January 11, 2023

Graves Light Lenhart Q1’23 Client Newsletter

Main Points:

- Equity, fixed income, and commodity investments generated nicely positive returns during the recent quarter ended December 30th. As a whole, 2022 was a miserable year for both equities and bonds. The S&P 500 suffered an 18.1% decline over the entire year inclusive of the 7.6% increase over December. The fixed income market experienced one of its worst years with the benchmark Bloomberg Aggregate index plunging 13%; so much for the “safe asset.” Commodity exposure was a rare bright spot during 2022 with the Bloomberg Commodity index generating a 16.1% return.

- We expect 2023 to remain challenging given the uneven global economic environment and still troublesome inflationary conditions. Central banks have been aggressively reacting to the global surge in inflation, but their “tools” are blunt instruments which take months to years before the resulting effects can be fully appreciated. We believe the economy will meaningfully slow, if not fall into recession, during 2023. Nonetheless, we do not intend to substantially change our investment positioning for the foreseeable future. We are, however, looking to increase overall fixed income exposure while maintaining lower than benchmark duration.

- In an effort to side-step the S&P 500’s valuation challenges, we believe that positioning client equity holdings to be meangingfuly different than the S&P 500 continues to make sense. In our opinion, small-cap stocks offer a superior long-term equity opportunity, given their significant discount to their large-cap bretheren and low absolute valuation, which could provide a cushion for disappointing EPS resulting from a weak economic environment. Similarly, international stocks continue to trade at a large P/E discount to the S&P 500 and provide meaningfully higher dividend yields.

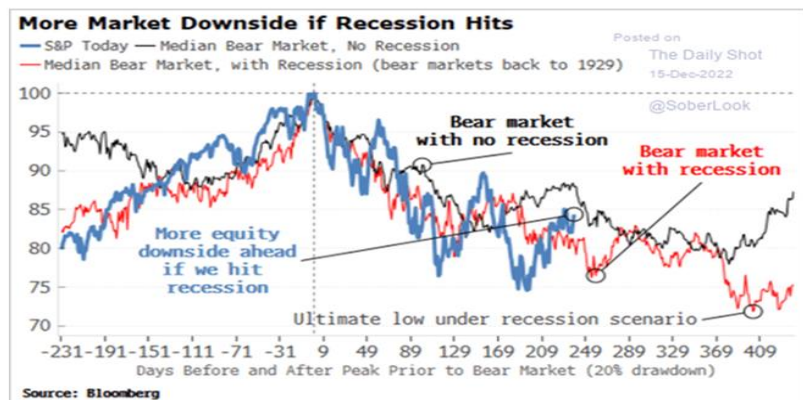
- The Federal Reserve has a myriad of instruments at its disposal to fight inflation – all of them blunt. Roughly, they aim to raise interest rates in the U.S. economy to a point that economic activity begins to slow, which in turn reduces price pressure. It is a difficult task, and the effects of their policies occur with a lag of uncertain length. Fed actions in controlling inflation raise the possibility that its intervention may push the domestic economy into recession. Though this is a significant risk, it is not a foregone conclusion.

- Please come visit our expanded and renovated office space! We encourage our clients to schedule in-office meetings which are well-suited for comprehensive discussions and work sessions.

Finance is often poetically just; it punishes the reckless with special fervor."—Roger Lowenstein

