JURIKA · MILLS & KEIFER
Private Wealth Management

Quarterly Investment Commentary

October 2022


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Shelter from the Storm

As portfolio managers, we continually consider a range of probable outcomes relative to what is currently priced into markets. This process drives our portfolio strategy and asset allocation.

We are mindful that peaks and troughs of markets coincide with high levels of bullish or bearish investor sentiment. Sentiment can be a good contrarian indicator, especially of near-term market direction, but it is not determinative. Just because sentiment is overly positive or negative doesn't mean that markets can't move higher or lower. Fundamentals, rather than sentiment, ultimately govern market direction and levels.

Current investor sentiment is quite negative and there is a long list of things to worry about including economic growth, high inflation, rising interest rates, shortages of energy and other commodities, ongoing supply chain disruptions, and a very dicey geopolitical environment.

These challenges and risks are widely known, but we do not think they are fully priced into markets, despite the significant declines year to date. Economic conditions are deteriorating and geopolitical threats are rising, reflecting a widening range of potential outcomes. Most of these outcomes involve slower economic growth and lower valuation levels. We therefore believe that risks are skewed to the downside and have taken additional steps to batten down client portfolios and provide, as Bob Dylan might say, shelter from the storm.

Inflation

Inflation is the result of an imbalance between supply and demand. If there is too much demand relative to the supply of goods and services, prices rise and you get inflation. Conversely, if there is too much supply relative to demand, then prices fall and you get deflation.

Inflation is typically caused by an excess of demand relative to supply, and can be regulated by Central Banks by raising interest rates. This tends to put the brakes on economic growth, curb animal spirits and bring demand back in balance with supply.

The current situation is quite different. Much of the inflation we are seeing today is caused by a shortfall in supply relative to normal demand.

- The war in Ukraine and sanctions against Russia have significantly reduced the available supply of oil, gas, wheat and other commodities relative to normal demand, sending prices for energy and food higher.

- China's Zero Covid policy and shuttering of major cities and ports like Shanghai have reduced the available supply of goods produced there, leading to shortages and supply chain disruptions everywhere.

- The lack of construction of new housing in the wake of the Great Financial Crisis has left the U.S. with a current shortage of 3-4 million homes relative to the current need. This has led to upward pressure on rents.

- The combination of retiring baby boomers and falling legal immigration in the U.S. has created a shortage of workers relative to available jobs. This has created upward pressure on wages.

The Federal Reserve can raise interest rates and create money out of thin air, but it can't create oil or wheat, housing or workers. It can't fix supply problems with monetary policy. The only thing that it can do is try to bring demand down in line with available supply through aggressive monetary policy. Investors hope that this can be artfully done to produce a "soft landing" where a recession is avoided, but this does not seem probable to us anymore. A soft landing will not slow the economy enough to bring inflation in check. With intention or by default, they will likely need to cause a recession to accomplish this.

We have written in the past that recessions, while not enjoyable, are a normal and regular occurrence and they do serve a useful purpose. They flush out speculative behavior and restore balance between prices and fundamentals, creating a stronger foundation upon which to build the next cycle of economic growth.

We are also mindful of the major increase in interest rates and change in economic conditions that has occurred in a very short period of time. We are coming off of a long period of easy money and heavy government stimulus. Investments that made sense in a time of fast growth and inexpensive capital may not look so good in a world of slower growth and significantly higher borrowing costs. Default rates will likely rise and we are watching for signs of economic stress in the credit markets.

Geopolitics

The current geopolitical environment, especially with respect to Russia, creates a clear and present danger to economies and markets. It is hard to assess, but the risks seem skewed to the downside.

President Putin made a colossal miscalculation about Ukraine and has backed himself into an impossible corner. He cannot win, but also can't afford to lose. The war is taking a large economic and human toll on the Russian people and economy. The conventional Russian military is in disarray and China and India have tempered their support of the war. Meanwhile, with each passing day, there are new reports of Ukrainian advances against retreating Russian forces.

If Putin backs down, he will likely lose his job and perhaps his life. For him, the war is existential. He therefore has an incentive to agitate and escalate to buy himself time and cause economic pain in the West. Russia was likely behind the sabotage of the Nord Stream Pipelines and is now threatening the use of tactical nuclear weapons. We hope we are wrong, but as we head into the Fall, we think things will very likely get worse for Russia, but with increasingly dangerous consequences for the rest of the world.

