Q1
2023

VINITY

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In a Nutshell

Last year was full of challenges, to say the least. Typical stock and bond portfolio mixes were fruitless as stocks did not work and bonds did not work, leaving investors frustrated and asset allocators with the task of picking up the pieces. US large-cap stocks are still expensive, although opportunities elsewhere show promise. US small caps, international developed, and emerging markets are all trading at attractive valuations on an absolute basis and relative to US large caps. Over the long run, we believe patient investors in those asset classes will receive validation. However, the near-term economic risks remain at the forefront, even though Wall Street is desperately trying to brush any hint of weakness under the rug. We cannot ignore the deteriorating financial position of consumers. Income is not keeping pace with inflation, the reliance on credit cards to make ends meet is at an all-time high, and the personal savings rate stands at a historical low, outside of the period just before the Financial Crisis. We believe the US economy will experience a recession this year, with the severity still up for debate. And the Treasury yield curve is currently inverted, a reliable recession indicator. Over the past 40 years, when the yield curve inverts, a recession has followed, typically within 12 months. At the end of December, we implemented portfolio changes to further our defensive positioning, reflecting our view of worsening economic conditions. We added more exposure to value stocks and introduced a strategy within the alternatives bucket to take advantage of sideways-moving markets and provide less downside exposure. We believe these moves will further enhance the ability of our portfolios to weather a potential storm, intending to provide a balance between downside protection and upside participation.

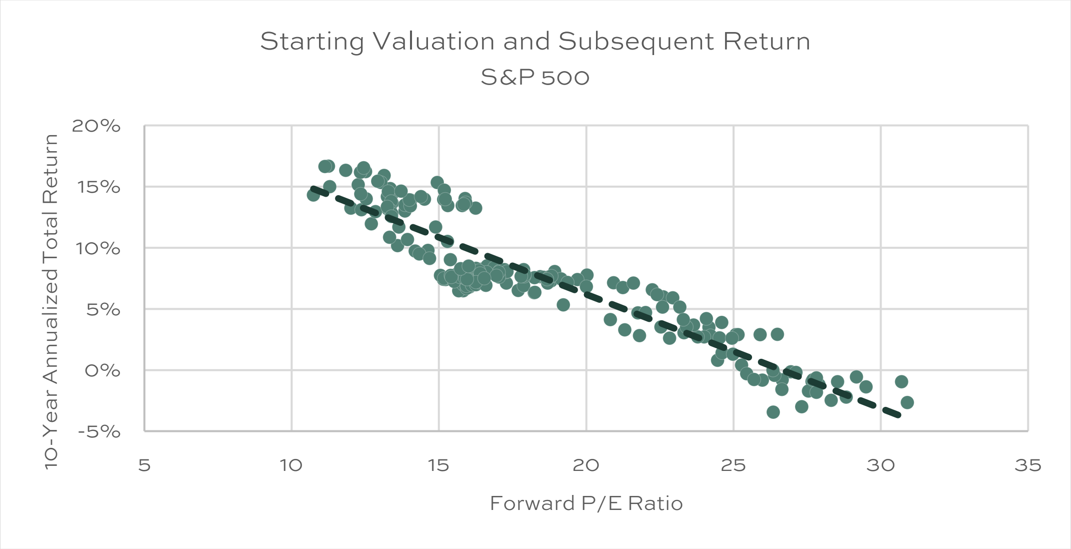
Seizing Opportunity Overseas

Last year marks the worst calendar year performance for the S&P 500 since 2008, falling 19.4%, while the Bloomberg US Aggregate Bond Index fell 13.0%, marking the worst year since its inception in 1976. The workhorse 60% stocks and 40% bonds portfolio turned in its worst calendar year since 2008 and the only year since at least 1976 where stocks and bonds delivered simultaneous negative returns. The backdrop is challenging, but the future is intriguing, depending on your time horizon and where you look.

