PCM
Peak Capital Management
PCM Report July 2023 Volume 14, Issue 7

Searching for a Sign

Brian Lockhart

Investors are constantly looking for signs or indicators to guide their investment and portfolio allocation decisions. Are we in a "risk-on" or "risk-off" environment? Are valuations attractive and support multiple expansion or are markets overvalued leading to multiple contraction? Bob Dylan's masterpiece, The Time's They Are A-Changin', poetically sends the message for people to recognize the signs of cultural change that was happening in the 1960's.

What guides your outlook and expectations for the markets? Do we rely on history or ignore it as no longer fashionable? Will history always repeat (or rhyme) and be our teacher or do we believe this time will be different? Do we follow the herd? Let the trend be your friend? Or maybe, we set it and forget it as a passive investor?

While there is no guarantee that the future will mimic the past, the words of Winston Churchill in a speech to the House of Commons in 1948 rings true for investors, "Those that fail to learn from history are doomed to repeat it." History is replete with data that mirrors where the economy and markets are today.

In November 2022, the yield curve inverted with the yield on the 10-year Treasury falling below the yield on the 3M Treasury. This has happened 11 times in the last 55 years and on every occasion, the economy experienced a recession. There is not a single exception. On average, a recession begins 12 months after the spread on the 10YR/3M Treasury inverts but the timing has been as short as 6 months (1974) and as long as 17 months (2008). History suggests the economy will be in a recession no later than 1Q2024.

Recessions have gone from garden variety to severe, with the Great Financial Crisis of 2008 standing out as one of the worst recessions in history. The stock market's performance, measured by returns on the S&P 500, has a wide dispersion for the 15 months following a yield curve inversion. Eight of the eleven occurrences were negative but the range was between -47% and +12% during that period.

It has only been 8 months since the yield curve inverted, so we are not yet halfway to the 15 months, but the S&P 500 is +13% since the inversion in late 2022. History would suggest that stock prices today have only one direction to go; lower, much lower.

While there are enough mixed signals on the economy to allow an analyst to make their case, the macro picture is not rosy. The Conference Board publishes the Index of Leading Indicators (LEI) to provide visibility on economic growth. The LEI is comprised of data on building permits, manufacturing new orders, average hours worked each week, and real wage growth among others. The LEI recently sank to the lowest level since July 2020 and has now fallen for 14 consecutive months.

> **"Those that fail to learn from history are doomed to repeat it." - Winston Churchill**

Monetary policy governed by the Fed influences both economic growth and market performance. There have been 11 tightening cycles by the Fed in the last 55 years and according to economist David Rosenburg, the stock market hits a bottom between 2 and 3 years after the Fed's last rate hike. While the Fed has paused for the moment, the latest inflation data, particularly the core PCE, shows inflation at 4% or higher suggesting the Fed may not be done with rate hikes. If history remains true, the markets may not bottom until mid-2025 or early 2026.

There is clearly a disconnect between the bullish sentiment among investors and what history suggests is coming. Bloomberg data shows the number of days between 3% corrections in stock prices exceeds 75 days, putting it in the top 90 percentile. It is true that Wall Street climbs a wall of worry but when the economy slips into recession, it almost always leads to a sharp correction and bear market. If the markets trade flat for the next 7 months, it would represent the best stock market performance following a 10YR/3M yield inversion in history.

Market indices have been driven by a select number of ultra-large, tech companies, that have gained nearly 30% year-to-date on average. The movement towards implementation of AI has justified part of rise of the Nasdaq but few see the gains as sustainable going forward. The labor markets remain tight but jobless claims have risen four straight weeks suggesting employers are hesitant about hiring today.

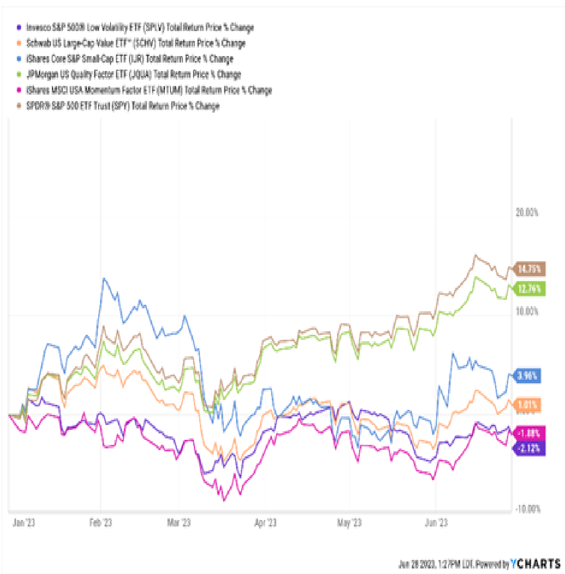
The recent strength in equities does provide investors with an opportunity to manage risk without selling into weakness. Long -duration Treasuries have historically been an effective hedge for market corrections and might make sense for investors who are overweight stocks.

