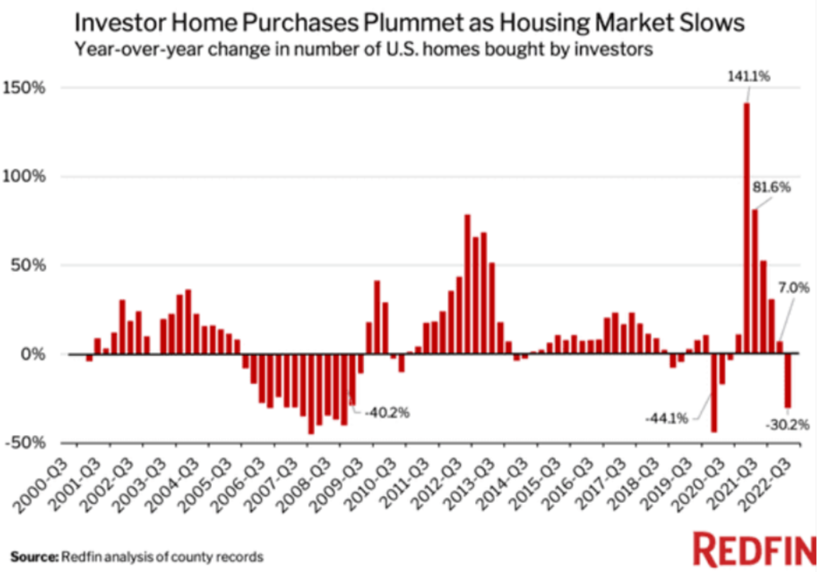
PCM
PEAK CAPITAL MANAGEMENT

Impaired Visibility

PCM Report December 2022 Volume 13, Issue 12

Brian Lockhart

You cannot begin the countdown on 2022, something many investors will bid good riddance, without at the same time looking forward to what 2023 will bring. In many ways, 2022 will be viewed in retrospect as a year of surviving. Investors and markets have had to survive negative GDP growth, the highest inflation in 50 years, the sharpest rise in interest rates in US history, the resurgence of Covid, and many other challenges. As we head into the last month of the year, the S&P 500 is down around 18% while the tech-heavy Nasdaq is trading 28% lower. Given the unprecedented circumstances, it could have been worse this year.



Looking towards 2023, we have impaired visibility in terms of what to expect. It is true that the Fed has hinted it is much closer to slowing (possibly ending) the pace of rate hikes but the labor market data suggests it might be much longer before the Fed is going to be able to be accommodative. A recent report from Goldman Sachs forecasts a labor shortage of nearly 2 million workers for US manufacturing by the year 2030 suggesting labor force tightness may get worse. The tech sector may be engaged in layoffs not experienced since 2000 but the overall supply of labor remains limited. The impact of mass protests in China over Covid restrictions is making global economic growth forecasts difficult. According to Barclays data, Covid restrictions are in place in over 70 cities in China that represent more than 60% of China's economic output (GDP). An economically ailing China presumably means slower growth for the world and likely ongoing supply chain challenges.

The inflation bug has now spread to the least likely economy to be impacted, Japan. The latest CPI readings in the Asian nation are the highest in more than 40 years and is a signal that the Bank of Japan, European Central Bank and others are just beginning the likely tightening of monetary policy that will be necessary that the US started almost a year ago. Global liquidity is likely to remain under pressure throughout 2023 as the era of 'cheap money' appears to have passed for this cycle. The result is likely to be a "risk-off" mentality for many institutional investors as volatility remains above normal.

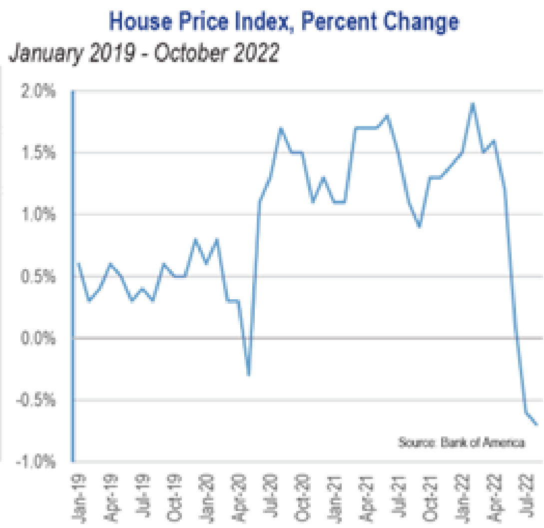
Further complicating visibility for 2023 is the current state of the housing market. Home purchases, such as the data below from Redfin, have fallen dramatically over the last 6 months and the trend is not slowing. Prices in major markets are beginning to reflect this reality but have much further to go as mortgage rates climb above 7%. Redfin data shows the amount of annual income needed to afford the median price home was $60,000 in 2020 and has risen to $108,000 today. When housing becomes this unaffordable, history suggests we are not near an inflection point for a rebound. Broad estimates suggest 20% to 25% of the economy is directly or indirectly impacted by housing so expect an economic headwind going into 2023. There are also increasing segments of the yield curve inverting and the longer this remains, the more economic damage is done. It is likely that lending standards will continue to tighten for the first half of 2023 meaning less credit availability for the shrinking segment of the economy looking to borrow.

