Current Comments

Gary N. Clark, CFA
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Markets incorporate, process, and evaluate information. We are currently living in a time when there is a lot of information to be evaluated. Market participants note various possible occurrences or trends, and essentially assign a value and probability to each, and then combine it all into current prevailing market prices, which, of course, are always changing because information occurs randomly through time.

We are facing security market prices which incorporate more dramatic information. On the negative side, the possible outcomes includes

a) Future path of Ukraine war
b) The expected value of nuclear war
c) Increased level of inflation
d) Lurking, are potential defaulting loans made by non-bank lenders to corporations and the business sector.
e) A slowing European economy, as fuel and energy prices rise this winter
f) A deteriorating Chinese property market

With a higher discount rate, and higher interest rates generally, growth company shares will likely be less richly valued. Much of this correction has already taken place. Most, if not all of this information, is already incorporated in prevailing prices. Overall, the U.S. S&P 500 index is down about 20% from its recent high.

On Inflation

Milton Friedman famously wrote, that "Inflation is always and everywhere a monetary phenomenon." Last issue included a chart of recent behavior of the M2 measure of the money supply. From early 2020 the quantity of money in circulation, as measured by M2, increased by about 42% - a big increase.

Milton Friedman also said changes in the quantity of money impacted with a long and variable lag, making it hard to predict. We noticed in 2020 that many asking prices, especially for local real estate, went up when the shift in policy was announced, even before the actual increases in

the money supply. And, it was followed by subsequent dramatic real estate appreciation, and inflation of other asset prices. Some of recent inflation can be ascribed to the Ukraine war, some to supply chain issues, and some to other disruptions, but here we are.

Much of the public pronouncements and rhetoric reference the recent increases in interest rates by the Federal Reserve. More interest rate increases are on the way. The institutional framework has changed somewhat since Prof Friedman wrote. While the interest rate increases get more publicity, I think the quantity of money in circulation will be more important, and its impact will be manifested with a lag. So, while the money supply, as measured by M2, grew **42%** in the approximate two year period since the beginning of the virus episode, the money supply has been **approximately flat** since the beginning of calendar 2022. If the Fed were to significantly shrink the quantity of money in circulation, this would result in not only downward pressure on inflation, but also on asset values. This would begin to create financial distress in some areas with accompanying anguish. Interest rate increases are more visible and dramatic, but they are not the most effective tool or lever on economic activity.

The recent behavior of leading economic indicators suggests that a recession is more likely in the fourth quarter of 2022 or in the first half of next year. While GDP decreased slightly in the first two quarters, the unemployment rate is historically low, and the domestic labor market is currently robust.

The Fed has keep the quantity of money roughly constant since the beginning of 2022, and it has not materially contracted it. We think this will continue in the near term.

It's Not That Bad

The recent Consumer Price index was up 8.3% over the past year. Looking in the recent inflation data in detail, some of the data suggest that some of the increased rate will be temporary, and some depends on what happens with the current war. And, some specific conditions may improve.

Improvement in supply of computer chips may make autos more available, and slow or reverse some price increases;
Housing costs may be less, as demand cools down somewhat;
The labor market will improve, leading to more output and better restaurant meals.

Jay Powell has referred to a 2% inflation target. We think that 3.0% may be more reasonable in the near future, and that 2.0 % will be pretty hard to get to.

In our view, the monetary authorities have managed U.S. rates at unnaturally low levels over the past several years. We moved away from fixed income, and looked for equities or bond substitutes with greater income characteristics.

Higher Interest Rates

The interest rate yield curve is now inverted. US Treasuries with shorter maturities yield more than those with longer maturities. This means that in the immediate period ahead, shorter-term fixed income may be preferable compared to longer maturities, but it also suggests that we are entering a period in which it would be good to include more longer-term fixed income in a portfolio. The peak in interest rates may be 4 or 9 months away.

The Potential

While there is some concern now, there is the potential for current conditions and our outlook to improve fairly quickly. Over the next few years, the U.S. will implement a drive to have a greater share of global semiconductor chip production (up from our current 12%). More semiconductor facilities are being built in the U.S.

Homeowners have much more home equity, improving their financial position;
Supply shortages will ease;
A smaller student loan burden on consumers;
Mr. Putin may be gone;
The population increases, and incomes grow.

This could be a long list. We expect the S&P 500 to be over 4800 within a year, which is about a 25% gain from here.

If you would like to discuss any of these or other matters, we are available at our office in Altadena on North Lake Avenue, by email, and by telephone.

Thank you for your continued confidence.

Gary N, Clark, CFA

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