Lacking Confidence

One of more interesting charts I have been following has been the divergence over the last 24 months of the Univ. of Michigan Consumer Sentiment and the Conference Board's Consumer Confidence surveys. You can see the strong correlations over the last 30 years between the two surveys and the massive divergence of late. While the pool of people surveyed is varied between the surveys, results have historically been similar. Both the Richmond Fed and the Kansas City Fed publish manufacturing indices and have been in contraction since 1Q2022. Labor participation rates have climbed recently but remain below the levels of pre-Covid. I think people intuitively know the economy is at a tenuous point and we would not be surprised if it is the Conference Board's survey falls to the level of the Univ. of Michigan survey.

- The tech bubble of 1998/1999 was the last time the S&P was as imbalanced as today. Leading the charge back then was Amazon which gained 966% and eBay that was up 409%.
- Nvidia may be the best example of a bubble in AI expectations as its market cap has risen from $250 billion last October to over $900 billion today as investors bid up the stock.
- The median stock in the S&P 500 is lower in 2023 and 27% of the 500 companies in the index are lower by 10% or more. Financials, particularly regional banks, lead the list of losers.

S&P 500 Return Breakdown



As we mentioned in last month's PCM report, the rally in stocks so far this year has been incredibly narrow, with only a few mega-cap stocks leading the way. According to Greenrock Research, as of June 2023, 121% of the S&P 500 Index return year-to-date has come from just seven stocks. This implies that the other 493 stocks collectively are down more than -3%. This scenario has occurred twice before. In 1998 the top 11 stocks of the S&P 500 contributed slightly more than all the return of the index, while in 1999 it was the top 6 stocks, according to the research. Furthermore, some of the top performing stocks from the 1998-1999 period took over a decade to get back to even.

- The rally's narrow leadership is revealed by the dispersion of factor returns year-to-date. Factors that are not tilted towards mega-cap growth names, such as value, low volatility and small caps, are either lower or more-or-less flat for the year. Only the high-quality factor has kept pace with the broader S&P 500 Index.
- When considering potential forward returns, the degree of the performance differential between the factors and the broader S&P 500 we are experiencing today is not likely to persist if history is any guide.

More Hikes to Come

After the June interest rate pause by the Federal Reserve, markets began to hope that the May 25 basis point increase was the last increase for the year. However, Federal Reserve Chair Jerome Powell reiterated his previous hawkish comments last week that the central bank is not done tamping down on inflation and that the recent pause was partly due to uncertainty over credit conditions. Powell even went as far as hinting at the possibility of consecutive rate hikes at upcoming policy meetings, starting with their next meeting in July. As inflation remains persistent, it has become clear that the Fed is focused on returning to its 2% target, even if the economy suffers in the process.

- According to the CME Groups FedWatch Tool, there is now an 81.8% probability that the Federal Reserve will decide to raise their target rate by another 25 basis points during the July meeting and 16.4% probability they hike an additional 25 basis points in September.
- With the possibility for an additional 25 basis point rate increase after the July meeting, the Federal Funds Rate will have increased by 375 basis points over the last year.

Quinn VandeKoppel

Macro View – Impending Recession?

