QUARTERLY COMMENTARY

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The Investment Counsel Company's latest quarterly commentary discusses our thoughts on current economic conditions, challenges and other trends, important to investors. We hope you find it to be of value.

Since the end of the last recession in 2009, investors have enjoyed one of history's strongest financial market recoveries. The past 12 years required minimal investor patience. The more risk investors were willing to assume, the more gains they incurred. Recently, this long upward trend was interrupted by a chain of circumstances caused by the pandemic, starting with supply constraints, resulting in rising prices for goods, energy and other commodities. Due to the subsequent global economic shock, the Federal Reserve Bank had been hesitant to raise rates to slow inflation until sufficient signs of a sustained economic recovery were apparent. Today, the confluence of these persistent challenges is compounded by war between Ukraine and Russia, further complicating the future direction of the global economy. Regions such as the Eurozone are more prone to enter a recession, while other nations are expected to only incur a temporary slowdown. As a result, coordinated efforts by the world's central banks to fight global inflation are impeded.

To be expected, financial markets struggle digesting multiple challenges simultaneously. The result is above average volatility in global financial markets. Rising inflation and accompanying increases in interest rates can benefit some industries. Banks and other financial services companies (such as J.P Morgan, American Express, and Aetna) profit by lending at higher rates than they borrow. Similarly, basic materials and energy companies (including Weyerhaeuser, Dupont, and Chevron) can command much higher profit margins for their products due to large increases in commodity prices. Conversely, the same circumstances prove a headwind for some areas of technology (Uber, Zoom Video, Teladoc, and Robinhood). These companies will be burdened with heavy debt at higher interest rates for years until profits materialize. Homebuilders (Pulte, Lennar, DR Horton) will find it increasingly difficult to maintain robust sales with demand for mortgage borrowing already falling due to rising interest rates. So rising inflation impacts our world, including investors, in different ways.

The area in the financial markets most sensitive to these headwinds is fixed income securities, more commonly referred to as bonds. Periods of rising interest rates and inflation are one of the few environments when bonds temporarily generate negative returns, offering little short-term protection. During the past ten interest rate tightening cycles by the Fed, high quality bond prices have always decreased leading up to the first interest rate hike. Why? Rising interest rates make bonds purchased beforehand at lower yields less attractive. Also, fixed income payments buy fewer goods and services when inflation rises. Now that you have heard the negatives, it is prudent to understand the advantages of owning bonds too. Unlike almost any other asset, bonds historically appreciate when the economy slows, especially as the risk of a recession increases. Similarly, when investors seek a flight to safety during periodic financial crises they buy and hide in the security of high-quality bonds, pushing prices up. So bonds uniquely can serve as an effective form of portfolio insurance.

Since most bonds are regarded as a safe investment, some investors get overly concerned when their prices drop. Even when prices temporarily decline, high quality bonds ultimately recover their value at maturity, erasing unrealized losses while paying income in the interim. Owners of short and intermediate-term bonds can also benefit from reinvesting interest payments and a bond's par value when repaid at maturity, helping to catch up with higher inflation. This is why bonds are regarded as one of the few time-proven asset classes worthy of being considered a core and necessary holding in any well diversified and prudently constructed portfolio.

Many investors are not aware that the Fed repeatedly signals its intentions far before it acts. This delay in action allows for the interaction of buyers and sellers to reprice fixed income securities in anticipation of the Fed's moves. Investors now expect the Fed to increase short-term rates by a total of 2% this year and another 0.50% next year. But they still have questions about how fast monetary policy will tighten. Uncertainty exists whether the Fed will accomplish its perceived mission to curtail inflation by eight 0.25% hikes this year or faster with 0.50% hikes at each of the next two meetings, then followed by 0.25% hikes later. Due to recent changes in bond prices, many industry professionals are convinced that prices have already reacted to the anticipated Fed moves, and therefore the worst of the bond market's troubles are over. Adding to this uncertainty, some investors are focused more on the Fed's intention to reduce their current buying of Treasuries (balance sheet de-levering), which will also put upward pressure on interest rates.

Today's combination of factors reduces investors' confidence that the Federal Reserve will engineer a "soft landing" without a recession. Because of the valuable lessons we learned during the late 1970's and early 1980's when inflation and interest rates rose far more rapidly than today and stocks acted in unpredictable ways, ICC has always avoided the most vulnerable fixed income and equity securities during such an environment.

It is vital to remember that higher volatility periods cause nervous holders of stocks and bonds to sell, leaving the market in stronger, more experienced hands that generally make money at the expense of others. In other words, growing persistent wealth does require patience. Like many things, this virtue is not complicated to comprehend, but difficult at times to live by. Signs that should give investors optimism include the number of companies declaring a dividend in the first three months of the year, which is at the highest level since at least 2004 and 58% above this time last year. Unlike company stock buy backs which can boost prices as well, dividend increases cannot easily be reversed when business slows. Likewise for fixed income markets, many conclude that seven to eight interest rate hikes have already been priced into the bond market. That might be a bit aggressive if job growth begins to slow during the second half of this year. The Fed is focused on reducing inflation, however should the economy slow, it could change its focus and stop, or even reverse any rate hikes.

Today's markets are performing consistent with similar periods in history. This aspect gives us comfort, unlike the beginning months of the pandemic. We remain vigilant in navigating through these uncertain times, mindful of those actions today that are most likely to lead to long-term preservation and growth in our clients' wealth.

Sincerely,

Randy A. Garcia
Chief Executive Officer

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