Outlook

And so our outlook is for slowing economic growth around the world. Europe should suffer from a moderate recession, China will likely experience little or no economic growth and the U.S. will likely experience a recession late this year or next. Additional actions by Putin to disrupt energy markets or European economies would make matters worse and are not reflected in current prices.

U.S. stocks have declined 20% year to date. They are reasonably priced based on current fundamentals, but not if fundamentals deteriorate further: something that seems likely to happen given our outlook. If revenues are declining or even growing at a slower rate, and costs and interest rates are rising, then profits, valuation multiples, and prices should also decline. Valuation multiples have already contracted but we have not yet seen any meaningful reduction in corporate earnings forecasts. We expect this to happen over the next few quarters.

International stocks have declined closer to 27% year to date and are inexpensive on an absolute and historical basis. While valuations are compelling, the fundamental outlook is very challenging. European companies are more economically sensitive, energy dependent and vulnerable to risks associated with the Russia-Ukraine War. Emerging market stocks are heavily correlated to China, as well as the overall level of global economic growth, interest rates and U.S. Dollar, all of which are trending in the wrong direction. In particular, Chinese economic growth has stalled as the Xi government enforces its Zero Covid policy, tries to exert more authoritarian control over the private sector and deals with a massive property bubble that is deflating.

Based on our historical analysis, in a moderate recession, the broad U.S. stocks market could fall another 10% to 20% before bottoming and rebounding. Underneath the hood of the market, there are some pockets of value to be found in areas such as healthcare, life sciences, energy and small capitalization stocks. International stocks are cheap but selectivity is important.

As market prices decline, expected future returns increase and start to become attractive.

Stocks have already discounted a fair amount of bad news. If they fall further, or we see a fundamental improvement in economic data or geopolitics, we will start increasing exposure to equities. For the time being however, we think it makes sense to maintain a more defensive asset allocation.

Meanwhile, bonds have become a lot more attractive. We think that interest rates will trend higher, which would have a negative impact on longer-term government and corporate bonds. But short-term bonds now pay 3% to 4% and short-term municipal bonds are paying almost 3%, which equates to a 5% to 6% tax-equivalent yield for individuals in the highest tax brackets.

In recent years there was a mantra of “There Is No Alternative” to owning risk assets like stocks, since bonds and cash offered almost no return. Now bonds actually offer a reasonable return for a relatively safe and defensive asset. They still are not keeping up with inflation, but as interest rates rise and bonds offer higher and more competitive yields, we expect more money to move from stocks to bonds, creating an additional headwind for stock prices.

Given all the uncertainty in the world right now affecting stocks, bonds, currencies, interest rates, and commodity prices, alternative assets continue to serve a valuable role in client portfolios and have made a very positive difference this year. This includes allocation to non-correlating strategies including commodities, long-short strategies, managed futures, private real estate, private credit, and private equity.

Finally, in taxable portfolios, we continue to harvest tax losses to offset gains.

As always, we continue to invest with a global focus; balancing investments targeted at areas of long-term growth and innovation with more defensive equity, alternative and fixed income strategies aimed at mitigating volatility and risk.

On behalf of the whole team here, we thank you for your ongoing trust and confidence. Please let us know if you have any questions or if there is anything we can help you with relating to your financial life.

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Disclosures and Notes

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Jurika, Mills & Keifer, LLC
Private Wealth Management

Main Office
3595 Mount Diablo Blvd, Suite 300
Lafayette, California 94549

San Francisco Office
Four Embarcadero Center, Suite 1400
San Francisco, California 94111

415-677-5430 Phone
info@jmkadvisors.com

About Jurika, Mills & Keifer

Based in the San Francisco Bay Area, Jurika, Mills & Keifer provides wealth management, planning and advisory services to a limited number of individuals, families and foundations.

We combine a forward-looking view of the world with a deep understanding of our client's needs and aspirations to build and preserve wealth and financial well-being over time.

Over the years, we have built a reputation for independent thinking, sound judgement, and a high level of individualized advice and service.

We welcome the opportunity to discuss your financial goals and priorities and how we can help you achieve them.

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