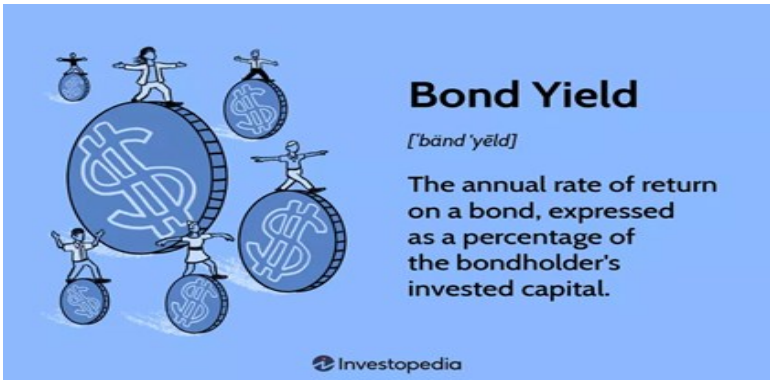
In recent months, we have written about how the current inversion of the 2-Year and 10-Year Treasury yields has been closely watched by both economists and investors given its track record of predicting recessions. Last week, HSBC Asset Management, a British-based universal bank and financial services group, warned that they believe the U.S. will enter a downturn in the fourth quarter, followed by a year of contraction and European recession in 2024. Joseph Little, Global Chief Strategist at HSBC Asset Management, said "while some parts of the economy have remained resilient thus far, the balance of risks points to high recession risk now, with Europe lagging the U.S. but the macro trajectory generally aligned". Despite their gloom-ish tone, the British bank believes that inflation will moderate and create an opportunity for Fed officials to cut rates later this year.

Taking Stock – Wealth Tax

As of late, a growing number of lawmakers from various states are joining together to form a coalition called "Fund Our Future" that would essentially impose wealth taxes on a state level. Washington, California, Minnesota, Illinois, New York, Maryland, Connecticut, and Hawaii are among the states advancing bills to tax one's "wealth" along with income. While all of the bill's objective are the same, the thresholds for the amounts taxed vary by state. For example, the bill in California would impose a 1% tax on wealth over $50 million + 1.5% tax on wealth over $1 billion whereas Washington would have a flat 1% tax on wealth over $250 million. Given that the current proposed bill by the Biden administration to congress is essentially dead-on-arrival, it appears democratic lawmakers have decided their next best option is to try to pass these bills at the local level even with strong opposition from Democratic Governors Hochul (NY) and Lamont (CT).

Fixed Income – "Generational Opportunity"

Last week, Gargi Chaudhuri, Head of iShares Investment Strategy at BlackRock, met with Yahoo Finance to discuss the opportunity investors have right now investing in fixed income. Currently, the iShares Core U.S. Aggregate Bond ETF AGG 30 Day SEC Yield is 4.09%. To earn these type of yields, while also investing in the core of the fixed income market (high quality, agency mortgages, investment-grade credit, and inflation linked bonds) is what she believes as a "generational opportunity of fixed income investors. In addition to fixed income ETFs, you can also currently purchase U.S. Treasuries, which are historically considered a "risk-free investment, ranging from three months to one year in duration that all have a yield-to-maturity close to 5.5%. Given the risk to return profile on these types of investments, its not surprising to see professionals like Chaudhuri enthusiastic about the opportunity.



Technical – Battle at 4,400

On June 29th, the S&P 500 closed at 4,396.45, only 0.08% away from a critical resistance point around 4,400. Earlier last month, the major index briefly surpassed that major resistance level and reached a new high for the year before pulling back after comments from the Federal Reserve Chair Jerome Powell hinting at additional interest rate hikes later this year. If the index fails to hold above the 4,400 level, we think we could see some acceleration to the downside to the 3900-4200 range where we have spent the majority of this year. With sharp accelerations to the upside like we have seen over the last month, it's best to be cautious because moves higher like this are often followed by sharp, quick retracements.

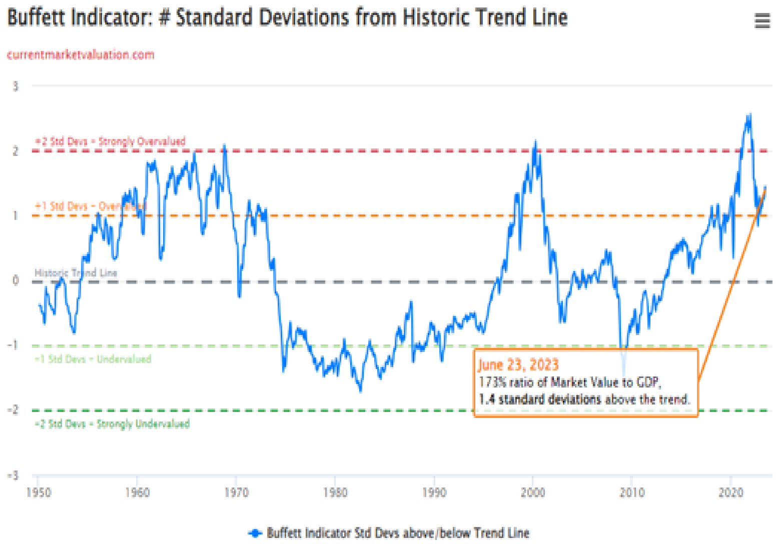
The Buffett Indicator

Clint Pekrul, CFA

Investors who follow legendary investor Warren Buffett will likely be familiar with the Buffett Indicator (BI). The signal is a guide to evaluate how cheap or expensive the stock market is relative to U.S. gross domestic product (GDP).