I do not want to point a 'gloom and doom' picture, there are bright spots investors can latch onto. Corporate earnings have remained very resilient during the rapid rise in interest rates. This is largely due to most balance sheets being healthy and not overindebted. Companies have also had more time to sort out supply chain issues and the availability of key natural resources has risen dramatically even as prices have fallen. Many industrial product prices are lower today than before covid hit in 2020 suggesting margins may remain strong in many sectors of the economy.

> **"Global liquidity is likely to remain under pressure throughout 2023 as the era of 'cheap money' appears to have passed for this cycle."**

I believe a disconnect remains between the health of the economy and equity market prices. The S&P 500 today is trading at more than 20 times my 2023 earnings estimate of $190. Given the rising risk premium on equities, I still expect the multiple to drop to 16, if not lower, suggesting the S&P would need to fall to 3,040 to get to fair value. I would suggest caution with equity allocations going into 2023 notwithstanding the number of voices suggesting to 'buy the dip.' Stocks will eventually get to fair value, they always do, it just takes patience. There are plenty of opportunities where you can find value, including in technology. History has proven that when a stock falls by 50% it is not necessarily cheap, do not be lured in by how far a stock has dropped but understand what the catalyst for a rebound is.

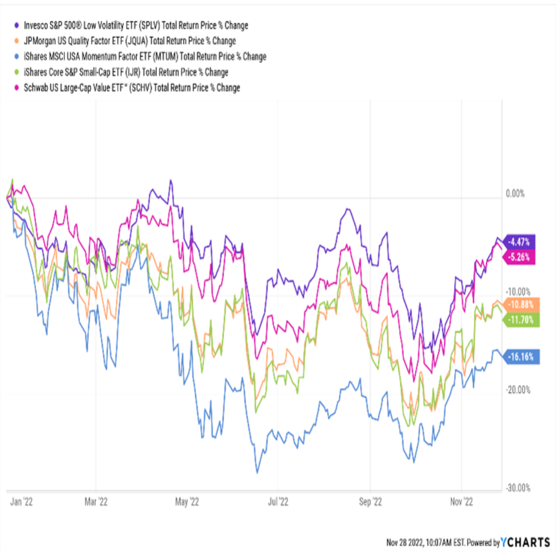
No Shelter for Housing



As mentioned in the Introduction of this report, the housing sector plays a key role in economic growth in the US accounting for between 20% and 25% of economic activity. Mortgage rates that have doubled over the last 10 months are just beginning to be factored into home prices. Higher mortgage rates forced many otherwise active buyers to leave the market as home prices remained high even as mortgage costs soared. Affordability metrics on housing are at extreme levels as witnessed by the amount of home purchase you can afford with a $2,000/ month mortgage payment. The chart shows how dramatically prices are falling on a monthly basis but likely still have a way to go before they return to levels that make homes affordable for the average person.

- According to data from the St. Louis Fed, one year ago a home buyer with $2,000/month for a mortgage payment could purchase a $700,000 home. Today that number is $463,000.
- The U of M survey on Buying Conditions for Houses has averaged 140 over the last 20+ years. Only a handful of times has the index had a reading below 120. Today the reading is at 33.
- Home prices typically decline during recessions with the average drop of 5% each year the economy contracts. The worst drop in recent history was a 13% drop during the Great Recession.

Factor Performance



Despite the headwinds we have faced this year, markets in general have been resilient. The chart to the right illustrates the total return performance for various U.S. equity factors year-to-date. We have experienced considerable performance divergence this year based on investment styles. What is noteworthy is how low volatility and value stocks have outperformed momentum and small capitalization stocks for the year. The results are not surprising considering how investors have become generally more defensively positioned. Given projections of a hawkish Fed intent on raising rates to quash inflation and a looming recession, investors have demanded stocks with reasonable valuations and below average price volatility.

