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It has been an awful time to be invested in the securities markets. Through the end of the third quarter, the Dow Jones Industrial Average was down 19.7%, the S&P 500 was down 23.9%, and the Nasdaq was down 32.0%. Unfortunately, there has been no refuge in bonds. The U.S. Aggregate Bond Index (AGG) was down 14.6%, and the 30-year treasury benchmark was down 31% year-to-date. *Over the past 80 years*, only 1969 saw U.S. stocks and bonds *both* decline for the year. These are uniquely challenging times.

We begin our letter with what we know. We are in a period of high inflation and rising interest rates. We also know that the global economy is slowing down. These realities alone constitute a poor macro backdrop for financial markets. However, a long list of economic and geopolitical issues raises the risk premium for equities, pressures corporate earnings outlook, and sends markets lower.

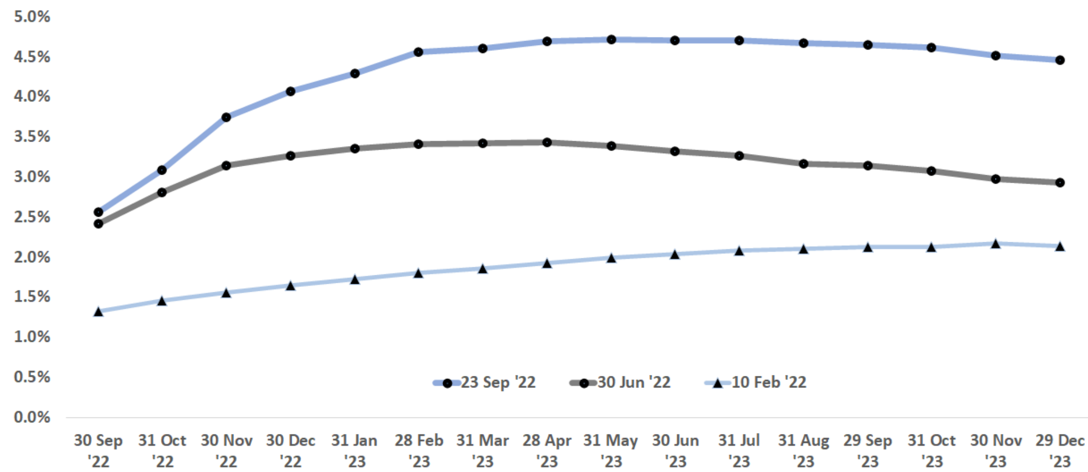
The markets seemed only recently to fully realize that massive, unprecedented monetary stimulus deployed during the pandemic period will need to be withdrawn. Also known, but not fully appreciated perhaps until now, is the explosion of government debt worldwide, much of it for years offering negative yields as part of a super aggressive, multi-national fiscal policy response to the pandemic. This further stoked demand for goods and services and stressed a global supply chain that failed to keep pace with surging post-Covid consumption. While the pandemic may technically be behind us, the occasional localized outbreak may continue to bedevil the global supply chain. With its zero-tolerance Covid policy and dominance in producing hard goods, China has become the epicenter of this concern. We are also worried about China's flagging economy as it deals with a significant housing downturn resulting from the decades-long overbuilding of residential property. In Europe, there is an energy crisis caused by the Ukraine/Russia war, the largest military operation on the Continent since WWII. There is no guarantee that the conflict will be contained. All of this is occurring against a backdrop of a new cold war between the U.S. and China that appears to be intensifying.

This is quite a list of poor macro conditions that, taken together, are why market consensus is now universally and resolutely pessimistic. It is virtually impossible to find any analyst, any pundit, or any forecaster who does not feel that all the forward-looking curves will bend in the wrong direction in the short term with an economic slowdown resulting. We agree with this assessment. But we think it instructive to review the issues on the list individually to gain a perspective on how deep the downturn will be and how long it will last. So, the purpose of this letter is to look at the significant factors driving poor market sentiment to see if we can identify cracks in the wall of worry standing in the way of healthier markets.

