

# We're Not In Kansas Anymore

*"Lions and Tigers and Bears! Oh my!"*

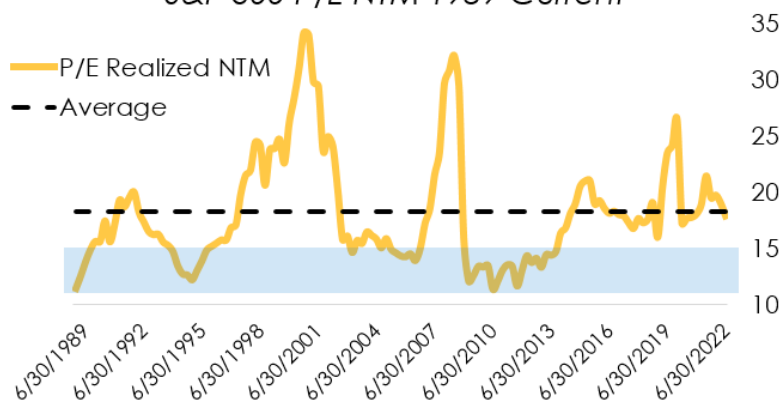
– The Wizard of Oz (Victor Fleming - 1939)

Most of us are probably familiar with Dorothy's harrowing experience in the Wizard of Oz as her world is literally turned upside down upon venturing to Oz before, ultimately, finding her way back home.

Many investors can probably relate to the turmoil of experiencing something anxiously unfamiliar given the continued reversal in markets through the first five months of this year. For many bond investors, year-to-date returns haven't been this negative since the inception of the widely-used US Aggregate Bond Index dating back to 1976. For stock investors, the market declines in the Nasdaq and the S&P 500 equity indices, bring back unpleasant memories of the COVID lows in March of 2020 (bear market territory as defined by negative returns of 20% or more).

To be sure, growth is slowing and the cycle is maturing but are the fundamentals as dire as the market returns would imply? We'd argue against that at this point. Instead, we believe that the fundamentals have taken a backseat to valuations so far this year. Stock and Bond investors have seen a valuation reset in order to reflect a very different inflation backdrop. As can be seen in the chart at right, the S&P 500 has had moments of overvaluations in the past (with the benefit of hindsight). Using next twelve month realized earnings, P/E multiples peaked in 2000, 2008 and 2019. COVID related stimulus led to another interim peak last year as speculative investments were in demand (IPO's, SPAC's, NFT's, crypto, etc). Now the air is deflating and valuations are coming back down to earth – "we're not in Kansas anymore" – though we think we may still have further to go. As depicted by the shaded region in the chart, S&P 500 multiples over the past 20+ years have corrected to around 14X (average of the bottom one-third of P/E's since 1989). Of course, most of

Follow the Yellow Brick Road  
S&P 500 P/E NTM 1989-Current



Source: Factset; S&P Dow Jones Indices. P/E NTM calculated using S&P 500 realized operating earnings over the forward 12 month period. Forecasted earnings are calculated based on Yellow Cardinal's proprietary earnings regression model used in P/E measures beginning 6/30/21.



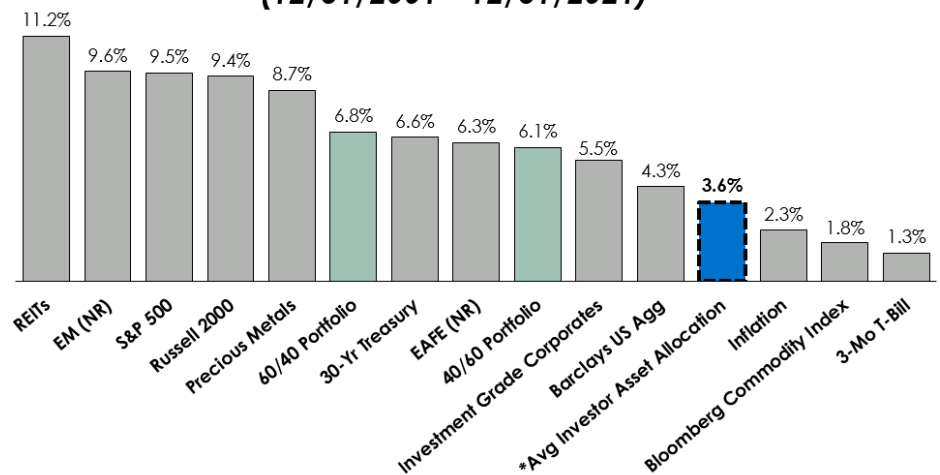
those corrections also coincided with a recession along the way – which resulted in the “E” (earnings) dropping as well. While that’s more likely an earnest discussion for next year, for now, we still see downward pressure on equity prices due mostly to valuations resetting to account for higher rates and inflation. From there, fundamentals will likely have a bigger impact.

