

Money Manager Newsletter

September 30, 2022

Investment Consulting Group, Inc.

"There are many people who think they want to be matadors (or money managers or traders) only to find themselves in the ring with two thousand pounds of bull bearing down on them, and then discover that what they really wanted was to wear tight pants and hear the crowd roar"
~Terry Pearce, Founder and President of Leadership Communications, b. 1941~

Dan Niles thinks the stock market is headed lower. He thinks we're headed for a recession with the S&P 500 index bottoming around 3,000; down another 25%. Coming into the year we were focused on two things: don't fight the Fed, and don't fight fundamentals. We expected the market would be down at least 20%. In May we revised that forecast to 30% to 50%, peak to trough, by next year. We thought inflation would pick up and that, as a result, the Fed would be more aggressive than anticipated. Three things would make inflation run hot: the tight labor market, commodity inflation, and our belief that due to record low interest rates, housing would be strong. About 70% of the U.S. economy is tied to services. Labor is two thirds of costs for the average corporation. The only way to deal with inflation is to drive unemployment higher.

Today the S&P 500 trades for about 20 times trailing earnings. If you look back at 70 years of history, when the consumer price index was above 3% the trailing price/earnings ratio was 15. That's a big drop from where we are today. As I like to ask, "when a stock is down 90%, how much downside remains?" The answer is 100%. Not 10%. One of the risks we saw coming into this year was Russia invading Ukraine. Another is China's reunification with Taiwan, which we still think will happen in the next five years.
[Barron's—September 5, 2022](#)

"It's a Fitbit." "What's that?" "The newest techno craze to distract us from enjoying life." Serge continued shaking his wrist. "Back in the good ol' days, people just walked around getting fresh air. The joy came from the elegant simplicity. How could it be more complicated than that? 'Can't I just walk around and smell flowers?' 'No, no, no, simple is over. Now you must monitor your heart rate, calories burned, oxygen saturation, elevation climbed, receive Internet notifications, listen to music, remotely control your thermostat. Forget it. You've ruined walking for me. I'll just relax and take a nap. No, no, no, you can't just take a nap. You need to monitor your sleep stages, restlessness and REM time, then as soon as you awaken, immediately log onto your computer to see your score against the competition. So they (messed) up sleeping, too."

Tim Dorsey—Mermaid Confidential

Three Fed statements:

- • • St. Louis Fed President James Bullard called for 3.75% to 4% Fed funds by the end of this year.
- • • San Francisco Fed President Mary Daly told LinkedIn the Fed is nowhere near done fighting inflation. "We are still resolute and completely united on achieving price stability. [This] doesn't mean 9.1% inflation, it means something closer to 2% inflation." Still have a long road to travel.
- • • Cleveland Fed President Loretta Mester insisted the Fed will keep hiking rates until inflation is under control. "It's a foundational piece of a healthy economy. That's what we're about."

Chief Economist Chris Low—FHN Financial

9/30/2022	"Current P/E" / "20 Year Avg. P/E"		
	Value	Blend	Growth
Large	12.1/13.7	15.1/15.5	20.4/18.6
Mid	11.8/14.4	13.8/16.3	19.7/20.3
Small	13.2/16.9	16.8/21.3	22.8/34.1
J.P. Morgan Asset Management			

We have been bullish on stocks since March 2009, when the S&P 500 traded as low as 677. What a time to buy! After we remained bullish. We didn't recommend selling during the Great Recession that lasted through 2010, a double-dip recession, additional foreclosures, a commercial real estate drop, Greek Bond defaults, Brexit, or Trump. We were called "Perma-bulls". With low interest rates and healthy profits though, we saw no other choice.

In June, we announced we were bullish no more. "We don't expect the S&P to hit a new high, above the 4,797, anytime soon." Until one of our two scenarios plays out—a recession or the realization the Fed has pulled off a soft-landing—US equities are likely to be in a trading range with potential bear market rallies that come and go. Our likeliest scenario is a recession arrives in 2023 (or early 2024) and stocks will remain low until then. Why? Because the Fed and monetary policy will have to be tight enough to reduce inflation.

In June we said that stocks could easily rally from then current levels, but that such a rally wouldn't last. After, the S&P rallied up from 3,675 to 4,305 before settling back down to 3,693 at Friday's close. Don't be surprised by other bear-market rallies, which will also fade.

