46 PEAKS
INVESTMENT ADVISORY GROUP

Place Your Bets?

ERIK MOSHOLT, CFP®
Chief Investment Officer

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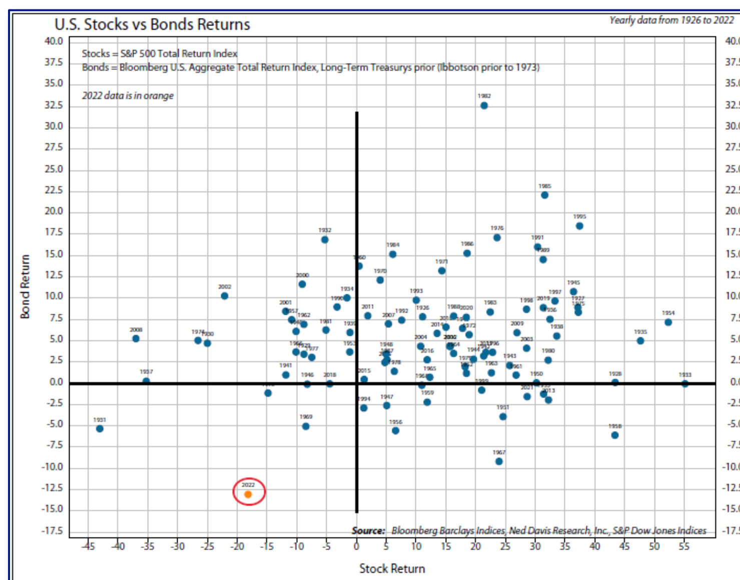
Welcome 2023! Investors are eager to bid farewell to 2022 as it was one of the most challenging years for investors in history. To be fair, there was nothing terribly unusual about the full year calendar results for most *stock* markets. Historically speaking, on average, stocks decline 1 or 2 years each decade and it's not uncommon to experience declines of 15 - 20%. When 2022 ended, for the year Large Cap U.S. Stocks had declined 18.2%. Small Caps dropped 20.4%. In what may come as a surprise to many, after a strong 17.7% bounce in the 4th quarter, non-U.S. stocks declined only 14.0% for the year. Stock market declines like these are far from fun. But not abnormal.

What WAS unusual about the stock market in 2022 was both the <u>consistency</u> of its downward trend AND its short-term <u>volatility</u>. We hope that our clients avoid watching the markets every day, week, month or even quarter. That's our job. And it was no fun last year as the S&P 500 declined each of the first three quarters, seven out of twelve months, and moved up or down at least 3% in a week 20 different times last year.



Another unusual experience last year was the performance of many former market leaders. Popular stocks like Amazon declined 50%. Google dropped 39%. NVIDIA fell 50%. And Tesla plummeted 65%. Last year's winners were not-too-long-ago hated and unpopular energy stocks like Exxon, which gained 87%.

Also unusual about last year was the performance of the other main pillar of investing – Core Bonds. Core Bonds, as measured by the Barclays Aggregate Bond Index, had their worst year EVER since the start of the index – declining 13%. The index only had four other down years in the last 40 years, and they were all relatively tiny declines ranging between 0.8% and 2.9%.

But the most unusual feature of last year, which made it one of the most challenging ever, was the coincident decline in both portfolio pillars – stocks and bonds. Prior to last year, since 1926, a simultaneous calendar year decline in both stocks and core bonds had only occurred <u>five times</u>. This picture may be worth a thousand words – curse words that is. It graphs the returns of stocks (vertical axis) and bonds (horizontal access) by calendar year since 1926. Up and right is good. Down and left is bad. The **red dot is 2022.** The easy winner for chart of the year.

