Independence | Asset Advisors

MARKET MATTERS

September 30, 2022

Stock and bond markets have remained unusually correlated in 2022 and with both investment categories down sharply, there has been nowhere for investors to hide.

With the Fed aggressively raising interest rates to quell the highest inflation in four decades, a "hard landing" (i.e., a recession) seems inevitable.

In this issue of *Market Matters*, we explore returns during and after recessions and consider investment opportunities.

EXECUTIVE SUMMARY

Markets roiled by historically high inflation have left investors with nowhere to hide in 2022.

- ✓ Historic inflation has resulted in accelerated monetary tightening.
- ✓ The chance for a "soft landing" is essentially zero.
- ✓ The S&P 500 Index fell an average of 1% during all prior recessions.
- ✓ Market returns after midterm elections have been strong.
- ✓ Equity valuations and bond prices have improved.
- ✓ Staying invested is critical to maximize cumulative long-term returns.

> *"I'd throw dollars out of helicopters if I had to, to stimulate the economy." Ben Bernanke*

RECESSION

In November 2002, Ben Bernanke, then a member of the Board of Governors of the U.S. Federal Reserve, referred to economist Milton Friedman's famous "helicopter drop" of cash as a solution for deflation. At the time, the U.S. Federal Reserve had just completed an aggressive interest rate reduction program that moved the cost of borrowing from roughly 6% down to less than 2%. The efforts to jumpstart a sluggish economy back in 2002 are in stark contrast to what is happening now, as the Fed has just completed its third consecutive 0.75% rate increase and signaled additional hawkish rate increases needed in the months ahead to tame inflation in an historically tight labor market.

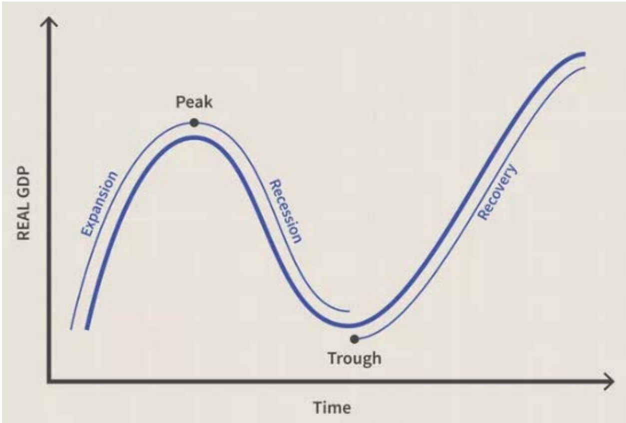
Heading into the year, markets were anticipating the Fed would only raise interest rates by three 0.25% increments, or a range of 0.75-1.00%. Once it was determined inflation was not transitory, the Fed's posturing changed quickly, and markets are now expecting interest rates to end the year at a range of 4.25-4.50%. As the Fed's tightening has done little thus far to bring down inflation, and with many market participants believing the Fed was woefully behind the curve, markets are now fearing the Fed will raise rates too high and send the U.S. economy into a recession.

Sources: Longtermtrends, WSJ, St. Louis Fed, Nasdaq, Barrons, Multpl, CSI Market, Fidelity, Nuveen, Forbes, JP Morgan, Bloomberg, CapitalGroup, Federal Reserve, TradingEconomics, CFRA Research

RECESSION

"What goes up must come down."

So, what can investors expect if and when a recession occurs?

