Economic and Valuation Review and Outlook

A strong summer rally gave some hope that the bear market was over, and we could all get back to making copious amounts of money. The month of September put an end to that hope. The S&P 500 fell 9.3% in September, taking the quarterly returns negative for the third month in a row. The fund that tracks the broad bond index (AGG) fell another 4% in the quarter, bringing year to date losses to over 15%. This has been a frustrating year for many, as diversification generally has failed to provide stability, and conservative investors have done roughly the same as aggressive investors. The reason for this is that this year, almost everything has lost value – US large, mid and small cap stocks, International stocks, bonds of every variety – even including inflation-protected bonds, real estate and gold. Commodities had a nice run to start the year, but they have been mostly negative for the last couple of quarters as well. Mark Hulbert noted that for the standard 60% US stocks/40% US bonds portfolio, we are on track to have the fifth worst year since 1793[1]. The exceptional characteristic of this year is not the stock market value drop – it is not that extreme… yet. It is the fall in bonds and the correlation of the two major asset classes that historically diversified each other. Going back to 1928, the worst year for treasury bonds was -11.1% in 2009. T-bonds had only lost more than 5% three times in ninety-three years. This year they are down 18%.[2] Add in high inflation eroding the nominal value of a portfolio and it is even worse.

The sharp summer "bear market rally"[3] had pundits declaring the downturn over, and advising clients to buy stocks now that they were cheap. I always ask, cheap relative to what? Stocks gave back some gains, but are still up about 20% from the end of 2019 – before the government forcibly shut down businesses to try to keep people from getting sick. Meanwhile, the common definition of a recession – consecutive quarters with negative GDP growth has been hit. The media are pointing out that this does not necessarily mean we are in a recession. I have even seen it bandied about that we are not officially in a recession yet. The first statement is true – the National Bureau of Economic Research (NBER) has the responsibility to declare recessions. Dating back to the 1940's, the shorthand of back-to-back quarters of negative GDP growth has coincided with an official recession every time, but it is possible NBER could rule otherwise this time, as it considers a lot of variables. That does not change the fact that the economy is shrinking. The second statement is just slight of hand. It takes NBER months to officially declare a recession, so the fact that it has not yet done so does not mean a recession has not started. We may be in a recession now and we may not, but to say we are not officially in a recession is misleading. Recessions are bad for stocks, but by the time recessions start, stocks have usually already anticipated them. By the time a recession is officially called, stocks may have recovered. Stocks market performance is a leading indicator of the economy, and not the other way around.

One indicator that has been good about calling recessions in advance is the "yield curve". Usually, the longer an investor commits capital, the higher return he earns. When the ten-year t-bond pays a lower rate than the two year (inversion), that is a signal that a recession is coming. This has

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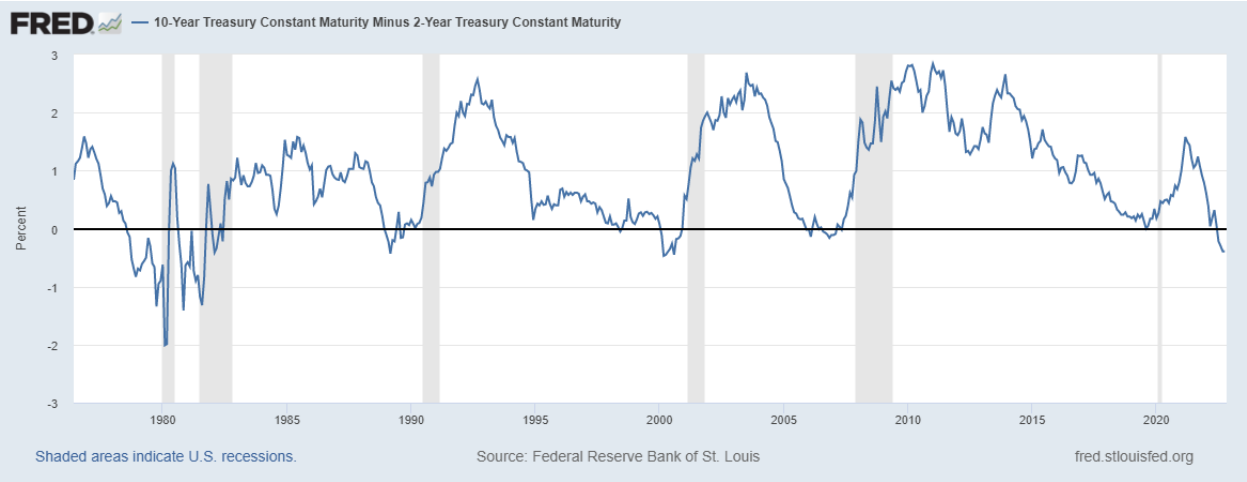
[1] (Hublert, 2022)

