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How Low Will It Go?

Since peaking in the first week of January, the S&P 500 has declined 18%. There are numerous factors that have played into the decline, including excessive valuations in many of the big growth stocks as well speculative so-called "meme stocks" and other very risky assets like the various digital coins. The resurgence in Covid infections in China has also played a big part as government lockdowns have depressed consumer demand there as well as created new and worse supply bottlenecks. But the central and most important factor in the decline in stock prices has been the surge in inflation. Inflation is the prime factor because it is the reason the Federal Reserve and other central banks are raising interest rates and tightening monetary policy in other ways. Corporate sales and earnings are still growing at a good pace now, but the markets are considering the possibility that tighter monetary policy will cause a recession and a decline in earnings sometime down the road—perhaps in 2023. The stock market is a discounting mechanism that tells us about the next step ahead in the future. Hence, the current decline in stock prices is consistent with a future recession. To make a judgement about the coming performance of stock prices, we must look two steps ahead in the future. This is problematic to say the least. All eyes are on the Fed and its goal to get inflation back down to 2%. To the extent that inflation starts to come down, the markets will start to anticipate an end to tight monetary conditions and prices will rally.

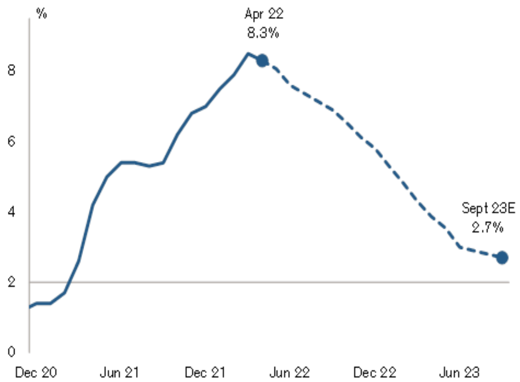
Summary Points

1. Inflation and the Federal Reserve's determination to reduce it via tighter monetary policy is the primary factor weighing on stock prices.
2. There is substantial uncertainty regarding the timing, but we are confident that the Fed will succeed in reducing inflation.
3. Economic growth is expected to slow and the current downturn in stock prices is already discounting the possibility of a recession in 2023.
4. Stock prices in the months and quarters ahead will be determined largely by the speed by which inflation decelerates.
5. We remain comfortable with our strategy that emphasizes strong business fundamentals and value. This stock pickers strategy should continue to excel versus passive indexing as the excesses of easy money and speculation continue to unwind.

Inflation Confusion

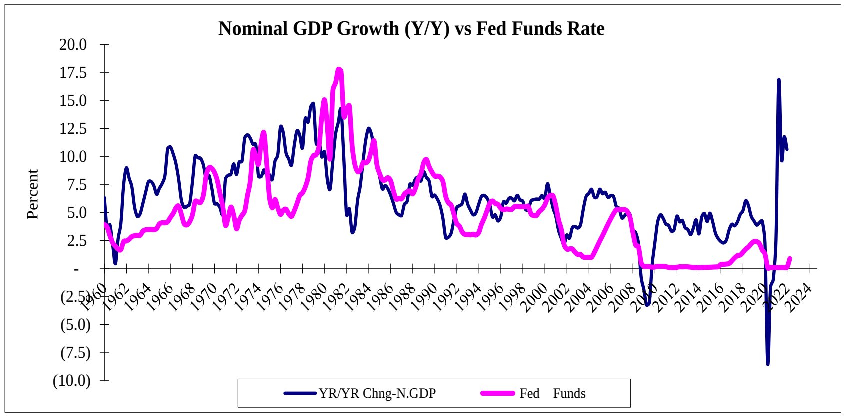
Inflation is ultimately caused by rapid spending growth (nominal GDP). The Fed, along with almost everyone else, has consistantly underestimated the rise in inflation over the past year. The question now is whether inflation will decelerate as fast as expected to 2.7% by September 2023 (see Chart below). Since the start of the 1980s, everytime the Fed attempted to raise interest rates (the pink line in Chart 2), nominal GDP growth started to head lower and brought inflation down with it. The Fed was always in a reaction mode. And in December 2015 through December 2018 the Fed was again raising (gently) the Fed Funds interest rate. But by 2019 some leading indicators were pointing to slowing growth and the Fed started reversing course with three 0.25% rate cuts. But that effort ran straight into the Covid pandemic in early 2020 when spending fell sharply (see the blue line in Chart 2). Naturally, given the downward trend in spending and inflation over the previous 40 years, the Fed was concerned that such a sharp and sudden decline in spending could result in an outright decrease in the price level (deflation), which would have had complex and uncertain effects. From this perspective, the Fed's willingness to greatly expand its balance sheet through the purchase of U.S. Treasuries and mortgage backed securites, i.e. "quantitative easing," and the resultant increase in the money supply, is somewhat understandable. However, it wasn't long before people started coming out of their houses and spending money at the same time that global supply chains became snarled and shortages helped fuel price increases. Nominal spending peaked at +16.8% in the second quarter of 2021 and has decelerated to +10.6% in the first quarter of 2022.

