Market Commentary – November 2022

"I Won't Back Down"

"Well, I know what's right
I got just one life
In a world that keeps on pushin' me around
But I'll stand my ground
And I won't back down"

Tom Petty as sung by Gators Nation ***https://www.youtube.com/watch?v=eL_Z3wSfGvA***

Investing is a funny game. It's a game that combines both something that is exact, like mathematics, with something that is very inexact, like human emotions. Sometimes it pays to "stand your ground", basing your investment decisions on sound facts and figures, but oftentimes, standing your ground and not backing down, will bankrupt you as markets can act very irrational for much longer than expected.

Football games are often like this too. Coachs' decisions are based on numbers, facts, and power-ratings, but often games are decided by the actions of inexact humans and their inherent emotional flaws.

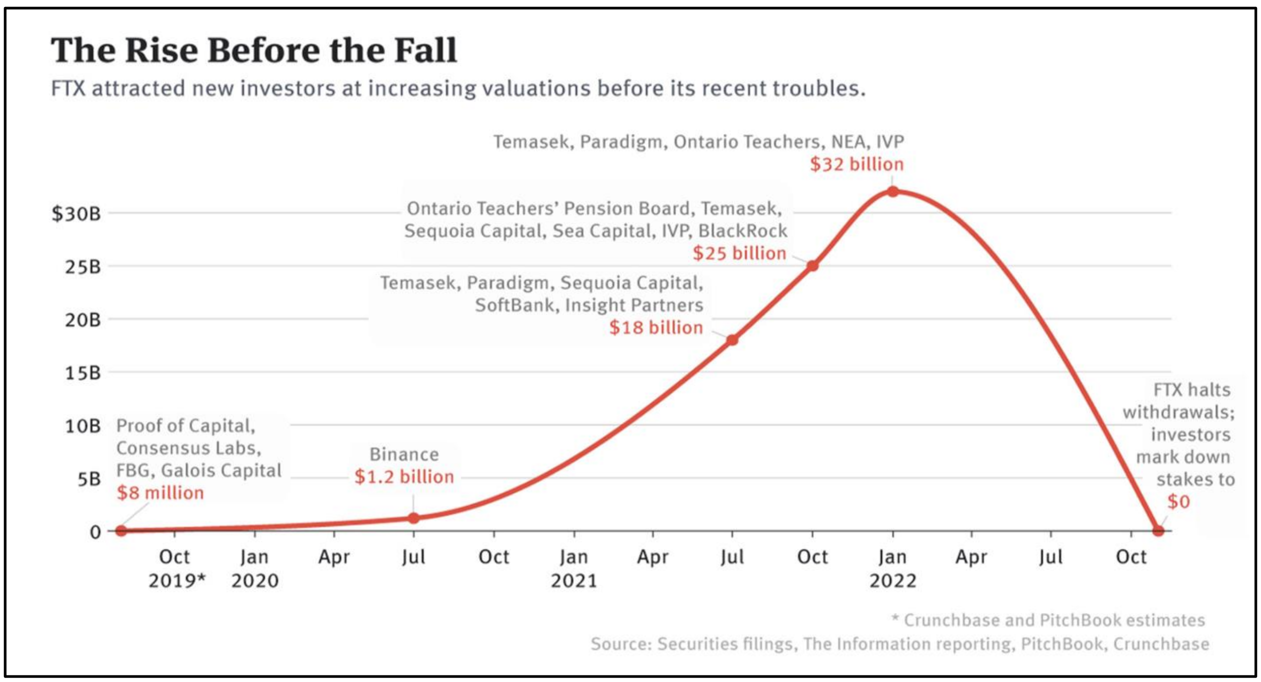
That's what makes it so much fun to watch. If everything went according to the numbers there would be no entertainment value. Investing is the same way. Of course, many investors don't find this uncertainty entertaining, but if you're going to be an investment professional you better learn to embrace this uncertainty or find another walk of life.

