1Q 2023 Market Insights
A Value Manager's Perspective on an Early Pivot
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"The Federal Reserve's job is to do the right thing, to take the long-run interest of the economy to heart, and that sometimes means being unpopular. But we have to do the right thing." - Ben Bernanke

2022 has turned out to be a painful year for investors. US stocks have declined by approximately 18%, with growth stocks faring a bit worse (-30%) and value a bit better (-7%), but with losses permeating across all market caps and styles. Likewise, bonds, the usual safe haven for conservative and balanced investors, have declined by roughly 13%. The combination has left most balanced investors with losses between 10-20%, with those like us, who favor a value approach to asset selection, doing a bit better at navigating through the landmines than some others.

While losses are always unpleasant, they occur in a variety of frequencies and levels of severity. In terms of normal market returns, a decline is rather rare. On a rolling 12-month basis, over the last 95 years, stocks have generated a positive return in 75% of those periods. However, losses occur occasionally, in fact the other 25% of the time. When they do, an 18% decline is rather ordinary among losses, slightly worse than average to be precise, but not meaningfully so. Said differently, losses in general are rare, but when they occur, an 18% decline is pretty common among those losses. Even the more extreme 30% loss is not super rare, itself a 1.27 standard deviation event or 10% probability. The moral, corrections like this are completely normal no matter how unpleasant they may be.

Now, the year for bonds is an entirely different matter. Using rolling monthly data back to 1976, there have been 64 negative 12-month periods for bonds. All, prior to this year, were less than 10% losses and 54 of those were less than 5% losses. The 13% decline for bonds is itself a 3.3 standard deviation event or a 0.04% probability. Exceptionally rare. Now, for both to be negative simultaneously, that's only happened twice prior to this year out of 64 observations. In both instances, losses for stocks and bonds were small, less than 3%. 2022 seems to be a true outlier in many ways.

So why is it that last year was so unique? After all, history would suggest that stocks zig when bonds zag. That is true, until the source of the pain in stocks emanated from bonds. Both stocks and bonds are long-term assets. A dollar paid 10 years from now is worth less to someone than a dollar paid today. That difference is called the discount rate. As discount rates rise, assets with long-term cash flows typically decline. That was the case in 2022 for both assets, as the Fed has embarked on a fairly aggressive rate hike campaign in order to combat inflation.

Regardless, as losses mount, it has left many to wonder if the Fed may be nearing the end of their rate hike campaign. Is a "pivot" nearby? In fact, just last quarter my colleague Ryan Lehman addressed this in the 4q 2022 Market Insights, *The Possibility of the "Pivot."* Now, this article is not about to be a repeat, although I suspect there may be some overlap. Rather, I intend to speak to our perspective, a value perspective, on what a premature pivot might mean for markets. That is, how do we as value managers expect events to unfold and what implications might there be if the Fed pivots too soon?

What is this about & what have they accomplished so far?

The issue at hand goes no further than inflation. After decades of largely stable prices, during the last year we witnessed one of the worst inflationary environments of the prior century. While we can debate the sources of this inflation, ranging from supply issues, increased demand, monetary and fiscal policy, or unique circumstances causing worker shortages, it is without question that inflation must be prioritized over economic considerations. The alternative is far reaching and erodes the standard of living much in the same way that wealth compounds, only from an expense perspective. Even a little inflation over a long time adds meaningfully to the expense side of the consumer's ledger.

Regardless of the cause, inflation is the enemy. In this fight, through whatever mechanism, the goal is very simple. The Fed must target the appropriate level of supply and demand at their desired price target. When demand exceeds supply, price becomes the equalizer. If your target is price, you can accomplish that goal by either increasing supply or stifling demand. Since the Fed has no control over supply, they must press down on demand to arrive at price stability. Put plainly, in fighting inflation, the goal of the Fed is demand destruction. They need consumers to be less willing to spend money so that demand and supply intersect at a lower price point. To do this, the Fed can take money out of our pockets through job loss. They can also make the cost of financing more expensive as a deterrent to large purchases and to siphon off disposable income if we do. Finally, they make us less wealthy through capital market declines. All of it has one goal, spend less to reach lower inflation targets.

About one year ago, the Fed indicated that inflation was rising and the appropriate policy action would be to tighten slowly. In fact, their first policy action wasn't until nearly 6 months after they first telegraphed the move. But, that didn't really matter. The bond market began pricing this in almost immediately, with the two-year treasury yield rising from 0.73% to 1.89% before their first shot was even fired. Why is this relevant? Because financial conditions are much tighter currently than what Fed Funds would suggest. Over the past year, the cost of debt financing across the entirety of the US bond market has increased meaningfully from 1.75% just one year ago to 4.68% at year end. Likewise, retail residential mortgage rates have climbed from 3.25% to 6.66% over this same period. Rates markets, as was the case before the Fed began their campaign, preemptively price in what is expected in coming months.