The Hawkish Fed; Rising Interest Rates; the Unwinding of Monetary Stimulus

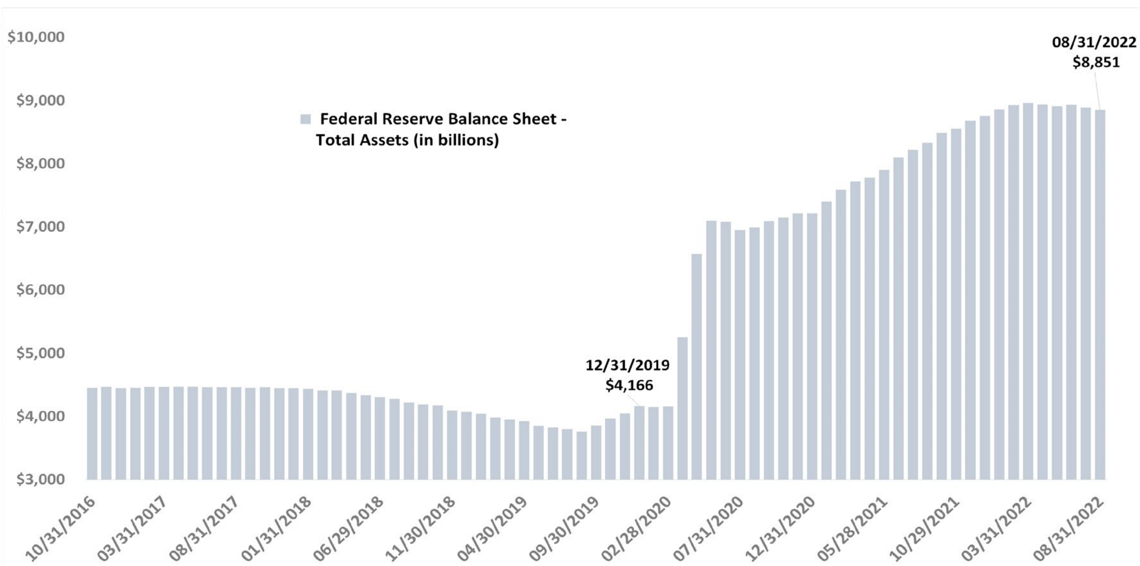
Undoubtedly, the Federal Reserve faces a monumental task in raising the cost of capital, withdrawing liquidity, and achieving a complex objective of reducing inflation while minimizing economic pain. The following graphs are illustrative of the challenge:

Fed Funds Futures Curve (bracing for higher rates)



Source: New York City Federal Reserve

Federal Reserve Balance Sheet – Assets (in billions)



Source: St Louis Federal Reserve

This deluge of money is likely the most significant contributing factor to year-on-year inflation in the U.S., currently running at more than 8%. So, what should we reasonably expect from the new tightening regime? No one knows with certainty but looking back at similarly stressful times of monetary excess may be instructive.

For us, the historical analog to the present may be the post-WWII era. The outbreak of war in Europe in September 1939 ushered in a period of inflation that exceeded the pace of price increases we are experiencing today. During the war, price controls were introduced as a form of rationing. With domestic industrial production redirected to the war effort, fewer goods were produced for civilian consumption. With controls removed post-war and an economy reverting to peacetime normalcy, inflation soared and peaked at 18% in 1946. By 1948, wholesale prices had more than doubled, the price deflator had somewhat less than doubled, and the amount of money in the system had nearly tripled.

This chart is a 1940's snapshot of some key indicators that are closely followed in today's high-inflation environment:

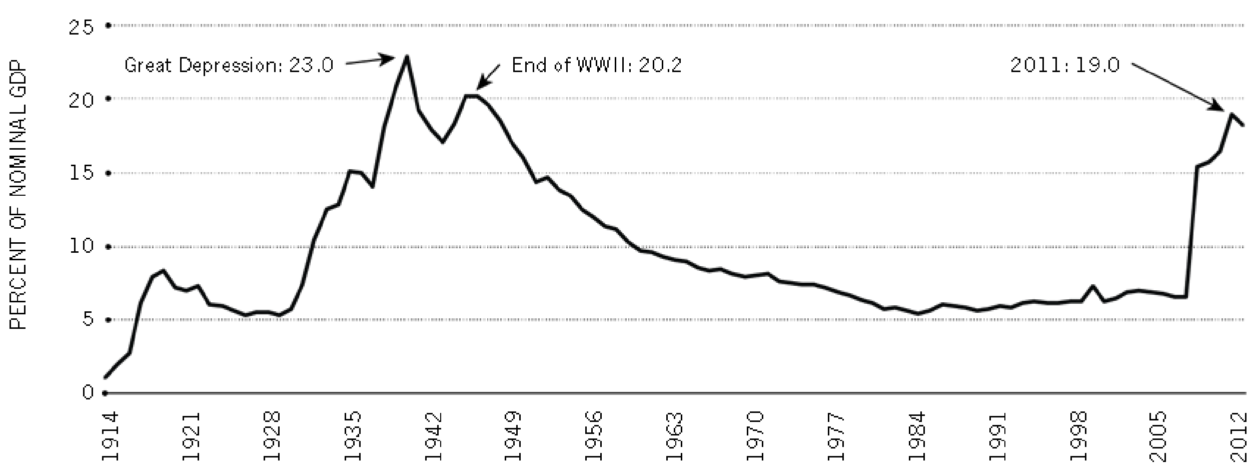
Year	GDP Growth Rate	Inflation Rate	Unemployment Rate	S&P 500 Total Return
1940	9%	1%	15%	-10%
1941	18%	10%	10%	-12%
1942	19%	9%	5%	20%
1943	17%	3%	2%	26%
1944	8%	2%	1%	20%
1945	-1%	2%	2%	37%
1946	-12%	18%	4%	-8%
1947	-1%	9%	4%	6%
1948	4%	3%	4%	5%
1949	-1%	1%	7%	24%

