6 Meridian Market Update Webcast

Recorded on January 27th, 2023 by Andrew Mies, CIO of 6 Meridian

NOTE: Note: The following is the output of transcribing from an audio recording. Although the transcription is largely accurate, in some cases it is incomplete or inaccurate due to inaudible passages or transcription errors.

This is Andrew Mies, Chief Investment Officer for 6 Meridian. Thanks for joining us for our 2022 recap and our 2023 Outlook Call. As you can imagine there is a lot to cover given what's happened in the last year. The returns for investors were generally disappointing. The Federal Reserve became very aggressive with regards to interest rate hikes and you had a number of asset classes that went down significantly during the year and so we're going to cover a lot of that and other things as we go through this presentation. Talking about 2022 as a starting point, we're going to cover the returns for the year but also where things stand on a longer term basis on returns for different asset classes. Then I want to talk about diversification and the impact that had on investors in 2022. And then finally we're going to recap some of the bursting bubbles that that we saw take place during the year. This chart shows you the returns. It's broken out. The top part is the returns for a equity investor and then the bottom part is the returns for a fixed income investor and the column labeled '22 obviously is the returns we saw last year. S&P 500 was down 18%. NASDAQ down over 30%. All equity markets were down and then you look below. That what's really unusual is a year where the equity markets are down significantly. It's unusual that you would also have fixed income down as much as it was. In fact for Bloomberg U.S AG, which is a second line item, it was down 13 which is one of the worst years ever for that index and that was all driven by the Federal Reserve hiking rates significantly throughout the year. If you look in the far right column, then on a 10-year basis, where things stand, even after the negative returns during '22, the S&P 500 compounded return over the past 10 years has been 12.5%, which is exceptional. The Dow is almost exactly the same at 12.3%. When you go down a few line items, you'll see MSCI EAFE which is the developed equity markets excluding the United States. So that would be markets like Japan and Europe and that has had a 10-year return of 5.3% which is okay, not great and less than half of what you got as an investor in the U.S markets. Then right below that you see the returns for emerging markets which have been horrible. They've compounded at just under 2% for the past 10 years and if you look at that after inflation, it's just been terrible. What we would tell you as a firm, what I'd tell you as an as an investment analyst, is that generally things that seem unusual or seem out of whack probably aren't going to continue and this gap between U.S. returns and the rest of the world is unlikely to continue for the next 10 years. It could go on for another one to two to three but on a trailing 10-year basis if we go to look at 2033 and we're looking at returns, I don't anticipate there being that significant of a gap and I wouldn't be surprised if rest of world outperforms U.S. over the next 10 years. It's just been an incredible run for U.S equities. If you go down below, you'll see the returns on a 10-year basis for fixed income and if you factor in the effects of inflation on these returns, they have been pretty poor. So the second line item, the Bloomberg U.S AG, compounded at 1.1% per year over the last 10 years. Inflation has averaged over double that so you have a negative real return. The only category where you had positive returns was in U.S high yield. I think also this is going to change going forward and the primary reason is the starting yield for example, for the U.S 10-year treasury right now at about 3.5%, that's a pretty good estimate of generally what you're going to earn. Certainly if you hold the bond to maturity and so go forward returns for U.S fixed income today are probably much better than they were 10 years ago and I would say the go forward expected returns for U.S equities are probably worse than they were

