

# Oasis or Mirage?

**“If you don’t know where you’re going, you might end up some place else.”**

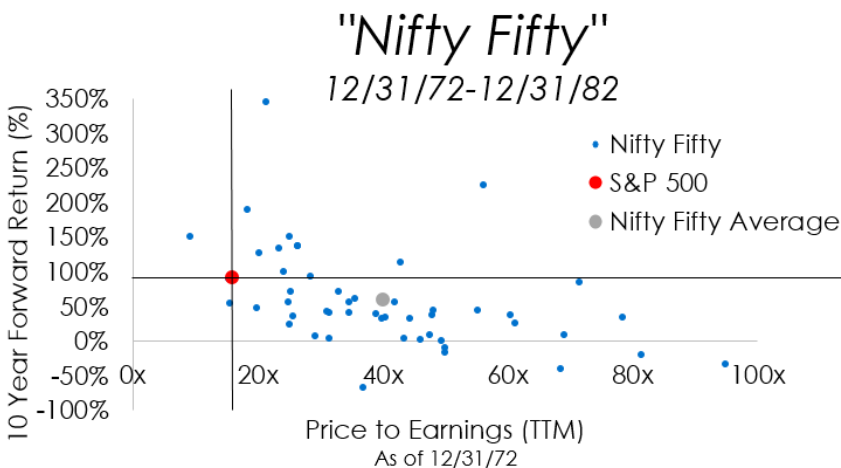
– Yogi Berra (MLB Player and Coach 1925-2015)

It’s been said that life is more about the journey than the destination. Being hyper focused on the end result can mean one might miss the bigger picture and the path to get there. In a similar fashion, the journey definitively matters for investing where the finish line is often dictated by the starting point.

To illustrate this critical concept, we recently studied the impact that starting valuations had on long-term forward returns. Note the key word here is long-term. Valuations typically have far less influence on short-term results yet far more explanatory value on what happens over the long-term.

A couple examples that we found interesting in relation to the top heavy market that we’re witnessing today include the “Nifty Fifty” run up ending around 1972 and the “Tech Bubble” blow off ending around 1999. Both periods evidenced significant outperformance by a subsection of the market that yielded a pronounced influence over the investor zeitgeist.

In the early ‘70’s, the “Nifty Fifty” was a list of 50 large companies (published by Morgan Guaranty Trust) that had enviable balance sheets, profitability and growth rates. Examples include names like Poloroid, Kodak, Sears and Avon – often described as “one decision” stocks to be simply bought and held because of their consistently strong fundamentals. As can be seen in the chart above, most of these stocks had above average valuations by the end of 1972 which led to their collective underperformance relative to the S&P 500 over the next decade. Yes, some stocks outperformed (12 out of 50) but that was more the exception than the rule. In short, the odds were generally not in one’s favor in owning those extremely expensive stocks. Some companies had the



Source: Barry Bannister, CFA Stifel Financial Group; Morgan Guaranty Trust Nifty Fifty List (never a "formal" index) was published in 1972. Stifel Sources: SRC Chart Books (various issues), Standard & Poor's, Bloomberg, Univ of Alabama Bruno Library historical financial reports database. P/E is a trailing twelve month number as of 12/31/72. 10 Year Forward Return is a cumulative total return number over the time period 12/31/72-12/31/82.



extraordinary earnings power to grow into their stock's high valuations, but it's very difficult to differentiate those long-term outperformers from the rest.

In the late '90's, the more familiar "Tech Bubble" witnessed the dominance of a couple of sectors that became beloved for their innovation and transformational technology that was used to harness the power of the internet and computing applications. While a large cap size bias existed in the "Nifty Fifty" list, it was less pronounced in the "Tech Bubble". To keep that size bias in tact – consistent with today's top heavy "Magnificent 7" analogue – we chose to use the Top 7 Tech and Telecom stocks by market cap at the end of 1999. That included the likes of Microsoft, Cisco and Intel among others. Keep in mind that using the entire Tech and Telecom sectors would have likely yielded comparable results because of similar starting valuations. We also evaluated the "Tech Bubble" analysis using the Top 20 names by market cap in the S&P 500 – regardless of sector – and the conclusion was the same.