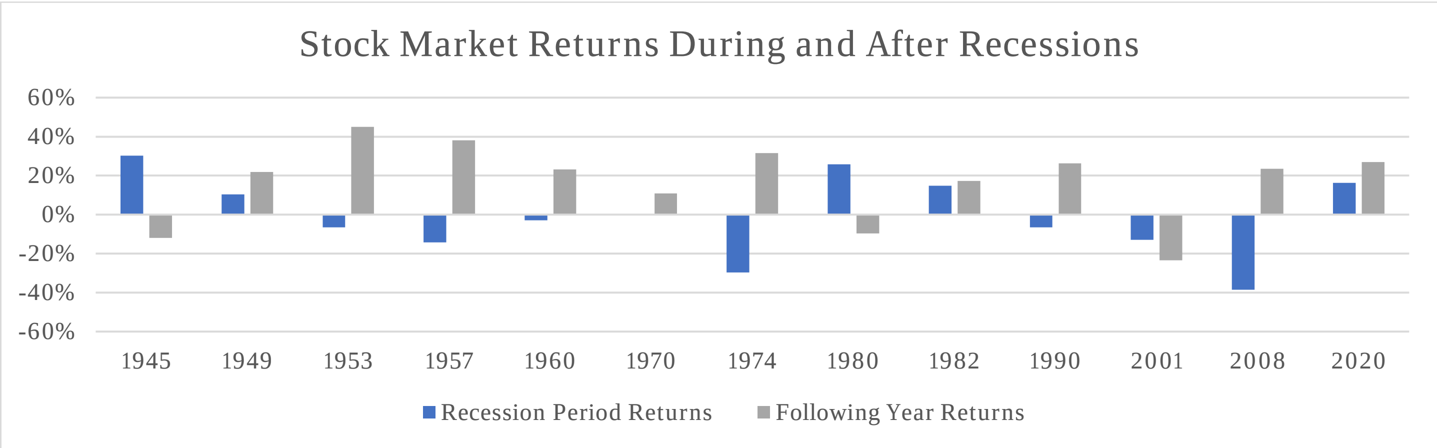


There are three phases of a "normal" market cycle: expansion, recession and recovery. The first phase occurs when the economy is running at full steam, with GDP increasing at a healthy rate, employment at or near its maximum level, and household incomes rising. This phase is often accompanied by higher stock prices and increased dividend payouts. Prices for goods typically increase as well, and by the economic peak, inflation has usually risen far above the Fed's current 2% target. To slow down an overheated economy, central banks tighten monetary policy by raising interest rates, which makes it more expensive for people and businesses to borrow money. If done properly, the economy will cool without freezing. However, if rates are increased too aggressively, economic growth can turn negative and phase 2 will begin as a contraction...

There have been 13 recessions since World War II, roughly defined as two consecutive quarters of negative GDP growth. Three of them have occurred in the 21st century, in 2001, 2008 and 2020, and another one could be on the way.

By now investors have all but given up hope for a "soft landing," or an economic shift to slower growth that avoids a recession. That is unfortunate. It is hard to predict when a market recovery might take place. Stocks rebounded 34% in 1995 after the Fed cooled the economy the year prior with seven rate increases without turning economic growth negative. Fed rate-hiking campaigns usually (but not always) precede economic downturns, and in this case the Fed's accelerated tightening agenda makes the prospect of a "hard landing" recession appear unavoidable.

With a recession looming, investors may be wondering how stocks have performed when the economy is faced with economic deceleration? Suprisingly well, actually. Since 1945, the S&P 500 Index has declined on average 1% during all recessionary periods (high of +30% and low of -39%). Equity markets usually bottom out and rebound months before the end of a recession. In other words, the worst is usually over for stock markets before it is over for the rest of the economy. According to CFRA Research, "prices lead fundamentals – therefore the stock market falling into a decline is traditionally an indication that most investors believe we are headed for a recession. When we do finally fall into a recession, that's usually a good time to get back into the market."



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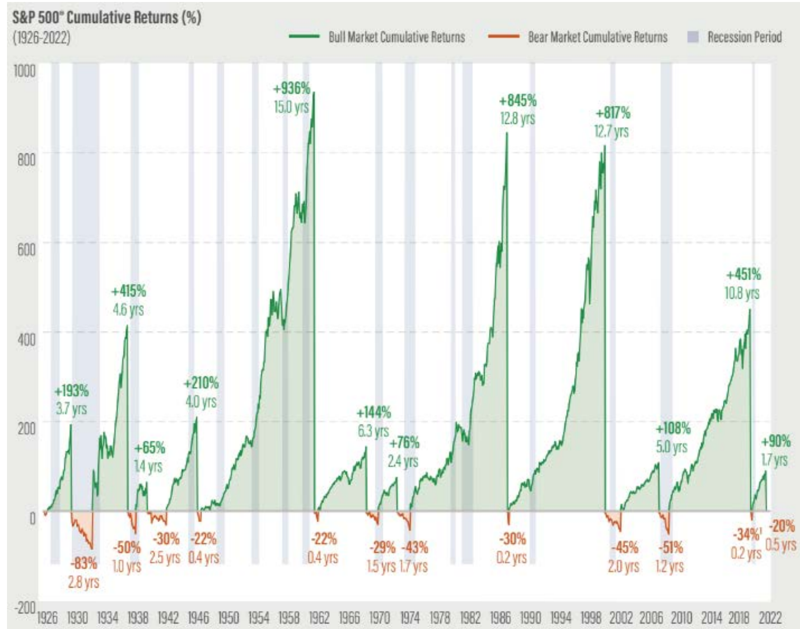
RECESSION



