KLCM Advisors, Inc.

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The Long Term

When the Federal Reserve wants to combat inflation, it raises benchmark interest rates. In theory, this increases the cost of credit for consumers and businesses, leading to less spending and investment, which leads to less demand for goods and services, ultimately resulting in lower prices.

Last quarter we wrote, "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."

Hiking interest rates and tightening credit conditions can also put pressure on many sectors within the economy. This is especially true today. For more than a decade after the Great Recession, benchmark interest rates hovered around zero. In that time, countless business plans and investment strategies formed around the presumption of a world with indefinitely available cheap credit. The events of the past several weeks would certainly suggest that some of these models have broken. The significant increase in short-term funding costs has put the regional banking system under pressure and raised concerns about their ability to remain profitable. We have also witnessed the take-under of Credit Suisse by their national counterpart UBS which was similarly driven by questions of long-run profitability given the sudden increase in rates. Both situations will likely result in a reduced appetite for banks to lend money. The reduction in credit availability may prove to have a more immediate impact on inflation expectations and economic activity than additional rate hikes.

Chair Powell has made it clear that fighting inflation is the Fed's most important objective. As that battle continues, it will be important to remember that we are investing for the long term. There will undoubtedly be additional bumps along the road. It is unlikely that a decade of relative excess can be wrung out over a short period of time without experiencing some pain. Investors have endured a bear market in equities and fixed income for the past two years. This reset is leading to opportunity.

This improved set of opportunities also provides a chance to reassess one's risk tolerance and allocations to different asset classes. For many years, fixed income was heavy on fixed and low on income. That has changed significantly. **The ability to "lock in" 4-6% annual returns on high-quality bond ladders has returned.** Balancing improved opportunities in the fixed-income market broadly is likely an equity market that will have more twists and turns than we've experienced over the past decade. Post the bear market of 2008 and 2009; equity markets have trended mostly higher with occasional dips that could always be bought. This muscle memory remains intact and has prevented capitulation in stock indices as money moves towards fixed income. This push and pull is likely to continue and result in a meandering market for some time. A directionless "market" should mean better opportunities for individual stocks to rise and fall on their own merits, an environment we welcome.

We know that legitimate longer-term questions about inflation, the dollar, and interest rates can not be answered at this time. However, we also know compelling valuations on great companies when we see them. After rallying 20% off the lows in October through early February, stocks have essentially given up this year's gains. We view this as another of the twists and turns the equity markets will experience over the coming years, providing opportunities at various times to enter or exit individual securities. **We do not expect the linear environment of the last decade**.

The long-term workout of the excesses of the past decade will be resolved through time and occasionally with sharp corrections in price. There will be further economic turmoil as credit availability is reduced and economic activity slows. This is our expectation for the back half of 2023. These are normal parts of the business cycle. Unlike 2008, the financial system is not choked with poorly underwritten loans, so the risk of a severe recession is relatively muted. We look back at that time and recognize the wisdom of John Bogle when he said:

"2009 will be an unusual year. But nobody should invest for 2009. You would be a damn fool to invest with a one-year time horizon and not for the long term. Investing now presents an unusual dichotomy. The Recession will get more serious, but will not be a depression. It will be one and a half to two years before the economy moves up. These are troubled times and it is not going to get easier. The stock market is down 50% from its high. The probability is that the stock market has over-discounted the economic difficulties. The market is a far more attractive value than a year ago… I expect equity investors will realize 8% to 10% returns over the next decade. But probabilities are not certainties… If you can't stand a 15% further decline in market values, then get out."

Parts of his message – such as return structure – may not be completely relevant or accurate. However, the core component - **one must take a long-term view and that we will make it through this turbulence - has never been more true**. Since 1929, the likelihood that you would have lost money by investing in the S&P 500 declined as the time horizon grew. On any given day, the index declined 46 percent of the time — just a bit less than you would expect with a flip of a coin. Over one year, though, losses occurred only 26 percent of the time, and that dropped to just 6 percent over 10 years. The U.S. stock market has not had a net price decline over any 20-year period. Again, the next 20 years could be different, and you could lose money in the market. Our expectation is that we will not – for one simple reason. As Warren Buffet stated in his 2021 shareholder letter…...

"In its brief 232 years of existence ... there has been no incubator for unleashing human potential like America," the chairman and CEO of Berkshire Hathaway wrote "Despite some severe interruptions, our country's economic progress has been breathtaking. **Our unwavering conclusion: Never bet against America."**