

Research Triangle AAI

July 23, 2022

High Valuations, Future Returns and A Fed Policy Mistake: What's an Investor to Do?

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John earned a BA from Davidson College and a PhD from UNC-Chapel Hill. He has held faculty positions at the University of Virginia's Darden Graduate School of Business Administration and UNCG's Bryan School of Business and Economics. John's practical experience includes trading commodities for a NYC investment bank and relationship and investment management roles for private wealth and family office firms. He holds the Chartered Financial Analyst designation and is a member of CFA Institute and the CFA NC Society. John serves his community on the Finance and Administration Committee of the United Way of Greater Greensboro.

Since 1928, Piedmont Trust Company has served as the family office for a large Greensboro-based family now in its sixth generation. Piedmont also works with other multi-generation families to meet their investment management, fiduciary, tax planning, foundation administration, and estate and financial planning needs.

July 2022 Discussion Agenda

Personal Declarations

- Like you, I am an individual investor & am speaking as such, not for Piedmont
- I am a long-term optimist on the economy & markets, but wary of the adjustment required to exit current policies & return to anything like “normal” policy and economic growth
- Policy makers at the Fed & in both political parties bear responsibility for our current economic environment; for years, fiscal, monetary & regulatory policies have stymied the activity of free market-based capitalism

Key Question #1—what do current valuations mean for expected return & asset allocation?

Bottom line—beginning valuation critical to long-term realized returns

- Even after year-to-date decline, asset valuations may not reflect future earnings prospects
- Policy-inspired excess liquidity now being drained by QT; no historical comparison
- Many investors have yet to behave as if they expect more downside; how about some “shock absorbers” in your portfolio?

Key Question #2—how will the Federal Reserve exit decades of easy policy?

Bottom line—policy makers have been reluctant to disappoint markets; will they have “the courage to act”

- The Fed completely whiffed on persistent inflation
- What if recession arrives, unemployment rises, and inflation is still too high?
- Are central banks trapped by history of ZIRP and debt-financed fiscal stimulus?

Key Question #3—does Fed inflation target have theoretical foundation and real benefit?

Bottom line—now seeing result of excess stimulus, massive bond purchases, plus supply chain disruptions

- “I think we now understand better how little we understand about inflation.” Jerome Powell, June 2022
- Why did the end of deflation in goods prices due to China surprise policy makers?
- Current environment is the definition of a policy mistake by the Fed

Key Question #4—do fiscal deficits matter?

Bottom line—yes, but not until they do!

- We are living through **real-time experiment in MMT**
- The world has witnessed several previous experiments; all ended in tears
- But, why is the dollar so strong and how will it impact corporate earnings?

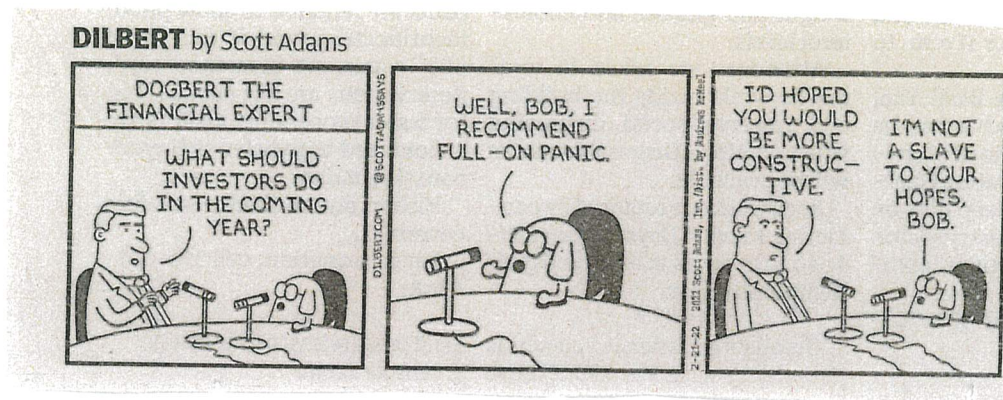
Key Question #5—what can an individual investor do to manage risk?

Bottom line—know your goals, time horizon & risk tolerance

- Have appropriate exposure to equities and a cash reserve for known needs
- Even if returns are low for next decade, that doesn't mean there won't be opportunities
- **Do not give up on active management, global diversification & alternative strategies**

Summary

- Disruption from big trends like tech, biotech and AI are real & will ultimately prevail, but resetting valuations driven by unhinged policy will be painful and may take some time
- Continued growth of entitlement spending & unfunded obligations (at all levels of government) creates real risks to your financial health
- Be educated & involved in our national & local fiscal debates.
- Be proactive & educated in your personal fiscal situation (distribution planning!)



The stock does not know you own it!

July 2022 Summary

Investment Opportunities

- Alternative strategies that hedge downside risk have come with opportunity cost in recent years, but will be useful going forward
- Volatility has remained relatively low with hedges relatively inexpensive; don't expect it/them to stay that way forever
- Value strategies have lagged, but don't give up; reversion to mean not dead!
- Active management lagged during this extended bull cycle, but will regain its mojo as volatility and dispersion continue and increase
- If dollar resumes its decline, non-U.S. markets will benefit; many emerging market countries have bright prospects, but please don't index!

Investment Risks

- Belief that "this time is different" led investors to assume: (1) high valuations are permanent; (2) the Fed can banish economic cycles and bear markets; and (3) you can borrow & spend your way to prosperity
- Stocks are still not cheap based on valuation metrics with strong historical records of correlation with future *realized* returns; even from current valuations, investors have realized poor *long-term* returns
- Crowded trades: mega-cap tech, profit-less tech, crypto, meme stocks, factor-based strategies, etc.
- Lack of liquidity, particularly in fixed income markets, makes for "brittle" markets
- Investors in covenant-lite debt structures will rue the day
- Belief that China's policy makers will to get it right consistently; remember Japan in the 1980s?
- Geopolitical risks to long supply chains now obvious
- Domestic political risks abound, especially around tax, regulatory and trade policy
- In America, there is no constituency for pain; what happens in a real bear market (is it today)?

Consider this:

In 1991, an investor's portfolio could have 98% in cash and 2% in fixed income to generate an expected 7% return with a standard deviation of 1.1%. Today, in comparison, an investor is required to include 90+% in growth assets to earn the same return of 7.0% in 2022, but this more complex mix of growth assets could come with a standard deviation of 17%. Put simply, you must take on much more risk to achieve a 7% return today. A little defense may be in order.

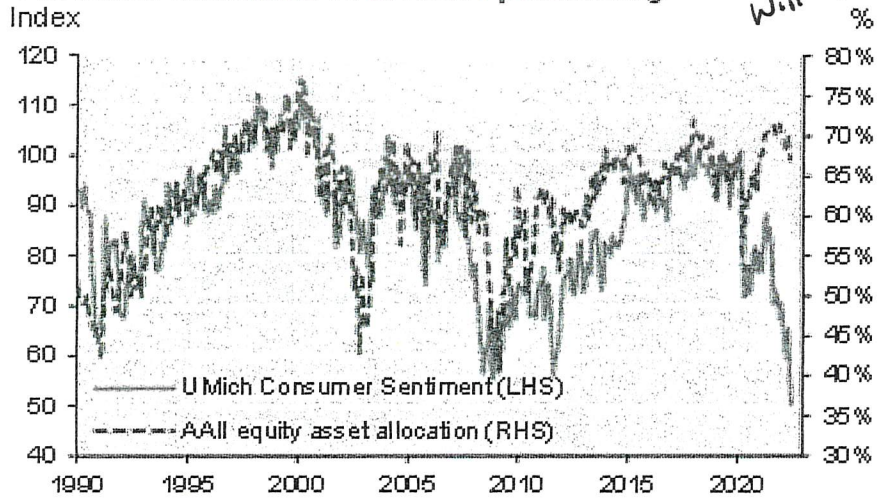
Quiz:

Name an item that people buy less of when its price is cut 40% - 50%?

Reminder:

The volatility of price is greater than the volatility of value.

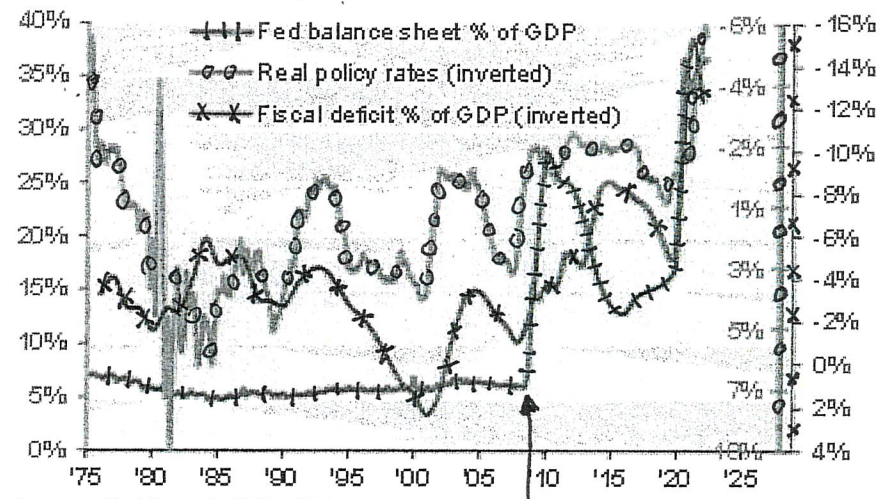
Consumer sentiment vs investor positioning



Source: University of Michigan, AAll, Bloomberg, JPMAM. June 2022.

Large gap - which way will it correct?

