A Rollercoaster Ride Towards Normalization

In our July Thinking Man (*Worst First Half in Half a Century*), we noted how the majority of global assets year-to-date (YTD) have suffered both historically *steep* and *swift* losses on account of global monetary tightening. Over the summer, we experienced a modest reversal of that sell-off with the S&P 500 climbing 17.3% after reaching a closing low of 3,671 in mid-June. Similarly, the yield on 10-Yr U.S. Treasuries retreated to as low as 2.6% at the beginning of August after having peaked at 3.5% on June 14.

The primary cause of this summer bounce was premature optimism surrounding the Fed's pace of tightening, combined with the view that the American consumer is strong enough to allow the Fed to maneuver a "soft landing." Ultimately, this optimism proved to be short-lived, as the surprise August Consumer Price Index (CPI) print (8.3% year-over-year (yoy) headline and 6.3% yoy core) made it clear that the Fed's inflation containment effort is still, at best, *a work in progress.*

Since then, the sell-off has resumed, with equities retesting and breaking their June lows, and short-term Treasury yields blowing past their prior YTD highs. Since July, the yield curve has remained inverted (the 2-Yr Treasury yield currently offers a 30-50bps premium over the 10-Yr Treasury yield), the 30-Yr fixed rate mortgage is within shouting distance of 7%, and the DXY (which measures the strength of the U.S. dollar relative to a basket of global currencies) has continued its relentless climb upwards, approaching levels not seen in 20 years.

These moves are all, in part, a result of the September FOMC meeting where the Fed delivered a 75 bps hike (its third consecutive hike of this magnitude) and increased its fed-funds rate expectations for 2023 from 3.8% to 4.6%. The Fed also seemed to indicate that normalizing inflation would require some unspecified amount of economic "pain" (i.e. demand destruction) all but guaranteeing that a more meaningful recession would be a necessary condition of containing inflation. In sharp contrast to the rhetoric of the last 15 years, the Fed is now prioritizing maintaining credibility and anchoring inflation expectations over shoring-up asset prices. To that end, it will need to see both a moderation in prices *and* weakness in the labor market (given that wage inflation and labor scarcity continue to be key components of higher costs).

As a result of this decisively hawkish shift in tone, Treasuries have resumed their sell-off, pushing up yields across the credit spectrum. At year-end 2021, the yields of the

The Thinking Man's Approach

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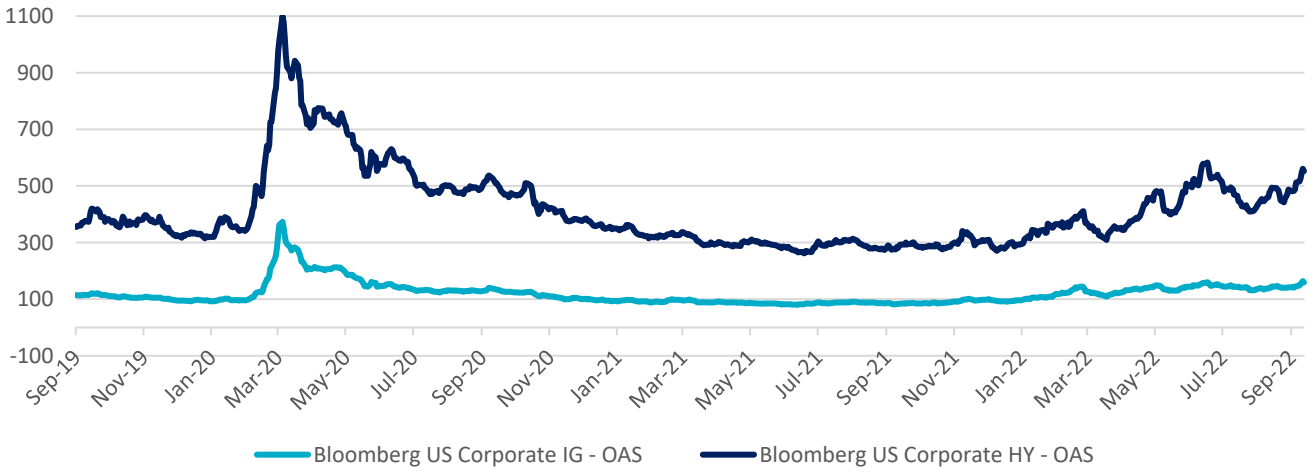
- Markets have given back their summer bounce and the Fed's policy reversal has continued to push every rate higher
- As we approach peak rates we favor moderately extending fixed income duration while maintaining high credit quality
- All of the correction in equities YTD has been the result of increases in rates, as earnings estimates have barely budged
- With a recession all but a certainty, we continue to see more downside to earnings
- Value pockets and defensive sectors like healthcare are attractive for long-term investors, even though the lows are not likely in yet
- Taking the monetary policy "medicine" now will ultimately be constructive for preserving the integrity of capital markets, and investment returns in the long-term

