October 2022 Market Commentary

Like A Hurricane

You are like a hurricane
There's calm in your eye
And I'm gettin' blown away

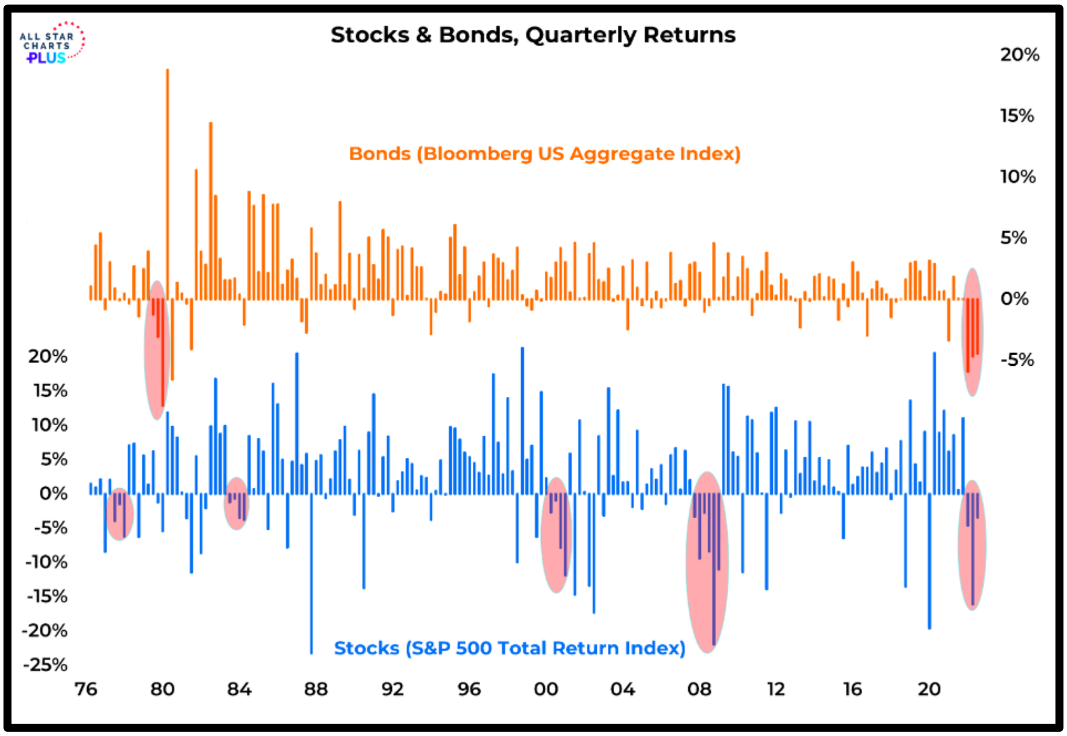
Neil Young – Like A Hurricane - https://www.youtube.com/watch?v=-yxiu1o63CA

Big problems usually start out as small problems. We see that in nature, where small disturbances off the coast of Africa sometimes become hurricanes, and we see it in the economy too. It's no surprise that after years of calm, smaller economic disturbances have compounded into something much bigger.