The end of the Gargantua era



Source: Fed Board, BEA, OMB, BLS, Shiller, JPMAM. May 2022

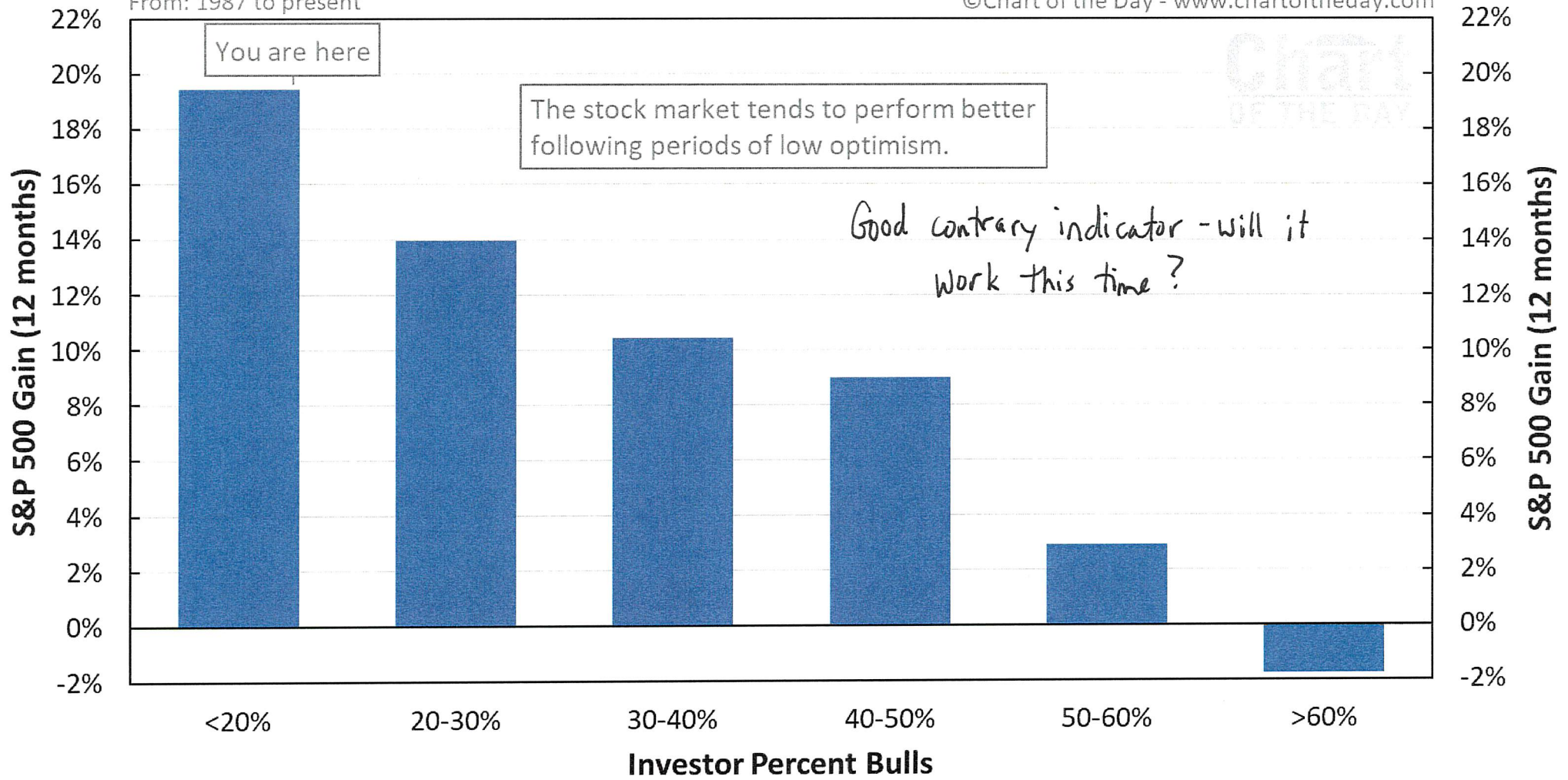
Negative real rates for a decade - what could possibly go wrong?!

The Fed became all-purpose bail-out agent.

S&P 500 12-month Gain vs AAll Bulls

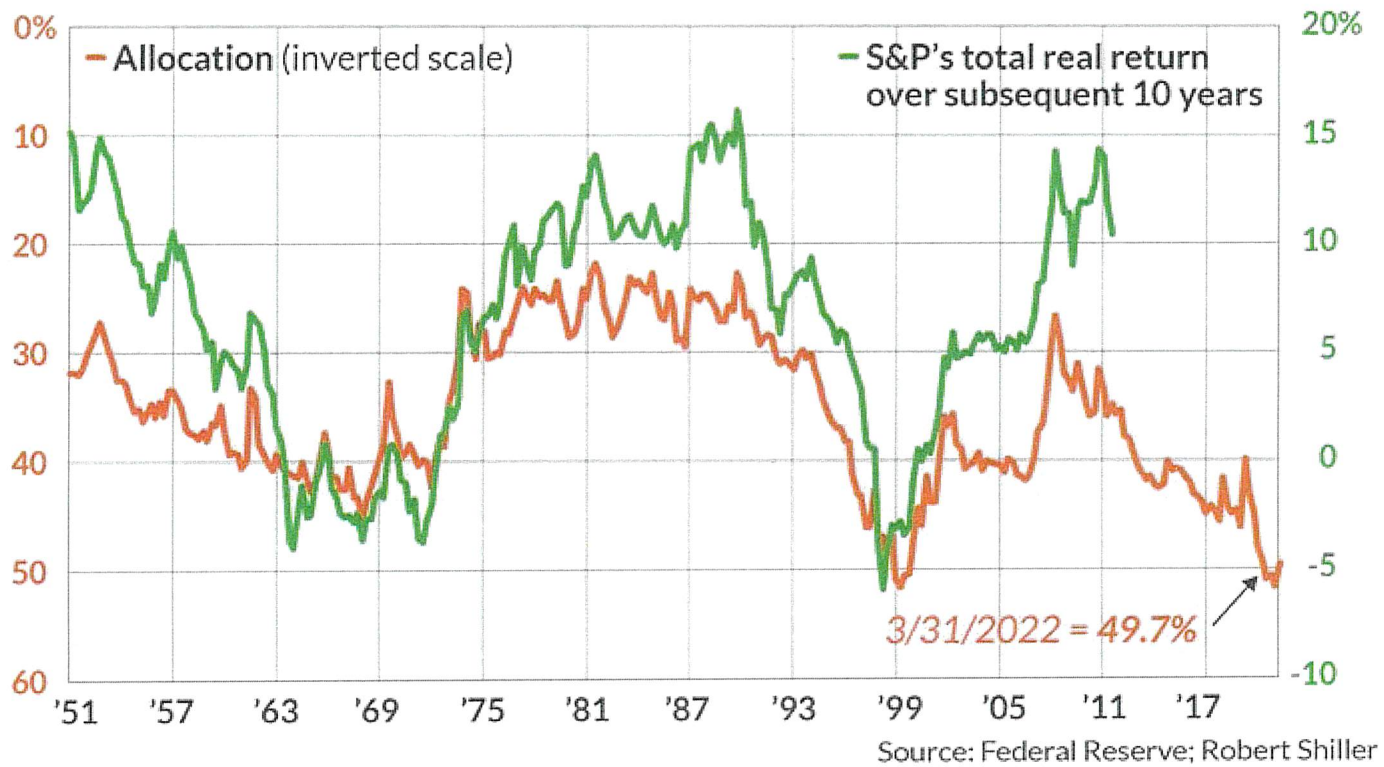
From: 1987 to present

©Chart of the Day - www.chartoftheday.com



Watch out below!

U.S. household equity allocation versus S&P 500's inflation-adjusted total return over subsequent 10 years



Uh oh, a different contrary indicator.

Even after this year's decline, valuations still high.

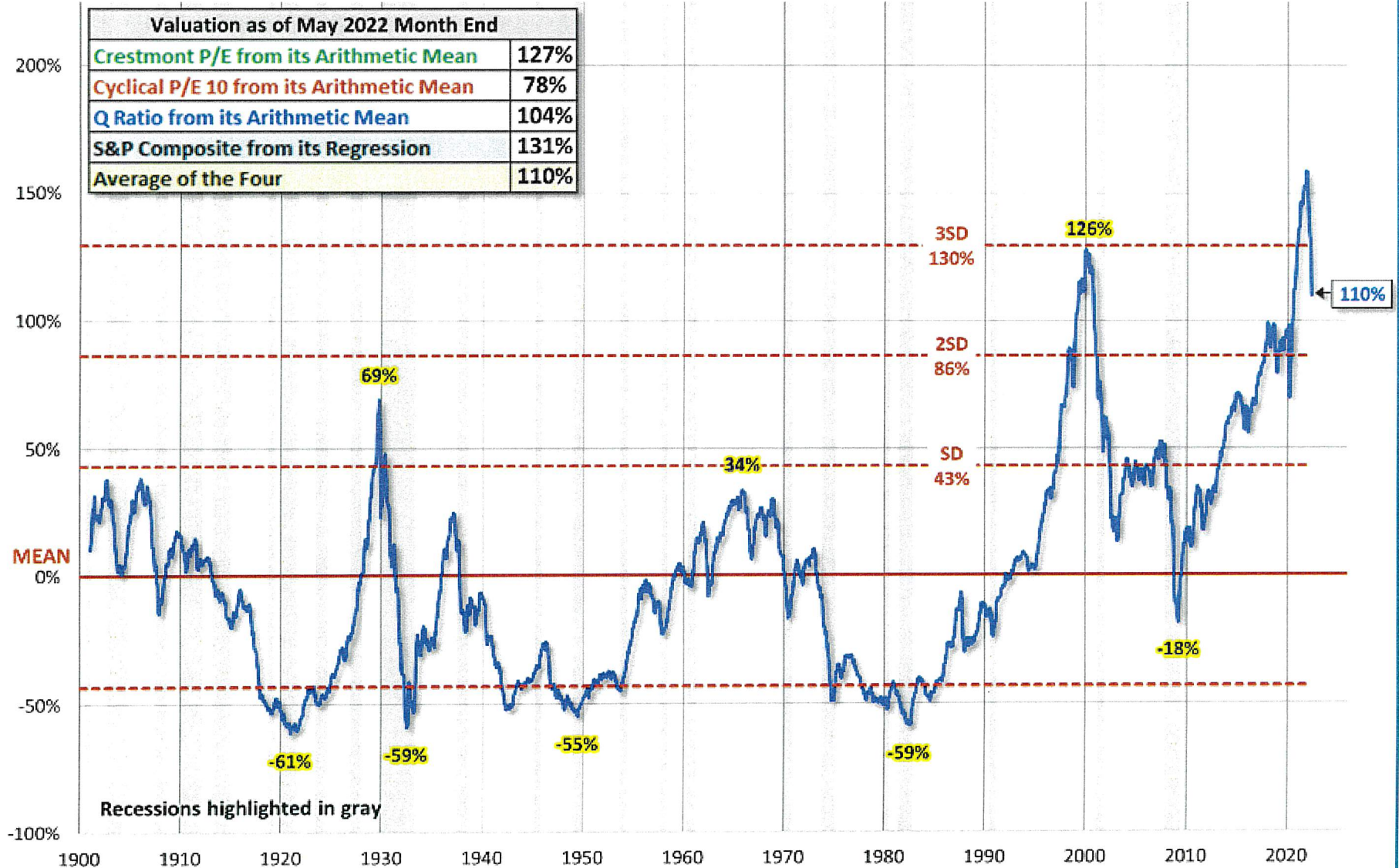


Ditto!

