Market and Economic Outlook

After a rocky 2022, bonds are yielding a reasonable return again, at least if you ignore the effect of inflation on the real value of your investment. Stock valuations are at levels not sustained since way back in 2014, as measured by the popular price/earnings ratio (trailing twelve months of earnings). As of 12/31/22 the ratio was 19.8x, 1% below the fifty-year average of 20.0, and about 20% below the twenty-year average. How did we get here? Ben Carlson notes that the stock market had its seventh worst year on record, at -18.1%. Three of the worsw years were in the Great Depression, with the Great Financial Crisis, the Dot Com Crash, and 1974 rounding out the worst years.[1] That's bad enough, but what made this year especially destructive was that bonds had their worst year on record. Usually diversifying between stocks and bonds protects a portfolio, but not last year. Carlson further notes that a standard 60/40 portfolio (60% US stocks and 40% bonds) had its third worst year, trailing only 1931 and 1937. That sounds bad, but it gets worse. In 1931, the inflation rate was -9%. The purchasing power of a 60/40 portfolio declined by 20.8% when accounting for deflation. In 1937, inflation was 3.6%, so the purchasing power of a 60/40 portfolio declined by 22.5%. In 1974, inflation was 11%, so the 60/40 purchasing power loss was 23.15%. In 2022, the official inflation rate was 6.5%, pushing the loss of purchasing power to 22%, just barely behind 1931 for the worst third worst year ever. If you thought 2022 felt bad, it's because it was bad.

The Worst Years Ever For the U.S. Stock Market

Year	S&P 500	Reason
1931	-43.8%	Great Depression
2008	-36.6%	Great Financial Crisis
1937	-35.3%	1937 Crash
1974	-25.9%	1973-74 Bear Market
1930	-25.1%	Great Depression
2002	-22.0%	Dot-Com Crash
2022	-18.1%	The Great Inflation
1973	-14.3%	1973-74 Bear Market
1941	-12.8%	WWII
2001	-11.9%	Dot-Com Crash
1940	-10.7%	WWII
1957	-10.5%	1957-58 Recession

The Worst Years Ever For a 60/40 Portfolio

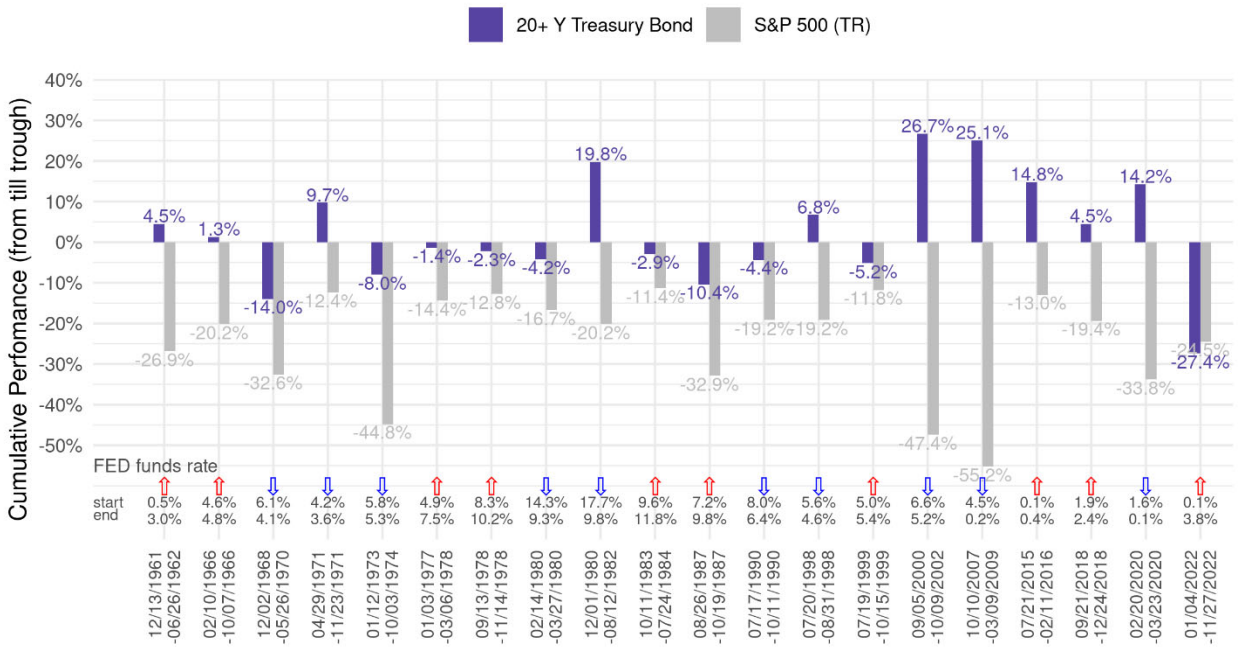
Year	60/40 Portfolio	Reason
1931	-27.3%	Great Depression
1937	-20.7%	1937 Crash
2022	-16.9%	The Great Inflation
1974	-14.7%	1973-74 Bear Market
2008	-13.9%	Great Financial Crisis
1930	-13.3%	Great Depression
1941	-8.5%	WWII
2002	-7.1%	Dot-Com Crash
1973	-7.1%	1973-74 Bear Market
1969	-6.9%	Nifty Fifty Crash
2001	-4.9%	Dot-Com Crash
1966	-4.8%	1966 Bear Market