Thankfully, several **Alternative strategies performed strongly last year**. In contrast to publicly traded REITs which dropped 26%, many Private Real Estate funds eked out small positive gains. Despite the devasting Hurricane Ian that blasted Southwest Florida in September,

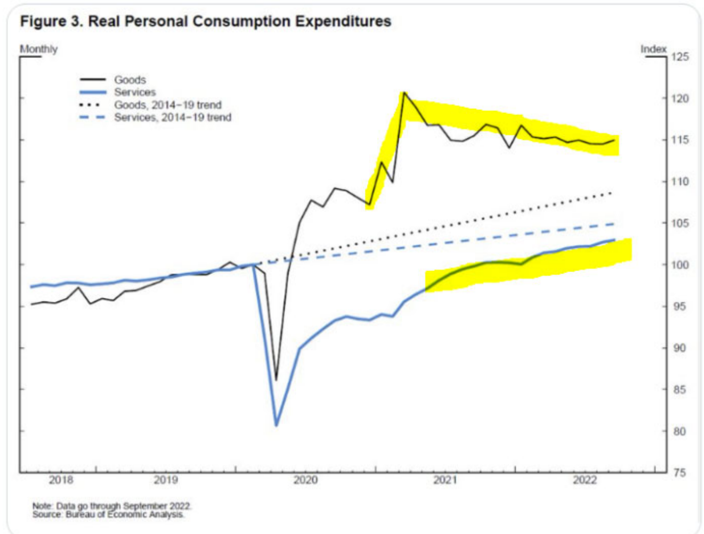
Reinsurance also posted positive performance last year. And several strategies, especially Managed Futures, zigged when core markets zagged, not only smoothing overall portfolio returns with timely diversification, but ending the year with nice gains to partially offset the declines in stocks and bonds.

Last year's villain is now well known - the Federal Reserve. The Fed, facing inflation levels not seen in 40 years, raised short-term interest rates at the fastest pace ever, wreaking havoc on both stocks and bonds. But 2022 is in the rear-view mirror and investors now want to know – Does ***What Happened in 2022 Stay in 2022?*** Or following all the interest rate hikes of 2022, will 2023 look more like ***The Hangover***?

As we weigh the odds for the capital markets in 2023, last year's key factor – inflation – will certainly play a key role again. On the topic of inflation, we are optimistic. Why? Well, inflation is almost always reported in an annual manner, for good reason – to smooth out the seasons and any short-term peaks or valleys. The December inflation numbers were just released and, when looked at it on a trailing 12-month basis, inflation is still running hot – at 6.5%. But inflation for the last six months tells a different story – running at an annual pace of **only 1.8%.** Surprised?

Last year, inflation was like two very different halves to a football game. The first half, inflation ran at an annual rate of about 10.3%. But the last six monthly inflation figures were only 0.0%, 0.1%, 0.4%, 0.4%, 0.1%, and wait for it… -0.1%. Yep, overall, prices in December were DOWN. Prices have declined the most in Energy, Used Cars, and Medical Services. It gets better. The cost of shelter (a.k.a. – rent and the cost of housing) was reported as rising 0.8% in December (a 9.6% annual rate). Many analysts agree that number is misleading as house prices have been declining and rents in many parts of the country are no longer rising much, or at all.

But there's even more nuance to the inflation numbers, and it has to do with the aftereffects of the Pandemic. This chart separately illustrates inflation of "Goods" (the top line) and "Services" (the bottom line). Immediately after the economy re-opened, the cost of "Goods" shot up as supply chains broke and everyone stuck at home flush with stimulus cash wanted to buy stuff. Yet, the cost of Services plummeted and didn't rebound as sharply. Over the past few quarters, this has somewhat reversed as the price of many goods has been declining, while the cost of services has been rising. Goldman Sachs predicts that the cost of "Goods" (cars, furniture, clothing, etc.) will <u>decline</u> the next couple of years!



While a cooling of inflation is good, a severely slowing economy is not, and over the past few months several Leading Economic Indicators (LEI's) have cooled as well. In fact, these LEI's are at a point now that historically has **preceded a Recession EVERY TIME**. A recession would likely mean at least a 10% decline in corporate profits and (at least) 10 -20% lower stock prices in the U.S. markets. We are not bold enough to dismiss these historically accurate indicators, but we are not convinced either. For a few reasons:

- There may be a disconnect between today's economy and traditional measurement techniques. Remember that GDP DECLINED each of the first two quarters of 2022? There is no specific definition of a recession, but two quarters of shrinking GDP has always coincided with an official recession. Until last year.

