Westshore Wealth *Insights*

Are We There Yet?

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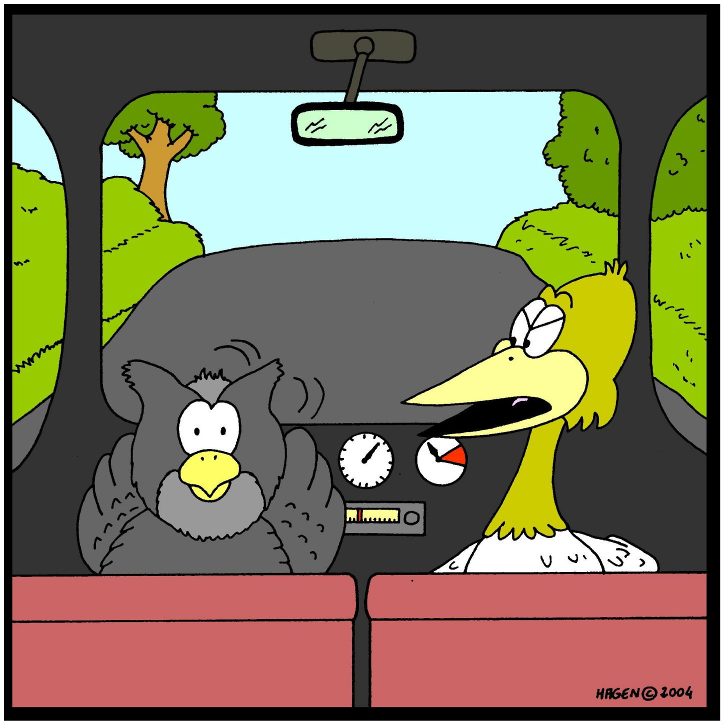
WESTSHORE WEALTH

Are We There Yet?



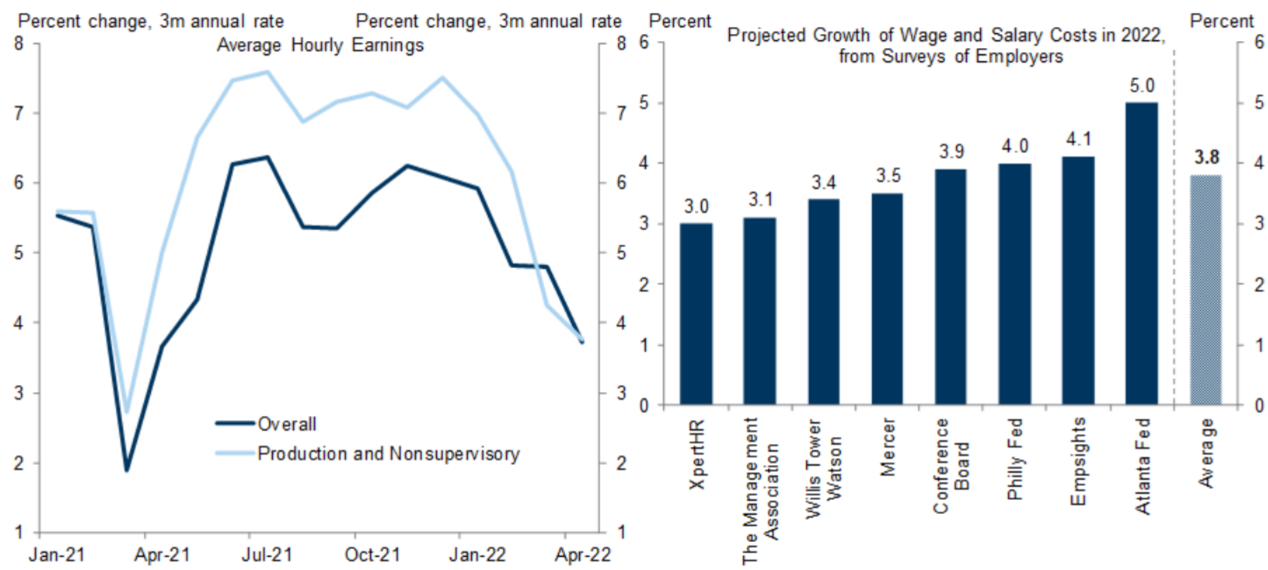
Would you please use your rear-view mirror!
You're freaking me out!

