AWM Investments

September Market Update

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MARKET SUMMARY AS OF 8/31: TOTAL RETURNS

The July rally was short-lived, as global stocks retreated again in August amid tighter central bank policy and recession fears. Global bond returns also declined as inflation remained high.

- The S&P 500 Index dropped more than 4% for the month, as early-August's optimism faded. Despite slowing inflation data, Fed Chair Jerome Powell insisted the Fed's inflation-fighting work was far from over, dashing the market's hopes for a near-term Fed pivot.
- Corporations generally reported stronger-than-expected second-quarter earnings, yet most S&P 500 sectors declined in August. The energy and utilities sectors delivered gains, while the information technology sector declined more than 6%.
- Recent data pointed to continued economic weakness, especially in the housing market. However, jobs growth remained strong, fueling expectations for another 75 bps Fed rate hike in September.
- U.S. inflation slowed to 8.5% (year over year) in July, compared with 9.1% in June. Amid a mounting energy crisis, European inflation rose to a record 9.1%, while U.K. inflation hit a fresh 40-year high of 10.1%.
- Worries about recession and energy supplies contributed to broad losses for non-U.S. developed markets stocks, which modestly underperformed U.S. stocks. Conversely, better outlooks for many developing countries pushed the broad emerging markets index higher.
- Expectations for additional Fed rate hikes drove U.S. Treasury yields higher in August, and bonds generally declined.

Returns (%)

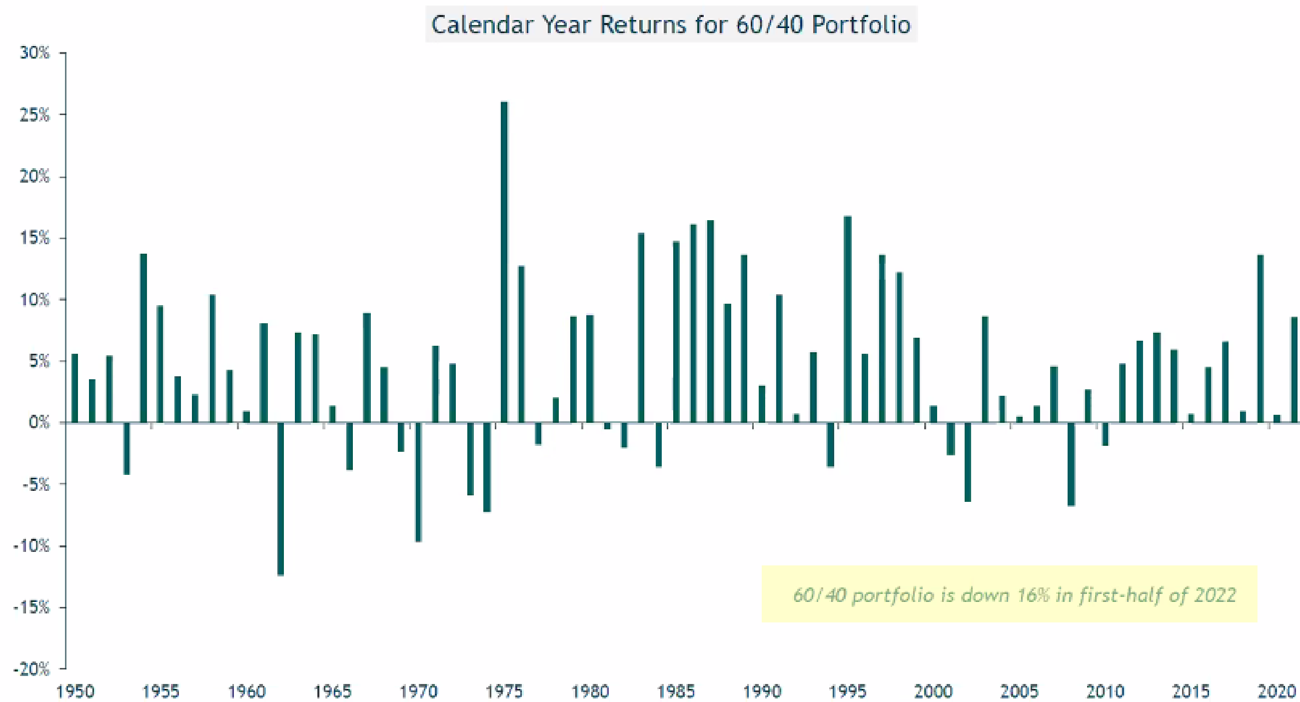
INDEX	1 MO	3 MO	YTD	1 YR	3 YR	5 YR	10 YR
U.S. Large-Cap Equity							
S&P 500	-4.08	-3.88	-16.14	-11.23	12.38	11.82	13.07
U.S. Small-Cap Equity							
Russell 2000	-2.05	-0.72	-17.16	-17.88	8.58	6.95	10.00
Intl. Developed Markets Equity							
MSCI World ex USA	-4.67	-9.35	-18.70	-18.56	2.98	2.08	4.95
Emerging Markets Equity							
MSCI Emerging Markets	0.42	-6.49	-17.49	-21.80	2.73	0.59	2.92
Global Real Estate Equity							
S&P Global REIT	-6.03	-6.78	-18.90	-14.02	0.05	2.85	4.98
U.S. Fixed Income							
Bloomberg U.S. Aggregate Bond	-2.83	-2.01	-10.75	-11.52	-1.99	0.52	1.35
Global Fixed Income							
Bloomberg Global Aggregate Bond	-3.95	-5.05	-15.55	-17.61	-4.39	-1.46	-0.28
U.S. Cash							
Bloomberg U.S. 1-3 Month Treasury Bill	0.18	0.32	0.42	0.44	0.54	1.07	0.62