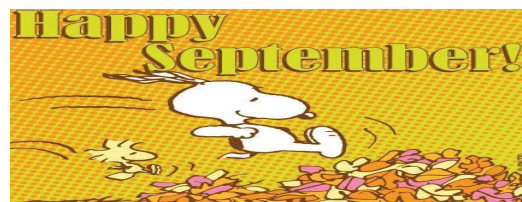
Our Capitalized Profits Model to assess fair values for the stock market uses the yield on the 10-year Treasury Note to discount profits. At 3.7% the fair value would be about 3,600. But long-term yields may go higher. A 4% yield would lead to a fair value of 3,325. Even without higher yields, a recession could affect corporate profits, leading to lower numbers still. Either way, there could be rough seas ahead. Long-term investors should not be affected by this. Ride the wave. Those trying to time the market could consider that better entry points could be ahead in the broad market indexes.

[First Trust Monday Morning Outlook—September 26, 2022](#)

Regardless of what is said remember one fact: the market does not have to be logical. Just because a model says "this is the fair value" doesn't mean that's where the market will actually trade. GameStop, for a while, was worth more than Best Buy. Hedge Funds have gone bankrupt because "The market is wrong" (see the Nobel Prize winning managers of Long Term Capital Management). Markets are efficient, but not always right.

Ross Stanforth

Treasury Market Yields	9/30/2022	12/31/2021	12/31/2020
2 Year	4.22%	0.73%	0.13%
5 Year	4.06%	1.26%	0.36%
10 Year	3.83%	1.52%	0.93%
30 Year	3.79%	1.90%	1.65%
SP 500	1.81%	1.26%	1.60%
Commodities			
Oil (\$/bal)	\$79.49	\$75.21	\$48.52
Gold (\$/oz.)	\$1662.40	\$1827.50	\$1893.10
CRB Index	\$268.29	\$232.37	\$167.80



DJ IA	Nasdaq	S & P 500	Russell 2000	MSCI EAFE	Crude Oil	Euro	10 yr Treas.	Fed.Fund Rate	Prime Rate
28,725.51	10,575.62	3,585.62	1,664.70	7,663.16	79.49	1.0203	3.83	3.00-3.25	6.25

Eloquent. Extraordinary. Timeless. Paradigm-shifting. Classic.

Leonard Read's "I, Pencil" still evokes praise. This little essay opens eyes and minds among people of all ages. Leonard's main point: economies can hardly be "planned" when not one soul possesses all the know how and skills to produce a simple pencil. No one person, repeat no one, no matter how smart or how many degrees follow his name could create from scratch a small, everyday pencil, let alone a car or an airplane. Maximilien Robespierre, a consummate statesman who worked tirelessly to plan the lives of others, is said to have blessed the horrific French Revolution with this chilling declaration: "One can't expect to make an omelet without breaking eggs." History is littered with presumptuous plans for rearranging society to fit a vision of the common good. If such a process ever earns a final epitaph, it will be this: Here lies a contrivance engineered by know-it-alls who broke eggs with abandon but never, ever created an omelet. While "I, Pencil" shoots down the baseless expectations for central planning, it provides a supremely uplifting perspective of the individual. As the interest of countless individuals from around the world converge to produce pencils without a single "master mind," so do they also come together in free markets to feed, clothe, house, educate, and entertain hundreds of millions of people at ever higher levels.

Lawrence W Reed, President, FEE May 2015

I, PENCIL

By: Leonard E. Read

I am a lead pencil, the ordinary wooden pencil familiar to all who can read and write. Writing is both my vocation and my avocation: it's all I do. You may wonder why I would write a genealogy. Well my story is interesting and I am a mystery. I will teach this lesson better than an automobile or an airplane or a dishwasher because I am seemingly so simple. Yet not a single person on this earth knows how to make me. Two billion of my kind are used in the US each year. Pick me up and look me over. What do you see? There's wood, lacquer, the printed labeling, graphite lead, a bit of metal, and an eraser. My family tree begins with a cedar of straight grain grown in Northern California and Oregon. Think about the saws, trucks, rope, and the countless other gear used in harvesting and carting the cedar logs. Think about mining ore and making steel; it's refinement into saws and axes. Hemp is grown and made into rope. Logging camps with their beds and mess halls, the food to feed the workers. Thousands of people were involved to bring every cup of coffee to the loggers! Imagine the individuals who make flat cars, rails, engines and install the communication systems. The cedar logs are cut into small, pencil-length slats less than one-fourth of an inch in thickness. People prefer that I look pretty, not a pallid white. The slats are waxed and kiln dried. How many skills went into the making of the tint and the kilns, into supplying the heat, light, and power; the belts, motors, and all the other things a mill requires? Include also those who poured the concrete for the dam of a Pacific Gas & Electric Company hydro plant which supplies the mill's power! Each slat is given eight grooves by a machine, after which another machine lays lead in every other slat, applies glue, and places another slat on top; a lead sandwich, so to speak. Seven brothers and I are mechanically carved from this "wood sandwich". My "lead" is actually graphite mined in Ceylon (Sri Lanka). There are miners with their tools, the makers of the paper sacks in which the graphite is shipped, those who make the string that ties the sacks, those that put the sacks aboard ships, those who make the ships, and even the lighthouse keepers along the way. The graphite is mixed with clay from Mississippi. Wetting agents are added such as sulfonated tallow: animal fats chemically reacted with sulfuric acid. The mixture is cut to size, dried and baked for several hours at 1,850 degrees Fahrenheit.

