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In a Nutshell

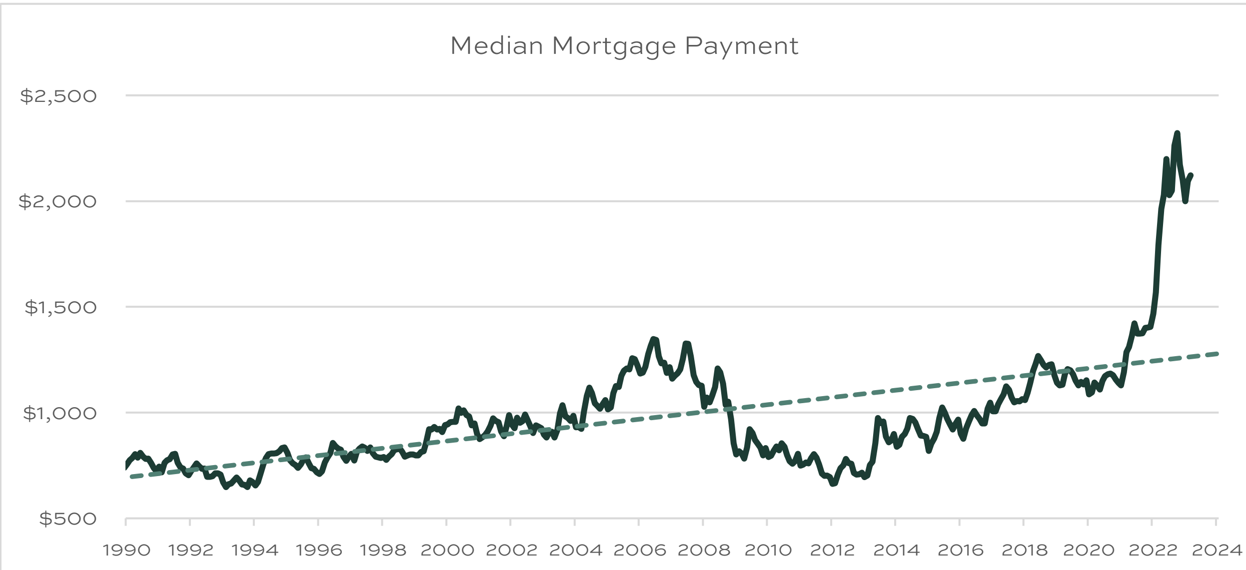
Prices have been rising briskly since 2020, and although inflation is cooling, prices are still going up. It is increasingly prohibitive to finance large purchases as higher interest rates have supersized monthly payments. The median mortgage payment has increased by 86% since the start of 2020, and the monthly payment for a five-year used car loan has risen by 50%. Meanwhile, average hourly earnings, when adjusted for inflation, are flat. This is not sustainable, and people will eventually run out of money. The tailwinds propping up consumers and sending the market higher are subsiding. Consumers are saving less and relying more on credit cards, a trend that can only persist for so long. Based on the 7% return for the S&P 500 during the first quarter, it appears business as usual despite the biggest bank failure since the Financial Crisis and the continued deterioration of the economic backdrop. However, the performance is attributable to five large-cap growth stocks, which account for 73% of the S&P 500's performance over the first three months. Those five stocks had an average return of 56%, while the bottom 495 had an average return of just 2%. To start the year, small caps and value stocks were some of our top picks based on attractive valuations and were among the top performers in the market before the regional bank conundrum. Regional banks are smaller companies typically classified in the value segment. Investors did not waste time contemplating and instead systemically punished the whole group while rewarding large-cap growth stocks. For the adored big tech stocks, valuations may never matter. However, the rest of the market is subject to a different standard, and we believe valuations are still meaningful in the long run. Small caps and value stocks remain attractive long-run opportunities, although our thesis may require more patience than initially anticipated.

