INVESTMENT THEMES

October 2022

Earnings Are Decelerating: Two key factors negatively impacting the stock market recently are slowing corporate earnings growth and rising interest rates. This rare combination historically results in the weakest market returns, as shown in the following chart.

World Equities Returns by Asset Yield and Earnings Environment

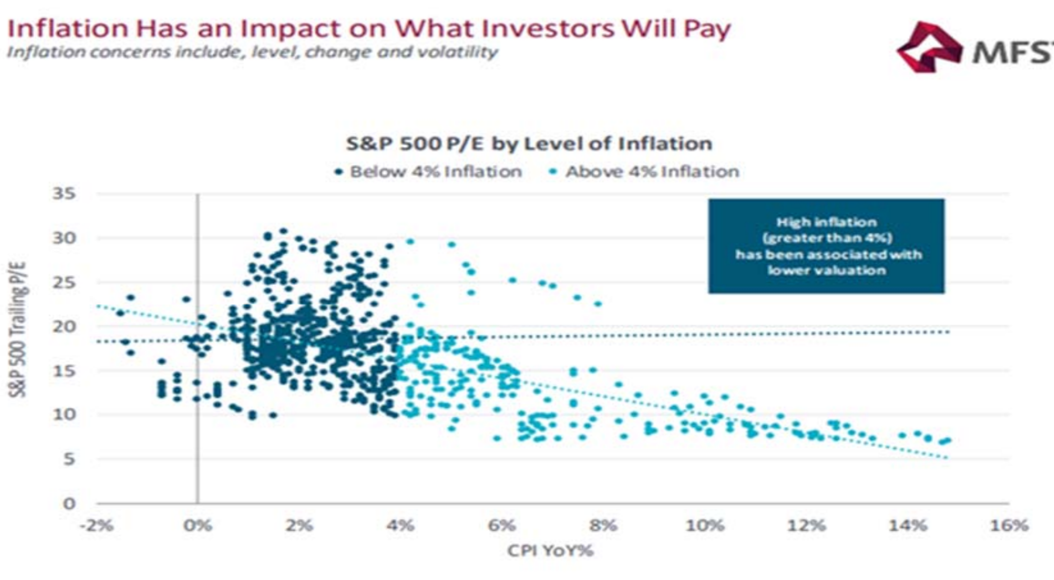
		Falling Asset Yields		Rising Asset Yields	
	All Periods	EPS Rising	EPS Falling	EPS Rising	EPS Falling
Environment Frequency	-	30%	20%	35%	15%
Excess Return	4.9%	31.5%	22.9%	-11.4%	-35.8%

Source: Bridgewater Associates, LP

Corporate earnings peaked in the first quarter, and consensus earnings growth for 2022 is less than 1%. Excluding booming energy profits, earnings are expected to decline. Earnings for 2023 are predicted to grow 14%, which seems unlikely; we expect those estimates to decline. In addition to inflation and slowing economic growth, the sharply rising U.S. dollar hurts the earnings of large companies with significant revenues abroad.

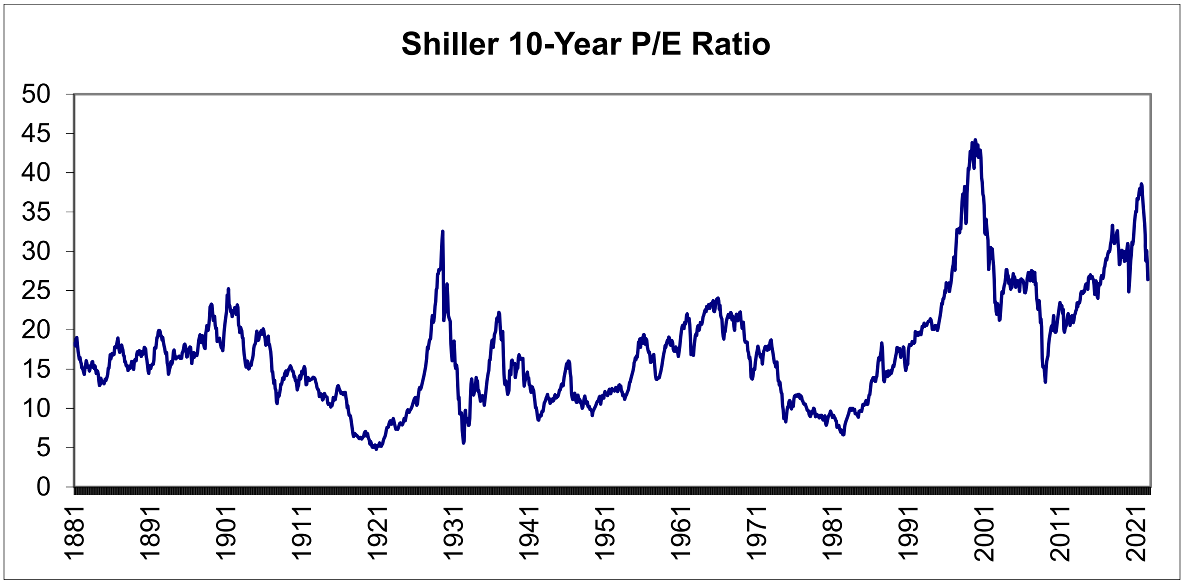
Small company stocks, which tend to have less international exposure, are a bright spot with expected earnings growth of 13% this year and 22% next year. Combined with much lower valuations relative to large company stocks as we described last quarter, this strong earnings growth makes small company stocks attractive.

