# Research Update

June 17, 2022

CAPITAL ADVISORS

During volatile times in the asset markets, we are often asked if our thinking has changed. In this note we seek to address this question by updating several observations from our last commentary. The format for this approach begins with a verbatim reprint of the Key Points from the commentary we distributed on May 16th – in black font – with our updated thoughts inserted in blue.

## Key Points (originally printed May 16, 2022)

- Financial markets have already priced in a lot of bad news, having registered declines of 18% to 29% for stocks – depending on the index used to measure them – and an astounding 10% drawdown for investment-grade bonds.[1]
  **Update:** As of the close on June 16th, the range of decline for stocks has extended by roughly five percentage points to -23% - 34% (primarily for Growth indices), while the negative return for bonds has deteriorated by one percentage point to approximately -11%.[2] The latest move lower gained momentum one week ago when the government's report on consumer price inflation showed disappointing strength across a broad spectrum of categories. This prompted the Federal Reserve (Fed) to accelerate its pace of monetary tightening on Wednesday by raising its target interest rate by 0.75%, despite the Fed's prior forward guidance for a 0.50% increase.

- Since asset markets discount the future, there is a silver lining to these declines in that a lot of bad things can happen now without *necessarily* triggering substantial further downside in financial markets.
  **Update:** This notion is more appropriate the further markets fall. We recognize there is little comfort in this "silver ling" when asset markets are dropping, but it is important to remember that financial markets are always looking forward. If history is any guide, the downside in financial markets will be over well before an "all clear" seems obvious within real the economy.

- We suspect this dynamic may be particularly supportive for the bond market, where current prices already discount an aggressive path for monetary policy toward a Fed Funds Rate over 3% by early 2023, up from zero at the start of this year.[3]
  **Update:** Recent events have pulled forward the expected pace of central bank interest rate hikes, while raising the estimated terminal rate for Fed Funds toward 4.0%, up from approximately 3.25% before this week.[4] When market interest rates move higher, bond prices shift lower (all else equal).

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[1] Source: Bloomberg; Data represents the peak-to-trough decline as of the low point in 2022 thus far for the S&P 500 Index, NASDAQ Composite Index, and year-to-date for Bloomberg U.S. Aggregate Bond Index as of June 16, 2022.
[2] Source: Same as footnote 1
[3] Source: Bloomberg
[4] Source: Bloomberg; Expectations are derived from prices in the Fed Funds futures market.

The negative impact on stocks from this shift in Fed policy likely has two dimensions. First is stock market valuation, whereby the price-to-earnings (P/E) ratio for stocks tends to move inversely with interest rates due to the negative impact of rising interest rates on the discounted present value of corporate earnings and dividends. We suspect the second dimension is an increasing fear among investors that the Fed is on course to drive the economy into a so called "hard landing," otherwise known as a recession.

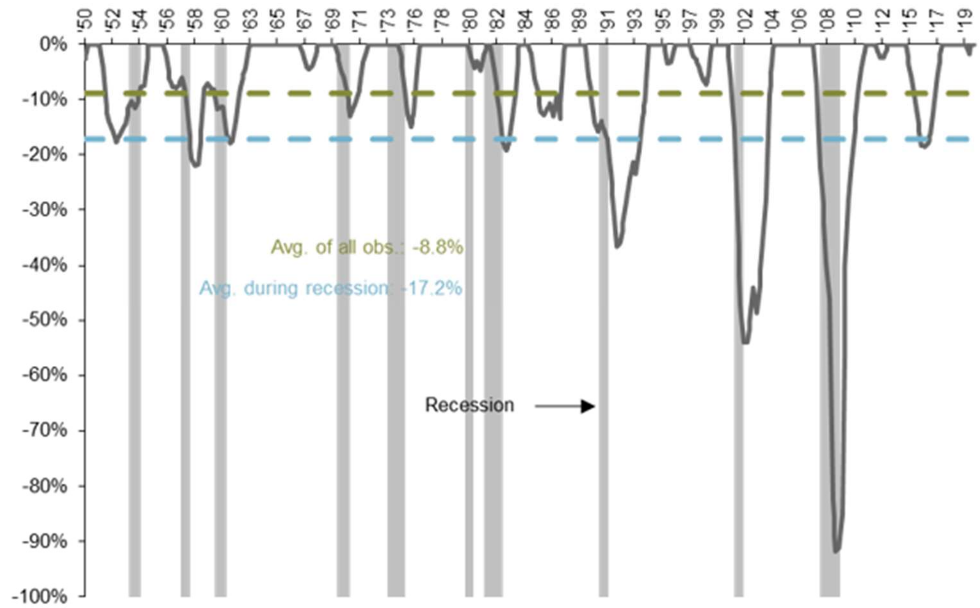
- The stock market is much more uncertain, of course, but declines in the 20% to 30% range have been sufficient in the past to reflect a "normal" recession, where normal is defined as a mild backslide in economic growth and corporate profits that is not overlaid with a concurrent trauma like a credit contraction (1929-39 and 2008-09), or the bursting of an asset bubble (2000-02 and 2008-09).
  **Update:** Thus far, the decline in stocks has been mostly driven by P/E multiple contraction, rather than downward revisions to corporate earnings estimates. We say this because *so far*, the Bloomberg consensus earnings estimate for the S&P 500 Index has remained stable throughout the recent drawdown for stocks.[5] Consequently, the forward P/E ratio for the S&P 500 has dropped to roughly 16 as of June 16th, from 21 at the start of the year.[6]