With markets resetting, investors are naturally uncomfortable. Market volatility has a way of triggering emotional responses that can often lead to poor investment results. We’d caution investors against letting day to day market movements dictate long-term strategic decisions. An annual study done by the Dalbar Group – an independent market research firm – is a good illustration of why. As referenced below, the Dalbar study was conducted to understand what the average investor’s return experience has been over the past twenty year period. The exercise not only looks at what investors have owned but, more importantly, when they have owned it in order to get an estimate of the actual return experience. Returns are based on the net of aggregated mutual fund sales, redemptions and exchanges each month. The results are pretty telling.

First, the average investor is estimated to have underperformed virtually every major asset class over the past twenty years except for inflation, commodities and cash.

Keep in mind that the average investor’s allocation has generally represented a 70/30 (70% Stock, 30% Bond) portfolio over time. That 70/30 allocation has significantly underperformed a more conservative 60/40 portfolio and even a 40/60 portfolio, annually. In short, the average investor has taken on more risk and gotten less return to show for it.

**20-Year Annualized Asset Class Returns  
(12/31/2001 - 12/31/2021)**



Source: Yellow Cardinal Advisory Group, Dalbar Inc., Factset, Zephyr. Indices used are as follows: REITs: FTSE NAREIT All Equity REIT Index, EM (NR): MSCI Emerging Markets Index, Precious Metals: Bloomberg Precious Metals Index, 30-Yr Treasury: Bloomberg Barclays US Treasury Bellwethers - 30Yr, Investment Grade Corporates: Bloomberg Barclays US Agg Credit - Corporate - Investment Grade, Barclays US Agg: Bloomberg Barclays US Aggregate Bond Index, EAFE (NR): MSCI EAFE Index, Inflation: CPI, 3-Mo T-Bill: ICE BofAML US Treasury Bill - 3Mo, 60/40 Portfolio: balanced global portfolio consisting of MSCI All Country World Index (60%) and Bloomberg Barclays Global Aggregate (40%), 40/60 Portfolio: balanced global portfolio consisting of MSCI All Country World Index (40%) and Bloomberg Barclays Global Aggregate (60%), \*Avg Investor Asset Allocation: based on analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions, and exchanges each month as a measure of investor behavior. Returns are based in USD, annualized, and represent the 20-year period ending 12/31/2021 to match DALBAR's most recent analysis.

We think this a pretty clear illustration of what can happen when emotions drive long-term decision making – very suboptimal long-term results. Remember, cashing out of the market only works when prices are falling. It can feel good in the moment but the eventual market recovery requires a quick shift to get back to fully invested. That’s wickedly difficult to time correctly. We’d much prefer to keep the emotions at bay – the strategic allocation intact – and make tactical adjustments around the edges. That’s what disciplined investing is all about.



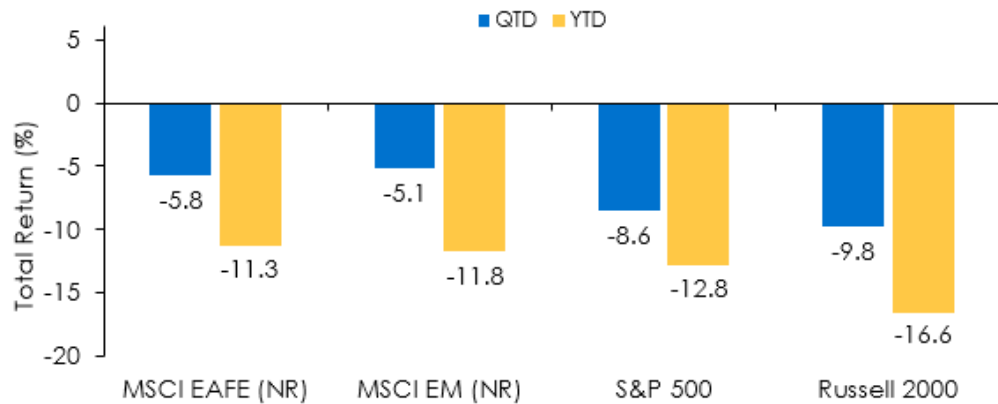
After such heady returns for risk assets in 2021, performance reversed course in most of these areas so far this year. As such, the S&P 500 suffered its worst five month stretch since the introduction of COVID in March of 2020. Commodities were the lone bright spot while Stocks and REIT's saw valuation compression. Meanwhile, Bonds remained pressured given high inflation and rising interest rates.

