SPECTRUM
ASSET MANAGEMENT, INC.

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Say It Again SAM

A QUARTERLY REPORT ON ECONOMIC VIEWPOINTS AND INVESTMENT STRATEGY

THE GREAT TRANSITION

The capital markets were anything but ordinary in 2022. Inflation soared, interest rates spiked, energy saw huge price swings, stocks experienced a bear market and bonds endured their worst year since the American Civil War.

Throw in a Russian war, China lockdowns, midterm elections and an unprecedented lame duck session of Congress where $1.65 trillion was spent despite $30 trillion of outstanding US debt, and investors are left to contemplate many unique variables.

> *"OMELETS ARE NOT MADE WITHOUT BREAKING EGGS."*
> - GENERAL FRANÇOIS ATHANASE DE CHARETTE

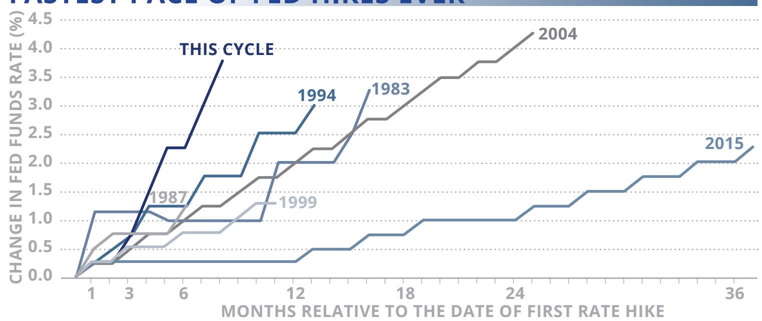
2022's market returns were not just an anomaly, but they should be viewed as one of the all-time anomalies. There have been years when both stocks and Treasuries fell at the same time, but they are not common. The fact that both asset classes declined 20-30% in the same year? That is one-and-only. The closest comparison occurred in the late 1960s, but even then Treasuries fell by about half as much as they did in 2022, and not for the full calendar year.

Still, anomalies occurred before 2022 (both to the upside and downside), and there are sure to be more in the future. While anomalies are difficult to anticipate, they are just part of a larger process. It is the longer-term economic and business cycles that help us determine where we are and where we might be headed.

"This is a minor setback. The hunter-gatherer economy is still good."

Early 2019 marked the Federal Reserve's big dovish pivot that drove strong returns from Treasuries over the following two years. 2020, of course, was the COVID recession where the Fed reduced short-term rates to 0% and the government started spending trillions of dollars to provide liquidity to the economy. Treasuries benefited from the former, while stocks benefited from the latter, resulting in a huge disparity that saw double digit gains for Treasury bonds and huge outperformance from the S&P 500 at the same time.

FASTEST PACE OF FED HIKES EVER



Source: Charles Schwab Institutional

Today's Federal Reserve has been decidedly Hawkish. The Fed funds target rate went from 0% to 4.5% over the course of ten months. This was the fastest pace of Fed hikes ever. Despite economic reports that show a weakening US economy, the Fed has suggested short-term rates will remain higher for longer.

Inflation eased to 7.1% in November and is expected to ease further in December (released on Jan 12). However, even as prices have rolled over for durables, pent up demand for services continues. In addition, recent increases in "sticky" prices for necessities like shelter and transportation ensure inflation will likely remain elevated throughout 2023.

The Fed acknowledges inflation is a lagging indicator and that it is trending in the right direction, but there is a valid reason to believe the Fed funds rate could continue higher. At the same time, falling long-term yields are "predicting" a recession in the coming year, as are falling commodity prices, and leading economic indicators.

Many dominoes have fallen leading up to the current environment, and their analysis is helpful to understand where we may be in the cycle. A few dominoes are still standing, such as corporate earnings and profit margins, as well as a tight labor market.

The labor market is the key to Fed policy going forward. It needs to see increased weakness to pause its rate-hiking campaign. Similarly, an earnings recession has not yet taken place, but corporate earnings have shown vulnerability. The S&P 500 earnings per share is expected to decline during the fourth quarter for the first time since the global lockdown.

The global financial markets have been transitioning from an artificially, over-stimulated, excess liquidity environment to a reduced liquidity environment. Many effects of this Great Transition have already been observed, and the continuing deceleration will be a rolling weakness, but 2023 could represent a period where equilibrium is reached.

