WealthIQ: October 2022

“The key to making money in stocks is to not get scared out of them.”

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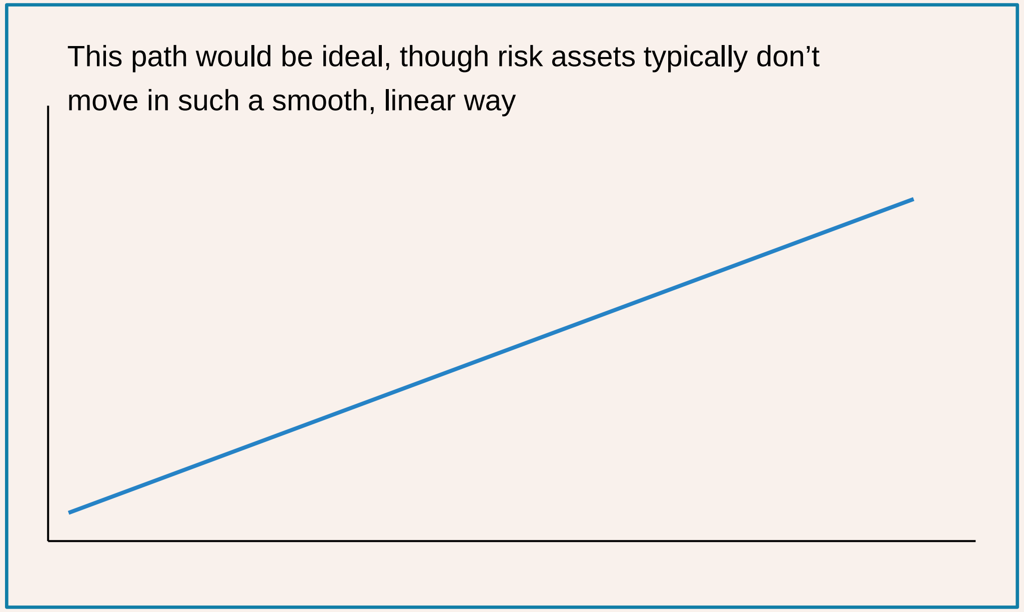
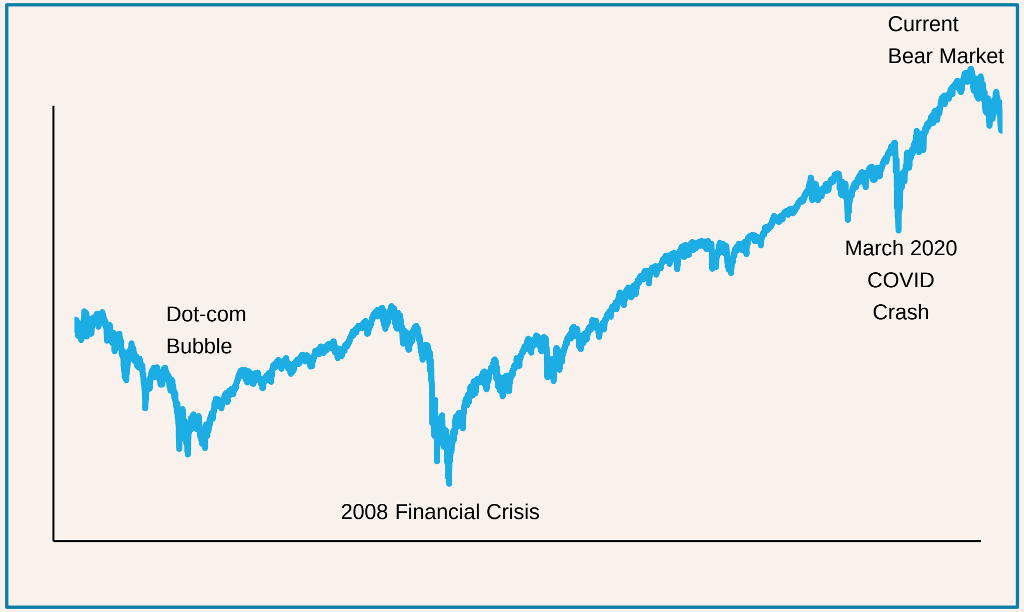
1) Put simply, bear markets stink. Testing the mettle and weighing on the minds of even the most experienced investors, they are a brutal process for investors to go through. According to the U.S. National Parks Service, the best way to survive a grizzly bear attack is to lay flat on your stomach and remain still until the bear leaves the area. While admittedly a strange reference for a financial commentary, the core reaction function for a physical bear and a market bear attack are similar- the need to override our innate fight or flight reflex and remain composed under dire circumstances to reach the other side.

On the prior page we quote investment legend Peter Lynch: “The key to making money in stocks is to not get scared out of them.” Lynch, as well as other investment icons such as Benjamin Graham and Warren Buffet, have all noted a similar pattern of investor behavior: the preference to buy at high levels and sell at lower levels. That psychology is one that we’ve seen play out in real-time over the past twenty-four months. During much of 2021, investor behavior seemed exuberant, as the thrill of rising prices led some to question if they should be taking additional risk to chase higher prices. This year, financial markets feel like a mirrored opposite. With a sharp shift from headline exuberance to headline risk, investing anxiety may lead some investors to wonder if they should be taking less investment risk today.

Before the ‘fight or flight’ reflex kicks in, take a moment to visualize what a stock market chart looks like- is it a straight linear line from bottom left to upper right, or one that gradually moves higher with peaks and valleys along the way?