Sources: The Balance; Bloomberg

Fed Balance Sheet Redux

The following is a graph of the Fed balance sheet going back one hundred years or so. We often use the word unprecedented to characterize the monetary policy of the pandemic era. This is undoubtedly hyperbole. The Fed's balance sheet was almost as forcefully deployed first in the thirties due to the Depression and then in the forties in support of the war effort:

Federal Reserve Balance Sheet (Historical View)



Source: St Louis Federal Reserve

The resemblance of the forties to current conditions is striking. In response to cataclysmic worldwide disruptions to our everyday lives, the Federal Reserve lowers interest rates to negligible levels. During the war years, the Reserve Banks agreed to purchase Treasury bills at an interest rate of three-eighths of a percent per year, substantially below the typical peacetime rate of 2 to 4 percent. The interest-rate peg became effective in July 1942 and lasted through June 1947. In addition, the Reserve Banks reduced their discount rate to 1 percent and created a preferential rate of one-half percent for loans secured by short-term government obligations, substantially below the 3 to 7 percent that had been common during the 1920s. All of the

Reserve Banks implemented these rates in the spring of 1942. The rates remained in effect until January 1948.[1] The federal government then embarked on extraordinary deficit spending to meet the economic challenges posed by two existential threats. As a percentage of GDP, gross debt peaked in 1946 (121.7%). Today it stands at 121%. In both periods, the Fed's balance sheet balloons to a multiple of where it usually resides. In 1945, the Fed held assets of $46 billion, or 20.2% of GDP. Today, the Fed's balance sheet stands at 35% of GDP.

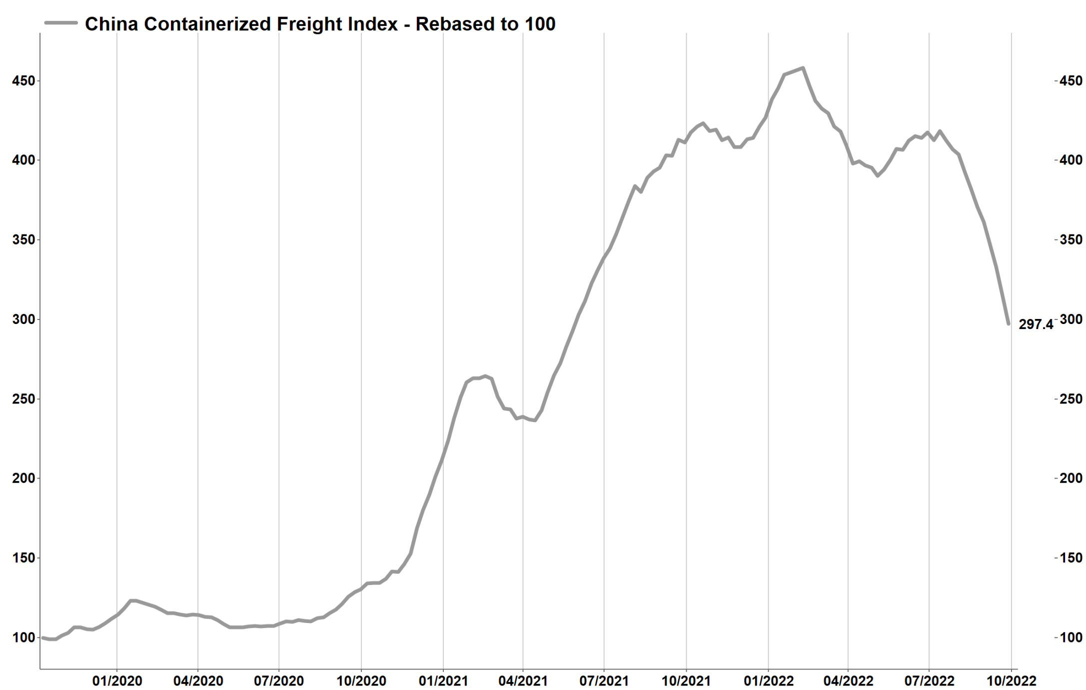
As one might expect, the hangover was significant. The U.S. economy was essentially in recession for three years following WWII. So, it is unsurprising that the consensus now is that we will be in a recession sometime in the next few quarters. But it is also noteworthy that the stock market held ground post-war except for one down year, 1946, a year of a deep recession. The tepid but positive markets of the late forties were a prelude to an extraordinary stock market of the early fifties. We are not making the case that the path out of our current travail follows the pattern of the post-war years. We are just observing similarities in the macro environment in the two periods and that we came out of the war years just fine.

