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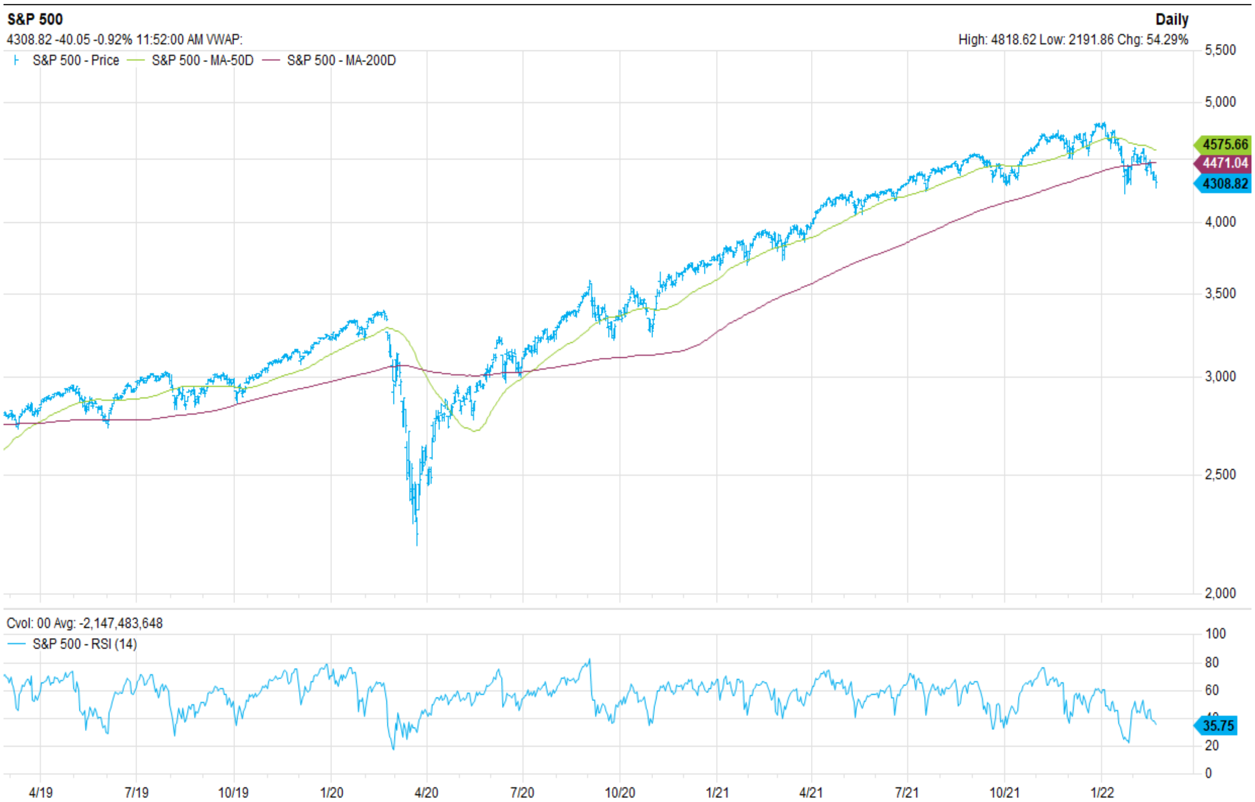
S&P 500



Stock Investors Earning Their Returns

The S&P 500 has declined 10% from its early January peak, and further volatility is expected. From 1930 through 2021, a period that included the Great Depression, a world war, the Great Inflation and the Great Recession, the S&P 500 has had nominal returns of 10.2% annualized (6.9% after inflation). In contrast, ten-year U.S. Treasury bonds and 3-month Treasury Bills returned only 5.1% (1.8%) and 3.4% (0.2%). The higher returns earned by equity investors is compensation for their willingness to tolerate higher risk in the form of a greater volatility. At this juncture, equity markets are suffering from fears about a Russian military invasion of Ukraine, and the increasing certainty that the Federal Reserve will aggressively increase interest rates in order to combat inflation. The historical record leaves us less concerned about the geopolitical situation in Europe, but increasingly concerned about inflation. Looking ahead, the outlook for bonds remains very negative. Long duration (growth) stocks also have a negative outlook because of their greater sensitivity to changes in inflation and interest rates. Value stocks look least vulnerable to continued market weakness.

Exogenous shocks like acts of war and terrorism are not the type of risk that cause prolonged bear markets in stocks. From the perspective of the U.S., a Russian invasion of Ukraine is not a direct threat to the economy. Russia has a relatively small economy and trade with the U.S. is minimal. The U.S. businesses that would be directly affected include Pepsico, McDonalds and other non-strategic areas. The greater impact would be indirect, including potential economic softness in Europe and a decline in business sentiment. But as seen in Chart 1, major geopolitical events tend to have a fast, negative impact on stocks followed by recovery. The longest time it took for the market to hit bottom in the examples below was the 1990 Iraq invasion of Kuwait. In that case the trough took 50 days to be reached and came along with a 15.9% decline in stock prices. Already, as shown in the Chart above, the S&P 500 has a 14 day RSI (a measure of short-term overbought ~70, and oversold ~30) of 36. The record would suggest that now is not the time to panic. We may be nearing a bottom in this correction.