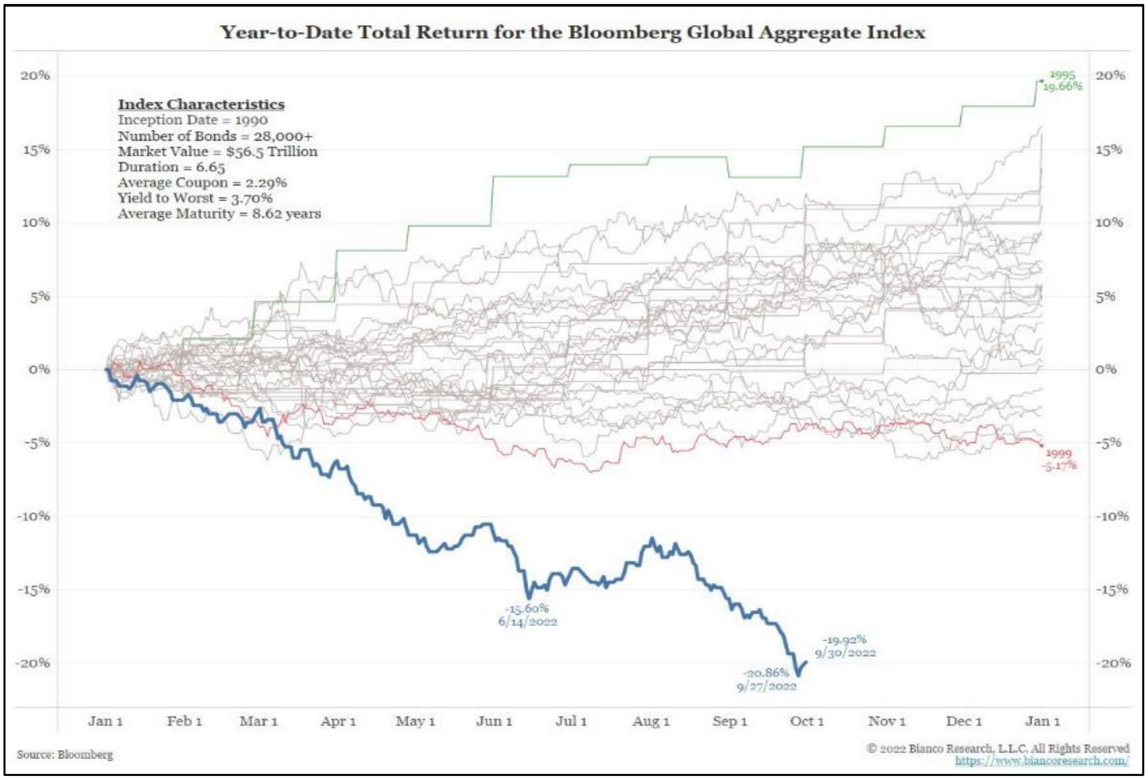
The hurricane metaphor came to me last week after sitting through a near miss from hurricane Ian in southern South Carolina. Fortunately, we were on the right side of the storm and suffered minimal damage, unlike so many others in Florida and South Carolina.

Our growing economic hurricane has many similarities to actual hurricanes, but unlike nature this hurricane will leave few of us untouched. Nearly everyone will feel its effects and some will be wiped out, but we will survive and hopefully build back stronger.

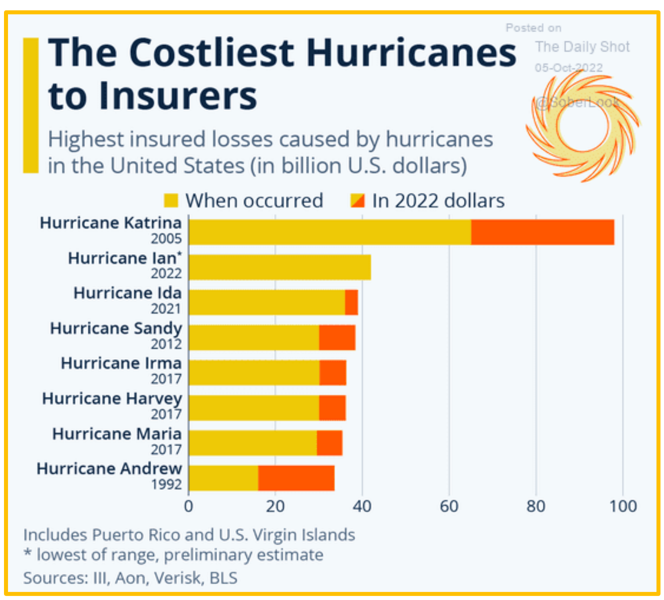
What makes this storm unlike any we've seen before is its ability to destroy what were previously considered safe havens. In the equity markets we're used to getting blasted every several years, but those storms were survivable because we had the relative safe haven of the bond market to retreat to. That is not the case today. For the first time in history, we are experiencing quarter after quarter of losses in the equity market as well as the bond market. The word **"unprecedented"** is often used lightly in our profession but it is very apt today. **The chart below shows that for the first time ever we've experienced three consecutive quarters of losses in the stock market as well as the bond market.**



What makes this storm so different is the unprecedented rout in the bond market. When central bankers peg interest rates at zero for years on end, there is nowhere to go but down when rates start to rise. Jim Grant coined the phrase **"Return Free Risk"** many years ago, and this is exactly what he was referring to.



We often judge the severity of a hurricane by how much damage it has done. Beyond the unmeasurable loss of life, hurricane Ian is projected to be the second most costly storm after hurricane Katrina, with projected property losses of $40 to $50 billion.

