# Investment Strategy Update

**May 2022**


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Good afternoon, we wanted to share some current thoughts on the markets and portfolio construction given this challenging investment environment.

- So far this market decline looks similar to the declines equity markets experienced in 2010, 2011, 2015, 2016 and 2018, at least on the surface. As of the market close on Monday 5/9/22, the S&P 500 is down -15.9% year to date (all time highs for the S&P 500 occurred on 1/3/22). Each of the five previous declines referenced above ended up being -15% to -20% peak-to-trough drawdowns for US Large Cap equities. That said, not many other similarities exist between the current decline and these previous instances.

  - Previous declines were associated with growth scares that never came to fruition. The majority of this sell off has been driven by a re-rating of asset prices to this point. We distributed an Investment Strategy Update in January on this topic, please reference that email for additional information.

  - Previous declines saw other equity asset classes (US Mid Cap, US Small Cap, International Developed & Emerging Markets) all experience larger sell offs than the S&P 500. Year to date, non US equities are down slightly more than US large cap equities, while US small and mid-cap equities are down around the same as US large cap equities.

  - This is the first time in the post 2008 era (and really since the 1960's) that we have seen interest rates move higher (bond prices go down) while equity markets have sold off in a meaningful way.

  - In addition, commodities have acted as a true portfolio diversifier to stocks and bonds, instead of simply another risk asset correlated to stocks.

  - Unlike the COVID crash when technology stocks acted as a safe haven, technology related stocks have been the epicenter of this market decline, which has been ongoing for over a year now in the smaller, non-profitable businesses. The S&P 500 is down only about half of what it was in February / March 2020. The NASDAQ is down -25% year to date through 5/9/22 vs. its -30% decline in February / March 2020.

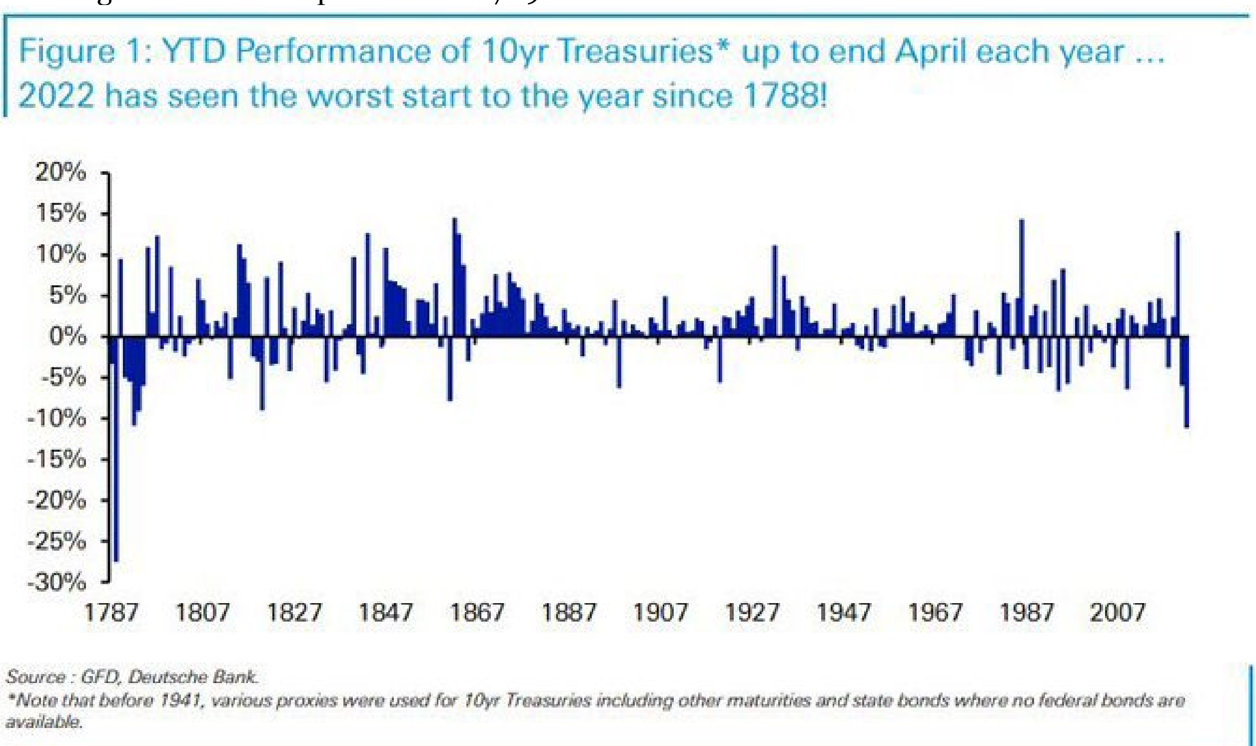
  - Crypto currencies have quickly lost their narrative as an "inflation hedge" or "store of value." They may have plenty of value moving forward, but 2022 has displayed their true characteristics as a high beta risk asset (highly correlated to the NASDAQ).

  - These facts are among the increasing evidence we are interpreting as a signal of a regime change across the economy capital markets. Simply stated, we believe investors are going to need to structure portfolios differently for the next several years than they have for the last decade given the 180 degree shift in central bank policy and 40 year high inflation readings, which exist across most of the world – not just the US. 2009 – 2021 will go down in the history books as the "QE era."

## The Bond Market

- Most investors usually focus their attention disproportionately on the equity market rather than the fixed income markets, which is probably justified most of the time as the bond market is often "boring" from a return perspective. Unfortunately that is not the case year to date. The most common broad measure of the stock market is the S&P 500, which is down -15.9% YTD through Monday 5/9/22. The most common broad measure of the bond market - the Bloomberg Barclays Aggregate Bond Index - was down -10.4% YTD through Friday 5/6/22. The Bloomberg Barclays Aggregate Bond Index has data back to 1976, and since inception the worst calendar year return for the Bloomberg Barclays Aggregate Bond Index was -2.9% in 1994 *(source MBL Advisors & FactSet)*.

  In addition to the Bloomberg Barclays Aggregate Bond Index, 10 Year Treasury bonds are often used as another broad measure of the taxable bond market. Jim Bianco tweeted a chart from Deutsche Bank which noted that 10 Year Treasury bonds are having their worst total return start to the year since 1788! Jim noted that this was just before George Washington was elected president in 1789.




