Graves Light Lenhart
Build. Protect. Thrive.

July 1, 2022

# Graves Light Lenhart Q3’22 Client Newsletter

## Main Points:

- There was nowhere to hide during the June quarter. Stocks and bonds both experienced painful declines with the classic 60% stock/40% bond portfolio experiencing a worse quarterly result than experienced during either the Great Financial Crisis or Covid washouts. Even commodities suffered a negative overall quarter (-5.7%), resulting from the weak price action over the last three weeks of June.

- Economic growth has materially slowed down. Classic recessionary indicators have yet to be triggered. However, we are cognizant of the myriad economic crosscurrents, ranging from soaring energy prices to the reduction of monetary liquidity. We acknowledge that the odds have increased dramatically with a 50%/50% chance, in our opinion, of a recession over the next year or so.

- We intend to maintain our current portfolio positioning, which remains purposely structured to be meaningfully different than popular asset class benchmarks (i.e. S&P 500 and Bloomberg Aggregate Bond Index). To be clear, our goal is to absorb potential market declines while maintaining appropriate investment structures to meet client goals. Trying to actively avoid potential declines introduces market timing complications, which often lead to material reductions in long-term wealth accumulation.

- Small-cap stocks continue to provide superior long-term return possibilities, in our opinion. We continue to add exposure to this market segment but reiterate that such positions will likely experience significant short-term volatility.

- We remind our clients of the various merits we posited for non-investment grade fixed income in 2021 (GLLW 2Q21 Newsletter). Market conditions are providing attractive entry points to start accumulating exposure in the high yield space. We have begun to slowly add exposure in client portfolios.

***"You make most of your money in a bear market, you just don't realize it at the time"—Shelby Davis***

Bear markets are not fun with the current cycle causing more pain than normal with the coincident carnage in both stocks and bonds. Diversifying equity exposure away from mirroring the S&P 500 helped portfolios hold up somewhat better than the index's 16.1% decline during the June quarter, but there was "nowhere to hide". Fixed income, as measured by the Bloomberg U.S. Aggregate Bond Index, fell 4.7% during the quarter, puncturing the safe part of the "safe asset" moniker. Markets remain hypersensitive to inflation and the probable reactions of the Federal Reserve to reestablish price stability. Unfortunately, this dynamic will be with us for some time. We don't know when or where the markets will bottom; we've provided historical benchmarks later in this letter solely for a frame of reference. However, we do know that now is the time for investors to honestly appraise their risk tolerances and financial goals for proper alignment. We firmly believe that investment success is driven by the rigorous construction of financial plans and the ongoing confidence to stick to them.

## Market & Economic Overview

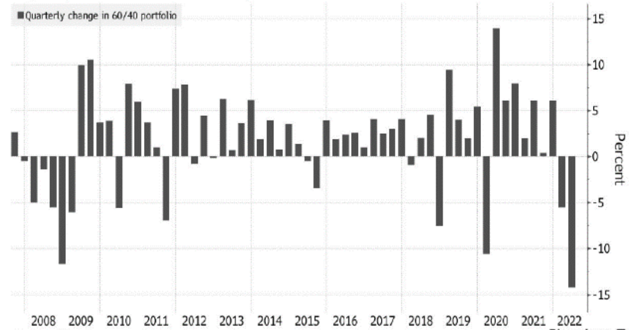
Economic growth materially slowed around the world during the past quarter, which has been compounded by alarming inflationary trends. We do not believe that 1970's style stagflation (stagnant economic growth with high inflation) will reemerge. However, we are on watch due to the increasing odds of a recession over the next year or so. Classic recessionary signals are not flashing at present, but we are cognizant of the strong headwinds that could bring such conditions. Importantly, investors will not be able to count on the Federal Reserve (Fed) to come to the rescue in the short-term with lower interest rates due to the specter of inflation.

There are really two reasons that inflation is such a key measure for us to follow. The first reason is, of course, that inflation measures the reduction in the value of dollars, which provides a direct barometer for the increasing relative costs of goods and services across the U.S. economy. The second reason is that the Federal Reserve, as part of its dual mandate, is obligated to maintain price stability (in other words, to keep inflation low).

