as an anchor on valuations "by reducing the present value of cash flows expected in the future by high growth companies".[5] Nowhere was this more apparent than in the tech heavy Nasdaq which dropped nearly 33% in 2022.

Moreover, it means that more mature businesses with defensive characteristics and a penchant for returning cash to shareholders in the form of a dividend should continue to perform admirably. The S&P 500 paid a record amount in dividends in 2022 and the companies that paid dividends outperformed. The introduction of a new excise tax on share repurchases in 2023 means the trend to grow dividends will likely continue.[6] Further, as our quote at the beginning stated, 2022 brought investors back to a reality where "profit matters". This reality is particularly true in a world where currency, interest rate, inflationary, and geopolitical risks are more readily apparent.

The bond market is also likely to continue experiencing headwinds. New bond issuance was down in 2022 due to higher rates and healthy cash positions. Even though much of the interest rate risk was discounted into the price of previously issued bonds over the course of the year, investors are still clipping small coupons. Unfortunately for income seeking investors, this means much of the return of existing bonds will be recognized the closer the bond gets to its maturity date. In time, we expect the coupon on newly issued corporate and municipal bonds to rise as the need to raise funds rises. This is

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[5] Denton, Jack. What A Crazy Year: A Bear Market, Oil's Pop, and Those Bond Yields. Barron's. December 30, 2022. [What A Crazy Year: A Bear Market, Oil's Pop, and Those Bond Yields]

[6] Maurer, Mark. Companies Spent Record Amounts on Dividends, Despite Looming Downturn. WSJ. December 30, 2022. [Companies Spent Record Amounts on Dividends, Despite Looming Downturn].

also likely to occur in the Treasury market. Nearly 40% of the federal debt will mature in the next two years and new bonds will need to be issued, likely at higher rates.[7] Until coupons become more attractive, we are comfortable owning a combination of money market funds, which benefit from rising rates, and short-term bonds.

With the increasing probability of a recession in 2023, we continue to focus on owning businesses with durable competitive advantages trading at attractive valuations. We are finding plenty of opportunity after last year's decline. Further, we will be judicious about putting cash to work in these volatile markets.

Sincerely,

J. August Gerhardt, CFA

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[7] Strategas. Quarterly Review in Charts. January 3, 2023.