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JURIKA · MILLS & KEIFER
Private Wealth Management

Quarterly Investment Commentary

July, 2022

Sea Change

Getty Images and Jurika, Mills & Keifer

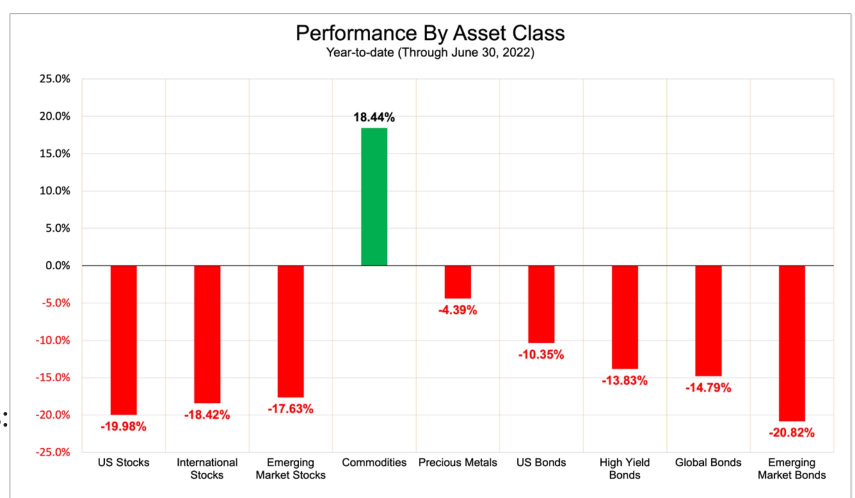
The sell-off in financial markets accelerated in the second quarter, reflecting rising concerns about inflation, interest rates, economic growth, and geopolitics.

As **Chart 1** below shows, all major asset classes other than commodities are down for the year. This is very unusual, especially with respect to bonds, which traditionally serve as a defensive and anti-correlating asset class.

Since 1928 – a period spanning about 94 years - there have been 26 years when U.S. stocks were down (including this year) but only five years (1931, 1941, 1969, 2018, and 2022) where stocks and bonds were both negative for the year.[1]

Typically, when stocks go down, bonds go up, or at least hold their value. The reason for this is that when investors sell stocks, driving stock prices lower, they typically buy bonds, driving bond prices higher. If investors are worried about a recession, they expect interest rates to fall, which makes bonds more valuable.

Chart 1



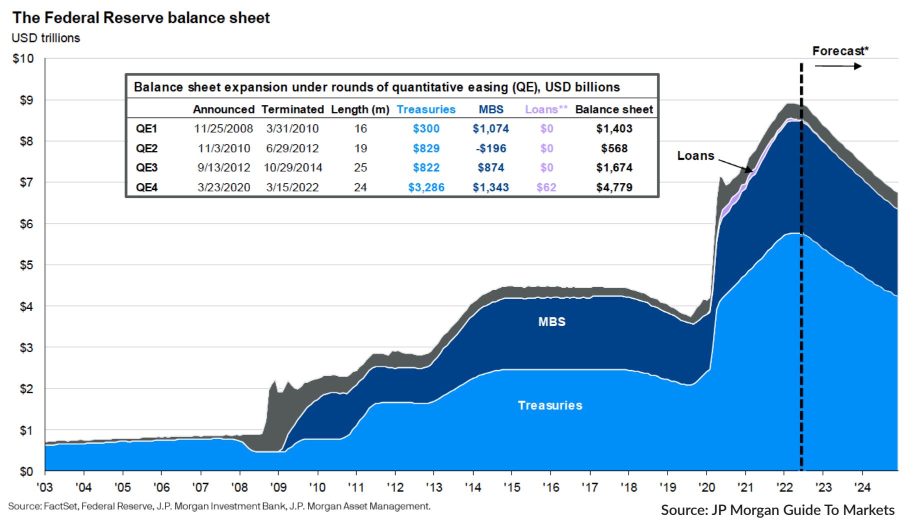
Source: Morningstar, Jurika, Mills & Keifer

The exception to this general rule, as has occurred this year, is when concerns about an economic slowdown are coupled with high inflation and a sharp rise in interest rates. In this scenario, the current value of both stocks and bonds *(as well as other longer-duration assets)* declines: Investors anticipate a reduction in future profits and income, and value them at a lower level. Higher inflation and interest rates make future cash flows worth less.

Therefore, although the sell-off so far this year has been both unpleasant and unusual, it makes complete sense given the sea-change in economic and other conditions that has occurred over the last six months.

The most notable of these conditions is the reversal in the tide of extraordinary monetary and fiscal stimulus measures that were launched in the wake of the Credit Crisis in 2008 and then supercharged during the pandemic in 2020.