10 years ago just because they performed so well over that time period. Talking about diversification and what happened to an investor who had a diversified portfolio, this chart shows you the return to a 60/40 portfolio which is 60 U.S equities, 40 U.S fixed income and the data goes back to 1976. You can see this is the second worst year . '22 was the second worst year for a diversified investor only topped by 2008. I can tell you having been in this business in 2008, 2009 and same for a lot of the the advisors here at 6 Meridian, January of '23 feels much more comfortable and confident than January of 2009 did. Coming off of what happened in 2008, at the end of 2008 there was concern about the financial stability of everything in the global economy. That's not really the concern today but the reality is that the negative drawdown in investor net worth is very similar to what we saw during 2008. In '22 we saw this is just picking on two particular asset that two particular investments but there were many that had similar performances. We're looking at ARKK which is an ETF that tracks with what's considered Innovative Technology companies. Super high growth, generally not profitable and then Bitcoin the cryptocurrency and what you see is from September 30th of 2001 through the end of '22 a massive decline in the values. Down 60, 70 percent from where they started. This is those bubble themes, bubble stocks, bubble assets and had a massive crash. I would tell you that when you see crashes like this, they generally don't get resolved very quickly. You can go back and look at charts of the NASDAQ coming off of the dot com bubble in '99 and 2000 and it took over a decade for those assets to recover to their previous peaks and so when people are looking at putting deploying money and we still do see a lot of retail investors putting money into ARKK and then to Bitcoin, I would tell you once a bubble bursts in the way that it does here, generally they don't recover the previous highs for some long period of time and some of them don't ever.

So moving on to talk about '23 because I think that's what most people are most interested in is what do we see and what's our anticipation. I want to talk about a few different things. The first bullet point I'm going to talk about is 'What is Nobody Talking About' anymore. If we look back a year ago, what was the big concerns and today some of those don't seem to be very concerning and then of course we need to talk about inflation, talk about the Federal Reserve and their response to that and we want to talk about the economy and earnings and then finally we're going to talk a little bit about financial markets. So what's nobody talking about right now? Nobody's talking about in terms of an investment theme or an investment risk, COVID. So it still is out there. It still obviously has negative impacts and we're seeing a massive wave of COVID and spread in China given their policies that they've changed over the last several months but nobody's talking about how COVID's going to derail the economy and 12 to 18 months ago that was topic number one, two, and three. The next one is this is kind of a wonky one that maybe not everybody was familiar with but this idea of secular stagnation. So in 2019 and 2020 there was significant concern around the economy's ability to grow and the concern that we were in a permanently deflationary environment where prices just continue to grind lower. It's called secular stagnation. You have low population growth, low productivity and as a result the economy really struggles. I can tell you today, nobody's talking about them because the topics right now are overheated growth, strong labor markets and very high levels of inflation. Growth stocks and meme stocks in 2020 the fourth quarter of 2020, I can tell you I had a lot of client conversations that started out with hey my son, my daughter-in-law, my friend was talking to me about this stock or that stock or crypto or this coin and I don't have any of those conversations anymore. All of those things have gone by the wayside. A lot of them have either disappeared or the prices have come down dramatically and as a result the investor interest in that has declined significantly. That covers crypto and then the final one is MMT . It is kind of similar to the secular stagnation but there was a popular theory in 2020, there was an economist who and several economists talking about this idea of Modern Monetary Theory which basically said you should print as much money as necessary to encourage full capacity, productive capacity in the economy, full employment and the only thing you would ever have to worry about is possibly inflation. Well as it turns out inflation came roaring back much quicker and I'm going to talk about that in more in a minute and today there's very little conversation, very little press on MMT. So moving into inflation. That is the big story for '22 and it actually started in '21 you see on this chart two lines, one is the CPI which is the Consumer Price Index and that's the brown