VINITY

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In a Nutshell

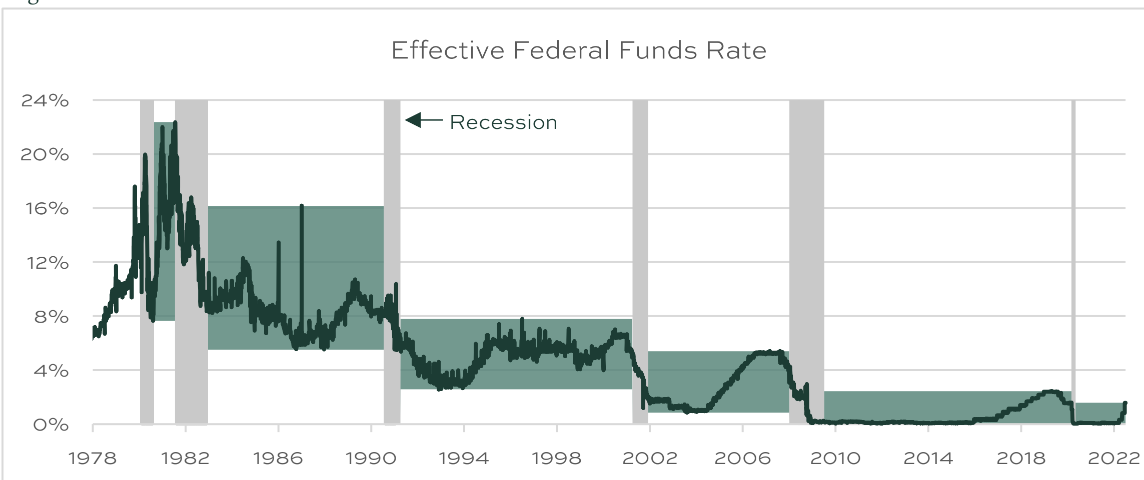
Stocks and bonds delivered poor results to start the year. Negative performance from both asset classes during the same period is not typical, but we are not in typical times. Economic conditions are deteriorating, inflation is out of control, and wages are not keeping pace. We are now at an unsavory point where interest rates must rise to combat inflation, but economic growth is not present to support higher interest rates. The situation portends more of the same, with stocks and bonds producing weak results simultaneously while in the rising interest rate environment. Stocks were overextended heading into this year, exacerbating the already fragile situation. Valuations have come down over the first six months of the year, which has been painful, although inevitable, and will serve as a benefit over the long run. Our concern moving forward is on the earnings side of the equation. Analyst estimates for earnings are effectively unchanged from the beginning of this year. Considering all that has changed, including higher inflation, more rate hikes than anticipated, and negative wage growth after inflation, we believe downward revisions are on the horizon. As companies report their second-quarter earnings and provide outlooks for their businesses over the coming weeks, we will gain better insight into the path forward. We are cautious heading into the second half as the economic outlook worsens. We believe earnings estimates still need to come down, which may result in further downside for the market. As a result, we have not rushed out to buy stocks during the first half. Given our pessimistic view, one may ask why we do not sell everything and go to cash? Attempting to time the market is not a viable investment strategy. Big up-and-down days tend to occur clustered together, and missing a handful of the best trading days can cause significant impairment to portfolios. For a $10,000 investment, missing just five of the best trading days from 1990 through 2019 results in $115,000 versus $173,000 for a fully invested portfolio. We will continue to review market conditions, and as our outlook changes intend to take advantage of any opportunities should they present themselves.

Four Decades of Exceptionalism Waning

The first half of this year has challenged both stocks and bonds. Stocks, measured by the S&P 500, fell by -20.6% through the first six months, the worst first half of a year since 1970. And U.S. Treasuries are off -10.4% for the year through June. Deutsche Bank estimates that's the worst first-half performance since 1788.

Typically, bonds act as a safe haven, frequently generating positive returns when stocks experience considerable declines. The uncorrelated nature of the two asset classes makes them great complements in a portfolio and has historically produced a steady return stream for investors with below-average risk. Fueling this over the past 40 years was declining interest rates. The Federal Funds rate, arguably the most important interest rate in the U.S., is the rate at which banks borrow from each other overnight and influences the rates charged for many consumer loans, like home, auto, and credit cards. The rate also affects short-term Treasury yields, which influence longer-dated Treasury yields. The Fed Funds rate is one of the monetary policy tools available to the Federal Reserve. The committee sets the target rate based on economic conditions to promote economic growth or rein in inflation. A lower policy rate encourages growth by lowering borrowing costs, while higher rates make borrowing more expensive. In July 1981, the Fed Funds rate peaked at 22% while the Fed battled double-digit inflation. From then on, during periods of economic weakness, the Federal Reserve would lower the policy rate to stimulate growth, which provided a boost for bonds. Bond prices move inversely to interest rates, so when interest rates fall, bond prices rise. In the below chart, over four decades, after each recession the Fed Funds rate traded in a progressively lower range, boosting bond prices.