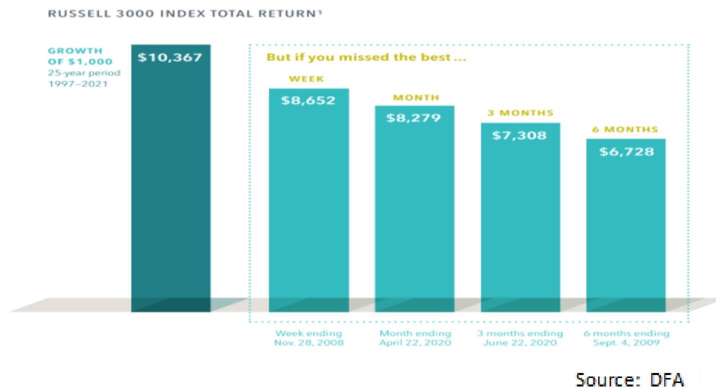
During our two previous quarterly newsletters, we wrote that "there was nowhere to hide" as securities across the investment spectrum experienced dispiriting declines. Fortunately, we can report that equity, fixed income, and commodity investments generated attractive returns during the recent quarter ended December 30th. As a whole, 2022 was a miserable year for both equities and bonds. The S&P 500 suffered an 18.1% decline over the entire year inclusive of the 7.6% increase over the December quarter. Differentiating from the S&P 500 helped cushion the full fury of the Bear market as the S&P 500 Value index experienced a relatively tame 5.2% drop for the year with the international equity EAFE index declining 14% and the S&P 600 Small-Cap Index falling 16.1% over the same period. Fixed income experienced one of its worst years with the benchmark Bloomberg Aggregate index plunging 13%; so much for the "safe asset." Commodity exposure was a rare bright spot during 2022 with the Bloomberg Commodity index generating a 16.1% return.

We expect 2023 to remain challenging given the uneven global economic environment and still troublesome inflationary conditions. Central banks have been aggressively reacting to the global surge in inflation, but their "tools" are blunt instruments which take months to years before resulting effects can be fully appreciated. We believe the economy will meaningfully slow, if not fall into recession, during 2023. Nonetheless, we believe our portfolios are well structured for the most probable future economic environments, and so do not intend more than gradual changes in our investment positioning for the foreseeable future.



Simon White, Bloomberg Markets Live Blog

We expect the annualized return of the S&P 500 will remain meaningfully below the long-term average of 10% over the next five years or so. Therefore, the overall characteristics of our equity investments remain significantly different than the S&P 500 with a continued focus on value, small-cap, and international stocks. Our fixed income exposure continues to carry a shorter duration (i.e., interest rate sensitivity) than the benchmark Bloomberg Aggregate but has edged higher over the past few quarters as yields have increased. In addition, we are slowly increasing the portfolio weight of fixed income towards the relevant benchmark weight. We are patiently adding to high yield fixed income as well. Our clients' commodity exposure was pared during 2022 as prices moved higher. The investment case for commodities has dimmed but we continue to hold relatively small exposure as a partial hedge against ***unexpected*** future inflation; current market-based inflation expectations assume orderly disinflation back below the 3% level by the end of 2023, which is aggressive based upon historical precedent.



Clients should not expect us to attempt major portfolio changes based upon near-term market conditions. Regarding equities, we appreciate that the historical precedent for bear markets portends more downside price pressure for stocks, especially if the economy falls into a recession. Naturally, no one wants to experience further losses, especially if a recession does occur. Nonetheless, the historical record of market timing is poor. The temptation is to sell now with the intention of repurchasing the asset exposure following the expected price drop, which is commonly referred to as market-timing. We profess no special ability to successfully engage in such maneuverings which have proven detrimental to the wealth of many who have tried over the years. Those who try to side-step potential market declines are implicitly obligating themselves to repurchase at lower prices where the news flow/fact pattern will be worse than when they sold.

Furthermore, even if one is ready to repurchase "at the bottom", the risk of missing the strongest part of the rebound is ominous. For example, missing only the best week during the entire 25-year period through 2021, resulted in a 16.5% reduction in ending wealth. Missing the best six-month period resulted in a 35% reduction, as shown in the chart on the preceding page provided by Dimensional Fund Advisors (DFA). This underscores the reality that markets tend to rebound strongly before a recession is formally declared over.

So what to do? The good news is markets tend to rebound strongly following the inevitable market declines (even though "in the moment" of severe drawdowns it seems that stock prices will never go up again). History shows that sticking to a thoughtful financial investment plan incorporating an appropriate asset allocation is a major driver of long-term wealth accumulation and meeting key goals.