line which is the the main headline one that gets reported and then core which excludes food and energy prices. Over time these generally end up being very similar. You can have periods of time where and you see that in '22, the brown line got well ahead of the red line. They're starting to converge now but this level of inflation, this chart goes back to 2011, and I could take this chart back 10 years prior to that, and still this would be well above anything that we've seen since the 80s and in some regards since the late 70s early 80s. So this was the problem that was created. Why was it created? Why did all of a sudden inflation all of a sudden appear? The reason isn't it, just give me, humor me for a minute, so remember back to if you took economics and if you didn't I'll give you the quick and dirty on the simple explanation for why inflation took off. In economics there's something called the supply demand curve and what that looks at is where is the intersection between the supply of goods across the whole economy and the demand for goods and that intersection has a quantity and then a price and that matches in an equilibrium. In COVID what happened is you had a massive reduction in supply and it was a reduction supply of workers, of goods, of ability to move goods across the the world. As a result, the supply or quantity of goods shifted, but what the, in particular the U.S., what they did is they supported consumer incomes and you didn't have a significant decline in incomes and so as a result you didn't have a decline in consumer demand. So the demand remained the same, the quantity of goods available shrunk and so as a result, the thing that had to change was the price and that's what we saw, you saw it in used cars, you saw it in Peloton bikes, you saw it in building materials and the prices just skyrocketed because there was a significant demand and a limited amount of goods. That's starting to remedy and work itself through but as inflation gets embedded, workers start to say, hey what I used to get paid my 2% per annual raise my 3% annual raise. That wasn't good enough and I'm going to require a stronger compensation growth and that's the big driver and that's the big thing that the Fed is concerned with right now is growth in employment or the low level unemployment and growth in wages. This chart shows consumer expectations over the next five to ten years. We've seen this tick up. Fed watches this very closely. If consumers start to anticipate and expect inflation then it gets built into their wage negotiations it gets built into their purchasing decisions and so this is one that the fed and it's very noisy you see how much movement you have around it, but generally over the last year the trend in this has been up and so this is something that the Fed is watching closely. Employment, I mentioned, this top chart shows weekly claims for unemployment. You saw a huge spike during COVID and it's come down to extremely low levels meaning there's not a lot of new filing for unemployment but this is the chart really that's important to look at and that's the unemployment rate. We are at, 3.5% which is at or near all-time lows. The red line shows you the moving average the 12-month moving average and the reason that we put this on the chart is that if you look at the recessions that we saw in 2001 in 2008 and even in 2020, the COVID recession, but those previous two ones, which were more traditional recessions, when the red line, sorry when the brown line crosses over the red meaning the current unemployment rate crosses above the trailing 12-month average, you generally are in or about to enter a recession and we're not there yet and so there's a lot of people talking about, is the economy in a recession and the thing that we keep going back to and pointing to is the employment picture is not conducive or is not suggestive of a recession at this time. We're getting close though. As that gets closer to those lines converging and when they do converge you generally are either in or just about to enter a recession. Finally on inflation, the last point I'm going to make is a big driver of inflation coming out of COVID, was commodity prices and you saw people talk about lumber, oil, gas, and all types of different commodities and one of the challenges that and this is a chart I use but it's true for a lot of commodities, is that coming out of 2010 through 2014, there was a huge explosion of new investment in oil and gas, mineral mining, other raw material, CapEx and that has plummeted and as a result the amount of money being spent to find new commodity natural resources, the decline means that we are going to go through a period of time where probably the the supply of commodities is not going to meet growing demand and as a result it's going to take many many years of investment from those companies in order to generate new supply. In this chart I think, just it's really staggering, if you look at the decline in spending for oil field services and equipment over a 10-year period, it was cut by 77 percent.