- Due to Covid, we have already had a deep recession in parts of the economy (Restaurants, Travel, Leisure, Trade). These sectors may remain strong while a contraction hits only the parts that will suffer the most from higher rates and reduced access to capital. Housing and Technology come to mind.

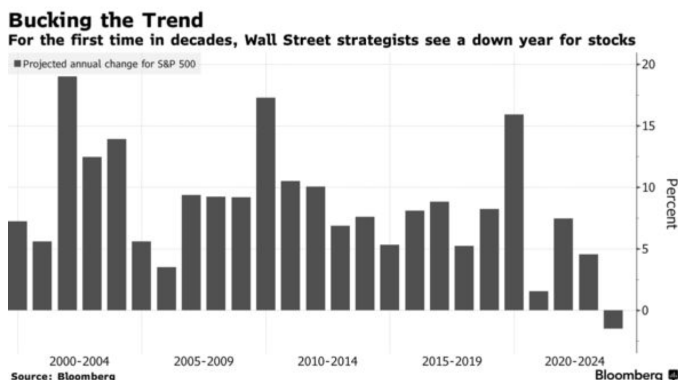
- Then there's the labor market. It's hard to have a recession without significant job losses. Today, unemployment is still low. Recent layoffs seem concentrated in New York and San Francisco, and in the Tech and Finance industries. While this can change, we think we are far from the levels of layoffs needed to really hurt demand, and that after finding it

difficult to hire workers the past few years, many smaller businesses will be reluctant to lay people off.

If it's still possible that what happened in 2022 will stay in 2022, it will likely depend, once again, on the Fed. The Fed does not meet in January. Markets expect them to raise short-term rates further in February and March, to around 5.0%, and then pause. We think they will. If so, this should be a calming influence on markets.

Looking beyond inflation and the Fed, we find other reasons to be optimistic that markets may avoid a hangover from last year:

- The **unanimity of it all**. The investing legend Ned Davis once said…" *If it's obvious, it's obviously wrong*." To start the year, over 40% of economists in one survey predicted a recession in 2023 – by far the highest number since the survey began in the 1960's. Then there's the fact that Wall Street strategists are predicting stocks to decline this year. As this chart from Bloomberg shows – they have not predicted a calendar year decline in <u>decades</u>. In sports betting, they call this the "**reverse lock**".



- Universally **poor sentiment**. Bear markets usually start during periods of euphoria, when everyone thinks the good times will last forever. Bull markets usually start during despair. Do you know many people feeling great about the markets nowadays?

- **The Cycle** – We've shared before that mid-term election years are often difficult. Last year held form. Going back to the 1960's, there have been 8 down years for the S&P 500 during a mid-term year. The next year? Positive all eight times. Gains over 10.8% all eight times. An average gain of 24.6%. Maybe 2023 breaks the streak. But maybe not – gridlock in Washington is often a good thing for the markets.

- **Technicals** – While it's still in an unclear position, the market has exhibited real strength lately. Time doesn't heal all wounds in the stock market, but it can help. In late November, the S&P 500 closed over its 200-day moving average after spending more than 6 months below it. That's happened 13 other times since 1950. Only once, in 2002, were returns 6 or 12 months later negative. Overall, gains averaged 18.8%.

- **Better = Good** – Russia/Ukraine. The Fed. China's Covid situation. All of these hurt in 2022. While they may not be "good" in 2023, they could all get better. And for markets, "better" is often better than "good".

