L. ROY PAPP & ASSOCIATES, LLP
INVESTMENT COUNSEL

2201 E. CAMELBACK ROAD
SUITE 227B
PHOENIX, ARIZONA 85016
(602) 956-0980
ROYPAPP.COM

# VIEWS FROM CAMELBACK MOUNTAIN

## *Where not to invest*

During 2022 investors learned a lot of things. One clear lesson from this year is that Vladimir Putin is not our friend. We were not too fond of Mr. Putin in previous years, but the world now understands that he is a murderous thug who cares little for his own people and even less for the people of Ukraine he claims to be liberating. Our clients own no direct investments in Russia and never have. Many pension plans, endowments, and other so-called sophisticated investors had minor direct holdings in Russia which are now essentially worthless. Kim Jong-un is not our friend. He means us and other democracies ill. Our clients have no direct investments in North Korea and never will. Nicolas Maduro is not our friend. Venezuela is a wild and crazy place for multi-national investors. We have one company that some of our clients own that has a very small part of its business in Venezuela and that would be Chevron. We are evaluating Chevron on a client-by-client basis because most client holdings have large unrealized capital gains. It would be foolish to sell Chevron and pay large capital gains taxes to avoid a minor financial impact to the company. Our clients have no direct exposure to investments in Iran, Afghanistan, or Cuba and we are happy about that.

So far, we are not bringing you any remarkable insights. Let’s turn to China. All kinds of sophisticated investors are invested in China directly or through emerging market funds, most of which are roughly 40% allocated to China. Xi Jinping is not our friend, and he means us harm. China has had long-term, very clear ambitions to reunify by taking over Taiwan. The probability of military action by China against Taiwan is quite a bit greater today than a year ago, or five years ago, in our opinion. Our clients do have indirect exposure to China. Far and away, our largest exposure is through Apple, which contracts to have most of their products manufactured in China. Apple’s situation in China is complex because Apple indirectly employs millions of Chinese workers, and it fuels a large export business which is lucrative and attractive to China. Nevertheless, a Chinese invasion of Taiwan or other hostile actions would create serious difficulties for Apple. We are confident that Apple is diversifying its manufacturing geography as rapidly as practical, but it is very much a work in progress.

We are well aware that, by some measures, China is the world’s second largest economy and with its enormous population, may eventually become the world’s largest. We think direct investment exposure to China, Hong Kong, and unfortunately Taiwan is dangerous and unhealthy at this time. While this may seem obvious, pension plans, endowments, and other sophisticated investors, as well as the SEC and a variety of U.S. government regulators are “monitoring conditions carefully” but at the end of the day, essentially taking no action. Our clients pay us to safeguard their assets and we think it’s irresponsible to have significant direct investment exposure to China, Hong Kong, and Taiwan.

## *Higher for longer*

The big investment news of the year has been dramatically higher inflation, met with dramatic increases in the Fed Funds rate from our Federal Reserve. Our Federal Reserve was so out of touch with reality that they were still stimulating the U.S. economy in March by purchasing United States Treasuries and mortgage-backed securities through their quantitative easing program. History won’t give them high marks for that. Some of you may have seen a graph of the M2 money supply growth

for the last several years which is the smoking gun that leaves most of the blame for today's inflation with the Federal Reserve. They've had help with fiscal spending from irresponsible administrations starting with George W. Bush, who doubled the U.S. debt in eight years. Not to be outdone, President Obama doubled the debt again in his eight years. President Trump only increased irresponsible deficit spending and now President Biden's administration has taken expenditures and deficits to new highs. Treasury Secretary Janet Yellen wrote an op ed piece in the Wall Street Journal recently championing what a fine job Biden has done on the economy. We are indeed fortunate that she is no longer directly involved in the Federal Reserve. She is a lousy economist turned politician, and one has to believe that she truly doesn't understand that the massive deficits are a significant factor in today's inflation. Happily, she'll soon be retired.

All of this will likely require the Federal Reserve to continue raising interest rates and importantly, to keep them at relatively high levels for quite some time, perhaps several years. As the Fed has been raising interest rates this year, we've had five separate instances in the financial markets where investors started to price in the good news that inflation had peaked, and that the Fed was almost done raising rates. Each time, bond yields dropped and stock valuations advanced. Each time rational economic observation indicated that underlying inflation was still present to a large degree and that further rate hikes were necessary, meaning that rate cuts wouldn't come anytime soon. Each time, stock prices subsequently fell. The markets have been guilty of lots of wishful thinking this year, which we suspect was driven in part by the fact that almost all investment analysts and Wall Street experts are too young to have experienced the inflation and high interest rates in the '70s and early '80s.

As we close out the year, the Fed Funds rate is 4.5% and the prime rate is 7.5%. We anticipate that the Fed will raise the Fed Funds rate at least 0.25% two or more times next year. History tells us that there is a substantial lag of about a year (plus or minus six months) between Fed actions and the eventual impact on financial markets. As a result, it is too soon for us or the Fed to gauge accurately how effective the 2022 Fed Funds rate increases will turn out to be for the broader economy. We predict that the Fed will <u>not</u> be cutting rates during 2023 and it is relatively unlikely in 2024.

Fortunately, the economy is on very solid footing. The unemployment rate is 3.7% and it may go somewhat lower before the Fed rate hikes begin to turn it slightly upward. Most corporations are healthy and feature strong balance sheets. In aggregate, individuals also have strong balance sheets currently, although they are spending down some of the surplus that the government has sent them over the past three years with ill-advised fiscal stimulus programs. State and local governments are currently swimming in money, so overall consumption demand is still quite healthy.

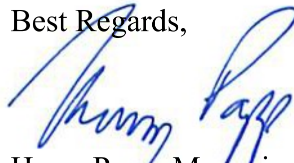
The higher interest rates so far and additional rate hikes coming in early 2023 will slow the growth of the economy some and the unemployment rate should tick up. Some industries that are highly sensitive to interest rates like homebuilders and automobile manufacturers will see particular weakness. We expect the broader economy to slow a little bit, but to enjoy at least modest continued growth. Stock valuations may have already discounted most of the bad news from 2022 and the additional adjustments that are likely to arrive in 2023. As such, we expect reasonably favorable stock market returns in 2023, in line with long-term averages. We are not suggesting that investors reduce equity exposure at this time.

Given the poor financial market conditions in 2022, and the additional interest rate increases coming in 2023, it would be easy to be discouraged about near-term prospects. We are actually

optimistic about the future. We continue to think an impending recession is unlikely, but if it were to come in 2023, it may very well be short and mild. It's also important to note that as disappointed as we may be with our political leaders and their policies, we are still fortunate to live in the U.S. Our country has abundant resources, deep capital markets, and a strong entrepreneurial spirit. Despite some regulatory excesses, it's still a lot easier to do business here than anywhere else around the world. The U.S. also leads the globe by a wide margin in technology of almost all types. Our universities and research centers are constantly churning out new technologies to improve human health and to deal with many of the important problems facing the world today. We are confident that the U.S. will continue to lead for future generations. We started this letter explaining where not to invest. We continue to believe the safest long-term place to invest is right here in the United States.

All of us here at L. Roy Papp & Associates, LLP hope that you have enjoyed happy holidays. We wish you health and prosperity in 2023.

Best Regards,



Harry Papp, Managing Partner
L. Roy Papp & Associates, LLP
December 30, 2022