Figure 1.



Over four decades, the conventional 60% stocks and 40% bonds portfolio worked like a charm[1]. From 1980 through 2019, a 60/40 portfolio, rebalanced annually on the first day of January, generated a 10.4% annualized total return. During the "lost decade," from January 2000 through December 2009, when stocks produced a -1.0% annualized total return, the same 60/40 portfolio delivered an annualized 2.6% total return. In dollars, a $100,000 investment in the all-stock portfolio and 60/40 portfolio was worth $91,000 and $129,000, respectively, at the end of ten years.

The experience during market drawdowns is where the 60/40 portfolio earns its keep. From September 2000 through December 2002, the Fed cut the Fed Funds rate twelve times from 6.50% to 1.25% as the economy dipped into a recession. And stocks fell an annualized -19.7%, while bonds rose an annualized 10.2%. Over the period, a buy-and-hold 60/40 portfolio produced a -6.2% annualized total return.

Again, from July 2007 through March 2009, the Fed slashed the Fed Funds rate from 5.25% to 0%. Over the period, stocks dropped an annualized -28.7%, and bonds increased an annualized 6.5%. The 60/40 portfolio generated a -13.4% annualized total return. Of note, the index representing the bond allocation has multiple sectors, including U.S. Treasuries, corporate bonds, and mortgage-backed securities. In 2007, about 22% was allocated to Treasuries. Keep in mind during 2008 the housing market buckled, mortgage defaults spiked, and the U.S. banking system almost collapsed. So, Treasury bonds were the only safe place to hide. An index only comprised of Treasury bonds with maturities ranging from three to seven years rose an annualized 12.2% over the period in focus.

[1] All references to, stocks, refer to the IA SBBI US Large Stock Index through September 1989; and the S&P 500 Index thereafter. All references to, bonds, refer to the IA SBBI US IT Govt Bonds Index through April 1996; and the Bloomberg US Aggregate Bond Index thereafter.

In the wake of the Financial Crisis, the Fed Funds rate remained at 0% for seven years until the Fed hiked it by a quarter point in each of the following two years before embarking on a policy normalization quest in 2017, hiking the policy rate seven times over the next two years to 2.25%. By the fourth quarter of 2018, the market threw a tantrum, and the Fed reversed course, cutting the policy rate to 1.5% by the end of 2019. And in response to the pandemic back to 0% in early 2020, where it remained until March 2022. The market was beyond elated, bottoming on March 23, 2020, just eight days after the 0% policy rate announcement. From the bottom, the S&P 500 rallied an annualized 55.8% total return to the top on January 3, 2022.

The first six months of this year are the consequence of bidding up asset prices for no particular reason. Through the end of the second quarter, stocks are down -20.0%, and bonds are off -10.4%. Our same 60/40 portfolio generated an underwhelming -16.1% total return. The difference this time is the lack of performance from the bond allocation. The stark contrast is the direct result of higher rates. The Fed has raised the policy rate to 1.50% in the first half and indicates further rate increases this year. The policy of higher rates as growth slows and markets sell-off is a bleak departure from prior economic slowdowns occurring during environments that afforded the Fed the ability to cut rates.

So, one may ask why the Fed Funds rate cannot stay at 0% if that was the fuel for the great bull market of the 2010s? The Fed must raise the policy rate now because letting inflation run hot for too long will lead to a larger decline in consumer spending, and businesses will have to lay off more employees as profits decline. The Fed intervention should lead to a more measured slowdown relative to allowing inflation to go unchecked. The prolonged 0% policy rate over the prior decade was made possible by slow growth and inflation running below the Fed's long-run target. Which ultimately gave birth to TINA (There Is No Alternative). In the period leading up to the Financial Crisis, an investor could purchase a ten-year Treasury bond and receive a risk-free real yield, after inflation, of 2%, on average. While that will not make you rich, it is essentially a risk-free return on your investment and will outpace inflation by 2% per year for ten years. In the post Financial Crisis low-interest rate environment, the real yield on a ten-year Treasury bond averaged 0.3%. So, investors piled into stocks as bonds did not make a compelling alternative.