- Inflation, as measured by the consumer price index (CPI), seems to be cooling somewhat, which suggests that the Federal Reserve is close to ending its tightening cycle. Investors anticipated this in late September. Consequently, stocks have rallied considerably from their yearly lows. Value and low volatility stocks are only lower by roughly -5% year-to-date. A positive annual 2022 return for these factors is not an unreasonable expectation.
- Momentum's YTD underperformance could reverse quickly, considering how the factor gradually rebalances to stocks that have outpaced the overall market. Small capitalization stocks, however, might have a more difficult road ahead, considering their sensitivity to higher interest rates.

Big Tech Slump

In July of this year, railroad workers threatened to strike after more than three years of failed contract negotiations. Last month, four of the 12 railroad unions, whose members make up the majority of workers, rejected a labor agreement most recently brokered by the Biden Administration. Now, many of the unions have set a potential target strike date of December 9th, resulting in shortages, spiking prices, and the halt of factory production. According to CNN, such a strike could also disrupt commuter rail services for up to seven million travelers a day and the transportation of 6,300 carloads of food and farm products a day, among other items, according to the business groups. If a deal cannot be brokered, many businesses are calling upon Congressional leaders to be prepared to prevent a nationwide freight rail shutdown by imposing a "cooling-off period".

- In a September report, the Association of American Railroads quantified the impact of a strike on the supply chain and the U.S. economy at up to $2 billion a day.
- The unions have generally pushed for a pay increase, better working conditions, relaxed attendance rules, and additional paid time off without fear of punishment.
- Since the Railway Labor Act was passed in 1926, Congress has intervened a total of 18 times when interstate commerce was threatened.

Quinn VandeKoppel

Macro View – Chinese Crackdowns

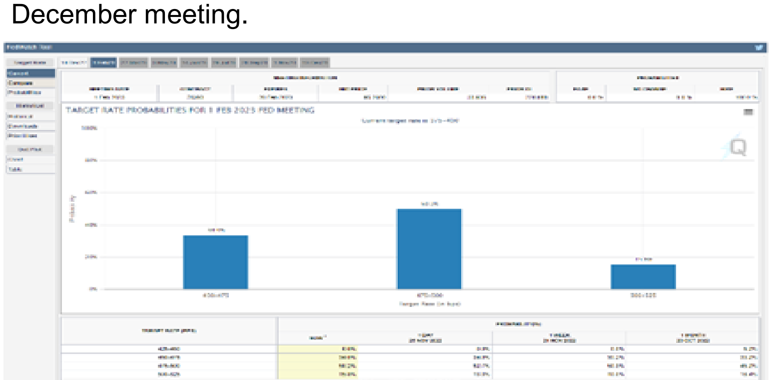
It is becoming increasingly clear that the Chinese people are fed up with Chinese Communist Party's (CCP) and Chinese President Xi Jinping's "Zero-Covid" policy. Over the weekend, widespread protests broke out after a fire erupted in the western Xinjiang region killing 10 people, who were locked inside their building due to COVID restrictions. Protests can also be attributed to Chinese soccer fans turning into the World Cup and seeing that the fans are able to gather maskless in the stands. Additionally, while the majority of documented cases have been asymptomatic, the CCP has signaled its reluctance to make major changes to its Covid policy. With the continuation of this policy, more stringent virus testing requirements, among other restrictions, have weighed on business and consumer sentiment and it is hard to believe restrictions will be loosened as a result of these protests.

Taking Stock – From Bad to Worse

As if this year for cryptocurrency investors has not been bad enough, last month, we witnessed the collapse of FTX, one of the world's largest cryptocurrency companies. A company that was valued at nearly $32 billion in January with investors including SoftBank and BlackRock filed for chapter 11 bankruptcy not even 12 months later on November 11th. A few days later, John Ray, who famously led the disgraced energy titan Enron through bankruptcy, was announced as the next CEO of FTX. In Ray's first days as the new CEO, he noted "never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here". As the bankruptcy proceedings continue, many will be waiting to see what else comes to light on what else was happening behind closed doors.