Now, on top of higher financing rates, capital markets have also played along. Since the beginning of 2022, global liquid wealth has declined from $253T to $208T across global equity, fixed income, and crypto markets. In total, this represents 46% of global nominal GDP. Talk about taking away the punch bowl! Suffice it to say, declining wealth tends to impart both a real world and psychological blow to spending. As wealth rises and falls, this tends to encourage or discourage spending on the margin. While it's difficult to pinpoint how much is enough, it is fair to say that markets are meaningfully tighter now than they were one year ago.

Global Wealth Declines Contribute to Tightening

Chart 1

Positive wealth effects have been used previously in the years after the Great Financial crisis for economic benefit. We are now experiencing a negative wealth effect with the economic price to be paid to come.

Source: MSCI, Bloomberg, ICMA, CoinMarketCap

Why do Central Banks Pivot?

While the term pivot has taken on multiple meanings recently, we will interpret it in the broadest way to simply mean a change from the current policy. This could mean a hike or a cut to Fed Funds when there were none before, or a pause from a path of prior action to inaction. That is, doing nothing instead of hiking or cutting.

The primary reasons for a pivot of any sort are either a financial crisis or a change in economic conditions. In the early 90's, the shift to rate cuts was due to softening economic conditions around the time of the first Gulf War. In 1994, with the economy booming, Fed Chairman Greenspan began removing the accommodative financial conditions set forth in the Gulf War recession as the economy demonstrated clear strength. In 1998, the Fed was forced to cut unexpectedly due to the Asian debt crisis and the collapse of Long-Term Capital Management. Likewise, after the dot-com bubble burst and the events of 9/11, the Fed was again cut aggressively.

In more recent times, we've seen similar actions during the Great Financial Crisis and at the onset of the COVID pandemic. The commonality is that something changes to require the corresponding change in policy. In our current circumstance, this is likely to result in a pause in rate hikes within the next few months. The question is what happens from there? It seems to be a foregone conclusion that the Fed's path is from hike to pause to cut. However, I would caution those who believe this. Paul Volker had many fits and starts in his rate hike campaign during the early 1980's before breaking the back of inflation. Any thought of cutting at this juncture is exceptionally premature. Why? Something would need to break first. That something being financial markets or our economy. The Fed is unlikely to cut rates without one of those occurring.

What happens if the Fed Pivots too soon?

Allow me to take a glass half full approach. Let's assume that the Fed stops rate hikes where they are, without a path to cutting. That is, nothing has broken. They just stand still. On Main Street, it will take some time, but we haven't felt the full effects of the tightening that has occurred thus far. That still needs to filter into the economy. By this time next year, we should be able to assess the damage. If I survey current conditions, I see valuations in the US that are high and are likely to inflate further for two reasons, one good and one not so good. Initially, I would expect, as we saw recently, that a pivot would evoke a positive response from stocks. Equities would rally, further inflating an already expensive market that hasn't fully corrected the excesses of the last decade. The second reason for valuations inflating relates to downward pressure on earnings, as companies deal with higher costs of labor, raw materials, and financing. This is likely to undo any short-term positive effects from the pivot and be the final stage in the two-stage scenario that we laid out many months ago, those being downward pressure on valuations from discount rates, then a decline in earnings. If the Fed pivots too soon without ample evidence that inflation is gone, long bond yields will likely rise. This spells trouble for stocks if the pivot is just that, premature. Therefore, to pivot, the Fed needs to be sure that inflation is gone.

