Berkshire
DIVIDEND STRATEGY

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DOUBLE WHAMMY

While this one feels less dramatic, it's been a bad stretch for investors. Almost every major equity and bond market around the globe has experienced sharp declines. Most large-cap mainstream U.S. stock markets have dropped 20-30%. Many emerging growth and technology strategies, particularly the ones that looked the most expensive a year ago, are in utter free fall. Some have fallen 50 to 70% or more.

Experienced investors are used to equity market declines. They are unpredictable but expected, and largely unavoidable. But this time the equity losses come with an unwelcome companion: a simultaneous beatdown of the bond market.

Bonds are supposed to be the asset class that holds steady during equity market drawdowns, but not this time. High-quality, intermediate-term bonds? Down nearly 10%. Longer-term bonds? Down nearly 15%. These are the "mainstream" relatively conservative fixed instruments. Investors who stretched for yield with even longer bonds, bonds of lower quality, or bond funds that borrow money are probably faring much worse. Some of these higher risk structures – sold to supposedly conservative investors to enhance their income, are down more than 30%. While bonds come in many flavors, we believe fixed income investors should always stick with vanilla.

One extreme example is the 100-year bond issued by the Austrian government in 2017 at a yield of 0.88%. It was a great deal for the Austrian taxpayers who locked in that interest rate, but a horrible one for the pension funds and investors who bought them. The bonds were down 55% earlier this year due to rising interest rates. Most of these income shenanigans came when interest rates were at historical lows. This easy money bond bubble popping will make a great case study for years to come.

(Source: Bloomberg - An AA+ Rated Government Bond Down 55% Shows the Pain of Higher Rates).

The reason behind the simultaneous declines is simple. Monetary policymakers around the globe are raising interest rates in an attempt to cool demand and tame very high inflation. Ironically, it's an attempt to quell the inflation they created by constantly lowering rates and printing money to battle earlier bouts of deflation. Talk about the old adage "be careful what you wish for!"

Higher rates make it more difficult to borrow and create lower asset prices, but they also usually slow economic growth. Faced with that conundrum, Fed chairman Jay Powell seemed unsure for a while which poison he would pick and tried to walk a fine line. But after yet another dismal inflation report in late August, he signaled a willingness to keep raising rates to lower inflation, even if it meant weaker economic growth. Equity and bond markets took another leg down late in the quarter.

YTD performance as of 9.30.2022

- S&P 500 Index – 23.88%
- Russell 1000 Value Index -17.78%
- Russell 1000 Growth Index – 30.66%
- Barclays Intermediate Bond Index – 9.63%
- Barclays Aggregate Bond Index - 14.61%

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IN THIS REPORT

- Global equities and bonds under pressure
- Policy makers tighten monetary conditions
- Threats to economy: Inflation? Deflation?
- Recession fears growing… but it's not like 2008
- Berkshire strategy: holding relatively steady amidst the turmoil

THE SILVER LINING

Is there hope the Fed can engineer a soft landing and get inflation under control? Yes, but multiple needles to thread require a skilled seamstress.

It’s fairly easy to see where the hope is coming from. While media pundits and some investors focus only on recent headlines and squawk about inflation and rates spiraling upward forever, we see clear signs that demand and inflation are cooling.

For example, mortgage rates are now north of 6.50%, which has finally slowed the housing market. Key commodities like steel, oil, and lumber are tumbling. 10-Year Breakeven Bond Yields – a forward-looking measure of inflation expectations – are shifting lower. These trends are welcome, even if they are somewhat deflationary.

But will the Fed kill the economy as it kills inflation? Recessions are normal and part of business cycles, but the memories of 2008 are still fresh in people’s minds – no one wants a repeat of that disaster.

Here’s the thing – trying to anticipate where these big picture trends are going is a train to nowhere. What if a recession is already priced in? We’ve had a huge decline already. What if we go into recession but it's milder than people expect? It's possible that the market could rally in that situation. What if we have a recession but no credit cycle unfolds? Bank underwriting and reserves appear solid. What if… what if… what if… this is what it looks like to make investment decisions based on macro thinking. And let’s not forget how difficult it is to time the market.