*Source Deutsche Bank & Bianco Research*

- It seems rather obvious in hindsight, but government bonds markets were manipulated for years through quantitative easing programs and central bank policy. Although it is painful in the short term, restoring a free market to the most important asset class in the world (US Treasury bonds) is a very healthy dynamic for investors across all asset classes in the longer term.

- Some silver lining around the bond market is that it would be very difficult for interest rates to continue to move higher at the same pace which they have over the last 6 months or so. Although fixed income yields are not attractive relative to current levels of inflation, short term treasury bond yields are at levels which haven't been seen since 2008, outside of a brief period in 2018. For example, 3 Year Treasury bonds are generally considered to be a low risk investment and their yield to maturity is currently just over 2.8% per year.

## Additional Perspective on Technology Stocks

- Over the last several months the most severe drawdowns have occurred precisely in the areas of the market in which they should have occurred – the most speculative corners. Cathy Wood's ARKK ETF was the poster child for "disruptive" and "innovative" businesses. Her flagship ARKK ETF had a some terrific years including producing gains of 87% in 2017 and 152% in 2020 *(source: https://ark-funds.com/funds/arkk/)*. Nonetheless the tides have turned, and ARKK has given up all of its cumulative relative outperformance (and then some) vs. the S&P 500 over the last five years. ARKK is down -56% YTD through 5/9/22 *(source: MBL Advisors & FactSet)* after being down -23% in 2021 *(source: https://ark-funds.com/funds/arkk/)*. These same stocks are no longer referred to as "disruptive" or "innovative" by the financial media, but rather "non profitable," "speculative," or "COVID stocks."

- Even many good / great, profitable businesses are down -30% to -50%+ YTD including Amazon, Facebook, Salesforce, Nvidia, PayPal, BlackRock, Home Depot, Starbucks, Walt Disney, Adobe, to name several. These businesses share two general things in common: (i) Their valuations were way too high, and many of these companies are still far from anything resembling "cheap" on most metrics, and (ii) they are all found (outside of BlackRock) in one of three sectors – technology, communication services or consumer discretionary.

- We believe the likes of Amazon, Salesforce, etc. (just as an example, could pick any of the names listed above) will trade to and through their previous all-time highs at some point in the future. Who knows when, but these businesses are not impaired in any way, shape or form, and are still incredibly profitable and successful companies. Similar to the broader equity indices, they were just priced for perfection in a world of 0% interest rates, which is no longer the reality. When this cleansing process is finished we believe it will be a very healthy adjustment for the markets and is the exact thing we needed in order to set up quality, profitable businesses to experience normalized and sustainable performance in the years to come.

- Conversely, many of the non-profitable, "world changing" businesses may never see their previous all-time highs ever again. Some of them have lost an enormous amount of capital over the last several years and remain unprofitable.

- Over the last twenty years Chase Coleman has built Tiger Global into one of the most well renowned growth investors in the world. Wikipedia estimated that Chase Coleman's personal net worth was $10.3 Billion as of October 2021, at 46 years old (source: https://en.wikipedia.org/wiki/Chase_Coleman_III). Tiger Global is best known for its (public market) hedge fund but they are also an increasingly large player in the private markets. In 2021, Tiger Global invested client capital into 335 private market deals and various media outlets were declaring that Tiger Global was changing VC investing

(Source: https://www.businessinsider.com/tiger-global-changed-venture-capital-startups-funding).

To be clear, our take on investing in 335 private (mostly startup) businesses in a single calendar year means it wasn't humanly possible to conduct much due diligence on these investments.

Even worse, as of the end of April, Tiger Global's public market hedge fund has lost $17 billion year to date and given up roughly two – thirds of their cumulative gains since their inception in 2001 according to estimates from LCH Investments (source: https://www.marketwatch.com/story/hedge-fund-tiger-global-loses-17-billion-due-to-tech-stock-rout-11652189689?mod=newsviewer_click)

Our point in noting all of this is to reinforce the narrative that a regime place is taking place across markets, and investing might not seem as "easy" moving forward. We don't necessarily interpret this as a bad thing, as markets should become more fundamentally driven than they have been for at least the last couple of years.

## Some guesses on where equity markets could go from here

- Of course, nobody knows where we go from here, and we never claim to be special in that regard. But there are several items we are thinking about for some semblance of guidance right now.

- At the beginning of the year we noted the terrific research from Dan Clifton and Strategas Research Partners regarding stock market volatility in midterm election years. The average peak to trough drawdown during a midterm election year is -19% in comparison to an average correction of -13% in years 1, 3 & 4 of the presidential election cycle *(source: Dan Clifton & Strategas Research Partners)*. An average midterm election year decline would mean that the S&P 500 would bottom out for the year around 3850 +/- . Additional good news is that the S&P 500 has experienced average gains of 31% one year after the midterm correction low *(source: Dan Clifton & Strategas Research Partners)*.

- Where and when the re-rating process is ultimately finished will be heavily influenced by the path of interest rates and Federal Reserve Policy. Regardless of the outcome, meaningful progress has been made on this front. The S&P 500 traded at 22x to 24x forward earnings from May 2020 through December 2021. As of the market close on 5/9/22, the S&P 500 now trades at 17.04x forward earnings estimates. The S&P 500 has traded at 15.78x forward earnings on average over the last 20 years. The S&P 500 almost never trades exactly at an "average" valuation metric, but for context this would equate to roughly 3700 on the S&P 500. The 2015, 2016, 2018 and 2020 bear markets all bottomed around 14x – 15x forward earnings. U.S equity markets were less expensive from 2009 – 2012.

- The average trailing 12 month P/E Ratio for the S&P 500 over the last 20 years is 19.07x. The S&P 500 is currently trading in line with its 20 year average at 19.61x trailing 12 month earnings as of 5/9/22 or roughly 4000 on the S&P 500. The 2015, 2016, 2018 and 2020 bear markets all bottomed around 15x – 17.5x trailing twelve months earnings.

- Technical analysis considers Fibonacci levels to be of significant importance. Fibonacci levels are mathematical patterns which when translated to financial markets help in determining levels of support and resistance. The 38% retracement levels refers to giving up 38% of the gains from the COVID lows to the all-time closing highs. This equates to roughly 3800 on the S&P 500.