In our August 5, 2021 essay, entitled It's (Never) Different This Time, we penned the following warning: "Our policy makers, the Federal Reserve Chairman, and the Secretary of the Treasury continue to aggressively stimulate the economy, even while it is roaring back to life, betting they can avoid overheating and that inflationary effects will be transitory. History is not on their side." We unearth this previous comment not as a back-slapping victory lap, but rather a simple observation that you have already passed your destination when you see it looking through the rear-view mirror. A year ago, the only thing that seemed to be of focus for the Federal Reserve was returning the economy to full employment. Despite numerous warning signals that inflation was rising at unacceptable levels they powered ahead with more monetary accommodation. The market also ignored these cautionary cues, clinging to the reassuring words of Jerome Powell that he could miraculously thread this economic needle. Fast forward to present. Full employment was achieved, but at a significant expense. Inflation is now dramatically above targeted levels, the Federal Reserve has performed an abrupt about-face by shifting to an aggressive tightening bias, and the market has corrected severely year-to-date with the Bloomberg US Aggregate Bond index down 9.37% and the S&P 500 equity index off 17.05%. So, with such dramatic carnage having taken place in markets, have we arrived at a destination where it is safe to deploy money once again?

The latest rout in markets seems to be inspired by thinking that price stability will not be achieved until the Federal Reserve has raised the Fed Funds rate to 3.5% (for context, prior to March 2022, they held these levels between a 0% - 0.25% range). Many market participants believe such an austere tightening cycle would be enough to push the US economy into recession. However, before we leap to such a conclusion, let's examine the facts. It is important to understand that the equity and bond markets are discounting mechanisms. They tend to predict the future. To illustrate, while the Federal Reserve has raised its benchmark interest rate two times for a total of 0.75% since March 2022, longer-term interest rates have moved much more aggressively. The 5-year US Treasury Bond has risen by almost 2% in the past 12 months to approximately 3% and other forms of credit have responded in kind. For example, 30-yr mortgage rates have risen from 2.75% to 5.25%, auto finance rates have climbed from 2% to 5% for 5-year loans, credit cards have jumped by 3% - 5% depending on customer credit scoring, and finally 5-year investment grade corporate borrowing rates have inflated from 2.15% to 4.76%. All these rate adjustments will ultimately translate into slower housing and autos sales, lower corporate capital expenditure, and a drag on consumer discretionary spending. In other words, the war against inflation is already being fought by the bond market and the Federal Reserve is simply tagging along to the party.

Interestingly, as some market participants have just awoken to the problematic trend in inflation, the data is starting to flatten, and in some circumstances, roll over. Both the Consumer Price Index (CPI) and the Fed's preferred Personal Consumption Expenditures (PCE) measure, both surprised to the downside in the March period, the first downward observation since August 2021. They steadied at that same level in April, but if we peel back the onion a touch, the driver of inflation is starting to change. The most insidious form of inflation is wage inflation, as it creates a circular pattern. Higher wages beget higher prices which ultimately reinforces even higher wages and so forth and so on. However, as we can see below, wage trends, while still rising, are starting to decelerate their pace of growth (see illustration below). This is very good news, and it seems to be falling on deaf ears at present.

Exhibit 1: Sequential Wage Growth Has Moved Back to 4% Annualized



Source: Department of Labor, Federal Reserve, XpertHR, The Management Association, Willis Tower Watson, Mercer, The Conference Board, Empsights, Goldman Sachs Global Investment Research

The culprit behind the latest source of inflation has been continued supply chain disruptions, acutely exacerbated by Chinese COVID lockdowns. If that can ever normalize, perhaps the transitory pieces of inflation can ultimately start to fall back. The final point is that future inflation expectations seem relatively tame. Most consumers expect inflation to dip back to something closer to 3%. To be sure that is above the Fed's target levels of 2%, but it is a far cry from 8% plus CPI numbers that we have recently encountered. Why is that important? The Fed cares just as much about actual inflation as they do inflation expectations. If consumers expect to pay more tomorrow for something today, they start to change their behavior. At this point, that doesn't appear to be happening. In the most recent Commerce Department surveys, respondents said it was a bad time to buy a house, a car, and other consumer durables. It looks as if consumers are delaying purchases as they expect supply chain normalization to result in more reasonable future prices. Again, this is good news. It signals the Fed may not have to unload quite as much ammunition in this fight.

