American Investment Advisors, Inc.

3330 University Avenue, Suite 120 ♦ Madison, WI 53705-2167
608.238.3500 ♦ 877.242.2424 ♦ Fax 608.238.9050
aiai.biz ♦ bill@aiai.biz

Thursday, October 13, 2022

Dear Client:

"October. This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August, and February." – Mark Twain

We all know that there is risk when investing in equities and Mr. Twain makes the point that it doesn't matter which month – every month is risky. This past quarter was particularly poor in that the S&P 500 was down an additional 4.88%, which means the S&P 500 is down 23.87% for the year so far. We are presently going through a period where the market is adjusting to the new reality of higher interest rates; thus, corporations and assets (think Bitcoin and other crypto currencies) with non-existent earnings are being abandoned as investors refocus on the fundamentals of investing like strong balance sheets, good cash flows and companies that actually make money after paying their expenses. After all, stocks that are not making money now have a little competition for investment dollars - bonds.

As the stock market adjusts to the new world of higher interest rates, the bond market is also adjusting. Last summer the Federal Reserve Chairman Jerome Powell stated that the Federal Reserve was not going to make any promises regarding interest rate hikes. Their chief concern was bringing down inflation. Inflation impacts everyone from the wealthiest to the poorest of the poor. Chairman Powell reiterated more than once that the Fed was going to be data dependent. If they continued to see prices climb within the data they review, they would continue to increase the overnight lending rates that banks charge one another – the Federal Funds rate. They have stuck to their guns and it is widely expected that the Fed will raise rates from 3.25% to 4.00% next month and many believe we will see them raise rates another 0.50% to 4.5% by year end. The bond market (the rest of the yield curve not including the ultra-short-term side that the Fed controls) has acknowledged this Fed posture and has priced in next month's 0.75% increase. As rates increase, bond prices fall. And boy have they fallen. The Bloomberg US Aggregate Bond index has decreased 14.61% through September 30th. Since 1926, the worst year for bonds was 1969 when bonds were down 8.1%. If the year were to end today, the bond market would set the new "worst year" mark since reliable records were kept in 1926. Many analysts believe the worst is behind us from a bond perspective. Remember, the bond fund managers we have are adjusting their portfolios and higher yields going forward are already appearing within their portfolios. All of our intermediate term fixed income funds (e.g. Metropolitan West, PIMCO Income, etc.) save the US Tips fund have SEC yields of 4-5% at the present time. While we are down close to 15% with our bonds, I can only imagine the rally we will have once the Federal Reserve states that they plan on pausing their interest rate increases. In the meantime, we are collecting income with these higher yielding bond portfolios. If an investor says, "I've had enough!" and exits the intermediate bond space, they are essentially locking in those bond fund losses and will have much smaller yields in the money markets and CDs going forward.

"If Fed Chairman Alan Greenspan were to whisper to me what his monetary policy was going to be over the next two years, it wouldn't change one thing I do." – Warren Buffett, 1994

I love this quote. Value managers always brag about not caring what happens to the macro economy or the stock market in general. They concentrate on purchasing securities from the ground up – they look at each individual company and decide for themselves which companies balance sheets, income statements are worthy to be included in their portfolio. Remember close to half of your equity portfolio is invested in this "value" category while the other half is invested in indexes – predominantly the total stock market index. I believe there are reasons for holding both strategies. Getting back to that quote from Buffett, we have not made many changes to your portfolio over the past few months. We have found cheaper alternatives for a couple of your funds, but other than that the model is pretty much the same model we had at the beginning of the year.

If you are extremely nervous about your portfolio's performance, please give us a call. If we have to sell 5 or 10% out of equities to help you sleep better, then so be it. That said, I was listening to one of CNBC's commentators, Josh Brown, the other day. He claimed that over the past 90 years the average total returns for a 100% stock portfolio out of a recession have been 21% in the first year, 48% after two years 100% over five years and 256% over 10 years. On the bond side, yields haven't looked this good in 15 years. Keep in mind that we are not in a recession yet and stock recoveries may begin soon after the recession begins. Another factor to consider: Recessions have been relatively short. The 2020 recession only lasted two months while the Great Recession lasted 18 months. Please realize that recessions are defined by the National Bureau of Economic Research (NBER) and that they are backward looking. Sometimes you don't realize you are in a recession until NBER announces it several months after they said it began. Thus, it would be kind of tricky to try to time one of these events.

As you may have guessed, the stock market is pointing the way to a recession occurring sometime in 2023. As we have discussed, we can expect the Federal Reserve to increase their overnight lending rate from 3.25% to 4.5% prior to year-end. There could be even more hikes in 2023. Should the Fed add language that states they plan on halting rates or pausing or something to that effect, you could see markets – both bond and stock markets – rise. Keep in mind that the stock market is predicting what is ahead for the economy even though the economy continues to add jobs at a remarkable rate. Also, remember it takes six to twelve to possibly eighteen months for the interest rate increases to work their way through the economy. Thus, we could start to see layoffs in January and February of next year. This slowdown in economic activity will help lower inflation. Investors will want to be on the front end of better times ahead – whether that is inflation beginning a decline or a possible resolution to the war in Ukraine. I continue to believe it is extremely important that we continue to ride out this storm with our current asset allocations.^ **Keep dollar-cost averaging. Be patient. Stay the course.**

Enclosed you will find your Portfolio Holdings statement as of September 30, Performance Analysis and Position Performance summaries and a quarterly Account Management Fee Statement. Please contact us for the latest version of the Form ADV Part 2A. Should your investment objectives or personal financial situation change, be sure to call us.

Best regards,

William A. Bullock

^ Obviously, if your personal financial situation has changed in some regard this may be a good reason to change your allocation. If that is the case, please let us know.