After nearly 40 years of playing this game, I'd like to think that I generally **"know what's right"**, and while I'll try and **"stand my ground"** I also know that sometimes you actually need to back down. This is called humility, and it is often served up by the bucketful in this profession.

Today we are in the midst of a bear market, caused by the Federal Reserve's attempt to rein in inflation, which was caused by many years of excessive money pumping. That excessive Federal Reserve liquidity combined with free money from the Treasury/White House, led to one of the biggest financial asset bubbles of all time.

Fortunately, the bulk of this bubble seems to have manifested itself in some of the newest/riskiest areas of the economy. We've seen $2 trillion in Crypto wealth eviscerated, along with many of the charlatans that were hocking their various Ponzi schemes. We've also seen many of the SPAC's and questionable IPO's repriced closer to what they may actually be worth (somewhere around zero).

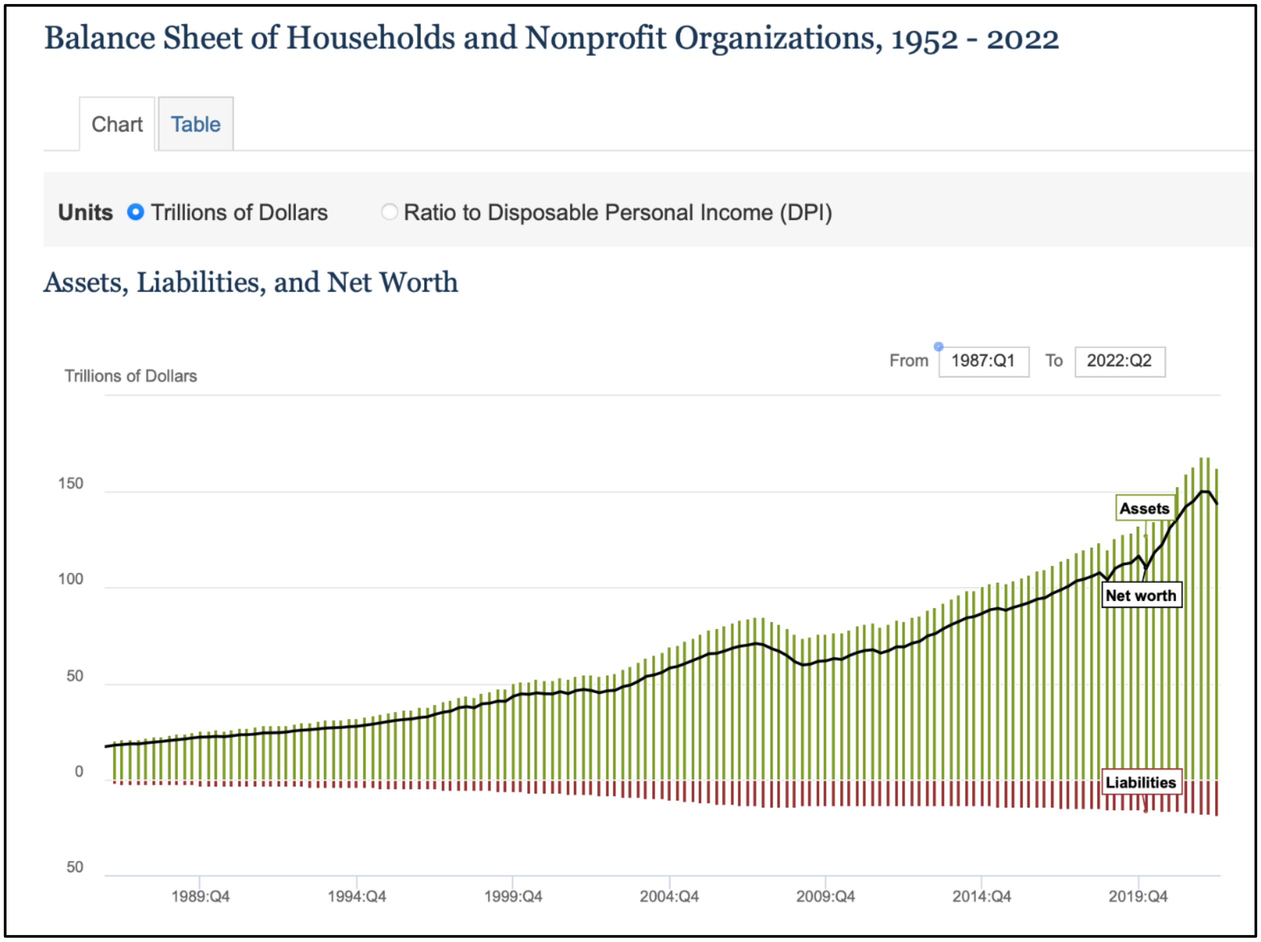
Here's an example of the most recent blowup in the Crypto world (FTX) and a list of some of their investors.



