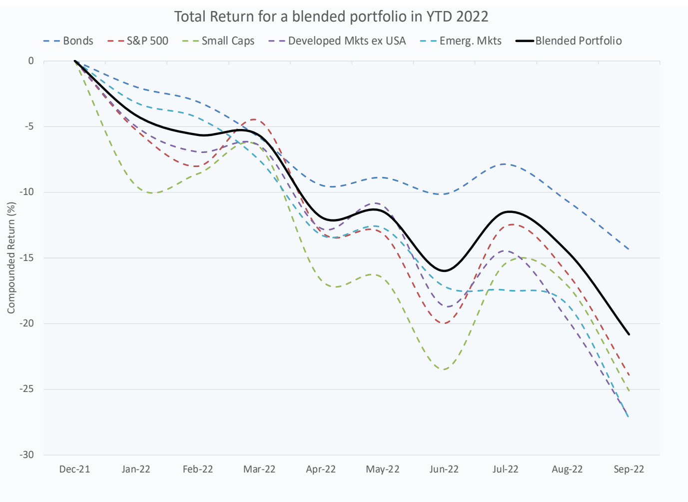
BLUMBERG
B + V ADVISORS

SEPTEMBER 1ST, 2022

RYE, NY
914.282.0941
WWW.BLUMBERGADVISORS.COM

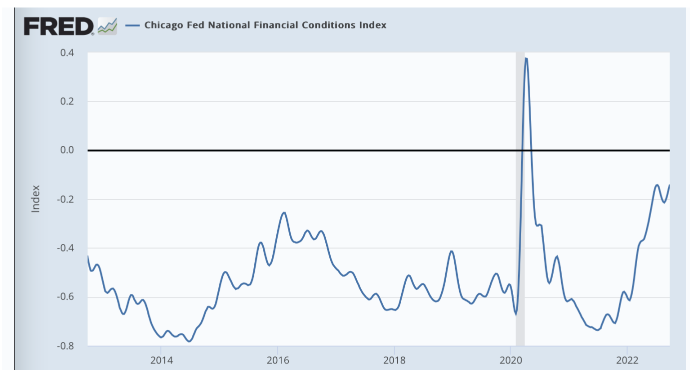
WHERE WE STAND – Q3 2022

A blended portfolio* of equities and bonds was down 5.7% (on a total return basis) in Q3 2022. For the year to date, down 20.8%. See the black solid line in the chart below. All asset classes have declined year to date led by Emerging Markets (-27.2) and Developed Markets ex USA (-27.1%). Sharp declines in the US too: Small Caps (-25.1%), Large Caps (-23.9%) and even bonds (uncharacteristically offering no diversification, -14.4%.) See the colored broken lines in the chart.



*A typical blended portfolio would be comprised of 60% equities and 40% bonds. For a benchmark, such a portfolio would arguably be 30% large cap US stocks, 10% US small caps, 10% developed markets ex-US, 10% emerging market stocks and 40% US government, investment grade corporate and GSE bonds.

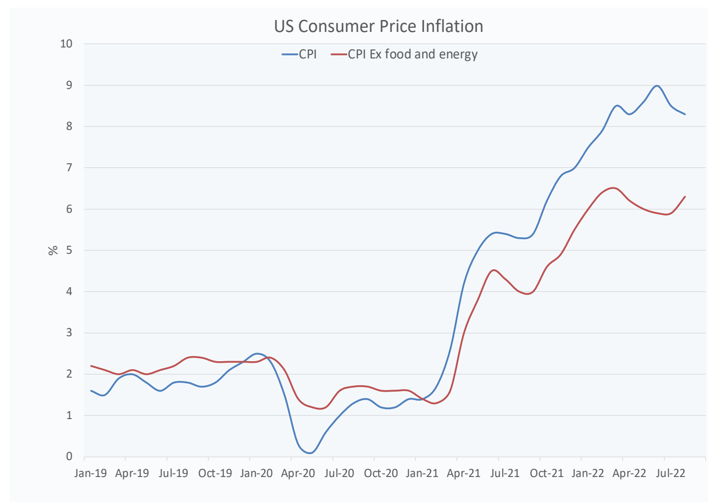
The Federal Reserve hiked its benchmark short-term rate twice during the quarter, by 0.75% in July and again by the same amount in September. This followed the 0.25% hike in March, 0.50% in May and 0.75% in June and brings the policy rate quickly to 3% after 2 years of a pandemic-induced zero rate target. Additionally, after halting quantitative easing in March (the buying of bonds by the Fed to introduce further liquidity into the system and to keep longer term rates low), the Fed continues its quantitative *tightening* it began in June. All this aggressive tightening of monetary conditions by the Fed, is a reassessment of their early thinking that inflation in the US economy was a 'transitory phenomenon', to the realization that it isn't. In the process, financial conditions have tightened substantially: a harbinger of economic slowdown. The chart below shows financial conditions (ex the pandemic) tightening the most in 10 years. Recession



is shown in gray in the chart.

