

Are We There Yet?

For those of us in Cincinnati, the “unofficial start” to Summer couldn’t have been more perfect. The weather was ideal for swimming, grilling, and hanging out with family & friends. For those who chose to go out of town for the long weekend, flight cancellations and crowded highways likely made Memorial Day a little less enjoyable. To be sure, more than one adult struggling to get the family to their holiday destination heard their offspring ask everyone’s favorite travel question - “are we there yet?”

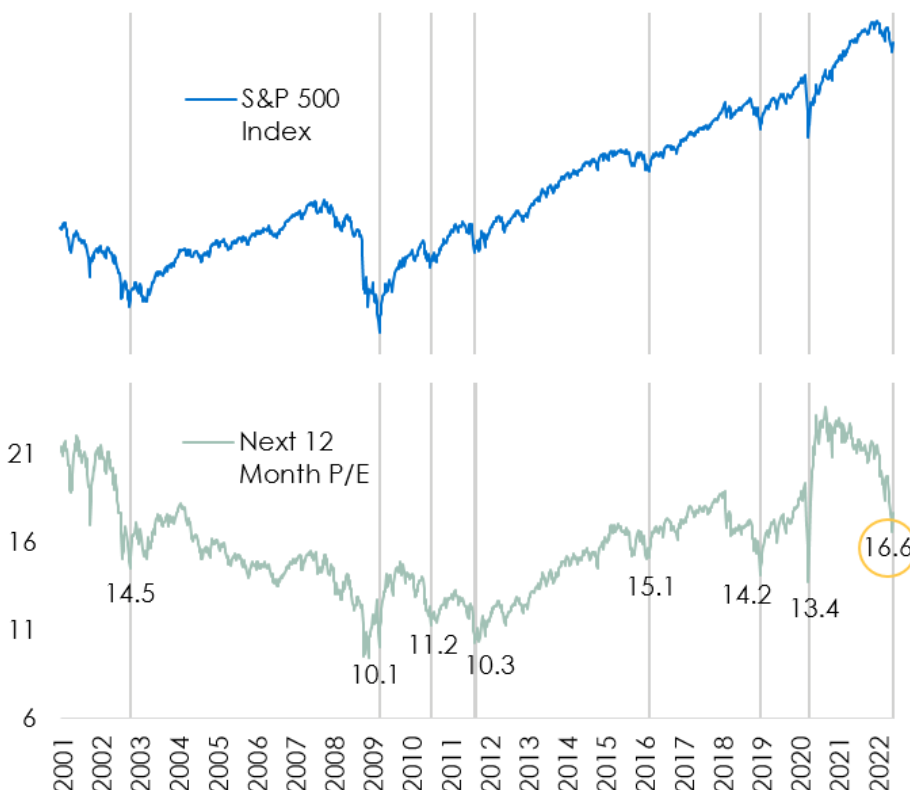
That’s also the million-dollar question for investors these days. A combination of high inflation, slowing earnings growth, concerns over Federal Reserve policy and geopolitical events have combined to place a giant “Memorial Day Sale - 20% Off!” sign on the stock market’s storefront. The question now is how much lower can prices go before we hit bottom?

To us, there are several factors at play that could cause stocks to sell off even further – even if America is able to avoid a serious recession.

The biggest reason to think that there might be more downside to the market’s slide is that stock valuations are still fairly high. Though forward-looking price / earnings (“P/E”) ratios have declined, they are still not at levels indicative of bear market lows.

As can be seen in the chart at right, P/E ratios typically settle in the 10-15 range following stock market declines. If history is any guide, the market could sell off another 10% or more from current levels in order to get that valuation multiple to more traditional trough levels.

Are We There Yet?



