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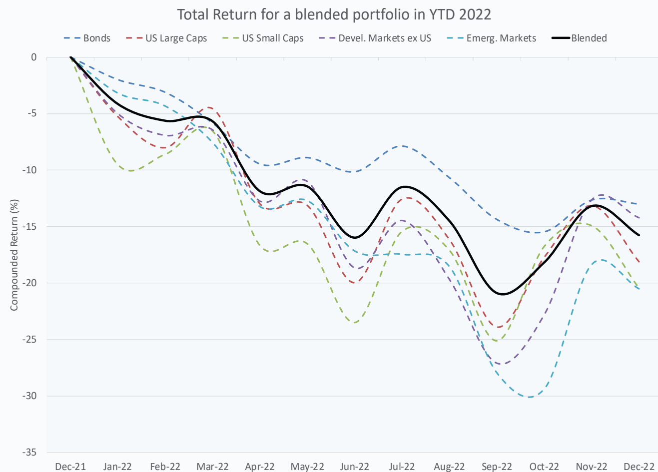
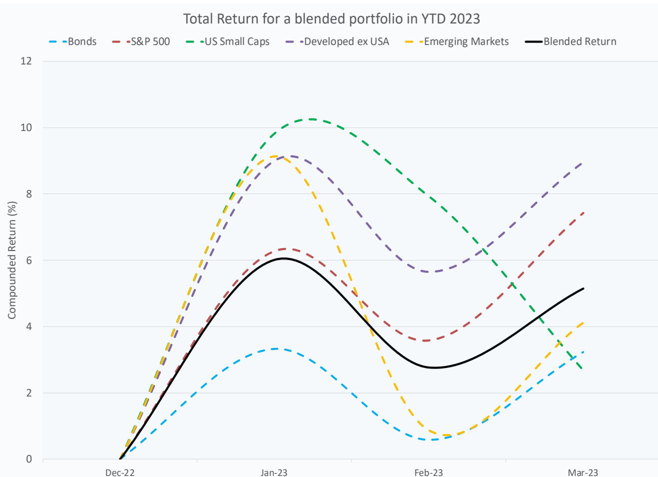
WHERE WE STAND – Q1 2023

A blended portfolio* of equities and bonds was down 15.8% (on a total return basis) in 2022. See the black solid line in the chart below.



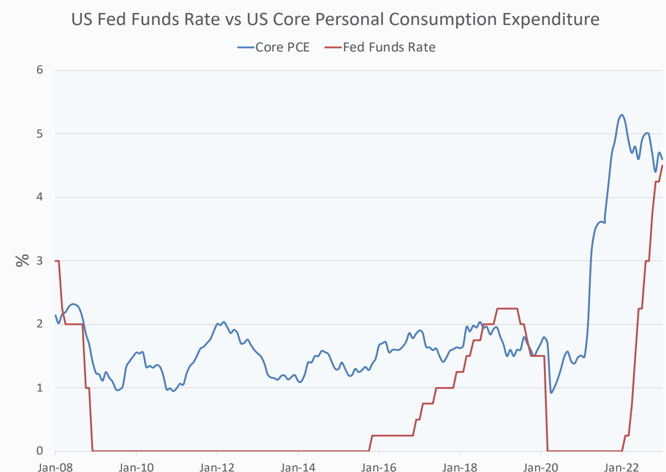
In Q1 of 2023, securities markets rebounded somewhat: the same portfolio is up 5.1% YTD. Leading advances were Developed Markets ex USA (+9.0%), US Large Caps (+7.4%) and Emerging Markets (+4.1%). Bonds managed to eke out a 3.2% gain while US Small Cap stocks disappointed with a 2.7% advance. See the colored broken lines in the chart below.



*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.

During the quarter, financial market valuations were primarily driven by the securities' markets perception of the Federal Reserve's success or not in bringing inflationary pressures under control. And secondarily, by what the likelihood is of a recession in the coming months.