**THE FINISH LINE IS OFTEN DICTATED BY THE STARTING POINT**

	Beg P/E	End P/E	Total Return
<b>"Nifty Fifty" Analysis - 12/31/72 to 12/31/82</b>			
Nifty Fifty Median	36	12	39%
Nifty Fifty Average	40	15	59%
S&P 500	16	10	91%
<b>"Tech Bubble" Analysis - 12/31/99 to 12/31/09</b>			
Top 7 Tech & Telecom Median	82	23	-38%
Top 7 Tech & Telecom Average	149	24	-25%
S&P 500	33	26	-10%
<b>"Post Pandemic High" Analysis - 12/31/21 to 8/31/23</b>			
Magnificent 7 Median	42	34	-5%
Magnificent 7 Average	80	62	2%
S&P 500	25	23	-3%

Source: "Nifty Fifty" data from Barry Bannister at Stifel Financial Group; Morgan Guaranty Trust Nifty Fifty List (never a "formal" index) was published in 1972. Stifel Sources: SRC Chart Books (various issues), Standard & Poor's, Bloomberg, Univ of Alabama Bruno Library historical financial reports database. "Tech Bubble" holdings from Top 20 S&P 500 Companies by Market Cap (1990-2023) finhacker.cz and include MSFT, CSCO, INTC, IBM, ORCL, T, QCOM. All other data from Factset. P/E is a trailing twelve month number based on earnings as reported by the company. Total Return is a cumulative total return number over the associated time period. "Post Pandemic High" Magnificent 7 include AAPL, MSFT, GOOGL, META, AMZN, TSLA and NVDA.

The punchline – good companies don't always make good stocks when valuations move to exorbitantly high levels. As a result, there tends to be an inverse relationship between starting valuations and long-term returns – as illustrated in the chart on the prior page.

As can be seen in the table above, in both the "Nifty Fifty" and "Tech Bubble" examples, stock valuations (as defined by price to earnings ratios) were so extreme that the next decade of returns significantly lagged the S&P 500. That wasn't because of material fundamental underperformance. In fact, in both cases, the earnings growth rate for each equally weighted basket of stocks was far superior to the S&P 500 index yet the cumulative total return was significantly weaker. Again, valuations tend to matter in the long run.

When comparing the past analysis to the present "Post Pandemic High", we think investors should take to heart the annals of history. Sometimes, the most expensive stock can truly become the long-term winner but, more often than not, the Oasis becomes the Mirage.

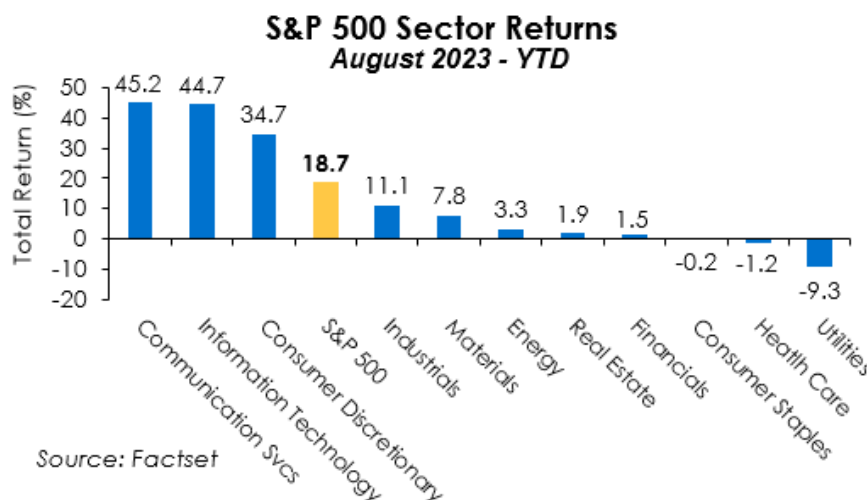
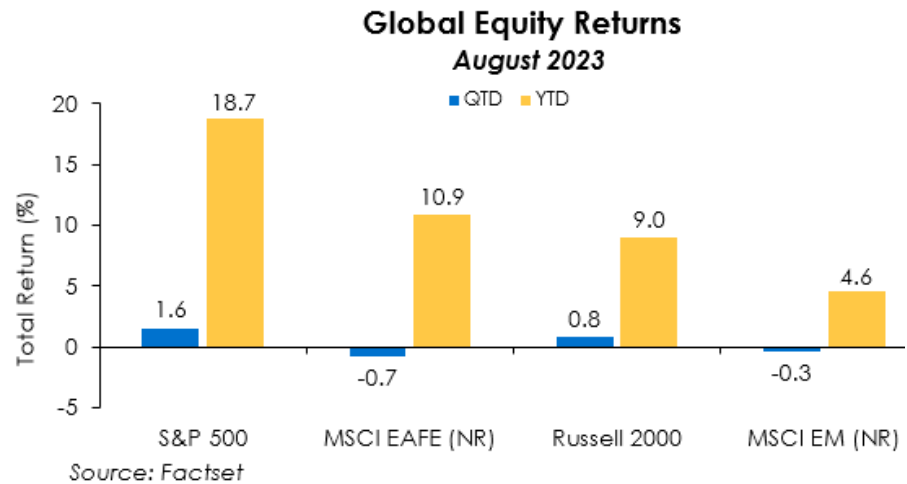