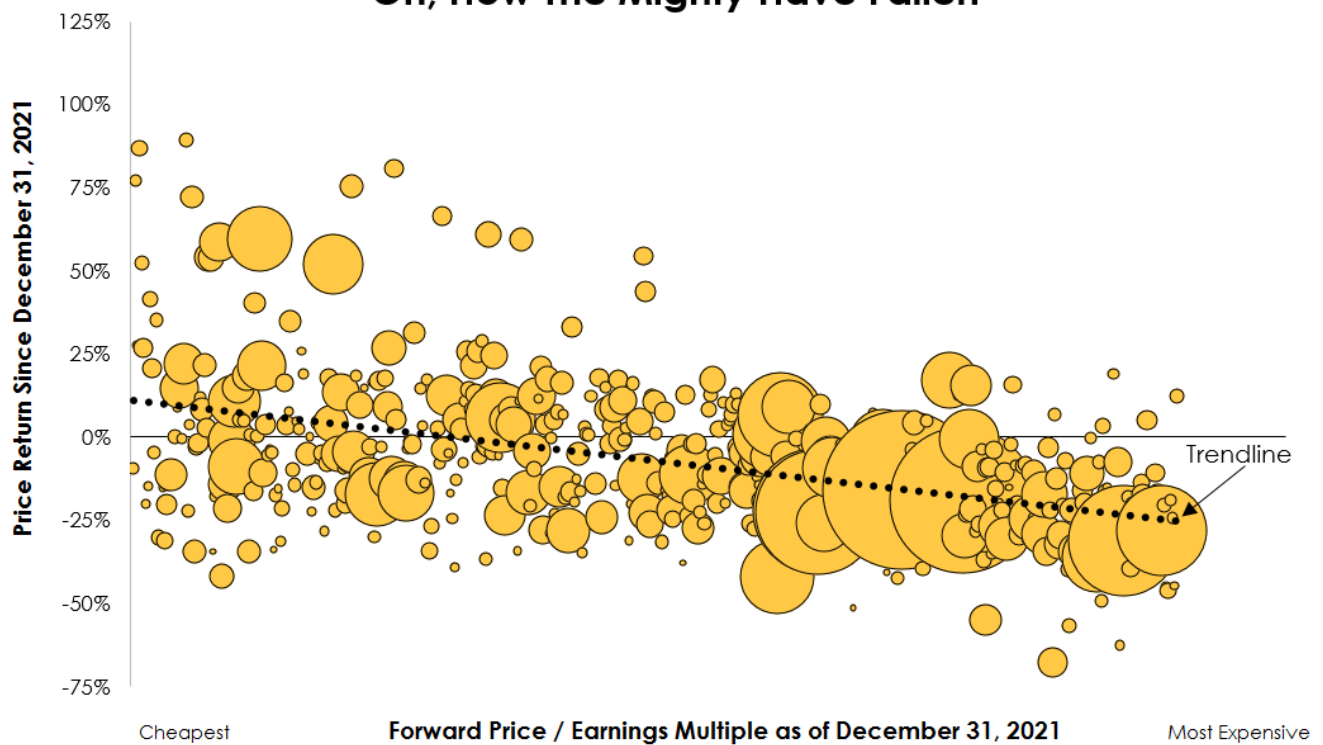
Source: Factset, YCAG Research. Data through May 27, 2022



What’s interesting about the stock market decline is that it has been driven almost entirely by falling P/E multiples. Leading the way down have been the large, high growth stocks that were (in our opinion) excessively valued for the past several quarters.

The chart below illustrates this point. The S&P 500 Index constituents have been charted on the horizontal axis according to their P/E ratio as of the end of last year. The vertical axis reflects the year-to-date price returns for each stock. Finally, the size of each bubble indicates the relative market capitalization of that company.

Oh, How The Mighty Have Fallen



Source: Factset, YCAG Research. Data as of May 27, 2022. Market Capitalization represented by size of bubble.

There are several important observations to take away from this exhibit. First, the cheapest stocks in the S&P 500 Index at the end of last year have been the best-performing group so far in 2022. And as you move further to the right, the stocks get more expensive and year-to-date returns get worse.

Another key point is that the largest companies were the most expensive at the end of last year (biggest bubbles are to the right of the chart), and that these companies have fared the worst so far this year. We have written about how concentration among the largest companies has been a concern for some time; now, we are seeing how these former market leaders are now dragging the broader market down with them.