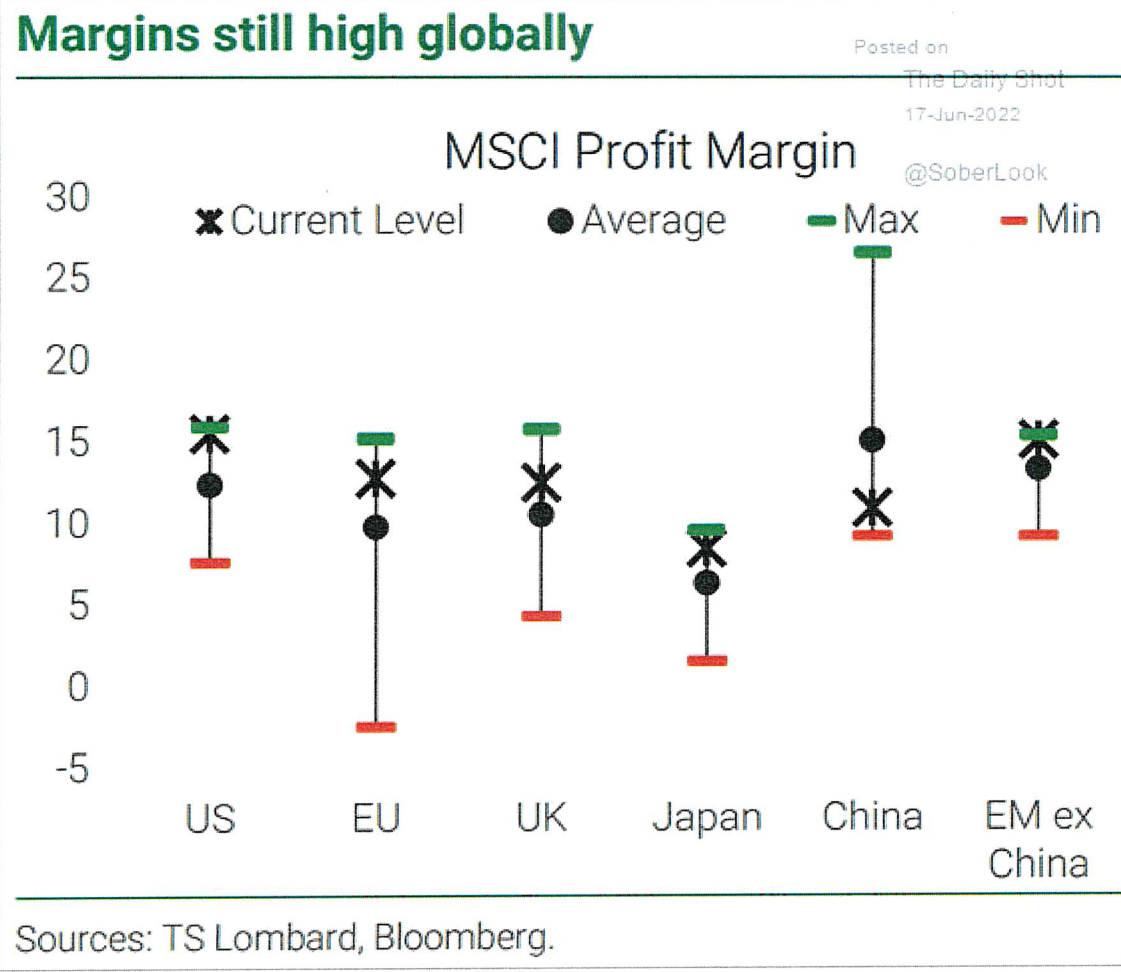
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Average of the Four Valuation Indicators

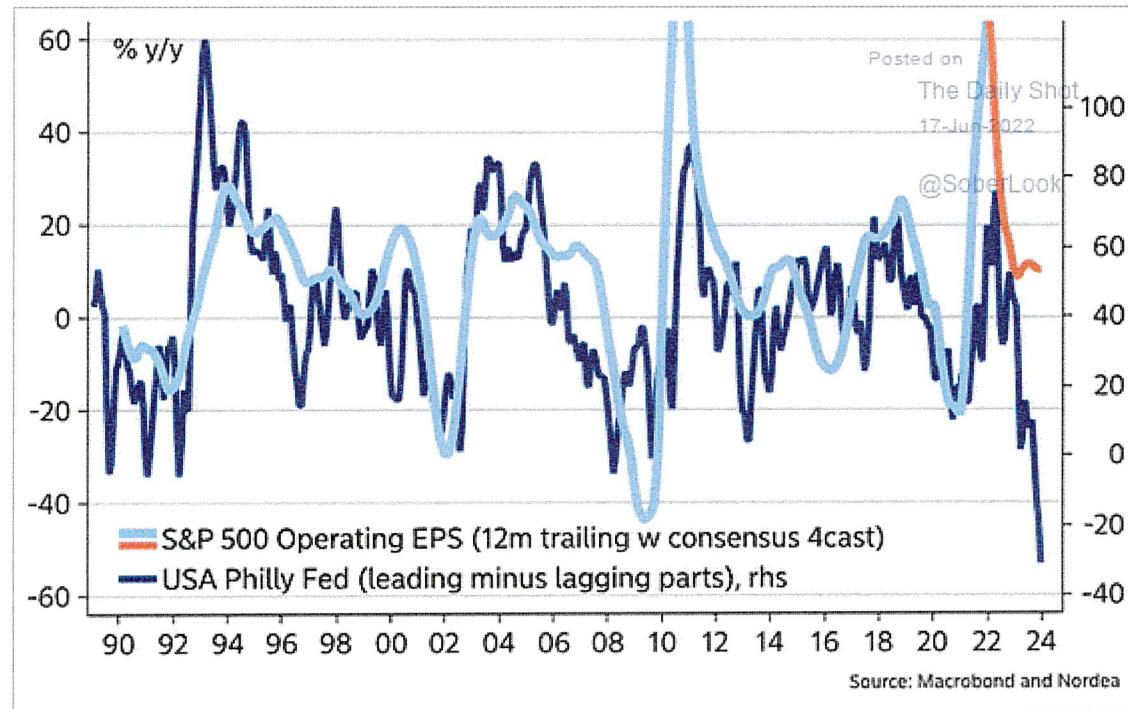
With Standard Deviations Highlighted



Will profit margins remain historically high?
Big impact on earnings.



Philly Fed readings say Operating EPS
due to fall markedly.



\$SPX S&P 500 Large Cap Index INDX
31-Oct-2002

© StockCharts.com

Open 890.71 High 898.83 Low 879.75 Last 885.76 Volume 2.1B Chg -4.95 (-0.56%)



Bear market rallies can be seductive. Some are very large!

@CharlieBilello

\$SPX S&P 500 Large Cap Index INDX
31-Mar-2009

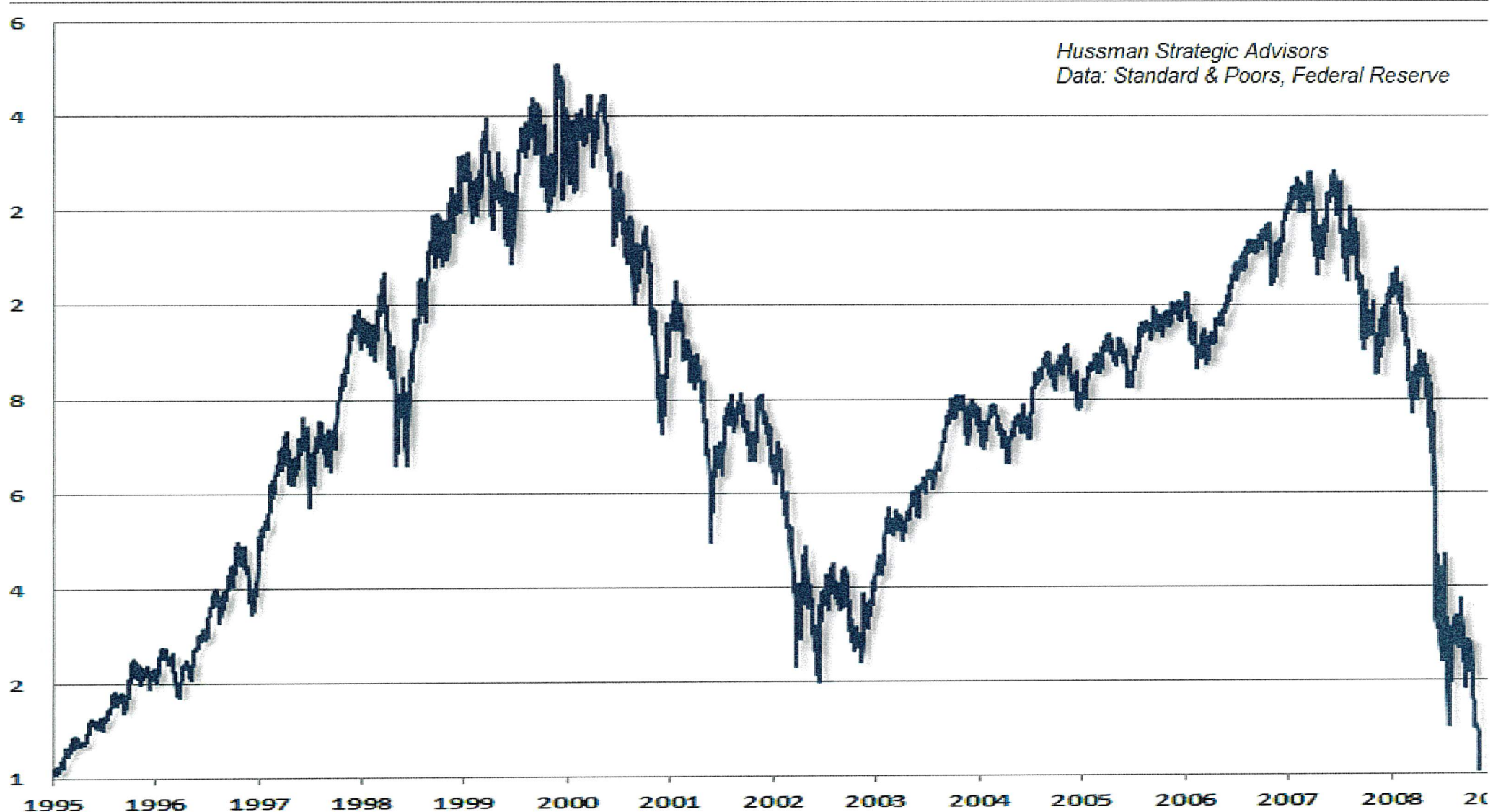
© StockCharts.com

Open 790.88 High 810.48 Low 790.88 Last 797.87 Volume 5.2B Chg +10.34 (+1.31%)



@CharlieBilello

Don't think T-bills can outperform stocks
over a 15-year period?