- The 50% Fibonacci retracement level, or giving up half of the gains between the COVID lows and all time highs would equate to a little above 3500 on the S&P 500. For reference, the pre COVID highs on the S&P 500 were roughly 3400 +/- in early 2020. S&P 500 earnings were roughly $161 per share in 2019. Granted, US equity markets were not cheap prior to COVID, but this is in comparison to $206 of S&P 500 earnings per share in 2021. Said another way, even in a recession scenario, there is a high likelihood that S&P 500 earnings would stay above pre COVID levels.

- One of the longstanding principles of the bullish outlook for stocks over the last several years has been the fact that stocks were cheap relative to bonds. If we look at data prior to 2008 this viewpoint maintains some validity today. Conversely, stocks are close to the most expensive they have been relative to bonds since after 2008. Our favorite measure of relative valuation of stock vs. bonds is the equity risk premium, which is the theoretical risk premium equity investors should earn over fixed income investors. If the 10 Year Treasury was at 3% (it's at 3.04% on 5/9/22), it would require the S&P 500 to trade at 16x forward earnings in order to achieve a healthy, somewhat normal post 2008 equity risk premium of 3.25%. This currently equates to 3750 on the S&P 500.

- Aside from a few days or weeks in late summer 2011 and in March 2020, the S&P 500 has traded above its 200 week moving average since late 2010. The 200 week moving average is an important line of support and markets trading above this long term moving average are the hallmark of a bull market. Currently the 200 week moving average for the S&P 500 is around 3500 and rising.

- Far more important than any specific level are various measures we use to help gauge if markets are oversold or not. The bottom line is that we are getting closer, but markets are not washed out like they were in 2011, 2016, 2018 or 2020. To be clear markets are oversold to a degree, but probably not to the degree required to mark the end of cyclical bear market. We are using investors' "actions" to measure oversold conditions, using various pieces of market data.

- One measure of investors' "words" is the most bearish it has been since the early 1990's. The American Association of Individual Investors polls investors to see if they are *bullish, bearish or neutral* in their outlook for the stock market on a weekly basis. Less people claimed that they were *bullish* during the last two weeks of April 2022 than they were at any point in 2008 or COVID. Our interpretation of this is because some retail investors have been concentrated in the growth stocks which have been hit the hardest this year. So to them, this correction feels worse than March 2020, and possibly even 2008 for the small cap growth investors.

  In summary, there are several guideposts which suggest that markets could find a bottom around levels 5% - 10% lower than we are today. Having said this, we ultimately will probably need to see true capitulation (we are monitoring but not there yet) and possibly even a casualty (i.e. a hedge fund blowing up) before this process is complete.

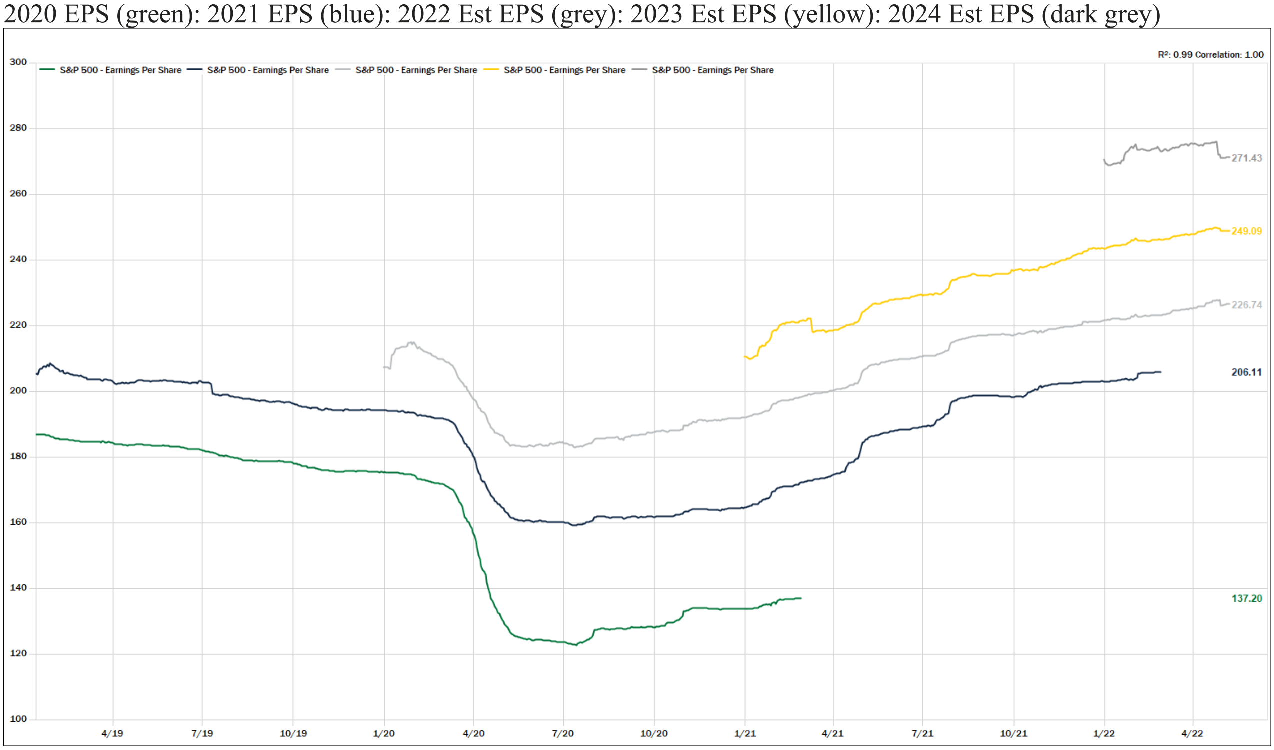
**Corporate Earnings**

- During the previous bear markets from 2010 – 2020 investors were concerned with a growth slow down and year over year earnings growth turning negative. 2020 was the only one of those instances when earnings declined in a meaningful way on a YoY basis. Up to this point, the current decline across asset classes has been a valuation adjustment in attempt to price in a very different economic environment. We do think it is important to point out that large bear markets almost always happen because earnings go down and valuations contract, at the same time.

