MarketView

Fourth Quarter 2022

gs INVESTMENTS

The Market Turmoil Continues

Last quarter we talked about the risk of an economic hurricane. Well, as Hurricane Ian was battering the Florida coast, the economic storm clouds of inflation, interest rates, and supply chain disruptions continued to pummel the markets. After a brief and powerful market rally in July, the rally turned into a rout in September leaving the S&P down nearly 25% and the Bloomberg U.S. Treasury Total Return Index down 13% so far for the year. This continues to be the worst year for balanced portfolios in decades.

The resumption of the bear market this fall is partially in response to rising recession fears. Technically, we are already in a recession with declines in GDP realized in both the first and second quarters, although the job market remains relatively strong. However, despite the strong labor market, wage increases are not keeping pace with inflation for the second year in a row, making this one of the toughest periods on consumers in quite some time.

There are also growing concerns regarding global growth that could disrupt our economy here at home. The war in Ukraine has led to almost a complete cut-off in natural gas supplies that Europe has become so dependent upon. In Germany, Europe's largest economy, the Economic Ministry is forecasting a recession in 2023 due largely to energy insecurity. From 2000 – 2020, Germany invested over $200 billion Euros in renewable energy projects while it shifted away from coal and nuclear energy. However, renewables still only amount to 10% of power generation leaving the country heavily dependent upon natural gas, mainly from Russia. Now Germany and many other European countries are trying to replace that Russian gas through LNG shipments from the U.S. and middle east sources, but these are at much higher prices. Despite a 25% reduction in gas imports, Germany has spent 165% more on those imports for gas. To fill the gap, they are turning back to coal and considering extending operations of nuclear plants that were scheduled to close. Some are even turning to firewood where demand has exploded leading to an 86% increase in firewood prices. While wood is considered by many to be "renewable", it is about as pollutive as coal and is being burned at a faster rate than it is being replanted. So much for those Paris Accord goals.

Even if widespread blackouts are avoided, the drain on European economies from higher energy costs and the nearly 20% drop in the Euro is expected to weigh heavily on economic growth over the next 12-18 months.

Asia is not suffering from high inflation as much as the rest of the world, but China's continued zero Covid policy is leading to on-going lockdowns that are severely impacting internal as well as international supply chains, leading to erratic and sometimes negative GDP

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growth. China has portrayed themselves as the model for the world in combating Covid. However, their vaccines are of questionable effectiveness, there are many vaccine holdouts, and the country has little herd immunity from prior infections, so they continue with city wide lockdowns whenever a few cases emerge. This had lead to several bouts of supply chain disruptions within China as well as in other southeastern Asian countries. Bottom line, if Europe and Asia fall into recession, it will be hard for the U.S. to avoid a deeper fall than it has already experienced.

Wall Street is Divided

Will inflation slow down and pave the way for future rates cuts, leading to a quick market rebound, or will the Fed continue raising rates, pushing us into a recession that causes further market decline. Wall Street is divided and as the saying goes, “That’s what makes a market”. We don’t pretend to know where the market will go in the short-term, but over the last 150 years, the trend over the long-term has been up. In any given year, the market is down about 30% of the time. However, over 5, 10, and 15-year periods, the market has been up 90%, 95% and 100% of the time, respectively.

Could it go down further? Sure, but that is where market timing can be disastrous. There have been several analyses performed over different time frames, and all have come to the same conclusion; If you miss the best day of the market during the year, you reduce your overall returns by more than half over time.

After a 25% sell-off, this does not seem like the best time to be big sellers. The best bet is to have appropriate liquidity to meet short-term needs while investing the rest for the longer-term.

Where does the Housing Market go From Here

30-year mortgage rates rose above 7% in early October; this was from the record lows a year ago of under 3%. After years of runaway prices, higher rates are starting to have an impact on home prices. Since the June price peak, prices have dropped an average of 6%, although they are still up 8% from a year ago. Mark Zandy of Moody’s Analytics expects an overall decline of 10% or 15% if we have a recession. In some of the hotter markets over the past couple of years, local price declines of 20-30% are possible in his estimation.

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What makes it so hard is that entry level homes, those that went up so much over the last few years in bidding wars, are much less affordable with 7% mortgage rates. The much larger move up market is expected to struggle as well. Think of entry level buyers who bought a $350k home and wants to move up to a $650k home. They are looking at roughly double the size of their mortgage at more than twice the interest rate. In other words, their monthly payment would be 4 times as large. That is too much of an increase for most to swallow. The expectation here is that many of us that secured low interest mortgages will be locked into our current homes as well until rates and/or home prices decline.

Potential for Blackouts in U.S.

While the price of energy in the U.S. is up substantially, the country is much less reliant on foreign sources for our electric needs. That said, there are pockets of the country where energy policy and environmental policy collide, resulting in supply risks.