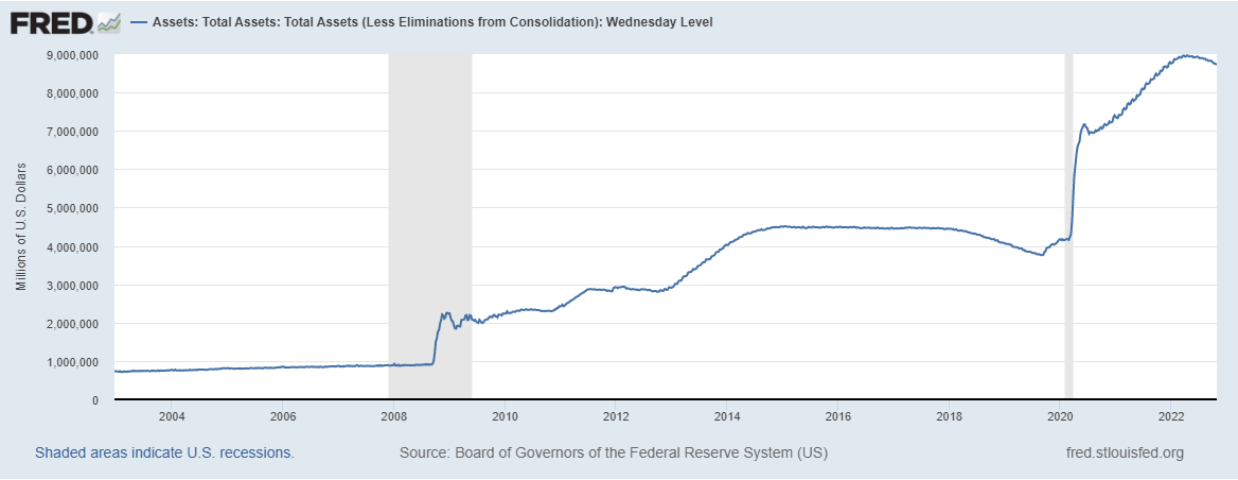
[2] (Kurbegovic, 2022)

[3] A bear market rally is an upward move in a bear market that fails to sustain. A bear market is generally defined as a 20% or greater drop in price for an index. Bear market rallies are common and dangerous. Investors mistakenly think the decline is over and get aggressive with their portfolios to try to catch the rebound, only to watch the market drop to new lows. We never know for sure whether a rally is a bear market rally, except in retrospect.

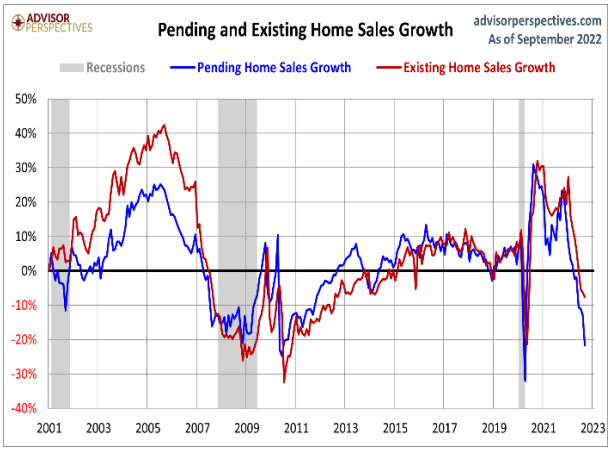
called each of the last six recessions. Generally, recessions have started within about 6-18 months. The curve inverted briefly in April and then more deeply in July.