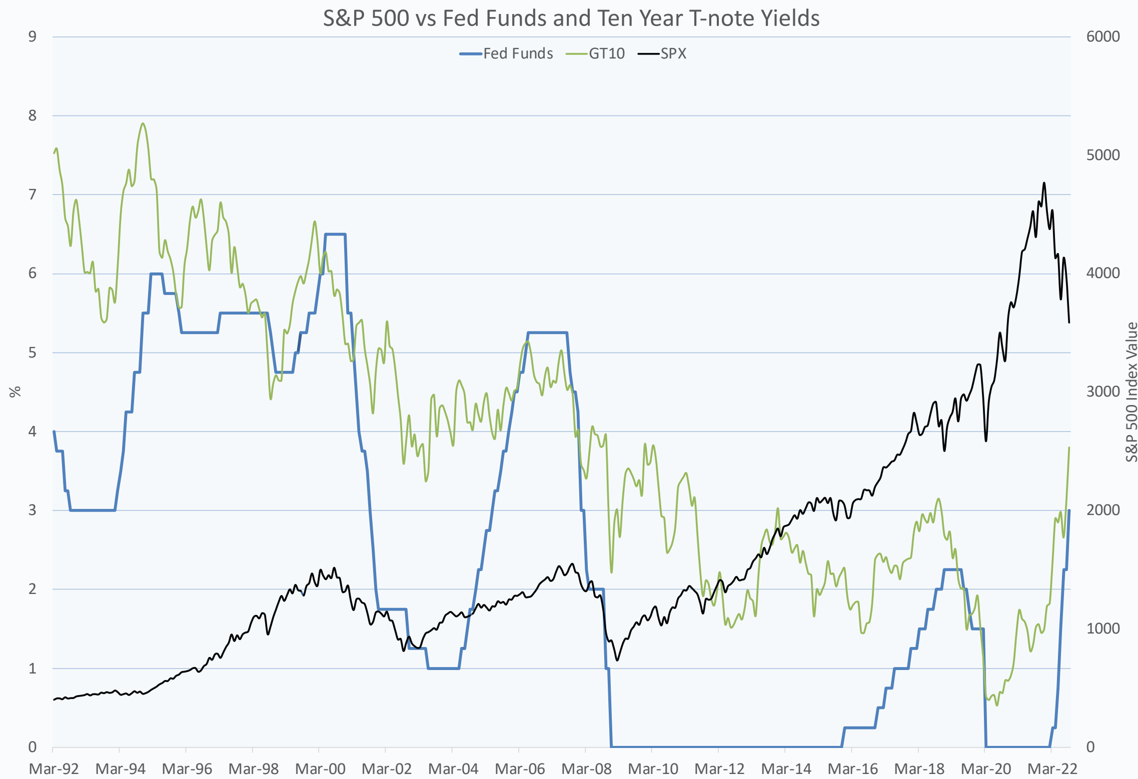
After the pandemic policy of flooding the US economy with liquidity, the actions of the Federal Reserve can be seen so far as a scene in three acts:

I. Even though inflation (see chart below) started to rise in late 2021, the Fed maintained that this was due to pandemic distortions like supply bottle necks and therefore maintained its zero-rate policy, still



mindful of the uncertainty of the pandemic's effect on economic activity.

II. In early 2022, with financial conditions inappropriately easy, and with US employment enjoying veritable boom conditions, the Fed acknowledged that it was time to start applying the brakes to its easy policy. Still maintaining that inflation was 'transitory', the Fed believed it had the luxury of tightening rates slowly (typically in 0.25% increments) and began with such a hike in March 2022.



III. By June, as can be seen in the above chart, the Fed began instituting extremely aggressive rate hikes, with three of 0.75% in June, July and September. Of note as can be seen in the blue line in the chart, for the first time in this century, the rate has risen very quickly to higher than the high rate of the last cycle. And, incremental to its hawkish stance, the Fed has guided the market that its intention is to continue with more aggressive hikes into 2023, with its target reaching as high as 4.5%.

The effect of this policy stance by the Fed has been dramatic and widespread, both in the financial markets (as shown in the first chart on the previous page) and in the real economy. For the latter, the effect can be seen in a marked slowdown in housing (where mortgage rates have risen from 3% to 7%), and various other measures of present and future economic demand.

In July, however, financial markets started to recover in the belief that because of signs of economic slowdown, the Fed would *pivot* at its next meetings and that it would indicate that the need for drastic rate increases would abate.

In late August, however, concerned specifically about the inordinate strength in the labor market and ongoing wage pressures, Chairman Powell expressed the Fed's policy as such: aggressive hikes will continue in response to high inflation pressures and that once done with increases, the Fed Funds rate would remain high for a long period of time. Fed governor is a tough task for sure, but it is noted that the Fed was way to slow in hiking rates at the beginning of this cycle and begs the question: is it making a policy error by being too aggressive on the other side of the cycle?

