SIERRA CAPITAL PARTNERS

WHEN GOOD NEWS IS BAD NEWS

Sierra Capital Quarterly Newsletter

October 2022

Investors watch the Federal Reserve as every piece of data counts

Key points:

Many investors have walked into the 4th Quarter of 2022 feeling the pain across the spectrum of investible assets. Equities are down 22%, government bonds are down 21%, investment grade and high yield bonds are down 20% and 18% respectively, gold is negative 6%, and bitcoin is down 57%. This is all while the US Dollar, oil, and commodities are up 16%, 17%, and 35% respectively.

As investors we must be able to manage multiple strategies in a single portfolio where one strategy might look great, and another might look terrible. Portfolios which are reliant on a single strategy have had a tough run in 2022 as both equities and fixed income have suffered, however diversification has helped in many cases. The importance of the direction of the US Federal Reserve on monetary policy direction has been a key focus for domestic and international investors due to the pull-on currencies and government bond values.

Valuations across equities have fallen as the risk-free rate rises and equity risk premiums rise. The relentless march higher for the cost of capital is in plain sight with long duration technology company valuations falling across both public and private markets. The inflation reading today of 8.2%, slightly higher than consensus, does not help the case for bulls as investors have been hoping for signs that inflation is slowing, allowing the Fed to ease up on financial tightening.

While we are hopeful, we must be realistic in our long-term expectations as it has historically taken an average of ~10 years for inflation to fall back to ~2% after a spike. Additionally, 11 prior inflation spikes were fixed by a recession, and in no other instances was inflation being solved without a recession.

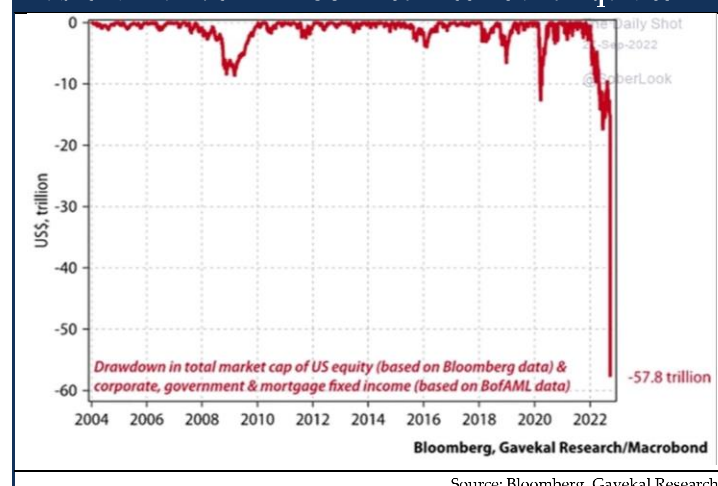
Investors that have been through various cycles are not surprised by the current environment. Environments such as today is where investors can position to generate returns for the future. We are constantly searching for where those returns will come from.

As we exit the 3rd quarter of 2022 and enter the 4th quarter, it is hard to find something to be bullish about when good economic news leads to a market sell-off. Recent September unemployment printed a new 50-year low of 3.5% and the S&P celebrated by falling 2.5% due to the then lower probability of a Fed pivot. Following another disappointing quarter and then a poor first week of trading, many investors might want to just throw up their hands and walk away until 2023. While this might be the best move to keep one's own sanity, trying to time the market or also being underinvested can hurt over the long run.

With corporate earnings starting and 5% printing this week, inflation read on October 13th followed by November 10th, and the mid-term election being behind us following November 8th, December will come soon enough with much more clarity around many of the items currently giving investors pause. As the Fed is on their war path towards a mid-4% fed funds, this clarity is much needed.

2022 has so far marked the worst performance in fixed income since the turn of the century and the worst Dow Jones performance since 2002. Given the losses in fixed income, nearly $58 trillion in US Equity and Fixed Income value has been destroyed. (Table 1)

Table 1: Drawdown in US Fixed Income and Equities



Source: Bloomberg, Gavekal Research

The Macro environment in which we are all operating has been consistently active ranging from atypical government policy moves, a pandemic, war on the European front, threats of war with China, a Chinese real estate slowdown, and a monetary tightening cycle that is nearly global in scale. As we have discussed in prior newsletters, since 2021 the global economy has started to suffer from the blunt policy response to Covid and other macro events. Fortunately, the high inflation we have seen may have started to peak in the US however much more time is needed to return back to "normal" inflation. On a global scale, the rally in the dollar and the European energy crisis has only worsened inflation on dollar terms.

