What's the right multiple to pay for stocks with rates at these levels?

ASTORIA Portfolio Advisors

Equities Gain in October

Amid hopes for a slowing pace of interest rate hikes, equities mainly were up in October as the Dow Jones Industrial Average Index gained 14%, posting its best month since January 1976. US small-caps were among the best performers (+12.1%), followed by US value stocks (+11.5%), and US mid-caps (+10.5%). Bonds were mixed as both high-yield credits and TIPS increased (+3.4% and +1.4%, respectively) while both the US Aggregate Bond Index and 7-10 year US Treasuries fell (-1.3% and -1.5%, respectively). Aside from gold (-1.8%), commodities produced positive returns as crude oil was up 9.6%, broad-based commodities rose 1.6%, and silver gained 0.7%.

Exhibit 1: Trailing Returns as of October 31, 2022

	Index/ETF	1-Mo	YTD	1-Y	3-Y	5-Y
Equities	US Small-Caps (SPSM)	12.13%	-13.70%	-11.95%	8.90%	6.93%
	US Value (IVE)	11.52%	-7.06%	-3.98%	7.72%	7.99%
	US Mid-Caps (SPMD)	10.45%	-13.30%	-11.44%	8.81%	7.29%
	US Large-Caps (SPY)	8.13%	-17.75%	-14.36%	10.13%	10.30%
	International Developed Equities (IEFA)	5.79%	-23.76%	-24.49%	-1.20%	0.00%
	US Growth (QQQ)	4.00%	-29.79%	-27.04%	12.72%	13.72%
	Broad-based Emerging Markets (IEMG)	-1.47%	-28.41%	-30.49%	-3.68%	-2.64%
US Fixed Income	High Yield Credit (HYG)	3.36%	-12.41%	-11.60%	-1.12%	1.17%
	Treasury Inflation Protected Notes (TIP)	1.42%	-12.67%	-11.71%	1.11%	2.05%
	Investment Grade Corporate Bonds (LQD)	-0.75%	-21.83%	-21.85%	-4.67%	-0.53%
	Municipal Bonds (MUB)	-0.85%	-11.39%	-10.62%	-1.76%	0.46%
	US Aggregate Bond Index (AGG)	-1.28%	-15.48%	-15.47%	-3.52%	-0.53%
	US Treasury 7-10 Year (IEF)	-1.46%	-16.88%	-16.26%	-4.15%	-0.68%
Commodities	Crude Oil (USO)	9.57%	31.59%	24.41%	-8.42%	-3.77%
	Broad-based Commodities (BCI)	1.55%	14.09%	8.22%	12.54%	6.36%
	Silver (SLV)	0.69%	-18.08%	-20.74%	1.84%	2.06%
	Gold (GLD)	-1.78%	-11.14%	-9.55%	2.59%	4.66%

Source: FactSet. Data as of October 31, 2022.

Fed to Hike Large in November, but may Debate Slowdown in Future Increases

At the upcoming November FOMC meeting, the Federal Reserve is expected to raise interest rates by 75 bps for a fourth consecutive time, leaving the federal funds rate at the 3.75–4.00% range. The magnitude of the hike is likely due to stubbornly high inflation readings, given September CPI (Consumer Price Index), PPI (Producer Price Index), and PCE (Personal Consumption Expenditures) data remain elevated relative to the previous month. However, some Fed officials and economists are arguing that it may be time to slow the pace of interest rate increases given the lagged effects of tightening on the economy. Earlier in the month, Fed Vice Chair Lael Brainard expressed that the US economy may be slowing faster than expected. Referring to sectors like housing that are directly affected by the level of borrowing rates, she said, "Output has decelerated so far this year by more than anticipated." Moreover, San Francisco Fed President Mary Daly recently stated, "The time is now to start talking about stepping down." This potential slowdown may materialize soon, given the majority of economists in an October 17th-24th Reuters poll have forecasted a 50 bps increase at the coming December FOMC meeting.

Housing Market Continues to Weaken

Among increasing rates, the National Association of Home Builders (NAHB) Housing Market Index fell for the 10th straight month in October. This marks the lowest builder confidence reading since August 2012, aside from the onset of the pandemic.