While the National Bureau of Economic Research (NBER) has not yet declared the official start of a recession, it often does so in arrears. The US experienced negative GDP growth in at least two quarters in 2022, and certain components like housing are already in a clear recession.

It is possible for the recession to be shallow, but market volatility will continue until the transition to tighter monetary conditions has run its course.

ECONOMIC VIEWPOINT

Inflation will be with us for some time to come, but the rate of increase will continue to moderate. While we do believe inflation has likely peaked for this cycle, the path down to the Fed's 2% core inflation target could be long and difficult in the absence of a recession.

Previous inflation peaks over the last 50 years have coincided with recession. So far, higher rates have shown up in financial markets in the form of higher mortgage rates, a stronger dollar, and tighter financial conditions. However, they have yet to fully percolate down to the real economy.

Looking at a rolling 8-month change in the Leading Economic Indicators (LEI) Index, we can see that the economy has recently reached a level that has historically marked recessionary periods. The lagged effect of tighter financial conditions, and the potential for continued Fed hawkishness suggest further declines in the LEI ahead.

The current 4.5% Fed funds rate was fully priced into the market by year's end, but investors' expectation for where rates go from here, or where they will be a year from now, is up for debate.

For its part, the Fed has clearly stated it will continue to tighten until inflation is clearly trending down toward the central bank's target of 2%. The yield on the 10-year treasury, net of the inflation rate, is still deeply negative around -4%. The Fed has not historically stopped raising while the Fed funds rate is below the inflation rate.

This is not to imply the Fed must continue to tighten. Just maintaining its current stance would probably be sufficient to knock inflation (and demand) down further in the coming quarters, assuming that money supply growth continues to be flat, and the government avoids sending out another massive batch of checks funded with the printing press.

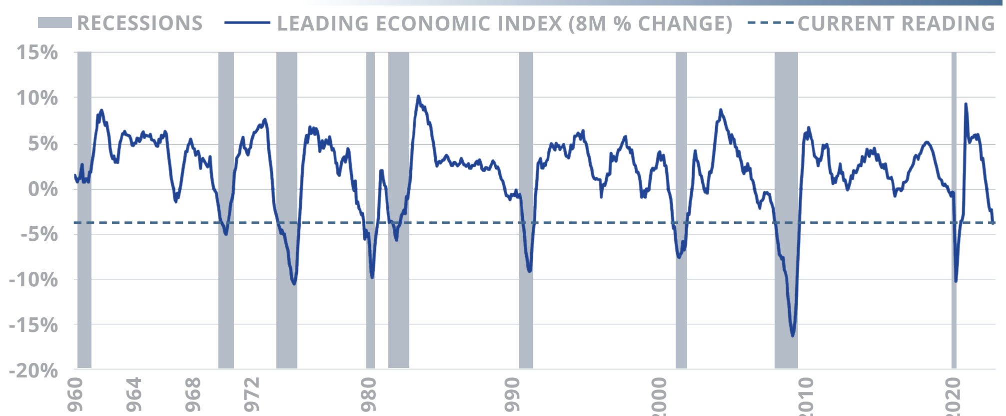
The bad news is that thanks to the 2020-2021 explosion of the money supply, the general price level will have realized a major increase that is unlikely to be reversed. Incomes net of inflation have suffered, and it will take a long time for purchasing power to recover.

Quantitative tightening has begun in earnest; however, the Fed's balance sheet has a long way to get back to any resemblance of normal. The Fed plans to reduce holdings by about $2 trillion over the next few years – which would leave the balance at about $6 trillion – roughly double the post-Great Financial Crisis high.

At the same time, the combination of aggressive Federal Reserve tightening, stricter bank lending standards and higher yields has weighed heavily on housing market activity and corporate capital expenditures. This resulting pressure on US demand growth is beginning to impact the labor market.

