Martin Capital Partners

Quarterly Point of View
Home To Roost

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The era of easy money ended in 2022. With it, years of policy decisions by monetary authorities and government officials, as well as the actions of some investors, have come home to roost. Equity markets tumbled, but bond markets collapsed.

Long term bonds had their worst year since 1793 (and no, that's not a typo).[1] The iShares 20+ Year Treasury Bond ETF, which tracks the investment results of an index composed of United States Treasury Bonds with remaining maturities greater than 20 years, declined a staggering 31%!

The S&P 500 fell 18% for the year, while the NASDAQ Composite declined 33%, as the cascading valuations of a whole host of mega-capitalization technology stocks did not let up. Since the official inception of the S&P 500 in 1957, the past year marked the index's fourth largest calendar year drop, and the deepest since a 38.5% plunge in 2008, the year that Lehman Brothers collapsed, and the Global Financial Crisis was in full swing.[2]

With inflation rising at its fastest clip in 40 years, the Federal Reserve and other global central banks began aggressively tightening monetary policy with a series of interest rate hikes, stoking fears of a recession, and crushing the high-end of stock valuations. The set-up to this period was years in the making, however, and we began discussing Fed policy risks as far back as almost a decade ago.

In October of 2014, we began to argue in our letter *Impolitic Fed*, that hyper-accommodative policy could distort decision making and create long-term, unintended consequences:

> *The Fed has to ask itself - what is more 'out-of-the-norm', the condition of the economy, or our policy to address it? We think the answer now is without a doubt, the Fed's policy. If that is true, then any benefits the economy might see by a continually hyper-accommodative monetary stance are not commensurate with the risks of a prolonged out-of-the-norm policy…Fed policy has now been easy for almost 6 years, so it can no longer be argued that it is being used as a short*

> *term tool. Artificially low interest rates for extended periods like this will distort decision making thereby creating long run, unintended consequences.*

In 2016's *Dovish Double Down* we wrote:

> *Most observers felt the Fed had set a course to begin a series of rate increases prior to their March meeting, and when pressed about the change in the projected path for interest rate increases after her (Fed Chairwoman Janet Yellen) New York speech, she further stated, "The major thing that's changed between December and March that affects the baseline outlook is a slightly weaker projected pace of global growth…global developments pose ongoing risks." It is difficult to respectfully describe how utterly inane those words sound. After almost a decade of keeping interest rates at zero a 'slightly weaker' estimated pace of global growth is now the excuse for not altering a policy that was enacted for an emergency situation?*

Finally, in 2019, after the Fed once again caved to market pressures in January despite previously setting a course to raise rates as late as December 2018, we wrote in *Third Mandate? A Less Conspicuous Fed:*

> *By all accounts this is just a stunning reversal, all in a month and a half. The about face only makes sense if their mandate is to support asset prices at all costs, but we clearly know their congressional charter states nothing of the sort. Ironically, the mere fact this seems to be the unspoken 3rd mandate of the Fed actually poses much more danger to assets prices over the longer term than leaving markets to function on their own.*

All of this looking back is not a boast, it is simply to illustrate the years and years of legitimate opportunities the Federal Reserve had to normalize interest rate policy. From our simple perch in Oregon, if we had the impulse to think and write about these building risks over almost 10 years, what were the more than 400 PhD's employed by the Federal Reserve thinking?

The Fed's congressional charter only contains two goals, referred to as its "dual mandate," that of price stability and maximum sustainable employment. Weaning the economy and markets off experimental policy, put in place as an emergency program during the GFC almost 15 years ago, would have shown wisdom and common sense. But fear of short-term market and economic pain, without concern, or at least recognition of long-term risks, changed the game.

As a result, the last few years we've seen an orgy of market speculation, "distorted decision making" as we mentioned years ago, and misallocated capital all around. This led to massive investor losses in the darlings of disruptive innovation from the past decade.

More importantly than even that, the years of easy money stoked inflation and with it a rapid rise in interest rates.

The next market era will not look like the last. The laws of economics and investing were not repealed, and in our view it will be a return to fundamentals over the next cycle, which may last for some time. In our mid-year letter, which we titled *Paradigm Shift?* we espoused these fundamental characteristics looking forward:

- Strong free cash flow producers, owing to distinct competitive advantages
- Dividend "cultures" with clear policies regarding sharing of profits in this manner
- Prudent use of leverage, not habitual borrowers
- Reasonable valuations

We were fortunate in 2022, as these attributes helped us outperform the markets dramatically, with our flagship Core Dividend Strategy finishing the year slightly positive.

The most enduring trend in finance over the past 40 years had been a slow but steady fall in the cost of money. Even if the Fed is successful in taming inflation - that they are to a large degree responsible for - we are not returning to that trend. As a result, it's our belief that it will behoove investors to view the coming investing landscape through a different lens.

We are immensely thankful to our clients and partners, many of whom have been with us through the periods - and letters - cited above.

It is a sincere privilege serving those that have entrusted us with their capital.

Respectfully,

Cameron K Martin
Chief Investment Officer
Martin Capital Partners, LLC

1. Bianco Research, @biancoresearch, 1/3/23
2. Dow Jones Market Data, The S&P500 Tumbled This Year, Barron's 12/30/22

Statistical and analytical data provided by Factset.