Data as of 8/31/2022. Performance in USD. Periods greater than one year have been annualized. Past performance is no guarantee of future results. Source: FactSet.

Source: Avantis Investors, data as of 8/31/2022

HOW HAS THE 60/40 PORTFOLIO PERFORMED IN 2022?

Started the year with its worst performance in over 70 years!



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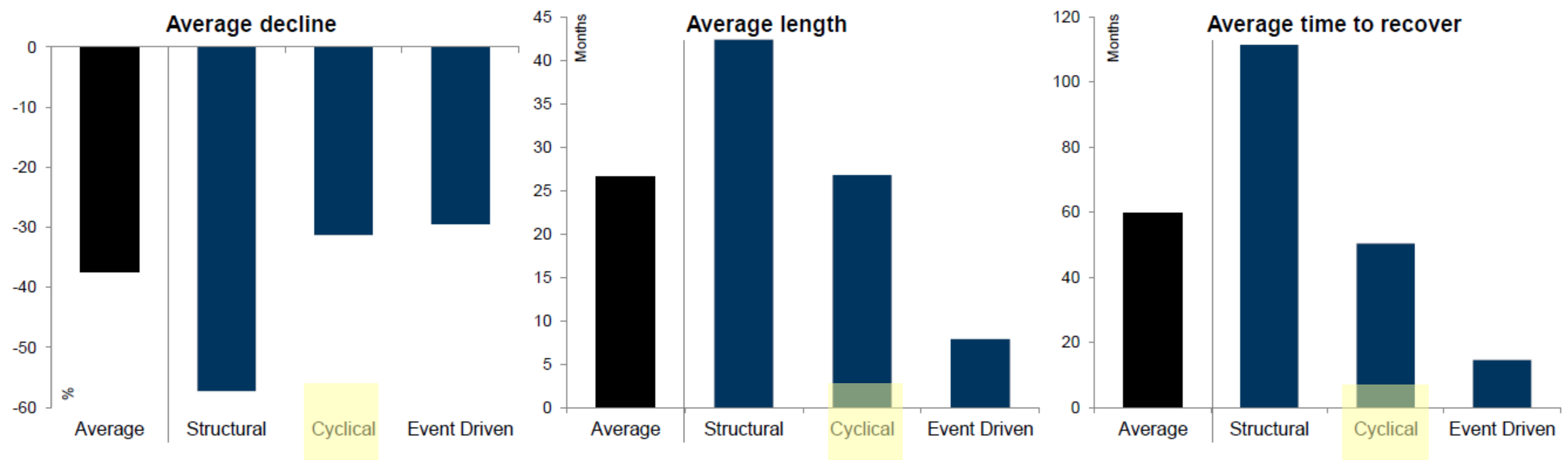
3 categories of bear markets

- **Structural bear markets**- triggered by structural imbalances and financial bubbles. Very often there is a ‘price’ shock such as deflation that follows.
- **Cyclical bear markets**- typically a function of rising interest rates, impending recessions, and a fall in corporate profits. This type of bear market is a function of the economic cycle.
- **Event-driven bear markets**- triggered by a one-off ‘shock’ that does not lead to a domestic recession (such as a war or a technical market dislocation).