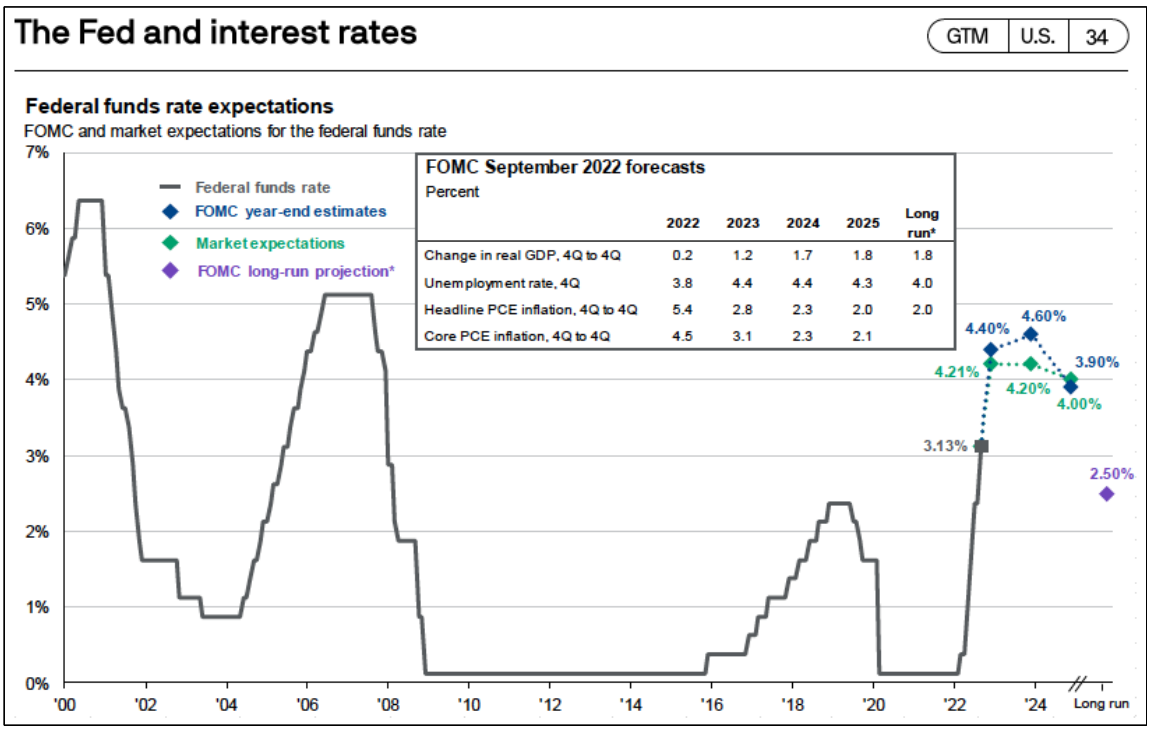


Those losses pale in comparison to the losses experienced by investors in stocks and bonds. We're used to volatility in the stock market, and while the year-to-date loss of $13 trillion is eye opening it is not totally unexpected. **What has really caught so many off guard is the $14**

trillion of disappearing wealth in the global bond market. The value of global bonds has fallen from $70.6 trillion to $56.5 trillion.

I still argue that the seeds of this storm were planted in the early 2000's when the Fed began in earnest to implement the **"Fed Put"**. The Fed Put is the unofficial policy of the Fed to rescue the financial markets from any extreme losses by quickly cutting interest rates. The chart below shows this strategy's implementation. Where the storm really gained strength was after 2008 when the Fed kept rates swimming in the very warm waters of zero percent for eight years. They tried to normalize rates starting in 2016 but were derailed by the pandemic. Now they are faced with runaway inflation and no alternative other than to slam on the economic brakes.

While they had help from a constant flood of stimulus from Washington, this is mostly a storm of their own creation.



Now expectations are for the Fed to continue raising the Fed Funds rate until they break inflations back. Currently peak expectations for the Fed Funds rate are about 4.60%. The key will be how quickly inflation subsides.

The chart below shows how this zero interest rate policy led to rapid inflation in financial assets. From March 2009 to February 2020 the S&P 500 soared 400%, or 15.8% annualized. And then when re-implemented during the pandemic, we saw an explosive 114% gain in less than two years, or 46% annualized. The Fed's goal is to crush inflation, and if the biggest benefactors of inflation were equity investors, it's safe to assume that equities will have a tough time while this inflation fighting is progressing.