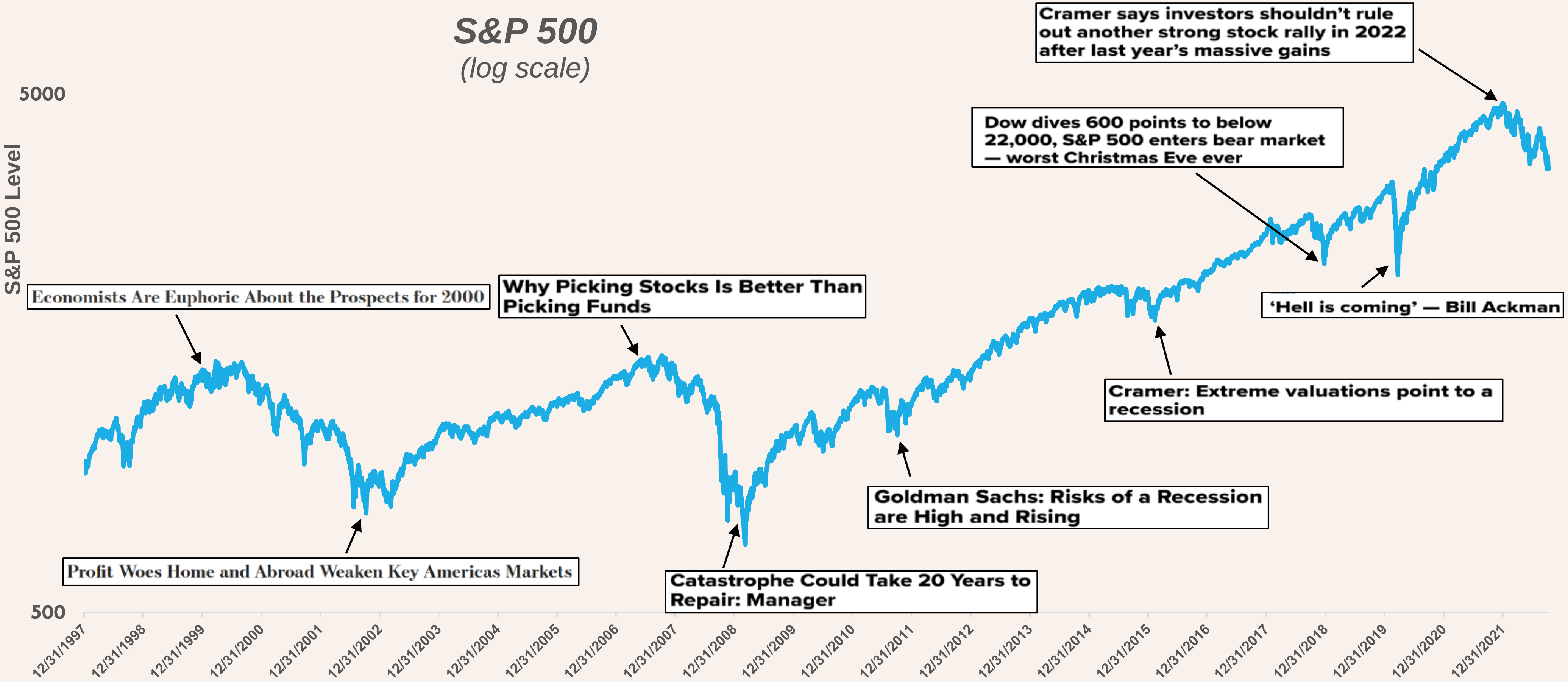
2) Did you visualize a chart like the one on the left or the right? Our guess would be your image aligned more closely with the chart on the right, which shows the S&P 500 since January 1, 2000. The chart is presented with a log scale, and we removed the dates and index values to place additional focus on the line's path. The chart features daunting peaks and valleys associated with the bursting of the dot-com bubble in 2000, the 2008 financial crisis, the March 2020 COVID crash, and today's bear market. Just as we always have in past volatile times, we continue to believe in 'buy and adjust', not 'turn and run'. Additionally, taking a big step back, we believe it's important to remember financial markets usually don't correct without some number of scary headlines.





Data Source: YCharts

3) Headline risk has run rampant in 2022. International war, the Fed, falling stocks, energy crises, and global central bank action are just a sampling of topics that have demanded investor attention through the first nine months of the year. While certainly daunting and deserving of our consideration, it is important to remember that headline risk is always present in financial markets. Furthermore, headlines historically have appeared most pessimistic around market bottoms and most optimistic around market highs. The chart below shows S&P 500 performance (log scale) since 1998 with some examples of financial headlines at various market peaks and valleys.



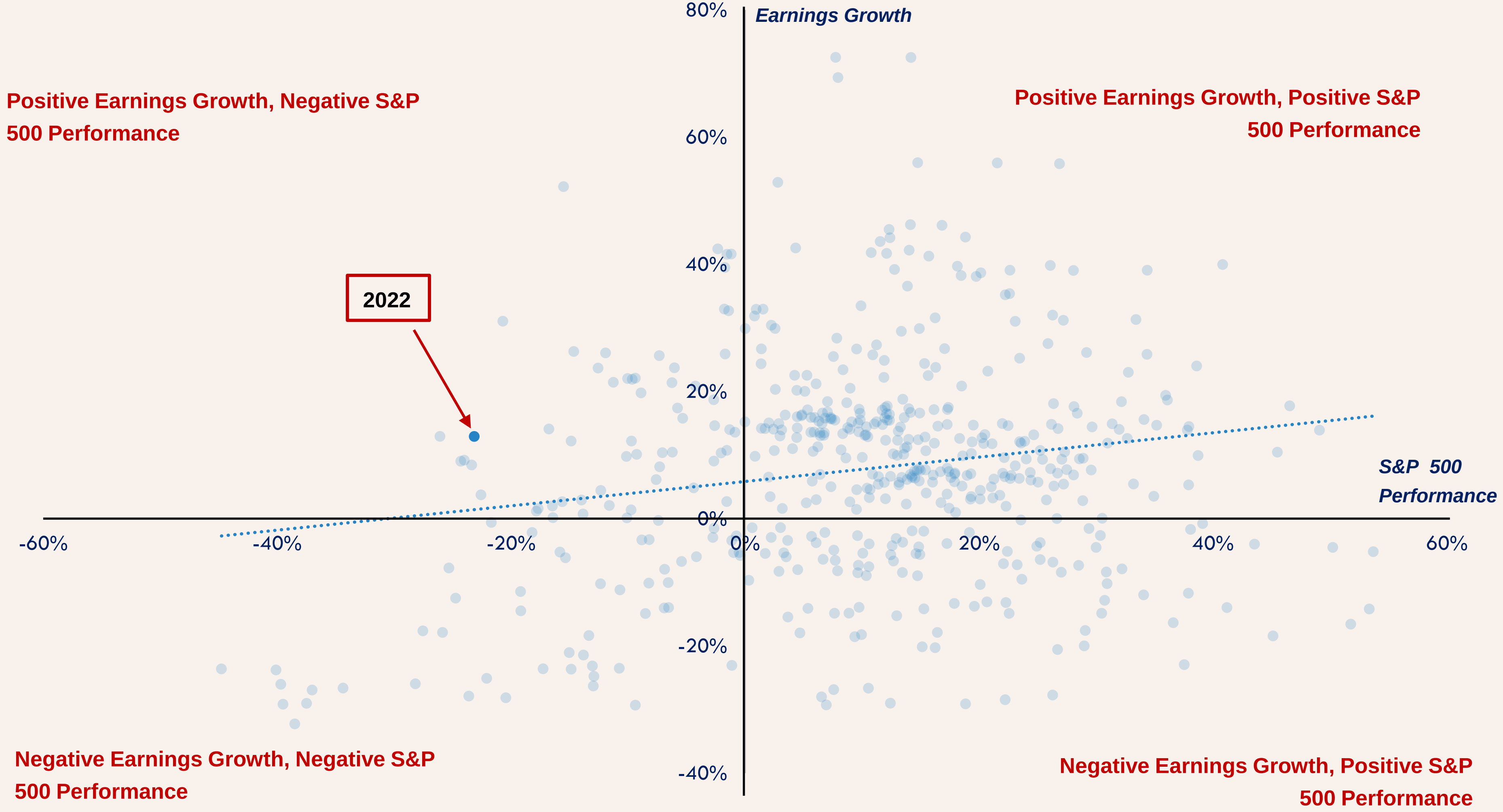
Data Source: YCharts; CNBC; Wall Street Journal

4) As of October 12th, the S&P 500 is down about -25% year-to-date, with more technology-oriented benchmarks, such as the Nasdaq, down by more than -33%. Intuitively, one would expect that when businesses do well, investors would also do well. However, this year has been somewhat unique, but not unheard of, in that corporate earnings have grown while equity prices have fallen sharply. The scatter-plot below breaks down the relationship between corporate earnings growth and S&P 500 performance since 1980 into four quadrants. Somewhat surprisingly, periods with positive earnings growth and negative equity performance (upper left) occur less frequently than periods of negative earnings growth and positive S&P 500 performance (bottom right).