So where do we go from here? Fed Funds futures, a financial gauge that predicts the level of Federal Reserve rate raises, embeds an expectation that short term rates will rise to 3.5% by July 2023. And that is not all. The market simultaneously expects the Federal Reserve to dramatically reduce the size of its balance sheet by selling the US Treasuries and Mortgage-Backed Securities that it holds. This would have the added effect of raising longer term interest rates. Our sense is that market participants are now over-estimating the duration and magnitude of the interest rate adjustment just as they underestimated inflation last year. With inflation already moderating, supply chains in the process of normalizing, it seems incongruent that the Fed will have to act so aggressively. That leads us to the following conclusion. We think the rate adjustment has been appropriate but has now reached a level where inflation can be combatted. As a result, our opinion on bonds has shifted to favorable. You will likely see us adding back investment grade corporate bonds that we jettisoned last year and increasing some of our maturities that we sought to shorten during the same period.

Where do we stand on equities? This is a trickier question and one where our answer is more nuanced. Despite the fact that the economy will no doubt slow in response to rising interest rates, our house view is that the economy will avoid recession. Why? We believe recessions are predominantly driven by job losses. At present, there are 11.2mm job openings and roughly 5.9mm unemployed individuals. In other words, the job market will be able to take a punch before it moves into contractionary mode. Second, while consumer finances have tightened due to rising gasoline and other inflationary trends, it is estimated that there is roughly $2.5 trillion of excess consumer savings sitting on the sidelines. With considerable pent-up demand for travel and other experiential services that were lost during the pandemic, consumer spending will slow, but it should hold up. Third, our domestic energy industry is apt to be a sustained beneficiary of the conflict in Ukraine. Not only will American producers be incentivized to increase production in response to higher prices, but they may see an export opportunity as well. As the Europeans reduce their reliance upon Russia for hydrocarbons, they may turn to liquified natural gas that can be fulfilled by the United States (something that we have in dramatic abundance).

With all that said, we aren't blind to the threats that confront equities. We fully acknowledge that corporate profitability is apt to come under pressure as growth slows. Furthermore, valuations were extreme prior to this correction and speculation in story stocks that lacked fundamental underpinning was rampant. This unwind will add to the pain that indices are feeling. As such, drawing a line in the sand is difficult. However, our general working assumption is that 3,700 on the S&P 500 index, or another 5% downside from today's levels, would represent an attractive area to become more aggressive. We arrive at that figure by assuming that the S&P 500 would revert to its historical average P/E multiple of 16x and then we multiply that by a normalized earnings figure of $230/share. However, to take a quote from Voltaire, we don't want to let perfect be the enemy of good. What does that mean? The stock market has already seen its valuation get much more reasonable and history tells us that recoveries tend to be relatively quick.

For reference, the S&P 500 is in its 19th correction of >10% since 1929. In the preceding 18 corrections, the median decline was 20% (that would represent 3840 on the S&P 500, meaning we are essentially there). The average selloff was 11 months in duration, and while we are only five months into this present correction, the market typically recovers the entire loss in 25 months. Said differently, if this correction follows historical averages, we could encounter a roughly 20% rally between now and the end of 2023. For longer term investors, we think it is a great time to buy equities, with the full knowledge that this correction might not yet be over. We will continue to populate our growth portfolios defensively with hedges and shock absorbers until, or if, we reach 3,700 on S&P 500. At said level, we think the risk/reward tilts significantly in our favor to lean more aggressively.