Running On Empty

Since the start of 2020, overall price levels have increased by 17.5%. While there has been a slowdown in inflation, prices are still climbing, albeit at a slower pace. A declining inflation rate is welcome but does not address current price levels for goods and services. And when you factor in higher interest rates, the results are shocking. For example, since January 2020, the median mortgage payment has increased by 86%, the median rent payment by 45%, and the monthly payment on a five-year used car loan by 50%. In contrast, average hourly earnings after adjusting for inflation have risen only 0.1%. At the current pace, people will eventually run out of money.

Prices for goods and services have increased rapidly, and with higher borrowing costs, affordability is quickly declining. Consumers are managing to slide by up to this point, but the underlying source of funds does not instill confidence. During the good old days from March 2020 to August 2021, when it felt like you were living inside a cash grab machine, consumers stockpiled $2.1 trillion in excess savings. Since August 2021, consumers have spent $1.4 trillion from their savings, leaving one-third of the peak remaining. Over the same period, credit card balances are up 27%, and the average interest rate charged on balances is now 21%, the highest on record and well above the historical average of 14.5%. Mortgage rates doubled in the first nine months of 2022 and spent two weeks in the fourth quarter above 7%, a level not seen in more than 20 years. Home prices and mortgage rates, taken separately, do not tell the complete story. Most homebuyers finance their purchase, so the intersection between prices and rates, measured by the mortgage payment, is the gauge to watch. As mortgage rates fall, you can afford a higher-priced home for the same mortgage payment, while the opposite is true when rates rise. For example, the mortgage payment is the same on a $300,000 home at 4% and a $350,000 home at 2.75%. A typical home buyer is truly purchasing a mortgage payment, not buying a home, meaning the actual home price is of little significance. So this explains why home prices rose rapidly during 2020 and 2021 without much pushback, as the monthly cost for buyers was unchanged. However, with elevated prices and mortgage rates near 20-year highs, affordability is supremely stretched today.

Figure 1.



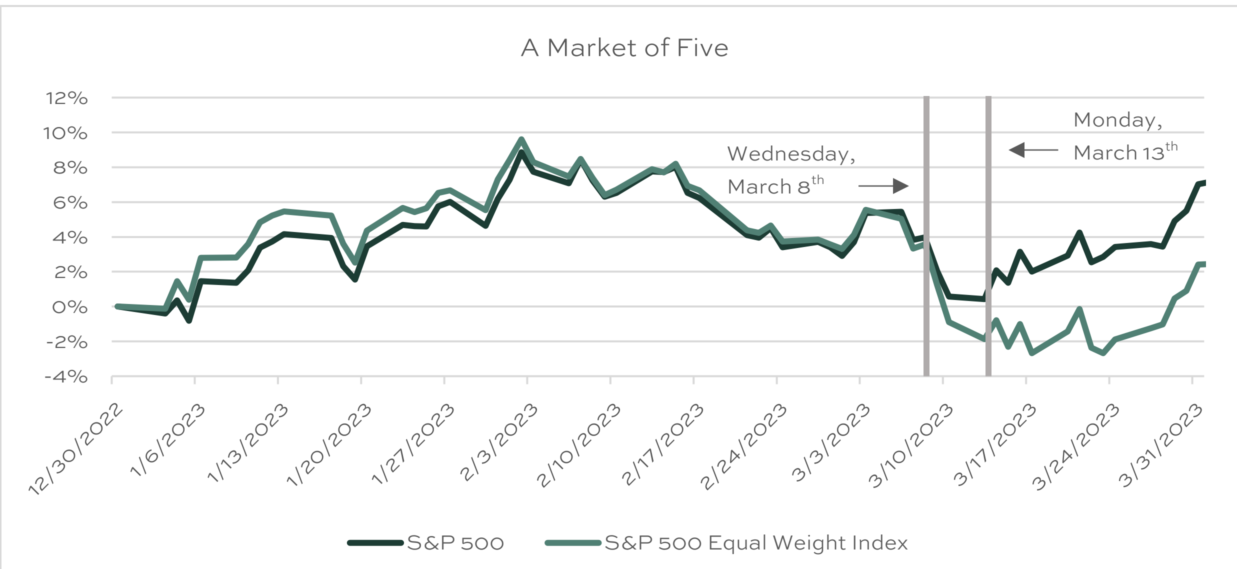
The dashed line in Figure 1. is the median mortgage payment trend growth since 1990. The current deviation from the trend is almost double the size experienced at the housing bubble peak in 2006. The median mortgage payment must decrease by 40% to align with the historical trend growth, involving some combination of a decline in home prices and mortgage rates. The magnitude of the current trend deviation has a 1 in 5,000 chance of occurring, so it is not surprising that something must give. Housing is not the only cost out of control, but housing encompasses the largest share of spending and is the second largest source of consumer wealth behind retirement accounts. So changes in home prices tend to have a meaningful impact on consumers' behavior and finances. But everything from groceries to travel and leisure has seen rapid price increases since January 2020, while inflation-adjusted earnings are yet to budge. To manage the current situation, consumers will depend more on credit cards and savings or reduce their discretionary spending. In either case, the outcome is a slowdown in economic activity and likely a recession within the next twelve months.