Source: NYU

Source: Ben Carlson, NYU

Michael Gayed looked at how the long Treasury Bond did in the last twenty stock market corrections. Surprisingly, it had negative returns in half of the cases. Most of the time, these losses were small – much smaller than equities. 2022 was just the third time in the last 60+ years that stocks and long bonds both lost double digits, and the first time that bonds lost more than stocks during a stock market correction.

[1] (Carlson, 2023)



Source: Michael Gayed via Twitter

Does this present a wonderful buying opportunity? Let's put the loss in context. Professor Aswath Damodaran states: "During the course of 2022, US equities collectively lost $11.6 trillion in market capitalization, but for balance, it is also worth noting that US equities are still holding on to a gain of $6.9 trillion on their market capitalization at the end of 2019. Given that we endured a pandemic, multiple political crises, and wars in the three years since that is almost a miracle."[2]

Bond investors should be concerned about the ability of corporations to repay their loans. A decade of low interest and easy credit means that loan covenants – the protections that lenders put in place - became rare over the last decade. S&P Global Market Intelligence tracks this and reported that "Covenant-lite" loans went from less than 10% of all new loans 2008-2010 to 91% by 2021.[3] Investor protections are not needed during good times, but as Warren Buffett famously said, "It's when the tide goes out that we see who has been swimming naked." Companies dependent on cheap financing with no questions asked could be in trouble in an economic downturn that coincides with tighter financial conditions.

Housing is another area of concern. Housing is a big economic driver, not only for the economic production of building houses, but also for everything that goes along with that – furniture, appliances, decorations, etc. Vitaliy Katsenelson observes that a median home with a 20% downpayment would have had an annual mortgage payment of $15,000 in 2019. This increased to $17,000 in 2021, as lower mortgage rates absorbed most of the cost of the 37% increase in median home price. As of November 2022, that increased to $30,000. Median after-tax household income is only $60,000, so this is a significant burden.[4]