Economy

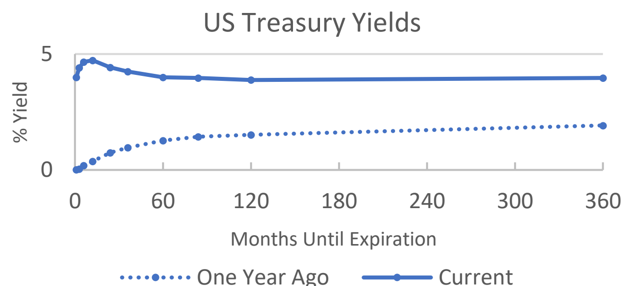
Current U.S. economic growth appears to have continued from the third quarter's strong 3.2% real annualized growth with indications that the recently completed fourth quarter will show similar, if not stronger growth.[1] The December 2022 unemployment rate dropped to 3.5% from November's 3.7%

[1] As of Dec 29, the Atlanta Fed GDPNow forecast for the 4th quarter is 3.7%.

reading. This unemployment level is low enough to contribute to unusually high inflation, for which the CPI provided an estimate of a 7.1% year-over-year price increase in November. Despite this elevated level of inflation, it was actually the 5th straight monthly deceleration (based on year/year change) in CPI, and this gives an indication that the Federal Reserve's efforts to increase interest rates in order to subdue inflation may be having the desired effect. Fed actions in controlling inflation raise the possibility that its intervention may push the domestic economy into recession. Though this is a significant risk, it is not a foregone conclusion.

Currently, our internal models still estimate about a 43% chance that the U.S. economy will be in recession one year from today. While this risk is down from our model's recent high of almost 50%, this is a significantly elevated risk that we continue to monitor and consider during our portfolio construction process. The Federal Reserve has a myriad of instruments at its disposal to fight inflation – all of them blunt. Roughly, they aim to raise interest rates in the U.S. economy to a point that economic activity begins to slow, which in turn reduces price pressure. It is a difficult task, and the effects of their policies occur with a lag of uncertain length. Given the uncertainties associated with the outcomes of Fed policies, and the urgency of lowering inflation rates, some of the biggest risks faced in the economy are that the Fed will raise interest rates too quickly and slow down the economy (reflected in real GDP) too much.

Most frequently the yield curve tends to be upward sloping. This classic pattern can be seen in the "One Year Ago" shape in the chart to the right. The shape of the current yield curve with comparatively high interest rates followed by lower ones is referred to as an "inverted" yield curve. Because of the risk of a negative economic shock implied by this shape, it is generally regarded as a negative signal for the economy. Cam Harvey, a finance professor at Duke University, first documented this finding in his dissertation in the late 1980s. However, there are limits of what may be inferred from an inverted yield curve – the risk of a negative economic shock is not a guarantee that such a shock will come to pass. In a recent interview, Prof. Harvey himself stated, "We're in a period of slow growth, which is consistent with the model, but as far as recession, I'm skeptical of that."[2] While yield curve inversions have been effective but not perfect at forecasting recessions in the U.S., they have been less effective internationally, underscoring the imperfection of the signal. In summary, we respect the current inverted state of the yield curve, but we are not presently making direct dramatic portfolio shifts to the weights of various asset classes (e.g., stocks, bonds, etc.) in response.



However, we are incorporating the current shape of the yield curve into the types of fixed income securities we are utilizing in client portfolios. While the inversion of the yield curve has implications for the evolution of the economy, it also has implications for investment allocation decisions. We discuss these implications in greater detail later in this letter. However, it is here worth pointing out that "baked

[2] See https://www.marketwatch.com/story/bond-market-recession-indicator-may-be-flashing-false-signal-says-pioneering-yield-curve-researcher-11671560339

in" to the yield curve we see today is the expectation that interest rates will be notably lower in the future. This implies that the market collectively believes that inflation will be notably lower beginning 3-5 years in the future. However, inflation uncertainty at this horizon is quite high, and we do have a concern that investors are not currently being compensated adequately for this particular risk over the intermediate horizon, since the yields are comparatively low. As a result, Graves-Light-Lenhart is currently limiting investments that provide exposure to the longer end of the yield curve.