With year-over-year inflation at the highest levels since the early 1980s, the Fed is clearly compelled to act to reduce inflation, and it has been taking steps to do so. The mechanisms that the Fed can use to accomplish this include both changing the Federal Funds rate (which is the overnight interest rate that banks borrow and lend to each other) and increasing or decreasing the Federal Reserve balance sheet by buying or selling (primarily) Treasury securities, which affects interest rates. The Fed began raising rates in March and is now targeting a Federal Funds rate between 1.5% and 1.75%, which is 1.5% higher than the range at the beginning of the year. The specific purpose of raising interest rates in this manner is to slow economic activity. However, this process is both inexact, and takes place with a lag. Larry Summers, noted economist and Former Treasury Secretary, compared the effect of changing interest rates on the economy to the adjustment of the water temperature in a shower located far from a hot water heater. For example, one adjusts the combination of hot/cold water to a desired temperature, then waits…if it comes in too hot or too cold, you gradually adjust. Since the effect of changing the Federal Funds rate can affect the economy months, if not years, after the change, the adjustment is a challenge both in finding the correct level and the elongated lags in economic effects.

Market conditions during the June quarter were brutal, with few places to hide. Even the classic 60% S&P 500/40% Bloomberg Aggregate portfolio, which is often targeted by endowments and retirees, experienced a worse single quarter result than the worst quarter experienced during the financial crisis of 2008 or the 2020 COVID experience! In previous reports, we cautioned that both the S&P 500 and bond market had been carrying valuations that provided little margin for error. We expect both asset classes will remain sensitive to inflation trends, with fixed income returns being particularly impacted for the foreseeable future.

**Nowhere Is Safe**
**60/40 portfolio set for a worst quarter than even 2008**




Source: Bloomberg

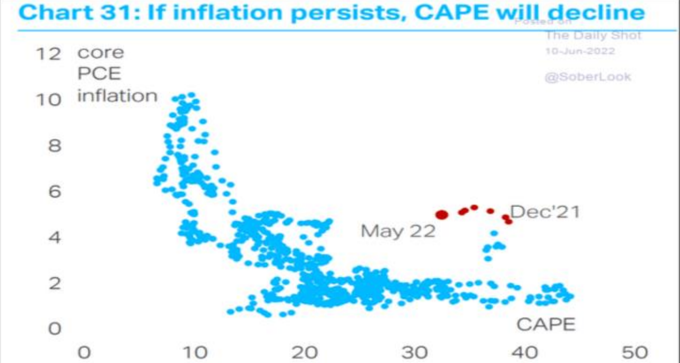
The S&P 500's negative return for the first half of 2022 was exclusively due to the meaningful reduction in the Price/Earnings (P/E) ratio as expected earnings-per-share (EPS) have remained resilient, so far. However, EPS estimates will be sensitive to evidence of an impending recession which could lead to new lows before the current bear market cycle is complete.

The table to the right displays a matrix to give a sense of the S&P 500's level based upon estimates for next year and an appropriate P/E multiple. The S&P 500 traded at 3,785 at the end of June, which is close to the implied level based upon the current consensus expectation of $250 of EPS during 2023 and the long-term forward 12-month P/E of 15x. Importantly, the EPS will likely drop if economic growth falters and/or the P/E multiple will decline if inflation remains above 4% or so into next year. It is too early to make firm determinations on either of these factors, but the matrix can identify realistic market levels as one stress-tests their assumptions.

| Forward P/E Multiple | Estimated 2023 S&P 500 EPS | | | | | |
|---|---|---|---|---|---|---|
| | $225.00 | $230.00 | $235.00 | $240.00 | $245.00 | $250.00 |
| 11 | 2475 | 2530 | 2585 | 2640 | 2695 | 2750 |
| 12 | 2700 | 2760 | 2820 | 2880 | 2940 | 3000 |
| 13 | 2925 | 2990 | 3055 | 3120 | 3185 | 3250 |
| 14 | 3150 | 3220 | 3290 | 3360 | 3430 | 3500 |
| 15 | 3375 | 3450 | 3525 | 3600 | 3675 | 3750 |
| 16 | 3600 | 3680 | 3760 | 3840 | 3920 | 4000 |
| 17 | 3825 | 3910 | 3995 | 4080 | 4165 | 4250 |
| 18 | 4050 | 4140 | 4230 | 4320 | 4410 | 4500 |
| 19 | 4275 | 4370 | 4465 | 4560 | 4655 | 4750 |
| 20 | 4500 | 4600 | 4700 | 4800 | 4900 | 5000 |

In addition, the S&P 500's longer-term valuation (i.e. 5 year return potential), as measured by the CAPE ("Shiller P/E"), remains relatively expensive at approximately 29x (as of June 30th) and will likely be further pressured if intermediate inflation trends track an annualized rate of 4% or more (see chart to the right). The good news is that investor sentiment readings at present are meaningfully bearish, which implies that many of these worries have been incorporated into current prices and presents the possibility of a strong bounce in the equity market if future economic news is not as bad as feared.