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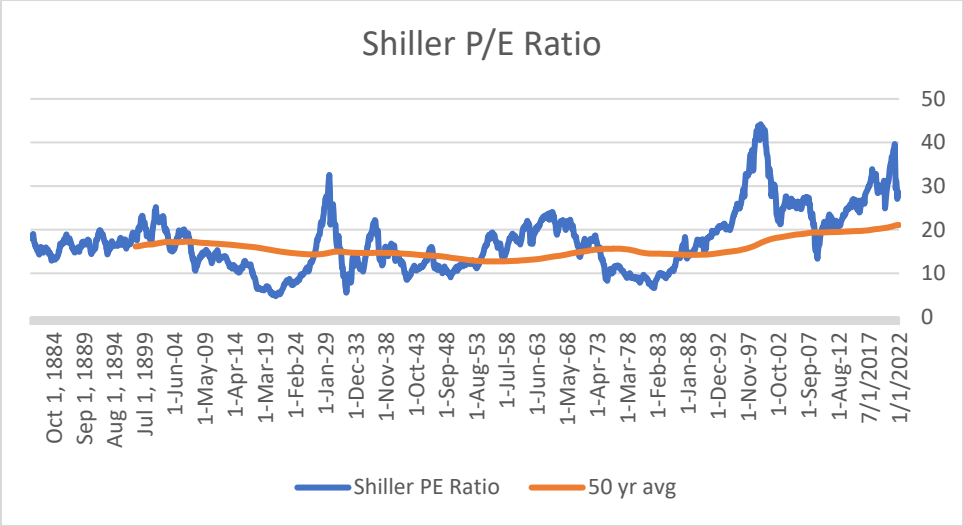
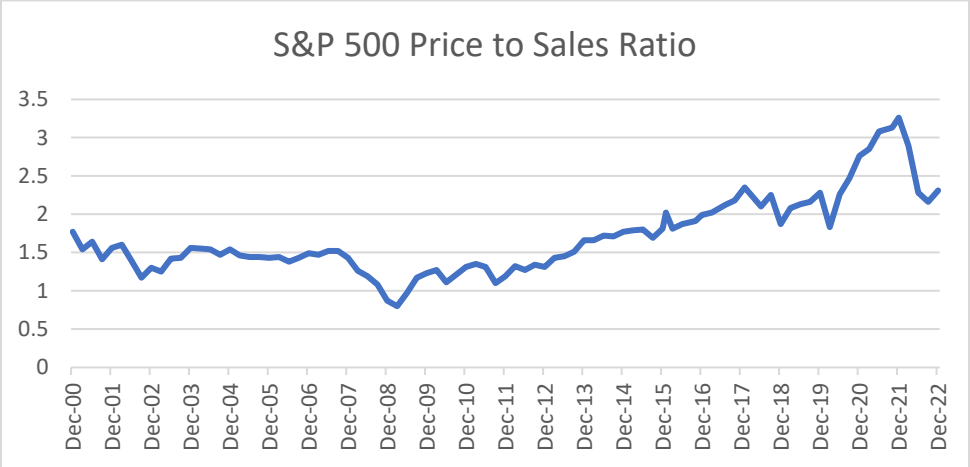
[2] (Damodaran, 2023)
[3] (Swedroe, 2022)
[4] (Katsenelson, 2022)

Valuations have become much more reasonable than in recent years, but are still stretched according to the metrics I find reliable. For instance, the Shiller Price/Earnings ratio is still well above its long-term average, while the Price/Sales ratio for the S&P 500 is 50% above its average of this century. Valuations are moving back toward reasonable levels, but are not there yet.