Domestically, the Federal Reserve has lifted its policy rate by 75bps 3 consecutive times to 3.25%. August Consumer Price Index (CPI) recently surprised to the upside with Core up +0.6% month over month, and the recent unemployment read of 3.5% was the lowest level in the last 50 years, signaling the Fed has much more room to tighten financial conditions to tame inflation before hurting employment. The continued imbalance in the demand and supply of labor is tough to forecast given the mixed economic data around the manufacturing and services economy, leaving the market quick to react to any news or Fed speak. Fed Funds futures are pricing in ~4.60% by early 2023 while some banks are estimating 4.75-5.00%. Guidance calls for another 75bps hike in November and 50bps in December and one or two hikes in February and March. Rate cuts may take place in the 2nd half of 2023 as inflation pressure moderates as some forecast a moderate recession in the United States. (Table 2)

Table 2: Probability of Recession

	Probability of recession within:		
Forecast	1 year	2 years	3 years
William C. Dudley[1]	70%	90%	90%
Mark Zandi[1]	45%	60%	66%
Jason Furman[1]	40%	65%	n.a.
GS Investment Research	35%	n.a.	n.a.
Investment Strategy Group	45-55%	65-75%	n.a.

Source: Goldman Sachs, Bloomberg

Looking outside of the United States and moving to Asia, President Xi is expected to secure a third term in late October while lockdowns have restarted in key cities, putting pressure on domestic demand and fixed asset investment. Hitting the 5% GDP target set earlier this year seems elusive given the current policies and that the real estate sector is still in limbo. Shifting to the UK, the new government's recent mini budget called for very strong fiscal spending which sent financial markets into chaos. It is actually interesting to see that markets did not approve of a fiscal spending package aimed to drive growth at the expense of inflation as yields spiked and government bond prices plummeted. The Bank of England had to then roll out quantitative easing programs in response to the UK Gilt devaluation by committing to buy 20+ year government bonds through October 14th. One can only ask themselves if this could happen in the United States if our elected officials throw in the towel on fighting inflation too soon in an effort to maintain growth. Powell, on the other hand, has voiced that he would fight inflation at the expense of growth.

In the Euro, the recent Nord Stream pipeline leaks have been criticized as sabotage. These pipelines transport natural gas directly from Russia to Germany through the Baltic Sea. Russia still continues to supply Europe with gas via pipelines through Ukraine and Turkey, albeit at much lower volumes than in the past. With the energy crisis and slowing economic activity around Europe, Germany is forecasted to enter a technical recession, however the severity is better than originally feared as companies have shown better than expected flexibility to gas shortages coupled with proactive fiscal policy. (Table 3)

Table 3: US and European Nat Gas Prices % YTD

Source: Factset, JP Morgan

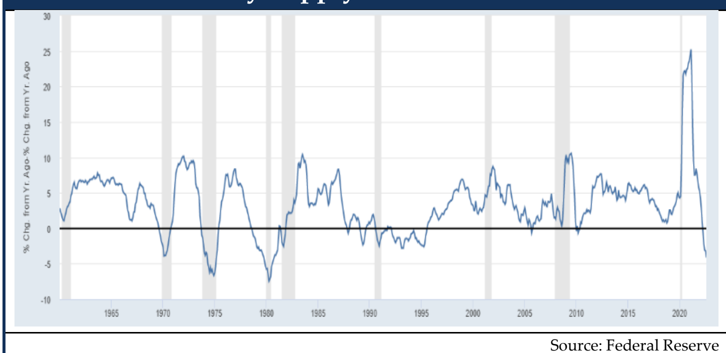
While all these economies operate and function on their own, one thing that ties them all together is the US Dollar. Former U.S. Treasury Secretary John Connolly was previously quoted as saying "the dollar is our currency, but it's your problem". Historically the dollar typically weakens when dollars are being created sparking outperformance in risk assets, while the opposite occurs during monetary tightening. The peak valuation of the S&P500 was right around the peak year-over-year change in M2 Money Supply (Supply of Dollars in the Financial System) and dollar depreciation. If M2 Money growth continues to decline, one can assume the same occurs to asset prices. (Table 4)