Valuations for US large-cap stocks have come down from extremely overvalued at the beginning of 2022 to just overvalued by the end of the year. Starting valuation is arguably the best indicator of future returns. The historical relationship between starting valuation and subsequent 10-year total return for US large caps is too significant to ignore. The lower the starting forward P/E ratio, the higher the return over the following 10-year period. Based on data from 1997 through 2022, a forward P/E ratio below 15 has typically shown double-digit annualized total returns over the ensuing ten years. While a forward P/E ratio above 20 implies mid-to-low single-digit results over the following ten years. Since January 2020, the average forward P/E multiple for the S&P 500 was 20.7, and the valuation multiple ended 2022 at 17.4.

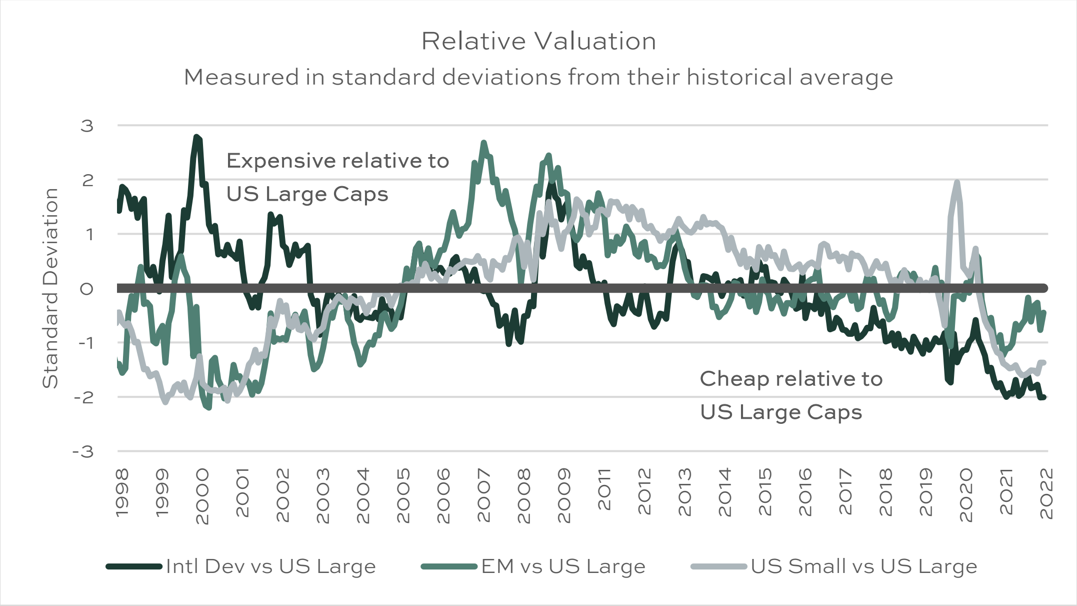
The focus is on earnings now, and we believe expectations are too high. Earnings are the denominator in the P/E ratio calculation, so dividing by a smaller number produces a higher P/E ratio. Earnings estimates will likely be revised lower, making stocks more expensive with no change in price. Assuming earnings decline 5% or 10% in 2023, the forward P/E ratio based on the S&P 500 price level at the end of 2022 is 18.5 and 19.5, respectively. If the S&P 500 heads higher while earnings decline, the forward multiple will swiftly advance to historically unattractive levels and increase the probability of a subpar decade for US large-cap stocks. As such, we will look elsewhere.

Figure 1.



Outside of US large caps, the prospects are much brighter. US small caps, international developed and emerging markets are all cheap compared to their long-run average valuation multiple and trading at bargain prices relative to US large-cap stocks. I have repeatedly talked about the attractiveness of international developed and emerging markets, although flying under the radar is the allure of US small caps. The group is trading at 13.7 times forward earnings, a 27% discount to its 20-year average valuation multiple, and about 1.5 standard deviations below its historical average relative valuation to US large-cap stocks.

Figure 2.



Opportunities like this do not come around often. The setup for assets sans the treasured US large caps has not been this appealing in 20 years. As asset allocators with a long-term time horizon, the above chart might as well be a Picasso. We have a high conviction in US small caps, international-developed, and emerging markets over the long run. However, looming economic challenges may present near-term headwinds for the asset classes. US small caps and emerging markets are more sensitive to the business cycle by nature; when growth slows, they often receive greater punishment than large companies and those in developed markets. Although, we believe the cheapness of the asset classes will mitigate potential downside to a certain extent. We are overweight in all three asset classes in our portfolios and view any pullback as a buying opportunity.