S&P 500 Index at inflection points

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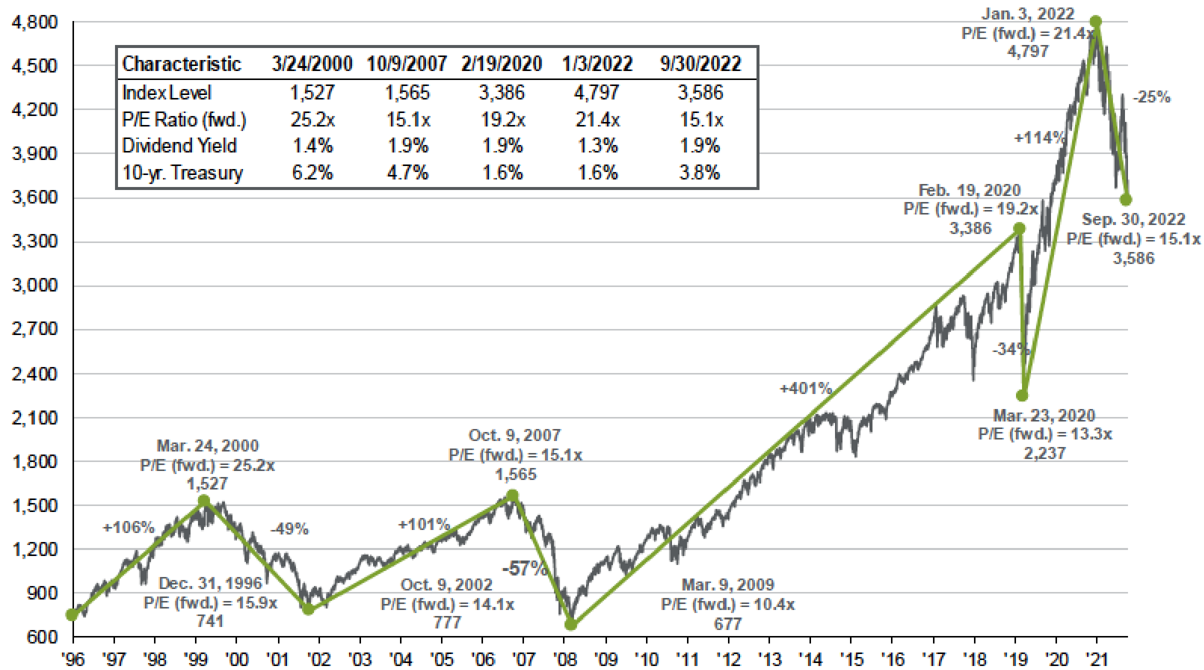


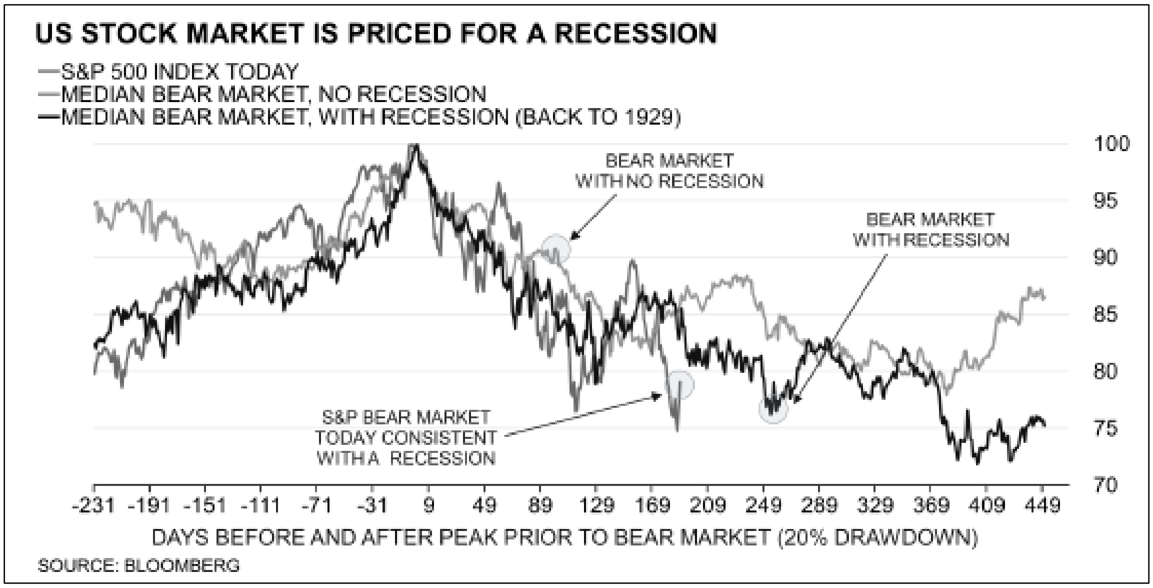
Characteristic	3/24/2000	10/9/2007	2/19/2020	1/3/2022	9/30/2022
Index Level	1,527	1,565	3,386	4,797	3,586
P/E Ratio (fwd.)	25.2x	15.1x	19.2x	21.4x	15.1x
Dividend Yield	1.4%	1.9%	1.9%	1.3%	1.9%
10-yr. Treasury	6.2%	4.7%	1.6%	1.6%	3.8%