The Supply Chain

The supply chain remains fragile for several reasons. Despite its economic challenges, China remains the world's major production center for technology hardware and consumer products. Covid, however, remains an issue there. As recently as September, China shut down an area of 65 million people across 33 cities based on small Covid outbreaks by Western standards. It is not beyond China's command economy inclinations to sacrifice vast swaths of its economy to prevent the spread. This wreaks havoc, temporarily, on the global supply chain. It, therefore, becomes more costly to source goods. Along the supply chain, localized labor issues, including rising wages and low productivity, exacerbate the inflationary picture. Add to this the trend of re-shoring foreign production and inflation expectations may worsen. The supply-side issue may not be intractable, but it will likely take time to reach a new normal.

One bright spot on the inflation front is the softening of freight rates:

China Freight Rates – Indexed to 100

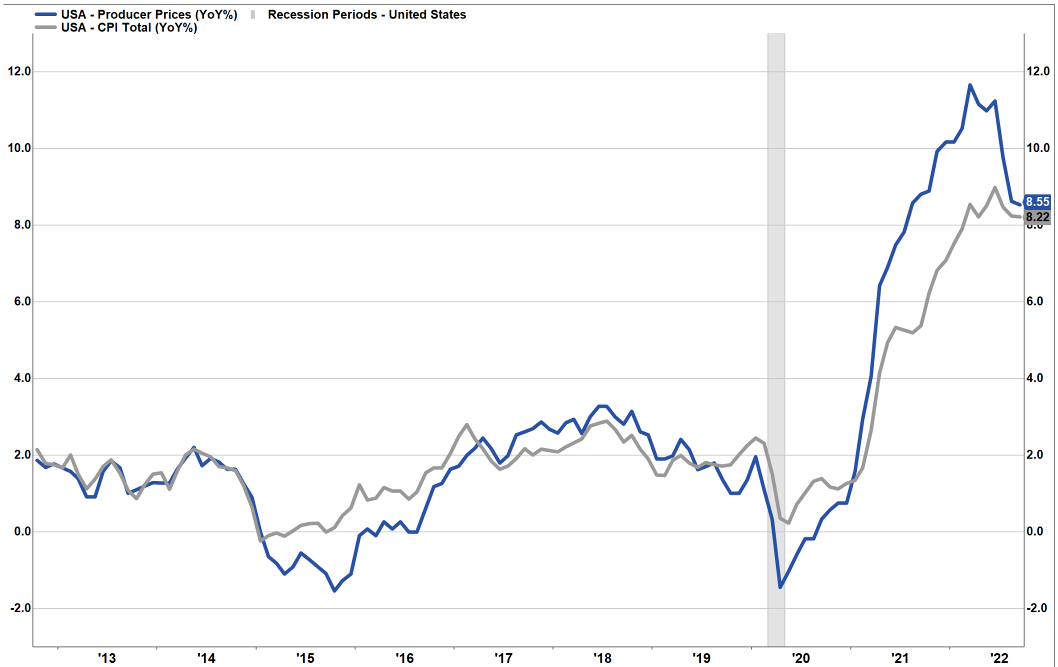


Source: FactSet

[1] Federal Reserve History, the Federal Reserve Bank of Richmond, November 22, 2013

We are further encouraged by commodity price declines. Additionally, the producer price index shows the first faint signs of rolling over:

Consumer & Producer Price Index – year over year % change



Source: FactSet

These alone will not be enough to bend the inflation curve. We believe labor costs and productivity improvements are the real keys. However, a slowdown or a recession may introduce more sanity in the employer-employee relationship that now decidedly favors the employee. A positive development on the labor front would be a true harbinger of a rollover of inflation.

