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Investment Reset – Light at the End of the Tunnel?

Market Talk with Mike Skoric

So far 2022 continues to be challenging for domestic and global investors. Broad US and many foreign equity markets have fallen close to or into "bear market" territory, which refers to a drop of 20% or more from a prior market high. Unlike most prior periods of equity market weakness, this round is made worse by similar returns in fixed income markets. For the first time in a while, traditional diversification is not working as both major asset classes struggle. Stock prices have been declining as a result of rising interest rates coupled with ultra-high valuations heading into the year. For example, the S&P 500 forward (next 12 month) price to earnings (P/E) ratio was at over 21x on 12/31/2021, compared to a 25-year average of below 17x. Currently, with this year's market drop together with continued, albeit more modest earnings growth, the forward P/E ratio sits at approximately 17x, a considerably more attractive level than expected. Additionally, we see even more attractive valuation levels and entry points in other segments of the global equity markets, such as US small-cap and emerging market stocks.

We have a comparable situation in the fixed income market where the Federal Reserve's aggressive tightening, in response to seemingly runaway inflation, has pushed the 10-year treasury to over 3%. That is nearly double the 1.63% where it started the year, though it has more recently fallen back down to 2.75%. Nevertheless, the result of the dramatic spike in interest rates is that after years of historically low yields, investors can now find attractive fixed income investments. A current example of this is investment grade corporate bonds now offer 4%-5% yields within a 5-10 year maturity range. Meanwhile, for high income earners, tax-exempt municipal bonds offer even more attractive after-tax yields.

Investors undoubtedly still face significant risks – primarily with respect to the continuing high inflation that is forcing the Federal Reserve to engage in more aggressive monetary tightening than it would prefer. This raises reasonable concerns that a recession is at least highly possible if not probable in the next 6-18 months. We should also keep in mind that markets tend to overshoot on the upside but also on the downside, meaning there could be more near-term pain despite the much more reasonable valuation levels. However, given the negative YTD 2022 returns across both major asset classes and the resulting meaningful improvement in valuation levels – we feel that this is a painful yet much needed "market reset." We can think of this as a healthy new base from which asset prices can resume growth at or close to their long-term rates after having let some of the excess air out of the stocks and bonds market bubbles. While seeing the value of portfolios decrease is certainly not enjoyable, we can take comfort in knowing that investment assets are now appreciably more reasonably priced and that this is much more likely to generate the kinds of returns that we expect going forward.

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