The indicator is straightforward. If the value of the stock market is considerably higher than the value of the U.S. economy (i.e., GDP), then we can argue that equities are overvalued and prone to a pullback. Conversely, if the value of the stock market is well below GDP, then stocks could be a bargain and prone to rise in value.

The simplest way to visualize the BI is to establish a long-term trend line and evaluate where the current indicator lies relative to the trend. The chart below illustrates the BI going back to 1950.



The blue dotted line across the middle of the chart is the long-term trend, while the red and green lines represent one and two standard deviations above and below the trend, respectively. As the chart illustrates, the BI tends to ebb and flow from overvalued (i.e., plus one or two standard deviations) to undervalued (i.e., minus one or two standard deviations).

The current BI sits at roughly 1.75x based on a stock market valuation of $46.16T and a GDP valuation of $26.61T. As the chart indicates, a measure of 1.75x is well above trend line (approximately 1.4 standard deviations), although not as high of a valuation as 2.6 standard deviations reached at the end of 2021.

If we go back to the beginning of the 1950s (the beginning of the chart) the BI stood at -0.4, suggesting that markets were relatively undervalued. Returns for the S&P 500 Price Index advanced roughly 250% in the 1950s and grew faster than GDP (hence the rise in the BI indicator to above trendline).

At the beginning of the 1960s, the BI stood at 1.1, or roughly one standard deviation above the trendline. This level suggested that stocks were modestly overvalued. Over the next decade, the S&P 500 Price Index advanced roughly 53%, or roughly one-fifth of the return from the prior decade. The BI was pushed up to over two standard deviations above trend in 1968 before falling to roughly 0.6 standard deviations above trend to end the decade.

Stocks remained above trend for roughly two decades based on the BI. We entered the 1970s roughly one standard deviation above trend and then endured two major recessions. Over the next ten years, the S&P 500 Price Index gained a paltry 17% and endured two major drawdowns. By the end of the 1970s, the BI stood at -1.3 standard deviations below the long-term trend line, suggesting that stocks were undervalued relative to GDP.

We began the 1980s undervalued based on the BI and the long-run trend. Over the subsequent 10 years, the S&P 500 Price Index gained roughly 227%. However, by the end of the 1980s, stocks were still undervalued based on the BI, which stood at -0.7 standard deviations below trend. Over the next decade, the S&P 500 Price Index advanced a whopping 315%, sending the BI indicator from below trend to 2.1 standard deviations above trend to end the 1990s (the highest level up to that point).

Over the next decade, the S&P 500 Price Index declined -14% (i.e., the lost decade), which sent the BI to -0.3 standard deviations below trend line by the end of 2010. By the end of 2020, the S&P 500 Price Index had risen by roughly 200%, sending the BI from undervalued to overvalued by 2.1 standard deviations (a level not seen since 1999).

The Path Forward

The BI reached an all-time high of 2.6 standard deviations above trend in August of 2021, when the Federal Reserve took its policy rate to zero after the COVID pandemic. After topping out in 2021, the BI has pulled back after the Federal Reserve reversed its dovish policy and began hiking interest rates.

In 2021, the S&P 500 Price Index fell roughly -19%. However, the BI remains roughly one standard deviation above the long-term trend line and has been above trend line for roughly 10 years. The consensus seems to be that given the end of the easy money era and a looming recession, the BI will more than likely approach the long-term trend or dip below into undervalued territory. This implies less than stellar returns for stocks over the near- to intermediate-term.

We have seen very narrow leadership supporting the current market rally, so the prospect of a lower BI in the near term is certainly worth considering. However, the BI has held above trend for more than 10 years before. Furthermore, the BI is heavily influenced by a handful of trillion-dollar market cap stocks.

Its worthwhile for investors to look under the hood and find areas of the market (i.e., factors, sectors, industries, etc.) that might be attractively valued.

Q: Will we see a repeat of 2000-2002 equity market returns?