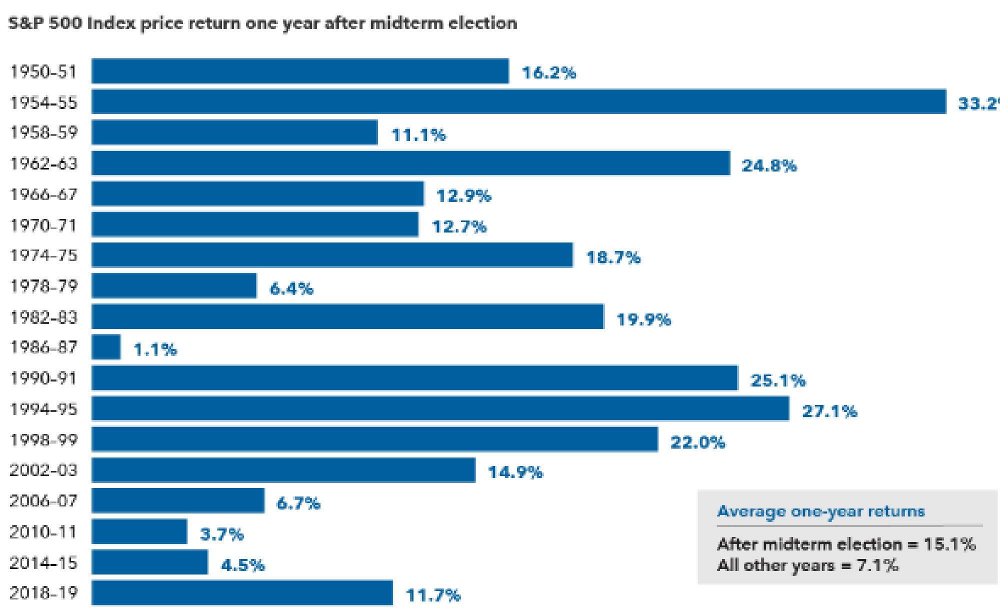
While markets have historically declined 1% during recessionary periods, they have gained on average 17% in the year following. This is the beginning of phase 3, also known as the recovery or expansion period. This is when the economy begins to grow again and firms increase their production, which leads to more hiring and wage growth. Phase 3 is typically accompanied by equity bull markets, which have lasted 6.7 years on average and delivered a cumulative return of 362% for investors who were able to avoid selling at or near the bottom.

As we move closer to a possible recession, there is some optimism among financial professionals that the recession period return could be improved, and phase 3 started sooner, because of the timing of this year's U.S. midterm elections.

Historically, market returns after midterm elections have been very strong, although volatility leading up to and during the elections is almost always elevated. The silver lining for investors is that markets have tended to rebound strongly in subsequent months, and the mini rally that has often occured shortly after Election Day hasn't been just a short term blip. Above average returns have also been typical for the 12-month period following the election cycle. Since 1950, the average return of the S&P 500 Index following the midterm election was 15%. That's more than twice the average return for all other years.

"Expect the Unexpected"

If CFRA Research is correct, and prices lead fundamentals, then the historically bad and unusually correlated stock and bond market returns in 2022 have sent a clear signal that a recession is imminent. History has shown that, on average, returns during recession periods are about flat, are positive in the one year following, and that midterm elections have always been followed by a year of gains. But buried in the averages are outlier returns that can wreak havoc on investment portfolios.



Our guidance to readers is to stay invested and look for opportunities that may arise as markets decline in advance of what is likely going to be an economic recession. In the following section we discuss some of these emerging opportunities.

Sources: Longtermtrends, WSJ, St. Louis Fed, Nasdaq, Barrons, Multpl, CSI Market, Fidelity, Nuveen, Forbes, JP Morgan, Bloomberg, CapitalGroup, Federal Reserve, TradingEconomics, CFRA Research