Talk about the fed or to to point to the Fed, this is the first chart I'm going to talk about and we're going to talk about, there's there are three competing narratives in the investment landscape right now. Three competing stories. The Fed is the first one that we're going to talk about and the Fed story is inflation is too high, unemployment is extremely low, I wouldn't say that they think it's too low but it is extremely low which is providing significant bargaining power to workers and as a result we're seeing wage growth in the 5 to 6% range. Wage growth of 5 to 6% is not consistent with inflation at 2% so as a result, we need to slow the economy and in fact the Fed has been not explicit but almost explicit saying we need the unemployment rate to go up in order to bring down the rate of inflation. The third paragraph here, the highlighted words, "it's not on rate cuts", this is in response to something somebody had asked Powell and said what are you most focused on and he said you know we're focused on bringing inflation down, we are not focused on rate cuts. This is very important because this is from a recent quote from him so the Fed's narrative is the rates will probably go up a touch more. I'll show you a graphic next in terms of where they think that's going to go.

Just go to that now so this chart shows you that it's expected by June that the Fed funds rate will basically be at 5% up from about 4.5% currently. At 5%, then the implied fed funds rate by the end of the year is all the way down to 4.5%. So right now the market is implying or anticipating that the Fed is going to cut interest rates by 50 basis points. So you have the narrative of the Fed saying we are going to raise rates and we're going to hold them there and the bond market saying we think that the economy is going to roll over and the Fed will be cutting very soon in the not too distant future and that rates 12 months from today are going to be lower than they are currently and as a result that's why you see the 10-year yield down at 3.5% roughly. Those two are not consistent with each other. What the Fed saying, what the bond market is saying, are very different messages and then the third message is what the equity market is saying, which is and I'll show you more data on this, the equity market is saying we think that there's going to be a soft landing, modest hit to the economy and that the earnings outlook is pretty positive so a soft landing. The bond markets saying we think a recession, equity markets thinking soft landing and the fed's thinking the economy is growing to the degree we can maintain a pretty restrictive financial policy. All three of those can't be right.

Here's a chart that talks about fed funds versus CPI. The point of this is how high do we think that the Fed funds rate needs to go. What this chart shows is the red line is where the Fed funds rate ended at the end of previous tightening cycles and it compares it to how high CPI was which is the brown chart. So let's just look at the far left. In 1974 a Fed funds rate went to 13% and CPI peaked at 10 and what you'll see if you look at each of these examples, is Fed funds exceeded the rate of CPI sometimes by a significant amount and that was necessary to bring inflation down. Right now Fed funds is still below the rate of inflation even though inflation is coming down, that is happening because we are seeing some of the supply chain bottlenecks ease, but there are some I think very smart analysts out there saying is it likely that this will be the one and only time where Fed funds can peak at a rate below peak CPI and resolve the situation. So that's a question to still be answered but it is something I think worth considering. Now talking about the economy as a whole and what the picture looks like. I think this chart does a great example, it does a great job of showing post-COVID, the unbelievable growth that we've seen and this shows nominal GDP so nominal GDP includes price rises. Real GDP strips out inflation. Nominal GDP includes it and so what this chart shows is that the combination of robust economy as well as above average inflation, has led nominal GDP to grow and deviate significantly from its trend line which is that red line and what this is the greatest deviation that we've seen going back to 1990 from trend and it probably will get resolved via at some point a recession which recessions always bring GDP down below trend and we've got quite a bit of ways to fall so it's a combination of the increased prices from inflation and the increased activity coming out of COVID and this dramatic stimulus that the government put into the market. That's what this chart shows. On the right, in particular what happens when you have stimulus poured into an economy, is that money gets cycled through, generally the money gets sent directly to consumers or small businesses but almost all of it ends up on the income statements of Fortune 500 companies. That's just the way the economy works and so even if when you send it to the individual the individual spends the money at Walmart or if you send it to the small business they spend it