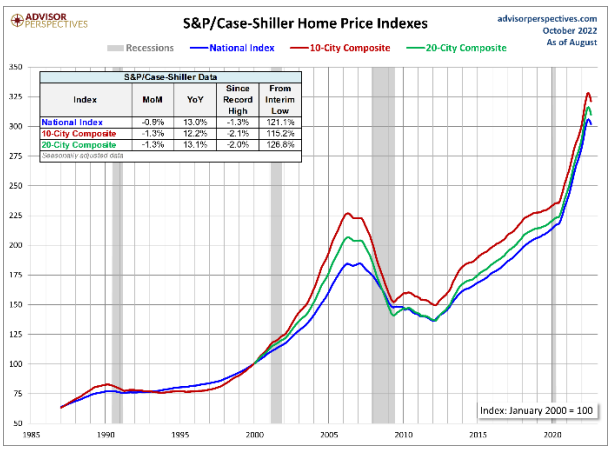


There are a couple of other concerning issues right now. First up is inflation. While pandemic related supply-chain disruptions and Putin's war in Ukraine have certainly contributed, I believe the largest factors are the massive increase in the money supply engineered by the world's central banks and secondarily, the ESG investing movement which is trying to starve natural resource companies of capital. There also appears to be a trend toward de-globalization, which is also inflationary. Inflation is painful for its distortive effect on spending and business decisions, and because it is uneven and unpredictable. The Federal Reserve is working on undoing its massive money creation.

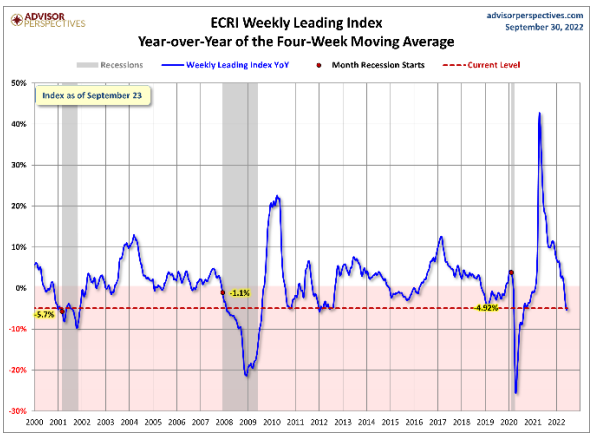


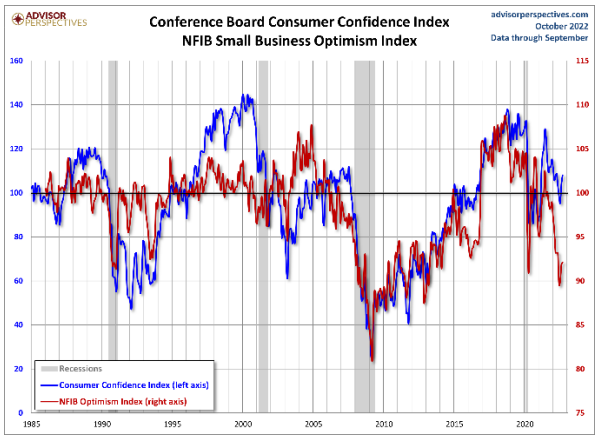
As I have stated in previous letters, this massive money creation is probably the biggest force driving the increase in valuations. All that money has to go somewhere. Easy money leads to speculation, which is how we got mind-boggling valuations for profitless tech stocks, meme stocks, cryptocurrencies, NFT's, fractional ownership in collectibles, huge SPAC listings and more. As the easy money recedes, we should see the most speculative of investments (using that term loosely) unwind. The Fed does not appear ready to give up on its quest for price stability, realizing that once inflation gets embedded in expectations it is very hard to root out. It takes years for commodity projects to produce, and governments and ESG investors still have their feet on the brakes, so inflation will have to be curbed via a supply response – economic weakening. This suggests interest rates could go higher than many expect, and will need to stay higher for a while. This matters for a few reasons. First, stocks are priced off of bond rates. (See educational spotlight.) Investors will bid risky asset prices up until they no longer yield an adequate expected return over safe bonds. When bond yields fall, stock prices should rise, as the future cash flows are discounted at a lower rate. Second, easy money encourages speculation. Not only does the expected return of the risk-free asset fall, but investors are forced to stretch for yield, taking on more risk than they would like to earn an adequate return for long-term goals. More money crowding into the same set of risky assets drives the risk premium down. This works in reverse as rates rise. Third, higher rates slow economic growth, as both consumption and business investment cost more. Consider: mortgages are loosely priced off of the ten-year treasury bonds. As mortgage rates rise, home prices fall, causing people to feel poorer and to spend less. It also makes it harder to move or to buy a home. There is a lot of economic activity tied to home buying – think furniture, appliances, decorations, remodeling, etc. Cash-out refinances to fund cars, college, home improvement, etc. don't work as rates rise and property value falls. Home sales have fallen sharply, but prices have yet to move much.