Chart 1 CPI Y/Y with Consensus Forecast



Source: Credit-Suisse

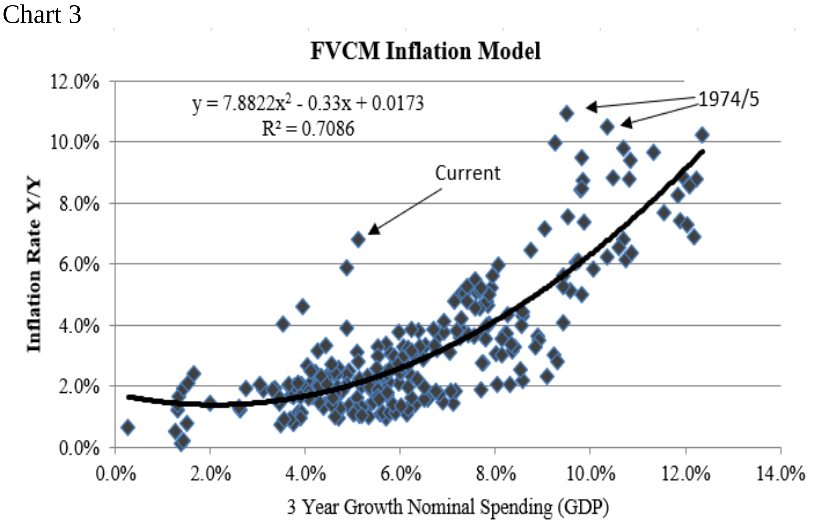
Chart 2



Source: Federal Reserve, FVCM

This kind of extreme variability in nominal spending, along with the global trade and production problems related to the pandemic, is completely outside the historical experience and any data sets available. We really don't know what inflation is going to be in the year ahead. Traditionally, inflation has been relatively slow to meaningfully accelerate, and once it takes hold it normally takes some years to bring it down substantially. Our research has shown that inflation tends to follow spending growth over the previous three years. Based on that historical relationship, inflation today should still be down in the 2% area. In other words, the huge burst in spending in 2021 followed a collapse in spending in 2020 and the "three year average" has remained low. As seen in Chart 3, the current level of inflation is far away (4.7%) from the model (the curved black line). Only in the first quarter of 1975 was the deviation (5.2%) greater. While these two periods were affected by unusual circumstances, some would call them "black swan" events, a difference is that the spending growth rates had been steadily accelerating in the 1970s, and spending has not been steadily accelerating recently—it was sharp down and then sharp up.

Chart 3



Source: Federal Reserve, FVCM; Note: Inflation measured by GDP Deflator.

The 1973-1974 Arab Oil Embargo brought an inflation shock of similar magnatude to today.