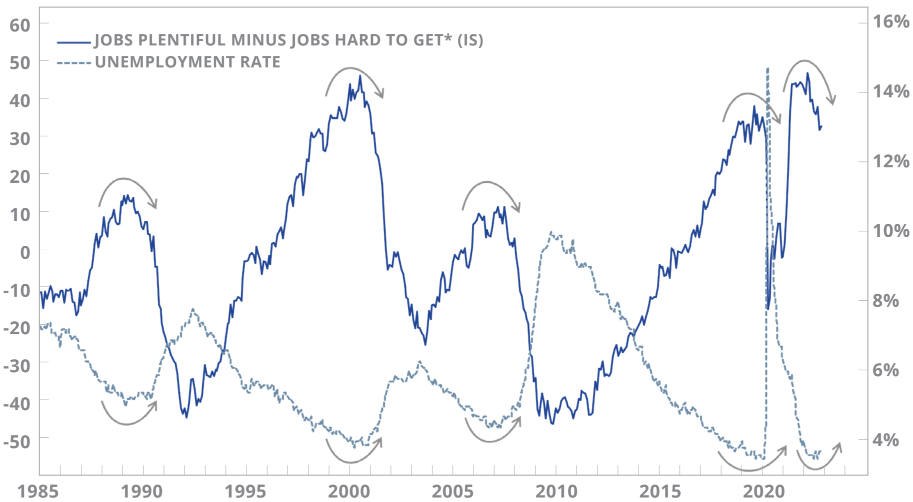
The US labor market is still tight. The number of job openings is very high relative to history, and those vacancies will likely need to be cleared before firms begin to lay off staff in mass. However, labor dynamics have started to turn, and wage growth pressures look set to moderate.

LEI INDICATING RECESSION



Source: Charles Schwab Institutional

LABOR MARKET IS TURNING



Source: Alpine Macro

When the ratio of job vacancies to people seeking work shrinks, unemployment begins to rise. While the Fed will try to navigate a soft landing, all post-WWII cases of just a 0.5% rise in the unemployment rate have been associated with a recession and have led to a significantly higher unemployment rate down the road.

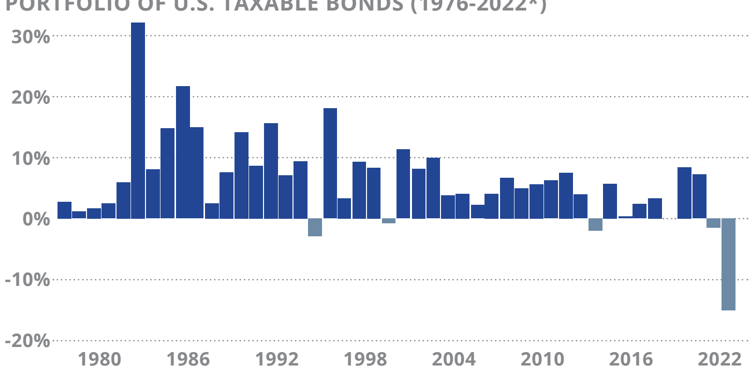
Markets are dramatically polarized on future Fed actions, which increases probability of market volatility ahead.

INVESTMENT STRATEGY

Stocks closed out their worst year since 2008, but what was most unique about 2022 was how poorly bonds fared. Yields typically fall (bond prices rise) when stock volatility increases as part of a flight to safety trade. Instead, yields soared in 2022 because of the Fed's aggressive rate hiking cycle.

WORST YEAR FOR BONDS

ANNUAL TOTAL RETURN (%) FOR A DIVERSIFIED PORTFOLIO OF U.S. TAXABLE BONDS (1976-2022*)



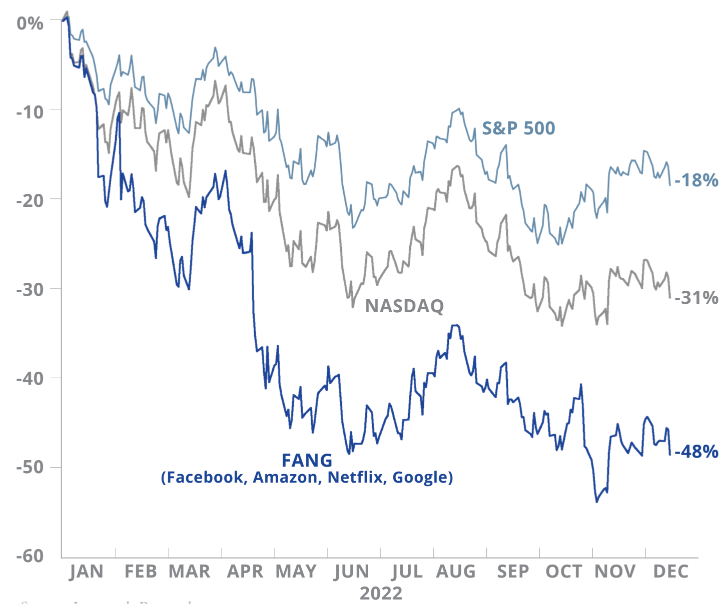
Source: Schwab Institutional

Negative returns are uncommon in a diversified bond portfolio. Over the last 45 years it has only occurred five times, with two of those being 2021 and 2022. In addition, except for 2022, each loss was just a few percentage points and was more than offset by strong returns in the stock market. 2022 was an outlier year as both stocks and bonds were down double-digits at the same time, and bonds suffered their worst selloff in 160 years.