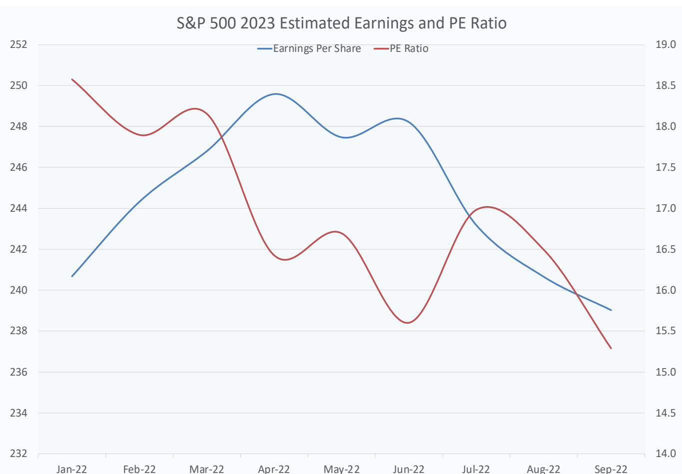
The reaction in late August was swift: strong dollar, weak equity prices and although the yield curve inverted (short rates rose more than long rates…an implicit early signal that the Fed is being too aggressive in its tightening), bond prices continued to decline due to rising interest rates.

Measures of inflation are difficult in that most are backward looking and capturing and interpreting data is a dubious exercise. But the yardstick, for better or for worse, is the CPI data. The collective financial world therefore waited with bated breath for the CPI report for August on September 13th. Investors were confident that the report would show an amelioration of price pressures, but the opposite happened: core prices rose by 0.6% on the month and instead of the YoY rate falling from 5.9% in the previous month, it rose to 6.3%. The Fed was quick to follow up with the third 0.75% hike on September 21st and to reiterate its extremely hawkish bias. For the rest of

September, it became a fog of war environment in the financial markets both domestically and internationally. Hedge funds, bond funds, sovereign entities and leveraged players in general, amidst a crisis of confidence, all having to adjust positioning in financial assets, largely by selling for solvency and collateral call purposes, without regard to the valuation they were/are selling at.

For now, financial markets are not seeing what they desperately want to see: an ongoing gradual improvement in the inflation rate. Especially regarding wage inflation. Bigger picture and longer term: fortunately, even though it may be too aggressive, the Fed is maintaining its credibility as an inflation fighter even if it means they could bring about a recession in the short term. This is a long term positive for financial market valuations and for unleveraged investors who can ride out the short-term dislocations.

The blue line in the chart below shows Wall Street's *bottoms up* earnings forecasts for the S&P 500 for 2023: $239 per share, up a nominal 15% from 2022. I would say these projections may be optimistic given the possibility of a hard economic landing, but bear in mind, at some point this level of earnings will be reached even if they must be put off for a period. This is especially so for companies that have good cash flow, wide competitive moats, pay a dividend, buy back their own stock and can take advantage of their competitive strengths to expand market share when competitors are failing.
Of note too is that nominal growth, in this inflationary environment, can be positive even in recession. And the prices companies sell their products at are expressed in nominal and not real terms. There is a relationship between equity market valuation and the size of nominal GDP of an economy. If nominal GDP is rising at 10% per year (as it has in the last year) and equity prices have fallen by 25% (as they have year to date), that is a 35% swing factor in favor of relative equity valuations over the period. These types of analyses are very 'top down' but still they offer a burden of proof towards those predicting a pure disaster outcome for equity prices.



The red line in the chart shows the forward PE ratio that the S&P 500 is trading at: 15.2 times earnings for 2023. Or an earnings yield of 6.6%. Assuming a more normalized inflation environment, these are reasonable valuations with a medium-term investment horizon in mind.

Where We Stand

As mentioned previously, our internally generated risk premium* for equities is as high as it has been since the sharp equity sell-off in early 2020.

*Equity Risk Premium=Potential Forward Return on Equities minus 10-Year risk free rate on US Treasuries. The higher the ERP, the cheaper the implied cost of equities.

Our strategy has been one of taking advantage of the sell-off that has spread to wide-moat, cash flow positive, dividend paying blue chip equities (and bonds) to invest funds, as we said we would, when opportunities like the current one arises. We continued to do this in the third quarter and are reaching a point where our portfolios are by and large invested. In the last month we have shifted our focus to increase our exposure to high quality foreign markets to take advantage of valuations and dividend yields in those markets especially given the discount we are achieving through dollar strength.

Our decisions have been driven by bottom-up analysis of each investment and the potential returns that these investments offer in the medium term. In our analysis of the S&P 100 for example, under very reasonable assumptions as to earnings, dividends and future price earnings ratio valuations, for the first time since March 2020, fully 68 of the S&P 100 offer potential IRRs of over 10% per annum going forward. And 33 offer returns of over 20% per annum. Its these sorts of companies that we are invested in. All have high free cash flow, wide investment moats and pay dividends while we wait for better investment conditions to return.