Looking beyond the next few quarters, there are several potentially overlooked positives following the poor performance of stocks and bonds last year. First, valuations on many stocks are now much lower and lower valuations generally portend stronger future returns. While Large Cap U.S. stocks remain slightly more expensive than usual, valuations on Small Caps, non-U.S. stocks, and Emerging Market stocks are cheap. Second, thanks to the pain of last year, Bonds now offer attractive yields. Consider today's yields vs. those from a year ago:

	12/31/21	12/31/22
Fed Funds	0.25%	4.50%
2-Yr Treasury	0.73%	4.41%
10-Yr Treasury	1.52%	3.88%
Inv Grade Corporates	2.33%	5.42%
High Yield	4.21%	8.96%

Those are **some juicy yields**! We're also excited about what higher short-term rates mean for the returns of many Alternative asset classes and strategies since the expected returns for pretty much every investment are driven by the T-Bill rate, now at its highest level in 15 years. In Finance 101, you're taught this equation to determine return expectations for an investment:

Expected Return = Risk-Free-Rate + Risk Premium

A good example of the benefits of higher T-Bill yields is their effect on Arbitrage strategies. Arbitragers take on risks that other investors don't want. They take these risks to earn a return of let's say 4% over "safe" cash (the "Risk Premium" in this equation). A 4% return is attractive in a 0% interest rate world, and that's about what many of these strategies returned the last decade. But 4% for a complex strategy is insufficient if simple cash is yielding 3-4%. Thus, if cash yields 3% the next ten years, we'd expect

these strategies to return around 6-8%.

Managed Futures benefit from higher rates in a different manner but get to a similar place. These strategies generally put 80% (or more) of their assets in T-Bills and invest the remaining capital in futures (stocks, bonds, commodities, and currencies). For the last ten years, those strategies earned almost zero yield on their cash. Looking forward, higher short-term yields will boost the returns on the cash held in Managed Futures strategies. Hypothetically, consider a managed futures strategy that strives to return 4% - If cash yields 0%, then we'd expect it to return 4%. If cash yields 3%, then we'd expect it to return almost 7%. Thank you, higher T-Bill rates.

Additionally, the return opportunities on many option-based strategies are based on both volatility and interest rates. The higher volatility or interest rates, the higher the opportunity. Last year saw a spike in both. As a result, currently, the upside opportunity in these hedged strategies is roughly **double** what it was 1-2 years ago. To us, along with lower valuations and following a 20% decline in the markets, this makes some option-based strategies like playing blackjack starting your hand with an 11, and getting 2.5x payout on 21. While you can still lose, the odds of losing have gone down (thanks to valuations) and the payout for winning has gone up (thanks to volatility and rates).

Then there's Private Credit, an asset class that we have not yet invested in, but which we are enthusiastic about. Private Credit strategies, broadly speaking, are loans to businesses. The interest rates that private lenders can charge borrowers are, of course, affected by yields in the bond market. They charge a "spread" over and above the rate on safe and liquid investments (that spread is the loan's "risk premium"). With higher rates on Government bonds and T-Bills, many Private Credit portfolios are now achieving yields of 10-12%. We think that's attractive.

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Most of the time, if a client asks which direction I think the next 20% move in the stock market will be, I can confidently say that I think it will be UP. Today is not like most of the time though. While we are cautiously optimistic, there is still significant uncertainty around inflation, interest rates, and the economy. A recession is a strong possibility, and another 20% decline in stocks could be in the cards. But we're also open-minded to a scenario where inflation continues to subside, the Fed pauses, and the markets not just stabilize, but rally.

So, to us the stock market outlook for the next 2-3-4 months or quarters is still a toss-up – betting today is akin to choosing **Red** or **Black** at the roulette wheel. With what seems like a very bi-modal set of outcomes, **we are not choosing sides**. Rather, we are emphasizing unemotional, non-predictive, and mechanical trend following strategies. These don't try to predict what's *going to* happen. They simply watch what *is* happening and go long or short different exposures. We're also seeking to capitalize on higher yields and higher volatility – We've added some U.S. Treasury exposure to most portfolios and are looking closely at those option hedged equity strategies.

For investors able to look beyond the short-term noise and uncertainty, we think you should share our enthusiasm for the next 2-3-4 years. After all, compared to a year ago, stock market valuations are lower, bond and cash yields are up, and the Fed is closer to the end than the beginning of their rate hike cycle. In our opinion, for diversified portfolios and investors willing to play the hand that's dealt to them, **we like our odds**.

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