Today, we have a lot of inflation, little growth, and an overvalued stock market, a recipe for disaster. The economy is looking at challenging times ahead, and the experience during the first half of the year with weak results from both asset classes is likely to be the norm.

Watch Your Step; Valuations Are on Thin Ice

Since the start of the year, multiple compression has been the driver of negative stock returns, with the S&P 500 down -20%. Multiple compression refers to shrinking price multiples and reflects the sentiment that investors are willing to pay a lower multiple of sales, earnings, or cash flow to own a stock. So far, all the multiple compression is attributable to declining prices, while the other side of the equation has yet to budge. The price multiple we are talking about is the P/E ratio, a valuation metric calculated as the price per share divided by the earnings per share. It tells an investor how much they are paying per dollar of earnings the company generates. For example, a stock trading at $50 with earnings per share of $5 has a P/E of 10 ($50 / $5 = 10). An investor must pay ten times the earnings to own the stock.

For a good part of the past two years, value investors have balked at valuations. The market did not seem to care. Stocks traded at new highs, and valuations stretched to their furthest level since the early 2000s Tech Bubble. The price declines this year have, on paper, caused valuations to come down from the consensus of 21.3 times the next twelve month's earnings at the start of January to 15.7 times the next twelve month's earnings at the end of June. The drop in the multiple brings "advertised" valuations just below their 20-year average of 16.6. Although, the problem is current earnings estimates are effectively unchanged from the beginning of this year. It is a mystery why analysts have not updated their estimates to incorporate the vastly different investment landscape that evolved over the first six months. Earnings estimates from the beginning of the year omit a war in Europe, associated supply shocks, a higher level of Fed tightening, inflation well above forecasts, and wages not keeping up. Valuations based on stale earnings estimates are likely misrepresenting current valuations. The higher the earnings component, the lower the P/E ratio. If earnings estimates come down, that will increase the P/E ratio. When the earnings part of the P/E ratio declines, investors are paying a higher multiple of earnings assuming no change in price. In the above example, the stock trading at $50 with earnings per share of $5 has a P/E of 10. If the earnings per share fall to $2.50, the stock is now trading at a P/E of 20 ($50 / $2.50 = 20). We believe the second half of this year will see an earnings reset, where estimates join reality and reflect the challenging environment ahead.

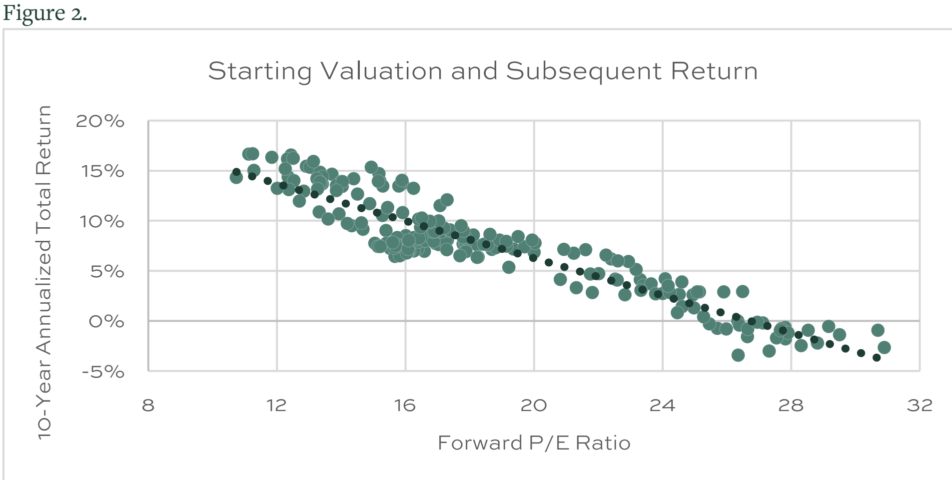
Over the next twelve months, through the second quarter of 2023, analysts call for 9.9% earnings growth. The average year-over-year second-quarter earnings growth from 2011 to 2019 was 8.7%. Economic conditions continue to deteriorate, so the idea that earnings will grow faster over the next twelve months compared to the historical average when economic conditions were much better seems a bit out of touch. In our view, earnings growth above zero would be a feat over the twelve months ending in June 2023.

The multiple compression this year has been painful for stock investors but healthy for the market over the long run. Stocks were way overextended, trading nearly two standard deviations above the average. The market is progressing toward normalized valuations, but we believe the P/E ratio is still too high, given current market conditions. The P/E ratio reflects the price multiple investors are willing to pay for future earnings. When investors feel more certain about the future, they are willing to pay a higher multiple, while the opposite is true when investors feel uncertain about the future. We mentioned the current P/E ratio is just below the historical average. Although, in our view, the visibility of the economic outlook is well below average. To justify the high uncertainty, we believe a P/E ratio of 15 is appropriate, placing the multiple halfway between the historical average and one standard deviation below the historical average.