Rolling 12-Month S&P 500 Returns (x-axis)

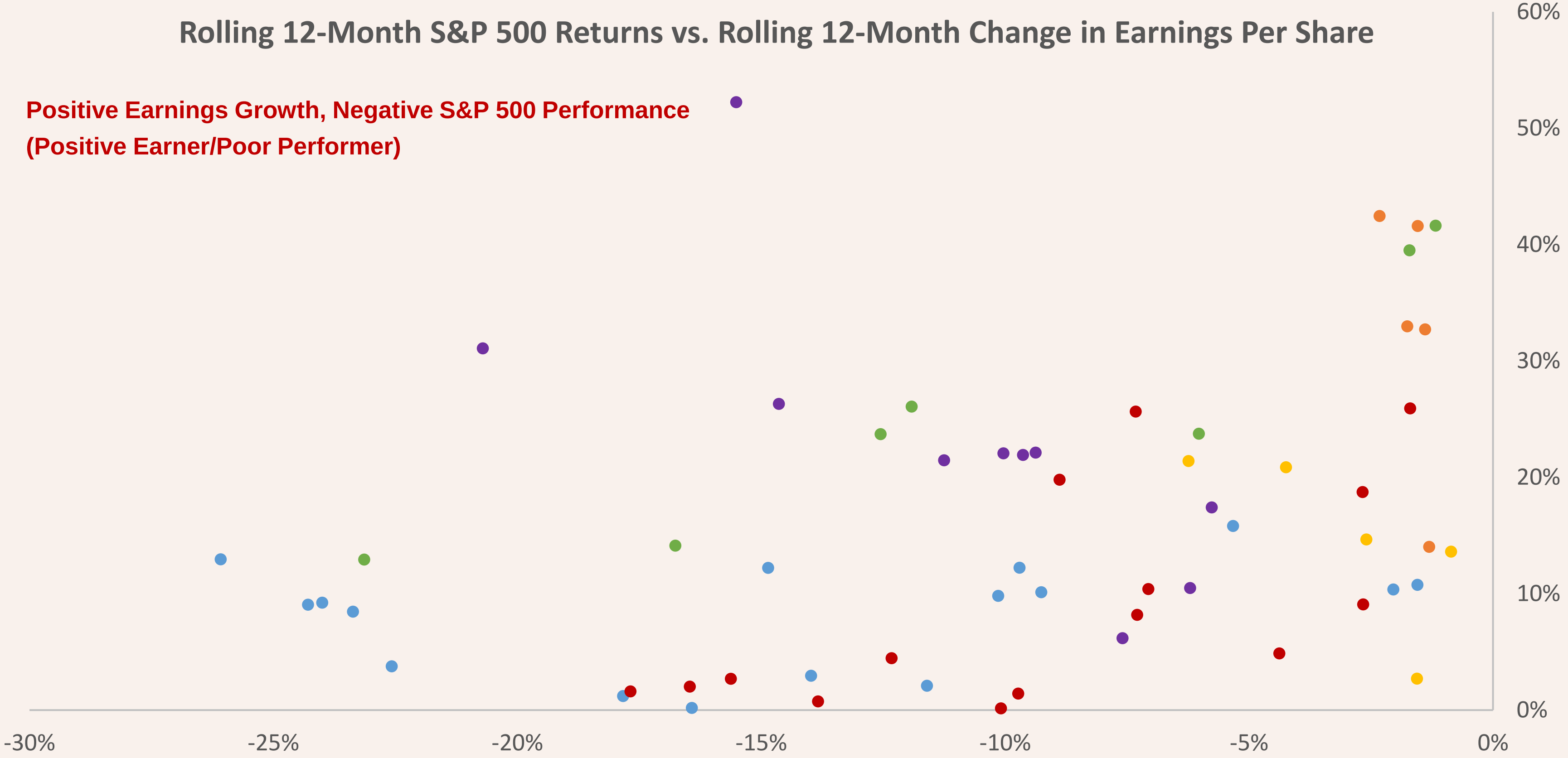
vs.

Rolling 12-Month Change in Earnings Per Share (y-axis)



Data Source: Bloomberg, L.P.; YCharts

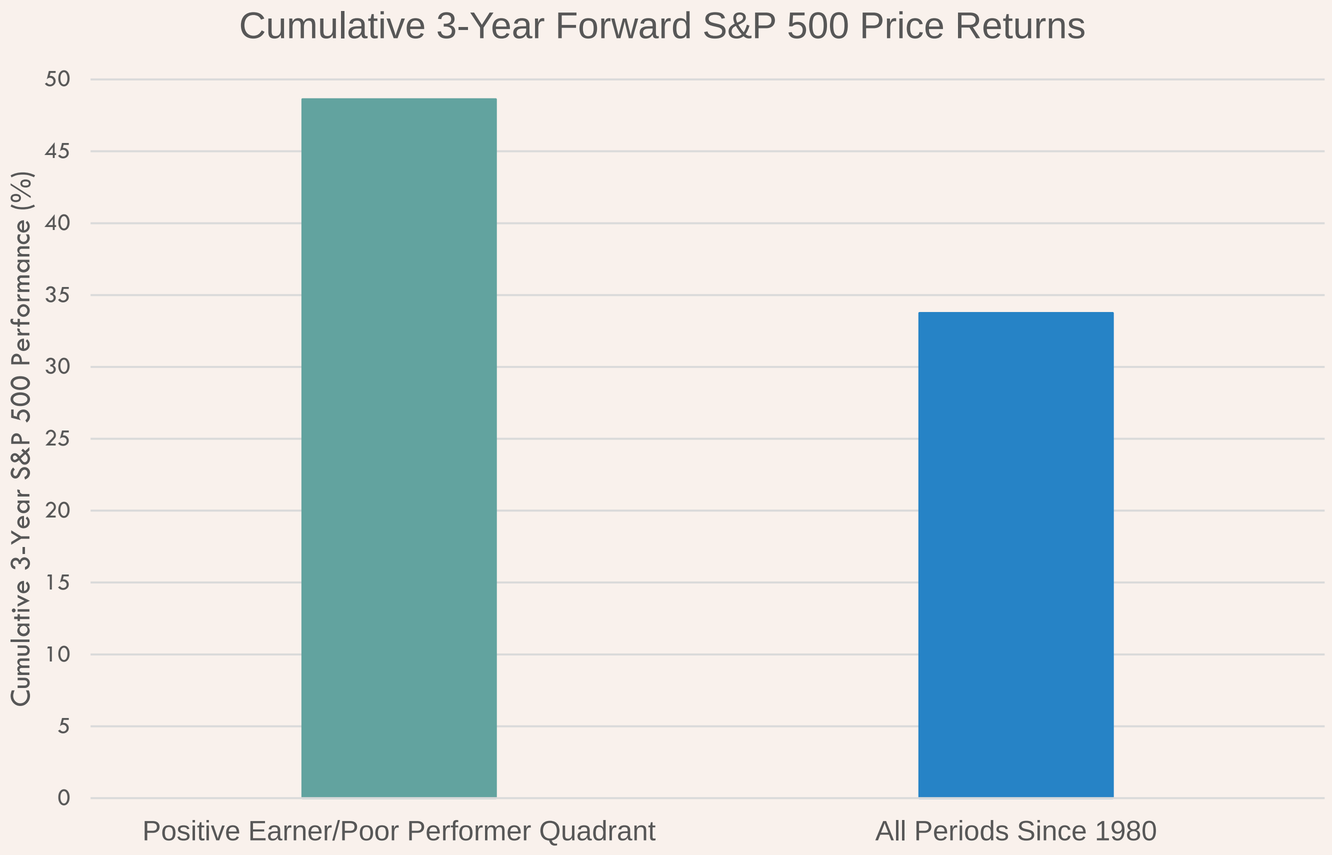
5) Focusing further on the upper lefthand quadrant of the chart on the previous slide, many of the data points come from time periods sharing similar characteristics to today. This includes a period of valuation multiple contraction in the early 2000’s and a period of sharp interest rate increases in the mid-1990’s, as well as the early 1980’s which seemed to offer a bit of everything. Interestingly, the early 1980’s, a period that is perhaps most like today, marked the beginning of a bull market that ran from 1982-1999.