Chart 2



Balance sheet expansion under rounds of quantitative easing (QE), USD billions

	Announced	Terminated	Length (m)	Treasuries	MBS	Loans**	Balance sheet
QE1	11/25/2008	3/31/2010	16	$300	$1,074	$0	$1,403
QE2	11/3/2010	6/29/2012	19	$829	-$196	$0	$568
QE3	9/13/2012	10/29/2014	25	$822	$874	$0	$1,674
QE4	3/23/2020	3/15/2022	24	$3,286	$1,343	$62	$4,779

Source: JP Morgan Guide To Markets
June 30, 2022

In the U.S., since 2008, the Federal Reserve has acted as a major marginal buyer of bonds and other risk assets, allowing its balance sheet to swell from $1 trillion in 2008 to $9 trillion in 2022. **(Chart 2)**

Meanwhile, the Federal Government has plowed $15.6 trillion in deficit spending into the economy, allowing total debt as a percentage of GDP to rise from 40% in 2008 to 100% of GDP today. **(Chart 3)**

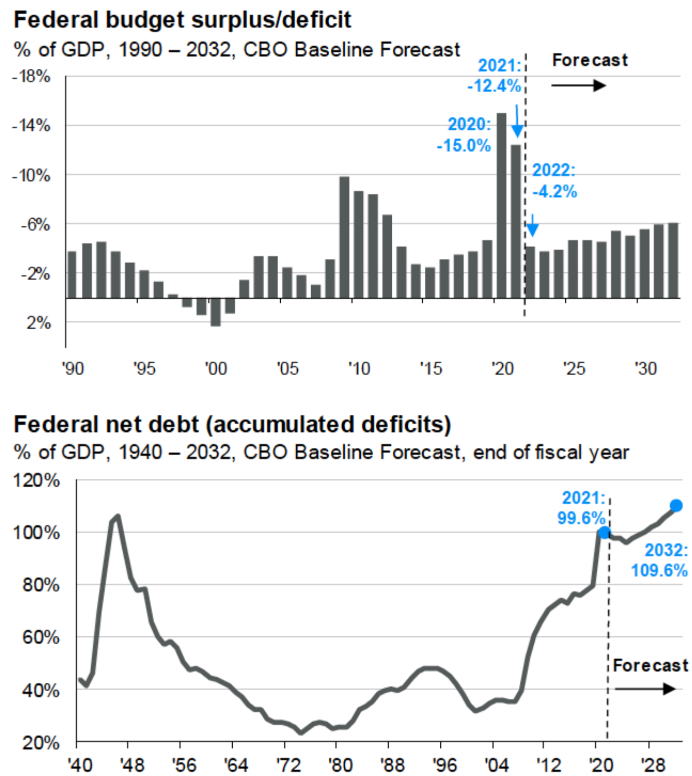
These measures in the U.S., along with similar actions in the Eurozone, Japan, and China, stimulated economic growth, depressed interest rates, and inflated the price of risk assets throughout the developed and developing world.

This all seemed to work as long as deflation was the prevailing underlying economic condition and governments were primarily concerned with preventing economic growth and employment from falling off a cliff.

Now, high levels of employment, inflation and supply shortages are the primary monetary and political concerns. Central banks have no choice but to raise interest rates to attack inflation and there is little political appetite for any major new fiscal spending programs.

Meanwhile, as the Federal Reserve starts to shrink its massive balance sheet, it will no longer be a major marginal buyer of bonds and other risk assets. Prices should fall and yields should rise as a result. **The tide of easy money has turned and is going out. It is unlikely to reverse any time soon.**

Chart 3



Source: JP Morgan Guide To Markets
June 30, 2022

Other forces are also at work, exacerbating current conditions. The war in Ukraine and sanctions on Russia have disrupted the supply and pricing of energy, wheat, and other commodities, and put Europe on the verge of a recession. China's "Zero Covid" policy has put a huge dent in Chinese economic growth and caused disruptions in the supply of goods from that region.

The bad news is that these disruptions are beyond the power of Central Bankers. They can set interest rates and create money, but they can't print oil or wheat.

We do think that some of these factors are temporal. The war in Ukraine and Covid in China will eventually resolve themselves and supply chains will be restored or replaced. Supply of goods will increase and demand will fall to reach a new equilibrium price, most likely lower than it is now, but considerably higher than it was a year ago.

And we are already seeing some recent signs that pricing pressures are easing. Since June 9th, the Bloomberg Commodity Index, a broad basket of energy, agricultural and industrial commodities, has fallen close to 18%.

This could be because of a growing expectation that the global economy is slipping into a recession, and demand for commodities will inevitably fall relative to supply.

