46 PEAKS
INVESTMENT ADVISORY GROUP

The Hunt for Green October

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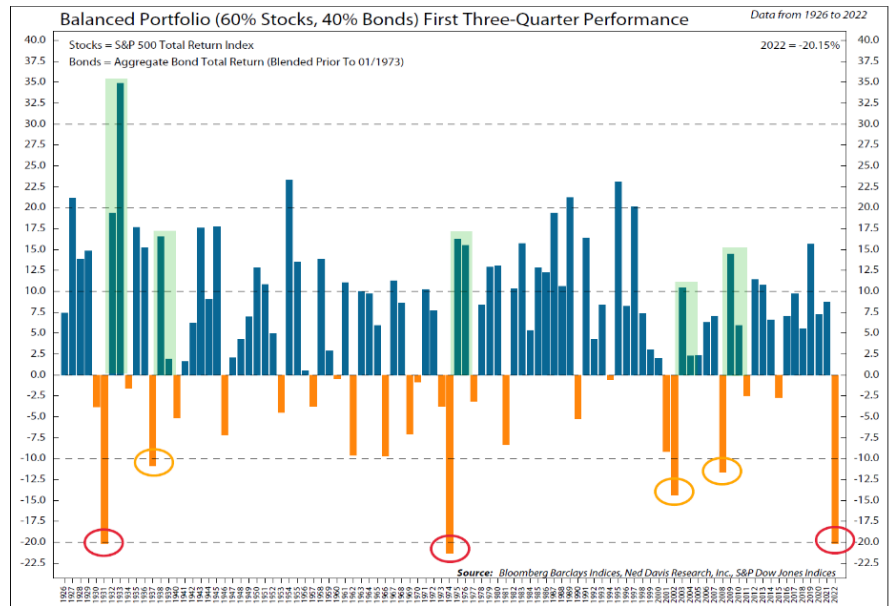
Four long months ago, we wrote a piece titled "*The Beatings will Continue until Morale Improves*." This quip reflected the unrelenting market declines during the first half of the year. Soon after, markets bottomed and the S&P 500 rallied 18.9% from mid-June through mid-August. *Relief, finally!* The respite was short-lived, however, and markets have been sliding with few interruptions since mid-August. With the chance at a do over, we would write that the beatings will continue until inflation improves.



For portfolios limited to core assets such as public stock and bonds, this has by some measures been one of the worst years ever. Consider that in the past, stocks and bonds have each experienced a period where they declined for three consecutive quarters. But they have never both declined simultaneously for three consecutive quarters - **Until this year**. Yes, both stocks and bonds have each declined every quarter this year, and after dropping 4.6% in the third quarter, core bonds are in their longest (time) and deepest (price) decline in their history. With core bonds down nearly 15% this year, their trailing five-year return is now negative - the first time ever that bonds have lost money over a five-year period. Bonds have declined in value nine of the last twelve months – investors would welcome a green October.

Bond returns this year have blown up traditional diversification. This bar chart, which begins in 1926 and illustrates the first 9 month's calendar year performance of a simple portfolio balanced between 60% stocks and 40% bonds, reveals that **2022 is the 2nd worst ever**.

As of October 13th, the S&P 500 is now down over 25% year-to-date. What makes these types of bear markets so difficult is not just the declines, it's the amount of time they take, as well as the numerous bear market rallies that can give you false hope. This year, in addition to the summer's 18.9% rally, we've had three other rallies between 8.8% and 12.8%. All head fakes. Bear markets demand patience and discipline to avoid making a bad situation worse.

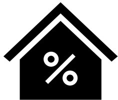
The market darlings of the last cycle – U.S. Tech stocks – are down more this year (over 35%) than during the Covid Crash. Remember when everyone was in love with Tech stocks and thought Energy stocks were dead money? While this year is chock full of important investing lessons, there's something to be learned from the performance of Energy and Tech stocks the past three years:

	YTD	2021	2020	3 Yrs.
iShares Energy ETF	34.30%	53.44%	-33.47%	13.03%
iShares Technology ETF	-35.92%	35.44%	47.46%	13.45%

Another lesson - For all the hoopla about Bitcoin being an inflation hedge, it's down 61% year-to-date.