at Costco. It all ends up getting cycled through and we see there were $7.3 trillion of new government spending just in 2020 and '22 across a whole variety of different programs and then on the left you see what happened to U.S corporate profits once this spending started to funnel through and it was a dramatic increase in corporate profitability and that's just functionally the accounting of it how it has to work if people don't save it and keep it in their bank accounts that can help the finance system and it gets spent it ends up as corporate profits and that's what this chart shows is profit margins are dramatic again we use a trend line over time profit margins have been growing and I think part of partially that's because companies have become more efficient and because more of the economy is driven by technology which has higher margins. But when you look at this, the deviation from trend, is pretty dramatic and it's starting to come down a little bit as costs, corporate costs, are rising faster than corporate revenues. In some Industries, not in all, but profit margins being this far above trend lead us to believe that it's probably not sustainable but that's exactly what most analysts are forecasting right now is that corporate profitability will stay dramatically above trend in '23 and in '24 and we think that's unlikely and will most likely lead to disappointing earnings results for S&P 500 over this year and next year. One of the big drivers of corporate profitability,in the past as we talked about, was the increase in the fiscal deficit and this just shows you how rapidly that fiscal deficit is declining. It's still large, but it's declining relative to where it was and as a result we think earnings estimates for corporate America are likely to continue to come down. This chart looks very complicated but if I walk you through it I think it'll be simpler. The black solid line at the bottom shows the 2022 earnings estimates as it developed throughout the year and so if you look at the far left in January of '22, the estimates for the full year '22 earnings were at about $223. They're going to end up coming in right at around $220 so not far off from the original estimates. Throughout the year they grew, they peaked above right below $230 and then they came down pretty significantly. The red line above that is the estimates for 2023 so for our current year what were analysts expecting last year for earnings in '23 and they started out above $240. They're now down to expecting earnings for this year to $230. Our best guess in our estimate and our belief is that that red line will continue to come down significantly and that the 2023 earnings will end up being at or below earnings for 2022 so we think there's continued decline in earnings estimates which we think will be a headwind for U.S. stocks as investors continue to reevaluate the earnings picture for U.S. companies. Talking about the economy at large, this is a graph that shows the leading economic indicators and generally these are growing so above above zero shows that the leading economic indicators are indicating the economy is expected to grow and the red obviously shows that it's expected to contract and what you see is that this generally is pretty close to a couple of months before a couple quarters before or coincident with the onset of recession. We're at a level of negativity now that would, if a recession doesn't come in the next three to six months, it would be the first time ever given this negative of a print that a recession didn't follow so this is something that is giving us a sign. The other one is the inverted yield curve. This simply measures what is the yield of a 10-year treasury compared to a two-year treasury. So the generally the 10-year treasury will yield more than the two-year, today it does not. Today it's about one almost a one to 75 basis points to one percent differential. This is the most inverted that the yield curve has been since the early 1980s and every other time that we saw an inverted yield curve that lasted like it has here, it led to a recession and that's, I should have mentioned this earlier whenever you see the shading on this chart, that's periods of recession. So when you see the red very soon followed you see the shading on the chart which means that the recession followed. So between what's happening with the leading economic indicators, what's happening with the inverted yield curve, I think quite frankly what's happening with the Fed being very clear they want unemployment to be to move higher, I mean they don't say that explicitly but generally that's what you can apply from their message, we think it's very likely that a recession is going to happen. Now I think that we probably are pushing it out because there are a few things happening now that are helping. Between China reopening between, quite frankly the stimulus that's coming to consumers from lower gas prices from lower utility costs that's a big help in Europe right now. All of those I think are delaying what is inevitably going to end up being a recession happening at some point in '23 or early in '24.