The declines in the stock market over the past year have primarily been due to valuation compression as a result of inflation shocks, geopolitics and Fed tightening. In other words, what investors are willing to pay for each $1 of earnings has declined substantially.

As interest rates have risen, the opportunity cost and financing cost of investing in stocks has increased. While the S&P 500 ended the year down about -20%, losses in more overpriced and speculative areas were more severe. The tech-heavy Nasdaq fell by more than -30% and the Covid-darling FANG stocks lost roughly half of their market value.

SPECULATIVE STOCKS HIT HARDEST



Source: Investech Research

Currently, valuations in the stock market have normalized from historically high levels back to long-term averages. The forward 12-month Price to Earnings ratio for the S&P 500 stands around 17. This P/E ratio is below the 5-year average (18.5) but above the 10-year average (17.1).

For Q4 2022, the estimated earnings decline for the S&P 500 is -2.8%. All ten sectors are expected to report lower earnings after a swath of downward revisions to EPS estimates. If -2.8% is the actual decline for the quarter, it will mark the first time the index has reported a (year-over-year) earnings decline since Q3 2020 (-5.7%).

Deterioration in earnings is often a driver of Bear Markets, and in the context of recession, it is likely the S&P 500's net profit margin will shrink from historic highs.

Source: Factset

The decline in corporate earnings has very likely just begun. Although stock valuations have improved due to declining stock prices, the deteriorating earnings component will cause P/E ratios to appear less attractive in the short-run and continue downward pressure on the most expensive sectors of the stock market.

Bear markets are typically a grinding, ongoing process, not a sudden crash. In the short-term, the ups and downs of market prices are primarily influenced by swings in investor sentiment and emotion than by changes in the underlying companies' future prospects. Because swings in investor psychology have a greater impact in the short-term and are difficult to predict, we focus on allocations based on the longer-term merit of companies and related ETFs rather than trying to time short-term movements in the indexes.

Purchasing stocks and ETFs for the underlying companies' commercial merit and viability, along with its sustainable earnings potential is a more sound reason to invest. If the company performs well over an economic cycle, then there's reason to believe its stock or related ETF price will ultimately rise.

Bear market rallies are an excellent example of how mentally challenging these time periods can be. The S&P 500 during the tech bubble collapse is a useful example: From the top in early 2000 until early 2003, over the course of that bear market, the index had numerous reflex rallies before the ultimate bottom was reached. From start to finish the losses were almost -50 %, and the tech heavy Nasdaq was down over -75%.

Though a bit quicker, the 2007 to 2009 bear market unfolded in a similar pattern. Once again there were many different reflex rallies that proved to be short-term head fakes before the ultimate bottom was reached. Ultimately realizing a -57% loss.

Attempting to perfectly time each of the short-term trades is virtually impossible and one of the main reasons why our focus is on risk management throughout the full market cycle.

If the US does officially enter recession, investors should not expect the sort of shock-and-awe fiscal and monetary policy responses that characterized 2008 and 2020. Investors should therefore be cautious about reflex rallies in the stock market as a US recession remains likely, and continue to hold positions in US treasuries, which now offer a viable return.

When the post-Covid monetary and fiscal tides were coming in, just about every asset class and market went up. In this environment of transition, earnings and cash flow matter more than "expectations" of growth. As the risk-free rate (US Treasuries) increases, fundamentals become more important.

Patience and discipline are crucial during volatile times. Warren Buffet's mentor, Benjamin Graham, famously described the stock market as a "voting machine" in the short-run, but a "weighing machine" in the long-run. Referring to historical market cycles is much easier than actually living through them. As we navigate the New Year our goal is to remain patient, disciplined and allow the data to drive an opportunistic decision-making process.

PREPARED BY: SPECTRUM ASSET MANAGEMENT RESEARCH TEAM

WWW.MYSPECTRUM.COM

1301 DOVE STREET, SUITE 720 NEWPORT BEACH, CA **TEL: 949.717.3400**