Source: Bloomberg

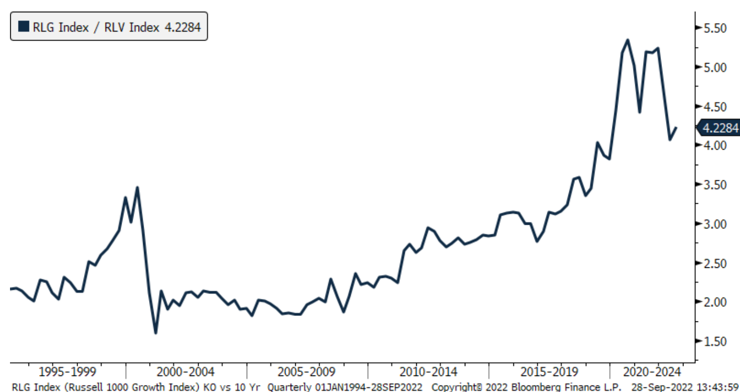
RELATIVELY GOOD NEWS FOR BERKSHIRE INVESTORS

We are pleased to report that your Berkshire strategy has avoided the bulk of the carnage and is faring well relative to major benchmarks. At the most basic level, we held up well in a difficult environment at least in part because of the strategy's value bias, low turnover, and long-time-horizon approach.

Interestingly, what's happening now is in many ways an echo of what was happening during the pandemic, however there is no guarantee. The Fed kept lowering interest rates, which favored bonds, large-cap growth, and emerging technology stocks. (Don't get us started on "crypto" – good riddance.)

All rose to silly valuations, which had some investors questioning the validity of a prudent and seemingly plain-vanilla strategy. Now those forces have reversed, and those past shooting stars are careening back to earth. Meanwhile, strategies like ours that focus on consistent cash flow and low valuations are coming back in favor. Staying true to what you know is simple… but not always easy.

Will value stocks continue to outperform? By most measures, such as price-to-book ratios, growth still looks expensive. And so far, the rotation toward value stocks looks very much like the 2000 period, which took quite some time.



(Source: Bloomberg)

Within the portfolio, the best results came from our stock selection in the industrials, healthcare and consumer discretionary sectors. Sector positioning results were more mixed.

Highlights:

- A selection of our health care stocks were only down a few percentage points, and a number of them are *up* for the year.
- Most of our consumer holdings were down less than 10%.
- Even some of the industrial names in the portfolio were only down a bit more than 10%.
- We hoped financials would fare better as rates rose, but fears of a recession have subsumed the potential margin expansion. Still – your team believes potential loan losses are manageable and that prospects for dividends remain solid in a sector that is trading at extremely low valuations.

LOOKING AHEAD?

It's not surprising to us that the U.S. and global economies are stumbling – a global pandemic and years of aggressive central bank rate cutting are going to leave a hangover. Despite the challenges, however, your team sees a lot of reasons to think things could be better than they were in 2008.