Thankfully, International stocks have performed better than U.S. stocks this year, finally offering that diversification that we've all been waiting for. But wait…you and I wouldn't know it because the U.S. Dollar has rallied so much (+10.4%) this year that after converting those foreign stock market returns to our currency, the declines of non-U.S. stocks have exceeded those of U.S. stocks. Ugh.

Well, by now you're wondering *"Has ANYTHING worked this year?"* Thankfully, Yes. Recognizing that both stocks and bonds were expensive and vulnerable to a synchronized bear market, we have used Alternative investments for quite some time, even increasing our exposure last year to over 30% of most allocations. This year, for the vast majority of our portfolios, our baskets of "Alternatives" have returned between -1% and +2% - a remarkable achievement considering the returns from core stocks and bonds. The big winners this year have been Managed Futures – a strategy we added in November 2021. Private Real Estate is also up this year, in sharp contrast to the 28.6% decline in publicly traded REITs.



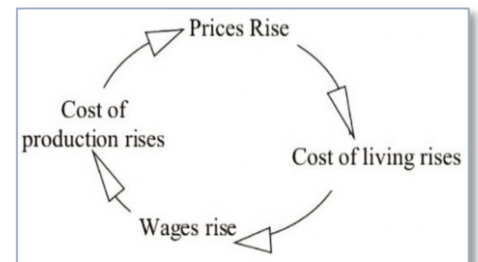
Speaking of REITs, it's worth mentioning the housing market, since it's on everyone's mind and it's important to the economy. Mortgage rates have climbed from ~3% to ~7%. At current rates and prices, housing affordability is at the lowest levels in decades. At these mortgage rates, prices should drop a lot, but markets are complicated. First, sellers are always slow to lower their prices. Second, supply has been low for years. Many potential upgraders are likely stuck in their current homes due to the low rates on their current mortgages, further limiting supply. To us, modest price declines (10%) are likely, but we expect to see both a temporary "buyers strike" and a "sellers strike" as transaction volumes dry up with tensions between buyers and sellers going unresolved due to current mortgage rates and supply shortages. Hug your realtor friends.

Besides hurting the relative outperformance of non-U.S. stocks for U.S. investors, the strength of the U.S. Dollar has been a wrecking ball around the world. Relative to the U.S. Dollar, the Japanese Yen has declined to levels not seen since 1990. The British Pound is at an all-time low. The Euro is at multi-decade lows. This is making inflation worse around the world. It's gotten so bad that the United Nations recently asked the Federal Reserve to stop raising rates due to the harm the strong U.S. Dollar is inflicting on Emerging Market economies. Unprecedented. The interest rate market is also rocking investment strategies designed during 30 years of low rates - This month, the U.K. faced a pension fund liquidity crisis triggered by interest rates rising (and bond prices falling) faster and farther than any "expert" models thought possible.

Just as fire and water were everything for cavemen, for investors right now **Inflation is Everything**. Nothing else really matters. Inflation is high and despite the Fed's efforts so far, it's stubbornly sticky. The most recent CPI came in at +8.2%, the highest level since 1982. The composite figures were led by Fuel Oil (+58.1%), Gas Utilities (+33.1%), Gasoline (+18.2%), Electricity (+15.5%), Transportation (+14.6%) and Food (+13.0%). Housing, which makes up about a third of the CPI, rose 0.7% (8.4% annualized).

Yet, many analysts point to inflection points in inflation that are not yet reflected in the numbers. Clearly, the housing market is cooling. Rent growth is slowing. This is not yet manifested in the CPI. Also, supply chain pressures are easing – the cost to ship a container from China to the U.S. is down from $19,000 to $3,000 over the past year. Inventories are up sharply – which means retailers will likely be lowering prices to move product. And many important commodities (copper and lumber) are now down sharply year-to-date and in downtrends.

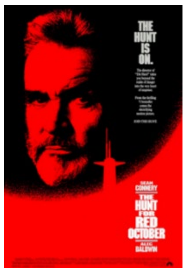
But the Fed is not just worried about the figures in front of us that are backward looking. They are worried about a phenomenon called a **Wage Price Spiral**. What's a Wage Price Spiral, you ask? It goes like this - Prices spike due to some short-term shock (Covid, War, Energy shortage, etc.). When prices rise, workers paychecks don't go as far, and they demand higher wages. Faced with higher labor costs, businesses then raise prices. And the loop gets completed and prices continue to go up and up, round and round, until something breaks the cycle. That something is usually a Fed induced recession. So, the inflation problem, in the Fed's eyes, is that the jobs market is just too strong – What person on the street would think that a healthy jobs market and strong wage growth are problems that needs solving? Main Street vs Wall Street.