Fixed Income – More Hikes to Come

Over the next two weeks, the markets will look to digest the release of a variety of major U.S. economic data reports. While many of these reports provide good insight on the state of the U.S. economy, all eyes will be on the Consumer Price Index (CPI), which is set to report on December 13th. The Federal Reserve, who has continuously stated they are going to remain data-dependent when making policy decisions, appears poised to continue to increase the Fed Funds rate even if CPI shows a year-over-year decrease. According to the CMG Group, there is a 66.3% probability of a 0.5% rate hike in the December meeting. While this may not be a surprise to some, the probability of an additional 0.5% rate hike at 50.2% in the February meeting, is certainly not what the market is currently hoping for and would likely cause concerns for those who were hoping for a "pause" after the December meeting.



Technical – Time to Shine

Since the price of GLD (SPDR® Gold Shares) peaked at 193.30 earlier this year in March, the share price of the ETF has been on a steady downtrend and hit a low for the year of 150.57 just last month. That was of course until November 8th when GLD broke the downtrend and accelerated to the upside. But what could have could have caused such a change in trend? Consequently, that same day, Bitcoin fell by almost 10% as the FTX collapse was unfolding. After a disappointing year of unsatisfactory returns for investors, will this downtrend line break provide to be a catalyst that will propel the price of the precious metal to the upside? We may not know, but it is a telling sign that investors are possibly starting to lose confidence the cryptocurrency market.

PCM Report December 2022 | Volume 13, Issue 12

Equity Valuations and Forecast

Clint Pekrul, CFA

This year might indeed be the first innings of a repricing cycle we have not experienced in almost four decades. As money becomes scarcer, i.e., interest rates rise, the cost of doing business goes up and overall economic activity slows. By design, the Federal Reserve is trying to influence consumer behavior through tighter monetary policy in order to tame inflation.

We have no crystal ball with respect to the Federal Reserve's monetary policy. Any interest rate forecast is fraught with significant error, but the consensus is that interest rates will remain elevated at least in the near term. Markets seemed to have priced this expectation. Recall late September of this year when the future path of interest rates seemed quite uncertain. Major equity indexes such as the S&P 500 and the NASDAQ were at their yearly lows.

Uncertainty about the Federal Reserve's terminal interest rate has resulted in higher-than-normal volatility in 2022, both in the stock and bond markets. Consider that the CBOE VIX Index, which is a measure of implied volatility for the S&P 500 Index based on short-dated options contracts, has averaged roughly 30 so far this year.

A VIX of 30 implies that there is roughly a 70% chance that the S&P 500 Index will move up or down 30% over the next twelve months. The long-run VIX average is approximately 15, so today we are roughly double the "uncertainty" of future outcomes for the broad S&P 500 Index. This ambiguity is no surprise considering that interest rates have gone from essentially zero to 6% (based roughly on the current LIBOR rate) in a relatively short period of time.

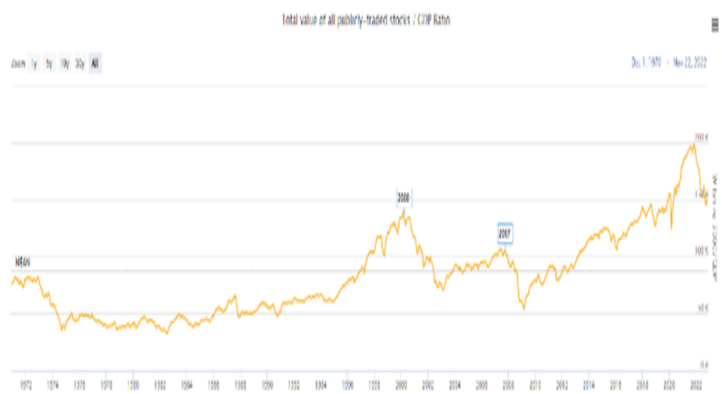
Collectively, we enjoyed the free money high from the COVID shutdown, but now assets are being repriced. For example, the S&P 500 Index reached a price-to-earnings ratio (PE) of approximately 39 at the beginning of 2021. Today, the PE for the same index is roughly 19, which is still above the long run average for stocks.

The reason valuations have come down more in line with longer term averages is multifaceted. The primary cause is that stocks, and risk assets overall, now have competition from interest rates on short term, secure deposits. Back in 2020, investors had no option to earn an attractive yield other than to allocate to equities, either in the public or private markets. Likewise, investors have reached for yield in the credit markets and real estate.

However, to no surprise, higher interest rates have changed investor expectations about future returns. Today, there is competition for investor dollars in the form of an attractive risk-free rate of return. Based on simple supply and demand, money has flown from risky assets into the security of a guaranteed yield.