4 CONDITIONS GENERALLY NEEDED FOR A RECOVERY

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Of the 4 conditions generally needed for a bear market to end and a recovery to begin, we are confident that 1 is in place- negative positioning*.* *Negative positioning refers to investor sentiment and how they have positioned their portfolios (underweight risk assets). In regards to the other 3 conditions progress has been made but more work may be need to be done for a full recovery to take hold.*

The 4 conditions generally needed for a recovery:

1. **Cheap valuations:** ?
2. **A bottoming in the rate of deterioration in economic activity:** ?
3. **A sense that interest rates and inflation are peaking:** ?
4. **Negative positioning:** ✓

Economic growth is slowing, and inflation remains high

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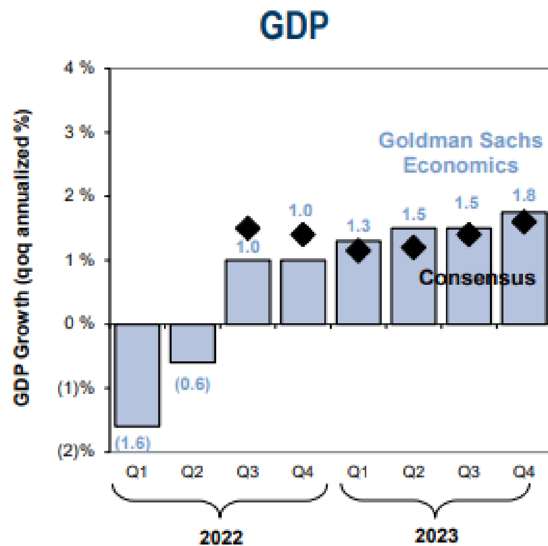

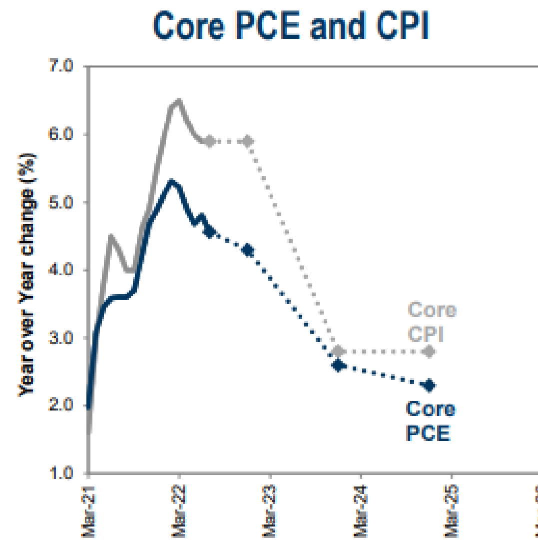

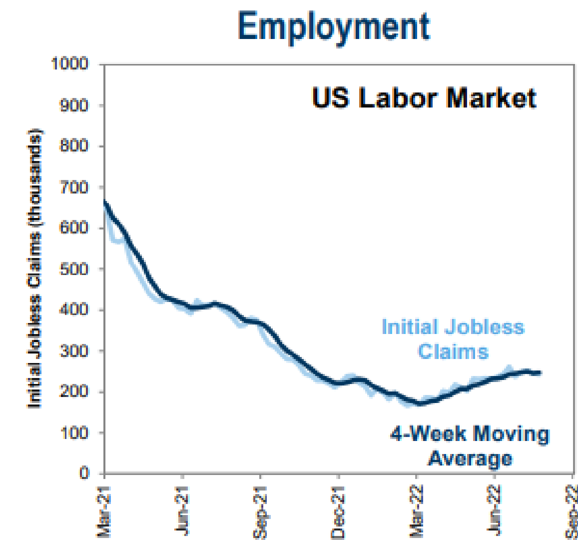

Real GDP

	2021A	2022A	2023E	2024E
Australia	4.8 %	4.6 %	2.3 %	2.1 %
Spain	5.1	4.5	2.1	2.4
UK	7.4	3.7	1.1	1.4
World	6.2	3.2	2.8	3.2
Italy	6.6	3.1	0.7	1.8
China	**8.7**	**3.0**	5.3	**4.6**
Euro Area	**5.3**	**2.9**	0.9	**1.9**
France	6.8	**2.6**	1.1	1.7
Brazil	4.9	2.1	0.7	2.3
USA	**5.7**	**1.6**	1.2	**1.8**
Germany	2.6	**1.5**	0.7	1.9
Japan	**1.7**	**1.4**	1.6	**1.2**
Russia	4.7	(5.6)	(2.9)	2.0

- ***Economic growth has slowed sharply around the world and the odds of a recession have increased.***
- ***Employment has stayed firm in the face of slowing growth.***
- ***Inflation remains high but is projected to drop in 2023 and 2024.***

WHAT ARE THE INDICATORS (FORWARD LOOKING) SAYING?