OPPORTUNITIES

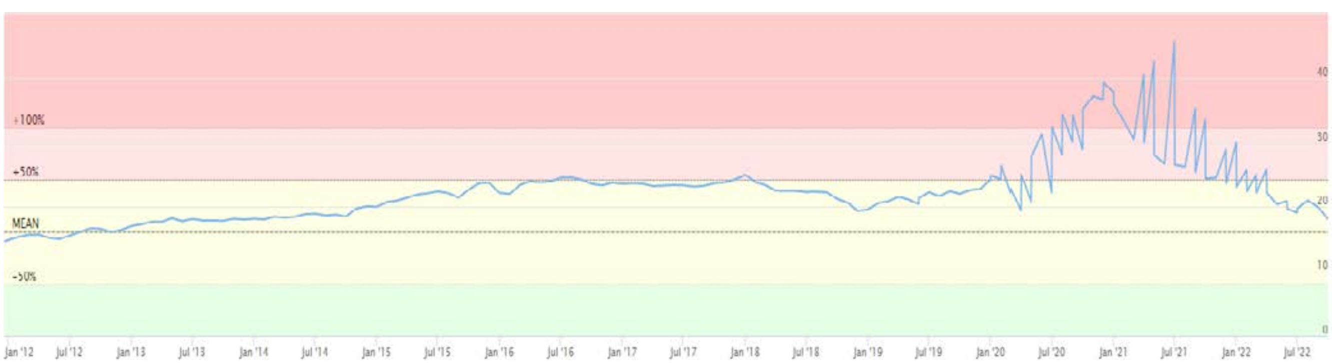
BEAR MARKETS AND BARGAIN BUYING

Current market conditions are exhibiting an historically unusual combination of plunging valuations in both equity and fixed income markets. Equity indexes were down as much as 29% year-to-date as of 9/30, and bond indexes are also deeply in the red, with investment grade and high yield indexes both down almost 15%. No class of bonds has been spared the decline, which has impacted government issues as harshly as credit. Market lows are painful, especially when assets decline across the board. However, they now offer a valuable opportunity for purchasing assets at a discount. This applies whether an investor is taking an opportunity for rebalancing, tax loss harvesting or putting new money to work. An investor with the wherewithal to hold investments through market volatility can take advantage of a down market for higher future gains. The ability to hold investments through a market downturn is a primary risk management strategy, and buying when valuations are low will serve investors well in the longer-term even if there is short-term volatility.

EQUITIES

U.S. equity indexes are down 24% year-to-date as of 9/30/22. With stocks in a bear market, valuations have become a more attractive prospect for putting capital to work. Stocks have been strongly overvalued for years compared to historical averages, and were subject to particularly inflated valuations between the beginning of the post-COVID-dislocation recovery period and the end of last year. Valuation ratios are used to judge whether the fundamentals of an underlying company support its stock price, or whether the stock is over- or under-valued. Price-to-Earnings (PE) ratios, or the price of a stock divided by the trailing 12 months or the future expected earnings of a company per share, are often used as a valuation metric for equities. Companies that generate more earnings and/or are expected to experience significant earnings growth can support a higher stock price. The modern era market average PE ratio for the S&P 500 has been around 19.6, just above where it currently stands, but overall valuation ratios have been steadily increasing for the last decade, reaching double this average at the end of 2020, when the ratio hit a high of 39.3 (unsmoothed in the chart below). In recent history, investors have been paying more for a company per dollar of its earnings than ever before.

S&P 500 PE Ratio: Last 10 Years



	S&P 500 (9/30)	Average/Mean	High	Low
Price to Earnings	18.1	19.6	39.3	13.5
Price to Book	3.8	3.0	5.1	1.8
Price to Sales	2.4	1.7	3.0	0.80

The current S&P 500 PE ratio as of 9/30/22 is ~18x based on trailing 12 months earnings and 16.8x based on forward estimates, vs. a PE ratio of 30x one year ago. Looking at the above chart, the ratio has moved into the average band (less than one standard deviation above/below the mean).

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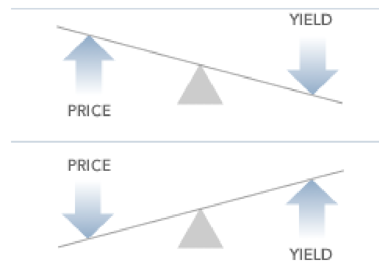
OPPORTUNITIES

While stock prices probably have farther to fall, the market is now fairly valued when compared to historical averages. S&P 500 price-to-book values have also been trending up for a decade, reaching a high of 4.7x in Q4 2021. The book value of a company is the current value of its assets, minus its liabilities. Price-to-Book value is a way to measure the net asset value that investors are buying when they buy a share of a company's stock. The current PB ratio for the index is hovering around 3.8x. For every $3.80 that an investor spends on stocks (on average) they receive $1 of net equity. This is still above the historical average of 2.9, but companies are much more fairly valued than they were as little as 9 months ago. Price-to-Sales (stock price per dollar of company revenue) and other ratios are also reverting toward the mean. These reductions are a testament to the fall in prices across the board, and particularly to the fall in tech stocks and other high-growth, not-profitable, and/or non-dividend paying stocks, which have tumbled precipitously from their highs.