## Stocks

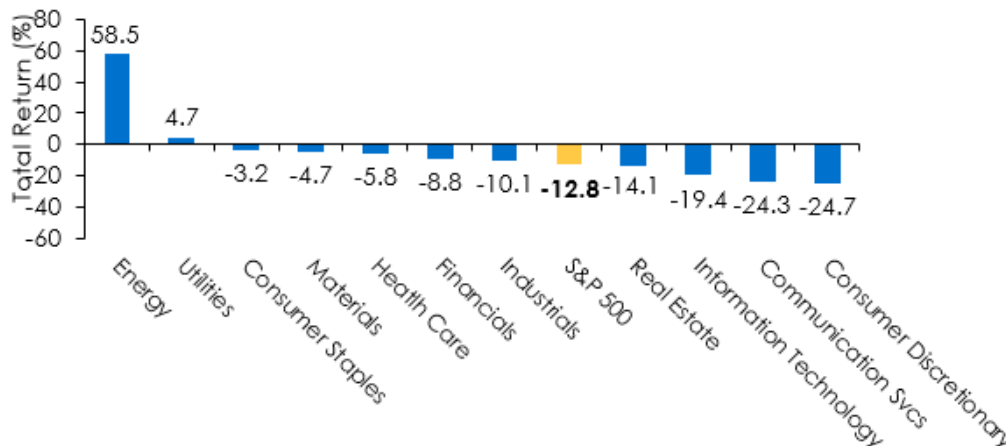
Stocks traded lower through the first five months of the year notwithstanding some slight gains in May. Year-to-date, domestic markets (S&P 500 and Russell 2000) underperformed international markets

(MSCI EAFE and MSCI EM) as expensive valuations (and rate sensitivities) in the former more than offset geopolitical risk in the latter, which was also helped by a weaker dollar in May. Only two sectors within the S&P 500 finished in positive return territory. Sector performance was influenced by valuation and inflation sensitivities as well. Higher priced Cyclical Growth sectors (Discretionary, Technology and Communication Services) and Real Estate were down the most while the least expensive Cyclical Value sectors (Energy, Financials, Industrials, Materials) outperformed alongside the more traditionally Defensive sectors (Consumer Staples, Utilities, Health Care).

### Global Equity Returns May 2022



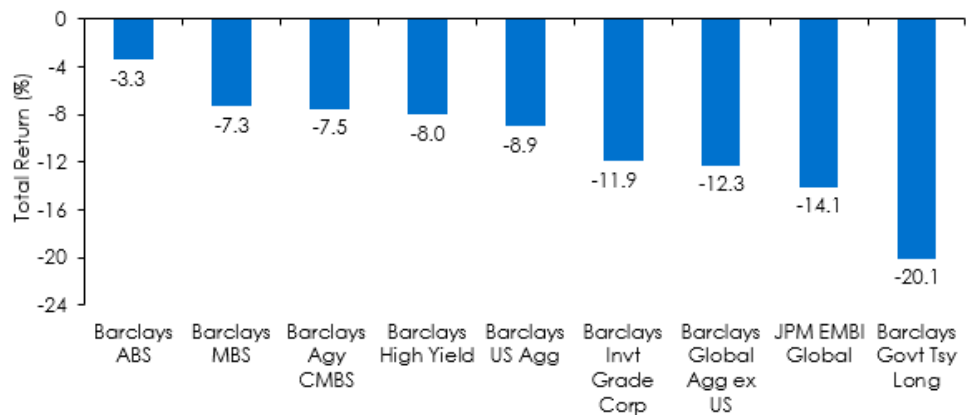
### S&P 500 Sector Returns May 2022 - YTD