- For context, analyst expectations for S&P 500 earnings declined by roughly 20% in 2020. In reality, actual S&P 500 earnings declined by roughly 16% in 2020 *(source MBL Advisors & FactSet)*. The peak-to-trough sell off for the S&P 500 in 2020 was -36%+/-. 2008 was the most dramatic decline in corporate earnings in the post-WWII era.

- S&P 500 earnings estimates have **not** been revised lower for 2022 or 2023 as of right now. Having said this, earnings estimates could begin to deteriorate, especially if record high profit margins begin to recede. Nonetheless, 2022 earnings have a good probability of coming in higher than 2021 earnings, and if 2023 earnings estimates continue to stay above 2022 earnings forecasts, this should ultimately be supportive for the market.

2020 EPS (green): 2021 EPS (blue): 2022 Est EPS (grey): 2023 Est EPS (yellow): 2024 Est EPS (dark grey)




*source MBL Advisors & FactSet*

- The main takeaway is that the green line shows how much S&P 500 earnings declined in 2020. There is little evidence to suggest that 2022 or 2023 will see negative earnings growth as of right now.

- Over very long periods of time, the stock market should appreciate by roughly the same rate at which corporate earnings grow. The multiple investors pay for a future stream of earnings is what causes the growth rates between stock prices and earnings to diverge over short and intermediate time frames. Using this general measure, stock market appreciation and corporate earnings growth were way out of line for most of 2021 but have become much more reasonable at the moment.

As we can see below, the appreciation in S&P 500 has outpaced the growth rate of S&P 500 earnings since the 2007 market top. This S&P 500 has drastically outpaced earnings growth over the last ten years, but this speaks to how cheap the market was on a forward P/E basis in the aftermath of 2008. Conversely, S&P 500 earnings are up by more than the S&P 500 over the last five years as well as since 1/1/20 which serves as a proxy for the pre COVID peak in earnings. Over the last three years, price appreciation and earnings growth have generally tracked each other. This is very different from various points during 2021 when the S&P 500 was more than 40% ahead of earnings on a rolling three year basis. Data can often say whatever someone would like it to say by cherry-picking starting and ending points, but the figures below speak to the fact that fundamentals and prices have converged over the last few months.

| **Starting Date** | **Significance of date** | **S&P 500 % Appreciation** | **S&P 500 % EPS Growth** |
|---|---|---|---|
| **10/9/2007** | 2007 Market Top | **155%** | 130% |
| **5/9/2012** | 10 Years Ago | **194%** | 106% |
| **5/9/2017** | 5 Years Ago | 66% | **73%** |
| **5/9/2019** | 3 Years Ago | **39%** | 37% |
| **1/1/2020** | Pre COVID | 24% | **34%** |

*Source: MBL Advisors & FactSet*

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- Another interesting exercise which crossed our minds is to strive to account for the inappropriate fiscal and monetary policy over the last couple of years and conduct an exercise of "normalizing" EPS. Using data from FactSet, we have discovered that S&P 500 EPS have grown at an average rate of 7.72% per year for the last 20 years. If we were to use the 2019 S&P 500 EPS of as a starting point, and compound earnings at a "normalized" growth rate of 7% per year, it would result in 2022 EPS $197 of and 2023 EPS of $211. $211 of S&P 500 EPS would also be the equivalent of holdings EPS flat from now through the end of 2023. Once again, this math could point to support in the S&P 500 around 3500 +/-.

**Economic Indicators**

- Generally speaking economic activity is telling a similar story to corporate earnings. Yes, growth is slowing / moderating / normalizing from unsustainable levels. This is not a surprise to anyone and is very well priced into markets at this point. Further downside surprises to economic growth and / or upside surprises to inflation data are the primary catalysts for increasing anxiety in markets.

- We read the most research from four different sources: Strategas Research Partners, Yardeni Research, BofA Global Research and FS Insight. Both separately and in the aggregate, they provide us with terrific insights and knowledge.

    - As of 5/9/22 Don Rissmiller and Strategas Research Partners are using a 40% chance of recession, 50% chance of a soft landing and a 10% chance of an upside surprise for the economy. Don is most nervous in regards to:
        - The Q1 2022 negative GDP print. Only 8 of the last 38 negative quarterly GDP readings occurred outside of a recession *(source: Strategas Research Partners).*
        - Inflation is likely becoming more sticky. The Fed can influence the demand side of the equation but they don't have any tools to fix the supply side issues.
        - Central Banks seem to be almost solely focused on controlling inflation at the moment, after completely ignoring that part of their mandate in 2020 and 2021.

    - As of 5/10/22 Yardeni Research is using a 30% probability of a recession and a 70% soft landing.

    - As of 5/9/22 BofA Global Research, led by Candace Browning Platt, is increasingly concerned about a "sharp slowdown" in economic activity during the second half of this year.

        - They note that 23 out of 34 global central banks are in "tightening mode," the highest since 2008.

    - Tom Lee from FSInsight is more of a market strategist than an economist. But he continues to point out that "everyone" is focused on what could go wrong, while he continues to point out what could go right for markets. Tom believes there is evidence of inflation beginning to peak and has also noted that "the bond market has done a lot of work for the Fed."

- It is unnerving to see virtually every investment strategist and major Wall Street firm raise their odds for a recession. Having said this, most of them are still using a probability of something less than 50% for a recession occurring in the next 12 – 18 months. We will be monitoring US Economic Leading Indicators, the labor market, and the shape of various yield curves for more clues on if a recession is becoming more imminent or not. Outside of an exogenous shock such as March 2020, there are very few, if any, instances we are aware of where a recession occurred and these specific economic data points didn't give a clear signal. Yield curves have steepened recently, the job market continues to look very solid at the moment, and US Economic Leading Indicators are currently at all time highs. These data points can change quickly, but currently they suggest it is premature to be ringing alarm bells for a recession as of right now.

## Bob Farrell's 10 Investing Rules

Bob Farrell is a legendary Merrill Lynch strategist who published his timeless list of 10 investing rules several decades ago, a version of which can be found at https://www.investopedia.com/articles/fundamental-analysis/09/market-investoraxioms.asp. It seemed some investors believed these rules were no longer as relevant as they once were when they didn't hold true to form during the extremely abnormal bear market and subsequent recovery in 2020. However, all of these rules seem especially pertinent today as we proceed thorough this more traditional bear market. We have written about Bob Farrell's rules before. But we truly can't observe them often enough, especially during times like this.

