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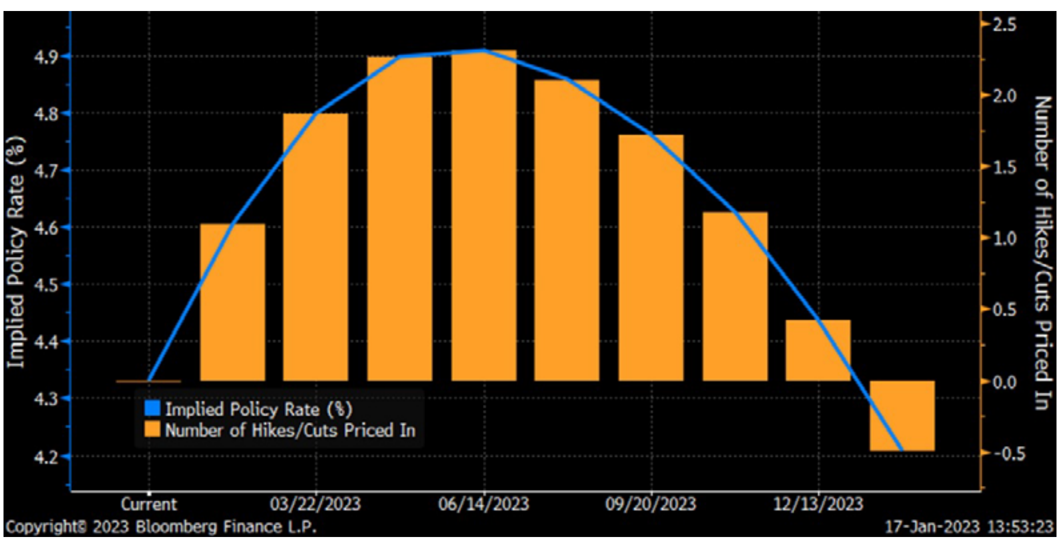
Current Market Environment

"This time is different." As 2022 began, that sentiment seemed pervasive. With the S&P 500 trading close to all-time highs, continuing to be led by mega-cap technology and growth stocks, despite rising interest rates and worrisome inflation readings, the time-tested rule that ultimately, the stock market is a discounting mechanism, was seemingly being ignored. However, as the year progressed and inflation continued to surge, reaching a 40-year+ high of 9.0% in June, this time proved, unequivocally, not to be different. The Federal Reserve, in an effort to tamp down consumer prices, aggressively raised rates – ultimately by fully 425 basis points on the year. As interest rates continued to rise, the market rotated from "voting machine" to "weighing machine" (to once again use a favorite Benjamin Graham metaphor) as expected future cash flows were discounted at much higher interest rates and the present value of formerly nosebleed valuations were adjusted much lower. Against this backdrop, value stocks trounced growth (the S&P 500 Value Index's decline of 7% bested its growth counterpart by nearly 23%), and many of the leaders over the past decade were hit hardest. For example, the so-called "FAANG" stocks saw an average decline of over 46% for the year, with Apple, the best performer among the group, declining over 26%. Indeed, there was seemingly no place to hide in 2022 as both stocks and bonds fell by more than 10% for the first time on record according to Ned Davis Research.

As 2023 begins, the market remains on edge. An unprecedented pandemic brought with it unprecedented economic and social impacts. An abrupt, global shutdown in 2020 led to drastic reductions in economic activity, followed by an equally abrupt reopening, supply and labor shortages with corresponding inflationary effects – the results of which we are still feeling today. Central banks globally have been tightening policy as a result, and recession fears abound. According to a recent Morgan Stanley report, "of the 38 central banks around with world, 32 (or 84%) have hiked their main policy rate over the last six months". Domestically, as we indicated in our last quarterly writing, we continue to fear the impacts of a potentially too-hawkish Fed. Although the CPI has declined month over month since the peak in June, it remains stubbornly high (over 6% at the last reading) and the employment market remains very tight. Meanwhile, the rapid rise in interest rates has caused the housing market to come to a virtual halt, as the 30-year mortgage rate, which ended 2021 at 3.31%, reached a high of 7.16% in October 2022 and remains well north of 6%. Other signs of cooling include the ISM Manufacturing Index[1], which recently registered a 48.4 (a level indicative of a contracting economy) and the ISM Services PMI[2] index for December, which also indicated contraction after 30 months straight of growth. Despite this, the Federal Reserve has indicated an unwillingness to cease tightening until inflation is closer to their 2% target, and are willing to slow the economy considerably to do so.

Moreover, the Fed's "dot plot" (the central bank's own projection of where they estimate the Fed funds rate will be in the future) indicates a plan to hold rates flat in 2023 once the terminal rate of tightening is reached – a plan which implicitly assumes a relatively strong economy. However, market expectations are not as sanguine and predict an economy not able to withstand short-term interest rates at such a restrictive level. As can be seen in the table below, market expectations are for the Fed to cut rates several times in the back half of 2023.



