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January 2023 Market Commentary

In 2022, the stock market, as measured by the S&P500 Index, declined by 18.1%, the worst year since 2008 (-37.0%), when the banking system almost collapsed under the weight of subprime housing mortgage loans. Starting in March, the Federal Reserve raised its policy rate, Fed funds, at every meeting from a level of zero to 4.25% in order to suppress a surge in inflation. In response to the likelihood of a weakening economy, the S&P500 declined 23% by June 16, thereby entering bear market territory. After rallying in July and August, the S&P500 faded again to a new low on October 12, declining 25% year-to-date. Another bear market rally lifted the S&P at the end of the year.

Inflation has not been this strong since the 1970s, when the Fed was trying to overcome high unemployment. Since then, there have been three distinct phases in Fed policy. From 1980 to 2005 (Phase 1), the Fed focused its policy on reducing the rate of inflation, known as disinflation. The result was an unprecedented decline in interest rates that favored financial assets. In 2009 (Phase 2), in the wake of the worst recession since WW2, the Fed shifted its focus to the risk of intractable deflation, which had afflicted Japan for twenty years. It lowered Fed funds to zero and implemented a new expansionary policy tool, the purchase of trillions in government bonds, known as Quantitative Easing (QE). In March 2020, Covid abruptly shut-down the economy, and Congress responded by enacting even more trillions in relief and stimulus. When the economy fully reopened in 2021, supply chains tightened, and inflation surged. In March 2022 (Phase 3), the Fed belatedly responded, raising Fed funds and allowing bonds to roll off its balance sheet as they mature, known as Quantitative Tightening (QT). The Fed's plan is to raise Fed funds and shrink its balance sheet to levels that will gradually reduce inflation to its 2% target.

In summary, this decade marks the third phase of Fed policy since 1980. Fed policy shifted from "tight money" (disinflation) to "easy money" (Fed funds of zero and QE), and finally, to "neutral money" (Fed funds of 4% and a smaller balance sheet).

To understand the magnitude of this recent shift in policy, consider that in 2022 the 10YR Treasury yield increased from 1.5% to 3.85%, representing a decline in price of 19%, one of the worst years on record for bonds. Many other financial assets followed the move in this benchmark yield. For example, residential mortgage rates increased from under 3% to over 6%. This has made it harder to qualify for a mortgage, especially for first-time home buyers. Housing activity has declined sharply, as the market struggles to adjust. Exactly what is the Fed trying to achieve with this policy shift?

The Fed fervently believes that low inflation is necessary to achieve long-term economic prosperity for all participants in the economy —workers, employers, and investors. As such, it is willing to endure short-term economic adversity, including a declining stock market, rising interest rates, weak housing, and even higher unemployment, in order to foster low inflation over the long-term. However, since Covid, employers have struggled to find workers to fill job openings. In this situation higher interest rates may not stem wage inflation as the Fed hopes.

The objective of Fed policy, low and stable inflation, is laudable. However, history shows that pursuit of this goal during the ups and downs of the economic cycle is fraught with risk for investors. Nonetheless, the stock market is remarkable for its resilience. Despite a global pandemic, inflation, a war in Europe, a bear market, and the prospect of a recession, the S&P500 has returned 7.7% annually over the last three years, and 9.4% over the last five years. This validates our buy-and-hold strategy as the best way to produce long-term appreciation. Furthermore, the recent decline in stocks has brought growth back-in-line with more reasonable valuations, thereby increasing potential future returns. This will facilitate our search for common stocks offering consistent growth at a reasonable price.

There were no material changes to our firm brochure (SEC Form ADV, Part 2A); however, if you would like a copy free of charge, please let us know. Please call us with questions or comments or if there are changes to your financial goals, investment time horizon, or risk tolerance.