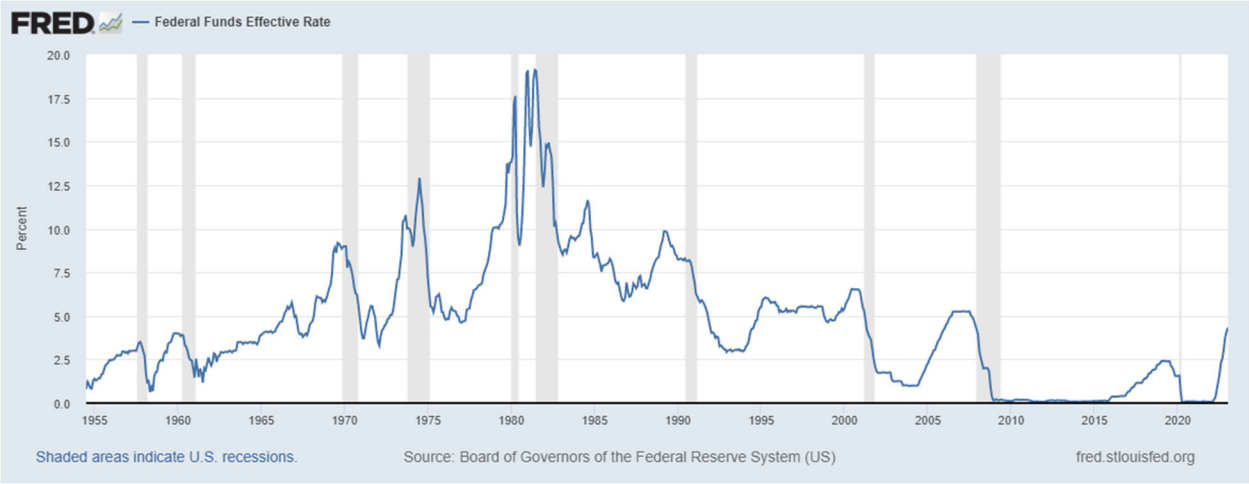


Source: www.multpl.com, calculations: RIM, as of 12/31/22



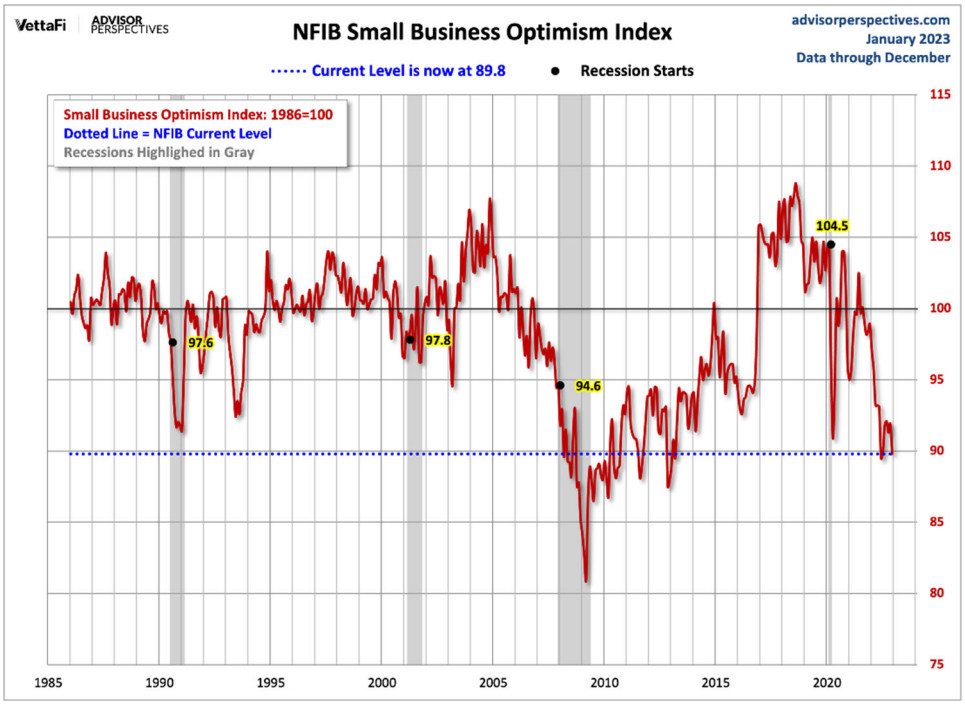
Source: www.multpl.com, calculations: RIM, as of 12/31/22

There is still much to be concerned about, starting with the expectation that the Fed will go back to the very easy money policy of the last few years, rather than realizing that it is an aberration. Yes, rates will likely go back down, but to what level? Will the Fed risk another major asset bubble by repeating its mistake of the past? Maybe, but maybe not.