When Bad News is Good News

In March, we found ourselves caught offsides as the biggest bank failure since the Financial Crisis halted all the momentum for value stocks and lit a fire under growth stocks. The reversal happened so fast that if you blinked, you missed it. On March 8, Silicon Valley Bank announced plans to shore up its balance sheet, investors and depositors panicked on March 9, and by Friday, March 10, the FDIC deemed the bank insolvent and took control. Over the weekend, the government announced programs to backstop the banking system, and on Monday morning, the value stock run was over. Large-cap growth stocks are back in vogue.

The first quarter is characterized by two markets: the top five and the rest. Over the first quarter, the top five return contributors in the S&P 500 generated an average return of 56%. By quarter-end, the group accounted for just over 18% of the index but represented 73% of the index's return. In contrast, the bottom 495 produced an average 2% return. Comparing the S&P 500 Equal Weight Index to the S&P 500 reveals the tale of two markets. The traditional S&P 500 weights constituents according to market capitalization. The larger the company, the greater the weight. The S&P 500 Equal Weight Index assigns an equal weighting to all holdings, with each representing 0.2% of the index. Both indexes performed similarly through March 8, before the bank collapse caused their paths to diverge significantly. The S&P 500 finished the quarter up 7%, while the S&P 500 Equal Weight Index ended with a 2.4% gain, leading to a much different experience for investors outside the top five constituents. When the market cap version of the index outperforms the equal weight version, larger companies have fared better than their smaller counterparts, as the traditional S&P 500 assigns greater weight to larger companies.

Figure 2.



To start the year, we positioned portfolios for continued uncertainty leaning further into undervalued asset classes like small-caps, mid-caps, and value stocks. Small-caps and mid-caps represented half the U.S. equity exposure in our portfolios, while the exposure to U.S. value stocks was 75%. We felt comfortable with our positioning to begin the year, intending to protect against further downside by investing in asset classes with the cheapest valuations. Stocks trading at lower valuations should fall less in a declining market as either the stock price is already depressed or the earnings potential is not yet fully realized by the market. Small-caps and mid-caps were trading at a discount relative to large caps, and value stocks were trading at a discount relative to growth stocks, providing an adequate margin of safety should the market experience further downside pressure. Amid growing uncertainty, we took a more conservative posture, not expecting to lap the market but rather to protect on the downside while participating on the upside. With our portfolio positioning, a regional bank failure is probably the only event that could occur in which neither goal is met.

Regional banks are small-cap and mid-cap companies typically classified within the value investing style. And the financial services sector represents nearly 20% of the small-cap and mid-cap value universe. As a result, we found ourselves in the middle of a crisis that no one saw coming. Most people had not heard of Silicon Valley Bank before the collapse. Even the analysts covering the stock had no clue the bank was on thin ice just looking at their price target estimates. At the beginning of March, just before the SVB collapse, the stock was trading at $280 per share, and the average price target based on 20 analyst estimates was $300, with a high estimate of $500 and a low estimate of $190.