FIXED INCOME

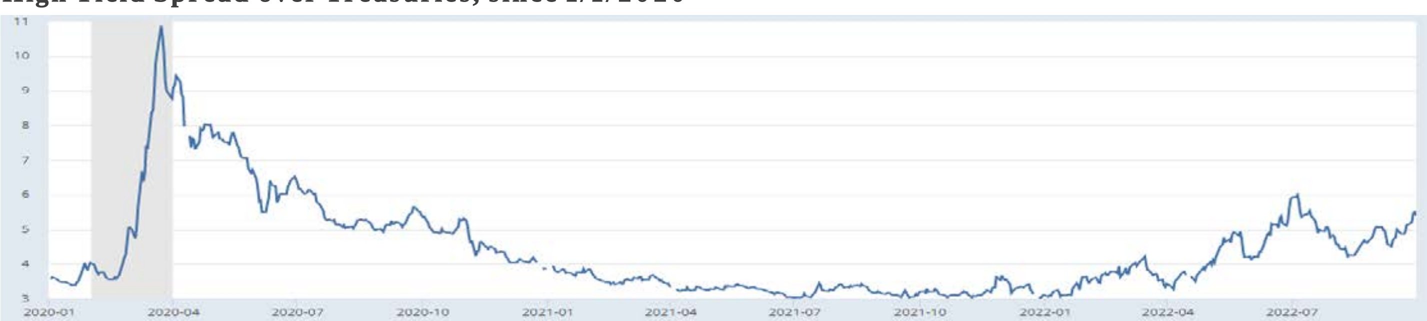
It's uncommon that stocks and bonds experience the present depth of valuation declines simultaneously. In current times, however, the same forces are weighing on both asset classes, and with similar gravity. Stocks are feeling the sting of recession risk due to Federal Reserve actions to slow down the economy and take the heat out of the labor market. Bonds, likewise, are reeling from steep, continual Fed interest rate increases, as well as inflation and recession indicators that affect the corporate credit market. As bond prices fall, yields rise due to consistent dollar coupon payments being paid on bonds discounted to lower prices (see inset). Buying bonds at a discount (at a price below par, or face value) can offer significant upside because the investor receives more coupon yield per dollar invested. With prices down double digits year-to-date across multiple bond classes, yields have risen steeply and steadily. Because an investor receives the full face value of a bond at maturity, even when purchased at a steep discount to its face value, bonds have shown an historical tendency to recover more quickly than stocks after a drawdown of the magnitude the markets are currently experiencing. A discount bond's price is "pulled to par" as it gets closer to maturity, giving the investor the upside of a gain, along with higher yield.



Yields/Spreads

Credit spreads, or the premium in current income yield that an investor is compensated for the perceived risk of a high yield bond over its government issued counterpart, have increased to 550 bps, or 5.5% (9/30/22) - an increase of almost 2.5% from a year ago.

High Yield Spread over Treasuries, since 1/1/2020



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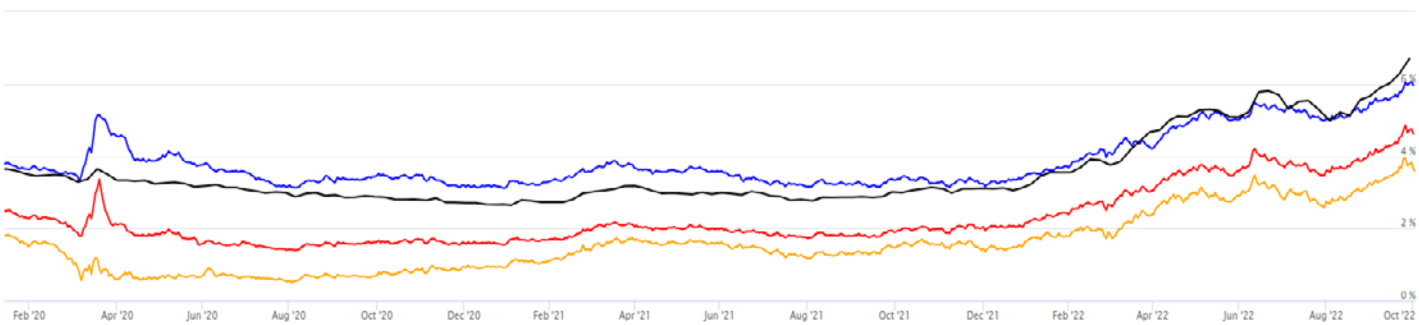
OPPORTUNITIES