China

We are worried about the current conditions in China. It is hard to find anything that's working in China. The property market continues to deflate, resulting from the overbuilding of residential property. The Chinese Communist Party continues to pressure technology firms to conform to its narrow vision of central control as the party views a free hand in cyberspace as a national security threat. Increasingly, foreign companies are strategically relocating production to neighboring countries, including Vietnam, Thailand, Indonesia, India, and Thailand. They are also revisiting expansion plans for their products and services in the country. Since the world is not rid of and may never be completely free of Covid, a zero-tolerance Covid policy will likely cause recurring economic problems in China that will affect sentiment inside the country and damage its supply chain. Although exports remain the one bright spot in the country's economic profile, the occasional shutdown of productive capacity due to Covid against a slowing world economy does not bode well for exports in the future. China is in a precarious state.

Covid

Covid is now a vastly diminished health threat in the West. Nevertheless, its economic effects will likely be felt for some time. Stimulus, inflation, and now the prospects of higher interest rates and recession are all tied to the onset of the pandemic. In addition, education setbacks, lack of motivation, and disappointing productivity may further damage growth prospects. Still, we think it is fair to assume that since the worst is over, the virus' effect on supply chains will continue to diminish over time.

The Russia-Ukraine War

Although it is no longer prominently featured in the mainstream media, the Ukraine-Russia war continues to rage on. There has been a significant human toll. Additionally, there have been enormous economic repercussions. Sanctions imposed by the West have made financing and navigating the global supply chain more complicated and expensive. Natural gas and crop prices have risen due to Putin's gas embargo directed at Europe and commodity-related production disruptions in Ukraine. Russia's lack of success may or may not suggest an imminent reckoning. Putin may commit significantly more resources to the war effort and prolong the suffering, or he may come to the bargaining table. Conceivably, he could depart the scene with his place taken by a more Gorbachev-like leader. We don't know.

The Strength of the Dollar

Another major concern is the U.S. dollar which has appreciated significantly against all major currencies. A strong dollar may reinforce the global slowdown that will likely occur as financial conditions continue to tighten. Although the U.S. will marginally benefit on the inflation front as a strong dollar can help contain inflation embedded in the price of imported goods, the strong dollar for most countries will be a headwind, especially those having dollar-denominated debt and dealing with their own inflationary environments. They can either support their currencies with higher interest rates and risk further slowdown or forego hikes and risk out-of-control inflation.

It all comes down to inflation, which is easy to spot but hard to understand. Yes, it's about too much money and strong aggregate demand. Still, there are also uniquely pandemic-era social, cultural, and geopolitical forces now in play that may affect inflation expectations, including inadequate supply-side fulfillment capacity, the erosion of labor skills, low productivity, and overall incentives to work. As a result, today's inflation is a complex phenomenon. We only know that until inflation subsides, there may not be lasting relief for markets.

We will likely see this reporting season that earnings outlooks will soften; combined with rising rates, market multiples may continue to fall. Given recent Fed guidance on interest rates, capital formation may be a much more challenging undertaking. As a result, economic growth may significantly disappoint. The pressure on the Fed to ease off the brake should intensify as new, disappointing data rolls in. We are already seeing the faint beginning of a new consensus forming that the Fed is fighting the last war and that it should now be more concerned about slowing growth than inflation. Additionally, although Fed Chairman Powell may not choose to save the stock market by going dovish, he would likely not stand by and watch the credit markets freeze up and threaten the financial system. Still, it is highly likely that some rollover of inflation will be the sine qua non of a Powell pivot.

We are living through a difficult period, but we don't believe we are embarking on a lost decade of market performance. We may instead be reprising the forties when the U.S. economy, like today, needed to adjust to a very different set of realities. But adapt it did. Confident that we will come out of this, we advise patience on the part of our clients.

The SeaBridge Team

If you'd like to discuss any of the strategy commentaries, or your individual portfolio, please let us know. Also, as always, we encourage you to contact us if there are any changes in your circumstances or goals that might suggest a change in the level of risk in your portfolio or in the investment strategy that we are managing for you. You can call (908) 273-5085 or email SeaBridgeTeam@SeaBridge.com.