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Monthly Update – December 2022

Two young fish meet an older fish, who nods at them and says, "Morning, boys. How's the water?" The two young fish swim along, and one turns to the other and says, "What the heck is water?"

- David Foster Wallace[i]

A month – and year – to forget

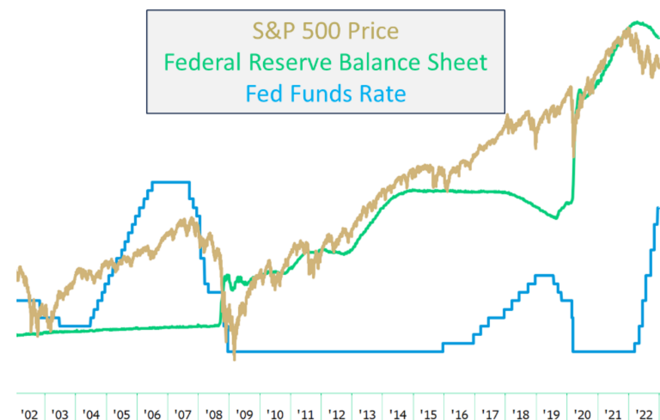
Sometimes we ignore the most important things. We are in a similar period in the financial markets. For our purposes:

Fed Easy Money Policies = Water

Specifically, the Federal Reserve introduced 'easy' money policies to stabilize markets after the Global Financial Crisis of 2008. The Fed then kept them in place far longer than originally intended, pumping money into the system and keeping interest rates generationally low. These policies went into overdrive during the pandemic, as illustrated in the chart below[ii].

After the Financial Crisis, the Fed:

- Increased the money supply in 2008 and again in 2020.
- Stimulated the economy with low interest rates until 2022.



Company profits and stock returns roared in the 15 years following the Financial Crisis. The S&P 500 earned 16% from the end of 2008 through the end of 2021—significantly above the long-term average of 10%.[iii]

This was "water": the important reality that propelled financial markets.

In 2022, the Fed changed the environment; it has begun to reduce its balance sheet and has undertaken its most aggressive tightening cycle since the 1970s, in terms of speed and amount of tightening. This drove markets down in 2022. The S&P 500 finished the year down 18%, and balanced portfolios experienced their worst year since the 2008 GFC.[iv] We'll talk about what this means for the future in our outlook, but first let's review December's performance.

December Market Review

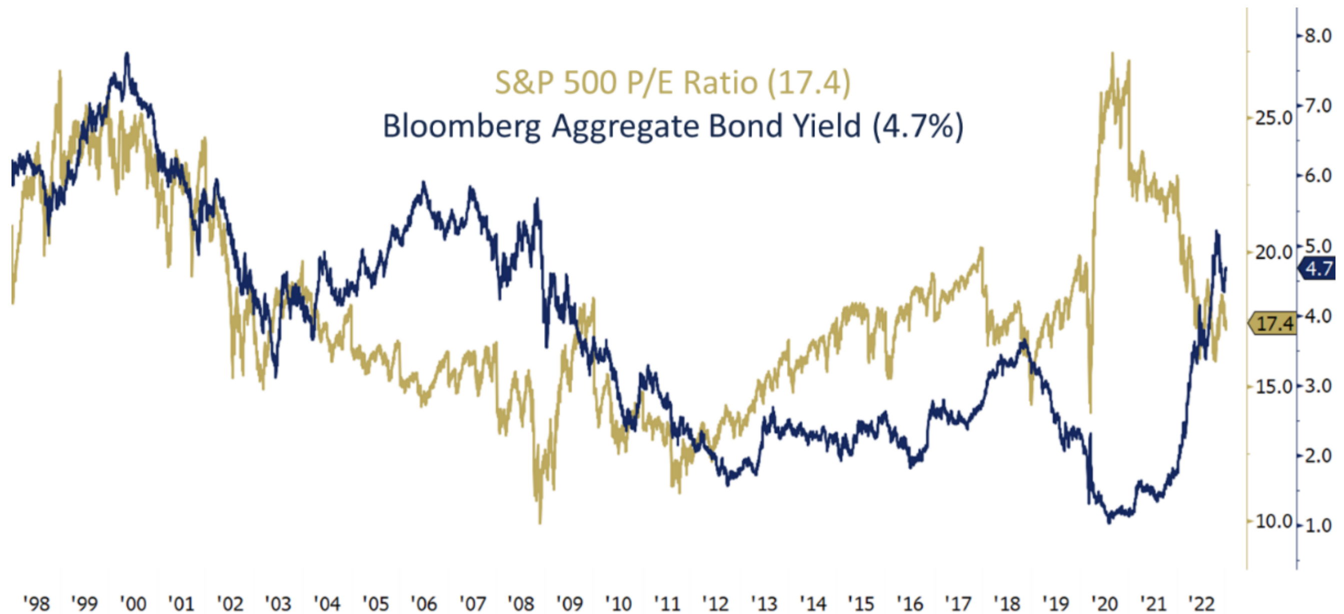
The S&P 500 lost 5.77% during December. International stocks continued their fourth quarter outperformance as the MSCI EAFE finished up 0.11% while emerging markets stocks lost 1.5%. US bonds suffered slight losses but remained solidly in positive territory for Q4 as inflation fears receded and recession fears grew.