Credit risk, connected to high yield bonds given their lower perceived creditworthiness, is the risk that the issuer will default, or fail to make its promised payments of interest or principal. Defaults can come in the form of postponed payments, partial payments, or a complete loss to the investor. The current economic environment is increasing the risks (among others) that company cash flows could deteriorate in a recession and that refinancing debt will be unsustainable due to rising interest rates (rollover risk). With interest rates rising quickly, refinancing old debt with newly borrowed funds is expensive, and some issuers/companies may not be able to support this cost. Default rates have been low by historical standards since the Great Financial Crisis, and due to government intervention during the pandemic, corporate bond defaults have been exceptionally low lately - less than 1%. Though defaults are projected to rise as monetary policy tightens further, credit quality in the market is high and defaults are expected to remain below their historical average of 3.6%. Though risk is modestly increasing, investors are now being compensated for taking on credit risk after years of searching for yield.

Fixed Income Yields, Since 1/1/2020



30-Year Fixed Rate Mortgage Rate, **Baa Corporate Bond Yield** (Lowest Investment Grade), **Aaa Corporate Bond Yield** (Highest Investment Grade), **10-Year US Treasury Constant Maturity Rate**

Manager selection for private investments and separately managed accounts is even more important during times of heightened credit risk. A skilled manager can minimize losses due to default risk with expert due diligence and experience with corporate credits over multiple market cycles.

Putting Losses to Good Use

Tax loss harvesting is a potential upside to taking a loss on an investment. Realized losses can offset realized portfolio gains in the future, essentially as a tax deduction that reduces the investor's tax burden. A small amount of losses can be applied to ordinary income, and other losses can be rolled forward and applied to future tax years with no expiration date. Thinking broadly about one's return on investment, taxes paid are a cost that reduces what would otherwise be an investor's profit. Tax loss harvesting takes losses when market conditions are poor (or otherwise opportunistically raises losses) so that investors can apply them to reduce taxable gains, eliminating the need to pay gains taxes. This gives the investor the full amount of their investment profit, instead of merely +/- 80%. If an investor would otherwise need to liquidate assets in order to pay for the future gains tax bill, this offsetting then has a multiplicative effect. It eliminates taxes on realized gains, but also saves the investor from realizing more gains from selling assets to pay capital gains taxes in cash. This both allows those funds to remain invested and grow and saves the investor from an additional tax bill on the gains being realized to fund taxes on gains.

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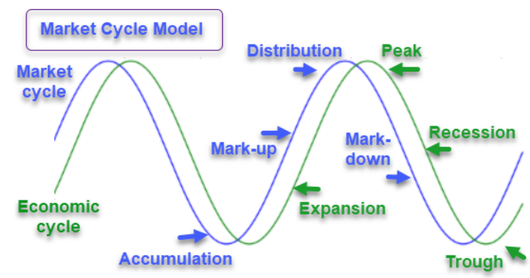
SUMMARY

While we have seen steep daily and weekly declines occur several times since the beginning of 2022, we expect that lower lows are yet to come. However, timing the market is a fruitless effort. Buying when there are opportunities, staying diversified while taking advantage of market dislocations and remaining invested through market volatility are consistently the best portfolio strategies.

The markets tend to be a "leading indicator" in the economic cycle. This is an essential part of why analysts refer to market movements as "pricing in" certain expectations. Because prices move according to future expectations, current prices are forward looking. Markets are currently pricing in higher terminal interest rates and a higher risk of recession. This is likewise why news like low unemployment and high consumer spending is driving markets lower (good news is bad news), as the economy still needs to cool significantly.



This is also one primary reason for remaining invested and buying when there are opportunities even if the worst is yet to come. The markets will most likely recover in advance of when we experience the recovery, and after the recovery an investor won't regret buying at a low even if it isn't the lowest. Whether this takes a few quarters or a few years, a long-term holding period will eventually pay off. In equities, buying in a down market gets investors more earnings, book value, or cash flow per dollar of price. In fixed income markets, buying bonds at a discount means getting more coupon (yield) per dollar invested. In both cases, buying in a bear market means getting more for your money.

Sources: Longtermtrends, WSJ, St. Louis Fed, Nasdaq, Barrons, Multpl, CSI Market, Fidelity, Nuveen, Forbes, JP Morgan, Bloomberg, CapitalGroup, Federal Reserve, TradingEconomics, CFRA Research