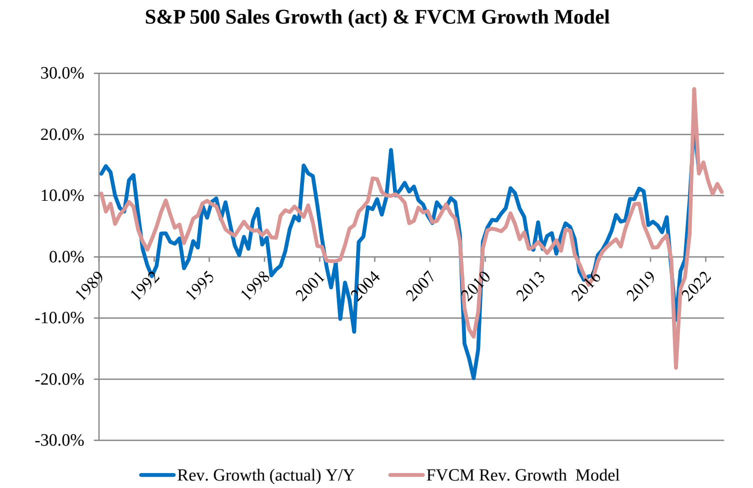
The inflation problem in the 1970s was long lasting. We are uncertain regarding the speed at which current inflation will be brought down, but persistant inflation over many years like we saw in the 1970s is very unlikely. We say this with some confidence because there had been theories back in time that inflation should be tolerated in order to bring higher levels of employment. We now know that theory (the Phillips Curve) to be nonsense. Inflation hurts low wage workers the most. It also damages the capital markets, the labor markets, and distorts all commerce. There is now a consensus in this regard. Hence, unlike the early 1970s, the Federal Reserve will not tolerate a sustained high level of inflation. Interest rates will continue to increase, and the Federal Reserve will reduce its balance sheet as much as needed. Furthermore, the U.S. dollar has been stregthening against most major currencies as foreign capital seeks the higher returns now being offered on U.S. fixed income securities. The strong dollar will have many and varying effects (see the section on corporate earnings below), but one effect is that a strong currency helps hold down the price of imports and applies downward pressure on domestic prices through competition. Foreign exchange rates are also a market-based price mechanism that offers signals regarding the relative purchasing strength of a currency. The strong dollar is a signal that the Fed is pursuing the right policy. Our level of confidence is not extremely high, but the downward trajectory in inflation, as seen in the consensus estimate shown in Chart 1, is reasonable. The downward slope is slightly less steep than was the case when inflation was rising, which is a characteristic one would expect—inflation is stickier on the downslope.

Corporate Earnings Still Rising

Based on the 454 companies that have thus far reported first quarter 2022 results, sales for the S&P 500 are up nearly 15%, year-over-year, and earnings are up 9.8%, which is ahead of our model's forecasted growth of 12.4% and 8.0%, respectively. The unusually rapid growth in sales reflects the current inflationary environment. Volumes are increasing, but much of the sales increase reflects the 8% rate of inflation (consumer price index) that the U.S. has been experiencing. Earnings have risen slower than sales because the cost of business, such as prices of energy, basic materials, shipping costs and other items, are rising even faster than general "headline" inflation. And, naturally, the overall movement in corporate results, as measured by the S&P 500, masks some dramatic changes in component companies and sectors. For example, according to S&P Global, earnings for the Energy sector are estimated to increase 325%, whereas the Financials sector is estimated to experience a 27% decrease in earnings. Another sector being hit with a decline in earnings is the Consumer Discretionary sector, where earnings are expected to fall 41% due largely to a 73% drop in Amazon profits.

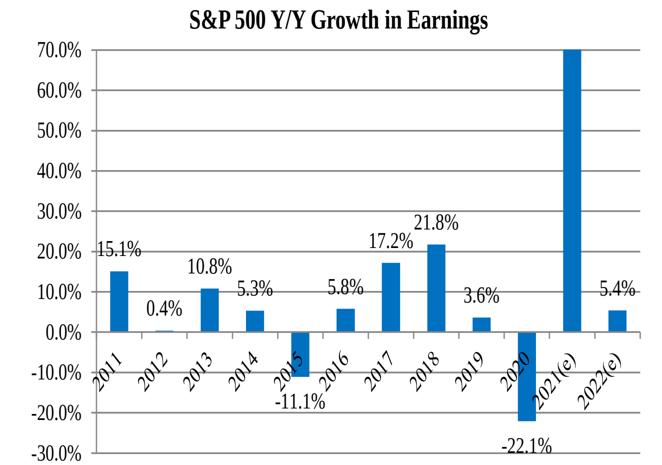
For the full year 2022, we expect earnings to rise only about 5% on an 11% increase in sale. Our model for sales growth uses nominal GDP and changes in the major currency index as factors. Very strong growth in spending is being party offset by a strengthening dollar (as much as a third of S&P 500 earnings comes from business overseas which must be translated back into USD). Our projected 5.4% increase in earnings for all of 2022, versus the 9.8% increase for the first quarter, may turn out to be too conservative. However, there are already signs that the economy is starting to cool and we should see more of such signs as the Fed raises interest rates through the year. We have not ventured to create a 2023 forecast yet because of the risk of recession. Certainly, the current decline in stock prices is a harbinger of a slowdown coming. Our base assumption is that sales and earnings growth will decelerate through 2022 and may decline in the first half of 2023 before resuming an upward trajectory.