As investors in the small-cap and mid-cap value asset classes, it is frustrating that the mismanagement of a regional bank resulted in an extraordinary shift in investor sentiment for these favorably priced asset classes. The dramatic fashion in which the SVB collapse unfolded, culminating in the largest and fastest bank run in American history, certainly exacerbated the market's response. It surely did not help that the SVB failure coincided with the 15th anniversary of the Bear Stearns collapse, the first financial institution to fall during the 2008 Financial Crisis.

While the sight of a bank collapse may stoke fears from 2008, the current situation could not be more different. Loose lending standards led some banks to make bad loans in the years leading up to 2008, like issuing a mortgage for more than a house is worth and not verifying income. Lenders with a high concentration of these loans had a problem when everyone defaulted at once, as they now possess an asset worth much less than the loan amount. Today the issue is not related to loans, as lending standards are much higher. The problem is with the bucket of money not loaned out but still needs to earn interest so banks can pay depositors and fund operations. Banks purchase Treasury bonds and government-related securities with these funds. Some banks purchased the wrong maturities of these instruments, for instance, buying a 10-year Treasury Note instead of a 1-year Treasury Bill. If you are a bank, you should know better. But this is not a credit-related issue like in 2008 and appears isolated to regional banks with unique deposit bases.

Regardless of individual circumstances, the market often paints with a broad stroke. The S&P Regional Banks Select Industry Index fell 21% over three trading days as the SVB saga played out. The action across the regional banks has been swift, changing the market dynamic. The value investing style had gained traction after being ignored for over a decade, and the whole thing came crashing down with the SVB collapse. Now, anything that looks like a bank or anyone that steps foot in a bank is out of favor, which generally encompasses the entire value segment. So, the growth trade is back on, and investor preference for safety is the big-five growth stocks.

Now to the elephant in the room. Do valuations matter?

Perhaps.

I have spent the past two years steadfastly explaining why valuations matter. Academic research and historical data show that selecting investments with lower valuations often results in higher future returns. In late 2022, small caps were cheap and trading at a discount relative to large caps. Small caps typically trade at a premium, so the asset class was compelling trading at a two standard deviation discount to large caps. The thesis worked brilliantly through February, as small caps outperformed large caps to the tune of 4.5%. However, the banking crisis in March refuted our theory, as large caps outmaneuvered small caps by 9% during the month. As a result, small caps ended the first quarter with only a 2% gain, while large caps finished the quarter up 7%. At the beginning of the year, large caps had rich valuations and are now even more expensive. Small caps were cheap to start the year and remain so. Certainly not the expected outcome, but the market is a voting mechanism, and the verdict is different standards apply to various groups of stocks. Investors are consistently willing to pay whatever the price for big tech while scrutinizing valuations for the remainder of the market. In the eyes of today's market participants, big tech can do no wrong. The market has decided these high cash flow generating asset-light companies with the ability to pivot on a dime are exempt from traditional valuation methods.

We continue to believe that valuations matter for the rest of the market. Although it is painful to watch undervalued assets continue falling in value, we are confident our thesis will receive validation in the long run. Investing in assets with lower valuations often results in better outcomes, but mean reversion can take five to ten years, not just three months or one year. As long-term investors, we will accept being early to the party, even if it means unfavorable short-term results. We still see ample opportunity in small caps and value stocks and believe that exercising patience during challenging times will be compensated in the future.

Figure 1. The median mortgage payment is calculated using the existing single-family home median sales price assuming a 10% down payment and the average 30-year fixed rate mortgage from the Freddie Mac Primary Mortgage Market Survey.

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 500 Equal Weight Index:** The equal-weight version of the S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 Equal Weight Index is allocated a fixed weight or 0.2% of the index total at each quarterly rebalance. **S&P Regional Banks Select Industry Index:** Comprises stocks in the S&P Total Market Index that are classified in the GICS regional banks sub-industry.

Sources: Axios, Cox Automotive, Federal Reserve Bank of St. Louis, Reuters, WisdomTree, YCharts.