Considering the competition, what is a reasonable valuation for equities? The chart below illustrates the Buffett Indicator, which is the ratio of the broad equity market capitalization (as measured by the Wilshire 5000 Index) to U.S. gross domestic product (GDP).

Wilshire 5000 to GDP Ratio



While no measure is perfect, the Buffett Indicator is a reasonable metric to consider. The rationale is to compare what we collectively pay today for future earnings based on our current productivity. As the chart illustrates, the Buffett indicator is still well above the long run average, despite the pull back we have experienced in stocks so far this year.

If mean reversion holds true, the long run outlook for stocks overall is somewhat grim. If the Buffett indicator reverts to the long run average, we would have about a -30% potential drawdown in front of us. Considering that the Federal Reserve might not backstop the market via lower interest rates, the downside risks are higher today than just a few years ago. Remember the competition, too, from higher yields on short term secure deposits.

We are not suggesting that investors abandon stocks. As we mentioned previously in the PCM report, certain factors have held up relatively well in 2022, and could continue to outperform in 2023. Low volatility and value stocks could remain in favor. Likewise, the momentum factor, which takes time to rebalance, could outperform the broader market if certain sectors, such as energy, continue to trend higher.

If indeed we do retrace from current valuations back to the long run Buffett indicator average, investors could be afforded a tremendous buying opportunity, based on historical observations. Investors with long term time horizons and substantial cash balances are now compensated to wait via higher interest rates. Earn a reasonable cash yield and deploy an allocation to stocks if valuations fall in line with long run averages (or perhaps dollar cost average).

As always markets are unpredictable. We suggest taking a measured approach to stocks with an eye on risk. We are at an inflection point with interest rates, so the investor experience with equities over the past roughly twenty years will likely be quite different going forward. For disciplined investors, the potential opportunity is tremendous.

Q: As a portfolio manager, what are you grateful for in 2022?

Given the way the markets traded on Monday; I am grateful for a healthy cash hedge in portfolios. As I noted earlier in the report, I believe there is still a significant disconnect between fair value of the equity markets and the economy, with investors still too optimistic regarding earnings. The ability to be long certain sectors or factors and short the overall market is also a great tool for portfolio managers trying to manage market volatility and drawdowns.

If I take a step back from the day-to-day responsibilities of managing portfolios, there are many things to be exceptionally grateful for. At the top of the list are the freedoms we enjoy. Freedom has become a somewhat relative concept but when you see what is happening in places like China where residents are literally caged from covid protocols, I am grateful for the rights we have (even when under attack).

I also am appreciative for the data analytics I have available as a portfolio manager. The world is awash in data but at any given time, much of that data is simply noise. I had an interesting conversation with Dr. John Kelly today (former CTO of IBM) and he talked about how the combination of humans and machines will be better than just human or machine for a long time. A statement I completely agree with.

As a portfolio manager in the business for almost twenty years, 2022 has been a unique experience. I began my career in 1999, at the height of the dot-com bubble. Back then equity valuations were propped up by empty promises of future earnings. Equity markets ballooned to the stratosphere but eventually came back to earth. Eight years later we faced the worst financial crisis of our lifetimes as over leveraged markets came crashing down. In hindsight, while the dotcom and 2008 financial crisis were devastating, investors could always turn to bonds. We were in the middle of a long secular decline in interest rates that began in the early 1980s. Almost every year we could rely on bonds to provide a positive real rate of return.

Fast forward to 2022 and the story is quite different. Today, bonds provide no refuge for the equity investor. In fact, bonds have been just as volatile as stocks and have experienced substantial losses. What I am thankful for as a portfolio manager, considering today's circumstances, is that we had a plan of action in place to deal with what we are experiencing today. While we don't have a crystal ball, we developed a strategy that is accommodative to various market environments. As portfolio managers, we have held up reasonably well this year against a backdrop of considerable headwinds. We have stuck to our discipline, and it has served us well.

Q: What should be on every investor's Christmas wish list?

Anything but coal for the coming year as coal is clearly one of the greatest threats to the population's survival. As mentioned, I believe stocks are greatly overvalued based on my expectations for 2023 earnings. I am often asked what would change my opinion about expected equity market returns. I believe there are always surprises that would change the valuation models and make stocks more attractive.

At the top of the list would be a marked improvement in the Labor Participation Rate (LPR) published by the St. Louis Fed. As late as 2010, the LPR hovered around 66% of the available work force. During covid, when companies were forced to shut, the rate fell to 60. Sadly, the participation rate has only rebounded to 62.4 today and that is leaving the labor markets too tight for margins to significantly improve or bring prices down. Every 1% improvement in the LPR adds approximately 1.5 million employed workers. A LPR of just 64 would likely reduce inflation to levels where the Fed could sit on the sidelines.