MARKETS HAVE HISTORICALLY SHOWN AN ABILITY TO RECOVER UNREALIZED LOSSES

ALL U.S. STOCK MARKET CORRECTIONS (SELL–OFFS OF -10% OR MORE) SINCE 1926

DATE OF MARKET CORRECTION			DURATION (# OF MONTHS)		DEPTH OF DRAWDOWN	IF PURCHASED AT PEAK	
PEAK	TROUGH	RECOVERED	SELL-OFF	RECOVERY		5 YEARS	10 YEARS
Aug-29	Jun-32	Jan-45	34	151	-83.40%	-17.40%	-4.90%
Feb-37	Mar-38	Mar-44	13	72	-50.00%	-8.60%	4.00%
May-46	Oct-46	Oct-49	5	36	-21.60%	9.10%	15.50%
Jul-56	Feb-57	Jul-57	7	5	-10.20%	10.00%	9.00%
Jul-57	Dec-57	Jul-58	5	7	-15.00%	7.60%	10.70%
Dec-61	Jun-62	Apr-63	6	10	-22.30%	5.70%	7.40%
Jan-66	Sep-66	Mar-67	8	6	-15.60%	4.30%	4.00%
Nov-68	Jun-70	Mar-71	19	9	-29.20%	0.40%	3.10%
Dec-72	Sep-74	Dec-76	21	27	-46.40%	-0.10%	7.60%
Aug-78	Oct-78	Mar-79	2	5	-11.20%	17.10%	14.80%
Nov-80	Jul-82	Oct-82	20	3	-18.80%	12.10%	11.80%
Jun-83	May-84	Dec-84	11	7	-10.80%	12.80%	13.30%
Aug-87	Nov-87	Apr-89	3	17	-29.80%	7.70%	13.40%
May-90	Oct-90	Feb-91	5	4	-16.80%	11.50%	16.70%
Jun-98	Sep-98	Nov-98	3	2	-12.00%	-1.30%	3.60%
Aug-00	Sep-02	Mar-06	25	42	-44.10%	-1.60%	-1.10%
Oct-07	Feb-09	Mar-12	16	37	-51.00%	0.60%	7.60%
Sep-18	Dec-18	Apr-19	3	4	-14.30%	?	?
		Average	11	25	-27.90%	4.10%	8.00%
		Median	8	8	-20.20%	5.70%	7.60%

Performance data quoted represents past performance, which is no guarantee of future results. Source: Wilshire Associates Incorporated. The **S&P 500 Index** is generally considered representative of the U.S stock market.

What if we are wrong and the economy drifts into recession? Admittedly, the Federal Reserve's history with engineering soft landings is not a good one. However, let's not panic. The average peak-to-trough pullback during a recession is 28% (we are already down 20% from the peak) and the median recession lasts 10.7 months. However, this is the important point. The S&P 500 tends to bottom well before the conclusion of the recession, on average, 5.3 months from the start. Furthermore, in 10 of 15 observed recessions since the Great Depression, S&P 500 returns over the course of the entire recession duration were positive (the median return was +6.7%). This confirms the point of the previous illustration. Now is not the time to sell, rather it is a time to think about adding to positions.

We understand these moments of volatility are uncomfortable and anxiety producing. However, before you succumb to the fearmongering of the nightly news, just know that the market has experienced all this before in some form or fashion. Perhaps you can take solace in the fact that in the last 70 years, we have only had 3 years where the equity market closed down in excess of -20%. Those include the Housing Crisis of 2007-08, the Internet Bubble Collapse of 2000/01 which coincided with the 9/11 attack, and finally the wrenching correction of 1974 (the Nifty Fifty stocks traded at an average of 50x earnings at the peak before correcting). There are obviously no guarantees in this game, but the circumstances that we are dealing with today certainly don't seem to be nearly as scary as those events.

We welcome any questions and are happy to engage in more substantive dialogue.

Important Disclosures

This commentary in this paper reflects the personal opinions, viewpoints and analyses of the Westshore Wealth employees providing such comments, and should not be regarded as a description of advisory services provided by Westshore Wealth or performance returns of any Westshore Wealth Investments client. The views reflected in the commentary are subject to change at any time without notice. Nothing herein constitutes investment advice, performance data or any recommendation that any particular security, portfolio of securities, transaction or investment strategy is suitable for any specific person. Any mention of a particular security and related performance data is not a recommendation to buy or sell that security. Westshore Wealth manages its clients' accounts using a variety of investment techniques and strategies, which are not necessarily discussed in the commentary. Investments in securities involve the risk of loss. Past performance is no guarantee of future results.

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