The Federal Reserve has responded to the stunning inflation numbers with aggressive rate hikes – the fastest, largest hikes since the early 1980's. To us, and many others, the Fed is moving too fast. It's common knowledge that there is a long (up to 9 months) lag between Fed rate hikes and their impact on the economy. But having been

burned by high and persistent inflation already, **the Fed is embarrassed**. They're also reading from the playbook that says inflation must be corrected quickly, lest it get "embedded" in expectations and society, after which it gets even harder to undo. (After this rate hiking cycle, importantly, we think this means the Fed will be loath to lower rates much in the future – setting up a new paradigm of structurally higher rates going forward.)

The Fed is indeed between a rock and a hard place. The rock is that inflation hasn't come down yet. The hard place is that if they keep raising rates, bad things are likely going to happen. The more aggressively they raise rates, the greater the risk of a bad outcome. First, there's what everyone is already talking about – a Recession. The other risk is what mostly only people in finance are talking about – something in the market "breaks" (e.g. - the U.K. Pension problem mentioned earlier).



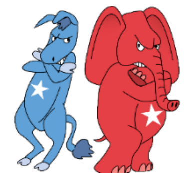
In the 1990 classic thriller, *The Hunt for Red October*, Sean Connery played the commander of the nuclear armed soviet submarine Red October, who broke ranks and plotted the sub toward the U.S. He was either defecting with the lethal sub to save the world, or he was going to fire his nukes at the U.S. The U.S. had to guess what the sub commander was doing. The stakes could not be higher. This is where we are with the Federal Reserve and its Chairman Jerome Powell now. Will they succeed at charting a course that tames inflation without causing a bad recession and more global economic hardship? Will further financial system stress lead them to blink, and we'll be stuck with elevated inflation? Or will they raise rates to the point that the economy, stocks, and bonds suffer significant further damage?

One argument for further downside in stocks is the increased risk of a recession. The bad news – in addition to the state of the bond market, nearly all our indicators suggest a recession is inevitable, and that it will likely begin as early as this month or as late as Spring of next year. The good news – the economists that we trust the most think the next recession is likely to be mild.

The two major arguments for a mild recession are – a) Economic growth has been fairly timid and "*it's hard to get hurt falling out of a basement window*", and b) Our economy is well balanced and diversified, with no pockets of major excess that would fuel a severe recession. The argument for a bad recession is that we currently have so much debt that today's higher interest rates will crush consumers and businesses.

If a recession is in the waters, what would that look like for stocks? Since earnings and valuations typically decline during bear markets and recessions, we can make an educated guestimate that were S&P 500 earnings to decline from ~$225 to around $210, and the P/E valuation at the time of the earning bottom is 15, then the S&P 500 would bottom around 3150 – about 12% below today's levels. This would bring the total peak-to-tough decline in U.S. Large Cap stocks to around 35% - consistent with many previous bear markets associated with recessions. Just as the worst-case scenario in *Hunt* was hard to imagine, this isn't the worst-case scenario, however. Since WWII, there have been three recession-linked bear market declines of 47% or more, lasting between 17 and 30 months. If the Fed hikes really kill the economy or something breaks in the global financial system because of these hikes, it is possible that we are only halfway through this bear market.

There are reasons for optimism, however. With all the excitement this year, it's been easy to forget that there is a mid-term election in a few weeks. Mid-Term elections have been significant positive developments for stocks - In 18 mid-term cycles since 1950, in the six-month period from November through April **the stock market has gone up all 18 times, with an average gain of 15% in those six months**. Is this something to base portfolio decisions on? No, not by itself. Should it be totally ignored? No, we don't think so. While we are skeptical of extrapolating historical trends in today's more fractured and divisive environment, 18 out of 18 is statistically significant and we'll allow ourselves a small sliver of optimism that the passing of the mid-term election could play a supporting role in helping to reverse this year's awful trends.