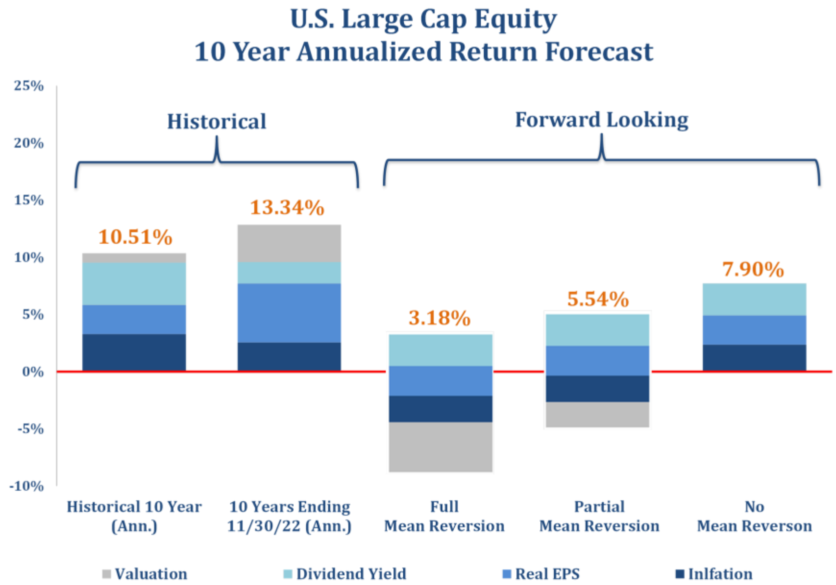
Setting the short-term aside, what about the long term? While short term effects on assets can be highly uncertain and dependent on dozens of variables, long-term results are heavily influenced by valuations and typically fall within a narrower range of their expected outcomes. While we at iCM, use many methods to project future long-term returns, perhaps the simplest, and one of the most effective, is our building blocks of return methodology. Equity market returns come from inflation, growth of real earnings per share, dividends, and the change in valuation (P/E multiple expansion or contraction). We've done this exercise in many past Market Insights (most recently in the 1q 2022 Market Insights), and the results vary by only a few basis points from top-down trailing returns, so I will spare everyone the calculation as a proof statement here. Although, if you'd care to see our prior work, it's all available on our website or alternatively feel free to reach out to us and we'd be glad to share the research.

Given this, I present you with Chart 2. Here we can see the historical long term average return, the return for the last 10 years and a few projections; full mean reversion, where valuations fall to their historical average, partial mean reversion, where valuations fall halfway, and no mean reversion, where valuations remain stable throughout the next decade. All are broken into their component sources. To be fair, over long periods like a decade, valuations are very likely to experience at least some mean reversion. But there is a method to my madness for showing the other scenarios! They all lead to the same conclusion. Let's start by comparing the last 10 years to the historical average.

As we can see, the last 10 years were nearly 3% better on an annualized basis than the historical average. At first glance, real earnings per share growth contributed 5.14% per year, more than double the historical average. However, earnings growth and dividends are two sides of the same coin. What you distribute as dividends is not available for earnings growth and what is used for growth cannot simultaneously be a dividend. What separates the two is simply a management decision to either retain or distribute. Historically, the two combined contributed 6.25% per year to the historical total. Over the last decade, the two contributed 7.02%, a bit better than the historical average, but not the primary contributor to the outsized returns. That came from the change in valuations, which contributed +3.25% over the last decade vs less than 1% historically. Now, let me state the not so obvious. Any expectation that valuations will increase forever and always make a positive contribution is flawed. Eventually, investors will find something else that simply looks more attractive. Perhaps a government bond yielding 5% or 6% or 7% becomes available? Why pay top dollar and risk capital, when a risk-free return may be available at a similar level? Valuations need to remain at a level such that the stable sources of return; earnings and dividends can do their job (plus inflation).

The Decade Ahead

Chart 2



US equity returns for the next decade face the overhang of above average valuations which typically lead to reduced returns absent further expansion of valuations. From below average valuations it may be reasonable to assume that inflating valuations will add to returns. However, from average or above average valuations the more likely path is for valuations to fall back toward their average and subtract from returns, resulting in low to mid single digit results, as the likely path for US stocks for the next decade.

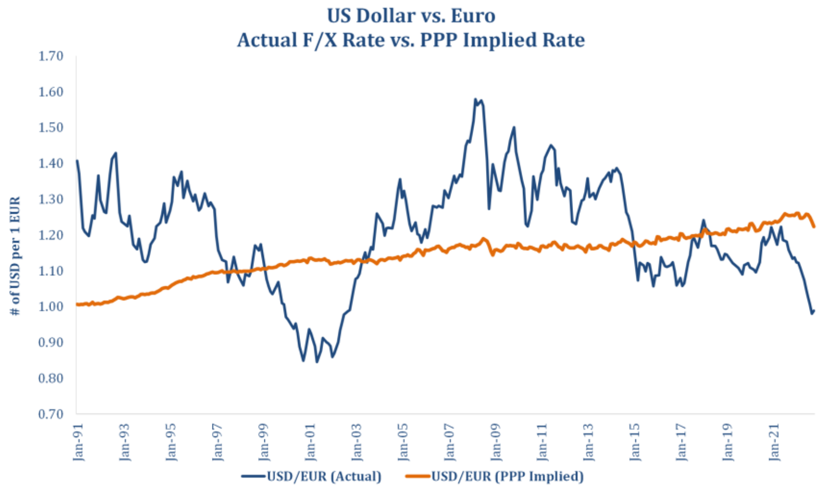
Source: MSCI, iCM Capital Markets Research
This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance. Assumption are subject to change.