Market Returns Ending 12/31/2022					
Category	December	Fourth Quarter	1 Year	3 Yr (Ann.)	5 Yr (Ann.)
US Stocks					
S&P 500	-5.77%	7.5%	-18.1%	7.6%	9.4%
Russell Mid Cap	-5.40%	9.2%	-17.3%	5.9%	7.1%
Russell 2000 Index	-6.49%	6.2%	-20.5%	3.1%	4.1%
International Stocks					
MSCI EAFE	0.11%	17.4%	-13.9%	1.4%	2.1%
MSCI Emerging Markets	-1.51%	9.6%	-19.9%	-2.4%	-1.1%
Bonds					
Bloomberg Aggregate Bond	-0.45%	1.9%	-13.0%	-2.7%	0.0%
Bloomberg Global Aggregate Bond	0.54%	4.5%	-16.2%	-4.5%	-1.7%
Bloomberg US High Yield Bond	-0.62%	4.2%	-11.2%	0.0%	2.3%

Source: Bloomberg

Review of Our Navigator Process

Valuation: The silver lining of 2022's dismal performance is that valuations for both stocks and bonds are far more attractive than a year ago. The chart below[v] shows a 25-year history of the S&P 500 P/E ratio alongside the Yield of the Bloomberg Barclay's Aggregate Bond Index. A couple points to note:



1) Stock valuations are back to their averages of the last 25 years but are still higher than long-term averages. Other valuation measures tell a similar story; stocks were very expensive and have become – if not cheap – less expensive.[vi]
2) The yield on bonds has become far more attractive than just a year ago. In fact, bonds yield more now than at any time since the Global Financial Crisis.

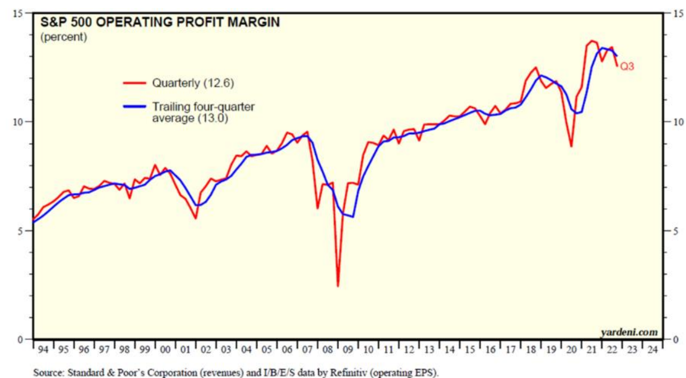
3) Stocks are not significantly cheaper than bonds anymore. “Stocks are cheaper than bonds” has been a theme of the last decade of low rates: “TINA (There Is No Alternative) to stocks” is a mantra that no longer holds.

We are far more excited about our investment portfolios than we were a year ago.

That is probably not how you feel, is it? What’s important today are the prospects of future returns. Valuations tell us they are decent – not yet back as high as historical averages, but optimistic for the long-term investor.

There are two caveats, however. First, when stocks and bonds are very expensive, they go back to average, as they are now. But, when they revert, they dip below average. Don’t be surprised to see more downside. Focus on the long-term.

Economy: The second caveat is that earnings may decline. We have been monitoring earnings, specifically profit margins. The chart on the right[vii] illustrates that profit margins may be returning to their averages after earning higher returns than normal during the post-COVID expansion.



Inflation is less concerning than it has been. However, the consensus is that a recession is likely.

Technicals: Short-term measures have begun to show some fatigue during the strong returns the first couple weeks of January, but medium- and long-term indicators are neutral to positive.

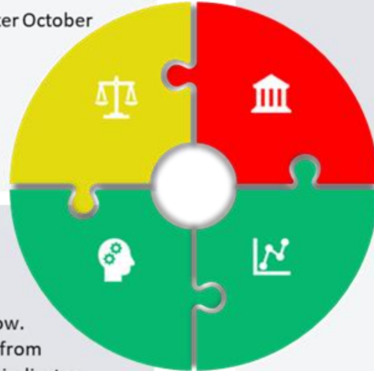
Sentiment: Investor sentiment has been negative since the summer, and this contrarian indicator, combined with recovering consumer sentiment, is positive.