Another reason for optimism is simply the history of what happens after declines of 20% or more. Take another look at that first bar chart and the two calendar years (shaded in green) that followed the previous four worst years (circled in red or orange) for a balanced "60/40" portfolio. Looks good, right? Even if one thinks a recovery will take a long time, consider that from 9/30 levels, if it takes the S&P 500 **five years** to return to its all-time high, the index will have to average 7.9% per year for the next five years.

Then there are valuations. While the forward Price/Earnings ratio for large cap U.S. stocks is currently around 15.1x (not quite cheap yet), for Japan, Europe, and Emerging Market stock markets, its 11.8x, 10.5x, and 10.4x. We are not overly bullish on non-U.S. stocks due to their exposure to Russia and China, but these valuations are compelling. Closer to home, U.S. Small Cap stocks are trading at valuations rarely

seen in the last 35 years, especially relative to Large Caps. Support levels and sentiment are also potentially bullish. The S&P 500 is near its very long-term (200 week) moving average, a level that acted as strong support in 2011, 2016, and 2018. Investor Sentiment, a reliable contrary indicator in the past, is unsurprisingly on the floor - at levels only seen twice since 1987 – near the 1990 & 2009 lows.

Importantly, one of the biggest reasons for optimism has nothing to do with stocks. For years, investors were "forced" to buy stocks because with interest rates so low, the T.I.N.A. principle was in effect - There Is No Alternative (to stocks). With current yields, **T.I.N.A. can R.I.P.** - investors have a broader opportunity set outside of stocks. Consider these yield levels to start the year and where they were 9/30/22:

	12/31/21	**9/30/22**	Change
10 Yr. U.S. Treasury	1.52%	**3.83%**	+2.31%
Investment Grade Corporates	2.33%	**5.69%**	+3.36%
High Yield	4.21%	**9.68%**	+5.47%

What happens next with inflation, the Fed, and the economy is impossible to predict. Our current assessment is that in the short-term, we see a 50% likelihood of another 10-12% downside on stocks over the next 4-6 months – mostly because a recession seems likely, a bear market has never ended before a recession started, and bear markets associated with recessions often see peak-to-trough declines of 30-35%. Another 10-12% downside would also get us to valuation levels more consistent with the end of bear markets. However, inflation could drop in the months ahead, the election cycle could help, there may be progress between Russia and Ukraine, and things could get better quickly. The market has a way of surprising investors and currently, it seems everyone is bearish. We think there's a 25% chance that this is the case and the low occurs this month. That leaves an uncomfortable 25% chance of a longer, deeper bear market in stocks, fueled by the witches' brew of higher interest rates, a long recession, markedly lower earnings, and a bitter dash of a potential global "event" – either financial or political.

While that may sound unoptimistic, we're actually kind of…**excited**. For one, bear markets in stocks set the stage for future gains and we have some dry powder to capitalize on lower prices when the time is right. Our defensively positioned Managed Futures exposures remain on the field for now as we wait patiently to get more aggressive. In the meantime, the current interest rate and volatility environment is producing some attractive opportunities. One example is an option-hedged ETF that allows investors to fully protect against another 15% decline in small caps over the next twelve months while participating in gains up to 24%. Very interesting.

Looking beyond stocks, the return of "real" interest rates resulting from the demise of T.I.N.A. means the investing opportunity set is much bigger than it's been in years with yields near 4% on U.S. Treasuries, over 5% on Investment Grade Corporates, and over 9% on High Yield. There may be opportunities in higher yielding and beaten down Infrastructure and REITs as well.

Within Alternative investments, those linked to the economy like Private Equity and Real Estate may face some mild headwinds, but several other strategies **directly benefit from higher short-term rates** – Managed Futures and Arbitrage are two. Private Credit, where yields are 8-9% or more, is another. We've got our eye on this space.

Like the plot in *The Hunt for Red October*, the stakes are currently very high. These are not easy or comfortable times. While we're not exactly searching for Russian submarines at the bottom of the Atlantic, our radar and systems are working overtime hunting for the investment solutions and tactics to navigate this uncertain environment. We're encouraged by the opportunities that we're finding and reminded that in the movie, the good guys won in the end. We are striving for a similar outcome for our clients and their portfolios.

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