Valuations Are Impacted by Higher Rates: Along with slowing earnings growth, the stock market has been repricing for higher interest rates. As the following chart shows, higher inflation is typically associated with lower valuations.



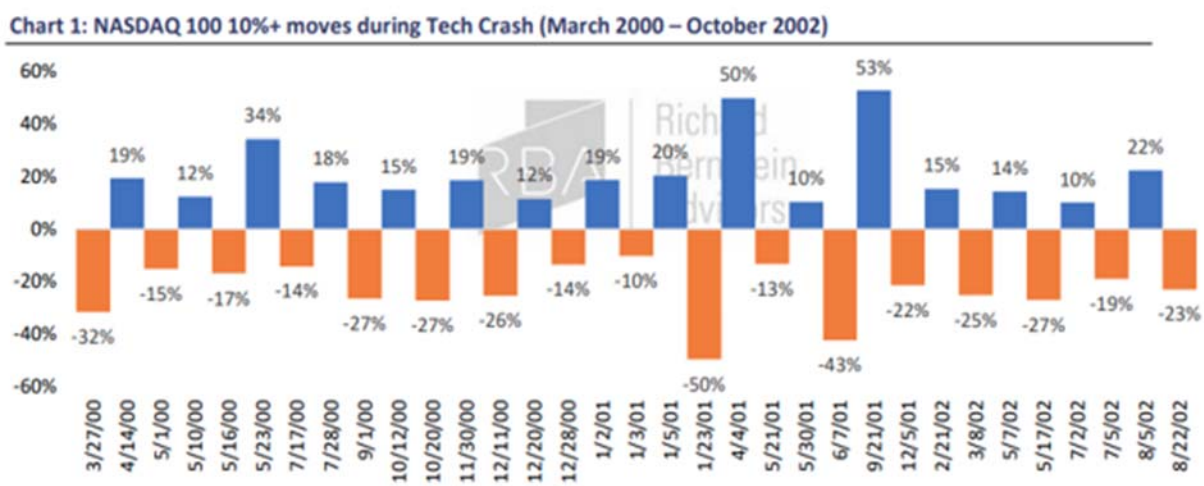
Source: Bloomberg. Monthly data from 31 January 1954 to 28 February 2022. CPI = Consumer Price Index.

Valuations have declined from their historic extremes at the beginning of the year, but are still on the high side, as shown below using the 10-year cyclically adjusted P/E ratio. This P/E measure has declined significantly from 38.3 to 26.4 in 2022. Based on one year of trailing earnings, the P/E ratio is currently 17.2, vs. 23.0 at the beginning of the year and 30.7 a year earlier, a significant decline to more reasonable levels, although still on the high side historically, especially during inflationary periods.



Source: Robert Shiller, Yale University

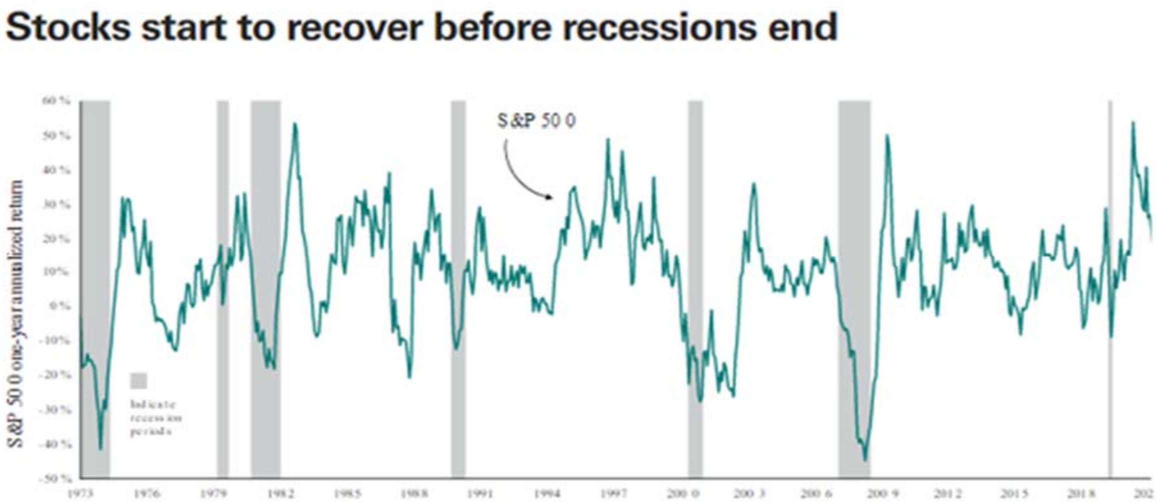
Volatility Within Bear Markets: The stock market this year has seen more volatility than most years. There have been multiple sharp rallies within the current bear market, a not uncommon occurrence. The following chart displays all the large rallies and declines during the two and a half years of the technology stock bear market twenty years ago. Despite the sharp total decline in technology stocks, there were 16 distinct periods of at least 10% rallies. We expect continued stock market volatility until this bear market ends.