## Bonds

For the year, bond returns remained in negative territory amid the continuation of an upward rate bias consistent with elevated and persistent inflation – though the month of May saw a modest reprieve as inflation data peaked and inflation expectations moderated. Still, the Fed is expected to continue to hike rates and begin reducing its balance sheet – both of which have influenced the rate move higher for much of this year. As a result, bonds that carried shorter durations – namely Securitized Assets (ABS, MBS, CMBS) – were better insulated. While credit spreads held steady for much of last year, they began to move wider in November (Omicron) and again year-to-date (Fed and Russia) to levels not seen since the second half of 2020. High Yield outperformed given higher carry and shorter duration positioning relative to Investment Grade corporate bonds. The most duration sensitive areas including long-term Treasury bonds and Emerging Market Debt (Govt Tsy Long and JPM EMBI Global) were among the hardest hit (and given the geopolitical backdrop in the latter).

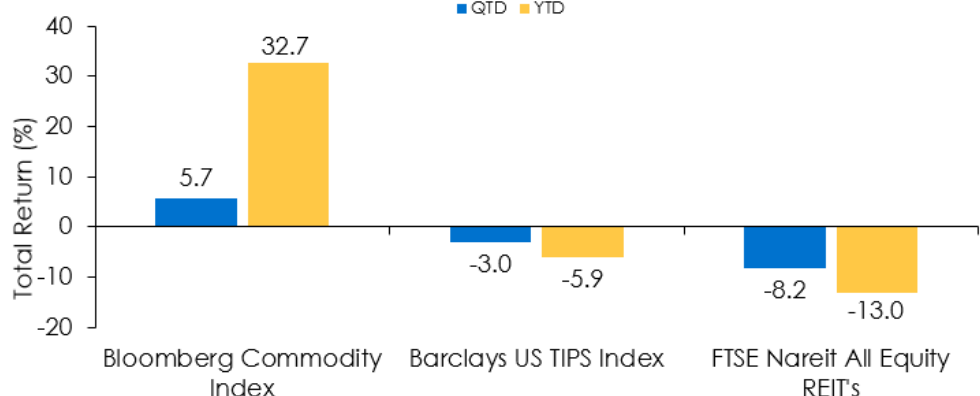
**Global Fixed Income Returns**  
May 2022 - YTD



## Alternatives

Alternatives posted the most disparate of returns year-to-date. Publicly traded Real Estate (REIT's) remained under pressure – with returns comparable with Stocks. Meanwhile, Commodities posted among the strongest (and positive) returns – acting as a strong inflationary hedge with particular strength in Energy, Agriculture and Industrial Metals prices – though the latter was notably weaker in May.

**Alternative Market Returns**  
May 2022



## Market Outlook

**“It’s tough to make predictions, especially about the future.”**

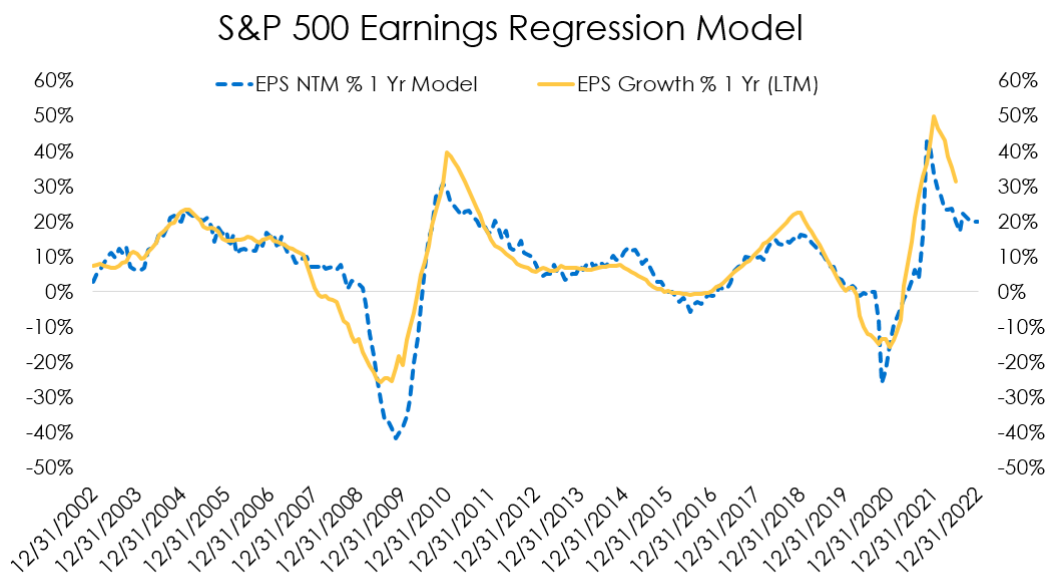
– Yogi Berra (1925-2015)

