Financial Markets Review

tandemadvisors.com/observations/january-2023

January 12, 2023

Long-time Tandem followers have undoubtedly heard us talk about mean reversion and even how the foundation of our investment process is built around reversion to the mean. If you stretch out a rubber band far enough, the more you pull on it the harder and the more violent the snapback will be. 2022 will go down as the year of the snapback.

Coming into 2022, over the prior three calendar years, the S&P 500 and Nasdaq had risen nearly 100% and 140%, respectively. The last time a 3-year run was that strong was at the height of the Tech bubble. Something had to give. After all, a rubber band can only stretch so far before breaking. Much of that advance was a direct result of the explosion in the money supply (M2) that was meant to combat the economic effects of the COVID lockdowns. In addition, a prolonged period of ultra-low interest rates led to rampant speculation across various financial assets and drove valuation metrics to historically extreme levels.

Equity and fixed income markets had enough, as both markets posted significant declines in 2022. To combat soaring inflation, the Federal Reserve and central banks around the world embarked on an aggressive path of tightening monetary policy. At the start of the year, the target Fed Funds Rate was 0.00%-0.25%. And seven meetings later, the target Federal Funds rate today sits at 4.25% to 4.50%. This policy caused yields across the Treasury curve to rise in dramatic fashion. Treasury bills, which represent the shortest end of the curve and have maturities up to 1-year rose from essentially a 0% yield to over 4%. In fact, maturities ranging from 3-months to 1-year are now approaching 5%. The longest end of the Treasury curve, where bond prices are most sensitive to changes in interest rates, suffered the most. As long-rates also climbed, the 30-year Treasury bond posted one of its worst years ever with prices falling roughly 30%.

The sharp rise in yields did not just affect bond prices, but also had a direct impact on equity valuations. Last year, the S&P 500 fell 19.4%. However, it was the technology sector and, more specifically, unprofitable technology companies that felt the brunt of contracting valuations, as seen by the Nasdaq plummeting by 33.1%. Broadly speaking though, the decline in equity prices was directly attributed to a mean reversion in valuation multiples.

Higher interest rates and a valuation correction in equity prices is a healthy and normal process that long-term investors should embrace. It weeds out speculators and reintroduces the concept of risk. Over the past couple of years, 0% interest rates inflated virtually all financial asset prices to the point there was no feeling of risk being taken, because everything just went up all of the time. In reality, the risks were ever increasing. And once the Federal Reserve ensured there was a cost of capital again, the valuation bubble was deflated.

After a tough year in the market, the good news is we are in a better place today from a valuation perspective. Things are starting to make a lot more sense. There is a rationality behind valuations that just didn't exist 12 to 18 months ago. We are even in a better place fundamentally. Based on current estimates, S&P 500 earnings appear to have grown nearly 5% in 2022. If you just looked at the world through the lens of falling equity and bond prices, you probably would've concluded the economy fell apart. But it did not. Rather, some semblance of normalcy was restored with a reversion to the mean.

The looming question is, where do we go from here? Now that a sense of risk taking has been brought back into markets, the risk in 2023 does not necessarily reside on the valuation side of the equation, but rather the risk going forward is to the trajectory of corporate earnings.

According to FactSet, 2023 S&P 500 earnings are currently projected to be $229, which would represent another 5% growth over 2022. To put these estimates into context, six months ago analysts were forecasting 2023 S&P 500 earnings to be $250. So, the good news is that estimates have been significantly ratcheted lower. The more uncertain news is that it's anyone's guess as to where they end up.

Consensus seems to be that 2023 S&P 500 earnings are too high, and they need to come down a bit more, which would likely point toward further equity market weakness. However, given the most recent payrolls report, there is a new found optimism in the "soft-landing" scenario. The fact that job growth remains resilient even in the face of numerous high-profile layoffs gives hope to an economy that might not fall deep into a recession. And with wage costs, CPI and the U.S. Dollar Index retreating from highs set a few months ago, there is again some hope that margins will not deteriorate as costs can be contained.

However, as we have mentioned several times over the past few months, there are other economic and market indicators telling a different story. Whether it is the inverted yield curve, the Leading Economic Index or even the most recent ISM Manufacturing and Non-Manufacturing reports, there are indicators screaming that a recession is around the corner. Over the next year, the market is pricing in 2-3 rate cuts by the Federal Reserve, while the Fed itself does not feel rate cuts in 2023 would be appropriate. If the market is correct, then the only way the Fed starts cutting rates is due to a recession or some other financial crisis. Either way, neither scenario is likely a positive for earnings and equity prices.

Over the next few weeks, we will learn a lot more as to where corporate America might be headed. And, even though the calendar has flipped to a New Year, most of the uncertainty and questions regarding our economic future remain. In the meantime, stay patient, nimble, and always be on the lookout for opportunities, as the volatility experienced in 2022 is unlikely to subside for the foreseeable future.

Written By: William "Billy" Little, Jr., CFA

Billy Little is a shareholder, Senior Vice President, and Portfolio Manager for Tandem Investment Advisors, Inc. Mr. Little began his career in the investment industry in 2004, as a Financial Advisor with Ameriprise Financial in Baltimore, Maryland. Mr. Little joined Tandem in 2006. Mr. Little oversees Tandem's corporate financials, including business planning, budgeting, and vendor negotiations. Mr. Little also directs Tandem's quantitative and fundamental research. He is a regular member of the CFA Institute and past President of the CFA Society South Carolina. Mr. Little graduated from the College of Charleston with a Bachelor of Arts in Business Administration with a concentration in Finance.