So let's talk about markets and specifically the US market and the bear market. We are in a bear market. That bear market started January of '22 and you see at the bottom there, it's ongoing, it hasn't ended. Some people are saying they think that the bottom on October the 12th where the market was down 25%, that's going to be the low for this bear market. I'm skeptical of that. I think that we are witnessing the most significant aggressive Fed actions that we've seen in 40 years and I think it's unlikely that results in a what would end up being a pretty modest bear market that didn't last very long. If you look at the number of days that this one lasted and didn't really result in that much damage it also wouldn't have resulted in a significant reset of valuations for companies. I'll show you a chart here in a minute.

Generally when you have bear market lows, the PE multiple will bottom out, high yield spreads will be much higher and none of that happened and so I think that there still is a bias amongst investors to believe that they want to make sure that they get in and capture the next up move as opposed to a bias of investors saying they want to get out and avoid the next down move and I think that bear markets generally take a long period of time to develop. They talk about bull markets climb a wall of worry. Bear markets slide down a slope of hope and I think that we are probably going to continue this bear market for a good portion of the rest of this year. Market concentration; I think this is an interesting point to look at because there can be some in every bear market, some things do better than others and some things can do fine and in this particular environment what I think is something we need to be aware of is the concentration of a small handful of stocks got to a point that we'd never seen before so what this chart shows you is the % of the S&P 500 that is comprised of the five largest stocks.So look on the left , you'll see at the peak of the dotcom bubble, five stocks accounted for 19% of the S&P 500. Those stocks were the ones that are listed there. At the peak of in '21 those five stocks that were listed, Apple, Amazon, Microsoft, Google and Facebook accounted for 25% of the market. An enormous concentration so if you think about five stocks or 25% of the market cap, 495 companies are the other 75%.That has come down now with this correction to 19.5% which coming from 25 down to 19.5, that's a big reduction but 19.5 still would be the highest concentration ever outside of what we just went through. It's very plausible that number comes down to the average of around 15% and as a result what that would mean is that the larger cap bigger stocks in the S&P 500 particularly the five largest that are listed here, underperform the other 495 and it's not that these companies don't operationally do well, it's that their stocks were just too high and too highly valued. Market value, so I mentioned that bear markets generally you see a big spike down in PE multiples you saw that it's hard to see on this but it right before the line 2010 that's the bottom of the GFC crisis you see multiples all got down to very low levels. This is a long-term PE ratio. It's called the 10-year CAPE. The US is well above that in fact the US is at very bullish levels of the CAPE multiple so that would be one thing that I would be cautious about in terms of calling a bottom in this market is that valuations still are very high but if you look at the rest of the world, so the two brown or darker lines, the non-red lines, those are at levels similar to those bear market bottoms in 2008 and so if you look at emerging market and rest of the world developed their PE multiples aren't levels that would suggest they could be set up for longer 10-year runs of very strong returns. I would also, going back to that chart at the beginning where I talked about the 10-year return for the U.S. market, a big portion of that isn't just the US companies are doing better, it's that this PE multiple on this chart if you look at from 2010 to 2021, it had an enormous expansion in the PE multiple so people went from paying 20 times earnings to 35 times trailing earnings and that was a huge driver of those excess returns that 12% annualized return. If that multiple normalizes over the next 10 years, that's going to be a headwind for investors. High yield spreads this is an exceptionally good indicator for when there's a lot of panic and a lot of concern and possibility of a bear market low. These spreads it's just the amount of yield that high yield has above treasuries and right now we're below average so the red dotted line is the average spread above treasuries and the current spread for high yield is below that so I think it's unlikely and this generally expands significantly during recessions and as a result of companies going bankrupt and other things and we haven't seen that but when high yield spreads get above a thousand on this chart that's usually a pretty good time to be a buyer and generally especially if that happens in the midst of a recession, I would tell you don't wait for the 2000 that you, the spread of 2182, that we saw in 2008 2009. That's something probably not to be repeated again just because as of the financial stress that was present at the end of the global financial crisis. So in summary for our call we see three conflicting messages being sent by the Federal Reserve by the bond market and by the equity market and depending on who's correct and it might be that there's a combination of they're all or a little bit correct, we do think there's risk for asset prices, we think there's a chance that bond yields will go higher which would cause bond prices to come down and we think that there's a risk to corporate earnings corporate profitability which could cause EPS estimates to come down. We also think there's a risk that the earnings multiple would come down if interest rates started to go up again. Wage growth which is really the key and then the Fed is focused on right now wage growth is the key to the inflation outlook and as a result if we continue to see four to six percent wage growth that's going to be inconsistent with the level of inflation coming down to two percent on a sustainable level but you also should be watching commodities as I showed in that one chart. There is a significant under investment in commodities generally and as a result we may see higher levels of commodity prices going forward. The next 10 years will be different. If you look at what happened in the U.S equity markets versus international, you look at what happened to fixed income returns and if you look at what's happened in terms of the top performing companies that chart I showed that had the concentration of the S&P 500, that will change, that will turn over. In 1980 the composition of the largest companies is very different than in 1990 or in 2000 in 2030 it'll be very different as well and then finally alternative Investments. Some of these, you should reach out to your advisor to talk about, they have can they did very well last year and we think they will continue to provide good diversified sources of return. Thank you for joining us on this call. Please reach out to us or your advisor if you have any questions. I hope you have a great day thank you.

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