Market returns were weak in August with Commodities, Bonds, Stocks and REITs all posting negative, low-single digit returns. Profit taking, rising rates and weak Chinese economic data were all cited as influential factors. Year-to-date, however, major Stock indices have been strongly positive. Bonds and REITs are up to a lesser extent while Commodities are down slightly.

## Stocks

Year-to-date equity performance remains strong with the spread between the U.S. Large Caps (S&P 500) and everything else widening considerably in August. US Small Caps (Russell 2000) gave back much of prior month's positive relative performance. Meanwhile, sector

outperformance has favored the higher priced "Magnificent 7" within the cyclical growth sectors (Technology, Discretionary and Communication Services). Conversely, both cyclical value (Energy, Materials & Financials) and defensive sectors (Health Care, Utilities and Staples) starkly underperformed despite the former group continuing to exhibit relative strength in the quarter. Elsewhere, equity performance in International Developed Markets (MSCI EAFE) has been solid – helped by a better than feared start to the year given warmer weather and the avoidance of an energy crisis in Europe along with better economic data out of Japan. Finally, Emerging Markets (MSCI EM) posted weak returns in August, once again, widening the gap with Developed Markets due to weak economic data out of China.

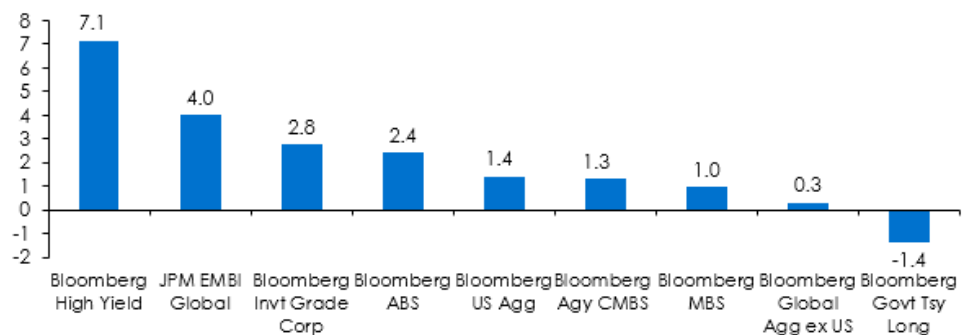


## Bonds

Following aggressive moves by the Fed – having now hiked short-term rates by 525 basis points (to 5.25-5.50%) amid ongoing balance sheet reduction – policymakers continue to “hold the line” on rate policy. Over the past year, longer-term rates have been volatile within a range. Recently, the rate bias has been higher despite a moderating (though still sticky) inflation backdrop. Meanwhile, the yield curve remains deeply inverted – an indication of macro stress as monetary policy restricts to the point of deteriorating growth prospects with the entire Treasury curve having moved below the Fed Funds rate. Despite the year-to-date upward move in rates, solid carry and tightening credit spreads have combined to produce slightly positive returns. Corporate bonds (High Yield, Investment Grade) and Emerging Market debt (JPM EMBI) outperformed. Securitized credit (MBS, CMBS) and International debt (Global Agg ex US) were positive but lagged. Duration based returns represented by Long-Term Treasuries (Govt Tsy Long) turned negative as long rates rose again in August.