  We believe the latest downward lurch in stocks includes skepticism about corporate earnings estimates. This would follow a typical sequence for bear market cycles, where the early phase of the decline is frequently driven by a downward valuation adjustment, while the later stage of the cycle includes a mark-down in corporate earnings estimates.

- Unfortunately, there are multiple risk factors today with the potential to serve as a "concurrent trauma" to an otherwise standard contraction, most notably inflation.
  **Update:** To frame the range of expectations for a *potential* final phase of the bear market, consider the graph on the next page showing historical earnings contractions for the U.S. stock market over the past seven decades. The data reflects an average pull-back in corporate earnings per share (EPS) of roughly 9% for all earnings contractions, with deeper drawdowns of around 17%, on average, when the drop in corporate profits is associated with a recession.

[5] Source: Bloomberg
[6] Source: Bloomberg; Standard & Poor's; Based upon index data as of June 16, 2022 and estimated earnings for the calendar year 2022

**% Earnings Contraction for U.S. Stocks**
**Jan. 1 1950 to Dec. 31, 2019**




Source: JP Morgan Asset Management; Robert Shiller; FactSet

This data supports the framework for bear markets we laid out in the May commentary. During shallow recessions and/or earnings corrections that do not include a recession, some combination of P/E multiple contraction and lower corporate earnings tends to result in a stock market decline in the 20%-30% range (where we sit today). However, when a deeper recession is overlaid with a parallel trauma like a credit contraction, or the bursting of an asset bubble, the drawdown in corporate profits tends to be worse, and the peak-to-trough decline for stocks can be deeper.

As things stand now, it is impossible to know whether the decline in stocks we have already experienced might be close to enough. For example, at its June 16th closing value of ~3,667, the S&P 500 would trade at a forward P/E of 17.8 *after* reducing the consensus earnings estimate for 2022 by 10%.[7]

We find further comfort in the fact that corporate balance sheets are generally (not universally) quite healthy, with many companies retaining much of the cash they raised during the COVID crises. Generally stated, managements have the flexibility to repurchase shares when they believe their companies' stock price is attractive, which could have at least a partial blunting effect upon any potential decline in earnings per share (EPS). Managements should be most likely to use funds in this way as they gain visibility into the economic outlook and future demand patterns. Another positive indicator could be the increased use of those funds to acquire innovative companies at more attractive valuation points.

[7] Source: Bloomberg; Standard & Poor's

To be clear, there is room for things to get worse if there is a more substantial mark-down to earnings estimates, and/or the P/E ratio contracts materially below 17. Both are possible. We believe second quarter earnings reports, starting in mid-July, may be an important checkpoint for this uncertainty. We expect the forward earnings estimates for many stocks may be downgraded during the upcoming earnings season. However, if the downward revisions are manageable in aggregate, as we expect, it might encourage a sense of relief for investors, rather than a new excuse to sell.

- Despite the very real possibility that stocks might have further to fall, we believe it is important to recognize the magnitude of disruption that has already occurred beneath the surface of the market averages.
  **Update:** The point of this observation is that the volatility of individual stocks is always an order of magnitude greater than the volatility of the overall stock market. This can create opportunities for active investment strategies to pursue opportunities in individual stocks that cannot be captured through a passive market index. We believe the disruption that has already occurred in the equity markets has uncovered opportunities worth pursuing sooner rather than later.