As we move through the course of 2022, we still think the phrase “Moderate Resilience” might best define the fundamentals. Said another way, growth rates moderating from elevated levels might apply to everything from corporate earnings to nominal GDP to inflation. Embedded within that view is the idea that the cycle is maturing, but last year’s well above average growth in the money supply (a key measure of liquidity) suggests some resiliency to nominal growth this year. So far, nominal GDP growth has peaked but the resiliency of inflation highlights a fundamental backdrop that’s – so far – more akin to the 30 year period starting in the ‘60’s than the three most recent decades. “Moderate Resilience” is also reflected in S&P 500 corporate profit growth which is expected to remain in double digit territory (on a trailing twelve month basis) for the next 6 months based on our earnings regression model – as can be seen in the chart at right.

As a result, our cyclical view continues to be that growth is slowing but it’s not necessarily slow, quite yet. As we look forward, much will depend on how the data evolves along with how the Fed responds – which will

influence the trajectory of the slowing growth trend. At this point, however, we think more of the broad based weakness across the expanse of financial markets has to do with valuations needing to reset to a very different inflationary setup.

Nowhere has this been more apparent than in the Tech oriented areas of the equity market, where valuations had been bid up over the past 10-15 years under the premise that growth was secular and rates and inflation

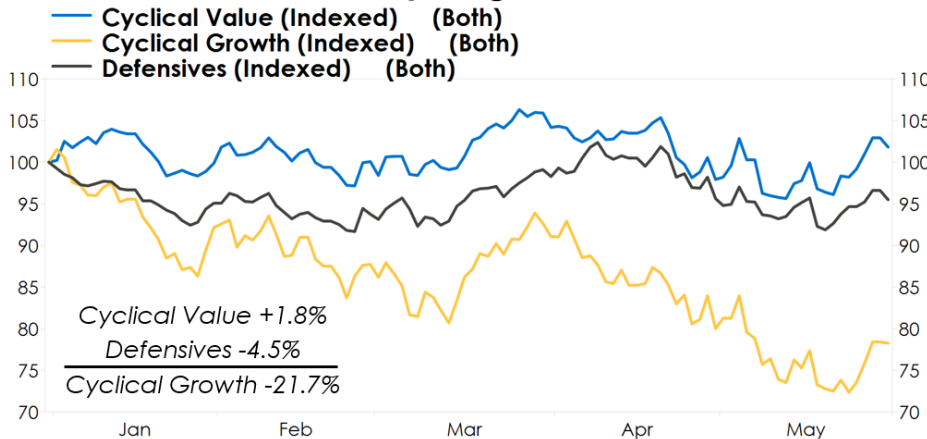


Source: Factset; Yellow Cardinal Research. EPS Growth Model is a proprietary regression model based on economic inputs that are found to be good predictors of the S&P 500 profit cycle with a 6 month lead time.



low and stable. Now that the paradigm around rates and inflation may be changing, investors are starting to question the valuations of these stocks and price performance has suffered as a consequence. As can be seen in the chart below, an equally weighted basket of Cyclical Growth stocks – comprised of Technology, Communication Services and Consumer Discretionary sectors – have more dramatically underperformed

**"Tech Wreck" vs "Everything Else"**



Source: Factset. Cyclical Value is based on an equal weighted performance basket of the Industrials, Financials, Materials and Energy sectors. Cyclical Growth is based on an equal weighted performance basket of Technology, Communication Services and Consumer Discretionary sectors. Defensives is based on an equal weighted performance basket of Consumer Staples, Health Care and Utilities. All baskets are based on price performance and Indexed to 100; Year-to-date through 5/31/22.

“everything else” including Cyclical Value (Industrials, Financials, Materials and Energy sectors) and Defensive stocks (Consumer Staples, Health Care and Utility sectors).