For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners. com

Bloomberg US Investment Grade (IG) Corporate Index and the Bloomberg US High Yield (HY) Corporate Index stood at 2.36% and 4.86%, respectively. As of the time of this writing, those indices are now yielding 5.69% and 9.70%, or approximately a doubling of yields. This has been the result of both the rise in risk-free rates, as well as a widening of spreads, with IG spreads increasing from 92 bps at year-end 2021 to 159 bps currently (+67 bps) , and HY spreads increasing from 283 bps at year-end 2021 to 552 bps currently (+269 bps).

Exhibit 1: U.S. Corporate Fixed Income Spreads



Source: Factset

Though we have not yet seen a major credit dislocation (i.e. a high profile default, or even just a large increase in the number of defaults), many investors are now pricing in the probability that with higher interest rates, lower-quality companies may not be able to make higher interest payments (especially if operating performance were to deteriorate). As a result, the widening in high-yield spreads has been accompanied by increases in the value of credit default swaps (which investors use to insure corporate interest payments), as well as highly elevated interest rate volatility (the ICE BofA MOVE Index, which tracks fixed income market volatility, is currently at ~148 , relative to a 5-Yr average of ~67).

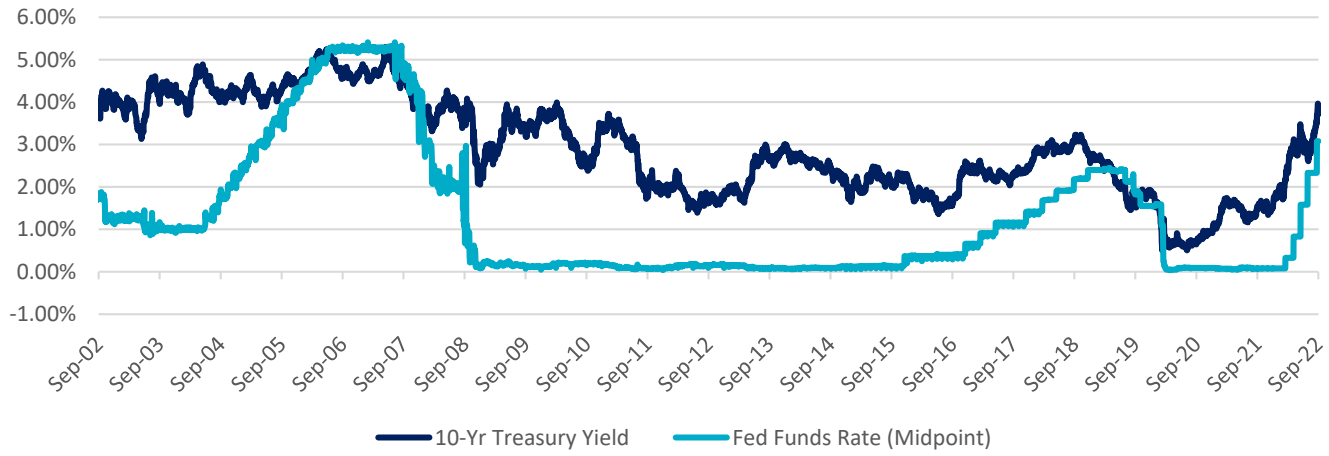
Exhibit 2: ICE BofA MOVE Index (Left) and CDX (Credit Default Swap) IG Index (Right)

Source: Financial Times, Bloomberg

So when and where is the bottom?

