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VINITY

Michael Friedman, CFA | Chief Investment Officer

In a Nutshell

Out of the gate, this year has been full of challenges, attributable to a complete disregard for valuations and setting up a particularly dangerous wealth-destroying hat trick. The jokers hiding behind internet message boards pledged "to the moon," and in the end, far surpassed expectations. Valuations for stocks, bonds, and housing were sitting on Mars to start the year. Stocks and bonds subsequently fell to Earth, and while housing moves slower, it is not far behind. The past three years have been overwhelmingly smoke and mirrors. A seemingly endless supply of federal aid propped up consumers and securities markets, averting a disaster akin to the Great Depression. This aid was not a symbolic bonus to consumers, the federal government had to borrow trillions of dollars, significantly expanding the outstanding debt, and the Federal Reserve had to create trillions of dollars, causing the highest inflation in 40 years. Once the remaining aid runs out, we will return to the same slow-growth posture just before the pandemic, except now with the added problem of out-of-control inflation. The dynamic has backed the Fed into a corner where they must implement restrictive policy measures in the wake of a slowing economy, resulting in elevated stock and bond volatility all year as the market continues to search for a direction. We believe most of the downside is behind us, although we are not likely out of the woods yet. And we expect the market to continue the nonsensical flailing around that has become a staple on big news days. Regardless, the market has made substantial progress on valuations which are finally approaching normalized levels. There is a meaningful relationship between starting valuations and long-term performance, making today a much better entry point than much of the past two years.

How Did We Even Get Here

The ride this year has been anything but smooth. Through the first three quarters, the S&P 500 is down -23.9% and bonds have been no help, with the Bloomberg US Aggregate Bond Index down -14.6%. Bonds have wreaked havoc on multi-asset portfolios, turning in underperformance of historic proportions. Bonds are supposed to serve as a source of safety in the wake of heightened stock volatility and economic uncertainty. This year they have only added further insult to injury. For perspective, during the first three quarters of 2001, stocks fell -20.4% while bonds gained 8.4%. And for the first three quarters in 2008, stocks fell -19.3% while bonds gained 0.6%. Concurrent double-digit negative performance for stocks and bonds is uncommon but not unexpected, given the unique circumstances of the current environment. It all boils down to the 0% interest rate policy and the need for rapidly higher rates to cool inflation. The price of a bond falls as interest rates rise. So, the blistering pace of rate hikes explains the worst performance on record for bonds. Typically, the Fed implements tighter monetary policy through higher interest rates to slow economic activity and keep a strong economy from overheating. And the Fed will cut rates in a weak economy to stimulate economic activity. Bonds held their own during 2001 and 2008 because the Fed lowered interest rates as the economy slowed. The Fed is currently implementing tighter policy in the wake of slowing economic growth, a peculiar situation, but fits the bill, as nearly everything today is unusual.

First, we need to figure out how we got here. By the end of 2019, economic growth was slow, inflation was low, and the Fed was poised to maintain its lower-interest-rates policy for longer. Over the ten years ending in 2019, inflation averaged 1.8%, real GDP growth averaged 2.3%, real wage growth averaged 0.6%, and the S&P 500 generated a 13.6% annualized total return. The outlook was mediocre at best, but low-interest rates kept a lid on bonds and left no compelling alternative to stocks. Impressive stock performance on the back of slow economic growth gave rise to the catchphrase "cautiously optimistic," to which we subscribed. Stocks remained overvalued, but low-interest rates continued to tilt sentiment toward stocks.

Little did we know it would take a global pandemic to jumpstart the economy and send the stock market soaring to new highs. The S&P 500 delivered an annualized total return of 23.4% over the two years ending in 2021. The Twenties were beginning to roar. Compared to the beginning of 2020, median family incomes were up 7%, home prices were up 32%, and a $100,000 investment in an ETF that tracked the S&P 500 was worth more than $150,000. The unemployment rate was below 4%, credit card debt was down, and from March 2020 to August 2021, consumers amassed $2 trillion in excess savings. By the end of 2021, household net worth surged nearly 30% above the level at the beginning of 2020. The period from March 2020 to March 2021 set a record for one-year growth in net worth based on data going back to 1949. As an added sweetener, consumers were told to ignore the rapidly rising inflation rate and were assured through much of 2021 that price increases would be transitory.