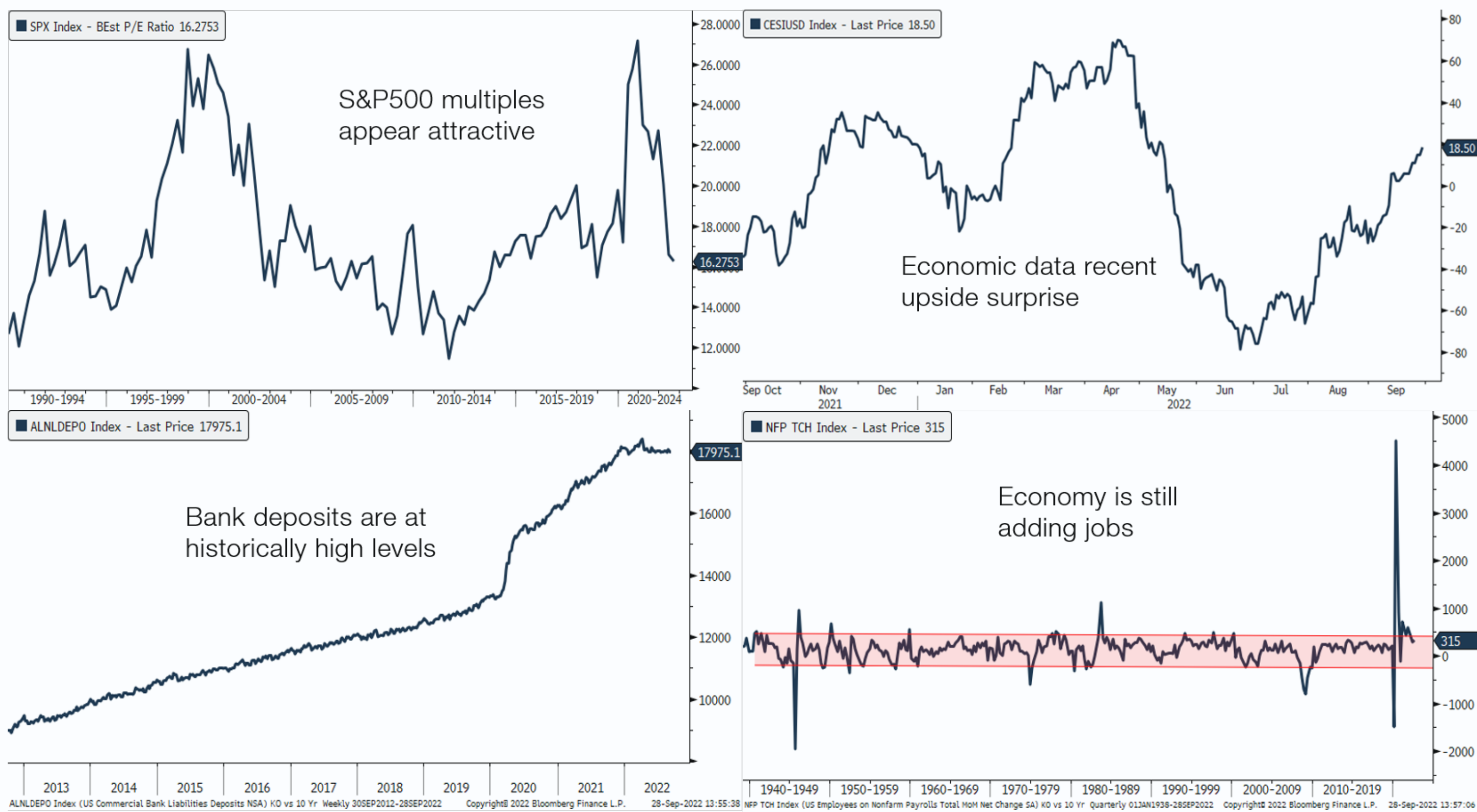
First off, the financial system is a lot stronger today than it was in 2008. Liquidity is high – U.S. bank deposits are $16 trillion. So, unlike 2008, banks can act as a stabilizing force as the economy works through its challenges.

Inflation has spooked investors terribly, but there are some signs the relentless upward pressure may subside. Treasury inflation-protected security (TIPS) valuations suggest that the markets expect inflation to even out at under 2%.

Another positive sign: The labor market continues to be very strong. Since there is a labor shortage now, it would be difficult to lay people off even if the economy remains weak. Maybe the recession doesn't hit main street this time.

We're not suggesting that the economy is in great shape, or that all of our losses are behind us… But the market is already down a ton – about 25% from the most recent high point. Historically, these kinds of peak-to-trough losses average around 30-35%. Many companies are reporting positive surprises on quarterly earnings. With valuations as low as they are, investors may well be set up for a period of positive results.

Our clients have been here before. Uncomfortable? Sure. But we believe combining high-quality dividend equities and high-quality intermediate bonds to match your risk tolerance is a strategy that is designed for consistency. Historically, in our experience, this approach has rarely let people down.



(Source: Bloomberg)

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[1] Past performance does not guarantee future results.

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