Since 2000, the only two times where the fed-funds rate has been *greater* than the 10Y U.S. Treasury yields was in the run-up to the 2008 financial crisis, and in late 2019. Both instances represented the peak of a Fed hiking cycle, which in both cases resulted in recessions. We only note this in order to support the argument that, if we are indeed in, or headed towards a recession, there is unlikely to be much more upside to Treasury yields. In our view, if 4.6% is in fact going to be the peak of the fed-funds rate in 2023, then the 10-Yr yield is likely to also top out around 4.5%-5.0% sometime in mid-to-late 2023.

Exhibit 3: Fed-Funds Rate vs. U.S. 10-Yr Treasury Yield



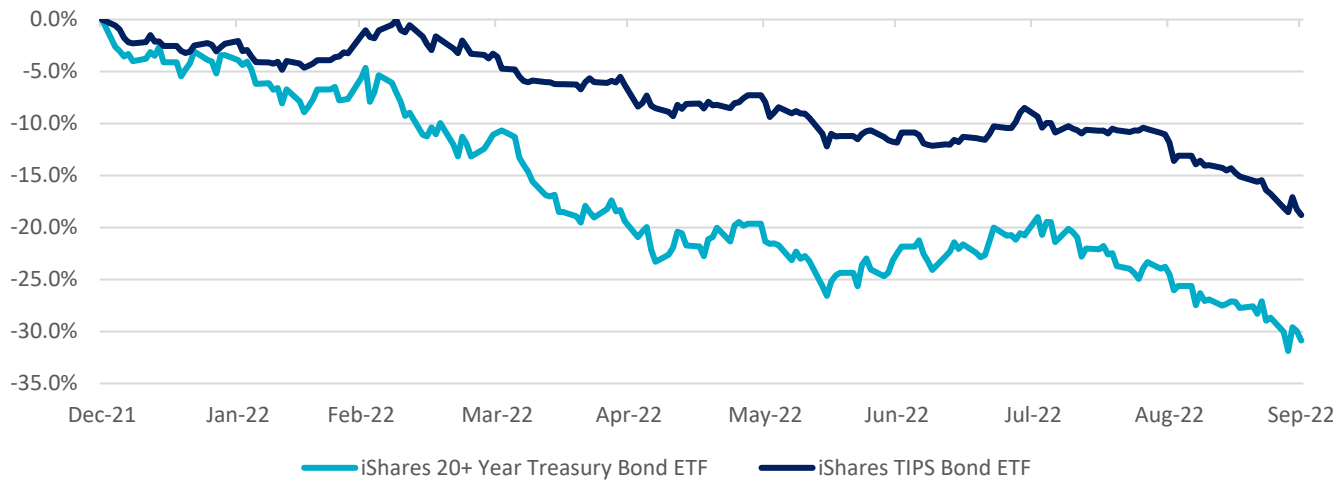
Source: Factset

To be sure, the phasing-in of the Fed's full $95 billion / month in quantitative tightening will represent an added headwind, given that it is unclear how well the market will be able to absorb this excess supply. Additionally, given that virtually every central bank in the world (with the exception of Japan and China) has had to pursue a faster pace of monetary tightening, the global stock of negative yielding debt has decreased from $17 trillion in 2021 to virtually zero today. Positive yields overseas combined with record dollar strength mean that U.S. Treasuries become less appealing to foreign buyers, which could in theory result in more upside to rates.

Balancing those risks against the historical precedent of prior hiking cycles nonetheless gives us some confidence that we are indeed at, or near peak rates. This has important consequences for our fixed income and equity outlooks.

BSP View: over the last year, we have favored *low-duration, high quality* credit, as our primary concern was the rising rate environment. With rates likely approaching a top, we now favor modestly extending duration in order to lock in attractive rates for the longer-term. With respect to credit quality, we continue to stress the importance of treading carefully, as we would expect a more meaningful credit cycle (i.e. defaults and restructurings) at some point in the next couple of years. Nonetheless, we see select opportunities in the IG/HY crossover space (BBB- / BB+) as being attractive. As a hedge against continued stickiness in inflation and the potential for still higher rates, we also favor exposure to short-term inflation protected U.S. Treasury securities.