Source: Richard Bernstein Advisors LLC

<u>Stock Buybacks Could Help</u>: On the positive side, according to Goldman Sachs, companies are expected to spend over $1 trillion this year on stock buybacks, up 12% from a year ago. Representing about one-third of all corporate cash usage, such buybacks could help cushion stock prices. In addition, a 1% tax will be implemented on all stock buybacks beginning in January, so we may see even higher stock buyback spending later this year as companies pull forward some of next year's buyback spending to avoid the tax.

Another positive is that as the stock market is forward-looking, stock prices typically rebound well ahead of the economy, as shown here.



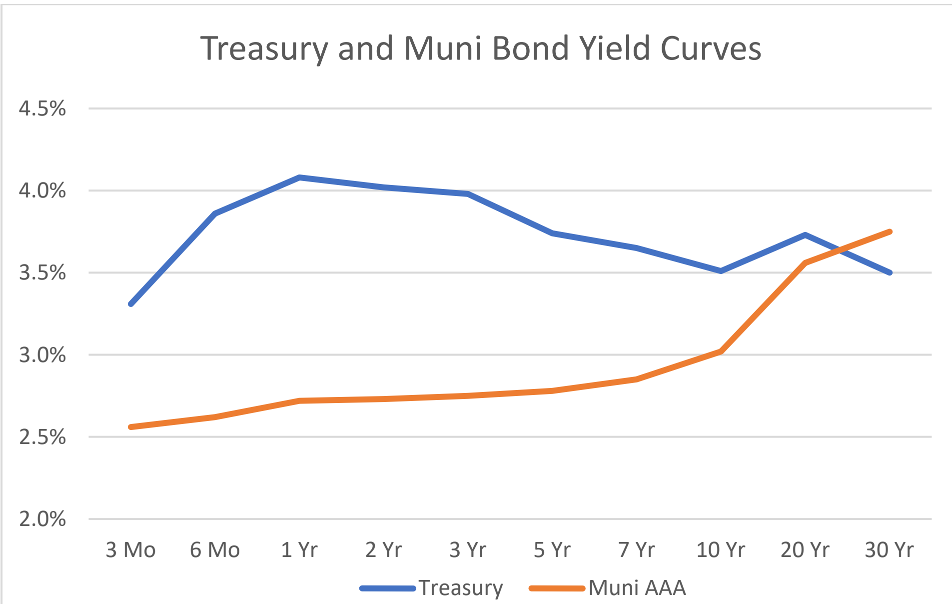
Source: Vanguard. Chart shows 1-year returns for S&P 500 from 1973 to 2021. Shaded areas represent recessions.

<u>Bond Bear Market Continues</u>: Interest rates have continued to rise throughout the year. However, there have been no major signs of distress in the corporate bond market (such as higher spreads relative to Treasuries), as shown below through late September. Rather, the market has experienced more of an orderly repricing of valuations due to higher interest rates, although some warning signs appeared in the last week of September.

Corporate Bond Market Distress Index

Source: Federal Reserve Bank of New York

As reflected in the following chart, one of the interesting nuances in the bond market recently involves the inverted Treasury and corporate bond yield curves (the blue line below is the Treasury yield curve) combined with a relatively steep municipal bond curve (the orange line). In other words, in the Treasury and corporate bond markets, short-term (1-year) bonds are offering higher yields than long-term (30-year) bonds. However, in the municipal bond market, short-term bond yields are still considerably lower than longer-term bonds.



Source: Bloomberg

Two implications of these trends are 1) we can earn a higher yield by investing in shorter bonds with lower durations, implying lower interest rate risk, and 2) short-term corporate bond yields are more attractive than short-term municipal bond yields, even after accounting for the tax-exempt nature of municipal bonds.

Paragon Portfolio: Our general model portfolio remains fairly conservative. Our fixed income portfolio is focused on high-quality, short-to-intermediate duration bonds, although we will likely lengthen duration soon as yields are much more attractive than were at the beginning of the year.

Our stock portfolio is still tilted toward cheaper “value” stocks and high-quality companies, and away from high-valuation stocks. We have a significant allocation to small company stocks, both domestically and internationally. Our target portfolio is globally diversified with a 40% allocation to international stocks, which is in line with global stock market weightings.

We also target a small portion of the portfolio to alternative assets, which tend to have low correlations to the stock and bond markets.

Cash money market yields have increased to close to 3%, so we are putting excess cash into these money market funds, which have safety of principal and daily liquidity.