Chart 1

Events	Start date	Trading days to trough	% change to trough	Trading days back to even
Acts of war				
U.S.				
U-2 shot down; cover unwound	May 7, 1960	2	-0.6%	4
Bay of Pigs invasion	Apr 15, 1961	6	-3.0%	14
Cuban Missile Crisis	Oct 16, 1962	6	-6.3%	13
Gulf of Tonkin Incident (Vietnam)	Aug 2, 1964	4	-2.2%	29
Tet Offensive (Vietnam)	Jan 29, 1968	25	-6.0%	46
Cambodian Campaign (Vietnam)	May 1, 1970	18	-14.9%	86
U.S. invades Grenada	Oct 25, 1983	11	-2.8%	15
Lead-up to U.S. Panama invasion	Dec 15, 1989	2	-2.2%	8
Lead-up to Gulf War (Desert Storm)	Jan 1, 1991	6	-5.7%	13
U.S. spy plane captured in China	Apr 1, 2001	3	-4.9%	7
War in Afghanistan	Oct 7, 2001	1	-0.8%	3
Lead-up to Iraq War	Feb 5, 2003	24	-5.6%	28
External				
N. Korea invades S. Korea	Jun 25, 1950	15	-12.9%	56
Lead-up to Six-Day War (June 6)	May 14, 1967	15	-5.6%	20
Yom Kippur War, Arab oil embargo	Oct 6, 1973	42	-16.1%	6 years*
Soviet-Afghan War	Dec 24, 1979	7	-2.3%	10
Iraq invades Kuwait, oilfields seized	Aug 2, 1990	50	-15.9%	131
Average		**14**	**-6.3%**	**30**
Terrorism				
U.S. Embassy in Iran seized	Nov 4, 1979	3	-1.0%	6
U.S. Marines killed in Lebanon	Oct 23, 1983	12	-2.5%	15
Oklahoma City bombing	Apr 19, 1995	1	-0.1%	3
U.S. Embassy bombings in Africa	Aug 7, 1998	5	-2.5%	7
WTC, Pentagon airplane attacks	Sep 11, 2001	5	-11.6%	19
Madrid train bombings	Mar 11, 2004	3	-1.7%	5
London Underground bombings	Jul 7, 2005	No S&P decline; FTSE -1.4%		
Paris Bataclan, restaurant attacks	Nov 13, 2015	1	-1.1%	2
Bastille Day attacks in Nice	Jul 14, 2016	1	-0.1%	2
Average		**4**	**-2.6%**	**7**

Inflation is a Bigger Concern than Russia

We have decided to discard our inflation model for the time being and believe that the risk to inflation is to the upside. The Shadow Open Market Committee (SOMC) is a group of economists who first organized back in the early '70s--during a period of inflation--to provide counter arguments to the Federal Reserve's Open Market Committee. We have a great deal of respect for this team and sat in on a meeting a bit more than a week ago. The takeaway from the meeting was that risk has increased that inflation may not fall this year as many expect. It may accelerate as the year progresses:

1. Inflation is accelerating and yet, even now, the Fed is still expanding its balance sheet and providing additional liquidity. The money supply was still growing at a 13% y/y rate as of year-end '21. QE should stop immediately.
2. The best interest rate measure of Fed accommodation is real interest rates, not nominal rates. With inflation running at ~7%, real rates are negative no matter how you measure them. Is the Fed going to raise the Fed Funds to a "neutral rate" of 7%/8% anytime soon? Not likely.

The conclusion by several of the economists at the meeting is that monetary policy remains, and will remain, expansionary, and the risk of inflation is to the upside. The FVCM model is based on trailing nominal spending under normal circumstances. The rapid increase in bank deposits/savings during the pandemic, thanks to government actions to alleviate any pain, has created highly unusual conditions. These conditions have produced the sharp rise in inflation and a rapid change in expectations, in a time-compressed way, unlike anything we've seen in recent decades. The last time the model failed this way was in the early '70s after the Fed closed the gold window and OPEC started an oil embargo following the '73 Yom Kippur War.

The Federal Reserve May Finally Get Serious

Right at the top of the Fed's responsibilities is price stability and the question now is only how fast monetary conditions should be tightened. Because of the inflation outbreak, the Fed is expected to raise rates numerous times this year and short-term rates are now expected to exceed 2% by year-end. Furthermore, the Fed's quantitative easing (QE) program of purchasing $80 billion of U.S. Treasuries and $40 billion of mortgage-backed securities per month is finally expected to end in the months ahead. The pressure on bond yields will be upward. Accordingly, bond investors can expect further losses. We recommend that fixed income investors stick with relatively near-term maturities. Our fixed income portfolios have an average time-to-maturity of about 2 years so that maturing securities can be rolled over into higher yielding securities as yields rise. The time to lengthen maturities will not occur until a recession is clearly on the horizon and the markets can begin to discount the next Fed easing cycle.

Value Stocks are the Most Attractive of the Investment Alternatives

Value stocks have recently performed very well versus growth stocks and that outperformance is expected to continue. A year from now when the quants do their factor analysis, we suspect they will find value to be one of the leading variables for performance. Growth companies that trade at high P/E ratios, because most of their earnings will occur in the more distant future, are like long bonds that don't mature for many years. Cash flows from both are far away and both are unattractive. Value stocks tend to pay higher dividends, have a greater proportion of real assets, versus intangible assets, and are making more money in the present and the stock price is less dependent on far away earnings. Stocks in general will continue to gain support from strong increases in nominal sales and profits but the inflation & interest rate outlook will weigh on valuations. Return expectations should be modest.