Asset Allocation

We do not find annual forecasts to be useful given the historical margin of error. For example, FactSet compiled the aggregate year-end target for the S&P 500 versus the actual end-of-year outcome, shown in the table to the right demonstrating the futility of such excercises.

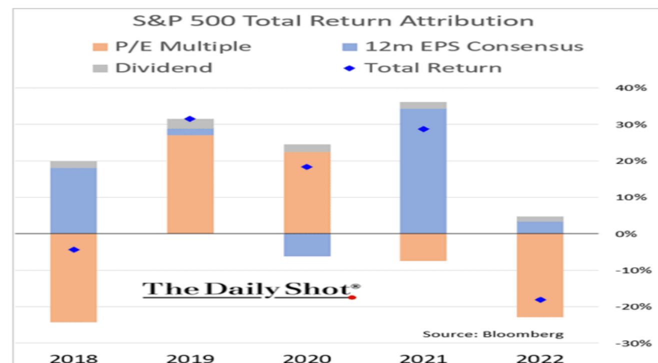
S&P 500: Bottom-Up Target Price Estimate (Start of Year) vs. Actual

	Beginning of Year Estimate	End of Year Actual	Percentage Miss
2011	1414.4	1257.6	-11.1%
2012	1475.1	1426.2	-3.3%
2013	1631.5	1848.4	13.3%
2014	1973.3	2058.9	4.3%
2015	2235.0	2043.9	-8.5%
2016	2342.2	2238.8	-4.4%
2017	2461.5	2673.6	8.6%
2018	2882.7	2506.9	-13.0%
2019	3118.2	3230.8	3.6%
2020	3442.7	3756.1	9.1%
2021	4044.4	4766.2	17.8%
2022	5264.5	3963.5	-24.7%

Source: FactSet

"I can calculate the movement of stars, but not the madness of men."—Sir Issac Newton upon losing the equivalent of $4 million during the South Sea stock market bubble.

The driver of S&P 500's 18.1% decline last year was focused on the dramatic decrease in the price/earnings (P/E) ratio over the year, especially within the technology sector. Analysts did a good good predicting the S&P 500's earnings-per-share (EPS) at the beginning of 2022, with the current $220.87 projection close to the estimate at the start of 2022. Yet, the S&P 500's P/E ratio collapsed from high historical valuation levels leading to severe losses. P/E multiples tend to experience pressure from high inflationary forces and investor psychology. The current consensus estimate for 2023 S&P 500 EPS is approximately $230. Based upon historical precedent over the 1957-2020 period, the S&P EPS estimates declined roughly 15% on average during recessions, which targets the 2023 estimate falling to $195. If accurate, a P/E muliple of approximately 20x will be needed to maintain the current market price level; the historical average P/E has been approximately 15x.

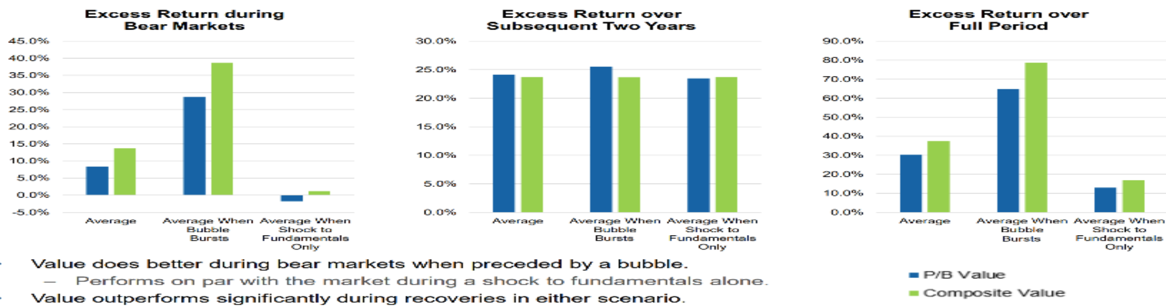


Estimated 2023 S&P 500 EPS

Forward P/E Multiple	$ 195.00	$ 200.00	$ 210.00	$ 220.00	$ 230.00	$ 240.00
11	2145	2200	2310	2420	2530	2640
12	2340	2400	2520	2640	2760	2880
13	2535	2600	2730	2860	2990	3120
14	2730	2800	2940	3080	3220	3360
15	2925	3000	3150	3300	3450	3600
16	3120	3200	3360	3520	3680	3840
17	3315	3400	3570	3740	3910	4080
18	3510	3600	3780	3960	4140	4320
19	3705	3800	3990	4180	4370	4560
20	3900	4000	4200	4400	4600	4800