Chart 4



Source: Federal Reserve, S&P Global, FVCM

Chart 5

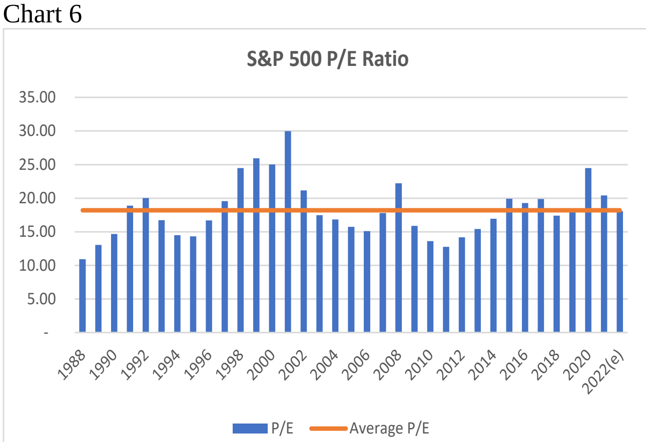


Source: Federal Reserve, S&P Global, FVCM

Back to Basics: Valuation

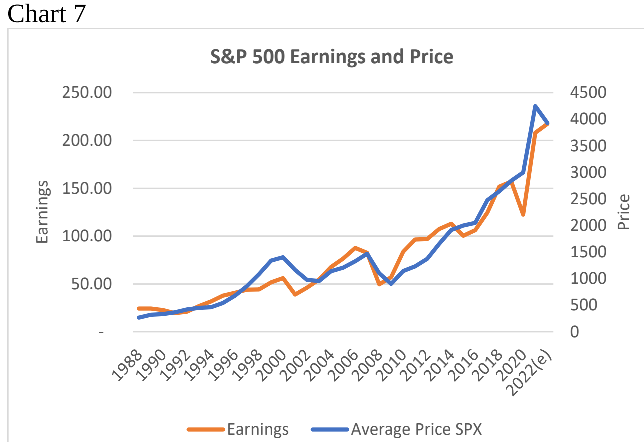
The S&P 500 closed at 3930 today (May 12, 2022). Based on our conservative earnings estimate for 2022, the index is now trading at 18.1 times earnings, which is just below the 18.2 average since 1988 (see Chart 6 below). Stock valuation is not science, it is an art. For example, we have a detailed valuation model the smooths out earnings for the business cycle and adjusts fair valuations based on inflation. That model still has the S&P being 30% overvalued. However, if one simply takes the average price for the S&P 500 for each calendar year and divides it by the actual earnings for each year, you get the results in Chart 6 below. On that basis, the S&P 500 looks like it is now trading at an appropriate level. We have also included Chart 7, which shows the average price of the S&P 500 against actual earnings for each year plus our '22 estimate. Notice that over time stock prices go up because earnings go up. When the blue line falls below the orange line, stock prices look cheap. When prices run above the orange line, prices look expensive. But over time they both move higher because of the never-ending human pursuit of discovery, innovation, and rising production. Long-term investors in equity markets reap the rewards of these achievements. It can be useful to keep this in mind when we enter periods of negative market adjustments.

Chart 6



Source: S&P Global, FVCM

Chart 7



Source: S&P Global, FVCM

High inflation and tightening monetary conditions are having the greatest negative impact on the most highly valued (growth) and speculative assets. During the ten years ending in 2021, the S&P 500 Growth Index produced compound annual returns of 18.7%, an amazing feat and well ahead of the 16.6% return for the S&P 500 and 12.4% return for the S&P 500 Value Index. But even these variances mask the concentrated flow of money into the largest and most popular stocks including Apple, Amazon and Facebook (now Meta Platforms). The era of easy money, low interest rates and low inflation enticed investors to direct capital to businesses that showed the greatest promise of growth. And in more recent years, capital began flowing into even more risky and esoteric "assets" like cryptocurrencies and "non-fungible tokens." The fact that serious profitability will not be achieved for many years into the future, or that there was questionable value creation underlying such assets, was of little concern because money was cheap. But the air has started coming out of these speculative assets. During the first four months of 2022, the S&P 500 Growth Index has had a negative return of 20.1%. The decline in the large growth companies also helped drag down the larger S&P 500 Index, which had a year-to-date return of negative 12.9%. For some of the biggest names, the results were much more severe. Amazon's stock was down 25%, Facebook (Meta) was off 40%, and Netflix's stock fell 68%.