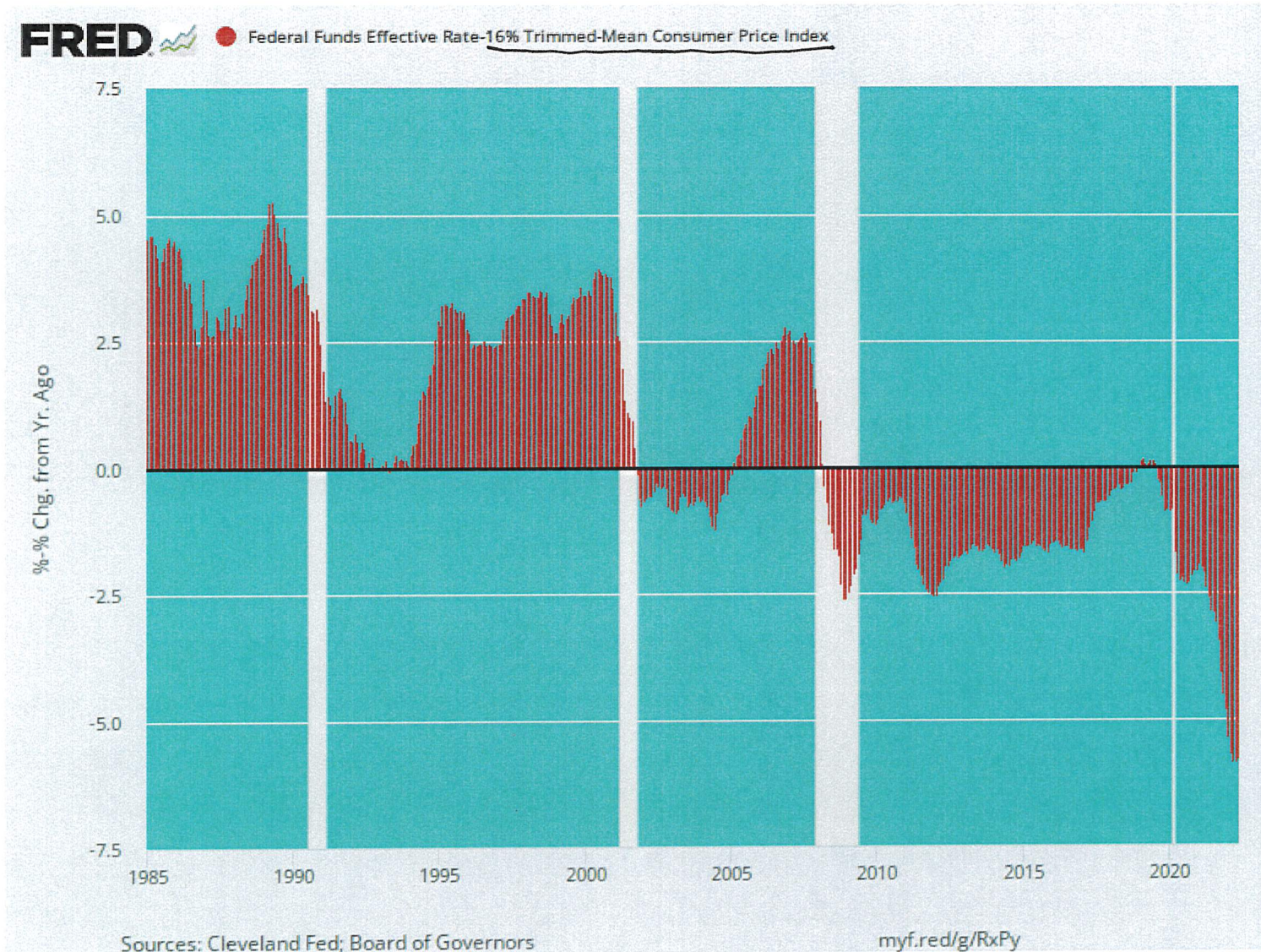


Hussman Strategic Advisors
Data: Standard & Poors, Federal Reserve

Cumulative total return of S&P 500 Index / Cumulative return of 3-month Treasury bills: May 1995- March 2009

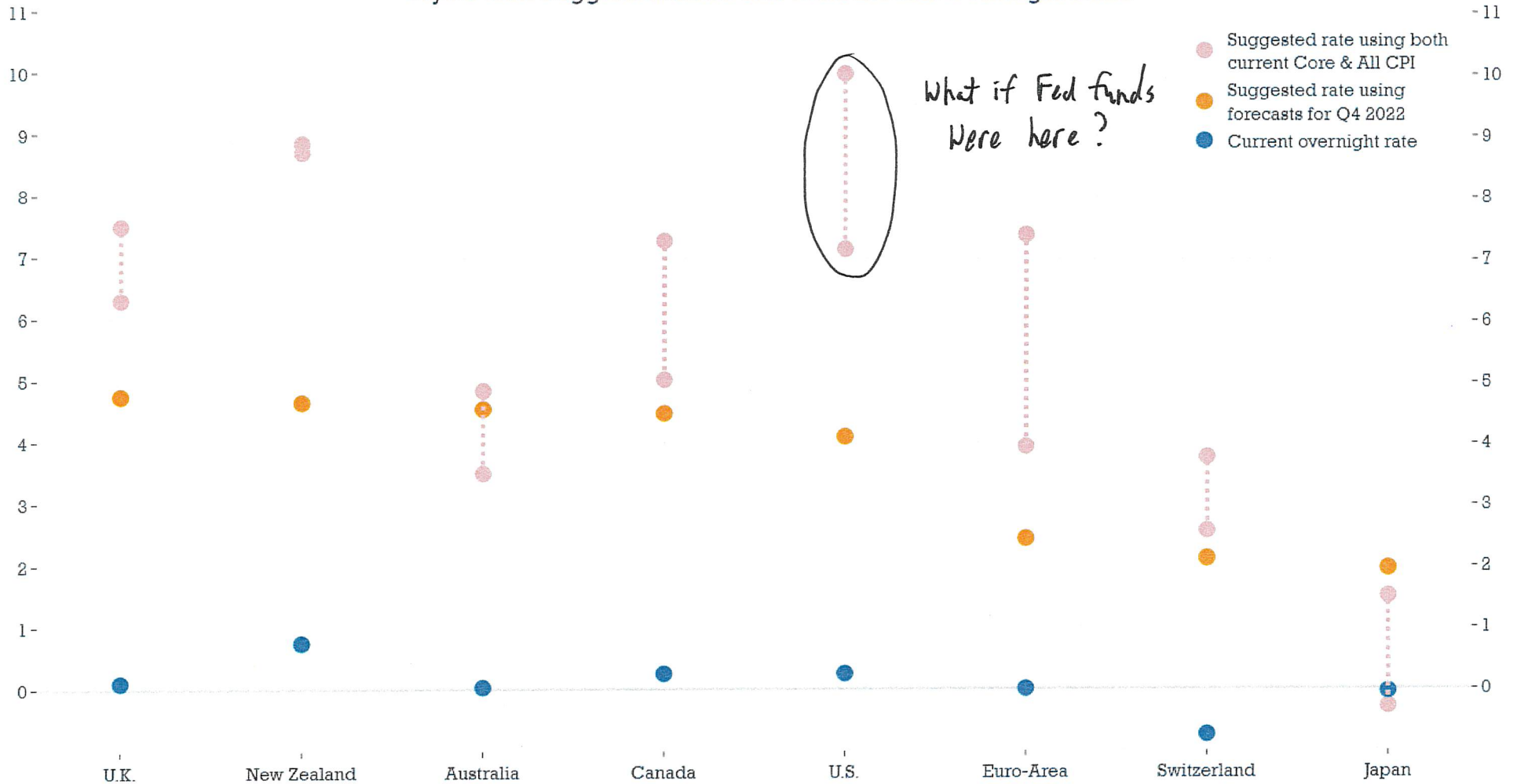
Another look at real Fed funds rate using a different version of the CPI.

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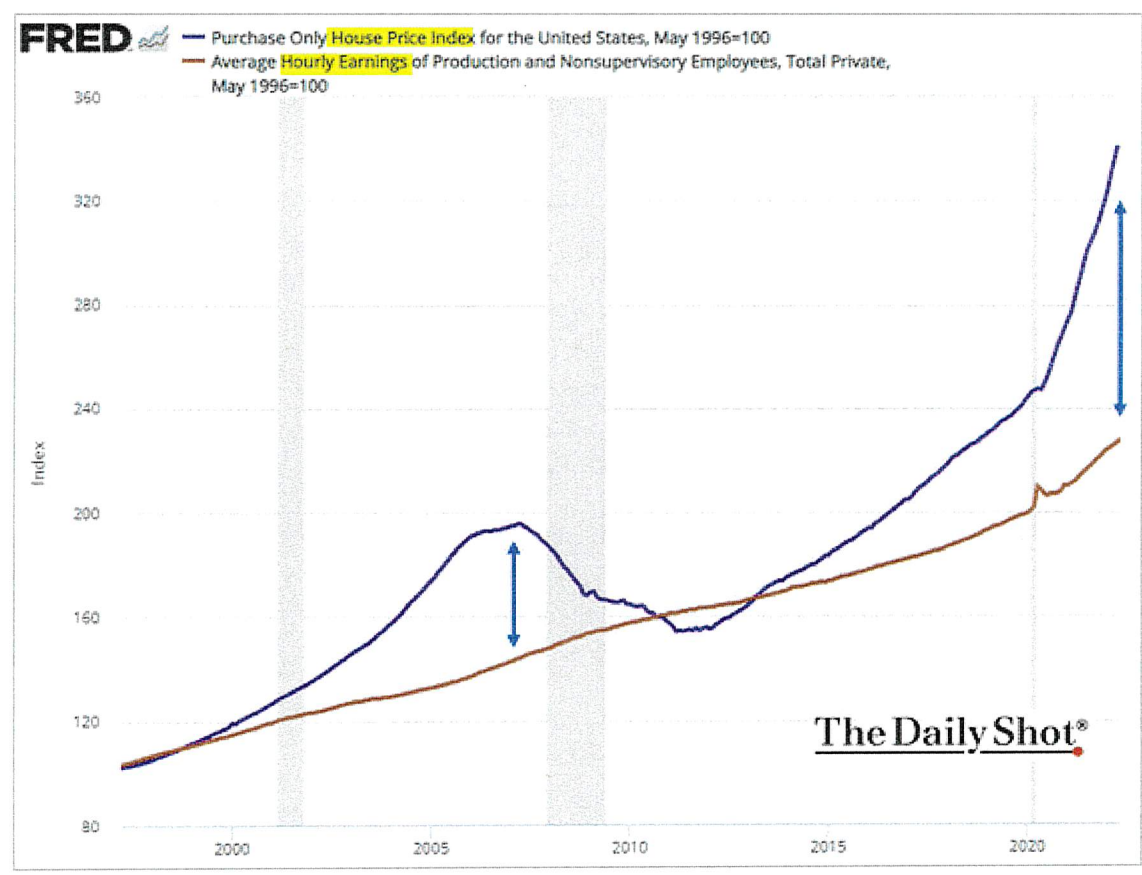
Rule-based monetary policy vs discretionary monetary policy.
Chart is from late last year, but you get the message.

