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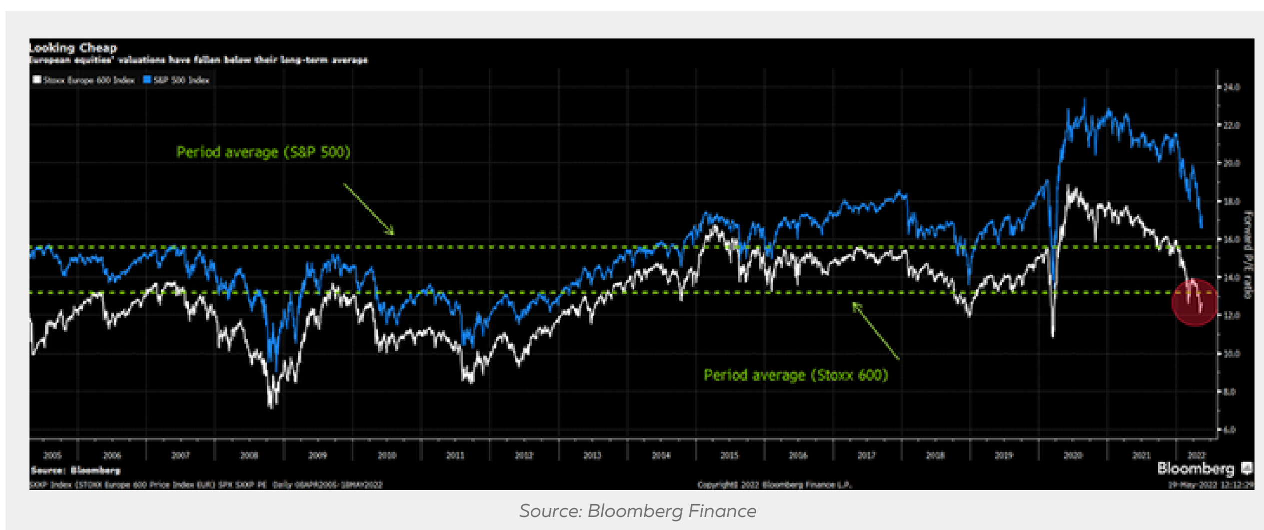
SUSTAINABLE VALUE INVESTING

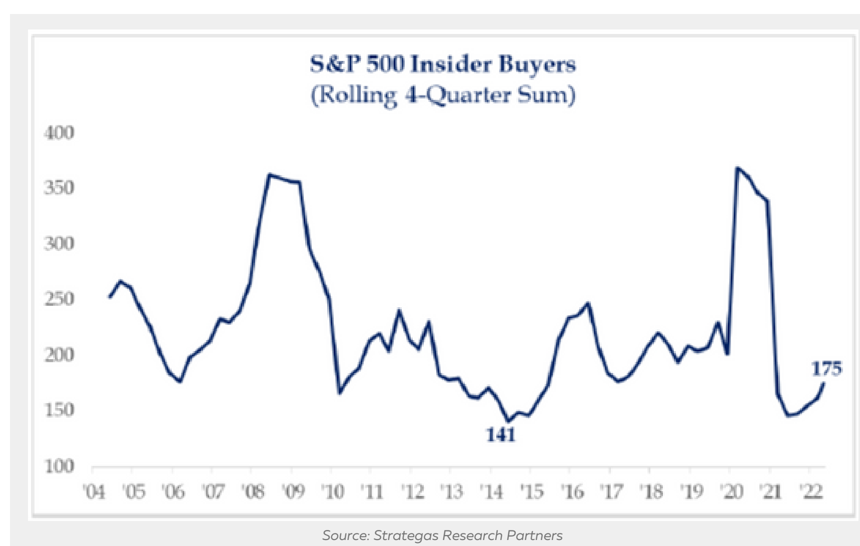
WEEKLY INVESTMENT **UPDATE** 20-21

In our last update we noted that the average stock in the US has declined by -24% which historically had marked an increased probability of a tradeable equity bounce. Last week broke the multiweek losing streak for global equities as most major indices produced a strong bounce. Equity declines prior to last week have gone some way in discounting the deteriorating financial market backdrop. The chart below shows the US price/earnings ratio (blue line) has fallen from almost 24x one year ago to just under 18x currently. European equity valuations have corrected more sharply on a relative basis and now stand at just 12x – below the historical average of the past 17 years.



