KLCM Advisors, Inc.

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Are We There Yet?

The end of the calendar year coincides with holiday celebrations and opportunities to spend time with your family and friends, celebrating the year that was and looking forward with optimism. For many, this includes a road trip to visit extended family. Those of us who either have or had young children know all too well that what starts out as a peaceful drive eventually turns into a critical mission to reach the destination - while fending off passengers asking - and then eventually screaming, "Are we there yet!!" That sentiment mirrors the markets in 2022, with investors being the anxious passengers and Federal Reserve Chairman Jay Powell our reluctant driver.

A year ago, we wrote, "The previous regime of easy money in search of inflation has ended. While the response is likely to be measured in the short term, over time, interest rates will move higher in an attempt to keep up with inflation." This was the start of that peaceful drive as investors welcomed the Federal Reserve's ability to raise interest rates. The Federal Reserve first raised interest rates by 0.25% on March 17th, highlighting a need to increase them further over time. Economists and investors debated the merits and necessity of further hikes and whether rates would exceed 1.50% by year-end.

As economic data continued to arrive supportive of a strong economy with higher than desired inflation, the Federal Reserve became more aggressive. They followed the initial hike with an increase of 0.50% on May 5th and suggested that further substantial rate hikes would be required to wrestle inflation to the ground. This was certainly unexpected at the beginning of the year, and investors started to wonder how long this trip was going to last and where it would eventually take us.

While real economic growth started to slow, the inflation readings continued to accelerate - peaking at 9.1% year over year in June. We previously wrote, "The Fed continues to have the tools necessary to fight demand-pull inflation, and the question will eventually shift to whether they possess the courage to use them." We did not anticipate a resolution to this question within six months!! However, the Fed has certainly brought the tools to bear. In June, they once again increased the pace of interest rate hikes, raising them 0.75%, and communicated a desire and need to continue raising rates at that pace.

The anticipated peaceful ride was quickly turning into a white-knuckle nightmare. Investors and economists were becoming increasingly intolerant of the pace of interest rate increases and were shouting for clarity as to the final destination. Our driver was unrelenting and forceful in his message delivered in a speech in late summer, "we must keep at it until the job is done. History shows that the employment costs of bringing down inflation will likely increase with delay as high inflation becomes entrenched in wage and price setting. The successful Volcker disinflation in the early 1980s followed multiple failed attempts to lower inflation over the previous 15 years. A lengthy period of very restrictive monetary policy was ultimately needed to stem the high inflation and start the process of getting inflation down to the low and stable levels that were the norm until the spring of last year. **Our aim is to avoid that outcome by acting with resolve now**." Suddenly, rates were 4.0%, and investors in all asset classes had gotten a bit carsick.

One of the difficulties of attempting to manage a market-based economy is that actions taken by the Federal Reserve act with long and variable lags. This oft-repeated message about monetary policy tools is critically important to understanding the remainder of this road trip. It has been estimated that the lag between implementation and impact is at least a year in the real economy. Investors attempt to look ahead and price these impacts into asset prices ahead of time. The magnitude and pace of the increases seen to date, combined with the long period of abnormally low-interest rates preceding them, has made this exercise extremely painful and imprecise. The economic impacts are finally beginning to show up in the most recent data. Growth is slowing, and inflation has started to moderate. The Federal Reserve, fully cognizant of this timing mismatch, slowed their rate of interest rate increases to 0.50% at their last meeting in December and hinted that a further slowdown in the pace of increases may be appropriate. While not saying we are there yet, the driver is slowing down, and there appears to be an exit sign ahead.

The current market debate now centers around whether the fed funds rate, currently 4.50%, will top out at 4.75%, 5.0%, or 5.25%. Compared to where we began this journey, 0% rates with an expectation of maybe reaching 1.5%, the difference in terminal rate seems almost inconsequential. **We are almost there!!** Like the kids in the back seat, investors need to remember that "there" is a destination. Chair Powell has made it abundantly clear that he intends to stay "there" for a while. How long will be determined first by the persistence of inflation and secondarily by the strength of the economy. **This is not intended to be a pit stop followed quickly by a return trip to the fairytale land of 0% interest rates**.

While it is entirely possible that the peak rate proves to be a bit too restrictive and requires an adjustment lower, the more important point is that the regime of perpetually low-interest rates is over. It is at this point that we find a great deal of hope for the future.

Without the benefit of "free credit," the speculative excesses that we have discussed at length in previous essays, including story stocks, cryptocurrencies, and other long-duration asset bubbles, are fading away; some in a more spectacular fashion than others. Having chosen not to sit at those gaming tables, we are merely amused observers of the spectacle. We have continued to focus our efforts on investing in established businesses that benefit from economic growth, possess pricing power, and generate significant cash flows that they can return to investors. This value-orientated approach to investing has been our guiding principle. With the return of a positive cost of capital via real interest rates, other market participants are looking more favorably at this strategy and the companies we own.

These real interest rates also allow us to build very high-quality corporate bond portfolios for our clients. TINA (There Is No Alternative – so buy more stocks!!) has been replaced with TARA (There Are Real Alternatives)!! We were reluctant to embrace TINA as fixed income, irrespective of the paltry rates, acts as a ballast for equity portfolios. We welcome TARA with open arms. Prospective returns in fixed income look attractive - especially as we build portfolios for clients who are trying to solve their specific income needs.

We acknowledge that many uncertainties are still in front of us. We also point out that very rarely is there not a list of things to worry about. Market volatility will continue to provide optionality, and we fully intend to use it. While we are holding more cash than normal, we are still finding opportunities to deploy our clients' capital on our terms. As individual stocks reach fair value, we will be happy sellers and, absent finding new opportunities, will not hesitate to hold more cash if that is the best alternative. Cash, now yielding 4%, is once again a real alternative!

With this improved set of choices, now is a great time to revisit investment plans and modify them if necessary.

Happy New Year!!