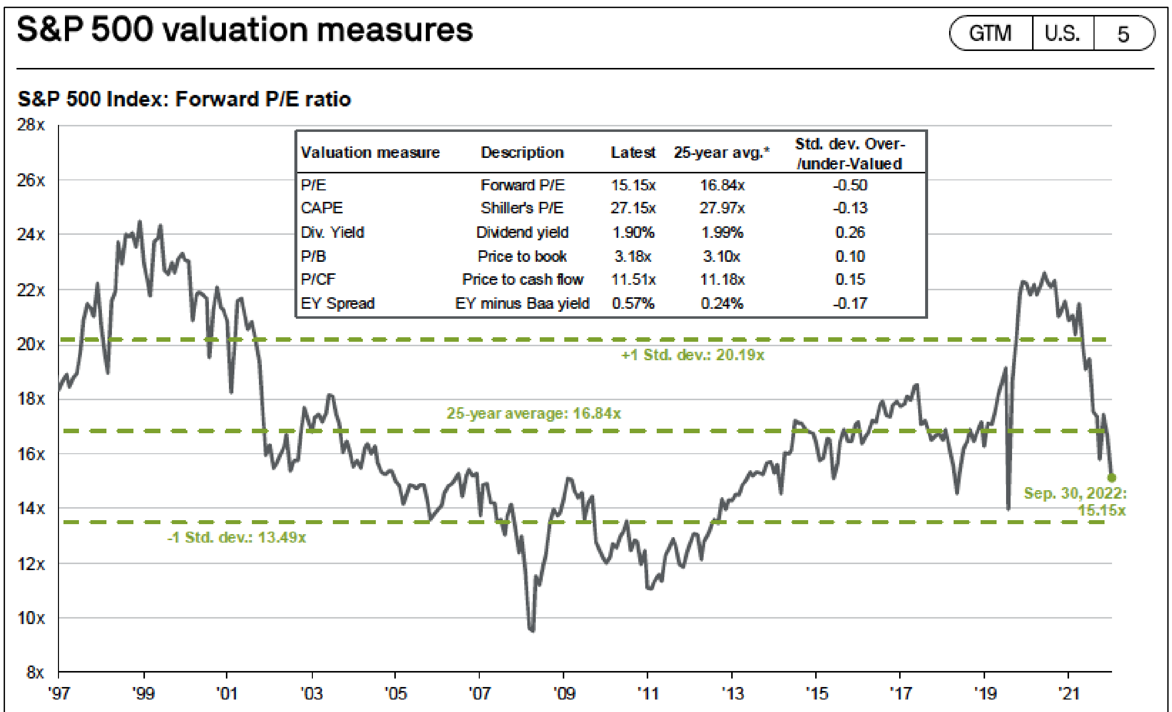
Source: Compustat, FactSet, Federal Reserve, Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management.
Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by Compustat. Forward price-to-earnings ratio is a bottom-up calculation based on IBES estimates and FactSet estimates since January 2022. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of September 30, 2022.

J.P.Morgan ASSET MANAGEMENT

If we're going to stick with the financial hurricane analogy, the good news is that this storm has already made landfall and the initial tidal surge has passed. We've already experienced some serious damage in both equity and fixed income markets. As the last two charts show, equities are currently pricing in a recession, and valuations are back to reasonable levels (not cheap but reasonable).

We're not out of the woods yet, as the Fed is insistent on taming inflation at all costs. This storm will churn over much of the global economy, but this is now a known known. It is not a surprise, and as such many investment assets are currently reflecting this reality in their valuations.





Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	15.15x	16.84x	-0.50
CAPE	Shiller's P/E	27.15x	27.97x	-0.13
Div. Yield	Dividend yield	1.90%	1.99%	0.26
P/B	Price to book	3.18x	3.10x	0.10
P/CF	Price to cash flow	11.51x	11.18x	0.15
EY Spread	EY minus Baa yield	0.57%	0.24%	-0.17

Source: FactSet, FRB, Refinitiv Datastream, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since August 1997 and by FactSet since January 2022. Current next 12-months consensus earnings estimates are $241. Average P/E and standard deviations are calculated using 25 years of history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure. *P/CF is a 20-year average due to cash flow availability.
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As Ian has moved out of the South Carolina area we have been blessed with blue skies for the last two weeks. I'm not being Pollyannaish here, especially with Chairman Powell professing that the beatings will continue until morale improves, but I am getting more interested in putting money to work at these more reasonable valuations.

This is not the time to prepare for the storm, that time has passed, this is the time to weather it and begin looking for the opportunities that are left in its wake.

As always, be careful out there.

Chris Wiles, CFA

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