Sadly, there is a distinct possibility that the next bear market ends up being similar to the carnage of 2000-2002. Today, like in the late 1990's, the Fed was forced to hike rates rapidly to address an over-heating economy. The market had narrowed in 2000 to the point where almost 80% of stocks were down but the S&P 500 was still showing positive results. We see a similar narrowing of market participation today with the S&P 500 only in positive territory because of the gains in 12 stocks. The pain inflicted by the 2000-2002 bear market was not simply how far stocks fell from peak to trough but also the amount of time it took to recover. The Fed cut Fed Funds from 6.5% to 1.75% in less than a year in 2000 but it still took almost 2 years (635 days) for the market to reach a bottom after the first rate cut. Given that the Fed may still hike further and the dot plot suggests no rate cuts until 2024, it could easily be 2026 before we see a bottom to the stock market based on historical data.

Each market correction or crash is based on the specific market dynamics at the time so there will certainly be differences in how investors react. Speculation had grown so great in the late 1990's when company valuations were based on "eyeballs" (how many people were visiting websites) rather than earnings or fundamentals. Valuations appear to be more reasonable today although still have a long way to revert to the historical mean.

Investors who experienced the bust of the dot.com boom of the late 1990s will remember the long, drawn-out agony of three straight yearly losses for the S&P 500 Index. We entered the period with exceptionally high valuations driven largely by a technology sector that represented a considerable weight in the S&P 500 Index. We know the story well – the bubble popped, and stocks dropped over 40%. Along the way we had several intermittent rallies, a terrorist attack and corporate scandals. It took the markets roughly seven years to get back to its previous high.

Last year was the pop of the "free money" bubble and the end of the easy credit era. We have already notched one losing year for the S&P 500 Index, and the probability of a subsequent negative year seems elevated despite the recent tech rally. Leadership is incredibly narrow and should the tech rally falter, there is not much support to push the overall market higher. Moreover, unless inflation abates to the Federal Reserve's target, we can't depend on the Fed put to come to the rescue. Given the current scenario it is not unreasonable to assume that we could have back-to-back negative calendar returns for the S&P 500 Index for the first time in roughly two decades.

Q: Will long-term Treasury bonds serve as an equity hedge in the near term?

I think long-duration Treasuries are attractive right now and do pose an alternative to other investments with yields around 4%. The economic data showing the economy slowing and inventories rising suggest to me that the long end of the yield curve will fall over the next 12 months creating an opportunity for investors hedging with bonds. We are in a very different environment with respect to bonds today than entering 2022. Interest rates were at generational lows and had been artificially been suppressed by the Fed over concerns about the economy recovering from Covid shutdowns. When stocks corrected by more than 20%, bonds were not able to hedge because interest rates were rising rapidly. If the stock market begins to correct in 2023 or early 2024, interest rates will likely have already peaked for this cycle and have room to fall. Not only might this soften the economic contraction, but it could also serve as an effective ballast in portfolios to contain losses from stocks.

There are a couple of ways to try and benefit from utilizing bonds as a hedge. You can secure yield at current rates and then see bond prices rise as yields fall in response to a recession. You can also add the more volatile zero-coupon bonds to the portfolio. These bonds are purchased at heavy discounts because they do not provide any income but typically have much stronger moves up and down. If rates fall, long-duration zero coupon bonds are likely to provide strong results.

Last year was a stark reminder that fixed income, particularly U.S. Treasuries, is not a guaranteed hedge against equity volatility. The Federal Reserve began to tighten in response to inflation, and asset valuations fell across the board. Bonds posted their worst year ever and investors began to question the traditional 60/40 portfolio. Based on their most recent policy meeting, the Federal Reserve likely isn't done raising their policy interest rate as inflation remains above target. Investors might question if bonds will continue to fail as an equity hedge.

It is important to remember, however, that yields across the maturity spectrum react differently to changes in Federal Reserve interest rate policy. Historically, longer-dated Treasury bonds have exhibited a strong negative correlation to stock returns during periods of market stress (e.g., external shocks, black swan events, etc.) and provide sufficient volatility to diversify an equity portfolio when it is needed most. The difference between today's yield environment to that of the recent past is that we are no longer hovering just above the zero bound. There is now sufficient room for long-term yields to fall and bond prices to rise should we be faced with heightened equity volatility. The stock-bond dynamic is much different now than just a year ago.

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.