1 The ISM Manufacturing Index is a monthly gauge of U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing firms.

2 The ISM Services PMI index is a monthly gauge of U.S. economic activity based on a survey of purchasing managers at non-manufacturing industries. The non-manufacturing PMI captures business conditions in the services sectors, such as new orders, production, employment, prices and inventories to determine whether the industry contracted or expanded during the period.

Thus, it seems the market shares our concerns of a Fed-induced recession. If the central bank does pivot in the coming months, it would not be surprising to see a knee-jerk rotation back into growth stocks and the tech leaders of the past decade. However, we are dubious this would be sustained, given there are many arguments to be made that we are in a "higher for longer" period when it comes to inflation and interest rates. Some of the major factors which impact our reasoning include:

- The Fed has only just begun their process of Quantitative Tightening. It is unknown what the impact of attempting to reduce their $9 trillion balance sheet will be. If they become more aggressive selling Treasuries, it could cause rates to rise above where they would otherwise be – just as rates were potentially artificially low during much of Quantitative Easing.
- China's recent decision to abandon their "zero-COVID" policy and reopen the economy will likely fuel demand for autos, and other durable goods, real estate, etc. over the coming years. Given the size of China's economy, potential for demand shocks exist, which could once again bring about inflationary supply / demand imbalances.
- Also related to China, a further chilling of our relationship with the country, especially when it comes to their intentions with Taiwan, could further the trend of domestic "onshoring" we have seen following COVID-induced supply chain disruptions, as more companies move manufacturing hubs and reliance on supplies away from China. This could serve to reverse decades of deflationary productivity gains.
- The Russia / Ukraine war remains an unknown, and an escalation by Putin could lead to further disruptions in the supply of energy, wheat, and other commodities, which would be additive to inflation.

In addition to these above factors, historically, as can be seen in the chart below, once growth/value rotations happen, they typically last for years.

Source: FactSet Research Systems

Positioning

Despite all the unknowns, and persistent volatility, we are encouraged by the fact that once again fundamentals and valuations seem to matter. We are in a proverbial "stock-pickers' market," and the backdrop of volatility has allowed us to find misvalued opportunities. The environment has allowed us to add cyclically exposed, quality companies at what we feel are discount prices. This includes companies exposed to the auto, housing, and technology industries. Many names in these groups are down 30–50% from their highs and we think as the Fed pauses investors will seek out these beaten-up industries. Unsurprisingly, we have done this in our typical gradual fashion.

We continue to see value within the property-casualty insurance sector. Specifically, insurers who

are exposed to rising prices for insurance risk and whose investment income should also benefit from higher interest rates. This includes underwriters and insurance brokers. We believe renewals at 4/1, and mid-year will show continued strength, which will benefit these companies.
We have become less enthused with lenders, given concerns about rising credit and deposit costs along with marks on banks' fixed income portfolios. However, the group is inexpensive on earnings and disliked by investors. This is in addition to the fact that capital levels remain healthy and bank underwriting has been conservative versus prior cycles. We could potentially increase our exposure to this beaten up group as 2023 progresses.

We tread cautiously when it comes to consumer staples. Our view is that investors are hiding in these durable cash flow names. However, they are trading rich relative to their history, are facing trade down pressures, and as the Fed gets closer to a pausing we think there will be a rotation into early stage cyclical names.

Importantly, while we highlight sector-level movements, bottom-up analysis is essential, and we follow and find opportunities anywhere we see attractively priced businesses with conservatively-stated balance sheets and reliable cash flows. Needless to say, the current environment is keeping us very busy.

Outlook

Equity and bond market declines have been pronounced. The Federal Reserve has aggressively raised interest rates in an effort to lower inflation, and equity and bond markets are likely to remain volatile until investors sense the Fed is about to pivot to a less restrictive stance. The U.S. and rest of the world continue to manage the impacts of high inflation, Russia's invasion of Ukraine, and China's rotation from a "zero-COVID" policy. In our assessment, markets reflect a reasonably high probability of recession.

Employment remains strong. Supply / demand imbalances in the labor market bode well for the health of the consumer given full employment and the prospect for further wage gains, which partially mitigates the impact of inflation on the consumer. We expect continued pressure on housing prices as a result of higher interest rates and affordability concerns. However, the shortage of housing after over a decade of underinvestment following the Great Financial Crisis should prevent a disastrous decline in home prices. Lower-income consumers have been most impacted by the current inflationary environment, but consumer balance sheets remain generally healthy for the majority of Americans, and consumer credit quality remains strong at the moment. COVID mortality has improved and related pent-up demand is impacting many areas of the economy. These are reasons to believe a recession could be less significant than the previous two recessionary periods.

Following years of lower interest rates helping to drive ever-higher growth-stock valuations, we feel value investing is ripe for a period of outperformance. Further, given the recent market correction, we are finding opportunities to invest in quality businesses with solid balance sheets and cash flows, whose share prices have detached from our assessment of the fundamentals.

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