**Chart 31: If inflation persists, CAPE will decline**

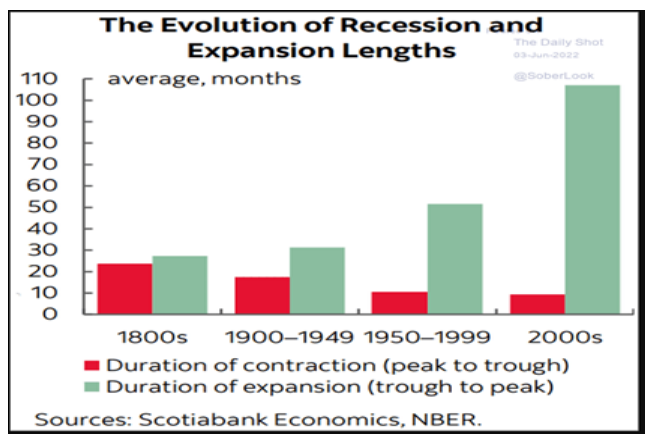



Sources: Robert Shiller's database, TS Lombard.

The environment for financial asset classes will become even more challenging if the economy falls into recession. Currently, recession worries have gripped the financial markets. As mentioned previously, we do not believe that a recession is imminent, but we acknowledge that the odds have increased dramatically with a 50%/50% chance, in our opinion. The classic yield curve (Fed Funds versus 10-Year Treasury Note yield) inversion signal remains far away from being activated. Prof. Campbell Harvey, PhD of Duke University and a Partner and Senior Advisor of Research Affiliates, LLC, pioneered the research on the link between inverted yield curves and subsequent recession. His work showed that all post-1960 recessions were preceded by an inversion of the classic yield curve, with an average lead time of 13 months. However, not all inverted yield curves resulted in a subsequent recession within the following 24 months, highlighting that no single indicator is infallible. If the economy is currently in, or will soon be in, a recession, it will be the first time without a classic inversion of the yield curve.

Nonetheless, one must appreciate the combination of economic stresses relating to the ongoing Ukraine/Russia war, inventory issues (both shortages and unplanned excesses from double-ordering), ongoing supply-chain snags, etc. in the face of historically high energy and food prices (which slow economic growth much like a tax), and central bank tightening. We believe the best case for U.S. economic growth is modestly positive real GDP (ex. inflation) growth of 1%-1.5% through 2023 with an equal probability of a mild recession over the same period. The important point is recessions have negatively impacted stock prices in the past, and the increased likelihood of recessionary conditions should compel investors to reexamine their risk tolerance and investment strategy to prepare against a possible further market decline from current levels.

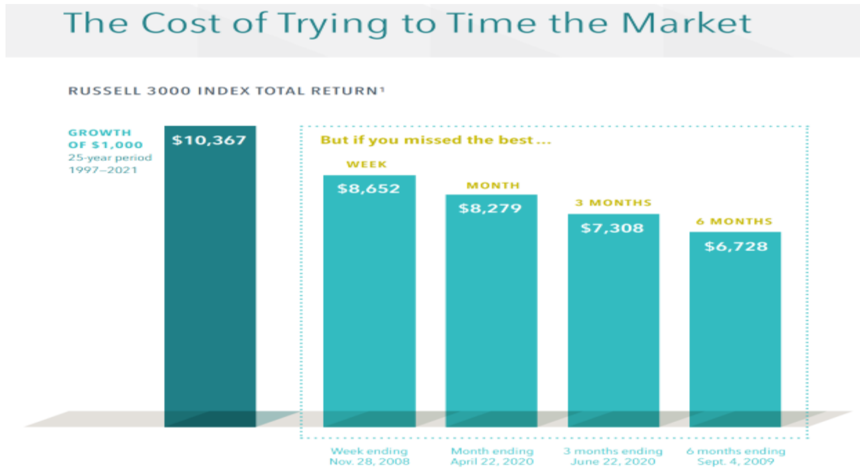
We prefer to focus on the post-World War II period, which is less impacted by the Great Depression. The Federal Reserve is far from omniscient, and we believe deserves to be criticized for acting far too late in the current inflationary environment. That said, we believe the modern Federal Reserve post-WWII deserves credit for helping to tame economic contractions and foster longer periods of expansion, providing a favorable environment for long-term stock appreciation. This is illustrated in the table to the right.