The future looked bright. Or at least that is the narrative many officials and talking heads tried to sell you. However, it was not real; the perceived opulence was all manufactured solutions in response to the economic fallout from a once-in-a-century global pandemic. Absent intervention from the federal government, we would have been talking about an economic collapse of a similar magnitude to the Great Depression. The extraordinary measures taken by the government and central bank intended to serve as a bandage, not to provide long-lasting prosperity. Although it may have been fun to receive checks from the government and borrow money at unprecedently low-interest rates, there is a collective cost to all the actions. There is "no free lunch," and this time is no exception. The government intervention avoided a depression, put cash in consumers' pockets, and encouraged lending at favorable rates, all amid great uncertainty. But the cost of that "lunch" will be rather expensive.

From support for small businesses, stimulus payments, and enhanced unemployment benefits; to public health spending and aid to state and local governments, the total cost of legislation enacted in response to the pandemic is over $5 trillion. And since the beginning of 2020, the federal government has borrowed $7.4 trillion, increasing the total debt outstanding by 30%, in large part to support the various relief programs. Since this probably appears like Monopoly Money, we will add some perspective. The total additional spending in response to the pandemic by all countries across the globe is $10.8 trillion, so the U.S. accounts for almost 50% of the total spent worldwide. For comparison, U.S. GDP accounts for 24% of the global GDP.

But wait, there is more. In addition to the legislative programs, the Fed enacted massive quantitative easing measures, a policy tool that involves purchasing government securities, thereby increasing the money supply. The initial goal in March 2020 was to ensure the smooth functioning of credit markets before shifting to supporting the economy and finally stimulating the economy. By the end of the

program in March 2022, asset purchases totaled a historic $4.6 trillion. Along with the asset purchases, the Fed slashed the Fed Funds rate to 0% and eliminated the reserve requirement for commercial banks. In total, the actions increased the money supply by more than $6 trillion, a 40% increase to the money supply since February 2020. It does not take a rocket scientist to figure out that an additional $6 trillion chasing the same, or in many cases, a smaller supply of goods and services, will result in exceptional inflation.

The cost of the "lunch" is the highest inflation rate since 1981. The price level for the average basket of goods and services consumers buy is up 14.4% from January 2020 through June 2022. Over the same time, average hourly earnings are up 13.2%. So, on an inflation-adjusted basis, average hourly earnings are lower than at the start of 2020. As one would expect, consumers have begun to draw down on the $2 trillion in excess savings accumulated. Since August 2021, consumers have drawn down about $1 trillion in excess savings. The real GDP growth rate has started to slow, and the Congressional Budget Office projects real GDP growth will average between 1.5% and 1.7% per year from 2024 through 2032. Considering the 50-year annual average real GDP growth is 2.8% and growth averaged 2.3% per year over the prior decade, the outlook is less than bright.

The unthinkable level of support from the federal government and central bank masked the underlying fundamental state of the economy. I have been steadfast in my concern for nearly two years that the market is oblivious and the perceived strength of the economy is all smoke and mirrors. We are not going to be better off as a result of a global pandemic. Once the remaining funds accumulated by consumers are exhausted, we will be in a more challenging economic environment than just before the pandemic. The cost of goods and services is higher, borrowing costs are higher, wages are not keeping pace with inflation, and economic growth looks to slow.

Toothpicks and Marshmallows

In the depths of the pandemic, stocks began to soar. A common explanation was that stocks are forward-looking, and the market anticipated sunshine and rainbows once the economy reopened. If stocks are forward-looking, one would expect that to work both ways. By the fourth quarter of 2021, the stock market was on thin ice as the economic outlook worsened. Assuming the forward-looking narrative holds, stocks should have pulled back in anticipation of a weaker economy. Instead, the S&P 500 surged to record highs and finished 2021 at 4,766. Well, the expectation for the year ahead must be lower then. Wrong again. At the start of 2022, the average Wall Street estimate for the S&P 500's year-end price target was 4,950. The forward-looking narrative sounds nice, but unfortunately, the market is not that efficient, is far too irrational, and is reactionary by nature. The stock market soared to record highs in the depth of the pandemic because the government direct-deposited $800 billion into consumers' bank accounts, and the stock market was the only thing open. The gains over the past two years are essentially sitting on a foundation consisting of toothpicks and marshmallows.