2022	Rising Rates; High Inflation; Contracting Multiples
2010's	Varying dates throughout the 2010's
Early 2000's	Dot-Com Bubble; Contracting Multiples; Recession
1994-95	Federal Reserve Sharply Raising Rates; Multiple Contraction
1987-1988	Months Following October 1987 'Black Monday' Crash
Early 1980's	Rising Rates; High Inflation; Recessions

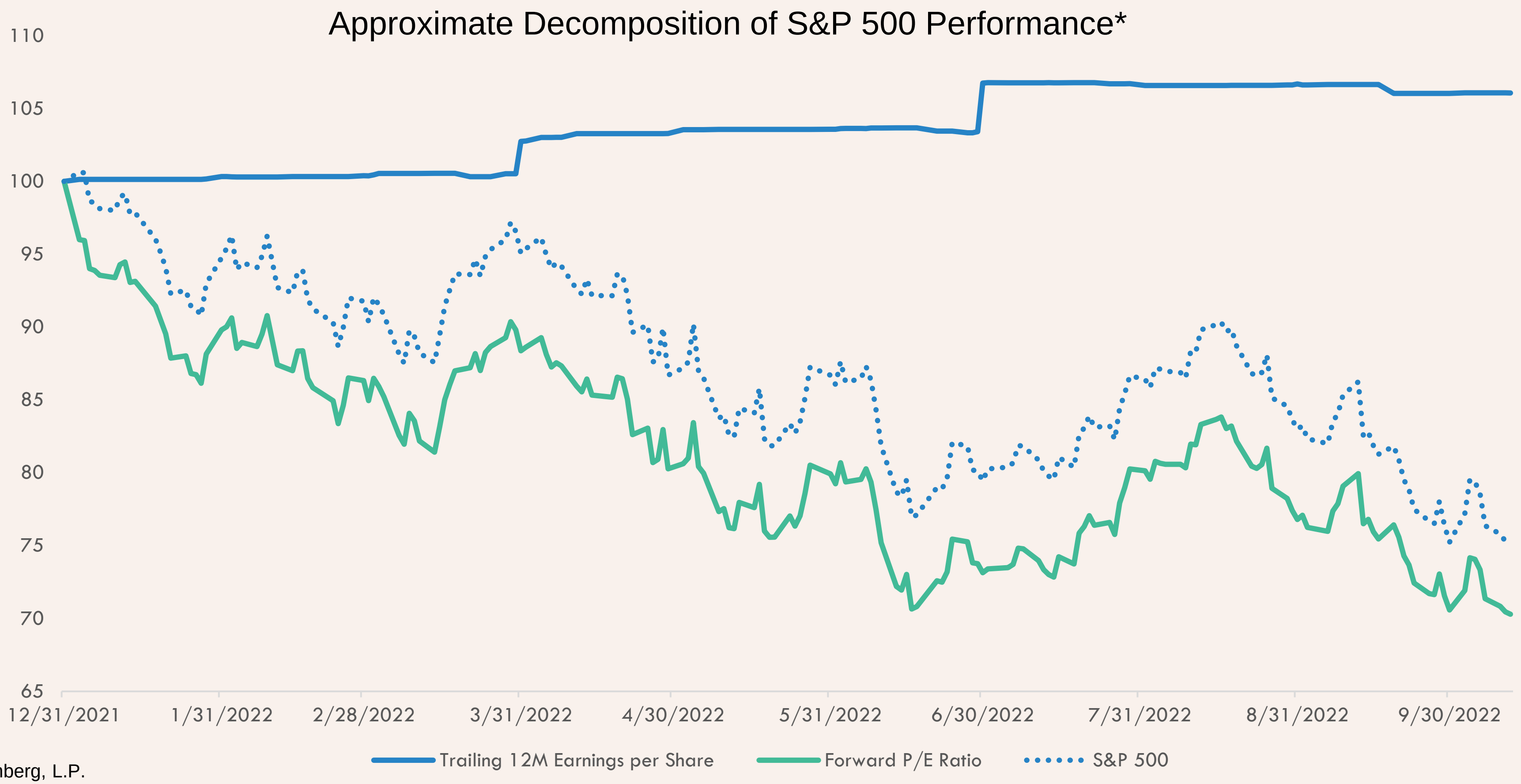
Data Source: Bloomberg, L.P.; YCharts

6) Future returns for this ‘positive earner/poor performer’ quadrant fared well despite some noted challenging environments. The average 3-year forward cumulative price return from the quadrant was +48.6%; this compares to an average 3-year cumulative price return of +33.8% for all rolling 3-year periods since 1980. While past performance is hardly a predictor of future results, it is worth noting that several of the ‘positive earner/poor performer’ periods experienced valuation multiple contraction, which may have benefited returns over future periods.



Data Source: Bloomberg, L.P.; YCharts

7) While corporate earnings have grown this year, equity valuation multiples have contracted. In the chart below, we break down the approximate drivers of year-to-date S&P 500 performance. Multiple growth (solid green line), or in this instance multiple contraction, is the primary detractor from year-to-date S&P 500 performance. With multiples contracting so sharply, earnings growth (solid blue line) has only been able to provide a minor cushion to S&P 500 performance (dashed blue line). In their simplest form, earnings multiples indicate how much investors are willing to pay for a dollar of earnings. For example, an earnings multiple of 20 would indicate investors are willing to pay/invest $20 for $1 of earnings. Since the beginning of 2010, S&P 500 earnings multiples averaged approximately 16.2x forward earnings. In the months following March 2020, earnings multiples peaked in the low/mid 20's but have fallen to around 15.2x today.