- This disruption has created opportunities for active investment strategies: With that in mind, we offer the following observations:
  I. **On De-Risking:** Regardless of one's current level of anxiety, we caution against dramatic action like selling out of the stock market completely. While we appreciate that de-risking may be appropriate for some investors (and we welcome these conversations with anxious clients), we encourage only incremental change – perhaps a 10% reduction in the equity allocation – rather than a complete overhaul of a well-designed portfolio.
  **Update:** We never like to assume we know more than our clients about their instincts regarding *their* money. When an investor feels anxious about their current investment portfolio, our challenge is to identify a more comfortable portfolio design that can still achieve the long-term objectives of that client. The cooperation we need from clients during these anxious conversations is to avoid overreacting. Bailing out of a well-designed investment portfolio has almost always backfired for the investor, in our experience.

  II. **On Un-invested Cash:** For investors fortunate enough to have cash reserves available for investment into equities, we believe the process of putting this money to work into stocks should begin and/or continue. This view is informed by our belief that there are attractive opportunities today at the individual security level, rather than any expectation that the overall market has found its floor.
  **Update:** No change in this advice for clients, and it is advice we are executing on clients' behalf – slowly and strategically – with the cash reserves we have in some of our equity investment strategies.

III. **On Fixed Income:** We believe investors should not be alarmed by media headlines about the Fed raising interest rates. Fixed income markets have already priced in a 3%+ Fed Funds rate, so the Fed needs to hike interest rates aggressively just to catch up to where bonds are already trading.

**Update:** As described above, this past week saw a material shift in the consensus expectation for central bank monetary policy, with the estimated pace of interest rate increases pulled forward, and the assumed terminal rate for Fed Funds pushed higher toward 4%.

**We do not expect the Fed to take its Federal Funds interest rate target materially above 4% during this tightening cycle. As such, we believe the worst of the bond market rout may finally be near, if not already in place.**

Several considerations underpin this view. First is our belief that the structural forces that drove inflation lower throughout the past 30 years have not disappeared. Of the three main drivers for structurally lower inflation, two remain in place, in our opinion, while the third may be disrupted, but it is probably not dead.

The first two drivers are demographics and digital innovation. Population growth has decelerated materially throughout the developed world in recent decades, keeping downward pressure on economic growth potential due to the impact of demographics on Gross Domestic Product (GDP), which consists of population + productivity (how many people are available to bake the pizza, and how many pizzas can each person bake in an hour).

Meanwhile, the trend toward digitization of everything continues unabated, in our view, allowing the productivity side of the GDP equation to promote "real" growth, net of inflation.

The third driver of structurally low inflation involves a multi-decade migration toward globalized supply chains throughout the developed world. Unfortunately, increasing geopolitical tensions with China and the war in Ukraine have thrown a wrench into this phenomenon with negative consequences for inflation. However, we observe that companies are already adjusting to the new world order by re-directing and/or reshoring their supply chains.

We also find comfort in a simple concept of inflation math that is easy to overlook. Specifically, prices don't need to *drop* to relieve the upward pressure on headline inflation. Prices simply need to stop going up.

We do not expect the price of most items – including food and energy – to *decline* in the foreseeable future. However, we believe it is plausible that the price of many items – including food and energy – can stabilize near recently elevated levels.

For every item in the typical consumption basket that simply stops surging higher, the upward pressure on the *year-over-year* change in inflation from that item can be relieved. For example, if oil is still trading around $120 one year from now, its contribution to year-over-year inflation will drop to approximately zero.

This dynamic cannot restore the loss of purchasing power that has already occurred for American consumers. However, we suspect there is scope for headline inflation to surprise on the downside sometime over the next 12-months, just as it has surprised on the upside more recently. This may be all that is needed to put a halt to the upward march of interest rates and allow stocks to find a durable bottom.

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The **Nasdaq-100 Index** is a stock market index made up of equity securities issued by 100 of the largest non-financial companies listed on the Nasdaq stock market. It is a modified capitalization-weighted index.

The **Russell 2000 Index** is a small-cap stock market index that makes up the smallest 2,000 stocks in the Russell 3000 Index.

The **Bloomberg US Corporate High Yield Bond Index** measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

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