Taylor Rule Suggested Rates and Central Bank Overnight Rates



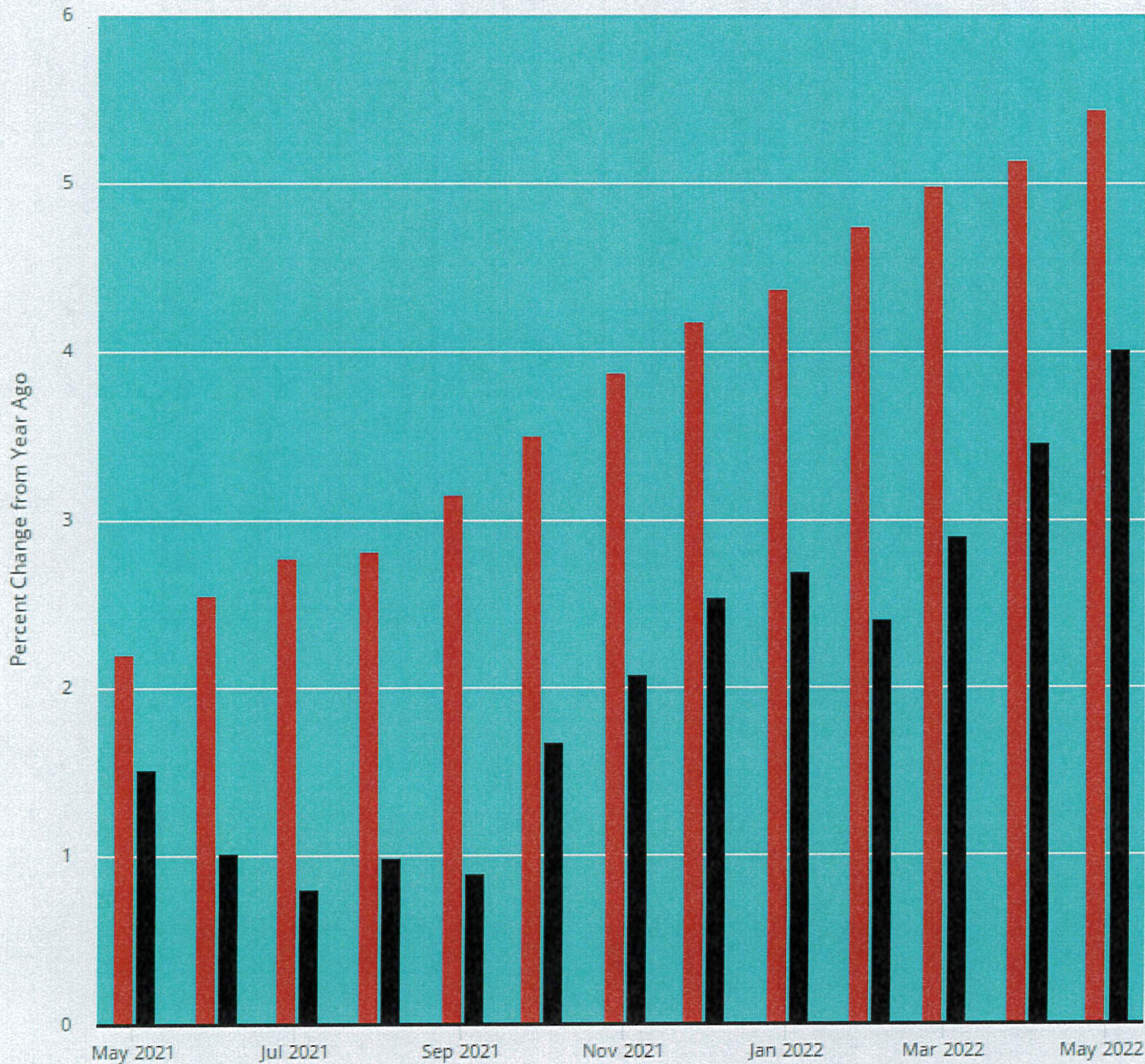
All estimates assume a 1% real rate. NAIRU's are an average of Bloomberg and OECD estimates, except U.S. which uses 4%. Calculations based on Bloomberg collected forecasts.

Don't earnings have to ultimately support asset values?
Housing affordability is tough today!



FRED

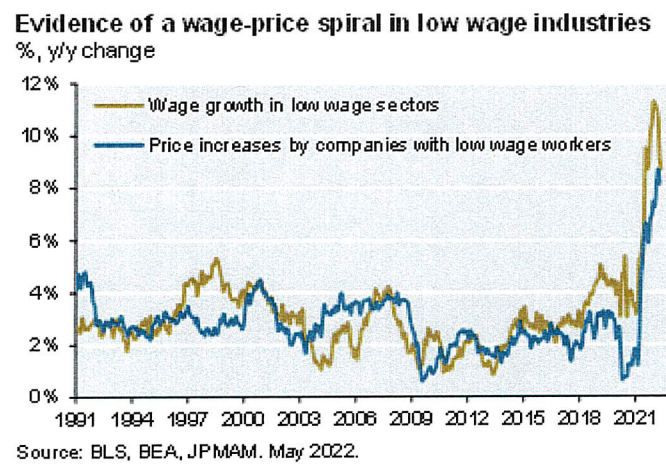
- Consumer Price Index for All Urban Consumers: Shelter in U.S. City Average
- Consumer Price Index for All Urban Consumers: Medical Care Services in U.S. City Average

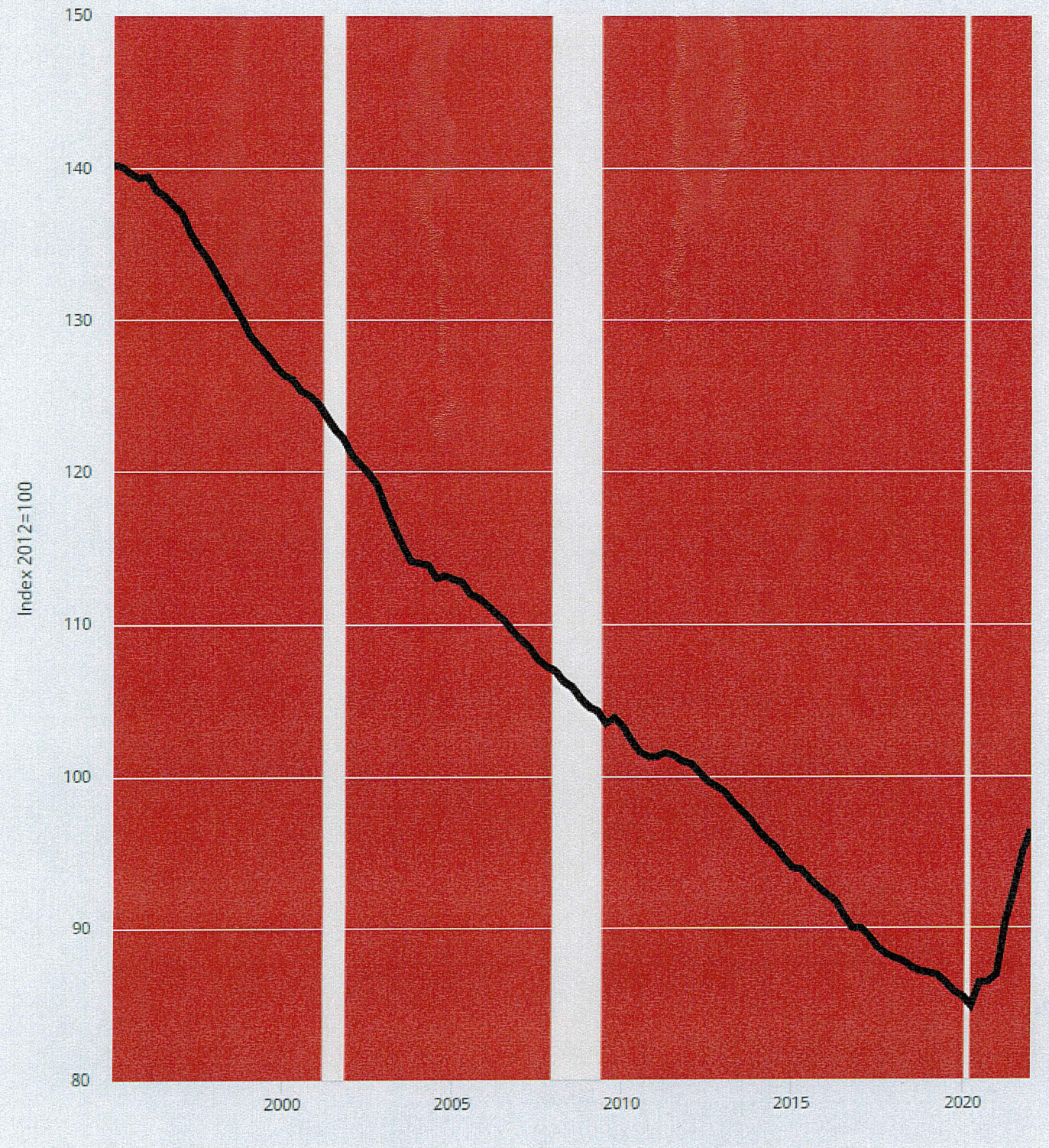


Source: U.S. Bureau of Labor Statistics

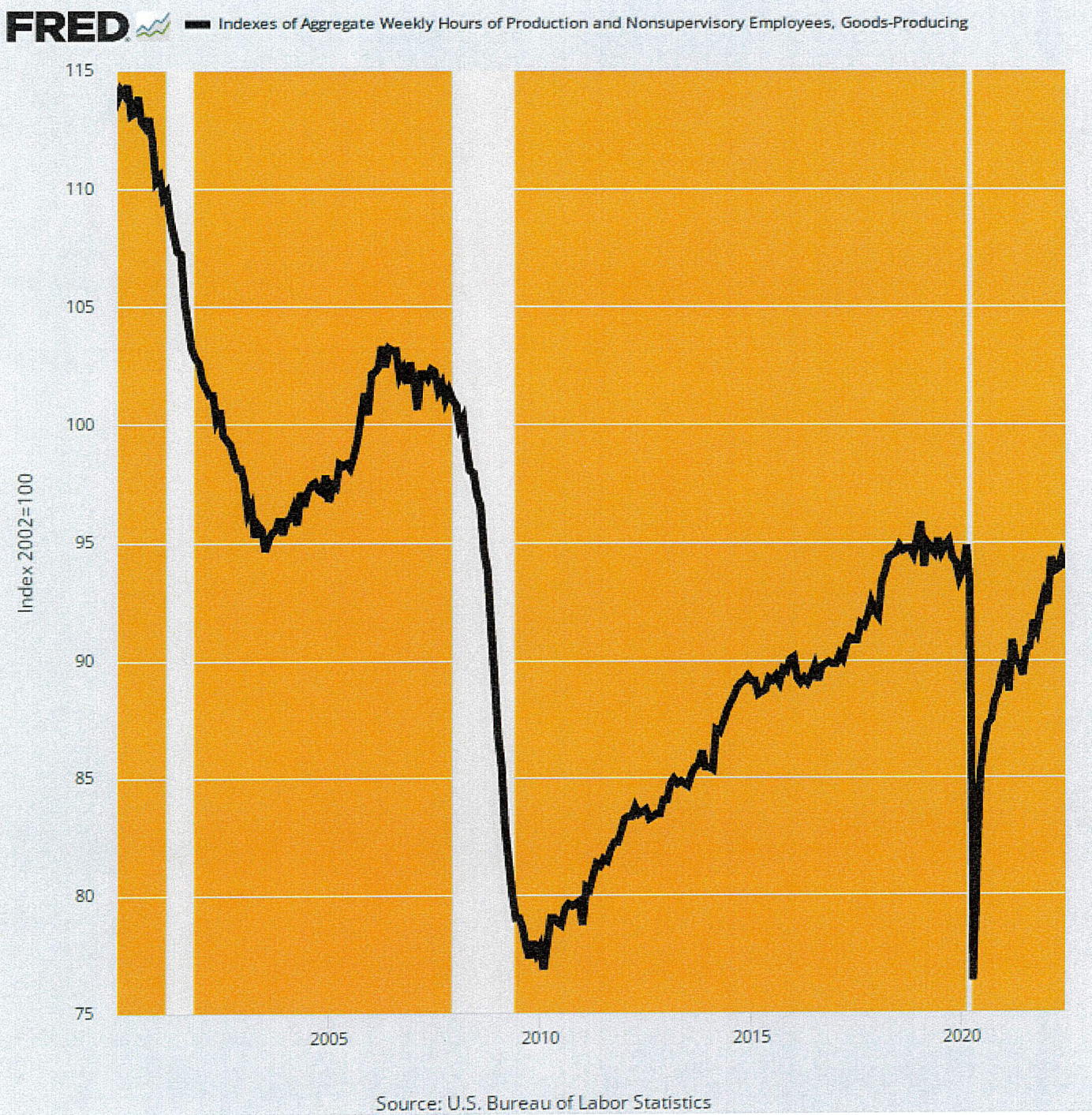
Even if gas prices fall, other larger components of CPI headed higher. Food, anyone?