*Earnings & Multiples Indexed to 100; Year-to-Date through October 12, 2022

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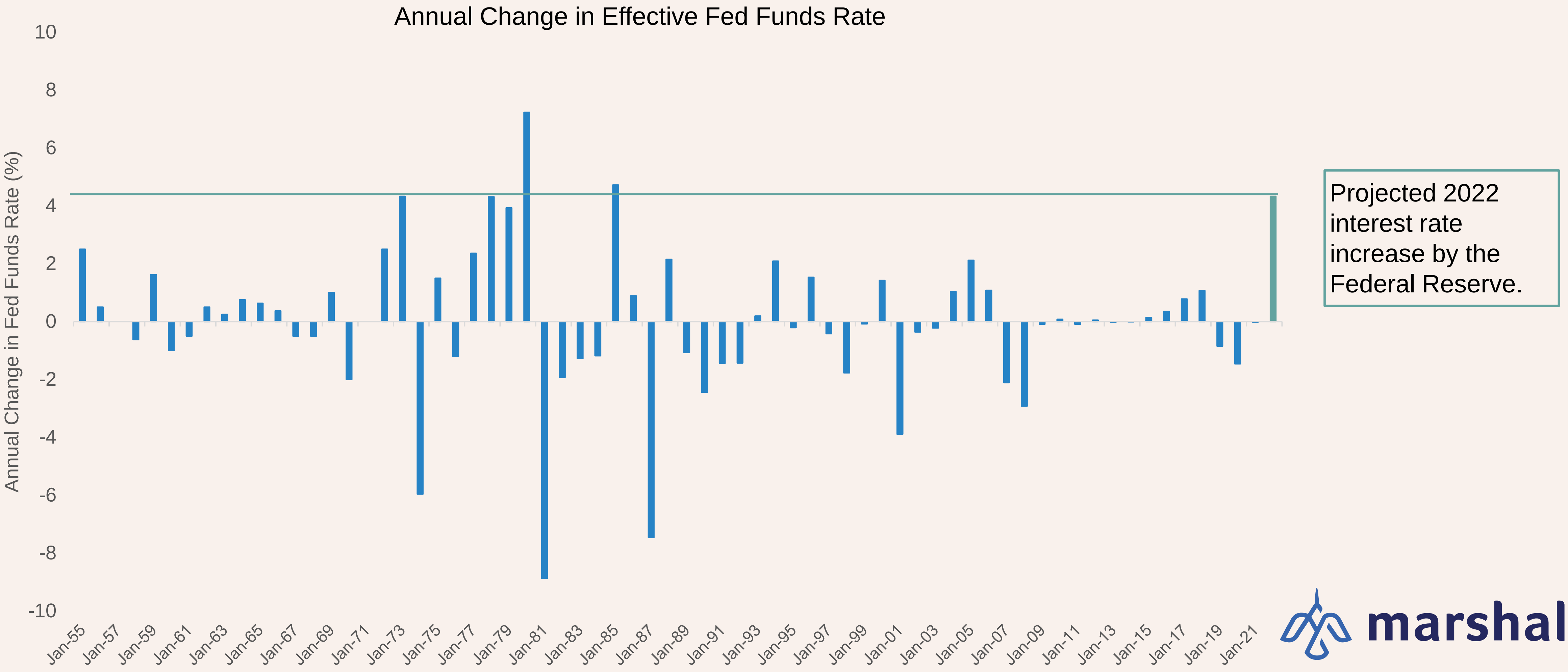
Data Source: Bloomberg, L.P.

8) This year's multiple contraction can likely be attributed to a sharp reversal of monetary policy by the Federal Reserve. As interest rates rise, like they have this year, investors have less incentive to pay a premium for future earnings when they can earn attractive yields today. In September, the Federal Reserve's 'Summary of Economic Projections' noted the Central Bank expects to raise interest rates to 4.4% by year-end. Should their projection be realized, 2022 will be tied for the 3rd largest single year interest rate increase by the Federal Reserve since the 1950s.



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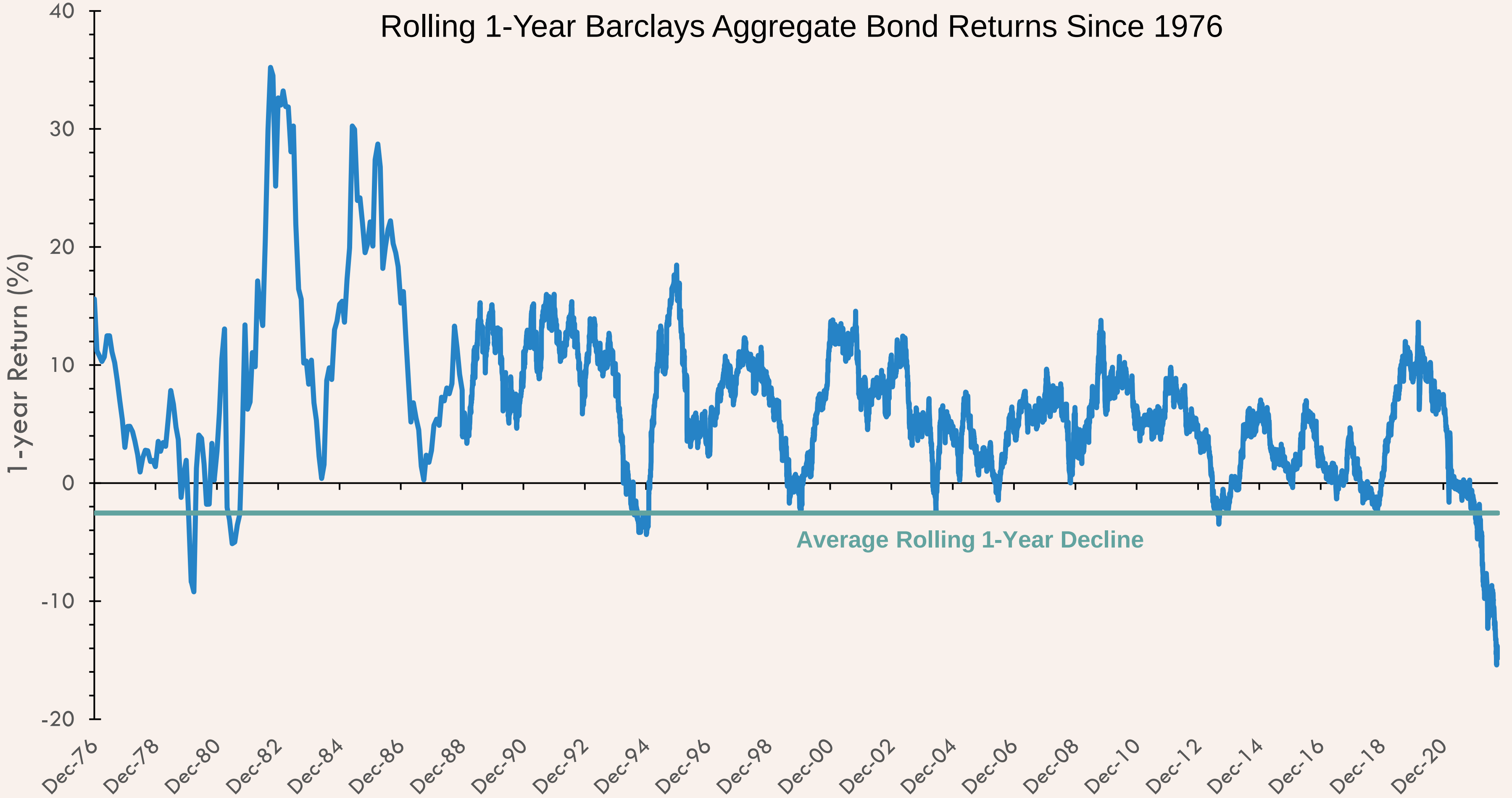
Data Source: St. Louis Federal Reserve; United States Federal Reserve