VALUATION

- Stocks and bonds both appear less attractive after October and November's strong returns.
- Stocks are cheaper than bonds.
- US large cap stocks are slightly more expensive than their long-term averages.
- Investment grade and high yield bonds appear attractive.

ECONOMY

- The Federal Reserve indicated rate hikes may slow, but the terminal (ending) rate, is likely to be higher and stay high for longer.
- Employment remains strong with some weakness in retail and average hours worked.
- Margin pressures are causing analysts to cut earnings estimates for Q4 and 2023.

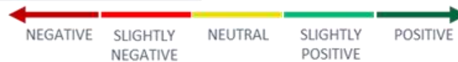


SENTIMENT

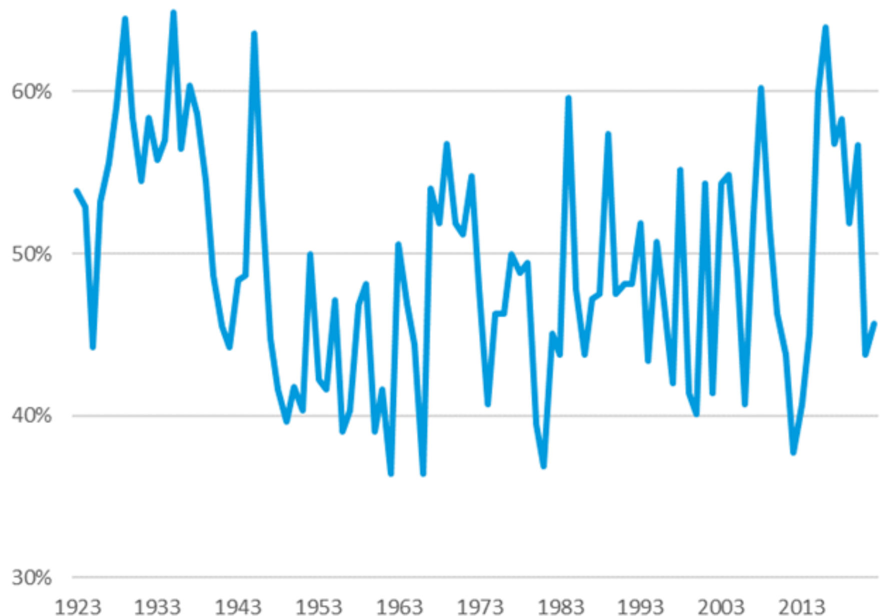
- Investor sentiment remains pessimistic.
- The University of Michigan and Conference Board surveys of Consumer Sentiment remain low.
- Consumer sentiment measures have recovered from their lows, and investor sentiment, a contrarian indicator, remains negative. These factors render Sentiment positive overall.

TECHNICAL

- Short-term technical indicators supported October and November's strength but are less positive after the recovery.
- Some long-term measures are positive, such as the strong bounce off the long- term moving average that was tested in October.
- Near-term volatility is likely, but the typical "Santa Clause" rally appears to be unfolding.



Outlook: The Chicago Cubs teach Reversion to the Mean



The Chicago Cubs have always been an average team – their 100-year winning record is 49.1%.

In 2016, however, they had a 64% winning percentage on the way to capturing the World Series. The six seasons since have brought long-suffering Cubs fans an illustration of reversion to the mean, as their winning percentage has fallen back below .500.

Mean reversion is also a powerful force in the investing world, affecting profit margins and valuation differences between asset classes.

The profit margins shown near the beginning of this article seem to be steadily going up, but at a pace which bounces around. After peaking last year, margins have been down for the last 5 quarters. This guides us to a

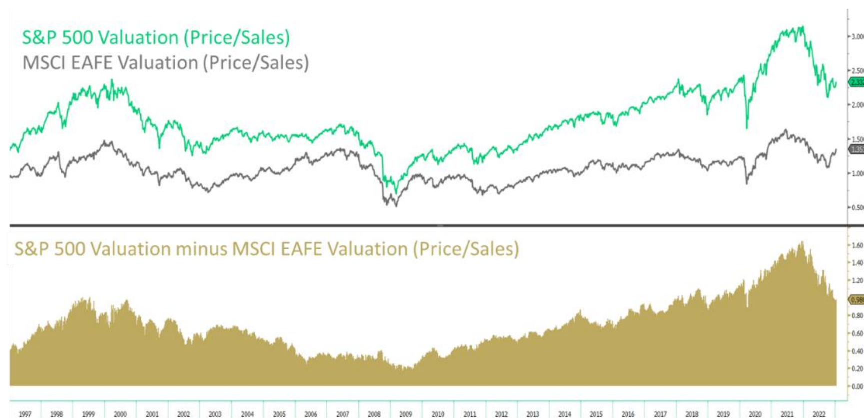
conservative view of corporate earnings growth and equity returns, consistent with a slowing economy.

Valuation also tends to revert to the mean on an upward sloping trajectory.