Table 4: Dollar Index - Red & M2 Money Supply - Blue

Source: Federal Reserve

Interestingly, we are now in an environment where the inflation adjusted M2 Money Supply is negative. This is something we have historically seen during or following a financial event and/or a recession. (Table 5) With the current strong unemployment data coupled with still persistent inflation, we expect inflation adjusted M2 money supply growth to continue to be low or negative as the fed keeps the proverbial foot on the breaks around monetary policy. In the absence of a Fed Pivot, risk assets and currencies are likely to remain volatile and depressed as other governments also tighten monetary policy on the heels of the Federal Reserve.

Table 5: M2 Money Supply less Consumer Price Index



Source: Federal Reserve

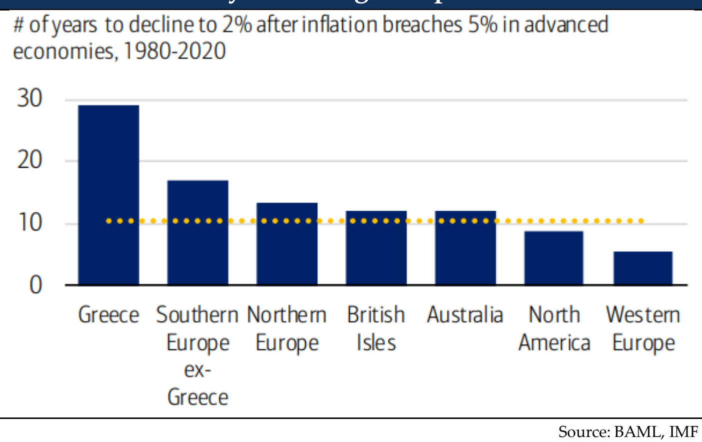
As mentioned earlier, the US Inflation outlook has recently improved with many economists estimating a 2-3% headline and core CPI read by the 2nd half of 2023 and beyond. University of Michigan survey, however, shows the 1-year expected inflation read to still be elevated around 4.7% but recently moved lower, likely due to the price reduction consumers have seen at the gas pump. The 5-year inflation expectation is closer to the Fed target at around 2.7%. (Table 6)

Table 6: University of Michigan Expected Inflation

Source: Goldman Sachs / Haver Analytics

While the current surveys and economic forecasts show inflation dropping over the next year or two, historically it has taken much longer to rein in inflation. It has taken developed countries 10 years on average to return to 2% inflation once 5% was breached, which the US hit in June of 2021 after averaging 1.7% between 2010 and 2020. (Table 7) Countries that represent the OECD, or Organization for Economic Cooperation and Development, are running inflation at 10% year over year.

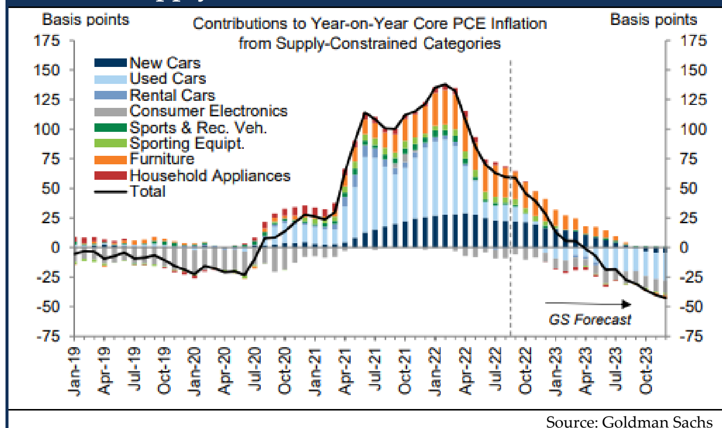
Table 7: University of Michigan Expected Inflation