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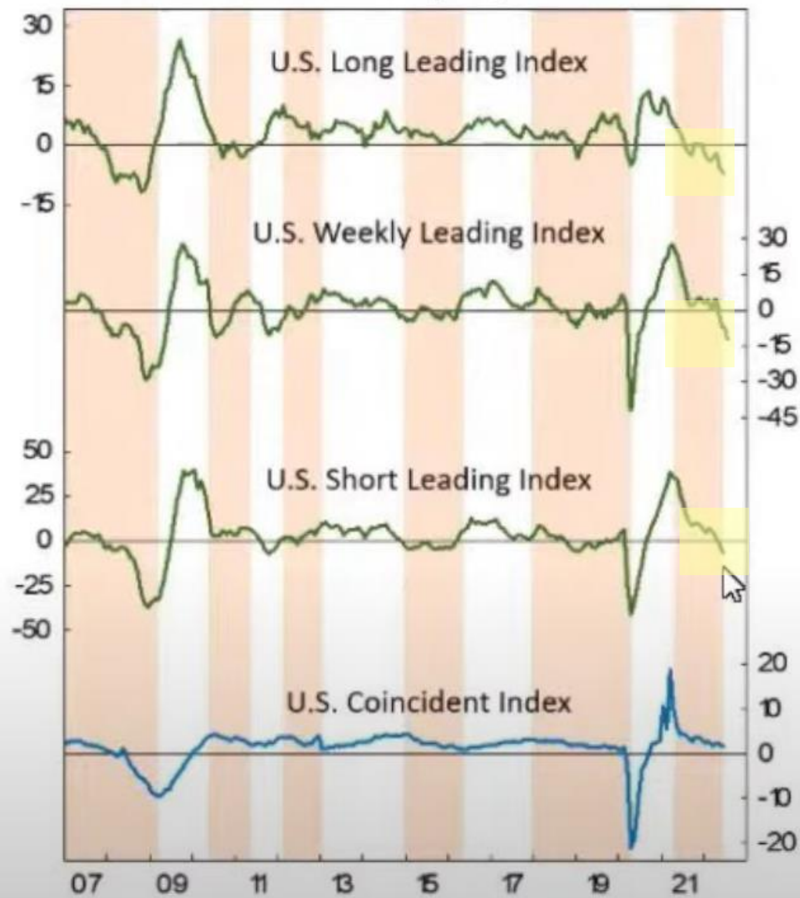
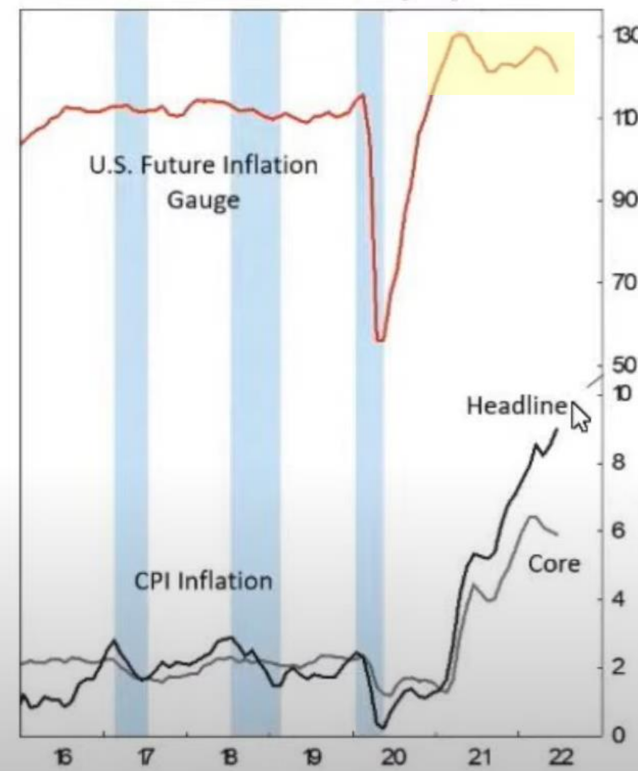
Forward looking indicators are suggesting a possible recession in 2023 and that inflation has peaked but may be sticky and come down slowly