- *Rule #1. Markets tend to return to the mean over time.*
  Could this be a year of digestion similar to 2011, 2015 & 2018? Each of those years experienced a 15% - 20% correction (all of which were "scary") and then finished the calendar year flat to slightly down. Of course this year could turn out to be worse than those years, but in each of these previous instances investors didn't believe "the bottom" was in until long after it was evident.

- *Rule #2. Excesses in one direction will lead to opposite excesses in the other direction.*
  Who knows how this turns out exactly, but there were no shortage of excesses in 2021. It seems like the market has been unwinding these excesses one by one for over a year now. Monetary policy has quickly shifted from inappropriately accommodative to the most restrictive we have seen in 30 years.

- *Rule #3. There are not new eras – excesses are never permanent.*
  Tech 2.0, Metaverse, NFT's, Crypto, SPAC's, IPO's, Clean energy stocks, Meme stocks, etc. All of the "innovative" investments are down the most. Uncle Warren never got near any of these things, and people proceeded to call him old and washed up. He's looking pretty good at the moment!

- *Rule #4. Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways.*
  The market overshot to the upside and now there is potential for it to overshoot to the downside – past where fundamentals likely justify. These are also precisely the moments in which investors are prone to becoming the most emotional.

- *Rule #5. The public buys the most at the top and the least at the bottom.*
  More on this below.

- *Rule #6. Fear and greed are stronger than long-term resolve.*
  Always a good reminder of the potential for our emotions to negatively impact our investment decisions.

- *Rule #7. Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names.*
  Large cap technology stocks were the sole driver of gains in the back half of last year; most stocks peaked between February – May 2021.

- *Rule #8. Bear markets have three stages – sharp down, reflexive rebound and a drawn out fundamental downtrend.*
  2020 made many believe this was no longer true anymore. Regardless of where this decline ends, price action in 2022 has been that of an old school bear market. This is also a reminder that there is a possibility that we could put

tradable lows in the next couple of weeks which are then retested later this summer. V-shaped bottoms might be a thing of the past, along with the QE era.

- *Rule #9. When all of the experts and forecasts agree – something else is going to happen.*
  More on this below.

- *Rule #10. Bull markets are more fun than bear markets.*
  Although bear markets are more violent, fortunately they also don't last nearly as long as bull markets on average.

**What worries us the most**

- There is clearly no shortage of items to worry about. But during times like this it is always good to remind ourselves that when markets bottomed in March 2009 or March 2020, they didn't bottom because of "good news." There was actually no semblance of genuinely good news whatsoever in either instance. Generally speaking markets bottom because the state of the world was slightly "less bad" than was feared or priced into markets. Coupled with the fact that markets often become extremely oversold and sellers exhaust themselves when bad news is at its peak levels.

- As referenced above in Bob Farrell's Rule #5, BofA Global Research and Michael Hartnett have noted that inflows into equities in 2021 surpassed the inflows into equities during the previous 19 years combined *(Source: BofA Global Research & Michael Hartnett).* On 5/5/22 Hartnett noted that "for every $100 into equities past year or so, only $3 has been redeemed." He continued to note that the $1.1T of inflows into stocks since January 2021 has an average entry point of just under 4300 on the S&P 500 *(Source: BofA Global Research & Michael Hartnett).*

Clearly this is concerning as investors could begin to panic as they become "underwater" in a more meaningful way. Conversely, we would remind ourselves that many investors had been underexposed to equities after experiencing two brutal bear markets in 2000 – 2002 and 2007 – 2009. Once again, deliberate or not, market timing is damaging a plethora of investors.

- See Bob Farrell's Rule #9 above: BofA Global Research and Savita Subramanian have a proprietary model which they refer to as the Sell Side Indicator. It is a contrarian indicator that measures how much equity exposure investment strategists are recommending to their clients. The track record of the sell side indicator is impressive; or said another way, the track record of average recommended equity exposure by strategist is stunningly poor. The highest recommended equity allocations in the last 40 years came precisely around the top of the tech bubble in 2000, and strategists followed this up during the housing bubble in 2007. According to the BofA Global Research Sell Side Indicator, in the aggregate investment strategists were recommending their highest levels of equity exposure since before 2008 in mid to late 2021.


*Source: BofA Global Research & Savita Subramanian*

- Over the long term, earnings and interest rates are the main drivers of the stock market, and we believe they will have an especially heavy influence on the direction of equity markets for the remainder of the year.
    - We have already discussed the fact that 2023 earnings estimates are likely too high and will need to come down in the months ahead. 2022 / 2023 earnings growth turning negative could create downside in markets below the 3500 +/- level we mentioned before. BofA Global Research and Savita Subramanian note that:

**Recession risks rising, would drop EPS to $200 or lower**

Recession risks are low but rising (see recession outlook). GDP recessions have historically resulted in 15-20% EPS drawdowns from peak to trough. But given the less cyclical makeup of the S&P 500 today, using median industry recessionary declines on the index would indicate just a 10% YoY decline in S&P EPS, or $200 (Exhibit 3).

*(Source: BofA Global Research & Savita Subramanian. 2023" bad macro, decent micro. 4/11/22)*

Our takeaway from this note is that even if we go into a recession, corporate earnings might not decline by as much as they have historically, and an inflationary environment only further supports this viewpoint.

- Tom Lee has talked a lot about how "the bond market has done a lot of the work for the Fed." What this means is that interest rates from two years out and longer have already front run the majority of the Fed Rate hikes. 2-to-10 year yields got to their spot in a hurry once the rate hiking cycle became apparent, before the Fed even hiked short term rates for the first time. Tom Lee points out that this move in intermediate term interest rates is abnormal for the beginning of rate hiking cycles and has already tightened financial conditions in a meaningful way, which is exactly what the Fed wants to do in order to combat inflation.

The bond market is currently pricing in a terminal Fed Funds Rate around 3.25% in late 2023 or early 2024. If it becomes clear at some point that the Fed will need to hike the Federal Funds Rate above 3.25% during this tightening cycle, this will very likely cause additional downside in equity markets through an even more severe re-rating of risk assets. Inflation data will be the key to if interest rates have to move higher than is currently priced in.