Source: BAML, IMF

The near-term reduction in inflation will likely come from various forces. The first is going to be base effects given the year-over-year increase in prices is already high and does not seem set to increase further. The second is going to come from the easing of bottlenecks across supply chains. For example, used and new car prices are likely to go negative as the chip shortage abates. Consumer discretionary items such as electronics and clothing are also sitting in warehouses or on store shelves turning at a much slower pace than they did both pre and during the pandemic, as confirmed by retailers such as Walmart and Target. (Table 8)

Table 8: Supply Constrained PCE Inflation Contributions



Source: Goldman Sachs

Tightening of financial conditions have put absorbent amount of pain on both the US consumer and the housing market. US housing is likely to see a small amount of price depreciation in many markets largely due to higher interest costs which, in some cases, which have doubled the monthly cost of purchasing a home versus 2 years ago. Shelter inflation, which makes up 33% of Personal Consumption Expenditures (PCE) has slowed home formations which will likely put pressure on building supplies, furniture, and other consumer goods, many of which were pandemic beneficiaries. (Table 9)

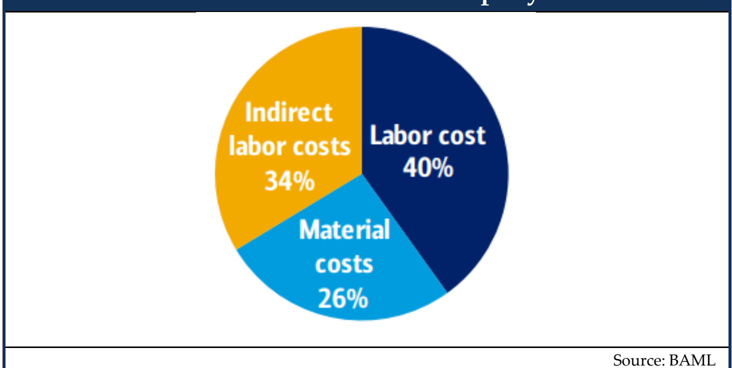
Table 9: Goldman Sachs Housing Affordability

Source: Goldman Sachs

Given the backdrop of the macro environment, we can then focus on what this means for the economy and public/private markets. S&P 500 consensus earnings have only started to be trimmed by most research analysts; however, some institutions have been early to cut earnings expectations. Much of the pushback we have received around lower earnings is that high inflation should help continue to prop up revenues and therefore the bottom line. There are, however, various key points that negate the inflation on revenue. First, the dollar has appreciated by over ~20% (DXY "Dollar Index") year to date, and over 30% of S&P 500 revenues come from outside of the United States. As we mentioned in our prior note, Morgan Stanley has estimated that every 1% change in currency equates to 0.5x hit to earnings per share, representing a 6 - 7% hit to earnings due to dollar strength last quarter, now +10%.

The next item is what is typically the largest cost of most business in the United States: salary and benefits. Wage inflation directly affects the bottom line, and while revenues may have increased, wages have as well. (Table 10) Non-manager wage growth hit 6% for the first time in 45 years and is running at 5.8%. As the baby boomer generation stays out of the market (39% participation vs 2011 levels), labor supply is likely to remain tight bringing us back to 20th-century type wage inflation averaging 5%.

Table 10: Breakdown of S&P 500 Company Costs

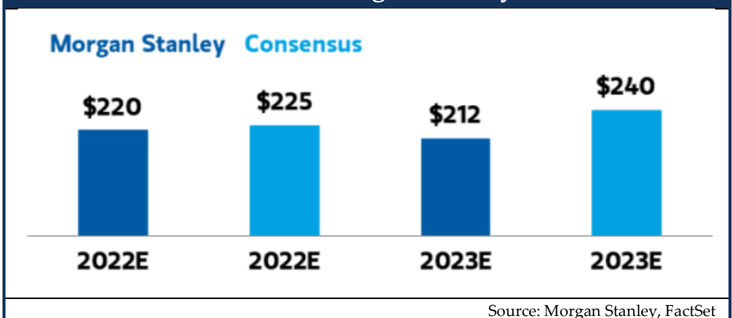


Source: BAML

Lastly, most companies attempt to maximize their cost of capital, and when rates were at all-time lows these companies added debt to pay for equipment, stock repurchases, and dividends. This cost of debt has doubled in the past year as the Fed hiked rates.