9) Many investors depend on the fixed income portion of their portfolio to provide stability during volatile periods. Unfortu nately, the rapid repricing of interest rate expectations this year has also wreaked havoc on fixed income markets. The Barclays Aggregate Bond Index, one of the most widely quoted investment grade bond indices, has fallen approximately -15% year-to-date. The chart below demonstrates just how unusual a move of this magnitude is. To help quantify just how unusual, there was roughly a 1 in 33,000 chance the Barclays Aggregate Bond Index would have declined so drastically in a rolling 1-year period based on the standard deviation of historical returns. For comparison, according to the National Weather Service, the odds of someone being struck by lightning during their lifetime are 1 in 15,300.



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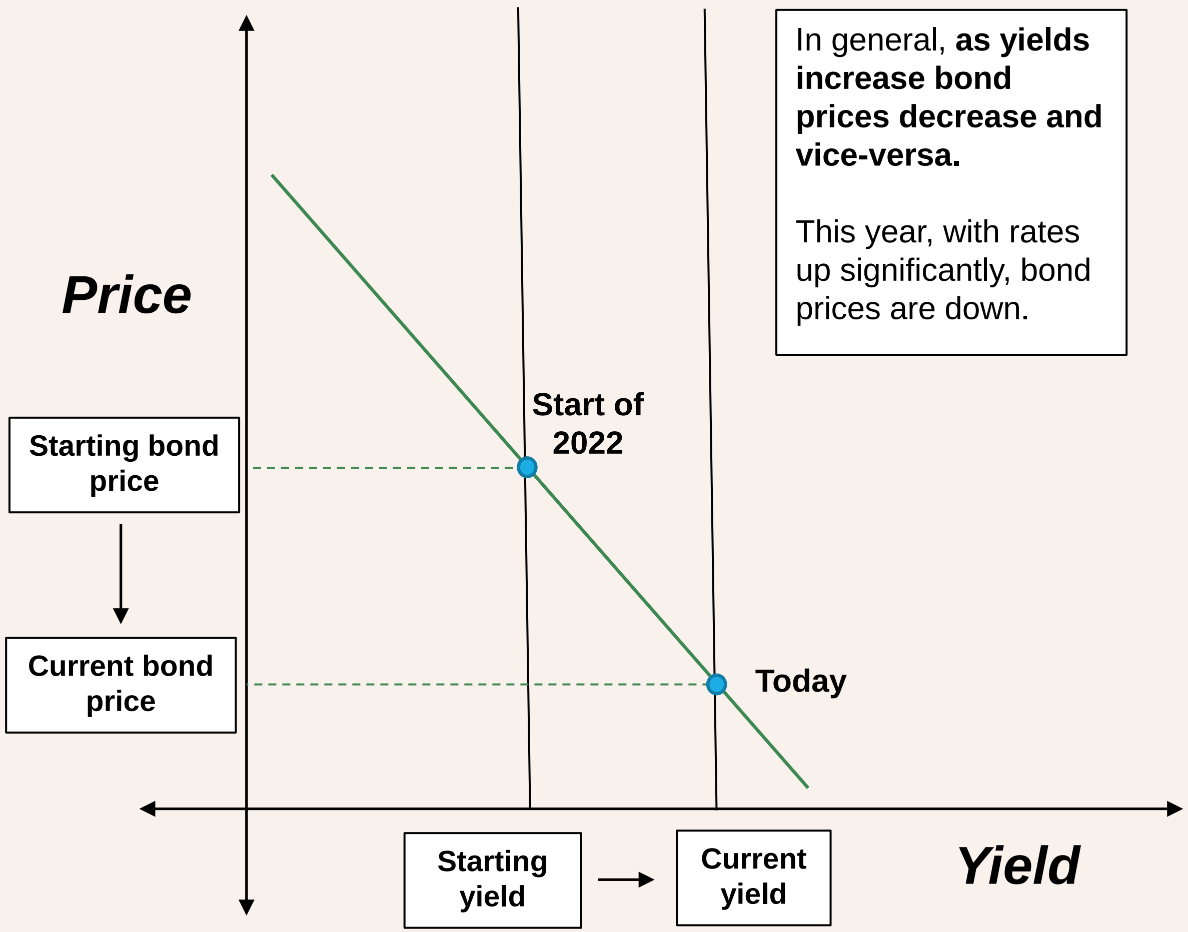
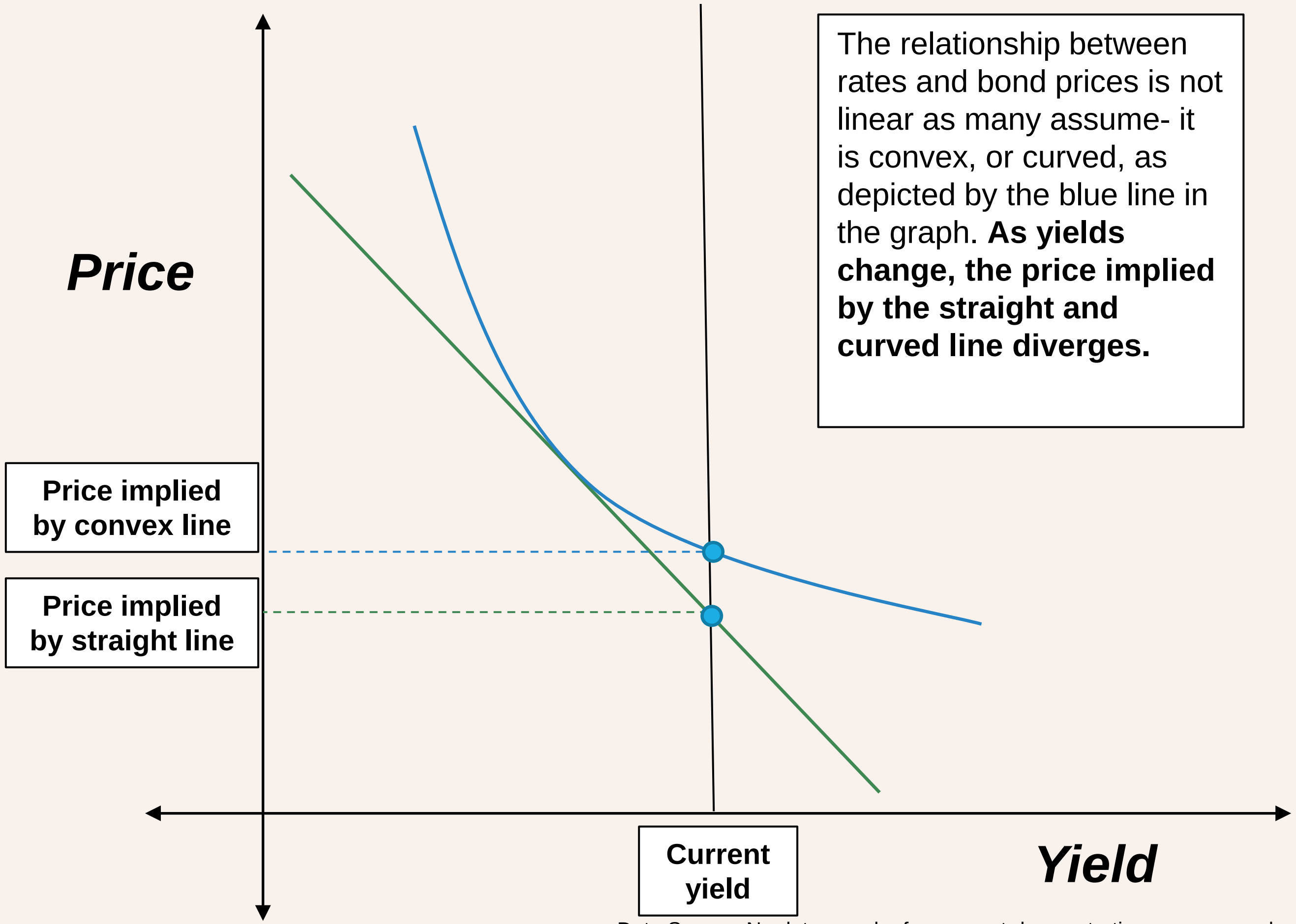
Data Source: Bloomberg, L.P.