Whether or not this turns out to be true, it may take some pressure off the Federal Reserve to fight inflation at the expense of the economy. If the inflation fire is tamed, they can return towards a more normalized monetary policy.

Whatever the case, higher prices and rising interest rates should create a downward drag on overall economic growth, profits, and asset values.

Economic and market conditions should therefore remain challenging in the near term, marked by ongoing uncertainty and volatility. We expect the bumpy ride to continue and think markets may have further to fall before they reach a final floor and start to recover.

That being said, as prices fall, potential future returns rise. Although stocks may have further to fall, as they do they become increasingly attractive to buy. From current levels, even if it took the S&P 500 four years to return to its prior high level of 4,797 reached early this year, it would represent about a 6% compound annual return. For long-term investors, that's not a bad starting point.

Underneath the hood of the broad market, some of the higher growth areas, such as technology and life sciences are down considerably more, offering even higher potential returns over the coming years. Outside the U.S., international stocks are also historically cheap relative to the U.S. stock market.

Markets around the world are already pricing in a fair amount of bad news and low expectations including a mild recession in the U.S., a deeper recession in Europe and a steep slowdown in China.

We think there is still a reasonable probability that the U.S. avoids a recession, and if there is one, we would expect it to be mild. Household and corporate balance sheets are in good shape and capable of weathering a downturn. Employment levels remain very high, and we don't see any major bubbles in housing or other key parts of the economy. There were clear bubbles last year in ultra-high-growth technology stocks, SPACs (Special Purpose Acquisition Companies), and Cryptocurrencies and related stocks. These all seem to have burst (down 50% to 80% or more from their highs) without causing meaningful collateral damage.

Current Strategy:

Given our outlook, we therefore think it makes sense to maintain a slightly defensive and broadly diversified overall asset allocation including global equities, alternative assets and credit.

This approach has been particularly helpful this year, especially with a high allocation to alternatives including hedge funds, commodities, private real estate, and private credit. Many of these alternative asset classes are actually up for the year and have helped to generate income and offset losses in other parts of client portfolios.

While we expect more challenges ahead, stocks are currently oversold and investor sentiment is very pessimistic. Consumer and investor sentiment tend to be good contrary market indicators when they reach extremes. We would not be surprised to see stocks stage a strong rebound rally on the slightest whiff of good news.

But, just because stocks are temporarily oversold, does not mean that they are fundamentally cheap.

We think that current and forward earnings estimates are overly optimistic and need to be reduced to reflect slower revenue growth, higher costs, and lower profit margins. In the coming weeks, it will be interesting to see what company managements report for second quarter profits and forward guidance, and how the markets react to those reports.

Perhaps we will be pleasantly surprised, but currently think the risks are still skewed to the downside. We would prefer to see how things play out before adding significant additional general equity exposure.

We have, however, been adding to some specific areas that do offer an attractive current combination of value, growth, and economic resiliency. These include healthcare, life sciences and energy infrastructure. Recession or not, we expect annual investment in these areas to increase.

Beyond equities, we still think that real estate remains an attractive diversifying and income-producing asset class. In particular, we like residential rental, multi-family and some industrial real estate focused on logistics and energy infrastructure. Although these areas have produced attractive returns, including this year, they should continue to enjoy strong demand in the coming years. The pandemic has shown the need to build out a more reliable and redundant supply chain and the war in Ukraine has shown the shortcomings of the current energy infrastructure in the U.S. and Europe. If Europe is going to wean itself off of Russian oil and gas it has no choice but to make major investments in this area.

In the bond and credit markets, high yield bonds are offering current annual yields between 6% and 8%. Corporate balance sheets are in good shape. Even in a recession, we would expect default rates to be low. In taxable portfolios, Municipal bonds also offer attractive current yields backed by strong fundamentals.

In short, despite all the bad news floating around, there are attractive places to allocate investment capital across a broad range of asset classes. This supports the value of a diversified approach to managing portfolios and underscores the importance of patience and perseverance. In our experience, through decades of corrections, crises and recoveries, these practices have been well rewarded over time.

Finally, in taxable portfolios, we continue to harvest tax losses to offset gains where it makes sense.

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.

Jurika, Mills & Keifer
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Disclosures and Notes

Opinions expressed are those of Jurika, Mills & Keifer, LLC, and are subject to change.

[1] Historical returns of S&P 500 and 10 Year U.S. Treasury Bond. NYU Stern Business School & Aswath Damodaran: www.damodaran.com

Source for data: Bloomberg, BCA Research, MRB Partners, J.P. Morgan, Goldman Sachs, Morningstar, and Ycharts. Investments in securities involve the risk of loss. There can be no assurance that investment strategies referenced will be successful, or that investment objectives will be achieved. Past performance is no guarantee of future results. One cannot invest in an index.

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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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