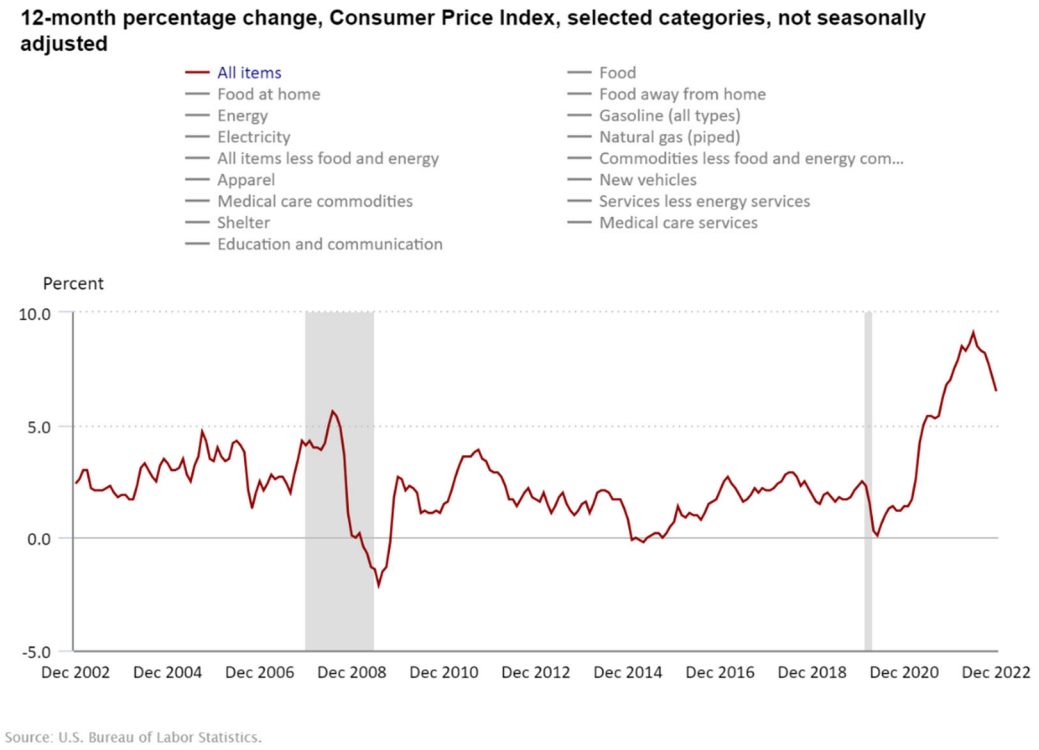


Source: US Federal Reserve

Economic signs of weakness, still exist. Consumer and business confidence are low. Small businesses tend to be the most in tune with what is happening in the real world. This confidence level is now lower than during the initial COVID lockdowns.



Some positive signs also exist, and the future is hard to predict. The recent employment report showed the lowest unemployment in decades. It also had massive adjustments to the data, calling its veracity into question. Inflation is coming down, but has a long way to go.



The Fed needs the market to cooperate somewhat for it to finish its job. Premature optimism pushes asset prices up, encouraging the unhealthy speculation the Fed is trying to squelch. It may take a recession to reduce demand enough to kill inflation. Even with the lower inflation and higher interest rates, Treasuries still earn less than inflation. Some pundits believe the economy is on the precipice of collapse, while others think a mild slowdown is all that will happen. I have seen numerous charts showing that every time a certain indicator was negative, we had a recession, but that is no guarantee that the next time will yield the same result. There is a lot of uncertainty, so investors should be cautious.

As mentioned in our last Market and Economic Outlook, profit margins are well above average and trending down, which can take a bit out of corporate earnings.

At the start of 2023, we see speculation is still alive and well (imaginary money is rebounding, Meme stocks and low-quality story stocks are coming back), even if not as strong as it was. Take, for example, niche auto-maker Tesla, which has risen 55% this year as of February 7, as just one example. Market corrections often start with the biggest areas of concern and then work their way to the less ridiculous stocks. This does not work in a straight line, and speculators see drops in value for their speculative darlings as buying opportunities. Generally, the market does not bottom until almost everyone has given up.

Despite all the uncertainty mismatched with generally high valuations, there are opportunities. Value stocks still make sense. There are different ways to measure value, and some have worked better than others in the past. We prefer using Enterprise Value (market capitalization plus debt minus cash) divided by EBIT or EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) or Free Cash Flow yield. The first method normalizes capital structure so that debt isn't ignored, benefiting highly leveraged companies. The second looks how much cash the company is generating divided by the value of the company. Both are finding great opportunities to buy quality companies at steep discounts to

the market. We expect that as the "everything bubble" continues to deflate, solid cash-producing companies will come back into demand. International diversification finally seems to be working, and we expect it is prudent to have an allocation to less expensive foreign markets. Having a system for risk management and sticking with it is key in a volatile environment like this.

While the ride is not smooth, investors can take solace in knowing that lower prices for their investments today means better returns in the future. Economic cycles will happen, as will booms and busts in the markets. Rather than trying to predict (guess) every squiggle in the long-term charts, we prefer to own solid investments at good prices and wait out the fluctuations, while employing systematic risk management to smooth out the returns.

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