10) With disappointing fixed income returns offering little to no diversification benefit this year, current stock market declines likely feel more painful than prior volatile periods. The next bit of information is a bit technical, but we believe it will help better explain fixed income markets today. Generally, as the graphic on the left shows, there is an inverse relationship between bond prices and yields. However, this relationship is not as linear as many may assume- it is convex, or curved, as depicted by the blue line in the graph on the right. As yields change, the bond price implied by the straight and curved line diverges. This means that yield changes have a varying impact depending on where you are on the curve. For example, as yields moves higher, it takes larger yield increases to drop bond levels than at lower yields.



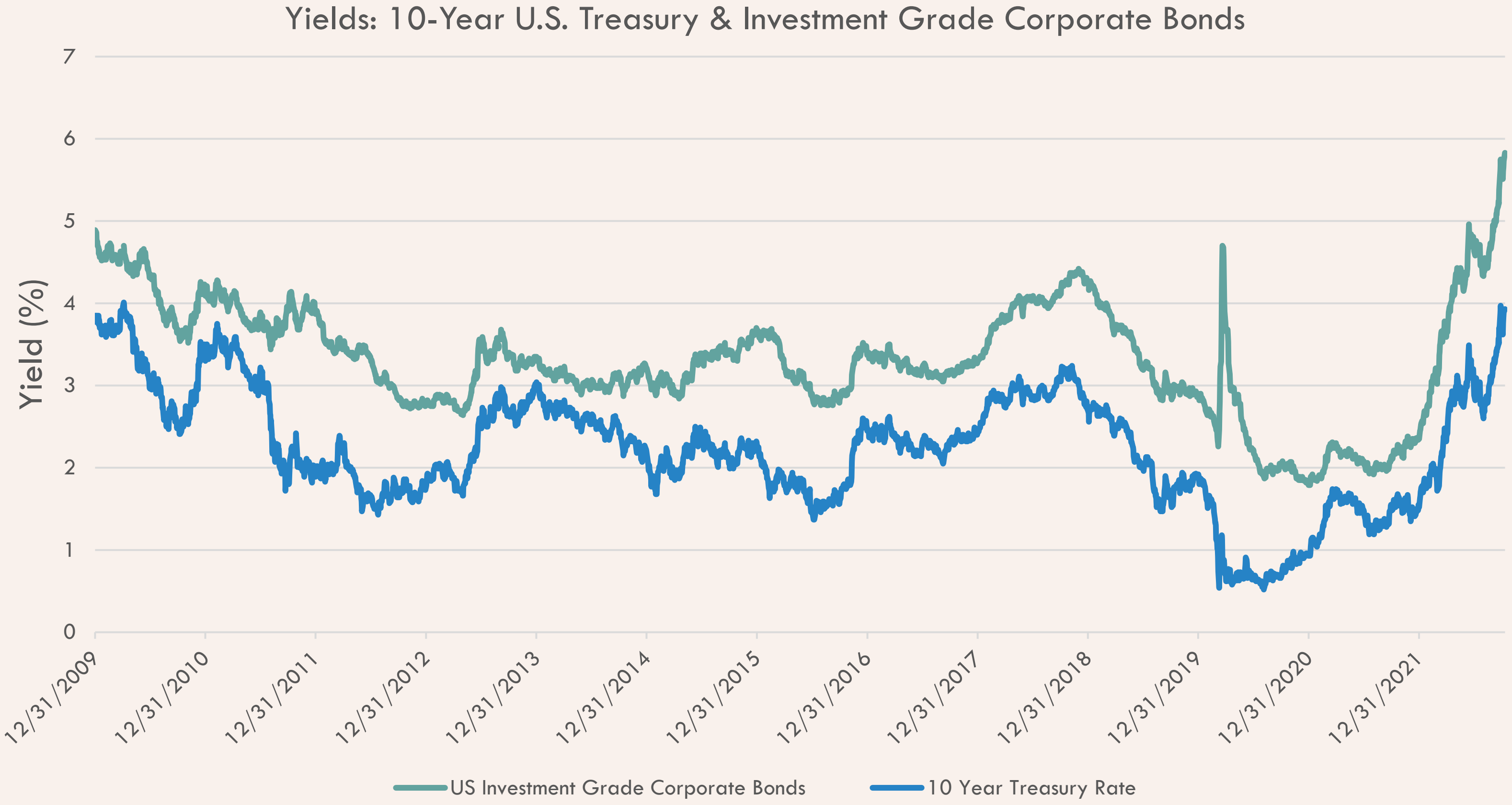


Data Source: No data, graphs for concept demonstration purposes only

11) If the prior slide felt overwhelming, we've included an example below. In Bloomberg, we pulled a U.S. Treasury (white line, blue shaded area) that matures in January 2026. The red line is the current yield on a 5-year U.S. Treasury. From October 2021 to March 2022, yields climbed from about 1% to 2%. Because bond prices and yields have an inverse relationship, the price of this Treasury bond fell about -4.1%. However, because of the convex relationship, a similar 1% increase in interest rates between late August and early October had less impact on the bond's price, causing it to fall less than -2.9%.