ECRI leading indicators



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Updated from 6/30 investment commentary…

- **Keep your portfolio diversified**- a well-diversified portfolio will keep you from being concentrated in assets that are getting hit the hardest (e.g. unprofitable tech, aggressive growth, etc.). It may also give you exposure to asset classes that are bucking the downtrend (e.g. commodities, real return, etc.).
- **Avoid the temptation to 'market time' bear markets**- it's fine to reposition portfolios, raise some cash and become more defensive in your portfolio allocation to ride out the bear market, but resist the temptation to go completely in or out of the market. You may get lucky on one of the decisions, but it's near impossible to consistently execute this type of market timing strategy. We know of numerous cases of investors getting out of the market completely, thinking they made a great decision, but then never got back in and missed the huge recovery. Do this a few times and it's disastrous to your portfolio's long-term results.
- **Have a spending strategy in place**- for retirees and investors that are withdrawing from their portfolios, make sure to have a spending strategy in place. Our recommendation is to have at least one to two years of your spending needs invested in high-quality safety assets like cash and short-term bonds. Having safety assets in place ahead of time will give you the confidence that you can meet your spending needs and may keep you from panic selling at the bottom of a bear market.
- **Rebalance your portfolio**- rebalancing your portfolio simply means that when an asset class or position gets too large in your portfolio it should be trimmed back to its long-term target, and conversely, when an asset gets too small in your portfolio you add to it to bring it back to target. This simple but disciplined strategy can add significant value to your portfolio over the long term.
- ***Avoid the noise and focus on long term value opportunities… Time Arbitrage!***

LONG TERM VALUE: U.S. SMALL-CAP STOCKS

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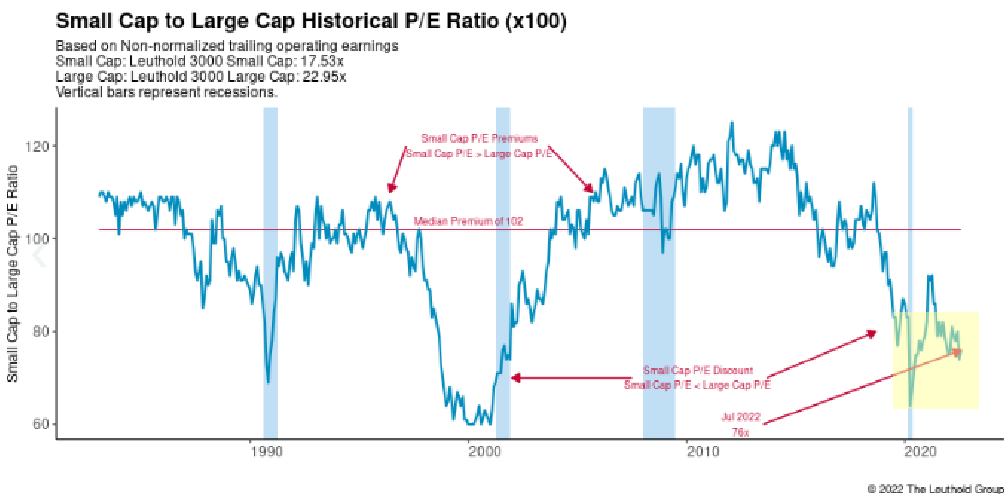
Small-cap stocks are cheap on a relative basis to large-cap

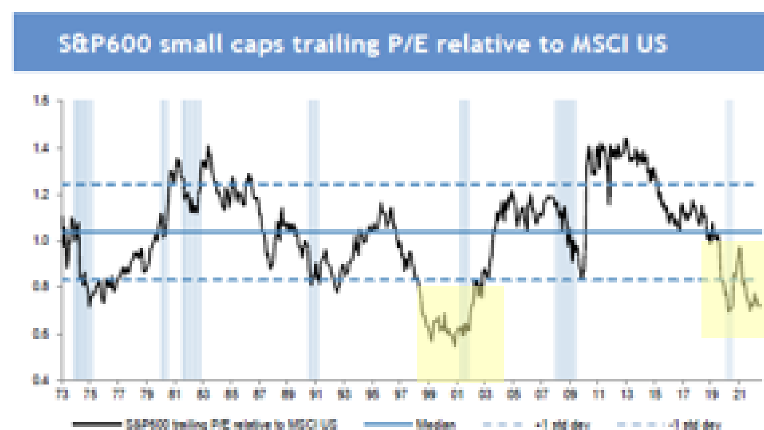
Cheap on many levels:

- Normalized earnings
- Relative to the broad market
- Relative to the QQQ

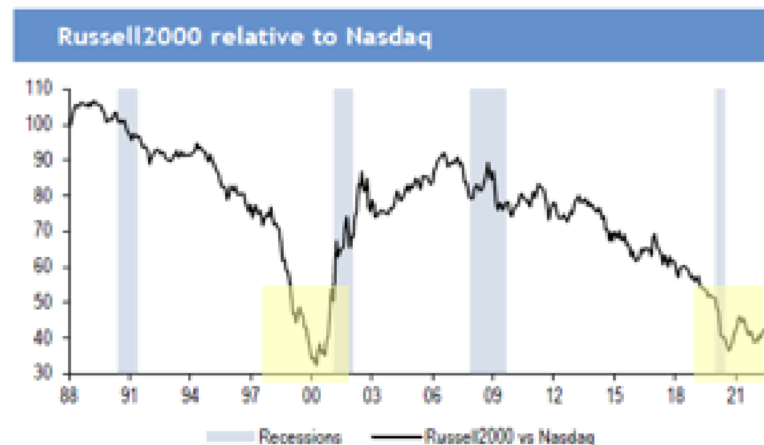
Small Cap vs Large Cap Historical P/E Ratio



Leuthold 3000 Small Cap non-normalized trailing operating earnings vs Leuthold 3000 Large Cap non-normalized trailing operating earnings.