Fed's fear is a wage-price spiral. It's here in low wage industries. What if it spreads?





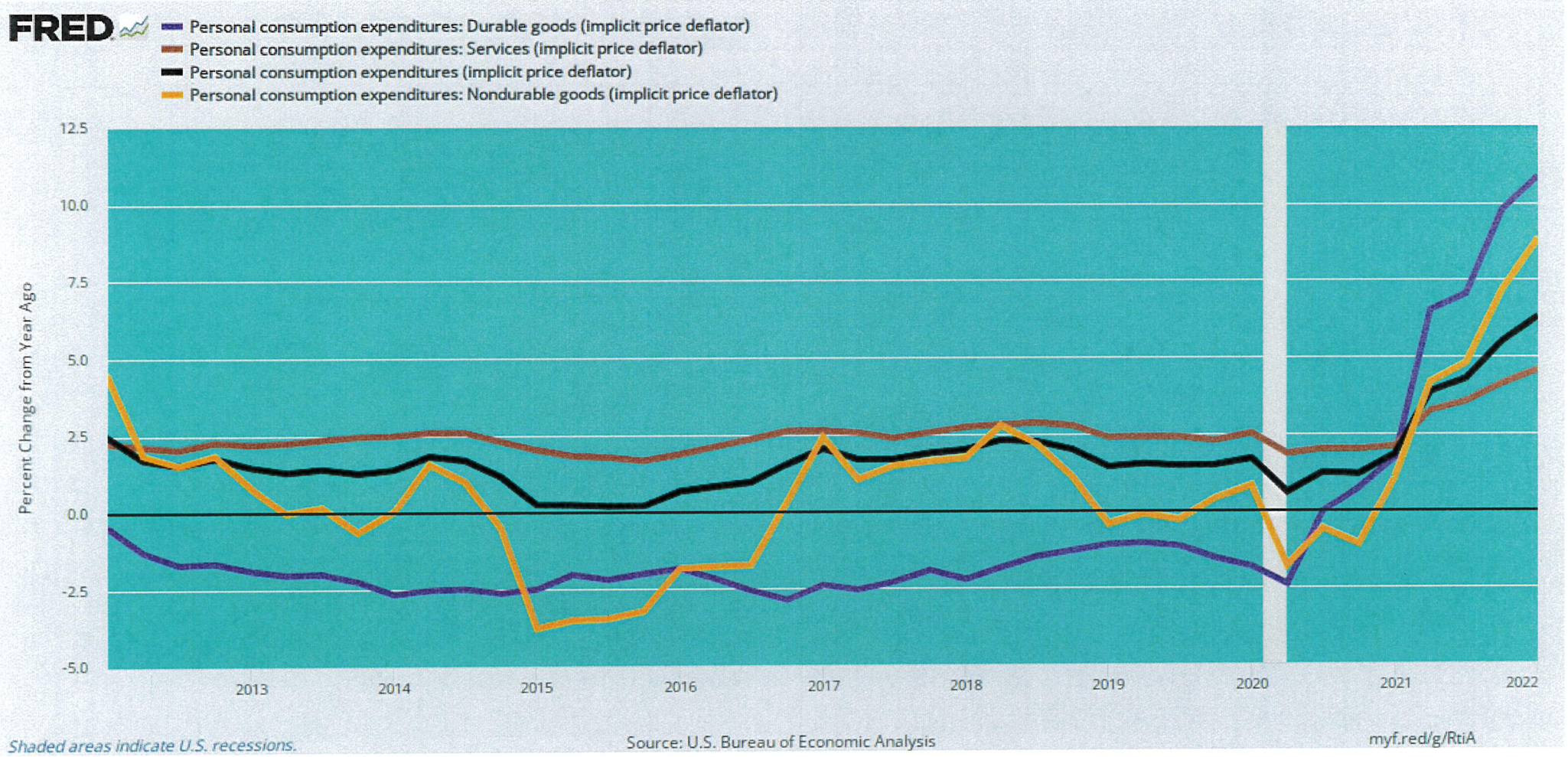
Why did prices of durable goods decline for 20 years? China!
 What happens when supply chains come home?

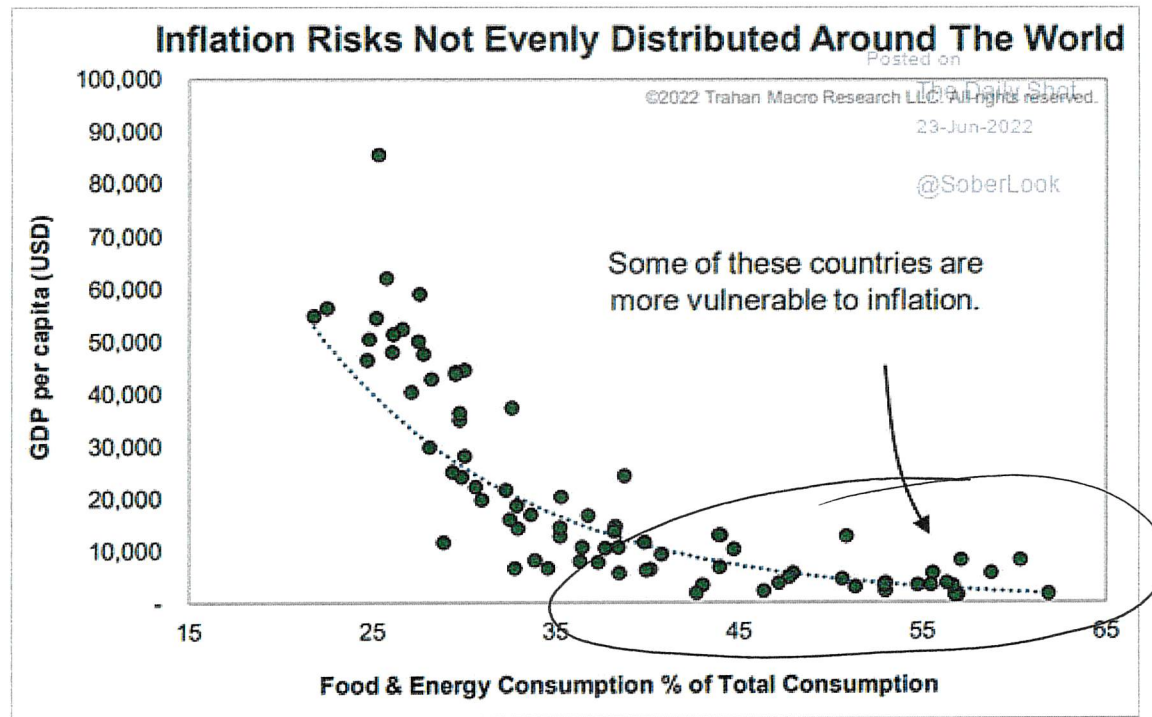


We off-shored a lot of manufacturing to low wage countries.

It's coming back, but how quickly? And at what impact on inflation?

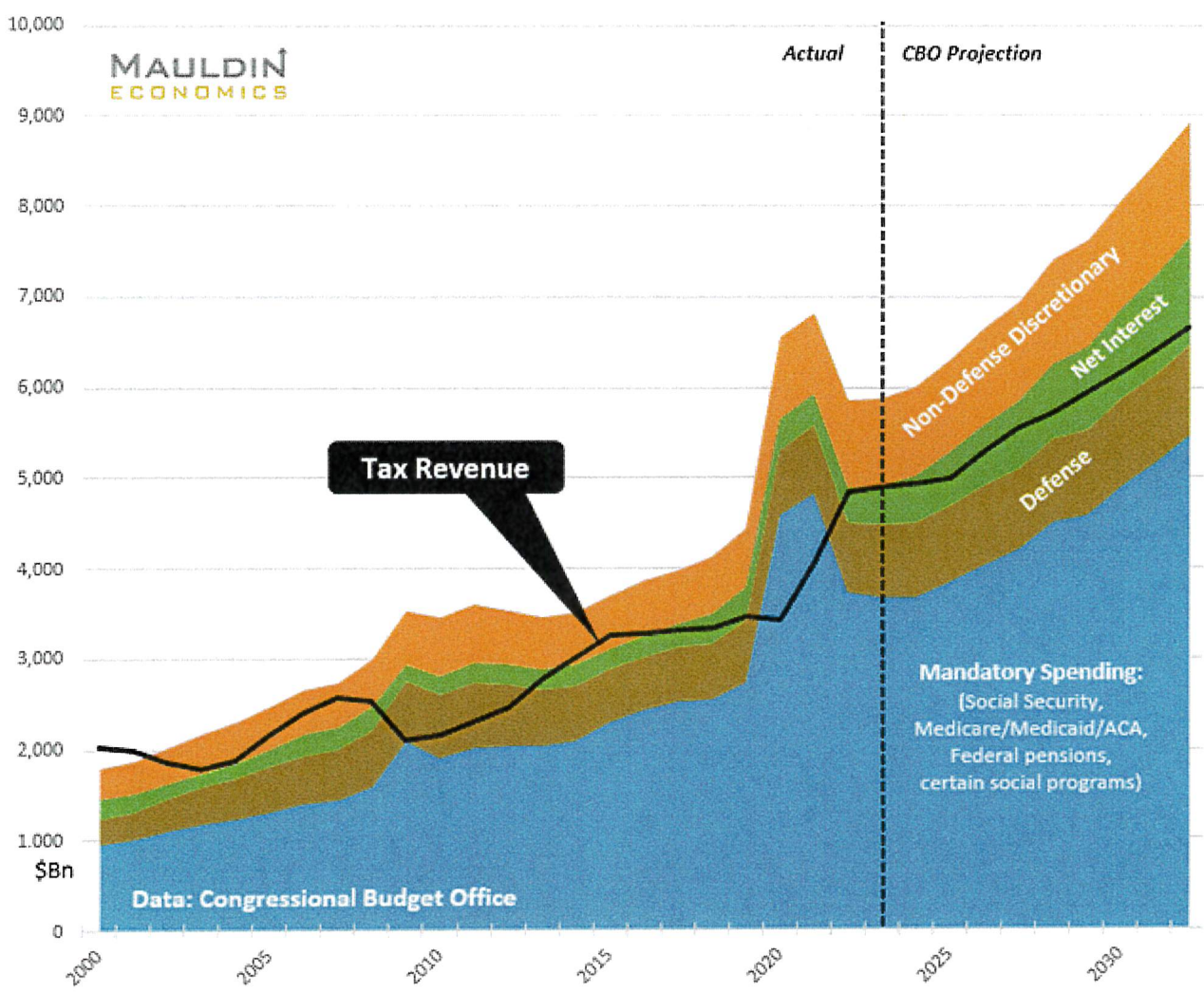
Another look at durable goods prices, plus services & non-durables. Look what rising fastest.