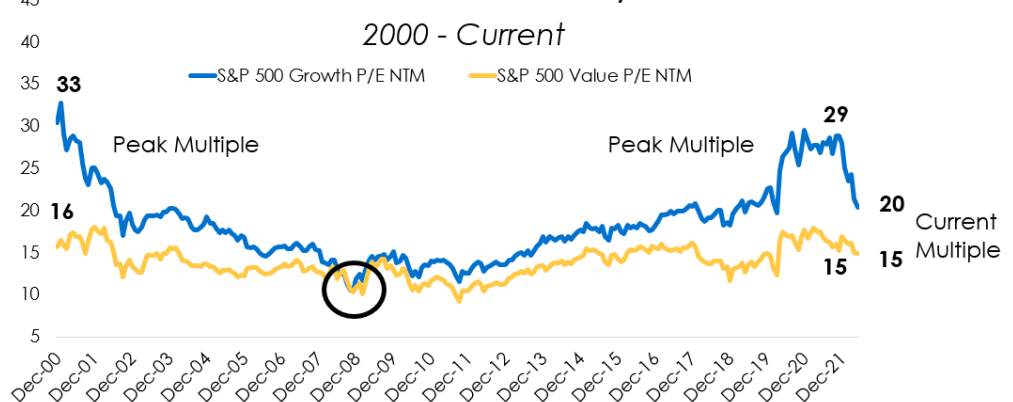
While the year-to-date underperformance in growth stocks has been dramatic, there may actually be more to go if history is a guide. As can be seen in the chart below, the last time the valuation disparity (as

defined by P/E NTM earnings expectations) between the S&P 500 Growth and the S&P 500 Value indices got this wide was in 2000. Back then, the valuation differential was a whopping 17 multiple points! Last year ended with a remarkably similar peak differential of 14 turns of the multiple. While the gap has closed rather considerably today (20 versus 15), a look back at history shows that Growth stock valuations bottomed at parity with Value stock multiples – a feat that took roughly eight years to accomplish! It would appear that growth investors might be just waking up to the notion that “we’re not in Kansas anymore”.

So what are the implications and key takeaways for portfolios?

At the beginning of the year, our expectation was for more moderate market returns with an increased likelihood for more volatility. Several conditions led us to that way of thinking including

**S&P 500 Growth vs Value P/E NTM**



Source: Factset; iShares S&P 500 Growth and Value ETF used to calculate P/E NTM data. Data as of 5/31/22.



forward returns following a peak in corporate profits growth, above average volatility in mid-term election years, valuation pressures when inflation is elevated and just more modest returns as a bull market ages. That perspective led us to focus on the importance of managing the overall exposure and mix of risk assets within portfolios – with an acknowledgement that the business cycle was maturing and a transition was occurring to the deceleration phase of the profit cycle (i.e. slowing growth). Risk assets needed to downshift accordingly.

From a secular perspective, we're still sympathetic to the view that inflation might linger for longer than expected. While today's inflation is consensus, the persistence of future inflation may not be. If the inflation paradigm is changing this creates both risks and opportunities in the market. The winners of the recent past – given their valuation vulnerabilities – may not be the same winners in the future. This continues to bias our view towards maintaining pro-inflationary tilts within portfolios.

As noted above, we think that the volatility that we've witnessed in stocks thus far has been driven more by downward pressure on valuations (given elevated inflation) rather than a quick deterioration in the fundamentals (which are slowing but not yet slow). Liquidity, however, is coming out of the market which tends to impact the fundamentals with a lag so this bears watching with implications for next year.

From a portfolio positioning perspective, we continue to believe that it's important to strike the right balance between Moderation and Resilience. To us, that means managing the overall exposure and mix of risk assets consistent with a maturing cycle (i.e. Moderation) while also being cognizant of the continued need for pro-inflationary tilts (i.e. Resilience). In essence, we're neutrally positioned with a pro-inflationary bias.

Within equities, our positioning is neutral to slightly UW and continues to favor a pro-inflation bias with a value sector tilt within our US exposure (along with a quality preference given OW's in both cyclical value and defensive sectors) and an OW to Developed versus Emerging Markets.

Within fixed income, to mitigate some portfolio risk, we remain UW the most cyclical parts of the bond market (High Yield and Emerging Market Debt) but our US Core managers are OW credit relative to Treasuries. We also continue to carry a shorter duration bias (less interest rate sensitivity). Our US Core Fixed Income exposure remains an OW supplemented by our UW position in International Fixed Income which remains a hedge against a weaker dollar environment.

Within alternatives, we are OW in aggregate and remain more barbelled. We're OW to Commodities as a way to bolster inflationary hedges while also being OW to Diversified Alternatives which provides some hedge against market volatility. Real Estate was trimmed previously – taking advantage of outsized profits last year.



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