Including the COVID related market collapse of 2020, there have been 14 bear markets since WWII with a median decline in the S&P 500 of 30.22% over 359 days; the worst bear market was the -51.93% decline over 403 days during the 2007-2008 Great Financial Crisis. Bear markets that incorporate recessions--eight started within two years of the start of a recession out of the fourteen total bear markets--experience deeper drops over longer periods (median of -34.99% over 449 days) compared to the six bear markets not associated with recessions (median of -28.22% over 198 days). In either case, the current bear market cycle has further potential downside risk based upon historical precedent.

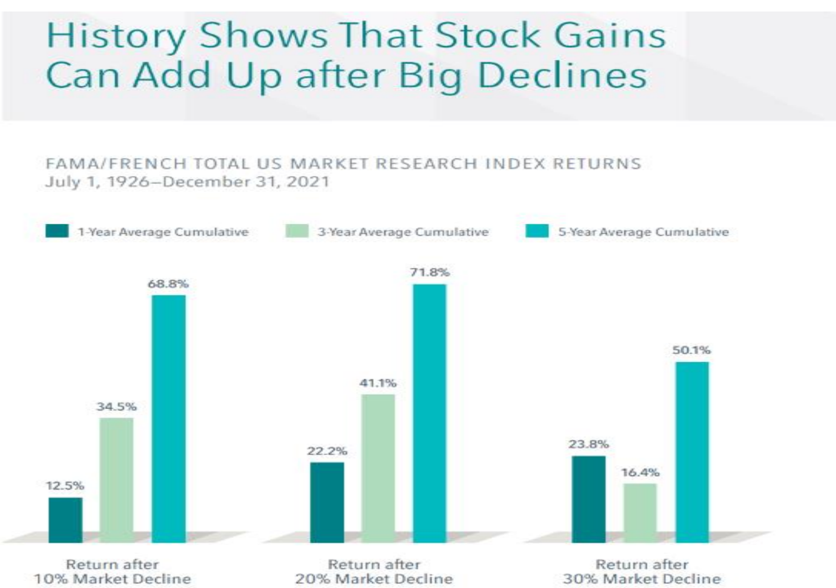
## Timing the Market

Naturally, no one wants to experience further losses, especially if a recession does occur. The temptation is to sell now with the intention of repurchasing the asset exposure following the expected price drop, which is commonly referred to as market-timing. We profess no special ability to successfully engage in such machinations which have proven deleterious to the wealth of many who have tried over the years. Those who try to side-step potential market declines are implicitly obligating themselves to repurchase at lower prices where the news flow/fact pattern will be worse than when they sold. The reality is that rarely happens given human nature.




*Source: DFA*

Furthermore, even if one is ready to repurchase “at the bottom”, the risk of missing the strongest part of the rebound is ominous. For example, missing only the best week during the entire 25-year period through last year resulted in a 16.5% reduction in ending wealth. Missing the best six-month period resulted in a 35% reduction! This is referenced in the chart above, provided by Dimensional Fund Advisors (DFA), and underscores the reality that markets tend to rebound most swiftly well before a recession is formally declared over.




*Source: DFA*

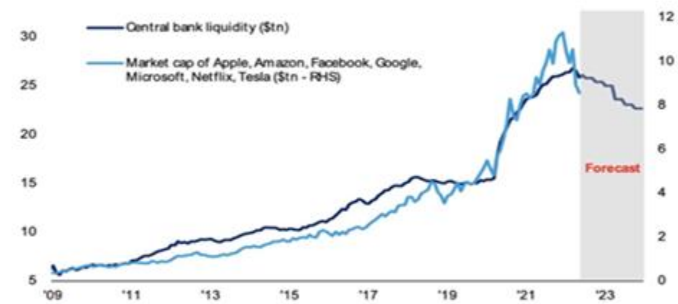
So what to do? The good news is markets tend to rebound strongly following the inevitable market declines, even though it seems that stock prices will never go up again during severe drawdowns. History shows that sticking to a thoughtful financial investment plan incorporating an appropriate asset allocation is a major driver of long-term wealth accumulation and meeting key goals.