While there are more answers to the margin compression such as waning consumer demand and future discounted pricing, these provide some basic rational to decreased corporate earnings on the horizon. Many equity strategists believe the outcome is likely a ~10% reduction in 2023 expected earnings per share (EPS), such as the recent revision by Morgan Stanley or a $200 2023 target from Bank of America. (Table 11)

Table 11: S&P 500 EPS – Morgan Stanley



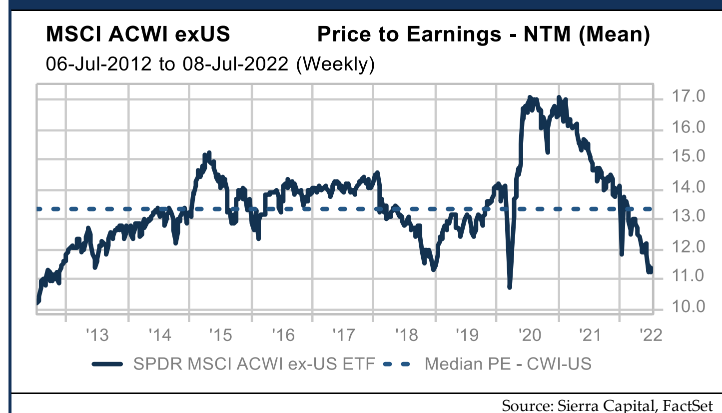
Source: Morgan Stanley, FactSet

With this revision in earnings per share expectations for next year, we now shift to look at where we are in regard to asset valuation. It is important to remember that the Federal Reserve is currently trying to fight inflation, and by doing so means that goods and asset prices

must be lower for a Fed pivot to occur. It is naïve to believe that equity prices are immune to this broad mandate of lower prices.

From 2021 to today, global stock indices have fallen more than their respective earnings estimates leaving the MSCI All Country World Index trading at a bit above 11x versus 17x at their peak. This sits 17% lower than their 10-year median. (Table 12)

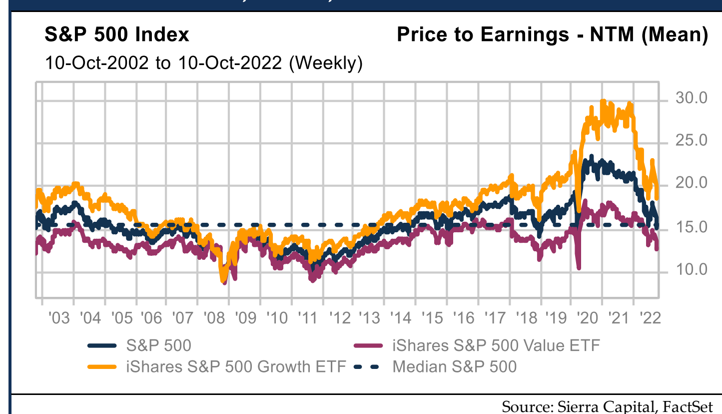
Table 12: MSCI ACWI Forward P/E – Ex. United States



Source: Sierra Capital, FactSet

If we were to move to the United States, the S&P 500 is trading around 15x, ~10% below its 10-year median but in line with its 20-year median. S&P 500 Value and Growth ETFs trade at 13x and 19x, a 4% discount and 7% premium to their 20-year medians, respectively. (Table 13)