Also on the wish list would be policies to encourage moving back to energy independence. The US economy experienced one of the greatest economic booms exactly at the time we became energy exporters instead of importers. Returning to the days of sub-$2 gas may not make energy as profitable, but it resulted in much higher discretionary income for everyday people and led to greater economic opportunity for all Americans.

A Fed pivot might be at the top of many investors' wish list, although the chances of our central bank turning from hawkish to dovish is unlikely. A reversal from tight monetary policy back to easy money would certainly buoy asset valuations and provide a short-term sugar high. Stocks would likely soar if the Fed surprised the market with a lower-than-expected rate hike (or no hike) and the bond market would recapture much of the losses experienced this year. A pivot would certainly be comforting news to investors who might have allocated to egregiously overvalued assets after the pandemic of 2020.

However, investors should not wish for a pivot. Its effects would be short lived. Rather, we should welcome the normalization of interest rates that began roughly a year ago. In the short run, the Fed's actions have been painful. Unwinding what we have done post 2008 financial crisis has been and will continue to be quite disruptive, yet necessary. For the first time in roughly 15 years, investors, particularly savers, can earn a meaningful rate on secure assets. Positive interest rates somewhat negate the risk-taking behavior we have been forced to pursue in search for yield. The wish is that the Fed raises rates to an accommodative level and maintains a steady monetary policy thereafter.

PCM

PEAK CAPITAL MANAGEMENT

9250 E. Costilla Avenue, Suite 110

Greenwood Village, CO 80112

Phone: 720.361.4016

Email: info@pcmstrategies.com

Website: www.pcmstrategies.com

This material is for general information and education purposes. The information contained in this report represents the opinions of Peak Capital Management, LLC, as of the report date and does not constitute investment advice or an offer to provide investment management services. Before purchasing any investment, a prospective investor should consult with its own investment, accounting, legal and tax advisers to evaluate independently the risks, consequences and suitability of any investment.

To the extent this deliverable incorporates statements of expectation, belief, projection, prediction, anticipation, or otherwise corresponding to future conditions, those statements are forward-looking statements. Please note that any such statements are inherently susceptible to uncertainty and changes in circumstances. Forward-looking statements are not guarantees of any future performance and actual results or developments may differ materially from those projected. Any projections, market outlooks, or estimates in this material are forward-looking statements and are based upon certain assumptions and should not be construed as indicative of actual events that will occur. Any forward-looking statements herein speak only as of the date on which they were made. Peak Capital Management is under no obligation to, and expressly disclaims any obligation to, update or alter its forward-looking statements, whether as a result of new information, subsequent events, or otherwise.

An investor cannot invest directly in an index. Index performance does not represent the performance of any investment product offered by Peak Capital Management, LLC. The performance of client accounts may vary from the Index performance. Index returns shown are not reflective of actual investor performance nor do they reflect fees and expenses applicable to investing. Portfolio composition will change due to ongoing management of the Funds. References to specific securities or sectors should not be construed as recommendations by the Fund, its Advisor or Distributor.

Past performance is not indicative of future results, loss of principal is possible. Please consider charges, risks, expenses and investment objectives carefully before investing. No representation is intended that any security discussed in this presentation was or would be profitable to any investor.

The data and information presented and used in generating this report are believed to be reliable. Peak Capital Management, LLC. does not warrant or guarantee the accuracy or completeness of such data.

Peak Capital Management, LLC, is a fee-based SEC Registered Investment Advisory firm with its principal place of business in Colorado providing investment management services. A copy of our current written disclosure statement discussing our advisory services and fees is available for your review upon request. Advisory services are only offered to clients or prospective clients where our firm and its representatives are properly licensed or exempt from licensure. No advice may be rendered by Peak Capital Management, LLC unless a client service agreement is in place. Nothing herein should be construed as a solicitation to purchase or sell securities; this can only be done by prospectus, which can be obtained by contacting Peak Capital Management, LLC or other financial professional. Likewise, nothing herein should be construed as an attempt to render personalized investment advice. A full listing of investment decisions made by PCM in the past year and relative performance is available upon request. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities presented here. Opinions expressed are those of Peak Capital Management and are subject to change, not guaranteed, and should not be considered recommendations to buy or sell any security.

GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.