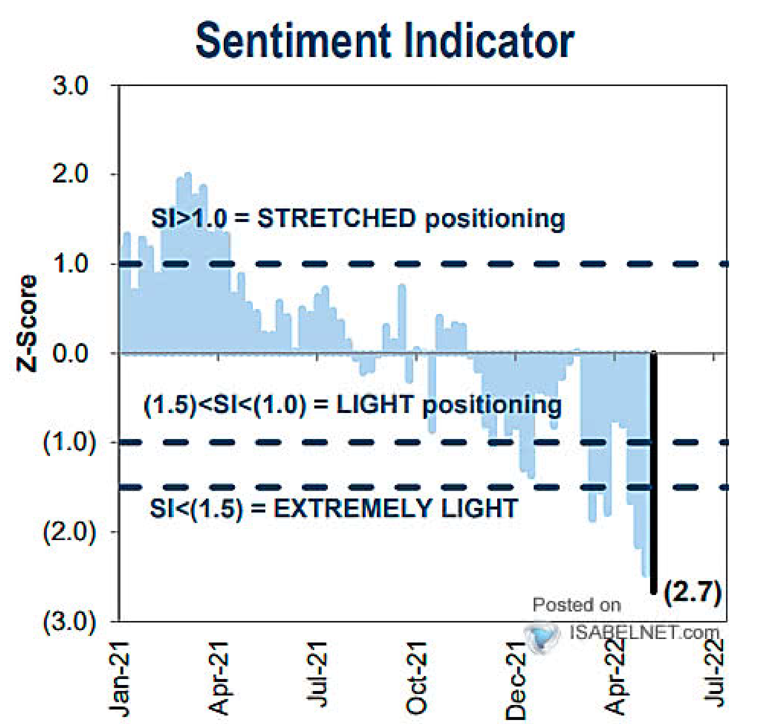
**Potential Positive Catalysts that could help the markets put in a bottom:**

- Sufficiently oversold technical conditions. (We are getting closer).

- Valuation support. (We are getting closer).

- Maybe most importantly, a less hawkish Fed as a result of evidence that inflation will be trending downward in the back half of this year.

- Tom Lee recently noted that the Goldman Sachs sentiment indicator remains extremely stretched to the downside (contrarian bullish).




Note: Sentiment Indicator measures stock positioning across retail, institutional, and foreign investors versus the past 12 months. Readings below -1.0 or above +1.0 indicate extreme positions that are significant in predicting future returns.

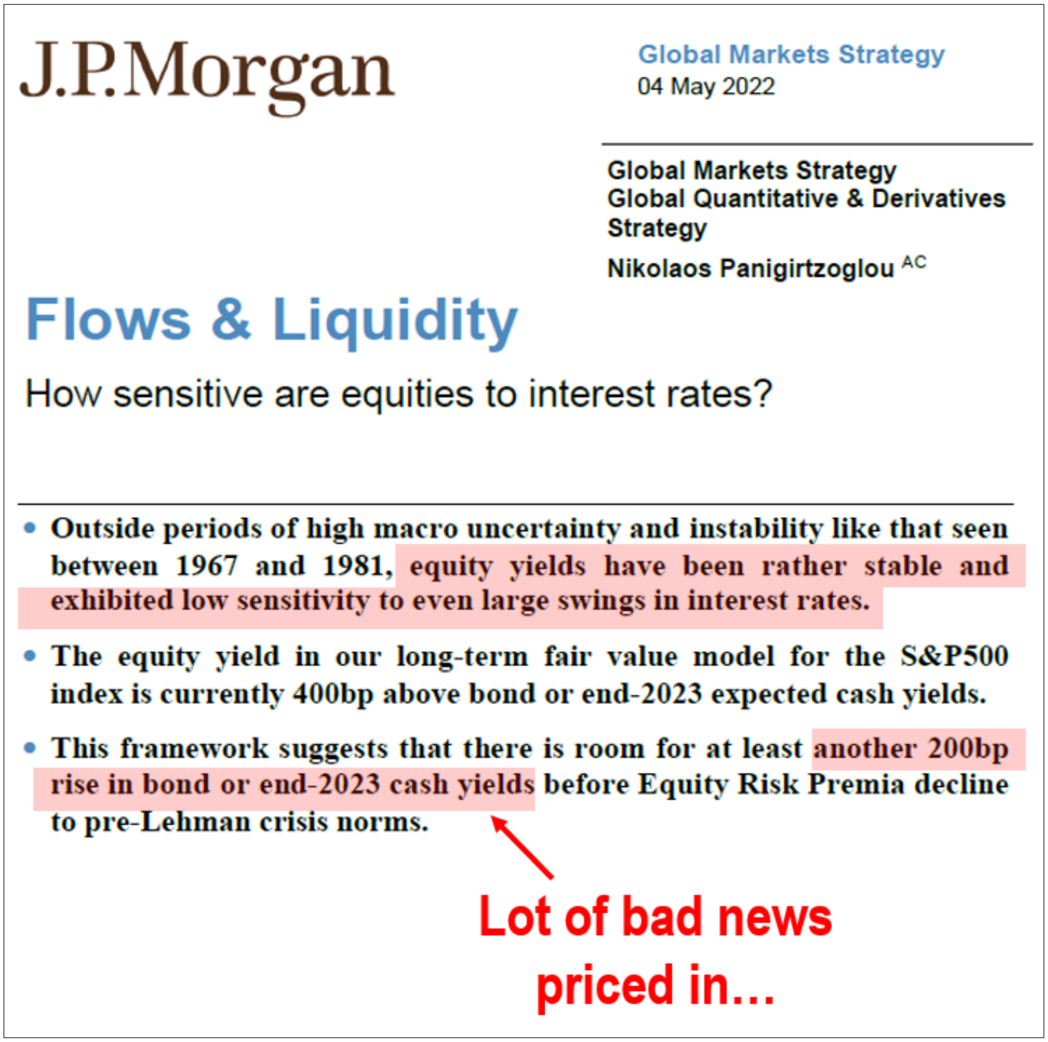
Source: Haver, EPFR, FactSet, CFTC, and Goldman Sachs Global Investment Research.

- Evidence that year over year inflation readings have peaked. (Big CPI report on Wednesday 5/11/22).

- Evidence that corporate profit margins can maintain these levels / cost pressures are beginning to ease.

- Better forward guidance during Q2 earnings season this summer.