Source: Bloomberg Finance

The emergence of some value in equities seemed to be confirmed by the recent change in insider buying behaviour. During market declines, it can be useful to look at the insider transactions to get an indication of when management believes their stock is cheap enough to buy. The latest data shows that insiders are slowly beginning to purchase stock (chart below) with the average stock down more than 20% from its 52-week high.



Source: Strategas Research Partners

Only time will tell whether the short-term rebound is the beginning of a sustained recovery in stock prices, or a temporary blip caused by selling exhaustion. It is important to remember that not all market bottoms look like the V-shaped one experienced after the initial Covid induced market meltdown. in 2020. Equity indices do not fall in straight lines. Recalling the bursting of the dotcom bubble, the NASDAQ Composite dropped a stunning 80% from its high in March 2000 to its nadir in October 2002. In that time, there were eight significant rallies in the Index that averaged just over 26% (chart and table below) and lasted from 2 weeks to 3 months. Calling the ultimate bottom of a market correcting many years of speculative excess is no easier today than it was 20 years ago.

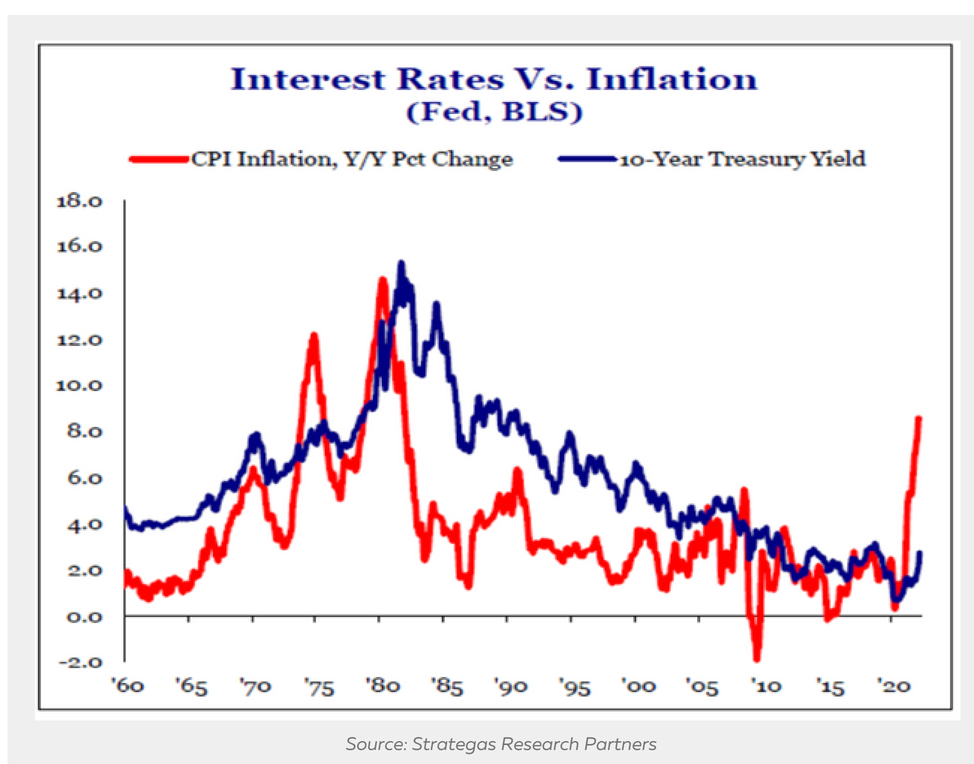
Source: Bloomberg Finance

NASDAQ Counter Trend Rallies
From March Of 2000 to October of 2002

Beginning Date	Ending Date	Return	Length In Days
4/14/2000	5/1/2000	19.17%	17
5/23/2000	7/17/2000	35.08%	55
8/2/2000	9/1/2000	15.74%	30
10/12/2000	10/20/2000	13.28%	8
11/30/2000	12/11/2000	16.06%	11
1/2/2001	1/24/2001	24.75%	22
4/4/2001	5/22/2001	41.19%	48
9/21/2001	12/6/2001	44.34%	76