## Asset Allocation

Of course, optimizing the risk/return potential of one’s financial assets is a principal focus when designing and implementing an investment strategy. In our opinion, the S&P 500’s potential annualized return over the next five years is meaningfully below the long-term average of 10%. Importantly, we don't know how the sequence of returns will onfold, which could include great returns for the next year or so before experiencing poor returns over the following few years to weigh on the overall five year return profile.

We believe that positioning client equity holdings to be meangingfuly different than the S&P 500 continues to make sense. For example, a handful of large-cap technology related stocks still account for 23% of the S&P 500's total market capitalization. We continue to underweight these stocks due to unrealistic growth expectations, in our opinion, and valuation concerns. Such stocks enjoyed enviable returns during the easy money conditions present through 2021. The Fed's current tightening phase could pressure the valuations of these stocks for some time, as we believe these select securities were direct beneficiaries of the liquidity tidal wave witnessed leading up to this year (see chart to the right).

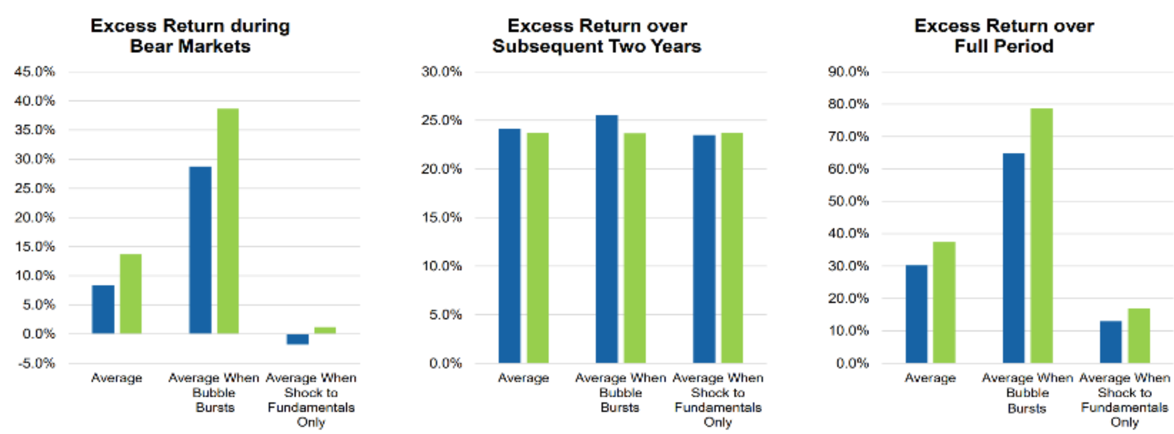
**Chart 6: QE was catalyst for 12-year tech boom**
Central bank liquidity and market cap of Tech




**Source:** BofA Global Investment Strategy, Bloomberg

Value stocks have experienced much more resilient returns so far during 2022. We continue to believe that value stocks are well positioned to outperform over the next few years. The value portion of the stock market is more heavily populated by stocks in the more economically sensitive industrial, financial, and materials sectors. Somewhat counterintuitively, value stocks have historically experienced excess returns during both bear markets and the associated recoveries.

**Value's Excess Return in Downturns and Recoveries, United States**




- Value does better during bear markets when preceded by a bubble.
  - Performs on par with the market during a shock to fundamentals alone.
- Value outperforms significantly during recoveries in either scenario.

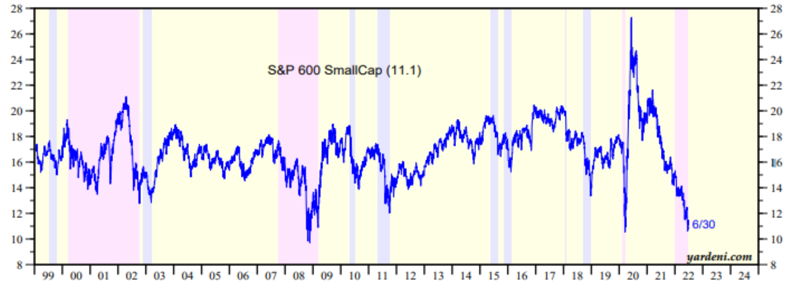
■ P/B Value
■ Composite Value

P/B-Based Value represents the long-only portion of the Fama–French Value Factor. Composite Value uses a similar methodology but selects by a composite of P/B, P/E, P/D and P/S. This analysis examines five periods of market drawdowns that were accompanied by recessions, Fiscal Tightening/Vietnam War (12/1968–6/1970), Nifty Fifty/Oil Crisis (10/1972–9/1974), Iran Oil Crisis/Monetary Policy Tightening (11/1980–7/1982), Tech Bubble Crash (6/1990–10/1990) and the Global Financial Crisis (10/2007–2/2009) Source: Research Affiliates, LLC, based on data from FactSet, CRSP, and Compustat.