### Global Fixed Income Returns

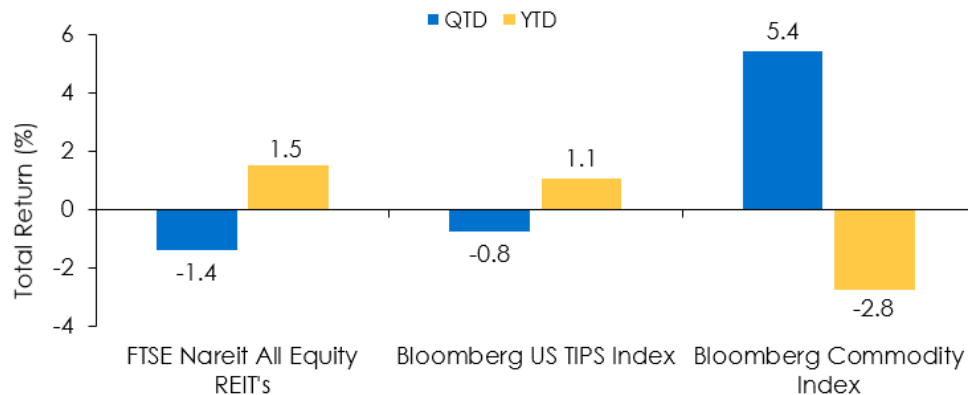
August 2023 - YTD



Source: Factset

### Alternative Market Returns

August 2023



Source: Factset

## Alternatives

Commodities traded lower year-to-date with positive returns in Precious Metals more than offset by negative pricing in Industrial Metals and Energy (notwithstanding the latter's reversal QTD). Meanwhile, publicly traded Real Estate (REIT's) declined after bouncing in July resulting in year-to-date returns that have materially lagged relative to equities. Finally, Treasury inflation protected securities (TIPs) – in comparison to nominal Treasuries – benefited from the positive carry in bonds year-to-date along with a bottoming in inflation expectations.



## Market Outlook

**“Woods are not like other spaces...Stand in a desert or prairie and you know you are in a big space. Stand in the woods and you only sense it.”**

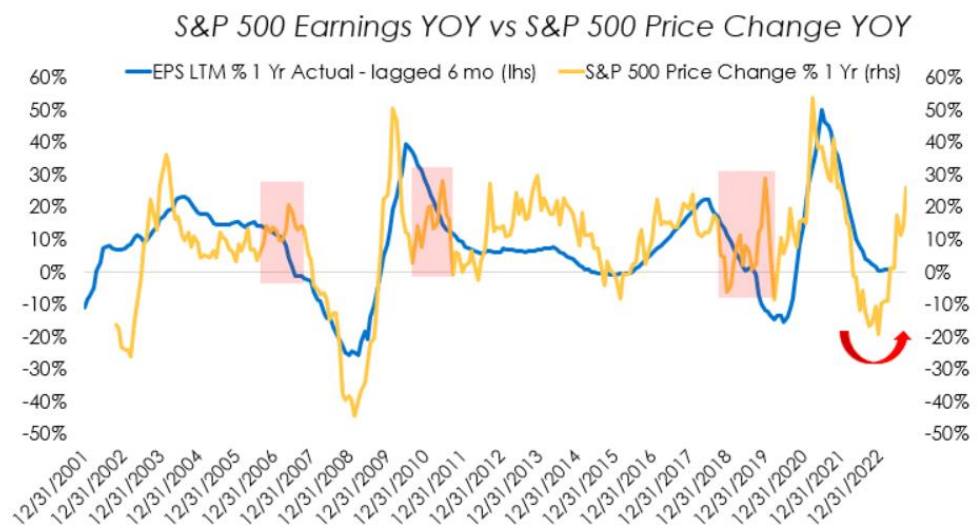
– Bill Bryson, *A Walk in the Woods* (1998)

We’ve dubbed our main theme for 2023 as “Seeing both the Forest AND the Trees”. As such, we think it’s especially important to have two frameworks for managing portfolios – the cyclical (shorter-term) and the secular (longer-term). The cyclical perspective is an attempt to assess where we are in this particular business cycle while the secular perspective evaluates where the structural tendencies might be over multiple business cycles.

From a secular lens, we remain sympathetic to the notion that the economic paradigm is changing to one that ushers in the potential for more persistent and volatile inflation. Such a backdrop might set the stage for a higher cost of capital environment acting as a weight on stock valuations. We find historical parallels today to the higher inflation regime that existed back in the ‘60’s-80’s and we think the Fed is re-learning the painful lesson of falling behind inflation – one that it hopes not to repeat any time soon. Additionally, we believe there are structural considerations that exist today that might also support this changing paradigm including changes to both aggregate demand (money supply) and supply (de-globalization, labor markets, energy complex).

At the other end of the spectrum is the cyclical

perspective, which has recently shown some improvement in the Fundamental data. The chart above suggests the S&P 500 has been anticipating an acceleration in corporate profit growth – which now looks like it may be bottoming. The two lines above (EPS growth and the S&P 500) tend to be correlated through time – not without some notable disconnects along the way including 2006-07, 2010-11 and 2018-19 (red shaded



Source: Factset; EPS Growth LTM actual earnings based on iShares S&P 500 (IVV) from Factset.



regions – so this is not necessarily a given). Nonetheless, the broadening improvement in the Fundamental data has been supportive of the market’s positive view on earnings.