Certainly, this massive liquidity injection found it's way into the real world too, with many Americans taking advantage of low rates and free money to buy cars and bid up housing. Higher rates will hurt many as excesses are purged from our economy, but I am actually pretty hopeful that the overall economic damage will be limited.

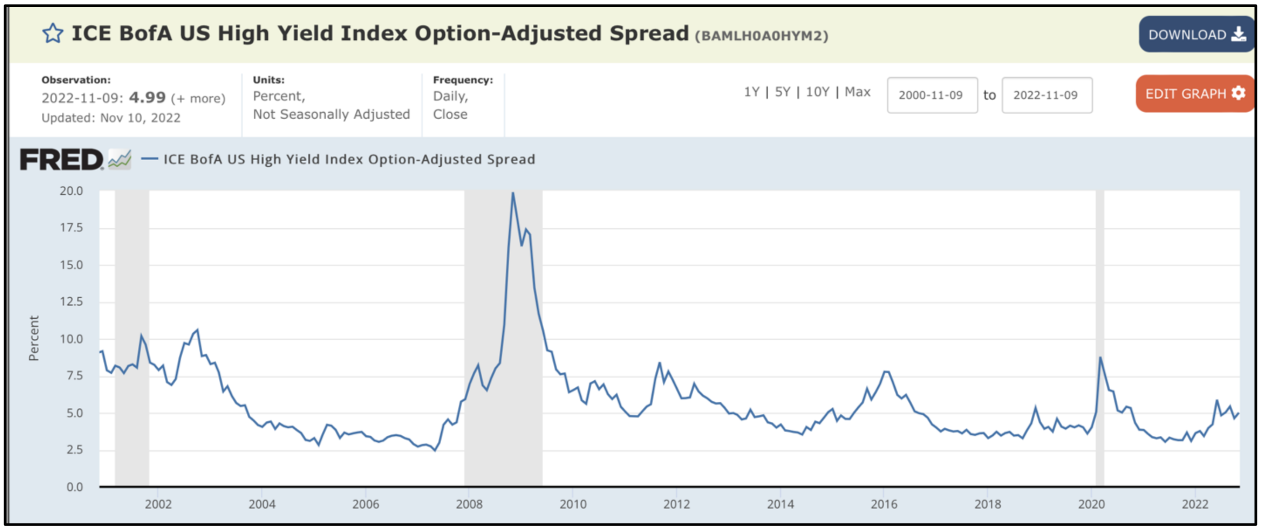
Why, you might ask? The reason for this optimism is that I don't believe our coming economic recession will be very severe. This financial bubble that the Fed and Treasury created, and are currently attempting to pop, will do its biggest damage to the most speculative areas of our economy. The majority of our economy is actually relatively healthy.

Household balance sheets are strong, and employment is still strong and not expected to weaken dramatically. We've seen a drop in Net Worth but nothing too dramatic.



Mainstream corporations are also pretty strong. Many of them used the decade of Fed largess as a means to clean up their balance sheets. When you think about the rapid rise in interest rates and coming economic recession, you'd expect High-Yield spreads to widen. Historically, that has always happened, but that has not happened today. The chart below shows that spreads have only widened out to about 5%. This makes sense when you look at the makeup of the high-yield universe, they are predominately energy and industrial companies that have fairly robust business prospects.