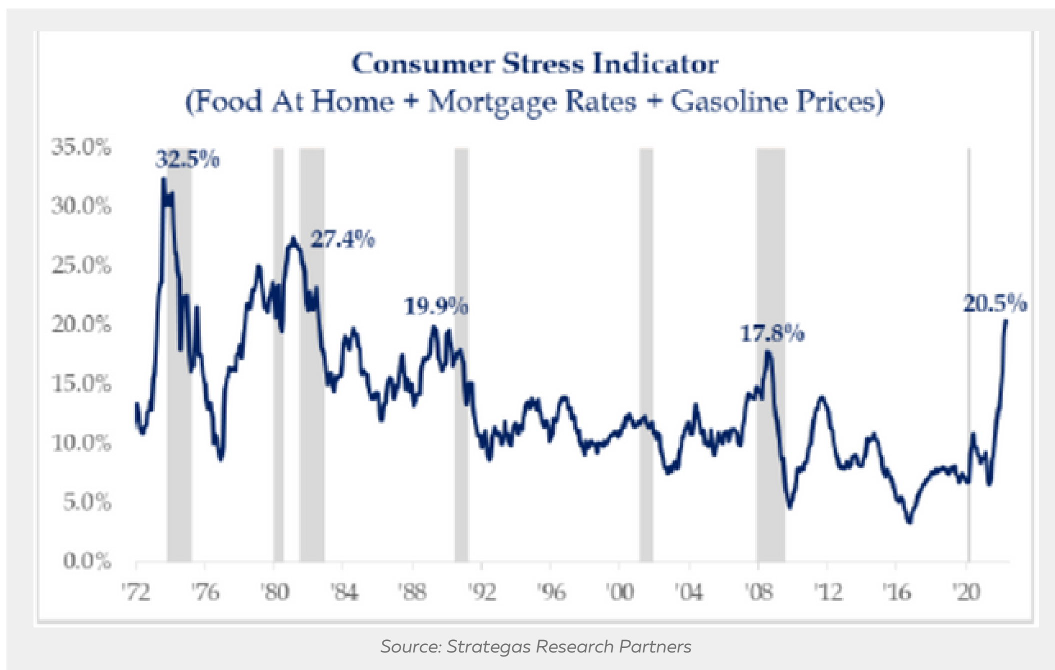
Source: Strategas Research Partners

Market optimist will point to the most recent US inflation figures which suggest some moderation in the pace of price increases. Recently released minutes of the last Federal Reserve meeting were interpreted as showing the willingness of the Fed to pause with rate hikes once it had achieved a more neutral level for the short-term rate (interpreted as close to 3%). We have produced the below chart in prior writings to highlight how behind the curve the Fed is in addressing the current spike in inflation. The Fed needs a lot of help in the form of smoothly functioning supply chains and declining commodity prices in order for inflation to falling quickly back to its 2% target without the need to raise rates beyond 3%. While not impossible, it does appear to be the low probability scenario at this point and suggests that a more defensive portfolio strategy is still warranted.