Some of the biggest losses are outside of the stock market and need to be monitored for follow-on effects. Just this past week Bloomberg reported that more than $200B of crypto wealth was wiped out in just 24 hours following collapse of TerraUSD stablecoin. In those 24 hours Bitcoin fell by as much as 10% to the lowest level since last December, and Ethereum down as much as 16%. The $80B so-called stablecoin Tether also became unmoored from its $1 peg, falling to 95 cents before subsequently rebounding. The crypto plunge came alongside hits to other liquidity- and momentum-linked assets and there are some fears a crypto crash could spill over into broader markets. The Fed warned in this week's Financial Stability Report that coins may lose value or become illiquid during times of stress. U.S. Treasury Secretary Yellen this week also reiterated calls for Congress to authorize regulation of stablecoins, citing risks to financial stability. We avoid these sorts of fads and momentum driven markets, but these must be considered within the overall context of the capital markets.

Because the Federal Reserve is expected to continue to tighten monetary conditions in the quarters ahead, value investments backed by strong fundamentals should continue to outperform more speculative "growth" investments. During the first four months of this year, while the S&P 500 total return index was off 12.9% and the growth index was off 20.1%, the equities in our portfolios were off only 2.4% (see footnote 1 on page 6). Our equities have a portfolio weighted trailing P/E ratio of only 12.3, versus 18.3 for the S&P 500, and a 2.6 price-to-book ratio versus 3.9 for the S&P 500. In the investment management educational literature, risk is typically measured using a calculation of stock volatility, e.g., beta, standard deviation, Sharp ratio. However, there is inherent risk in owning stocks of companies that have high valuations and whose promise of profitability is in the distant future. Such companies are at greater risk of disappointment and high valuations equate to a lot of downside risk. Growth is a vital component for investment success, but a conservative avoidance of overly popular fads and excessive valuation is better for long-term results. Sometimes such a strategy may mean that you lag as the crowds bid up such investments, but during times of turbulence, an emphasis on value typically pays off. As Warren Buffet once said, "you only find out who is swimming naked when the tide goes out."

In terms of portfolio composition, we continue to remain comfortable with our current overweight positions in Energy and Industrial stocks. Investment in traditional, carbon-based energy has been underwhelming in recent years. Firstly, after peaking at about $140 per barrel in 2008, the price of energy has been in decline because of rising production. This has led to reduced levels of reinvestment. Secondly, political pressure has been applied for energy companies to divert investment from carbon-based sources to renewable energy sources, which have the benefit of government subsidies. These two factors have led to constrained production of conventional energy assets such as oil and gas drilling infrastructure and pipelines for gas and oil transportation. This is a recipe for rising oil and gas prices and higher profitability for those companies that produce them. We have been 4 times overweight the Energy sector versus the S&P 500, and will remain overweight despite sector returns of 43% year-to-date. Similarly, investment in many industrial areas of the economy has been underwhelming as capital has chased every good and bad opportunity in the technology sector. Particularly in view of the global supply line issues now being seen, there is a growing sense that investment must shift back to domestic production.

We also plan to remain underweighted in Consumer Discretion and Financial stocks. Rising interest rates will almost certainly put downward pressure on consumer purchases (retail), housing, autos and other items. And, as interest rates rise, the banks will face the prospect of having to increase reserves for non-performing loans. The big banks are, in general, very poorly run and a horror show to manage because of years of complex mergers.

Lastly, we recommend investors continue to avoid long bonds—for now. Bond yields are likely to continue rising in the quarters ahead as the Federal Reserve tightens monetary policy. This equates to declining bond prices. However, when and if the data starts flashing warning signals that a recession is around the corner, we would consider making bond purchases. But that time is still a way off. We would need to see a flat 3 month/10-year U.S. Treasury yield curve, and the ISM PMI Manufacturing Index and New Orders Index fall to or below 50.

Footnote 1:
Performance data reflects the FVCM Strategic U.S. Equity Portfolio Composite and is gross of management fees, but transaction costs were deducted. Performance includes dividends, net of a withholding tax on foreigners that is credited back on local tax returns. Accounts included in the composite included only those that were invested according to a 100% equity only strategy. Accounts including other assets, such as fixed income securities, are excluded. Accounts added to the composite have a minimum account value of $500,000 at the time they are first included. Accounts experiencing material cash flows are excluded for up to three months or until such time that new cash balances are invested in equities pursuant to the SEP strategy and the client’s instructions. Past performance is no guarantee of future results.