Again, the excesses in this bubble are in highly speculative areas which didn't tap the high-yield market.



Where can we feel comfortable "standing our ground"?

When it comes to investing in the equity markets, one of the tried-and-true tools we use for determining the markets valuation is P/E, the price-to-earnings ratio. I also like to call this psychology-to-earnings, because what you are trying to determine is how much market participants are willing to pay for future earnings. Again, we're trying to combine hard numbers with human emotions.

First, the hard numbers:

- In 2019 (pre-pandemic), operating earnings for the S&P 500 were $162.97.
- In 2020 when we shut down the economy, they fell 14.2% to $139.76.
- In 2021, we saw a strong rebound of 49.2% to $208.53.

The softer numbers:

- In 2022, with three quarters nearly in the book, earnings are expected to finish the year up about 5.5% to around $220.
- 2023??

What about 2023? This is where things start to get fuzzy. Will we or won't we have a recession? If we do have a recession, will it be mild or harsh? Is there something else we should worry about (there is always something else to worry about)?

Currently Wall Street analysts are forecasting a gain in earnings for 2023 of about 6%, to $233. This forecast is assuming no recession.

I find this prognostication to be overly optimistic. It could happen, but with a hostile Fed telling you that rates are going to continue to increase until inflation breaks and that there will be "pain", it's really hard to see 2023 progressing without a recession. Again, anything could happen, but being conservative I think it would be prudent to forecast 2023 earnings flat with 2022's $220, or something lower.

How much lower? That depends on what type of a recession you think we'll have. The table below shows what has happened to earnings during the last 11 recessions. In all instances earnings fell. The smallest decline was 1953 at -11.6%, and the largest was the Great Recession of 2007-2009 when earnings fell 49.8%.

The median decline was -21.6%, but during recessions that coincided with inflationary shocks ('53, '73, '80, '81), the earnings decline was a more modest -17%. A decline of -15% in earnings would take us from about $220 to $187.

Corporate profits retreated in each of the prior 11 U.S. recessions

S&P 500 earnings declines surrounding recession periods

Recession start	Earnings peak	Earnings trough	Earnings decline duration (months)	Earnings peak per share	Earnings trough per share	EPS change peak to trough
July 1953	Dec. 1950	Dec. 1953	36	$2.8	$2.5	-11.6%
Aug. 1957	Feb. 1956	March 1959	37	$3.6	$2.8	-23.4%
April 1960	June 1960	June 1961	12	$3.6	$3.0	-14.6%
Dec. 1969	April 1969	June 1970	14	$6.1	$5.1	-16.2%
Nov. 1973	Jan. 1975	Feb. 1976	12	$9.6	$7.6	-21.6%
Jan. 1980	July 1980	Aug. 1981	13	$15.6	$13.7	-11.9%
July 1981	Aug. 1982	July 1983	11	$16.3	$12.1	-25.8%
July 1990	Aug. 1989	May 1992	33	$25.7	$15.5	-39.7%
March 2001	Sept. 2000	March 2002	18	$55.8	$41.3	-25.9%
Dec. 2007	Aug. 2007	Oct. 2009	26	$89.8	$45.1	-49.8%
Feb. 2020	Jan. 2020	Feb. 2021	12	$152.5	$122.8	-19.5%
Average			**20**	**$34.7**	**$24.7**	**-23.6%**
Median			**14**	**$15.6**	**$12.1**	**-21.6%**

Source - RBC Global Asset Management

On November 8, the S&P 500 was trading at 3,823, and using Wall Street consensus earnings estimates of $233, the S&P 500 was trading at a P/E of 16.4x. The spreadsheet below is my what-if tool. You can simply plug in your estimate for earnings, and your guesstimation of what investors will be willing to pay for those earnings, and abracadabra you get your return projection for the S&P 500. If you think earnings will be flat at $220 next year and the P/E ratio will stay at 16.4x, then you can expect a negative -5.62% return on the S&P 500 for 2023.