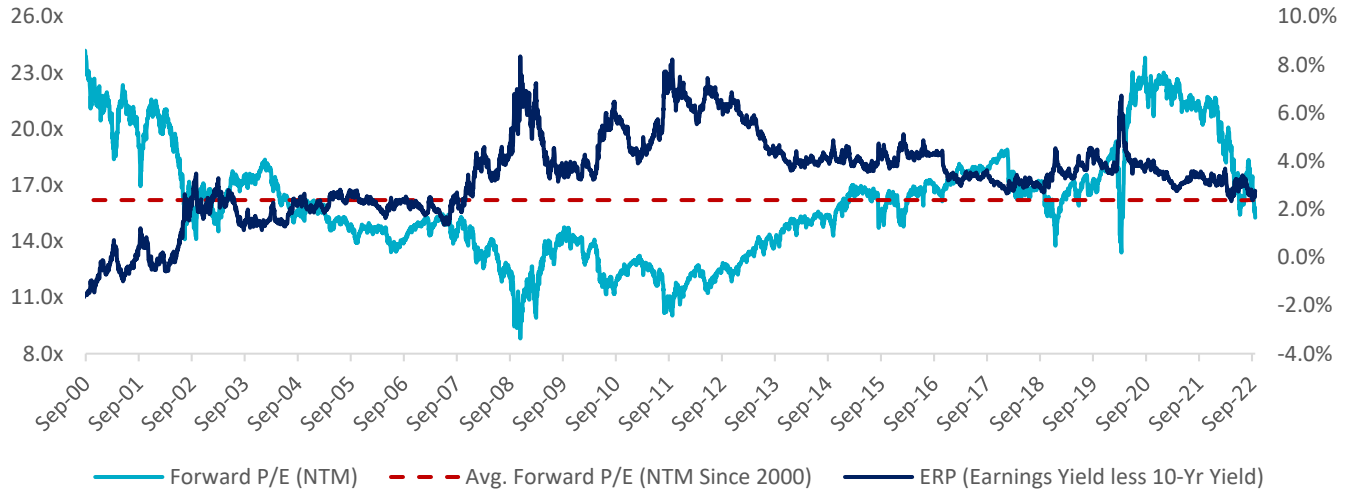
Exhibit 4: TIPS vs. Treasury YTD Performance



Source: Factset

With respect to equities, our focus is now on understanding how bad the earnings impact could be in different recessionary scenarios. As a reminder nearly 100% of the correction in equities YTD has been the result of the increase in rates, and the corresponding adjustment to the equity risk premium. At year-end 2021 the S&P 500 forward multiple stood at ~21.5x, which translates to an earnings yield of ~4.7%. With risk-free rates having more than doubled, the only way that the earnings yield can adjust upwards is either for expected earnings to increase, or for the price level to decrease. With consensus earnings estimates roughly unchanged YTD, the result has been multiple compression purely from a correction in the price level. At the time of this writing, the S&P 500 is currently trading at 15.5x forward earnings, which translates to a 6.47% earnings yield, and 2.7% equity risk premium (a multi-year low).

Exhibit 5: S&P 500 Forward Multiple (LS) and Equity Risk Premium (RS)



As rates approach a top and the economy (more likely than not) enters a recession we would expect the focus to shift from rate increases to the magnitude of potential earnings revisions. Until now, consensus earnings estimates have proved highly resilient, with bottoms-up Next Twelve Months (NTM) Earnings Per Share (EPS only modestly off their peaks of $238 reached in June 2022. For the most part, companies have been able to pass-on cost inflation in the form of higher prices to their customers, which has resulted in strong operating performance, expanding margins, and as we are all aware, meaningful increases in the cost of living. However, in a recession, what becomes more relevant is not what *prices* companies can sell their good/services at, but rather the *volume* of goods/services they are selling.

Equally important will be the degree of operating leverage, or the ratio of the change in a company's earnings relative to the change in its revenues. As business owners are aware, the whole point of scaling a business is that many expenses (i.e. fixed expenses like administrative and R&D expenses) don't increase at the same rate that volumes increase. In other words, as you grow and sell more units, the amount of profit you make *per unit* also increases. The flipside is that when volumes decrease, those expenses are not easily *turned off* which results in *lower* per unit profitability. In other words, when revenues fall, earnings tend to fall more.