Exhibit 2: NAHB Housing Market Index

Source: Calculatedriskblog.com. Data as of October 18, 2022.

S&P Gains as Earnings Growth Slows?

Through the midpoint of earnings season for Q3 2022, the aggregate difference between companies' actual earnings and estimated earnings is below their 5-year and 10-year averages. Yet, the S&P 500 Index is up over 8% for the month. A plausible reason for such market positivity is that investors expected earnings to crash entirely this quarter, but corporate profits have remained strong and haven't declined as much as anticipated.

Years with Fewer Up Days Tend to be Followed by Years with Stronger Returns

Through October 18th, the S&P 500 produced a positive daily return on only 43.5% of days throughout 2022. Aside from 1982, all years with less than 45% of up days have seen negative returns. Notably, 71% of subsequent years have seen positive returns, which tend to be above the 12.5% average return for these periods.

Exhibit 3: Years with Percentage of Positive S&P 500 Index Returns Below 45%

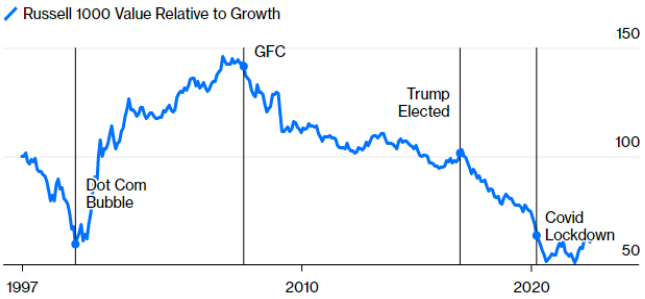
Year of Occurrence	Positive Days	S&P 500 Yearly Return	S&P 500 Return Following Year
1931	42.5%	-47.1%	-14.8%
1932	42.0%	-14.8%	44.1%
1941	40.4%	-17.9%	12.4%
1973	44.8%	-17.4%	-29.7%
1974	41.5%	-29.7%	31.5%
1982	44.7%	14.8%	17.3%
2002	44.4%	-23.4%	26.4%
2022	43.5%	-22.0%	???
Average Return		-19.7%	12.5%
Median Return		-17.9%	17.3%
% Positive		12.5%	71.4%

Source: LPL Research, S&P Dow Jones Indices, Bloomberg. 2022 return is YTD as of 10/18/22 The modern design of the S&P 500 Index was first launched in 1957. Performance before then incorporates the performance of its predecessor index, the S&P 90.

Value Looks Like it has a Lot Further to Run

Changes in market leadership oftentimes go under the radar. While many investors are continuing to buy the dip in technology and growth stocks, value is quietly outperforming. Our view is that we are entering into a multi-year trend where new market leadership will come from energy, materials, commodity equities, natural resources, and other value-centric asset classes. Only time will tell, but these cohorts demonstrate a margin of safety which isn't the case with growth stocks.

Exhibit 4: Is Value Ready to Grow Again?



Source: Bloomberg. Rebased: 100 = 09/30/1997.

What's the right multiple to pay for stocks with rates at these levels?

To be bearish after a 30-35% decline in the average stock would likely imply a belief that the economy is going into an extended and protracted recession. This is not our base case. Multiples have also derated significantly, and value stocks with PE ratios near 11 seem to offer a good risk reward if you have a long time horizon. Moreover, sentiment is as bad as it was in 2008. There are numerous reports showing that the 60/40 portfolio is currently on track for its worst return in 100 years. We view these stats as contrarian indicators. As inflation is the cause of this market downturn, we believe it should be the signal to identify a turning point. Forward inflation indicators are declining, and the economy is slowing quickly. We feel the Fed ultimately will acknowledge this and, in turn calm stresses in the global economy. We've had uncertainties about markets heading into 2022 and believe that view has materialized. Are there risks out there? Of course, but investing is never a slam dunk. Stocks now have competition with the fed funds rate at 3.00-3.25% and potentially heading to 3.75-4.00%. As of October 31st, you can purchase a 2-year Treasury bond and collect approximately 4.4%. What's the right multiple to pay for stocks with rates at these levels? We believe that's the biggest portfolio construction debate and will be for all of 2023. In the meantime, we advocate nibbling on stocks and high quality short-duration bonds with maturities ranging from 3-6 months.