

Quarterly Letter to Investors

Third Quarter 2022

Bear markets in bonds and stocks inevitably produce negative investment returns. That is the case thus far this year. We never like to report such numbers, but we believe that ours are relatively good numbers. We believe the higher quality orientation of our investments and valuation sensitivity we employ has helped our portfolios act defensively in a very difficult environment.

“Should the excesses we have discussed manifest themselves in economic or market turmoil, we feel confident that the best way to maneuver through such periods is to invest in quality.”

- Crawford Investment Counsel, January 2022

It is not our normal practice to quote ourselves, but the above, from our year-end quarterly letter of this past January, seems appropriate since we highlighted several economic and market excesses that we felt could lead to a more difficult environment for investors. As it has turned out, it has been a very challenging year with bear markets in both stocks and bonds, due in large part to the excesses we discussed. Since these elements are still at work in shaping the course of the economy and markets, we feel an update on their status is appropriate. Our aim is to provide perspective on these instances of “too much,” as we labeled them at year-end, and to measure the progress made in correcting or improving these conditions of excess.

TOO MUCH COVID. Last January we were enduring the Omicron surge and about to enter year three of the Covid pandemic. It is hard to overstate the damage that Covid has done to the U.S. economy. It disrupted the business cycle by limiting the supply of goods and services and set the stage for excessive monetary and fiscal initiatives that are, in large part, responsible for the inflation problem we now have. However, in this case we can cite good news. The number of cases and deaths in our country is down dramatically, and no less than the World Health Organization has declared the pandemic to be over. While we are still vulnerable to new and dangerous variants, and many countries continue to deal with outbreaks, a cautious assessment would suggest that the major damage done by this pandemic is behind us.

TOO MUCH INFLATION. Our assessment on inflation is not nearly as constructive. In January the Consumer Price Index (CPI) was up 7.5% year-over-year. Still high today at 8.2%, there is little to celebrate.* The best that can be said is that during the last nine months the Federal Reserve (Fed) has been increasing short-term interest rates and building their resolve to really go after this problem. Federal funds now reside at 3.25%, and projections are that a level of 4.25% will be achieved by year-end.

The Fed has no choice but to attack the inflation problem, but there are risks involved. The basic condition of the economy is that there is more full employment and demand for goods and services than there is supply. The result is inflation. The Fed, therefore, is attempting to bring supply/demand back into balance, and the only way for them to do so is to reduce demand. Here is where the interest rate tool comes into play. As interest rates rise, consumers and businesses are more reluctant to borrow and have to divert more resources to interest payments, thus leaving less for purchases. It should be noted that interest rates are a blunt monetary tool, and timing the effect of interest rate changes is difficult. The risk is that the Fed underestimates the impact on demand and drives the economy into a recession. We are not predicting a recession at this time and certainly hope one can be avoided, but we are well aware of the recession risk.

Even though inflation has worsened since January, our view of the eventual outcome of the fight against inflation is positive. We can only take the Fed at its word, and when Chairman Powell says, “Our responsibility to restore price stability is unconditional,” he is leaving little room for anything other than victory. Other Fed officials have expressed themselves in similarly strong terms, at the same time recognizing that the goal of returning inflation to 2% will entail economic pain. In this context, pain means higher unemployment. We might add that when unemployment begins to rise, it often indicates that a recession is not very far off. It appears that the Fed has made a decision that if it comes to continued inflation or recession, they will choose recession, for inflation is a more pernicious and longer lasting problem, and experience tells us that recessions can be ended.

This update on inflation concludes that not much progress has been made yet, but we believe success will eventually be achieved, although at some considerable cost to economic activity. This fight will not be easy.

TOO MUCH STOCK RETURNS? Most will agree that this excess is fast being corrected. Indeed, the stock market has been in retreat since January and now resides in bear market territory with declines in excess of 20%. In our January letter, we pointed out that things were unusually good for stock investors over the previous five years. Over that period stocks in general had provided annual returns in the high teens, far above historical averages. We were suggesting that the continuation of such returns was unlikely, and that it would be wise to lower future expectations.

It may come as small consolation, but due to the slide in stock prices this year, stocks have become cheaper. Granted, if the economy really softens or enters a recession, corporate earnings will almost surely contract. But for now, the price-to-earnings ratio on the S&P 500 has declined this year from approximately 23 times earnings to 17 times. While this level is still above the long-term average for price-to-earnings ratios, such a substantial decline in valuations presents greater value for investors. Looking to the longer term, we remain optimistic on the ability of corporate America to deliver on behalf of its shareholders, regardless of any shorter-term interruptions in this trend.

TOO FEW BOND RETURNS. Speaking from a point in time when yields were still very low, we suggested in January that it was possible that bond yields would normalize at somewhat higher levels and that this

would be a favorable development for the economy. As the inflation problem intensified, however, much-higher-than-expected interest rates have been required, pushing bond yields up across the maturity spectrum. For new investors in bonds this is a welcome development, but for longstanding bondholders it has been a painful process as their existing bonds have been marked down in price as interest rates have risen.

For bond investors, what can be said that is encouraging? If we are correct that the Fed will ultimately be successful in bringing inflation down to their target, some degree of normalcy should be restored to the economy. This would likely mean a sustainable economic growth rate of around 2%, and with lower inflation, a more favorable environment for bondholders. As we move toward normalcy, we are pleased that there is an opportunity to purchase bonds with higher yields than we have seen in recent years.

OVERALL ASSESSMENT. It has been an unpleasant year thus far, but in order to correct imbalances and restore stability, sacrifices have to be made. We believe considerable progress has been made in the area of Covid, and greater value has been restored to stocks and bonds. With regard to inflation, the most serious of our problems, the effort to restore price stability is well under way. Even though it will not come easily or quickly, we are optimistic that the eventual outcome will be a return to lower levels of inflation.

Perhaps a further word about recession is appropriate. Currently the economy is out of balance with inflation. It can also be out of balance when in recession. Importantly, these imbalances can be corrected, sometimes naturally, other times by monetary or fiscal policy. If we do have a recession it will end at some point and growth will resume. Over time, as more people come into the labor force and as participants work more productively, growth will return as the essential characteristic of the U.S. economy.

One final thought on the quote from our January letter. We stated our confidence that the best way to maneuver through periods of economic and market turmoil is to invest in quality. Nothing that has happened in the last nine months has changed our opinion. In fact, our confidence has been bolstered by the performance of our various investment strategies, all of which seek quality as their dominant characteristic. Quality as an investment characteristic has demonstrated its capability of preserving value in down markets, and we expect it will continue to do so. When better times return, we expect it to also perform nicely on the upside.

*Data as of 8/31/2022

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CRA-22-227