The market has finally begun to price-in reality, the S&P 500 is off more than 20% through the end of the third quarter, giving back the entire gain from 2021. More important is where we go from here. The setup is complicated as the economy endures the highest inflation in over 40 years. The Fed has embarked on the fastest rate hike cycle since they began targeting the Fed Funds rate in 1982 to curb rising prices. The tighter monetary policy will slow the economy and reduce asset prices in order to

stamp out inflation. At this point, a recession next year is inevitable. The New York Fed's recession indicator, which calculates the probability based on the yield curve, places a 23% chance of a recession in twelve months. Since 1960, when the measure is above 20%, the economy has experienced a recession about 70% of the time. And the most recent model from Bloomberg Economics projects a 100% probability of a recession within the next 12 months.

The S&P 500 is already in a bear market, down 20% from the most recent high. During ten of the thirteen bear markets since 1929, a recession has occurred alongside, with bear markets lasting on average 20 months and falling -41%. Over the same period, the average duration of recessions that coincide with bear markets is 15 months. In the post-war period, bear markets averaged 16 months and fell -35%, while recessions averaged 11 months. The current bear market is in its ninth month, with the S&P 500's price level -25.3% off the high at the end of September.

The post-war average -35% drop from the most recent high sounds reasonable, placing the S&P 500 around the 3,100 level. From a top-down fundamental perspective, assuming earnings fall 5% next year to $212 per share and we apply a 15 P/E multiple, we arrive at a back-of-the-envelope 3,200 price level for the index. When the S&P 500 closed at 3,973 at the end of March 2021, I said in my second-quarter 2021 letter we thought the fair value was in the 3,300 range. And I went on to caution: *"The S&P 500 will cross through fair value at some point; how dramatic that point will be is based on where we go from here, since ignoring reality and continuing higher will only result in more future pain."*

The market has been operating on borrowed time for quite a while, and the price declines this year should not be a surprise. Comparing price changes to the nearly 4,800 price level at the beginning of this year lacks usefulness. It is probably about as helpful as drawing a number out of a hat and comparing performance to that number. The price action in 2020 was nonsense, and the price action in 2021 was reckless. The pre-pandemic high of 3,386 is a better reference point, as I cannot provide a practical explanation for why the S&P 500 ever traded above that level.

On a positive note, the S&P 500 finished the third quarter conceivably closer to the bottom than the top. The market has made substantial progress toward normalized valuations, making today a better entry point than most of the past two years. The next piece of the puzzle is figuring out the appropriate level of earnings given the softening economic backdrop. A recession next year is inevitable, although the severity is still up-in-the-air. We hope to see a clearer picture of where consumers truly stand once the holiday season wraps up. After adjusting for inflation, spending continues to outpace income, financed by savings and credit cards. The personal savings rate retreated to 3.3% at the end of September, the lowest level on record outside of the spirited period from 2005 to 2007 when the rate dropped below 3%. Consumers are increasingly turning to credit cards with balances up 23% from the April 2021 low, which now matches the total outstanding in December 2019. If inflation falls precipitously over the coming months and income growth outpaces spending, a mild slowdown is still in the cards. In any case, the progress on the valuation front is encouraging and one less item to keep us up at night. Whether or not we get a better entry point than at the end of the third quarter is up for debate, but history is clear, investors with patience are often rewarded.

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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. **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: Bloomberg, Board of Governors of the Federal Reserve System, Brookings Institution, Business Insider, Congressional Budget Office, Factset, Federal Reserve Bank of St. Louis, International Monetary Fund, J.P. Morgan Asset Management, National Bureau of Economic Research, Peter G. Peterson Foundation, The Wall Street Journal, YCharts.

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