INVESTMENT PERSPECTIVE Q3 2022

REVERSAL OF FORTUNE

It's common to describe investors as either bullish or bearish. A more useful dichotomy would be to describe them as 'reversal' or 'momentum' oriented. Right now, the bulls are for reversal and the bears are for momentum. That is, the bulls need bond yields and stocks to revert into a prior range while the bears hold that the trend established this year (stocks down/bonds down) should continue. At the beginning of 2022, the roles were opposite. There's lots of evidence that both strategies work *over time* but not at the *same* time. So, there should be no priors in favor of one over the other. Let's look at the evidence.

For the reversalists, the S&P 500 is now down 25% and trades at about 16x its forward 12-months' earnings expectations. The past 30-year average is also about 16x. However, the free cash flow yield of the index is about 5.2%. That's solidly above its 30-year average of 3.7%. As a back-of-the-envelope estimate of stocks' long-term expected return, you could add the current U.S. 10-year yield (4.20%) as a measure of nominal growth to arrive at 9.4%. If this strikes you as a little cavalier, Professor Aswath Damodaran at NYU publishes a bottom-up cash flow model for the U.S. stock market. Today, his model implies a 10% expected return. The point is, we are in the range of attractive expected returns for stocks. Corporate earnings for Q3 2022 are coming in roughly as expected. With 25% of the index

Source: Bloomberg, Hirtle Callaghan. As of July 25, 2022.

members reporting, sales and earnings are beating consensus by 1% and 4.5% respectively. The earnings calamity the bears have called for has once again pulled a Godot. Trends ultimately require the sustenance of confirming data. The adage about stocks climbing a 'wall of worry' refers to the failure of actual news to validate the fears priced in.

Now let's look at the momentum arguments. Exhibit A is the Federal Reserve's rates policy. The Fed is guiding the market to expect cumulatively seven (0.25% increments) hikes by March of next year or another 1.75% of monetary restraint. And we don't know for certain that will be sufficient to dampen inflation. If inflation continues, the Fed pause and pivot may be delayed further into the future. Meanwhile, the impacts on the real economy in areas like housing are already severe. The current national average 30-year conforming mortgage is priced around 7%. While residential housing is very visible, it represents the tip of an iceberg of interest-sensitive sectors. Commercial real estate, automobile loans, commercial equipment leases and acquisition financing are all in the process of adjusting to a new paradigm for cost of capital. The other bete noire lurking in the closet is the effect of higher rates on the financial system. The turmoil in the UK government bond market set off by levered pension funds raising cash to meet margin calls may be just a canary in the coal mine. The next player that needs a government bailout may be less politically connected or short of good collateral. So, the momentum case is that there is a lot of inertia working to slow the system. At some point, it will trigger an insolvency that will topple a whole interconnected edifice of borrowing.

Next, there's the most anticipated recession since World War II. Bloomberg Economics this week forecast that the odds of a recession in the next 12 months are 100%. In the interest of balance, we should add that the Conference Board's survey of 136 CEOs showed only 98% predicted a recession. The forecasts do not specify the magnitude or duration of a recession. Also, the model is conditioned on current and future implied interest rate hikes, so its not a novel perspective. And, finally, there is the grab-bag of exogenous threats: the escalation of Ukrainian war, China's threats to invade Taiwan and an Italian government debt default are just the start of a long list.

The glue that holds these together is the continuation of the current state of play. The challenges we face from rising inflation and interest rates do not ameliorate. And it's a playbook that we recognize. I remember living through the tech bubble unwind and the tragedy of 9/11 and feeling a possible normalization of circumstances in Spring of 2002. Then WorldCom and Enron imploded in rapid succession. It does seem like there's another shoe to drop. One more body blow that will lead to a final cathartic purging of all risk. And it could turn out that way. But not necessarily.

This is not to recommend prayerful resignation. Rather, I think it's clear-headed risk management to acknowledge in equal measure what could go right as what could go wrong. Bertrand Russell once complained, "The whole problem with the world is that fools and fanatics are always so certain of themselves, and wiser people so full of doubts." Right now, the arguments of the momentum crowd are being sustained by a steady fodder of seeming confirmation. Rates *are* moving rapidly higher, and inflation *is not ebbing away*. Let's recall however that asset prices are reflecting exactly that preponderance of the evidence. A small nudge away from that scenario could set off a landslide of re-positioning. That's why I think it's so critical to consider the seemingly improbable. Perhaps, inflation moderates enough to allow the Fed to pause. And perhaps the recession is not the sudden stop of COVID or the Great Financial Crisis.

To be sure, we have some bets that lie in the direction of the current momentum. We are underweight Europe and Japan as the developed markets most exposed to a recession. We are also underweight duration. So as rates rise, we are winning relatively versus the benchmark. But we are watching these positions very closely. We are, in fact, requiring that the data continually 'sustain' the thesis. And we understand that we will have to remove them when all is seemingly in their favor. The holy grail is the trade purchased cheap as a reversal bet and held through its full blossoming. I would put our overweight on Treasury Inflation Protected Securities in that camp. We sold them last January/February when real rates were -1.00% and returned recently at real yields of 1.50%. But those are rare – maybe not holy grail rare – but almost.

Our goal is to have a mixture of reasonably sized and soundly reasoned positions that are not perfectly correlated. An important part of that balancing act is keeping an eye on momentum and reversal tendencies. As always, we look forward to seeing you in the coming weeks and discussing your portfolios in further detail.

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