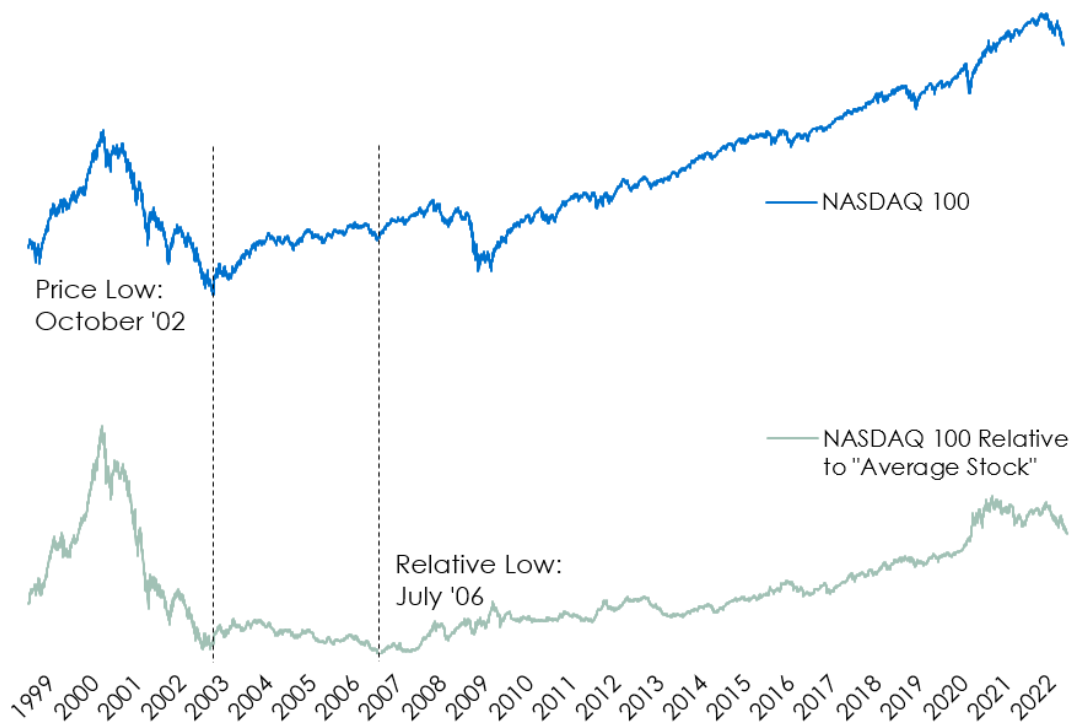


Looking back, it appears that these formerly-leading issues could spend quite some time in the penalty box. Generally speaking, when the stock market enters a bear market the groups leading the way down a) were leading the market up before the dip, and b) continue to struggle even after the market troughs.

As an example of this, refer to the chart below. Following the bursting of the Tech Bubble in the early 2000's, the NSADAQ 100 Composite Index posted its absolute price low in October, 2002.

Relative to the "average stock" however, the Tech-heavy NASDAQ didn't regain market leadership *until nearly four years later* in July, 2006!

Regaining Leadership Could Take A While



Source: Bloomberg, YCAG Research. "Average Stock" represented by the Equal-Weight S&P 500 Index.