- Tom also references a JP Morgan Global Markets Strategy report which believes that stocks don't have to see any additional multiple contraction until the 10 Year Treasury reaches 5%. I'm not sure we agree with this viewpoint, but we absolutely take note when people as smart as Tom Lee and the JP Morgan Global Markets Strategy team believe this.



J.P.Morgan

Global Markets Strategy
04 May 2022

Global Markets Strategy
Global Quantitative & Derivatives Strategy

Nikolaos Panigirtzoglou [AC]

# Flows & Liquidity

How sensitive are equities to interest rates?

- **Outside periods of high macro uncertainty and instability like that seen between 1967 and 1981, equity yields have been rather stable and exhibited low sensitivity to even large swings in interest rates.**
- **The equity yield in our long-term fair value model for the S&P500 index is currently 400bp above bond or end-2023 expected cash yields.**
- **This framework suggests that there is room for at least another 200bp rise in bond or end-2023 cash yields before Equity Risk Premia decline to pre-Lehman crisis norms.**

Lot of bad news priced in…

*Source: FSInsight & Tom Lee: JP Morgan Global Markets Strategy*

**Portfolio Construction Considerations**

- We have been managing most portfolios to an equity target which is in line with our longer term strategic equity targets since January 2021. There were times during the front half of 2021 when we wondered if we should have been overweight equities, but are now pleased we stuck to our discipline.

- Within equities our positioning has changed a lot over the last year despite remaining consistently in line with our strategic equity targets. We have continued to emphasize managers and / or factor ETFs which have tilted towards a quality / value / lower volatility bias and away from a growth bias.

- We downgraded non US equities in late February from a slight underweight to a large underweight position, the day Russia invaded Ukraine. We are generally 75% - 80% of our strategic targets in non-US equities.

- Currently our largest overweight within equities is to Equity Income, an asset class which we had no exposure at the beginning of 2021.

- Our allocations to Equity Income, Trend Following equities, Hedged equities and Thematic equities have all held up well relative to traditional, long only equity exposure YTD.

- We added a trend following manager to portfolios last summer who has produced positive returns YTD through 5/9/22. The PACER trend following strategies experienced some of the initial drawdown but have all been in cash for a couple of weeks now. As we have discussed, this serves as a systematic, rules-based way to cut equity exposure into market weakness, which effectively means the majority of our clients are underweight equities as of right now, giving us dry powder to rebalance back into equities in the days / weeks / months ahead.

- Our fixed income portfolios have been positioned in a defensive fashion relatively speaking, both through lower duration and higher credit quality. Most of our portfolios have been meaningfully underweight fixed income relative to strategic targets for the last 18 months +/-.

- Since the beginning of last year we have been overweight uncorrelated assets, which generally have positive returns year to date, thanks to commodities and real estate. Traditionally we managed the uncorrelated bucket to roughly 5% of portfolios. The uncorrelated bucket accounts for 10% - 15% of many client portfolios currently, aside from aggressive growth (85%+ equity) portfolios.

- In summary, we are always striving to think of new, prudent ways to protect capital in markets like these. Having said this, the majority of the tilts within our portfolios have made a positive impact on returns this year relative to "traditional portfolios" with similar allocations. We will be looking for opportunities to unwind some of the more defensive / uncorrelated positions for more traditional stock and bond exposure as we progress through the summer months.

**Conclusion**

In summary, financial markets are currently recalibrating in the aftermath of the over-stimulative fiscal and monetary policy of the last few years . Inflation and a hawkish Fed leading to a rerating of asset prices and a slowdown in economic growth is the narrative for 2022 thus far. But in times like this we need to remind ourselves that there is always a narrative, and it's always "different" in the moment. Some belief around "the new economy" is what usually causes various asset prices go to the moon, and "the world ending" is why asset prices get cheap. But neither of these narratives ever last in the end. Human behavior however, repeats itself over time and continues to reinforce the inevitable nature of economic cycles.

- The closest thing investors can realistically have to an investing superpower is to have conviction in their long term investment strategy during times of distress.
    - To know that they have a solid financial plan and live within their means.
    - To extensively understand their ability and willingness to assume market risk and to understand their strategic asset allocation is appropriate for their goals and risk tolerance.
    - To acknowledge that we know bear markets are going to happen – and our investment plan never involves "timing" them in any large way.
    - To recognize that investors always "wish" for buying opportunities, although they are never obvious even when they are staring you in the face.
    - Rebalancing portfolios is an incredibly important part of the investment process, and investors need to lean into this, even when it doesn't feel good to do so.

Chris Veronne and Strategas Research Partners have pointed out that since 1950, the average bear market associated with a recession hasn't been too much worse than the average bear market that occurs outside of a recession. If the S&P 500 were to go down by the average non recessionary amount of -23%, it would mean that this correction is roughly 70% complete, from a price perspective. If this current sell off ends up being an average recessionary bear market, then roughly 60% of the damage has been done from a price perspective. Regardless of the outcome, we should remind ourselves of the potential for strong gains once the bottom is eventually in.

**S&P 500 Bear Markets Since 1950**

| Peak | Trough | % Decline | # of Days | Breakeven | # of Days | Years |
|---|---|---|---|---|---|---|
| 7/15/1957 | 10/22/1957 | -20.7% | 99 | 9/16/1958 | 329 | 0.9 |
| 12/12/1961 | 6/26/1962 | -28.0% | 196 | 9/3/1963 | 434 | 1.2 |
| 2/9/1966 | 10/7/1966 | -22.2% | 240 | 5/4/1967 | 209 | 0.6 |
| 11/29/1968 | 5/26/1970 | -36.1% | 543 | 3/6/1972 | 650 | 1.8 |
| 1/11/1973 | 10/3/1974 | -48.2% | 630 | 7/17/1980 | 2114 | 5.8 |
| 9/21/1976 | 3/6/1978 | -19.4% | 531 | 8/15/1979 | 527 | 1.4 |
| 11/28/1980 | 8/12/1982 | -27.1% | 622 | 11/3/1982 | 83 | 0.2 |
| 8/25/1987 | 12/4/1987 | -33.5% | 101 | 7/26/1989 | 600 | 1.6 |
| 7/16/1990 | 10/11/1990 | -19.9% | 87 | 2/13/1991 | 125 | 0.3 |
| 7/17/1998 | 8/31/1998 | -19.3% | 45 | 11/23/1998 | 84 | 0.2 |
| 3/24/2000 | 10/9/2002 | -49.1% | 929 | 5/30/2007 | 1694 | 4.6 |
| 10/9/2007 | 3/9/2009 | -56.8% | 517 | 3/28/2013 | 1480 | 4.1 |
| 4/29/2011 | 10/3/2011 | -19.4% | 157 | 2/24/2012 | 144 | 0.4 |
| 9/20/2018 | 12/24/2018 | -19.8% | 95 | 4/23/2019 | 120 | 0.3 |
| 2/19/2020 | 3/23/2020 | -33.9% | 33 | 8/18/2020 | 181 | 0.5 |
| **Averages** | | **-30.2%** | **338** | | **603** | **1.7** |