The caveat – things can be good for a time but the question remains around such sustainability if a bottoming in growth also comes with a bottoming in inflation. As such, we continue to focus on the following set of conditions:

- We remain in the latter stages of the business cycle. What inning we’re in remains up for debate, but a combination of liquidity, labor market, capacity and confidence measures all support the conclusion of being late cycle. Perhaps the simplest measure is a 3.4% unemployment rate – a record low level reached earlier this year only seen in one other period over the last sixty years (in the late ‘60’s)!
- Liquidity is being drained from the economy. Lots of data support this notion including a dramatic decline in the savings rate, negative year on year money supply growth (approximately \$800b off the peak), the continued Fed tightening policy (including over 500 bps of rate hikes), a deeply inverted yield curve and credit standards that are the tightest since 1Q09 (ex Covid) – which have continued to worsen.
- Growth sustainability is unclear. While improving Fundamental data and market price action suggest the potential for improvement in underlying profit growth, the combination of the above can act as a governor on growth. If growth does lift off with an inflation follow through, central banks might have to respond with additional actions or their credibility might be called into question.
- Valuations are elevated. With flat earnings growth so far this year, strong stock market returns have resulted in the partial reversal of the valuation compression seen last year. The S&P 500 is now trading back above long-term forward valuation levels (19X P/E NTM versus 18X P/E NTM) and well above where multiples have typically bottomed during major



Source: Factset



valuation corrections over the last thirty years (10-15X). Of course, this has been most acute at the top of the market where the mega-cap growth stocks have seen more dramatic multiple expansion. This begs the question, will multiples begin to compress under the weight of the back up in rates especially at a time where there's now a real alternative to stocks (i.e. skinny equity risk premium)? To illustrate this point, the charts on the prior page show the relationship (over the last five years) between stock valuations (P/E NTM) and real yields (10 Year Treasury Inflation Protected – TIPs – Yield). The higher real yields go (inverted in the charts), the more stock valuations tend to compress. That's because interest rates are the key input for discounting future earnings to determine the present value of a company's stock price. The higher that interest rate, the more a company's future earnings must be discounted back. We've noted – boxed in red – the recent disconnect as real yields have continued to rise without a corresponding pull down on stock valuations. Not surprisingly, this disconnect has been more pronounced in the S&P 500 (market cap weighted) versus the equal weighted version of the index.

From our lens, stock valuations have priced in a soft landing scenario with greater risk in the most cyclical and growth oriented names should this not come to fruition. The most expensive stocks might be doubly at risk if the secular view results in perennially higher rates and a more volatile inflation backdrop.

Ultimately, late cycle backdrops are especially tricky as things are often good until they're not when at these inflection points. This doesn't mean that risk taking has to be completely absent though we find that it does mean that clear heads tend to prevail. As a result, to us, it still doesn't appear to be a great setup for significant risk taking – particularly in areas where there's a limited margin of safety.

So what are the implications and key takeaways for portfolios?

From a portfolio positioning perspective, we continue to believe that it's important to "See both the Forest AND the Trees". To us, that means managing the overall exposure and mix of risk assets consistent with a maturing cycle (i.e. Cyclical) while also being cognizant of the potential changing paradigm (i.e. Secular). While we entered this year with an UW to risk assets, we've let that UW lessen amid the year-to-date market rally as Fundamentals appear to be bottoming. Still, our composition within US Equities, US Core Fixed Income and Diversified Alternative managers remains more conservative in nature for the reasons cited above. Our overall portfolio bias has generally been to have more exposure to less expensive areas while maintaining conservative leanings.

Within equities, our positioning continues to favor a tilt toward the more traditionally defensive sectors (Staples, Health Care, Utilities) with a lesser lean toward cyclical value (Energy, Industrials, Materials) within our US LC exposure. We continue to be decidedly UW the most expensive, cyclical growth areas (Tech, Discretionary, Communication Services) as investors have taken on a "Heads I Win, Tails You Lose" mentality with speculative fervor.



Within fixed income, we remain UW the most cyclical parts of the bond market (High Yield and Emerging Market Debt) while our US Core Fixed Income exposure remains among our biggest OW in portfolios. Our US Core Bond managers are slightly OW corporate bonds, though we've previously moved up in credit quality by adding some Treasuries and lengthening duration consistent with a downshifting of risk in portfolios.

Within alternatives, we're slightly OW in aggregate with a bit more defensive skew. We remain OW to Diversified Alternatives which provides some hedge against market volatility (especially in an environment where there's lower correlations between stocks and bonds). We're generally EW to Commodities as a way to bolster inflationary hedges. Meanwhile, we're slightly UW Real Estate as a way to further reduce overall portfolio risk.

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