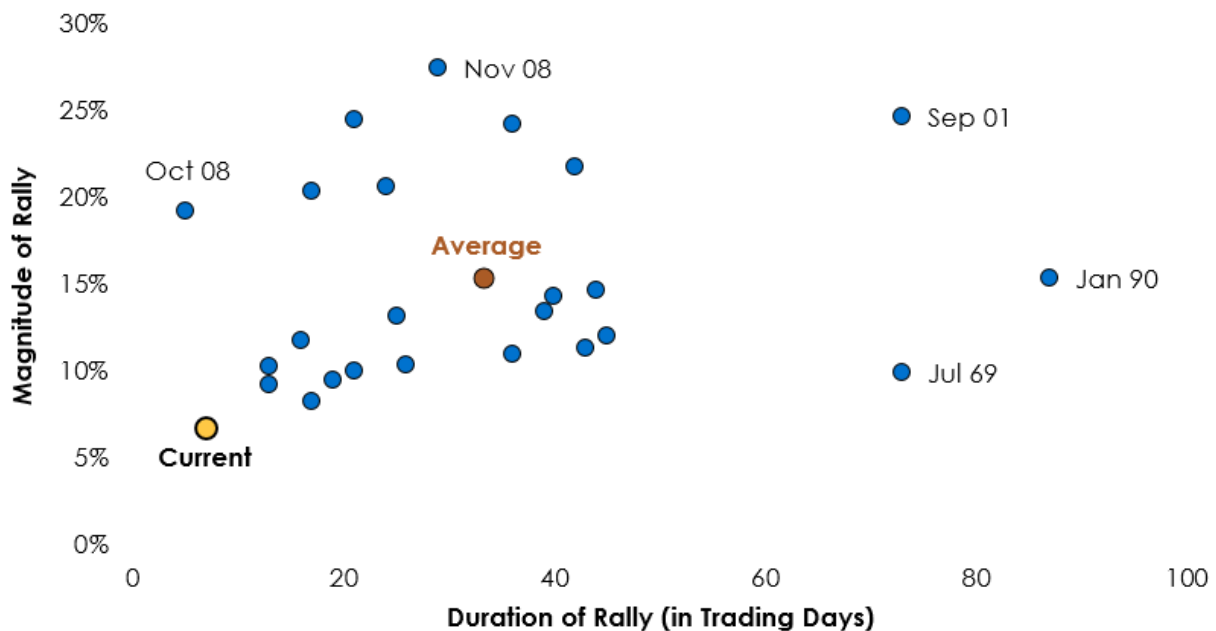
So while it can be tempting to "buy the dip" in order to gain exposure to the previous leaders, it might be some time before these stocks begin to outpace the previous laggards. This may be even more prescient this time around, as the previous market leaders – "growth" stocks – held that position for over a decade. Given the duration of their leadership run, and the magnitude by which they led – "growth" led "value" by a historical degree – it seems unlikely that "growth" will just bounce back and retake the reins.



This is not to say that there won't be some bumps on the way down to an eventual market low. Bear market rallies have always tempted investors into thinking that the worst is behind them (see chart below). In the past, some of these rallies have lasted for months and represented fairly significant gains. Each time, however, the rally fizzled out and the groups that were dragging the market down continued to do so.

Expect Some Bumps On The Way Down

S&P 500 Bear Market Rallies Since 1960



Source: Strategas. Data as of May 27, 2022.

Despite the challenges facing the Federal Reserve, we continue to believe that the macroeconomic picture this year is likely to be one of positive, yet moderating, growth (excluding the negative Q1 GDP report, which we view as an aberration caused by certain timing issues) combined with elevated inflation – a set of circumstances we've dubbed "moderate resilience". As such, we will continue to focus on "value" and "quality" as this economic cycle matures.

Stock market volatility, thus far, has largely been due to valuations resetting lower rather than a significant deterioration in the fundamentals. Throughout the past year, we have trimmed "riskier" assets in client portfolios (stocks and alternatives) to maintain a relative balance with lower volatility securities, like fixed income and hedges against market volatility.



We have become slightly underweight equities in general and we continue to favor “value” and “quality” within the large-cap domestic market. We’ve also taken steps to become more defensive in terms of our sector weightings in our individual equity portfolios. We also prefer developed markets over emerging markets, due to better insulation from the negative impacts of inflation.

In the fixed income area, we remain focused on higher quality credit-sensitive securities (with less exposure to the more cyclical areas of the market) with shorter maturities as a hedge against potentially rising interest rates.

Within the alternative market segments, we have maintained an emphasis on “real assets” (think commodities and, to a lesser extent, real estate) as a hedge against the potential for continued inflation. We maintain an overweight to the diversified alternative sector as a hedge against market volatility.



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