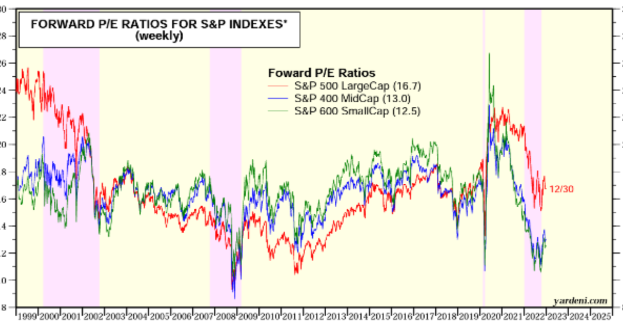
In an effort to side-step the S&P 500's valuation challenges, we believe that positioning client equity holdings to be meangingfuly different than the S&P 500 continues to make sense. Specifically,U.S. large-cap growth stocks will likely face continued margin and valuation pressures going forward, in our

opinion. Our calcuations lead us to believe that the S&P 500's potential annualized return over the next five years is meaningfully below the long-term average of 10%. Importantly, we don't know how the



sequence of returns will unfold, which could, for example, include great returns for the next year or so before experiencing poor returns over the following few years to weigh on the overall five year return profile. We continue to believe that value stocks are well positioned to outperform over the next few years. Somewhat counterintuitively, value stocks have historically experienced excess returns during both bear markets and recessions with superior performance during the associated recoveries.

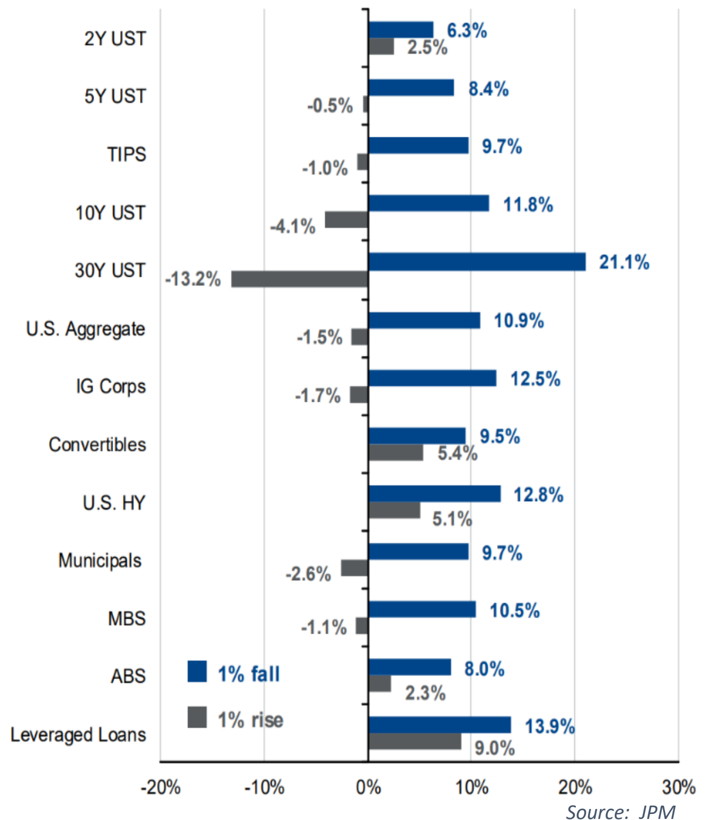
In our opinion, small-cap stocks offer a superior long-term equity opportunity, given their substantial discount to their large-cap bretheren and low absolute valuation. This discount provides a cushion against potentially disappointing EPS resulting from a weak economic environment. Similarly, international stocks continue to trade at a large P/E discount to the S&P 500, while also providing meaningfully higher dividend yields. Furthermore, international stocks can benefit U.S. dollar-based investors as appreciating foreign currencies translate into more dollars, all else equal, increasing domestic investor returns whiling helping to hedge against U.S. dollar weakness.