This is real risk world faces today. Really amplified by Russia vs. Ukraine.

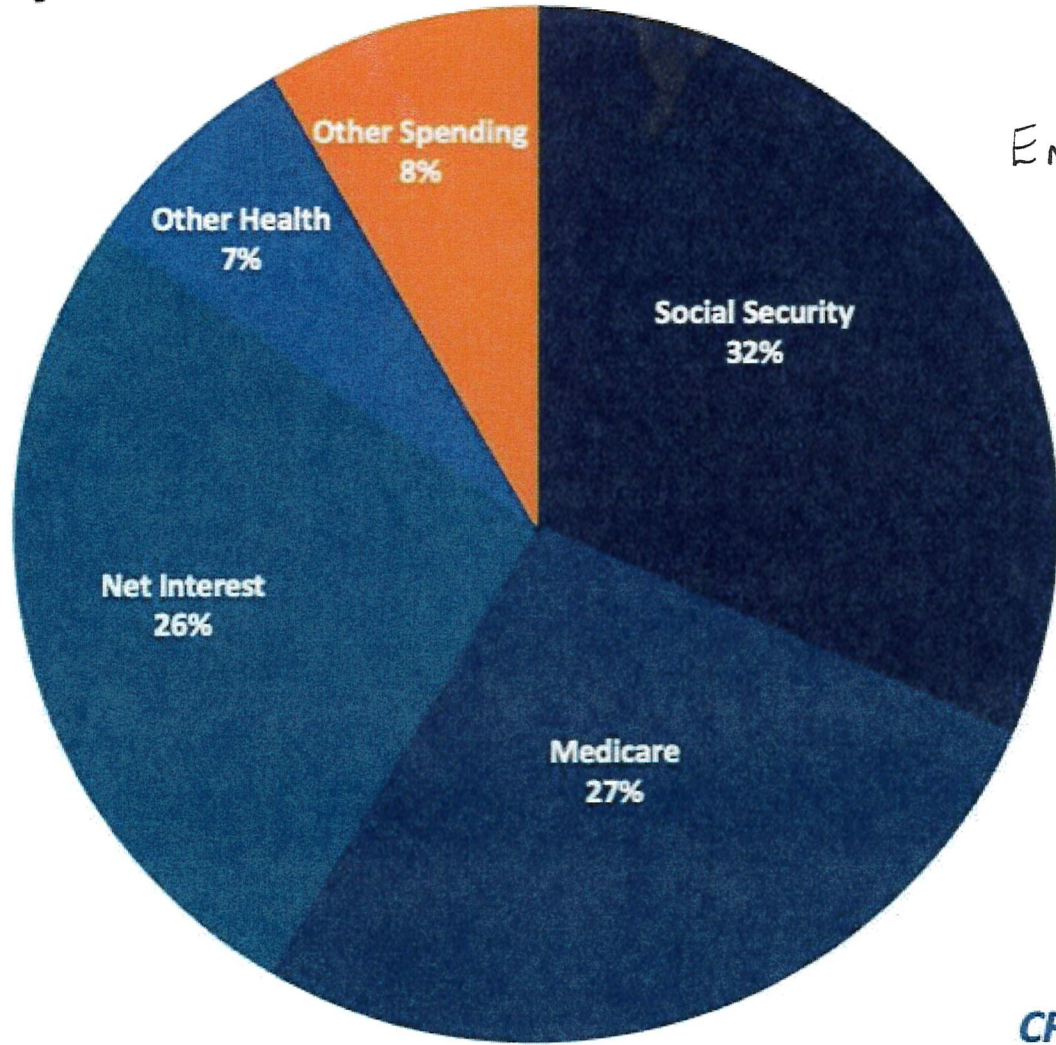
Federal Spending vs. Tax Revenue, 2000-2032



Can we really do this?

Social Security, Health Care, and Interest Explain 92% of Projected Spending Growth

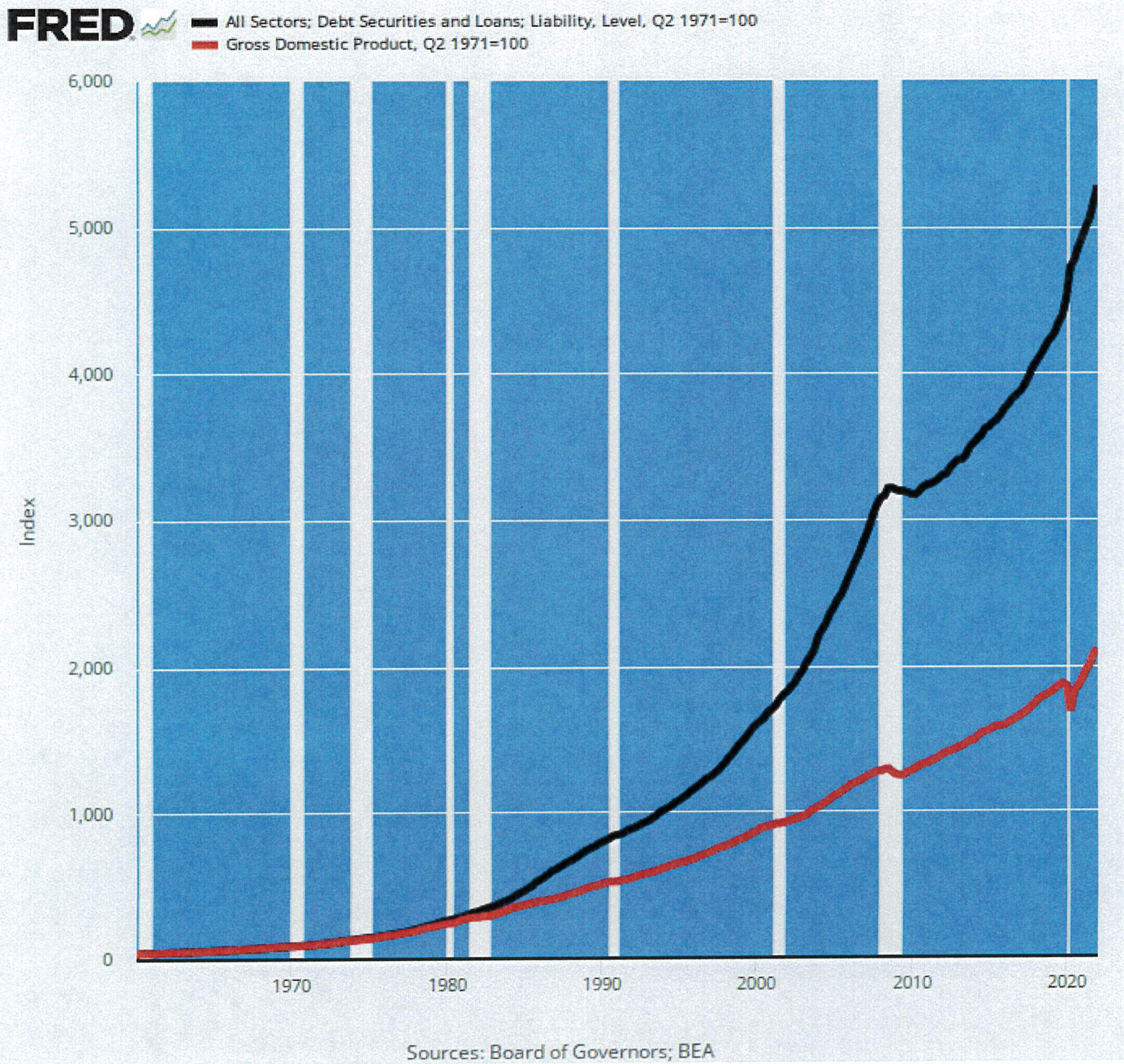
2022-2032 Nominal Spending Growth Under Current Law



Entitlements!
I want my 8%-10%
Social Security bump
next year!

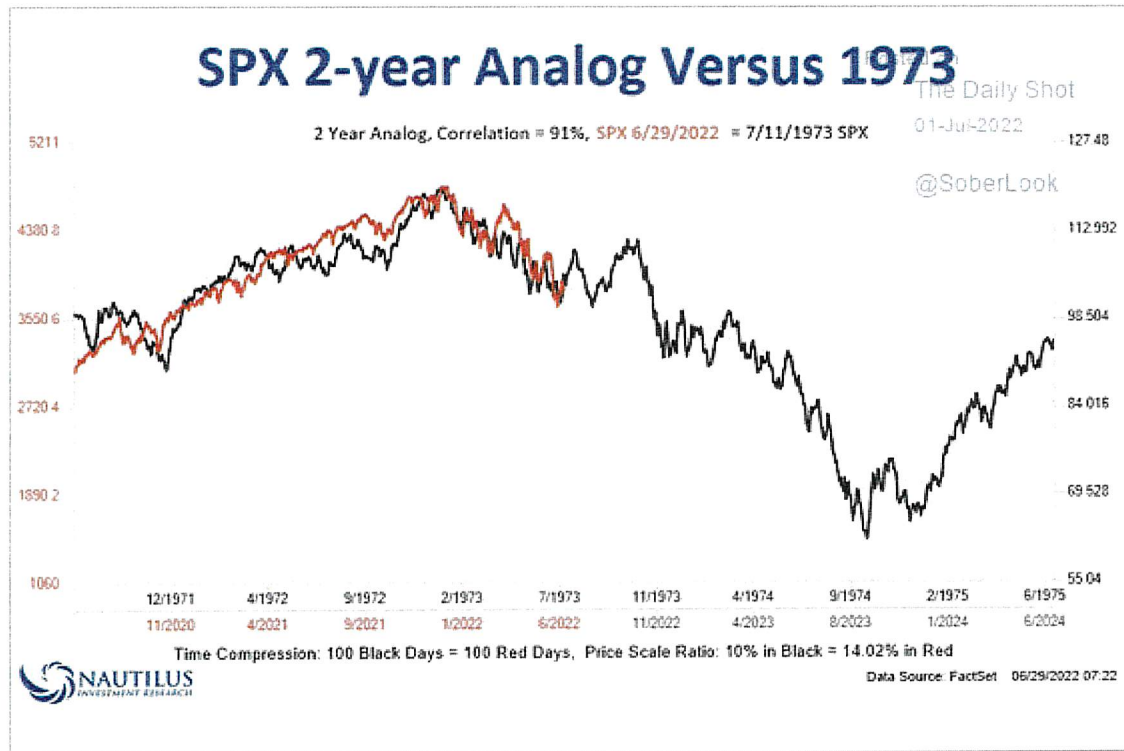
Source: Congressional Budget Office.





Enough "income" to support the debt? What is the limit?

Interesting historical analog. Not a prediction, but it gives you something to think about as you manage your portfolio.