On balance there is a perception developing that inflationary pressures are abating: see blue line in the chart below which shows the year-on-year change in the Feds favorite inflation measure, the Personal Consumption Expenditure Deflator. This disinflationary impulse is in response to the increase in the cost of capital driven by the very aggressive increase in the Federal Funds rate (red line).

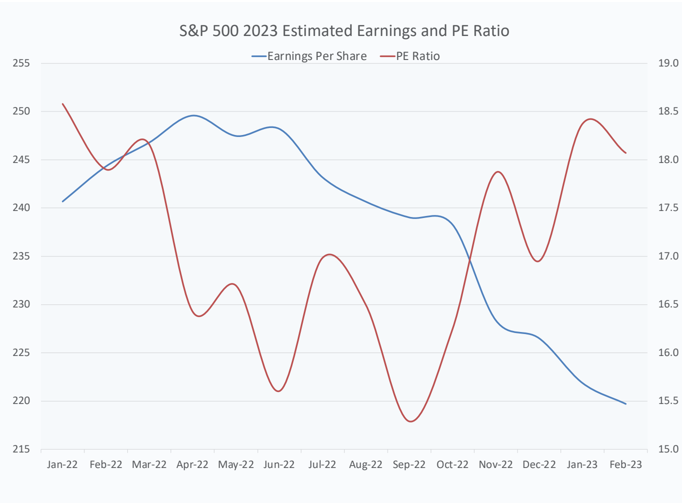


Late in the quarter, evidence that this sudden increase in interest rates was creating stress in the banking system, further solidified the thesis that the Fed was close to the end of its tightening cycle.

Now the debate is shifting to how economic growth will develop over the next few quarters given that monetary policy acts with long and variable lags. Will we have a hard or soft economic landing? Hard landing prognosticators argue that cracks in the banking system will result in a contraction of lending, undermine the real estate market and other credit sensitive sectors of the economy resulting in recession. The more optimistic argue that employment is still robust, that falling energy prices are stimulative, that the cost of housing is stable

given that mortgage rates are fixed at the recent lower level and that for many with savings, the higher level of interest on their savings provides another fillip to economic activity.

Since our last report, estimated earnings per share for the S&P 500 for 2023 have fallen from around $225 per share to around $219 per share (blue line below). Given that the equity market has rallied (apparently purely on multiple expansion) the PE ratio has risen from around 17x earnings to 18x earnings during the quarter.



These are not bargain-basement valuations (as was the case in October 2022) especially given the macro-economic uncertainty and the geopolitical backdrop.

However, our work shows a substantial range in relative valuations in the constituents of the broader indices. For example, our cheapest 10 stocks in the S&P 100 show a potential combined average IRR (given reasonable assumptions as to earnings, dividends, and future PE valuation) of as much 20% over the next 2 years. The bottom 10? Minus 4.6%.

Our projected IRR for the S&P 100 as a whole is around 8.7% and therefore, given the recent stabilization in the

10-year T-note yield to 3.5% (see previous chart), our internally generated equity risk premium is a relatively attractive 5.2%. If one does one's work as a stock picker in this new investment (and one could argue, more normalized) environment, there are opportunities to be found.

Where We Stand

As strategized, we had treated 2022 as an opportunity to rebuild our portfolios with the next investment cycle in mind.

Having done so, into securities that we believe have a value bias, we have participated in this year's rebound while at the same time are enjoying a respectable income on the portfolios.

We are cognizant of, but at the same time, deemphasizing macro issues like the potential for recession and the near-term path of inflation, in the belief that these issues will sort themselves out over time. Similarly, we believe sovereign self-interest will prevent current geopolitical tensions from deteriorating to the point that they become an existential threat to global investing.

Rather, we are concentrating on the bottoms up analysis of the blue-chip companies we are invested in, comforted by the fact that they will prevail over the medium term given their market position and operating and financial leverage. And while we wait for capital appreciation (which is inevitable over time), all pay respectable dividends that are available for reinvestment.