For fixed income allocations, our recommended positioning remains broadly unchanged. As interest-rates moved materially higher in 2022, the opportunity set for bonds has markedly improved. We refer to our prior quarterly newsletter which provides a deeper dive on the bond market and why fixed income securities are now comparatively attactive relative to recent history (GLLW 4Q22 Newsletter).

To summarize, presently higher yield levels provide a *greater* offset to potential future interest-rate rises. As the chart on the following page illustrates, based on year-end 2022 yield-levels, much of the

fixed income market is now able to either completely or largely withstand a 1% interest-rate shock without completely wiping out annual returns. This is a major improvement from prior-year stress tests, in which virtually every part of the fixed income market was unable to fully withstand a similar rate shock (or was significantlypenalized!). Such stress tests are what ultimately drove our core thesis for portfolios to carry a lower relative duration (or interest-rate sensitivity) to the Bloomberg Aggregate benchmark within fixed income allocations. With entry-level yields now more attractive, increasing overall allocations to bonds will make sense for many client portfolios. However, given heightened uncertainty around long-term inflationary trends, and possible investor optimism regarding the trajectory for future inflation based on the shape of the yield curve, we still prefer fixed income allocations to carry below-benchmark duration. Moreover, we see the ultra short-end of the bond market (inside 12-months maturity) to be attractive as this part of the curve remains steep, with yield levels comfortably above longer dated maturities.



Source: JPM

Lastly, we continue to see High Yield bonds (also known as "junk bonds") as suitable for client portfolios. Compensation for default risk, as revealed through credit spreads, has slightly narrowed since last autumn. However, for clients with a medium-to-longer time horizon, absolute yield levels continue to warrant exposure as the asset class appears appropriately priced for potential default risk.

Closing Thoughts

We are hopeful that market conditions will improve but our investment posture remains informed by historical precedent to balance further downside volatility with attractive long-term return potential. Regardless of which fork in the road the markets take near-term, our message remains to stick with thoughtful plans customized to your specific goals and look for long-term opportunities. We are actively analyzing events and stress-testing our assumptions and investment posture. Our goal is to shepherd our clients through unpleasant market conditions without jeopardizing their long-term goals. Please let us know if we can be of any assistance.

Best regards,

Asa W. Graves VII, CFA	Jason Fink, PhD	Ash Heatwole, CFA
Chief Investment Officer	Director of Research	Portfolio Manager & Director of Wealth Management

DISCLOSURE

Stocks offer long-term growth potential but may fluctuate more and provide less current income than other investments. An investment in the stock market should be made with an understanding of the risks associated with common stocks, including market fluctuations. Stock dividends are not guaranteed. Investments primarily concentrated in one sector may be more volatile than those that diversify across many industry sectors and companies. The technology industry can be significantly affected by obsolescence, short product cycles, falling prices and profits, and competition from new market participants. Global/International investing involves risks not typically associated with US investing, including currency fluctuations, political instability, uncertain economic conditions, different accounting standards, and other risks not associated with domestic investments. Investments in emerging markets may be subject to additional volatility. Stocks of small and mid-cap companies may also be subject to greater risk than that of larger companies because they may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

The value of fixed income securities will fluctuate with changes in interest rates, prepayment payment rates, exercise of call provisions, changes in the issuer's credit ratings, market conditions, and other variables such that they may be worth more or less than original cost if sold prior to maturity. There is also a risk that the issuer will be unable to make principal and/or interest payments. Although treasuries are considered free from credit risk they are subject to other types or risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate, and deflation risk, which may cause the principal to decline and treasury securities to underperform traditional securities.

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