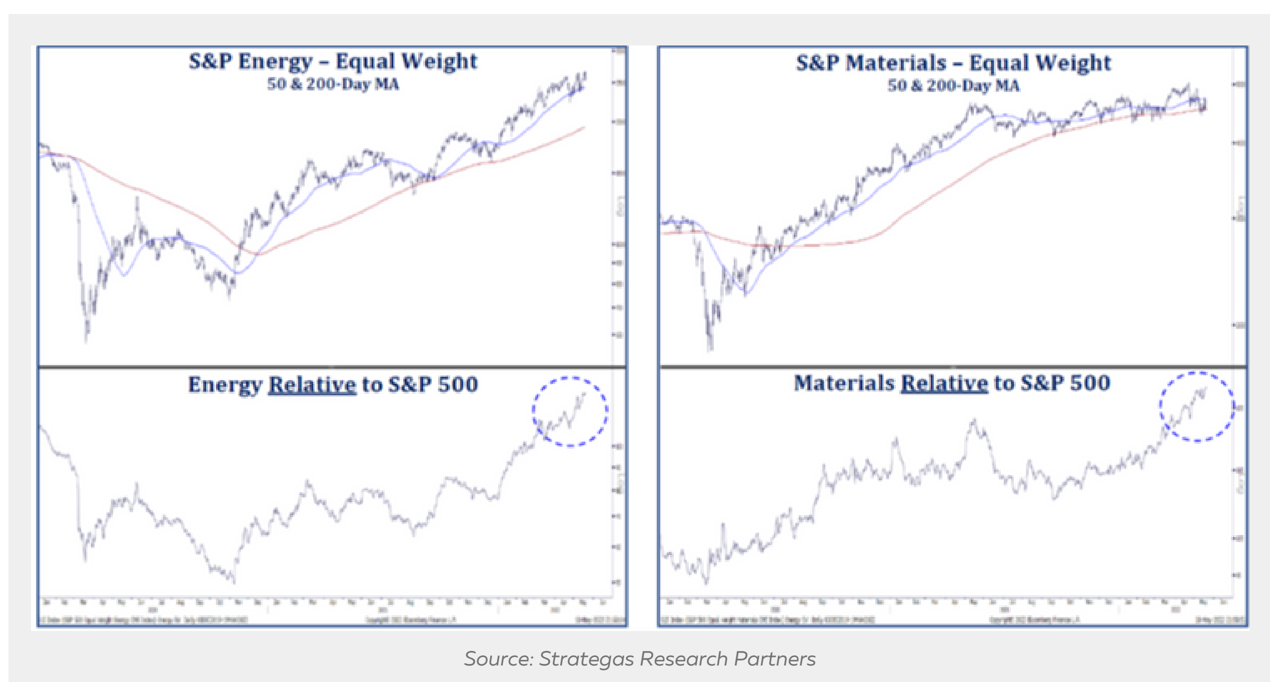
Source: Strategas Research Partners

If supply does not quickly improve to meet current levels of demand, then demand must fall to get back in sync with supply in order for inflation to moderate significantly. This is another way of saying that a higher probability scenario is that the Fed will need to induce an economic slowdown in order get inflation under control. The chart below would suggest that the effect of high commodity prices combined with the recent surge in interest rates is already placing pressure on the largest component of US economic growth – the consumer. Combining the year-over-year percentage change in food at home, mortgage rates, and gas prices shows that consumers' wallets have been the most stressed since the early 1980s. With the current reading above 20%, only two periods saw higher readings, both of which resulted in recessions. Consumer stocks have been pricing this in for some time, but there could still be more pain as unemployment is still historically low.



Source: Strategas Research Partners

We will remain faithful disciples to the weight of market evidence and certainly will change our tune should more indicators confirm the success of global central banks in engineering a soft economic landing while controlling the rise in inflation. However, currently we are not comfortable with the building consensus of a 'peak inflation' or rapid return to 2% inflation. The two charts below show the continued relative outperformance of the Energy and Materials sectors – it would be more consistent for the relative performance of both of these groups to peak before inflation peaks.