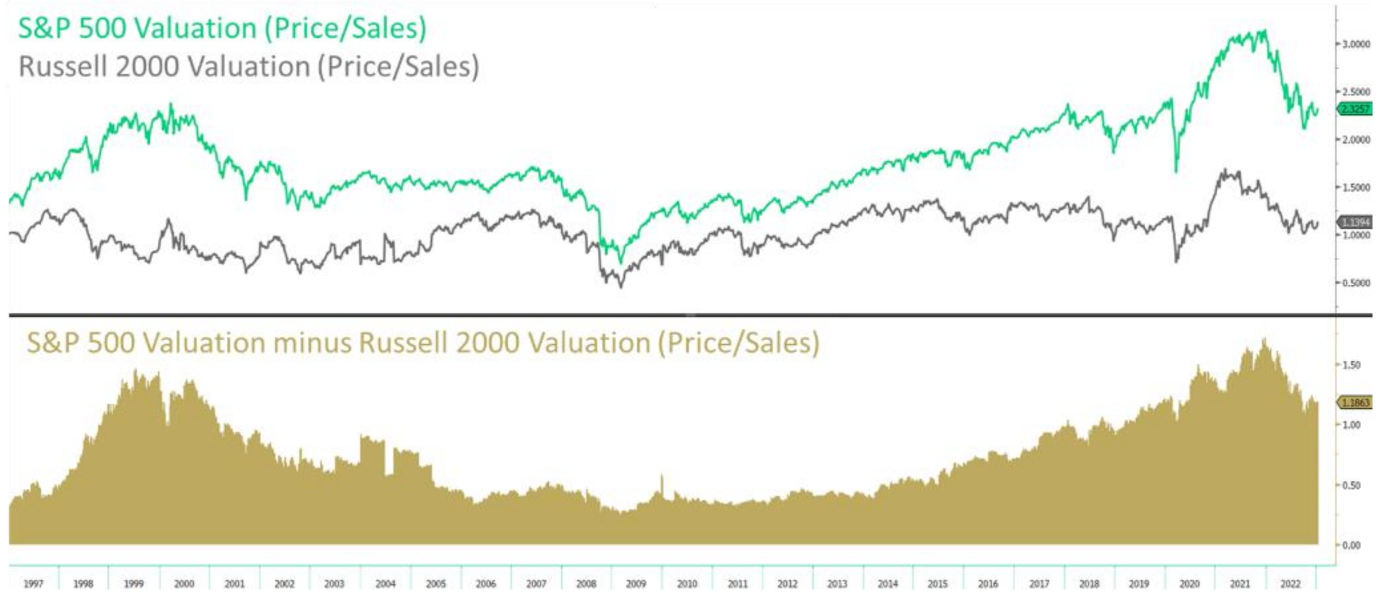
- Valuations have gone up over time as the economy has become more service-oriented and capital plays a bigger role relative to labor
- Asset class valuations tend to follow relationships over time:
    - Stocks relative to bonds
    - US stocks relative to international stocks
    - Large cap stocks relative to small cap stocks
    - Growth stocks relative to value stocks

The top part of this 25-year chart shows valuations[viii] of US and international stocks. Both times US markets reached their most expensive levels – during the tech bubble of 2000 and during the Pandemic recovery – relative valuations returned to their long-term relationships.

The US stock valuation premium over international stocks has come down since 2021. However, International stocks remain less expensive than the S&P 500[ix].



Large cap stocks (S&P 500) are at a premium to small cap (Russell 2000) stocks[x].



What is an investor to do? Here is a game plan for today's environment:

Portfolio Recommendations: Navigating the water

Understand the environment	**Embrace the environment**
Stocks volatility may continue	Consider using alternative strategies to lower portfolio volatility and capture diversified returns
Returns are likely to be below average in the coming years	Consider tactical strategies, rebalancing, and tax-loss selling where appropriate
Stocks may experience mean reversion	Consider increasing international and small/mid cap stock holdings
Bond yields are attractive again	You don't need to take excessive risk in the bond markets to earn attractive returns

Maintain discipline:

Above all, maintain discipline and stick with your plan. Talk to your advisor if you think your plan needs to be adjusted.

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[i] Source: Kenyon College 2005 commencement speech

[ii] Source: Bloomberg

[iii] Source: Aswath Damodaran, NYU: https://www.stern.nyu.edu/~adamodar/New_Home_Page/data.html

[iv] Source: Bloomberg

[v] Source: Bloomberg

[vi] Source: Bloomberg

[vii] Source: Yardeni Research, Inc

[viii] I have chosen to show Price/Sales ratio, rather than P/E. P/S is a less volatile measure; during the financial crisis of 2008 the P/E ratio was quite volatile.

[ix] Source: Bloomberg

[x] Source: Bloomberg