S&P 500 Estimated Return Scenarios

		Estimated Forward Earnings S&P 500								
		$ 170	$ 190	$ 200	$ 220	$ 230	$ 240	$ 250	$ 260	$ 270
	13	-42.19%	-35.39%	-31.99%	-25.19%	-21.79%	-18.39%	-14.99%	-11.59%	-8.19%
	14	-37.75%	-30.42%	-26.76%	-19.43%	-15.77%	-12.11%	-8.45%	-4.79%	-1.12%
	15	-33.30%	-25.45%	-21.53%	-13.68%	-9.76%	-5.83%	-1.91%	2.01%	5.94%
	16	-28.85%	-20.48%	-16.30%	-7.93%	-3.74%	0.44%	4.63%	8.82%	13.00%
Estimated	**16.4**	-27.07%	-18.49%	-14.20%	-5.62%	-1.33%	2.96%	7.25%	11.54%	15.83%
P/E Ratio	**17**	-24.40%	-15.51%	-11.06%	-2.17%	2.28%	6.72%	11.17%	15.62%	20.06%
	18	-19.96%	-10.54%	-5.83%	3.58%	8.29%	13.00%	17.71%	22.42%	27.13%
	19	-15.51%	-5.57%	-0.60%	9.34%	14.31%	19.28%	24.25%	29.22%	34.19%
	20	-11.06%	-0.60%	4.63%	15.09%	20.32%	25.56%	30.79%	36.02%	41.25%
	21	-6.62%	4.37%	9.86%	20.85%	26.34%	31.83%	37.33%	42.82%	48.31%
	22	-2.17%	9.34%	15.09%	26.60%	32.36%	38.11%	43.87%	49.62%	55.38%
	23	2.28%	14.31%	20.32%	32.36%	38.37%	44.39%	50.41%	56.42%	62.44%

Current (11/8/22) S&P 500 Price $3,823
Current 12-month Forward Earnings Estimate $233
Current S&P 500 P/E 16.41x

The earnings part of the equation is actually the easy part. The hard part is the P, the psychology, what will investors pay for those earnings. For the last ten years the average P/E for the S&P 500 has been 17.1x. In times of ebullience, the P/E expands into the low 20's, and in times of fear it falls into the low teens.

What will the mood be in 2023? Will investors be fearful of a deep recession, or will they be hopeful of a soft-landing? Will the Fed be successful in its inflation fight, and begin to take its foot off the economies neck?

Again, my feeling is that the real economy (not the speculative economy) is in pretty good shape. That inflation will subside, and earnings will slow but not collapse. I don't see ebullience, but I can make a case for P/E's in that 17-18x area. If that's the case, and earnings decline to about $190 the we still have about 10-15% downside risk in this bear market. Not great but not horrible.

The thing to remember if you're a long-term investor is that you want to weigh your risk and returns. After a more than 20% decline in the market, the risks have subsided. I don't think they're zero, but I feel better about putting money to work.