For reference, Strategas notes that the median peak-to-trough earnings decline in historical recessions has been -22%, though it was as low as -4.6% in the recession of 1980 which was triggered by the inflationary spiral set-off by the energy crises throughout the 1970's (arguably the most comparable recessionary period to the present).

Though we can't say with certainty where earnings will land, we *can* say with a high level of confidence that estimates that were set before the Fed's aggressive shift to more hawkish policy need to be revised downwards. A 10% downwards revision to earnings at the current S&P 500 price level of ~3,600 would imply a 17.2x forward multiple, which is only a slight premium to the historical average.

Exhibit 6: Earnings declines in prior recessions

Earnings Declines & Recoveries During Prior Economic Cycles & Recessions

Full-Cycle Period	Recession Period	Earnings Declines	Earnings Recoveries
1Q'28 - 1Q'33	3Q'29 - 1Q'33	-74.5%	-
2Q'33 - 2Q'38	3Q'37 - 2Q'38	-49.2%	197.6%
3Q'38 - 4Q'45	1Q'45 - 4Q'45	-29.4%	91.9%
1Q'46 - 4Q'49	4Q'48 - 4Q'49	-3.3%	185.7%
1Q'50 - 2Q'54	2Q'53 - 2Q'54	-17.6%	22.4%
3Q'54 - 2Q'58	3Q'57 - 2Q'58	-22.0%	57.7%
3Q'58 - 1Q'61	2Q'60 - 1Q'61	-11.7%	19.1%
2Q'61 - 4Q'70	4Q'69 - 4Q'70	-12.9%	94.4%
1Q'71 - 1Q'75	4Q'73 - 1Q'75	-14.8%	77.6%
2Q'75 - 3Q'80	1Q'80 - 3Q'80	-4.6%	97.0%
4Q'80 - 4Q'82	3Q'81 - 4Q'82	-19.1%	5.3%
1Q'83 - 1Q'91	3Q'90 - 1Q'91	-36.7%	103.1%
2Q'91 - 4Q'01	1Q'01 - 4Q'01	-54.0%	236.3%
1Q'02 - 2Q'09	4Q'07 - 2Q'09	-91.9%	243.9%
3Q'09 - 2Q'09	1Q'20 - 2Q'20	-32.5%	1933.1%
	Average	**-31.6%**	**240.4%**
	Median	**-22.0%**	**95.7%**

BSP View: we continue to favor value over growth names, while our preferred sectors continue to be energy (as a geopolitical and value sector) and healthcare (as a defensive sector with a more attractive valuation than utilities and consumer staples). Though we continue to tread very carefully, our fundamental approach has always been to stay invested while tactically shifting style, size, sector, and geographic exposures to maximize alpha. To that end, we think that, at current levels, beginning to "nibble" at high quality companies with high cash flows and reliable dividends is attractive for long-term investors that can tolerate short-term spikes in volatility.

Today's pain is tomorrow's reward

In our May Thinking Man (*Normalization and the Clearing of QE Era Excesses*), we noted that, though we correctly anticipated the epic correction in the more speculative pockets of the market (SPAC's, crypto, meme stocks, ARKK constituents) we failed to anticipate the *speed* with which that correction unfolded. Since then we have experienced historic levels of volatility in both equities and fixed income, with even mature and high-quality companies seeing more meaningful drawdowns. Routine daily increases of 20 bps in riskless yields, made short-duration fixed income transform from the black sheep of the family to the darling child of many portfolios. As we have discussed, the speed of the correction is a reflection of the speed in the Fed's policy reversal, which is itself a result of having incorrectly believed that stubbornly elevated inflation would resolve itself without a course correction. We went from an overly confident Fed, to a deeply humbled Fed all within a matter of a few months.

Only time will tell if central banks and our leaders will have the wherewithal to learn from their mistakes and press on with policies that actually encourage free-market price discovery and efficient capital allocation. What we can say for now is that the end of a monetary addiction is often best accomplished by quitting cold turkey, and it is precisely a "cold-turkey" policy that the Fed is now embracing. There is likely more pain ahead, but it is likely to be the sort of pain which allows markets and corporations to more fully blossom in the long term. As long-term investors we welcome this pain as a necessary condition of preserving capital discipline, confidence in our capital markets, and ultimately, the long-term investment returns for only the most value generating businesses that power our societies.

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