*(Source: Ben Carlson, CFA & awealthofcommonsense.com)*

**Major S&P Declines With a Recession - 1950 to Present**

| Start Date | End Date | % Decline | Recession? | Worst GDP Quarter | +250-Days |
|---|---|---|---|---|---|
| 2/19/2020 | 3/23/2020 | -35.4% | Yes | -31.2% | 74.9% |
| 10/9/2007 | 3/9/2009 | -56.8% | Yes | -8.4% | 68.3% |
| 3/24/2000 | 10/9/2002 | -49.1% | Yes | -1.7% | 33.8% |
| 7/16/1990 | 10/11/1990 | -19.9% | Yes | -3.6% | 28.8% |
| 11/30/1981 | 8/12/1982 | -18.9% | Yes | -6.1% | 55.4% |
| 2/13/1980 | 3/27/1980 | -17.1% | Yes | -8.0% | 39.6% |
| 7/15/1975 | 9/16/1975 | -14.1% | Yes | -4.8% | 27.5% |
| 11/7/1974 | 12/6/1974 | -13.6% | Yes | -4.8% | 34.7% |
| 10/12/1973 | 10/3/1974 | -44.1% | Yes | -4.8% | 34.7% |
| 11/29/1968 | 5/26/1970 | -36.1% | Yes | -4.2% | 46.2% |
| 8/3/1959 | 10/25/1960 | -13.9% | Yes | -5.0% | 30.0% |
| 7/15/1957 | 10/22/1957 | -20.7% | Yes | -10.0% | 32.0% |
| 1/5/1953 | 9/14/1953 | -14.8% | Yes | -5.9% | 37.7% |
| | *Average* | *-27.3%* | | | *41.8%* |

**Major S&P Declines Without a Recession - 1950 to Present**

| Start Date | End Date | % Decline | Recession? | Worst GDP Quarter | +250-Days |
|---|---|---|---|---|---|
| 9/20/2018 | 12/24/2018 | -19.8% | No | 1.1% | 37.0% |
| 5/20/2015 | 2/11/2016 | -15.2% | No | 0.1% | 25.5% |
| 5/2/2011 | 10/4/2011 | -21.6% | No | -0.1% | 28.5% |
| 7/20/1998 | 10/8/1998 | -22.5% | No | 5.1% | 38.1% |
| 8/25/1987 | 10/20/1987 | -35.9% | No | 3.5% | 16.3% |
| 9/21/1976 | 3/6/1978 | -19.4% | No | 2.9% | 11.5% |
| 2/9/1966 | 10/7/1966 | -22.2% | No | 1.4% | 32.1% |
| 12/12/1961 | 6/26/1962 | -28.0% | No | 3.7% | 34.2% |
| | *Average* | *-23.1%* | | | *27.9%* |

Ben Carlson, CFA and awealthofcommensense.com have their own interpretation around this data and narrative. They have slightly different starting / ending dates for a couple of these bear markets and they exclude the bear markets which didn't get down to at least -19%. Their research doesn't decipher between recessionary and non-recessionary bear markets but calculates the average bear market decline to be down around -30% over the course of 338 days. In this context, we would be about half way through this current bear market from both a price and time perspective. Ben has some previous work where he includes all corrections of -10% or more. In this scenario the average non recession correction is -15.1% while the average recessionary bear market is -29.1% *(source: Ben Carlson, CFA & awealthofcommonsense.com).*

Being a "long term investor" when markets are going up is the easier part of the equation. The more important side of being a long term investors is sticking to this mold when markets are going down, and investing becomes more challenging. Successful long term investing requires us to be uncomfortable in the short term on a more frequent basis than we would like. Our final thoughts include the following:

- Rebalancing back into equities shouldn't be conducted with the mentality of "catching the bottom" or the correction being finished. The odds that we time either of these correctly is slim. Rather, we need to think of things in the context of making purchases with a three year plus time horizon. Ideally, we will have the opportunity to identify entry points we feel have value for a three year time horizon overlap with oversold equity market internals.

- “The key to making money in stocks is not to get scared out of them.” - Peter Lynch

- For the last several years investors stated that stocks are expensive on an absolute basis but cheap relative to bonds. For the first time in a long time, we don’t have a valuation issue anymore in US equities. This doesn’t mean that US large cap equities are cheap, but they are no longer statistically expensive on a price to earnings basis. Investing capital from a starting point of 17x earnings and 3%+ bond yields should allow investors to capture normal or average like returns over the next five to ten years. This is a drastically more healthy starting point than the 22x earnings and 1% bond yields investment environment we had to live in for most of 2021.

- We believe that two factors will have the largest impact on investors’ 10 year plus returns. First, is an investor’s strategic asset allocation or their baseline allocation of stocks vs bonds vs uncorrelated assets. Second, is an investor’s behavior during times of fear (bear markets) or greed (FOMO in years like 2021). If nothing else from an investment standpoint, we will ensure our clients devise a prudent and appropriate strategic asset allocation framework that they can stick to with conviction to meet their long term financial goals.

We will look forward to discussing these topics and portfolio strategy moving forward with you in the days and weeks to come.

Sincerely,

Brian Gift, CFA

Disclosures:

*This material is intended for information purposes only and should not be construed as legal or tax advice and is not intended to replace the advice of a qualified attorney, tax advisor, or plan provider. Investments in securities involve risks, including the possible loss of principal. When redeemed, shares may be worth more or less than their original value. #5434467.2*

*The Standard & Poor's 500 Index (S&P 500 TR) is an index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.*

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