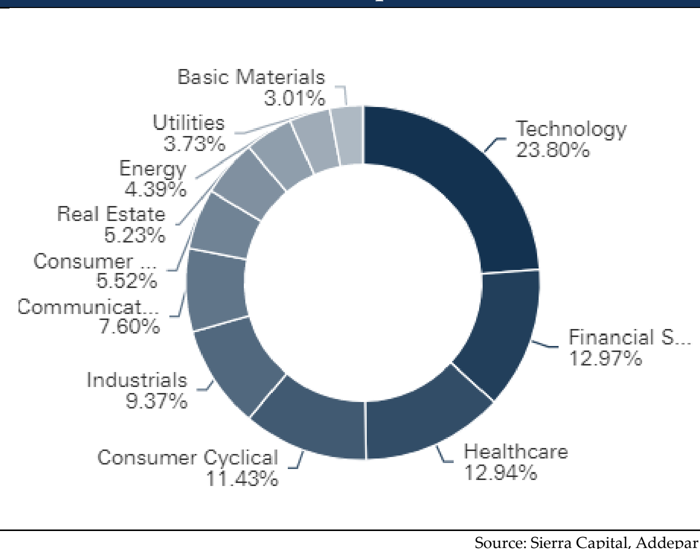
Table 13: S&P 500, Value, and Growth Forward P/E



Source: Sierra Capital, FactSet

While larger companies do command better pricing power and have more levers to pull to keep gross and net margins intact, we do see more value in active management than we have in the past to find companies with the best operating leverage and catalysts to provide returns. When investing in the S&P 500, the top 5 companies make up ~22% of the index; Apple, Microsoft, Amazon, Tesla, and Google. Only once you add the next 5 largest exposures do you deviate from technology with Berkshire, UnitedHealth, J&J, Exxon, and JP Morgan that together make up only 6.9% of the index. Altogether, the S&P 500 still consists of 25% technology and only 14% healthcare, 7% consumer defensive, and only 5% energy. (Table 14)

Table 14: S&P 500 Sector Composition



Source: Sierra Capital, Addepar

Moving back to the S&P 500 and where the index could move, Morgan Stanley recently revised its Mid-Year 2023 Price Target. Their base case target, however, is predicated on $219 2024 earnings and a Federal Reserve which has completed or even pivoted on financial tightening. Additionally, in the short-term Mike Wilson has vocalized a $3,000 to $3,400 S&P 500 before he would get more constructive. (Table 15)

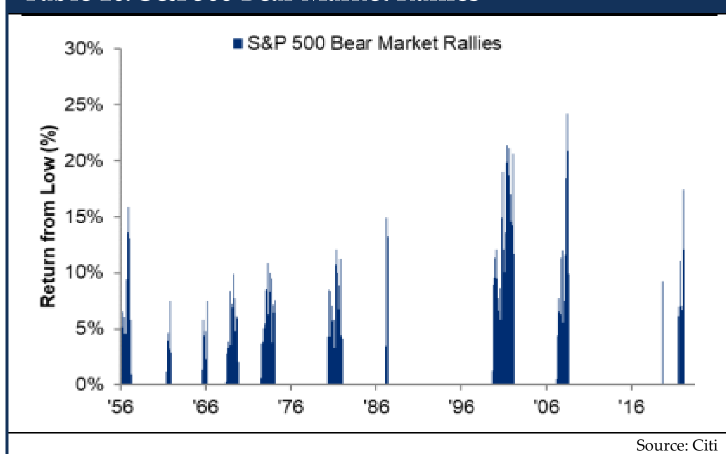
Table 15: Morgan Stanley Mid-Year 2023 Price Target

LANDSCAPE	EARNINGS	PRICE/EARNINGS MULTIPLE	PRICE TARGET	UPSIDE/ DOWNSIDE
Bull Case	$244	18.2	4,450	22.3%
Base Case	$219	17.7	3,900	7.2%
Bear Case	$205	16.3	3,350	-8.0%
Current S&P 500 Price			3,640	

Source: Morgan Stanley

In regard to investor positioning, many hedge funds and large investors have been building large short positions in equities, bonds, and currencies. In addition, many of the hedge funds on our platform have decreased their net positioning outright or synthetically through options. This has helped fuel recent bear market rallies and large wide ranges in many asset prices. It is important to note that this is not unusual as the market searches to find a bottom, and in fact, the US equity bear market rallies have been as large as 26% historically, but average around 10-15% (Table 16). We would caution that a low in the S&P500 may not be in until more clarity around earnings, inflation, and the direction of the Federal Reserve become more apparent, however, this does not seem far off from where we are today.