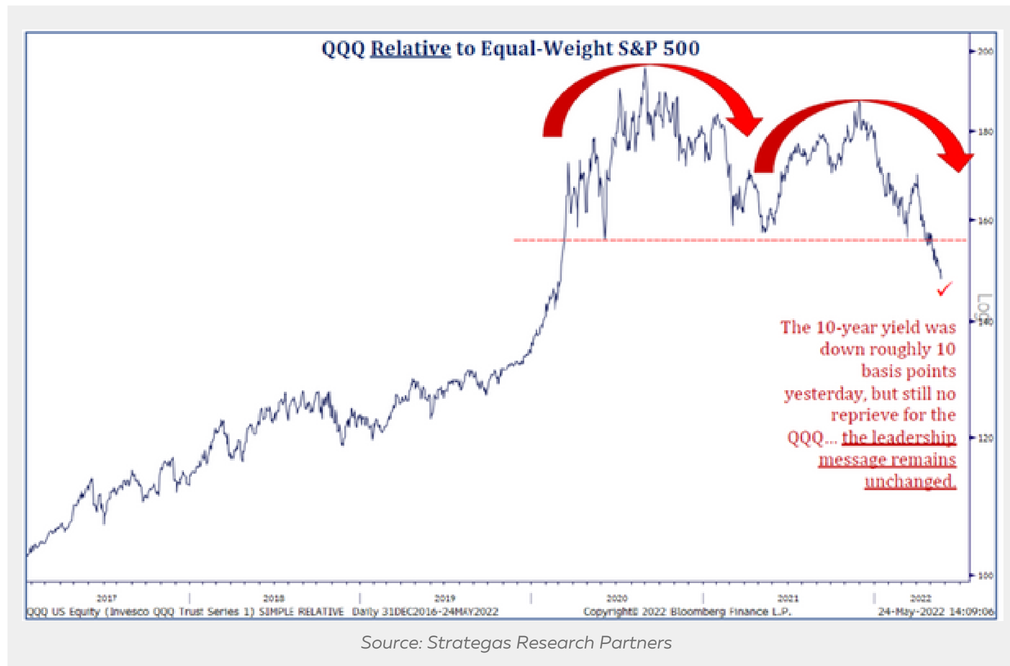


Source: Strategas Research Partners

We have also reproduced the chart below in many previous updates in the context that the market tends to not get into too much trouble once margins are in expansionary mode or at least stable. From the chart below, it is evident that margins have peaked and are clearly beginning to decline. The rising costs that companies face are proving to be too much even in a strong revenue environment. The weakening consumer, Fed tightening cycle, and rising energy costs are just beginning to bite. This pokes a hole in the argument that improved index valuations are building the foundation for a strong market recovery. The P in the p/e multiple calculation always responds first to signs of building economic risks. The E or earnings estimates only follow with a lag if indeed the concerns of an economic slowdown prove correct. Earnings estimates for 2022 and 2023 have remained resilient during the current market correction. With margins starting to roll over we suspect that current earnings estimates will come under some degree of pressure.

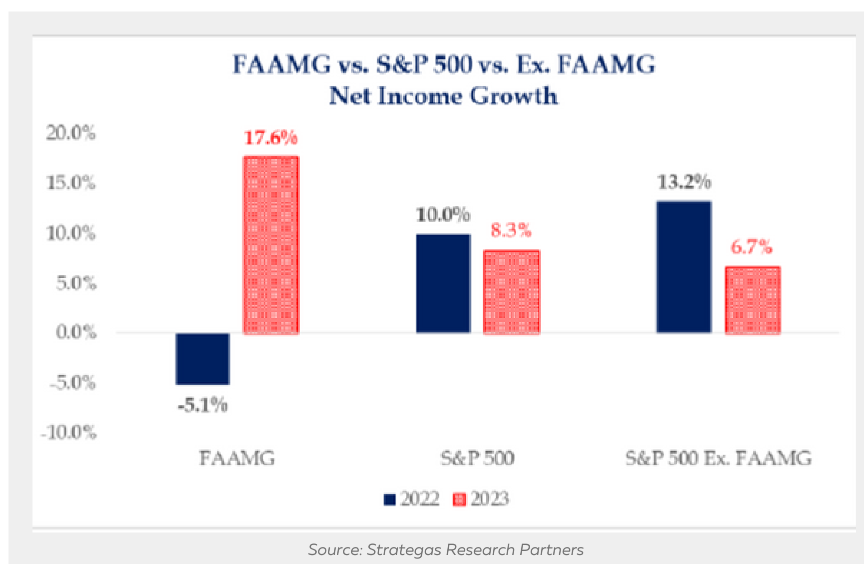
Source: Strategas Research Partners

In the current environment security selection and sector exposure will be crucial in a portfolio's ability to weather the current volatility and protect capital. It is important to pay attention when markets defy the consensus view or popular thinking. We have frequently encountered a general investor thinking that once bond yields find a top then it is the moment to build back exposure to the growth stocks (especially technology) that did so well in the zero interest rate environment from 2010-2020. Yet US 10 year bond yields are roughly -50bps off their highs, yet the chart below of the relative performance of the QQQ (Nasdaq ETF) vs. the equal-weighted S&P continues to trade at new lows. Investors expecting a return to the old playbook of buying growth at any price are failing to recognize the significant regime shift that has taken place over the last year.



Source: Strategas Research Partners

Income growth for the FAAMG (Facebook, Apple, Amazon, Microsoft, Google) stocks this year is expected to decline -5% (first chart below). This is a material change to years past where these stocks were growth leaders. Although the consensus believes growth will return next year for these companies, the bigger risk may be if growth expectations disappoint once again. The second chart below just shows the difficulty which sell-side analyst are having readjusting their recommendations despite the material change in the relative earnings strength of these companies and their still above average valuations. Despite a deteriorating earnings outlook, of the 164 combined analyst recommendations on Alphabet, Amazon, and Microsoft there is only ONE sell rating. This would suggest that expectations still need to be adjusted and it should be remembered that this FAAMG group still comprises > 20% of the overall index.



Source: Strategas Research Partners

Source: Bloomberg Finance

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