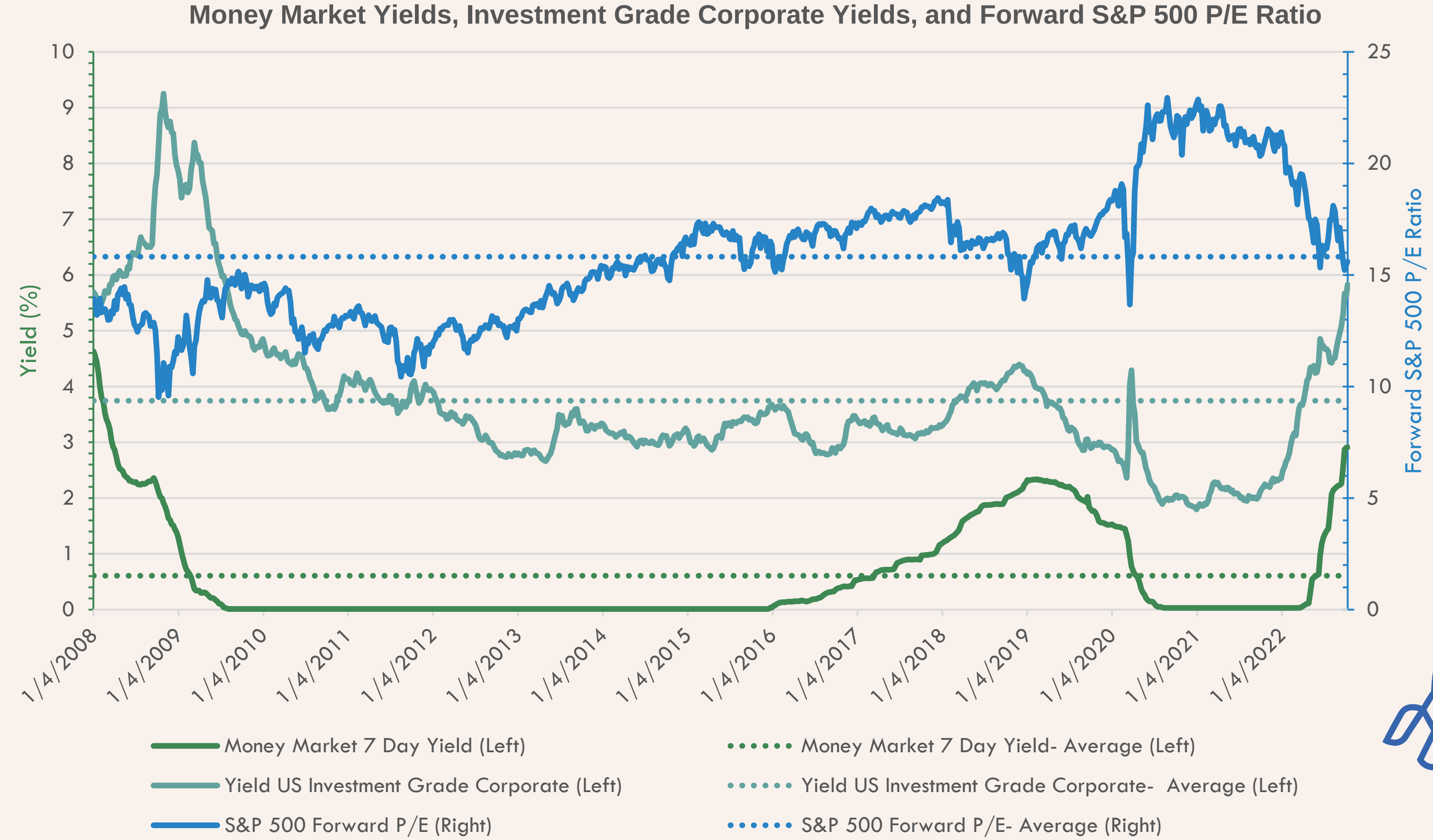
Data Source: Bloomberg, L.P

12) For some investors, fixed income can make up a sizeable portion of portfolios. While bond behavior has been more volatile than many would have liked to see, it's important not to over-extrapolate the poor returns. There are two great things about bonds: one being their prices are largely a function of math, and the other being debt instruments are more contractual than equities. That means for bonds trading at a discount to par value today as a result of interest rate volatility, such as the U.S. Treasury bond on the prior page, investors will receive full par value upon maturity unless the issuer defaults. Defaults are rare, especially in investment grade fixed income. According to data from S&P Global, even during the 2008 financial crisis only 0.4% of global investment grade bonds defaulted, which marked the highest default rate since data began in 1980. Looking forward, higher yields today on U.S. Treasuries and investment-grade bonds likely will make for a more constructive back drop for fixed income investors moving forward.



Data Source: YCharts; S&P Global

13) As we noted in our September WealthIQ, the remainder of 2022 will likely continue to be volatile and challenging for markets. However, longer-term investors may be able to welcome a more constructive investing landscape sometime during 2023. With money market mutual funds now paying over 2.9%, and investment grade corporate bond yields over 5.8%, retirees and less aggressive fixed income investors can once again earn tangible interest on less risky investments. For equity investors, earnings multiples have finally reverted from their post-COVID heights, potentially providing more attractive investment opportunities for accumulators. For diversified long-term investors, higher interest on less risky bonds and less frothy equity multiples presents a combination that has rarely been seen post-2008. While the benefit of these welcomed market conditions likely won't be felt immediately, they do help create the conditions needed for an improved investing environment in the future, and a potential reward for investors who braved the bear.



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The most important part of any investment plan is discipline. Short-term volatility is the price we pay for long-term investment returns, and those with the fortitude to handle temporary pain are often the ones rewarded with enduring investment success. Over the past 3 years, and especially in 2022, you have braved with the temporary pain of challenging investment returns. These tough times, which set the table for potential future market rallies, also bring with them valuable experiences and lessons. This hard-earned knowledge deserves both celebration and recognition. With that being said:

Having navigated uncertain times both past and present, what are some lessons you would share with other investors about handling market volatility? How has the recent volatility made you feel relative to other volatile periods, and how have you best dealt with it?

We would greatly appreciate you sharing any and all of your thoughts with us by replying at wealthiq@marshallfinancial.com. Additionally, please feel free to send any outstanding investment related questions and/or topics you would like to see discussed in a future WealthIQ to the same email wealthiq@marshallfinancial.com and we will do our best to address them as they are received.

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Thank you for reading; please be well and stay healthy.

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