My cedar receives six coats of lacquer. Do you know all ingredients of lacquer, how to make resins, or how the lacquer is made a beautiful yellow? My bit of metal is brass; zinc and copper was mined. The black rings are black nickel. There is "the plug;" the part used to erase errors. This rubber-like product is made by rapeseed oil from the Dutch East Indies reacting with sulfur chloride. The pumice comes from Italy and the pigment which gives "the plug" its color is cadmium sulfide. Do you still challenge my assertion that no single person knows how to make me? Millions of humans have had a hand in my creation. There isn't a single person who knows the whole process, including the pencil company president. From the standpoint of know-how the only difference between the miner of graphite in

Ceylon and the logger in Oregon is in the type of knowledge. Neither the miner nor the logger can be dispensed any more than the chemist at the factory or the worker in the oil field (paraffin is a byproduct of petroleum). Also interesting? Neither the worker in the oil field, the chemist, the digger of graphite or clay, any who sail or makes the ships, the drivers of the trains or trucks, the one who runs the machine that does the knurling on my bit of metal, nor the president of the company performs their task because they want me.

I, Pencil, am a complex combination of miracles: trees, zinc, copper, graphite, et al. You could argue that even government monopolies such as mail delivery is not as efficient. No individual possesses enough know-how to perform a nation's mail delivery any more than an individual possesses enough know-how to make a pencil. In a world where a person has been left free to try, the human voice is delivered around the world in less than one second; an event, visually and in motion, is sent to TVs around the world as it happens; 150 passengers go from Seattle to Baltimore in less than four hours; gas is moved from Texas to one's furnace at unbelievable low rates, four pounds of oil from the Persian Gulf goes to our Eastern Seaboard, halfway around the world, for less than the government charges for delivering a one-ounce letter across the street! The lesson to teach is this: leave creative energies uninhibited. Organize society to act in harmony with this lesson. Free men and women will respond to the Invisible Hand. I, Pencil, seemingly simple, offer the miracle of my creation as testimony to this practical faith; as practical as the sun, rain, a cedar tree, or the earth.

Leonard E. Read, President, FEE December 1958

Afterword

"None of the thousands of persons involved in producing the pencil performed his task because he wanted a pencil. Every time we go to the store and buy a pencil, we are exchanging a little bit of our services for the infinitesimal amount of services that each of thousands contributed toward producing the pencil. It is even more astounding that the pencil was ever produced. No one sitting in a central office gave orders to these thousands of people. No military police enforced the orders that were not given. These people live in many lands, speak different languages, practice different religions or politics, may even hate one another, yet none of these differences prevented them from cooperating to produce a pencil. How did it happen? Adam Smith gave us the answer two hundred years ago." Adam Smith stuck to his guns and refused to compromise his principles. That was why he was so effective in keeping alive in the early days, and then spreading the basic idea thereafter, that human freedom required private property, free competition, and severely limited government.

Milton Friedman—For More Economic Information go to www.fee.org

"Inflation is taxation without legislation" quipped the Nobel Prize winning economist Milton Friedman years ago. It's true, and its reality and ramifications are well cited. What advice would Friedman offer the administration and the Federal Reserve in today's severely inflationary environment? Not one to mince words, he'd cut right to the chase: Be bold, take decisive action, and do it without delay. If the Fed's mission is to keep inflation close to 2% and to foster a "soft landing," then the fed funds rate needs to increase above 4%. The unemployment rate will increase. However, it will be transitory and then "return to its natural rate of unemployment." If not, the recession and high inflation will potentially worsen and be even longer-lasting. Based on Chairman Jerome Powell's and the Fed's actions thus far, I think Friedman would question greatly whether the Fed will stick the landing.

Tom Verdi—Providence, R.I.