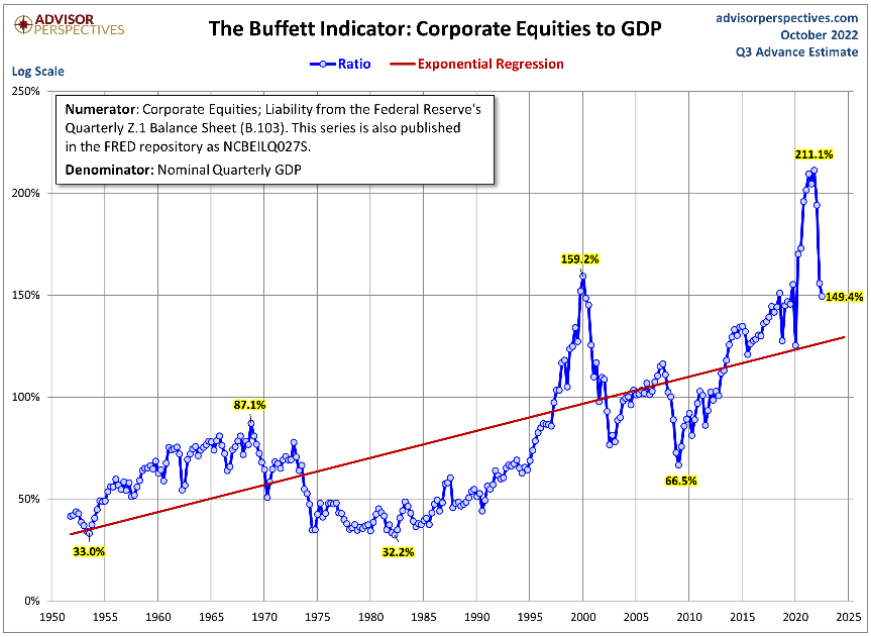


As inflation roars, growth slows and liquidity dries up, forward looking economic data are not encouraging. The Leading Economic indicators have fallen precipitously for about a year, while consumer confidence and particularly small business optimism have also dropped considerably.