"Everything Is Awesome" – Mr. Market, January 2023

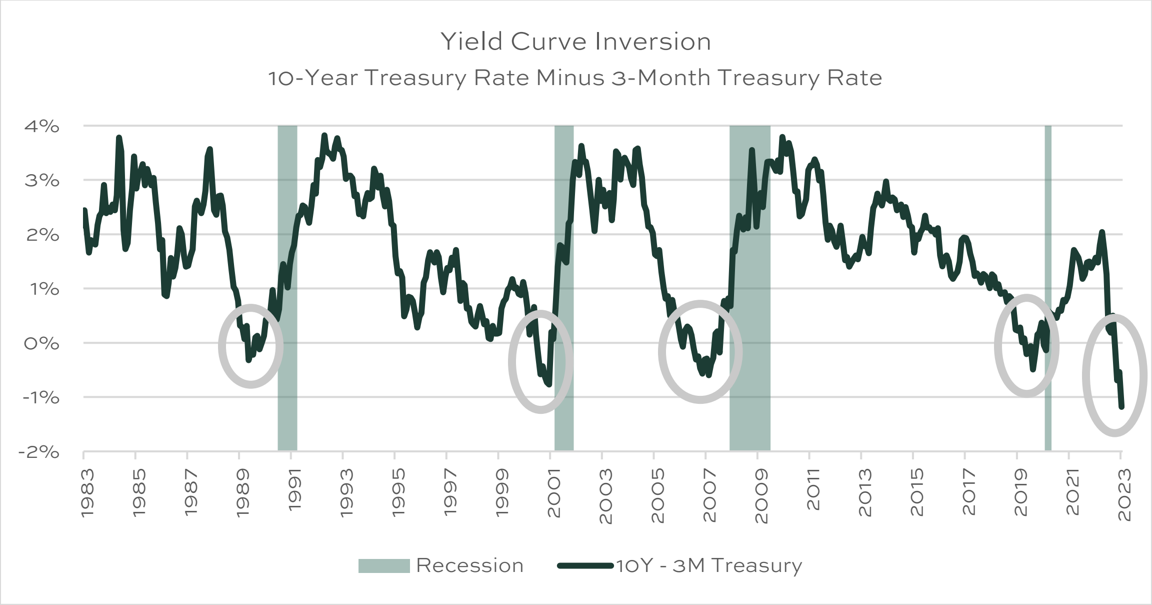
The most consequential unanswered question is whether the economy will dip into a recession and, if so, the severity of the economic decline. The path forward will be determined solely on this basis. We already know inflation is declining, and the market is finally coming to terms with the Fed Funds rate remaining at 5% for most of the year. The nearly 20% decline last year for the S&P 500 is attributable to the market repricing in response to higher interest rates. The risk for 2023 is the prospect of declining earnings in the wake of economic weakness. And the market is currently priced for unicorns and rainbows, which is a distant reality.

The story on the ground is concerning. Personal income adjusted for inflation has experienced a year-over-year decline for the past 16 months. Credit card debt is up 15% year over year. And the personal savings rate is alarmingly low at 2.9%. Savings had been trending higher over the past decade, averaging 7.2%, and finished 2019 at 8.7%. Consumers' income is not keeping pace with the rising cost of the goods and services they consume. As such, the savings rate has precipitously declined as consumers tap into the cash stocked away over the past three years to keep up with the cost of living. Filling the void is the rapid advance in credit card balances coming off a four-year low and ending 2022 at an all-time high. Higher balances are just one side of the equation. Credit card interest rates are considerably higher and stand at 20.4% at the end of 2022 compared to the 14.1% average from 2010 through 2019. The adjustment to higher credit card balances and higher interest rates means less spending on goods and services.