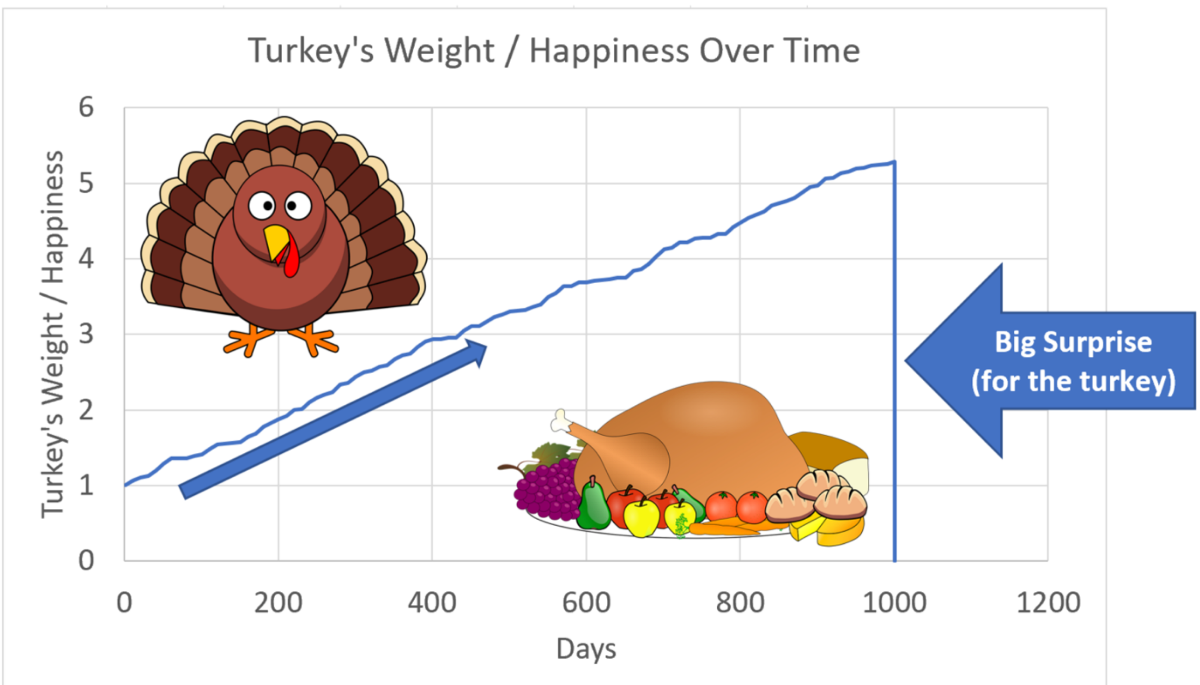
Also, on the fixed-income front, if you believe that we are getting closer to the end of Fed rate increases then you should be more willing to put money to work in bonds yielding 6-7%. Especially if you believe that inflation will retreat back towards its recent trend of 2-3%.

Taleb's Thanksgiving Turkey

Every Thanksgiving I like to share Nassim Taleb's story of the Thanksgiving Turkey and the Black Swan.

Taleb writes, "Consider a turkey that is fed every day. Every single feeding will firm up the bird's belief that it is the general rule of life to be fed every day by friendly members of the human race 'looking out for its best interests,' as a politician would say. Everyday for 1,000 days the turkey has his belief reinforced."

"Then on the afternoon of the Wednesday before Thanksgiving, something *unexpected* will happen to the turkey. It will incur a revision of belief."



The problem that Taleb is really attacking in his book is forecasting, particularly economic forecasting, and the practice of using past events to predict the future. Using inductive reasoning to forecast future events poses, for Taleb, not just something potentially useless or wrong, but something that actually has negative value.

"Consider that [the turkey's] feeling of safety reached its maximum when the risk was at the highest!" Taleb writes.

"But the problem is even more general than that; it strikes at the nature of empirical knowledge itself. Something has worked in the past, until — well, it unexpectedly no longer does, and what we have learned from the past turns out to be at best irrelevant or false, at worst viciously misleading."

And *this* is really what the problem of Black Swans is all about.

It isn't that we can't know the future, but that we delude ourselves into thinking we can, making forecasts about events that are inherently unforecastable and giving us false belief about what can or will or might happen in the future.

When a Black Swan event really occurs, it will seem outside what had previously seemed possible. But Taleb would likely argue that this event only seems outside previous beliefs about what was possible because of how we arrived at those possibilities. Namely, by using the past to forecast the future.

This is why we must be humble. Investing is about survival, and the only way to survive is to admit that what occurred in the past may not reoccur in the future. Invest with humility, don't be a turkey.

Happy Thanksgiving.

As always, be careful out there.

Chris Wiles, CFA

Where Trust is Earned