While it is reliable to assume that valuations should increase from below average levels, it's a coin toss from average valuations and unlikely to help from expensive valuations. In fact, from very expensive levels, it's highly unlikely that valuations will expand further. That leaves us with the remaining three scenarios as the likely path for returns, with the most optimistic, from a return perspective, being the next decade ends exactly as expensive as we are right now. That is, no mean reversion of valuations occurs to subtract from returns. The point in each of these cases, the likely path for future US large cap equity returns from where we stand now, is something less than the historical average. Our estimates of 3%-8% in total return feel very reasonable to me. Therefore, a second consequence of the Fed pivoting too soon is that valuations have yet to fully correct the excesses of the last decade. The result is very likely to be reduced, but positive returns for US stocks, perhaps for some time.

Now, an oft forgotten casualty in this battle against inflation has been virtually every foreign currency not named the US dollar. As the Fed acted aggressively against inflation, this attracted foreign capital seeking to take advantage of those higher US rates in lieu of lower rates at home. In turn, this drove the dollar higher.

The Dollar Wrecking Ball

Chart 3



Aggressive Fed policy relative to other central banks has caused a rapid strengthening of the US dollar and a decline in foreign currency values, which has helped our fight against domestic inflation at the expense of foreign nations. Given the overly strong level of the dollar, this seems likely to reverse with the primary consequence being that we re-import some of the inflation that we had exported in 2022.

Source: Bloomberg, iCM Capital Markets Research

The strengthening dollar has laid waste to local currency returns of most non-dollar denominated assets in 2022. The strengthening dollar has been equally painful to foreign central banks attempting to combat their own inflation. As the dollar rallies this makes US goods more expensive to foreign consumers and foreign goods cheaper for US consumers, which stokes inflation abroad. On average, a 10% appreciation of the dollar contributes about 1% to inflation abroad. Conversely, the dollar's appreciation has been helpful to our own domestic battle against inflation for the very same reason. Foreign goods are now less expensive than domestic goods and will draw consumption away from US producers. In essence, we've exported some of our inflation.

Now, assuming the Fed pivots, a third consequence is the potential for a reversal of the dollar and that we begin to import the inflation we have exported over the last year. Chart 3 demonstrates the value of the US dollar compared to the Euro. While the degree of dollar strength varies from currency to currency, the story remains the same. The dollar is fundamentally too strong vs. every major currency. An early pivot from aggressive Fed policy would likely see at least some of the interest rate differential between the US and the rest of the world removed, as foreign central banks continue to hike as we pause. This would likely benefit foreign stocks, bonds, and potentially commodities. The negative side effect of this is that the US will likely have some currency driven inflation, perhaps requiring the Fed to resume hikes much in the way that Paul Volker needed to nearly 40 years ago.

Summary

As I began this article, 2022 was certainly a mixed bag of emotions. Bonds, compared to their own history, have borne the brunt of the hardship, an unusual occurrence and one that we feel is unlikely to repeat itself. As a result of the pain last year, US bonds are now priced to yield nearly 5%, a level not seen in 20 years and a buffer against future price declines. Despite the potential for fits and starts of inflation, in our view, US bonds appear, dare I say, fairly attractive at this level.

Now, stocks are a different matter. To keep everything in context it’s hard for us as contrarian value managers to see much to like about US stocks from valuations that are considerably above their 40-year average valuations, not to even mention the degree of overvaluation compared to historical averages. This does not mean that we believe a massive decline is in order. We operate from the perspective that the short term is highly unpredictable and that valuations act like either a wind in your face or at your back, depending on whether the asset is over or undervalued. In the case of the US, expensive valuations are likely to lead to diminished returns to some degree over the next decade.

Finally, inflation is a formidable opponent. 40 years ago, it took the best shots that Paul Volker had to offer and rose from the canvas several times before final defeat. I suspect that we will see a bit of that. The Fed knows this and as a result I also suspect a bit of near-term disappointment with the timing of a pivot to rate cuts. Jobs and wages have been very stubborn. I doubt we will see rate cuts until the number of available jobs to job seekers falls closer to a one-to-one relationship from its current 1.7-to-1 level and thereby alleviating a major source of inflationary pressure. With some degree of optimism though, I am hopeful that next year at this time, this is all in the rear-view mirror. Thank you as always for your continued trust and confidence. I wish you all a happy holiday season and happy new year!

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