Naturally, the 2023 consensus S&P 500 earnings growth estimate was nearly 5% to begin the year, and the S&P 500 average Wall Street price target was 4,140, 8% higher than where the index finished in 2022. Marrying this “everything is awesome” attitude on Wall Street with the evident decline in the economic backdrop is puzzling, making me think once you pass through the gates on Wall Street, you must check reality into a locker before entering the park. Step aside, Disney World; Wall Street is clearly “the most magical place on earth.”

Although the decline in individual economic indicators suggests caution ahead, the best gauge of a recession is the slope of the Treasury yield curve. Historically, when the yield curve inverts, meaning longer-term rates are lower than shorter-term rates, a recession follows. Investors buy long-dated Treasury bonds when they expect near-term economic pain. The increased demand at the long end of the curve causes the yield on longer-maturity bonds to fall below that of shorter-maturity bonds. Investors are motivated to lock in the yield for a longer period in anticipation that the Fed will cut short-term interest rates to stimulate the economy in the wake of a recession. In particular, the spread between the 10-year Treasury rate and the 3-month Treasury rate reliably predicted a recession each time over the past 40 years when the relationship turned negative. The warning signal occurred on average 12 months before the economy dipped into a recession. The spread first inverted in October of last year and presently stands at the most inverted level in at least the past 40 years. Based on this trend, a recession should occur between June 2023 and March 2024.

Figure 3.



We maintain that a recession is the most likely outcome this year, although the severity is certainly up for debate. As such, we implemented changes to our multi-asset portfolios at the end of December, reflecting the outlook for a worsening economic backdrop and a higher-for-longer interest rate policy. Our view is expressed through additional funds to increase exposure to value stocks funded by a reduction in growth, along with the addition of a derivative income strategy within the alternatives bucket. We added two value-focused funds, one in the US and the other in emerging markets, bolstering our defensive posture and providing more diversified exposure to the value segment. The derivative income strategy includes a portfolio of high dividend-paying stocks combined with an options overlay strategy that sells call options to generate additional income. The strategy serves the purpose of providing income through dividends and options premiums should the market move sideways, while the defensive orientation of the underlying portfolio, combined with the income received, should serve as a buffer if the market experiences further downside.

We believe these moves will further bolster our portfolios to weather a potential storm, intending to strike a balance between downside protection and upside participation. The gain required to recover from a loss becomes exponentially greater the further the decline. To break even after a 30% drop requires a 43% gain, while a 50% loss requires a 100% gain to get back to even. The sky is the limit for capital appreciation, but you can only lose 100% of your money. With this in mind, we are willing to forgo taking part in a low-quality stock rally to emphasize downside protection during turbulent times instead.

Figure 1. 10-year annualized total returns, on a rolling monthly basis, beginning in February 1997. The forward P/E ratio represents the price at the start of the period divided by the next twelve months' earnings per share estimates. **Figure 2.** International Developed (Intl Dev) represented by the MSCI EAFE Index, Emerging Markets (EM) represented by the MSCI Emerging Markets Index, US Small Caps (US Small) represented by the S&P SmallCap 600, and US Large Caps (US Large) represented by the S&P 500. Relative Valuation (RV) is calculated monthly for each asset class versus US Large. RV equals the reference index forward P/E ratio divided by the S&P 500 forward P/E ratio. The dataset is standardized so the values plotted on the chart represent deviations from the mean [RV Deviation = (RV - Average RV) / Standard Deviation of RV].

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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.

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). **MSCI EAFE Index:** Measures the performance of large- and mid-cap equities across 21 developed markets countries, excluding the U.S. and Canada, and covers approximately 85% of the free float-adjusted market capitalization in each country. **MSCI Emerging Markets Index:** Measures the performance of large- and mid-cap equities across 26 emerging markets countries and covers approximately 85% of the free float-adjusted market capitalization in each country. **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. **S&P SmallCap 600:** Measures the performance of U.S. small-cap equities and is comprised of 600 companies across sectors.

Sources: CNBC, Factset, Federal Reserve Bank of St. Louis, Ibbotson SBBI, J.P. Morgan Asset Management, National Bureau of Economic Research, WisdomTree, YCharts.

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