Incorporating our views of a lower P/E ratio and flat earnings growth over the next twelve months, we arrive at a fair value on the S&P 500 of 3,300. Based on the information today, 0% earnings growth makes the most sense, but considering the path economic conditions are heading, a decline in earnings is increasingly likely. For example, if earnings decline 5% over the next twelve months, that would take us back to the level of earnings for the calendar year 2021. At the end of 2021, inflation was supposed to be transitory, the Fed Funds rate was forecast to reach 0.75% by the end of 2022, and the 30-year mortgage rate was 3.1%. Today, inflation is entrenched, the Fed Funds rate is forecast to reach 3.25% by the end of the year, and the 30-year mortgage rate is 5.7%. Although the contrasting periods may seem decades apart, that is the swift change in just six months. Considering how much economic conditions have deteriorated in a short period, -5% earnings growth over the next twelve months appears quite reasonable. The fair value for the S&P 500 with the decline in earnings is 3,100.

As asset allocators, we focus intently on valuations. In the short run, valuations are important, but the significance of the predictability is lower with shorter periods. However, over the long term, valuations are consequential. Historically, starting valuations have been a reliable forecast of returns over the subsequent ten years. The r-squared between starting P/E ratios and the following ten-year annualized total return is 85%. Meaning 85% of the variation in returns over the ten years can be explained by the P/E ratio at the beginning of the period. Using the equation of a line, we can estimate the return over the next ten years for a given starting P/E ratio[2]. Based on the forward P/E ratio of 21.3 at the start of the year, the estimated annualized total return over the following ten years is about 5%[3]. Well below the 16.5% annualized total return over the ten years ending in December 2021 that investors have become accustomed to.

Figure 2.



Given the high level of uncertainty and our belief that earnings estimates still need to come down, we believe there could be further downside for the market. As a result, we have not rushed out to buy stocks in the first half of this year. We had updated portfolios over the prior 18 months to reduce risk and remain comfortable with the positioning. The economic data released and commentary from individual companies over the next several weeks will be pivotal in understanding the path forward. As we synthesize the data and new information as it becomes available, we may find it necessary to implement portfolio changes should the opportunity present itself. Although our view is downbeat, the normalization the market is going through will set us up for more sustainable returns in the future. Over the long run, we remain positive on the market and firmly believe patient investors will be rewarded.

[2] We calculated the estimated return using the slope-intercept equation of a line (y = mx + b). The slope and intercept are derived from a linear regression of the forward P/E ratio against the subsequent 10-year annualized total return from 1/1/1995 through 7/1/2012. The 10-year period beginning 7/1/2012 covers the return from 7/1/2012 to 6/30/2022.
[3] The estimated return is a forward-looking statement based on assumptions we believe are reasonable and not a guarantee of future performance. Actual results may differ materially from the estimate.

Figure 2. 10-year annualized total returns, on a rolling monthly basis, beginning in December 1994. The forward P/E ratio represents the price at the start of the period divided by the next twelve months earnings per share estimates.

The views expressed are through the period ending June 2022 and are subject to change at any time based on market or other conditions. This material does not constitute a recommendation of any particular investment strategy or product. Although the information included is compiled from sources believed to be reliable, its accuracy cannot be guaranteed, and Vinity nor its affiliates assume liability for loss due to reliance on this material and/or such views expressed herein.

Past performance is not indicative of future results. Indexes are unmanaged and you cannot invest directly in the index.

Diversification does not guarantee a profit or protect against loss.

S&P 500: Measures the performance of U.S. large-cap equities and is comprised of 500 companies across sectors and covers approximately 80% of available market capitalization. **IA SBBI US Large Stock Index:** Measures the performance of U.S. large capitalization stocks. **IA SBBI US IT Govt Index:** Measures the performance of Treasury and Agency securities issued by the U.S. Government with 3 to 10 years in maturity. **Bloomberg US Aggregate Bond Index:** Measures the performance of the investment grade, US dollar-denominated, fixed-rate taxable bond market and includes Treasuries, government-related and corporate securities, fixed-rate agency MBS, ABS, and CMBS (agency and non-agency).

Sources: Callan, Factset, Federal Reserve Bank of St. Louis, Ibbotson SBBI, Reuters, WisdomTree, YCharts.

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