Table 16: S&P500 Bear Market Rallies



Source: Citi

For US Markets, the resiliency of inflation and US employment do not bode well for equity markets near term. As Citibank pointed out in a recent note, US equity markets have never bottomed before a recession has begun, and instead creates a floor halfway through a recession. And with equity markets only down ~20-25%, more downside may exist before a floor is made. (Table 17)

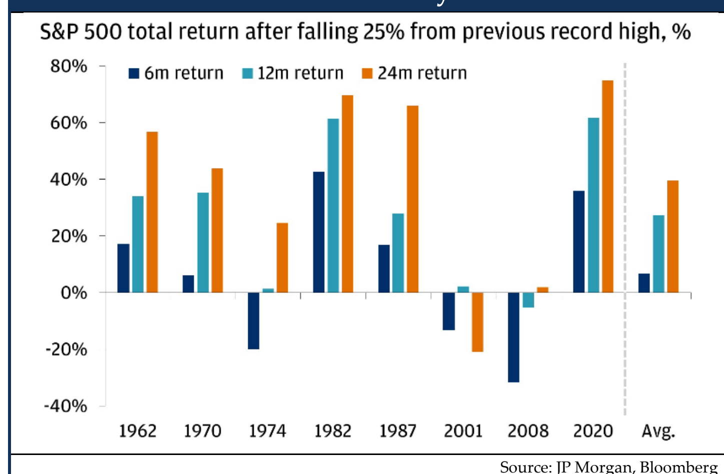
Table 17: Historical Recession Peak to Trough

Recession	Depth into Recession that trough occurred	Recession	Depth into Recession that trough occurred
Aug 29-Mar 33	77.3%	Nov 73-Mar 75	63.5%
May 37-Jun 38	76.7%	Jan 80-Jul 80	31.0%
Feb-45-Oct 45	11.5%	Jul 81-Nov 82	77.4%
Nov-48-Oct 49	60.8%	Jul 90-Mar 91	30.5%
Jul 53-May 54	14.6%	Mar 01-Nov 01	70.5%
Aug 57-Apr 58	21.6%	Dec-07-Jun 09	79.0%
Apr 60-Feb 61	59.3%	Feb-20-Apr 20	56.5%
Dec 69-Nov 70	43.5%		
		Average	**51.6%**
		Median	**59.3%**

Source: Citi, Haver Analytics

On a positive note, the risk-reward in both equity and fixed-income markets has gotten much better throughout the year. And while the uncertainty of the current environment makes it difficult to be invested, it has been historically rewarded over the long term. (Table 18)

Table 18: Market Pain Followed By Positive Returns



Source: JP Morgan, Bloomberg

We hope this commentary proves helpful and look forward to continuing to serve you and your families. Feel free to reach out with any questions.

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The simulated historical performance assumes that the asset allocations were in place and remained fixed over the periods indicated. We calculated the simulated historical performance by assigning a relevant index to each asset class in the allocation, blending the performance of those indices according to the allocation percentages, and assuming quarterly balancing over the time period shown. The performance shown reflects realized and unrealized appreciation and the re-investment of capital gains, dividends, and interest income. The performance shown is based on index returns and thus does not reflect the deduction of transactions costs, taxes, custodian costs or management fees that would lower the performance of an actual account. It also does not reflect factors that would affect the management of actual accounts, such as the timing of trades, liquidity constraints, cash balances, the timing of depositing and withdrawals, and other factors that impact decision making. The performance does not represent the performance of any actual accounts. Although certain of your accounts as of a specified date may have been used to construct the percentages for a current allocation, if shown, the performance was constructed using the performance of representative indices, not using the actual performance of your accounts for any time period. In addition, your asset allocation likely varied over the time period shown, unlike the simulated historical performance which assumes a fixed asset allocation, rebalanced quarterly. Because the asset allocations and the time periods used were selected with the benefit of hindsight, the performance does not reflect the results of recommendations that Sierra Capital made to clients during the time periods shown. The recommendations made by Sierra Capital and the performance of our clients over the time periods shown deviated, sometimes substantially, from the simulated historical performance. 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