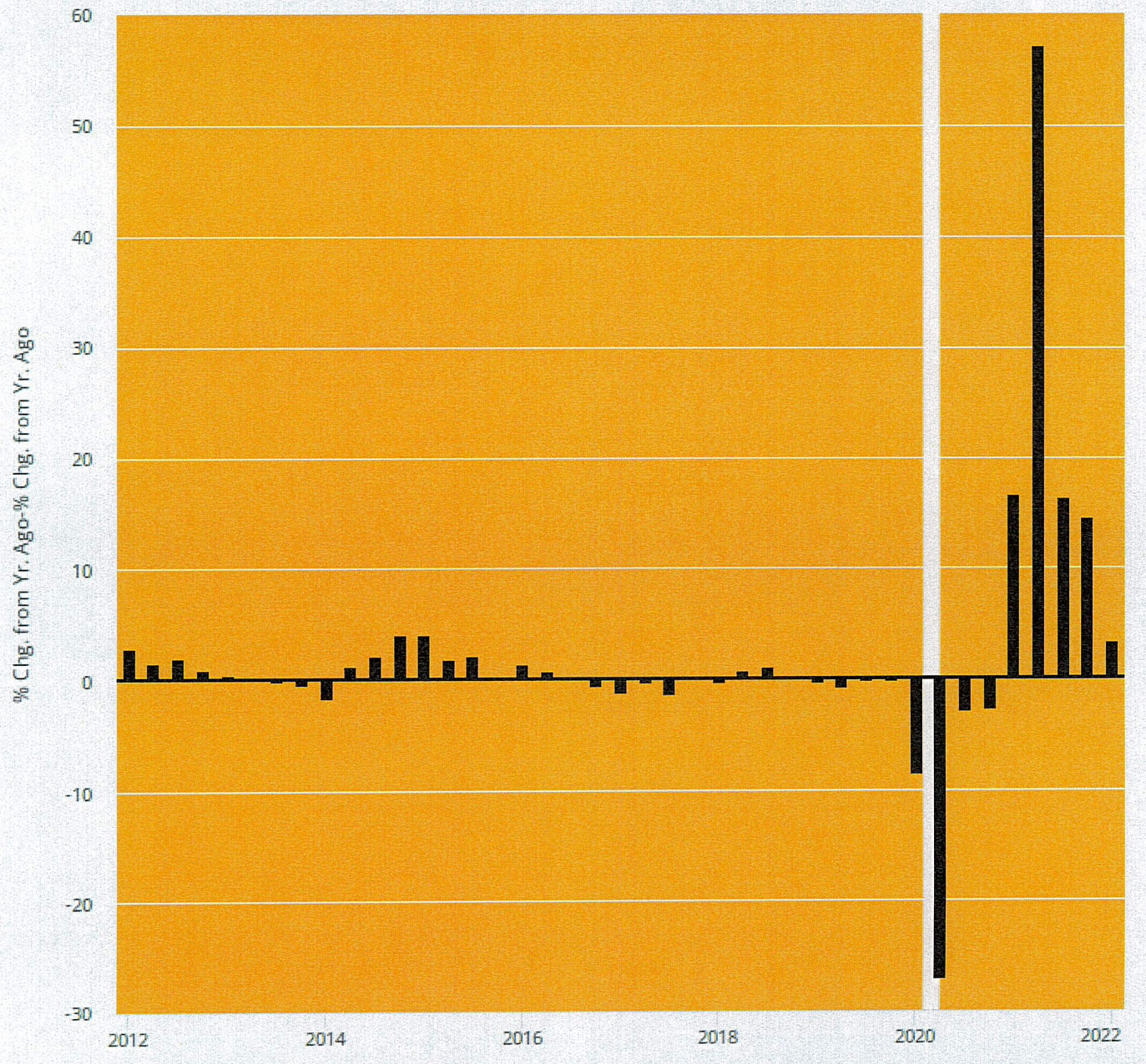


Yikes! Fixed income is supposed to help when stocks are down.

@CharlieBilello		Bond ETFs: Durations, Yields and Returns						
Data Source: YCharts as of 6/10/22				Total Returns (>1 Year = Ann.)				
Category	Ticker	Duration (Years)	30-Day SEC Yield	2022 YTD	1-Year	3-Year	5-Year	10-Year
1-3 Month Treasury	BIL	0.1	0.5%	0.0%	0.0%	0.5%	0.9%	0.5%
Floating Rate IG	FLOT	0.1	0.9%	-0.8%	-0.7%	0.8%	1.4%	1.2%
Short Duration IG	GSY	0.7	1.7%	-1.1%	-1.2%	0.8%	1.5%	1.4%
1-3 Year Treasury	SHY	1.9	2.4%	-3.3%	-4.0%	0.1%	0.7%	0.6%
Leveraged Loans	BKLN	0.1	4.2%	-4.1%	-3.1%	1.0%	1.8%	2.6%
Inflation Protected	TIP	7.4	12.4%	-6.6%	-2.7%	4.1%	3.5%	1.8%
Municipal	MUB	5.4	2.8%	-7.7%	-7.8%	0.2%	1.4%	2.1%
3-7 Year Treasury	IEI	4.7	2.8%	-7.9%	-9.4%	-0.7%	0.5%	0.9%
Commercial Mortgage	CMBS	4.7	3.1%	-8.7%	-10.0%	-0.3%	1.1%	2.0%
Mortgage Backed	MBB	6.0	1.9%	-9.0%	-9.7%	-1.4%	0.1%	1.0%
International	BNDX	8.0	1.8%	-10.5%	-10.8%	-2.0%	0.5%	N/A
US Aggregate	AGG	6.8	2.9%	-10.5%	-10.6%	-0.8%	0.7%	1.5%
US High Yield	HYG	3.9	6.5%	-11.4%	-9.9%	0.3%	1.8%	3.8%
EM Local Currency	EMLC	4.7	6.9%	-11.9%	-19.4%	-4.6%	-2.9%	-1.6%
7-10 Year Treasury	IEF	8.0	2.8%	-11.9%	-12.1%	-1.3%	0.3%	1.0%
US Investment Grade	LQD	9.3	4.3%	-15.7%	-15.3%	-0.4%	1.3%	2.7%
EM High Yield	HYEM	3.8	7.8%	-15.8%	-18.5%	-2.2%	-0.1%	N/A
EM Sovereign (USD)	EMB	8.1	6.1%	-18.5%	-19.4%	-3.9%	-1.1%	2.0%
20+ Year Treasury	TLT	18.9	3.0%	-22.6%	-18.9%	-2.9%	0.3%	1.4%
25+ Zeros	ZROZ	26.9	2.5%	-29.2%	-23.3%	-3.3%	0.7%	1.9%

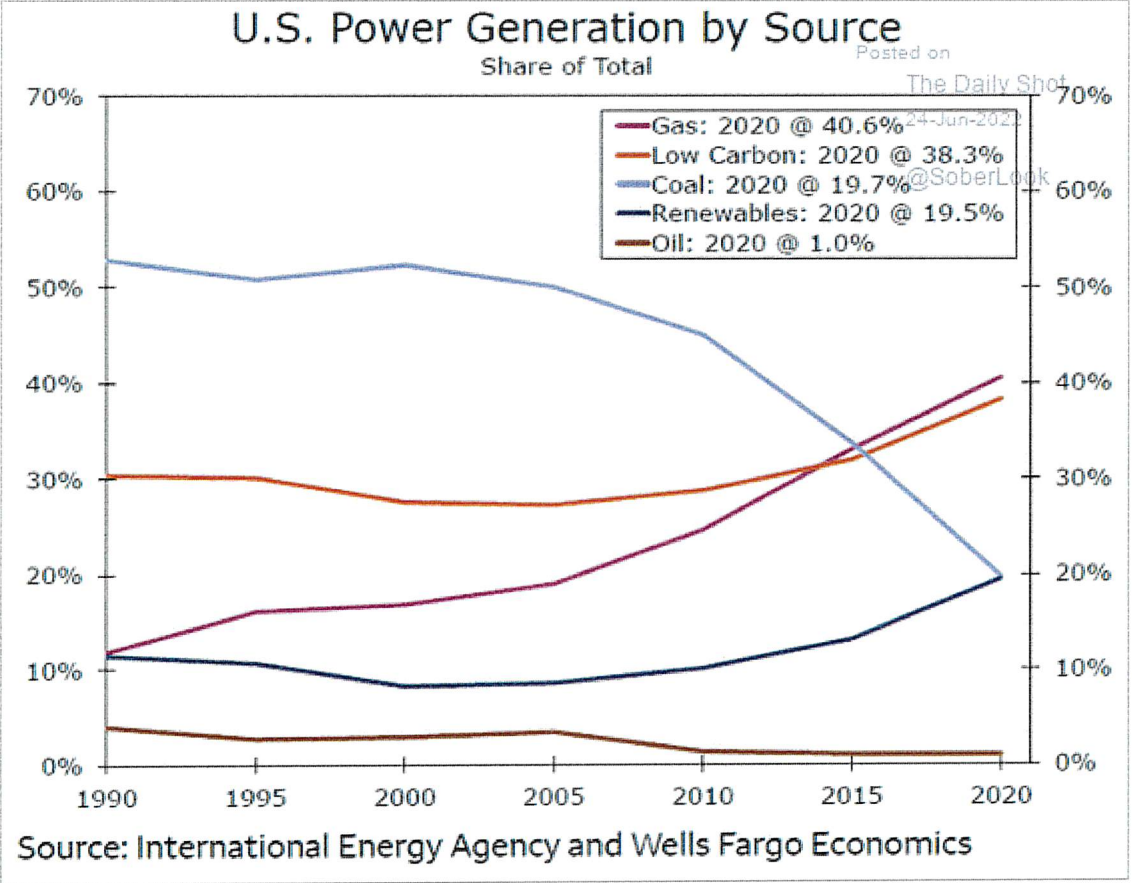


● Personal consumption expenditures: Nondurable goods: Clothing and footwear-Consumer Price Index for All Urban Consumers: All Items in U.S. City Average



Sources: BEA; BLS

Bonus look at pandemic-inspired volatility. How do you manage a supply chain? Gimme my stinnie!

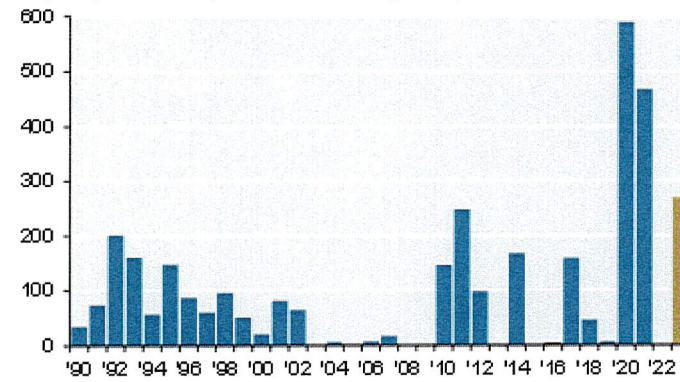


Long way to go to anything approaching "sustainable" electric grid.

It's not quantity of oil, it's refining capacity we lack.

US refineries permanently shut down by year

Capacity shut down, thousand barrels per day



Source: EIA, JPMAM. January 2022. Gold bar represents Lyondell estimate.