research affiliates

RAFI Indices

In our opinion small-cap stocks provide one of, if not the, best long-term equity market opportunities. Currently, the S&P 600 Small-Cap’s P/E ratio of 11.1x on expected EPS over the next twelve months is near both the COVID and ‘08/Great Financial Crisis lows (see chart to the right). EPS estimates will likely turn meaningfully lower if a severe recession develops but the current undemanding valuation provides cushion for near-term disappointment and above average long-term return potential.



* Price divided by 52-week forward consensus expected operating earnings per share.
Note: Shaded red areas are S&P 500 bear market declines of 20% or more. Blue shaded areas are correction declines of 10% to less than 20%. Yellow areas are bull markets.
Source: I/B/E/S data by Refinitiv and Standard & Poor’s.

International stocks currently have more attractive valuations than the S&P 500, but the earnings picture is much cloudier, mainly because of the Ukraine/Russia war. Interestingly, the EAFE (international developed markets) index has held up slightly better than the S&P 500 over both the first half of 2022 (-19.3% vs. -20.0%) and the June quarter (-14.3% vs. -16.1%) despite the attendant shocks to Europe. We believe international stocks will remain quite volatile until a resolution to the Ukraine/Russia war is settled but we continue to believe their longer-term potential warrants inclusion within client portfolios.

Within fixed income securities, the spike higher in rates and credit spreads (compensation for default risk) has led to more attractive yields/valuations. Getting to current entry yield levels has undoubtedly caused pain for bond investors, particularly those holding long duration assets with maturities far off the future. For high quality fixed income securities, history shows a strong correlation between starting yields and subsequent returns (i.e. starting yield-to-maturity will be close to the return experience through maturity). This dynamic, coupled with a nearly flat U.S. Treasury curve, underlines are bias towards shorter-duration high quality debt issuers (particularly corporate and municipal bonds), with some opportunities to marginally add duration. Overall, we still seek to carry less sensitivity to interest rate moves (i.e. duration) compared to respective benchmarks. Lastly, High Yield (or “junk bonds”) have seen yields nearly double(!) on higher rates and increased default risk. Specifically, the ICE Bank of America High Yield index has seen its yield blow out to 8.9% at 2Q22 end from 4.3% at the end of last year. At these trading levels, we believe it makes sense to include this asset class in a long-term portfolio.

## Closing Thoughts

Security values are based upon long-term business prospects balanced by an appropriate interest rate (i.e. discount rate). Unfortunately, the Fed’s battle with inflation and recessionary worries will likely result in manic investor behavior until clarity improves on both future interest rates and earnings potential, which will take time. Our message is to stick with thoughtful plans and look for long-term opportunities. Let us know how we can help.

Best regards,

| | | |
|---|---|---|
| Asa W. Graves VII, CFA | Jason Fink, PhD | Ash Heatwole, CFA |
| Chief Investment Officer | Director of Research | Portfolio Manager & Associate Director of Wealth Management |

*DISCLOSURE*

Stocks offer long-term growth potential but may fluctuate more and provide less current income than other investments. An investment in the stock market should be made with an understanding of the risks associated with common stocks, including market fluctuations. Stock dividends are not guaranteed. Investments primarily concentrated in one sector may be more volatile than those that diversify across many industry sectors and companies. The technology industry can be significantly affected by obsolescence, short product cycles, falling prices and profits, and competition from new market participants. Global/International investing involves risks not typically associated with US investing, including currency fluctuations, political instability, uncertain economic conditions, different accounting standards, and other risks not associated with domestic investments. Investments in emerging markets may be subject to additional volatility. Stocks of small and mid-cap companies may also be subject to greater risk than that of larger companies because they may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

The value of fixed income securities will fluctuate with changes in interest rates, prepayment payment rates, exercise of call provisions, changes in the issuer's credit ratings, market conditions, and other variables such that they may be worth more or less than original cost if sold prior to maturity. There is also a risk that the issuer will be unable to make principal and/or interest payments. Although treasuries are considered free from credit risk they are subject to other types or risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate, and deflation risk, which may cause the principal to decline and treasury securities to underperform traditional securities.

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