The large northeastern cities of New England reside just a couple hundred miles from the world's most economical and prolific source of natural gas in the Marcellus and Utica shale gas fields. However, regulatory, and legislative resistance to permitting several drilling sites and pipelines means that cities all along the east coast receive LNG shipments from overseas. Prior to the Ukraine war, Boston got its LNG from a terminal 4,500 miles away in Russia.

Now New England is competing with the rest of the world for those LNG shipments and there are only so many LNG ships. Not only has the natural gas cargo dramatically increased in price, but the cost of shipping it has soared as well. The daily shipping rate for an LNG tanker has risen from just over $14,000 per day to nearly $400,000 per day. Therefore, natural gas costs in New England have averaged 4-6 times the cost in most other parts of the country. Some are very concerned if there is a prolonged cold snap in the Northeast, there will be problems. "we're going into this winter basically crossing our fingers and hoping," FERC commissioner James Danly was quoted as saying.

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Paying more for less

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Inflation versus Shrinkflation

Some consumer product prices are increasing, but others have not. Or have they? To combat the perception of price increases some products have held prices steady, shrinking their size of the product instead. This is called Shrinkflation. According to Insider Magazine, General Mills has decreased the size of its family size cereal boxes from 19.3 oz to 18.1 oz. Gatorade's 32 oz bottle is now 28 oz. Burger King reduced its chicken nugget meal from 10 to 8 and Walmart's Great Value paper towel roll is 120 sheets versus its prior 168, all while holding prices steady. The list goes on. Personally, we noticed that the Halloween candy seemed smaller as well, and to be sure it was. Mars and Hershey have reduced candy sizes by various amounts. Our takeaway is that this Halloween's 'fun size' with be less fun.

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GSI Tenets

GS Investments

GS Investments, Inc. is an investment management company specializing in individual and institutional asset management. Privately owned and operated, GS Investments, Inc. is run by its owners, Glenn H. Steinke, C.F.A., John G. Steinke, M.B.A. and Greg Cunningham.

Glenn Steinke, CFA brings over 50 years of investment management experience to the business. Previous capacities include Vice President and Senior Investment Officer with a major pension fund ($1.8 billion under management) and Senior Vice President with a major Minneapolis-based financial institution ($3 billion under management). Glenn is a graduate of the University of Minnesota.

John Steinke MBA offers a broad financial services background with 29 years of portfolio management experience and 7 years of banking experience including capacities as a Vice President of a $50 million bank and as a private banking office for a large, Minneapolis-based financial institution. John received his BA from Concordia College (Moorhead) and his MBA from the University of Minnesota.

Greg Cunningham Prior to joining GS Investments, Greg spent 18 years at Minneapolis-based Ameriprise Financial, a national leader in financial planning with over 2 million retail clients and $300 billion in assets. Here he worked with the Chief Investment Officer in support of the international and domestic hedge funds and with the President and General Manager of RiverSource mutual funds. Greg is a graduate of Gustavus Adolphus College in St. Peter, MN.

Sheri Ritchie brings over 30 years of financial services experience to the business. Previous capacities include client service and support positions with Dean Witter and Kemper brokerage firms and a Minneapolis-based investment management firm. Sheri is a graduate of the University of St. Thomas.

GSI Investment Philosophy

GS Investments, Inc. utilizes a balanced approach for the majority of its accounts although each account is tailored to the individual needs of each client. Taxable or tax-exempt bonds are used along with a common stock component. The division between bonds and stocks is determined by the personal objectives of each client. A need for income and a willingness to assume risk are also determinants of an account's bond/stock mix.

GS Investments, Inc. emphasizes the purchase of quality securities and employs a long-term investment style, as market timing, frequent shifts in asset allocation and interest rate forecasting are not consistent with the firm's philosophy. In-depth market analysis and many years of experience support this approach.

GSI Fixed Income Strategy

GS Investments, Inc. emphasizes a staggered maturity approach when purchasing bonds. Individual security investment grades and call protection are considered when making these investments. Quality grades of "A" or higher are favored with tax-exempt issues. Government bonds are dominant among taxable securities.

GSI Equity Strategy

GS Investments, Inc. favors stocks emphasizing quality and growth. Appropriate cyclical growth stocks and small capitalization growth stocks are used periodically as well. Additionally, GS Investments, Inc. believes that a growth oriented philosophy tends to result in less frequent trading and lower tax payments (for taxable accounts) on realized capital gains. This provides a lower cost approach for the client.

GSI Client Communication

GS Investments, Inc. emphasizes client communication. Written investment objectives as well as periodic oral and written reports are used to heighten the understanding between the client and investment manager. In addition, easy to read, detailed reporting is provided by state-of-the-art investment software in order to inform the client of portfolio progress.