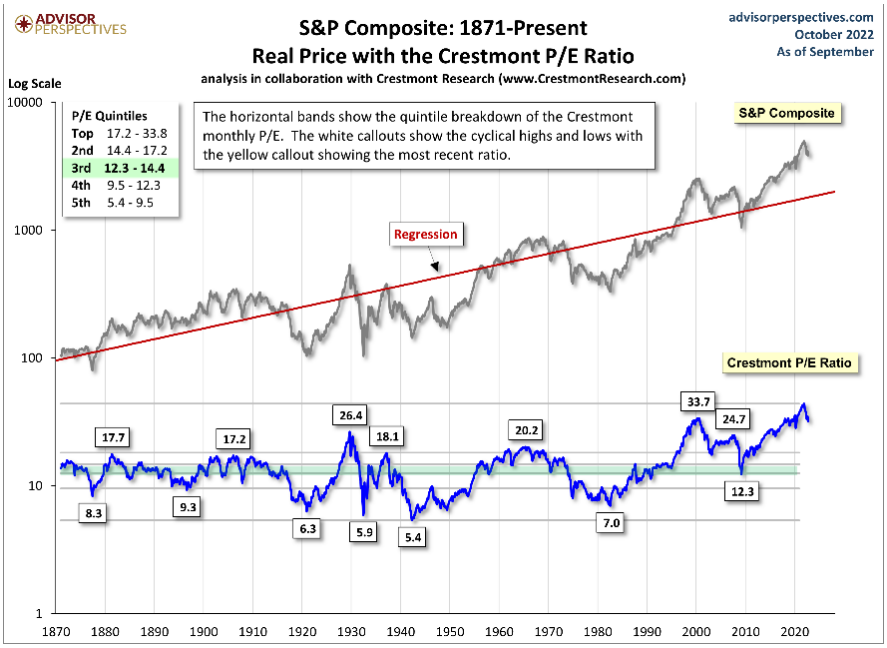




The second big concern is that profit margins have been coming down, but are still elevated. Low taxes, cheap energy and commodity inputs, low interest and relatively benign labor inflation, along with unrestrained consumer spending all contribute to that. Each of those factors has been reversing or is likely to soon reverse. As profit margins contract, earnings will decline, and this could easily be by more than a few percent. If the profit margin drops from 12% to 8%, a third of corporate earnings are wiped out. Many companies would survive, but at lower levels of income, while other companies may not be able to cope. One way to neutralize the distortive impact of the profit margin cycle on stock valuations is to look at valuation metrics that are not influenced by it – price/revenue, stock market value/replacement cost (Tobin's Q), or equity/GDP. Another way is to use longer periods to evaluate earnings, such as the Cyclically Adjusted Price/Earnings (CAPE), which looks at ten years of inflation adjusted earnings as the denominator to stock price.



This is one of my favorite charts. It shows the cost of all stocks relative to the total economy. The trend is relevant because investments have become more expensive over time. (The corollary to this is that we should not expect the historical return any more – by paying more now we are getting a lower yield over time.) This chart shows that in absolute terms, the stock market is still more expensive than any time other than just before the tech bubble burst. Even accounting for the trend of stocks getting more expensive, we still have a very expensive market, with a lot of room to fall, just to get down to its long-term valuation trend.



The Crestmont P/E seeks to remove profit margin swings. It shows a similar story. The bear market has only begun to pull the market back toward its trend. It could fall quite a bit further and still not be a bargain.

Even on a simple price/earnings basis, stocks are not cheap yet. The bottom of the market (so far) was October 12th, when the S&P 500 was 15.7x. Morningstar notes that the most expensive bear-market low to date occurred after the tech bubble burst, when stocks only got down to 13.5x.[4] This would need another 14% drop from the October low to just to get to the highest low ever. And this assumes earnings estimates hold up, which is unlikely if we enter anything close to a recession. The current estimate assumes 15% **growth** from the trailing twelve months of earnings.

The S&P 500, the proxy for the US stock market returned a whopping 16.6% average return for the decade ended 2021. Such exceptional returns for so many years dimmed investors memories of the tech bust and the Great Financial Crisis. Younger investors have only known double digit returns. A 2021 Natixis study found that US equity investors expected annualized returns of 17.5%.[5] I first became aware of the stock market in the 1990's, so I can relate. I, too, thought that stock investing earned 12% per year or better. Two crushing bear markets in ten years taught me otherwise. It is instructive to deconstruct what drove such delightful returns for this recent golden decade. The WSJ cites a Semper Augustus study showing that sales growth and dividend yield – the non-cyclical part of returns – combined for about 5.5% annual returns. An expansion of profit margins added 4% and an expansion of the price/earning ratio added another 6% per year. Corporate profit margins of 9.4% were not low at the start of the period.[6] If profit margins and earnings multiples returned to where they were at the end of 2011 (two and a half years after the market bottom), and if revenue growth from 2022-2031 equaled that of 2011-2021, total returns would be negative.

It is impossible to know what will happen in the near future, but the signs are not positive. Recessions are a normal and healthy part of economic cycles. As long as inflation was very low, the Federal Reserve intervened to try to stave off or shorten every recession this century. It no longer has that luxury. If the Fed holds its course, a recession will likely occur. How severe it will be is hard to guess, but the market is still priced as if revenue growth and high profit margins will continue unabated. Expecting the exceptional returns of 2010-2021 is unreasonable, and the market could easily decline further to get back to average valuations. Investors would be wise to have a plan based on reasonable assumptions, and to continue to favor defense over offense.

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[4] (Ward, 2022)
[5] (Jakab, 2022)
[6] (Jakab, 2022)

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