Keller Quarterly

Letter to Investors

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Summer has concluded and we're starting to feel the chill of winter. For reasons that I've never fully understood, the stock market "feels a chill" this time of year also. More often than not, September produces a negative return for U.S. stocks, and this September was no exception. For some reason, investors come back from their vacations and decide to sell stocks. October is only a little better. The market's seasonality is not as regular as a farmer's planting and harvest cycles, but it usually returns annually. Savvy investors have known for generations that this time of year presents bargain prices that other seasons often do not.

Of course, this season's downtrend wasn't just due to turning the page on the calendar, but to expectations that the Fed will induce a recession. We talked at length about this in our July letter. The Fed has few tools to fight inflation and most of them risk a recession. To make matters worse, the current Fed previously guessed that inflation wouldn't be too bad or long-lasting ("transitory," they called it), so they left rates unusually low (near zero) for a very long time. By the time they discovered they were wrong, inflation was raging and they felt it necessary to raise rates dramatically and quickly, further adding to the risk of a recession.

Last quarter we indicated that we thought it unlikely the Fed could rein in inflation without causing a recession. Three months later, it now seems that a recession is likely. Recessions have been rare over the last three decades, the result of very low inflation that allowed our central bankers to keep rates low. But we believe the rise of persistent inflation will make recessions more frequent. A recession two or three times a decade is actually much more common in financial history than the once-a-decade recession occurrence we've recently seen. Investors who are not accustomed to this frequency regard recessions as cataclysmic as earthquakes or alien landings, but this is not the case. We tend to look at recessions the same way farmers look at spring thunderstorms: nasty, but not unexpected. They're entirely manageable if you prepare for them.

Fear grips many investors as a recession nears, but, as we pointed out in July, strong companies often get stronger during a recession. Yes, their profits may decline for a few quarters, but their competitors are often hurt more during a recession, leaving the stronger company in a better competitive position. Additionally, the lower stock prices that cyclical bear markets produce mean that such periods are often the best times for long-term investors to be buyers of high-quality stocks.

Longer term, we do not believe inflation is temporary. We believe the strong disinflationary trends of globalization and deregulation have peaked during the last decade. We expect that globalization will continue to recede and that regulation of businesses will increase. Inflation creates special problems for investors. It is a silent financial thief, reducing the value of the cash an investor expects to receive in future years. Our portfolios are structured for long-term inflation because we believe that, even if we have a recession that reduces inflation, it will return quickly in the recovery thereafter. Inflation is a headwind, yes, but many companies are in a better position to deal with it than others, and these are the centerpieces of our equity portfolios.

I've received more questions about bonds this year than I have in decades. Specifically, investors are surprised that bond prices have dropped at the same time as stocks. In most recessions over the last 30 years, quality bonds rallied when a recession approached. It's different this time and for a single reason: rising inflation. With their fixed coupons, long-term bonds are especially vulnerable to the effects of inflation. Prior to the peak in long-term rates back in 1981, this sort of bond market behavior was common.

It's important for bond investors to keep their maturities shorter than they would have in recent years in order to protect principal. That's not only what we recommend, it's what we are doing in our fixed income portfolios. For several years, we have been using target date fixed income ETFs in short- to intermediate-term "ladders" for our asset allocation, balanced, and fixed income portfolios. Bond investors can structure their portfolios to take advantage of future inflation by rolling those laddered maturities into what we believe will be higher coupons in the future.

Whether you are invested in one of our equity strategies, asset allocation strategies, or fixed income/balanced strategies, you can be sure that we are not lackadaisical about inflation. We regard it as a major threat to real returns and overcoming it as our overriding concern.

We appreciate your confidence in us.

Gratefully,

Mark A. Keller, CFA
CEO and Chief Investment Officer

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