Source: Datastream, shaded bars denote recession

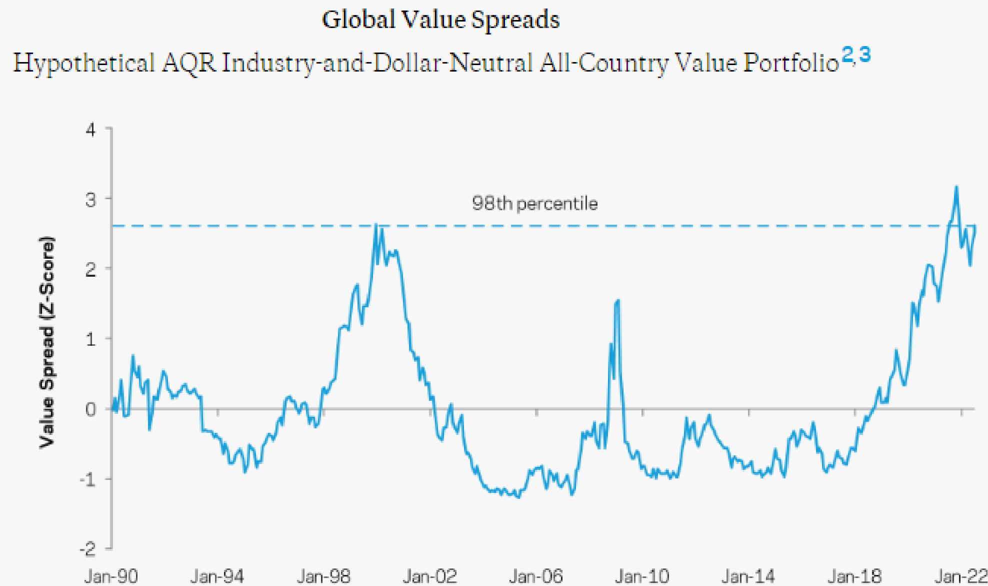


Source: Datastream

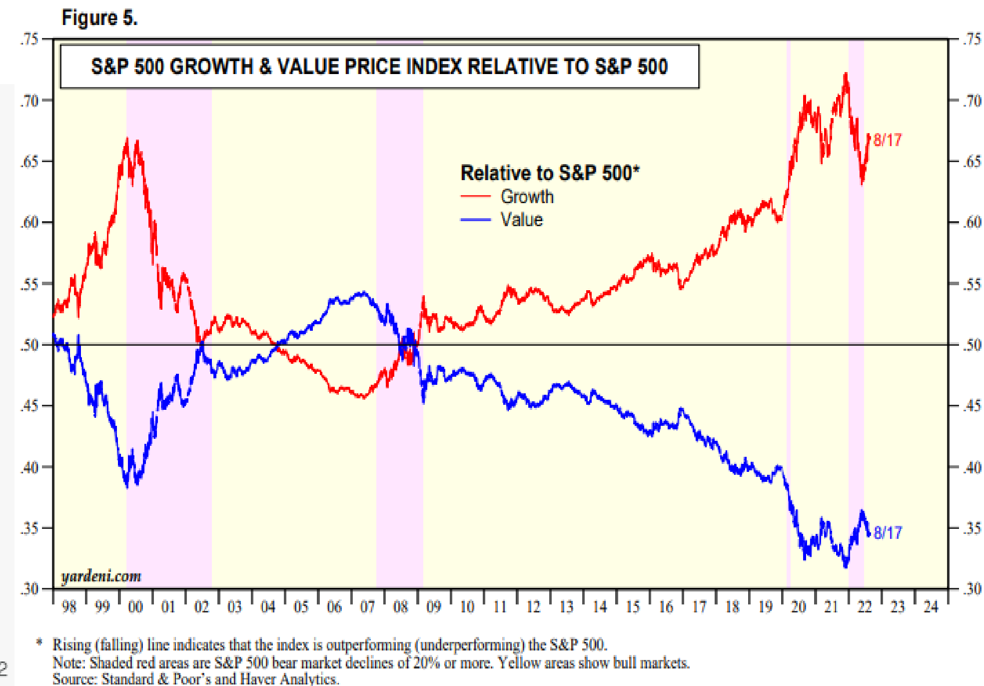
LONG TERM VALUE: VALUE STOCKS (GLOBALLY)

Value stocks are still historically cheap relative to growth; relative performance may be volatile, but value should outperform L/T

AQR Value Spread



Growth vs Value



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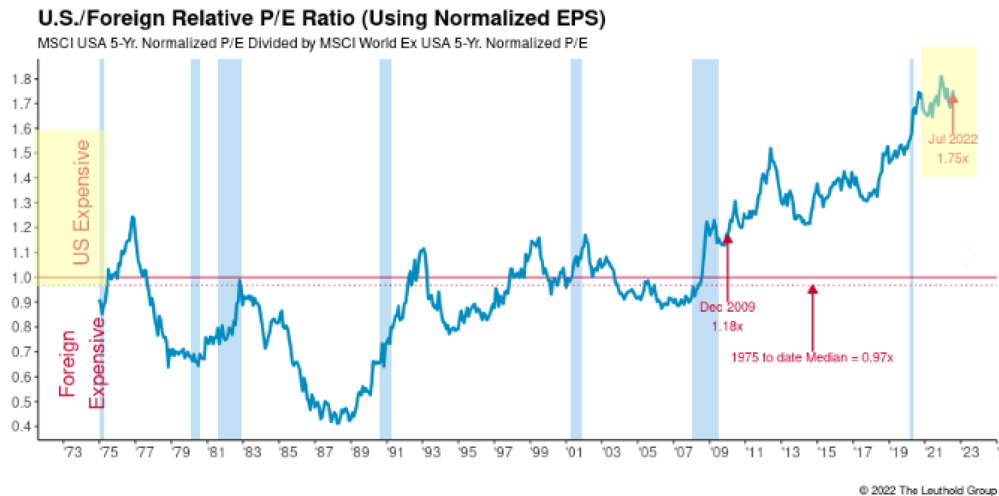
Foreign developed market stocks are historically cheap on a relative basis compared to the U.S.; dividend yields are significantly higher and should reward patient L/T money

U.S. vs Foreign Relative P/E Ratio



MSCI USA 5-year normalized P/E divided by the MSCI World Ex U.S. 5-year normalized P/E. The ratio is distorted in the late 1980s by the Japanese market bubble.

DM yield gap in the historical context

	Dividend yield	10Y Bond yield	Dividend yield minus bond yield	Average since '00	Current vs Average (bp)
US	1.6%	2.8%	-1.2%	-1.3%	9
Japan	2.4%	0.1%	2.3%	0.8%	145
Eurozone	3.3%	2.2%	1.1%	0.4%	64
UK	4.0%	1.9%	2.0%	0.6%	142

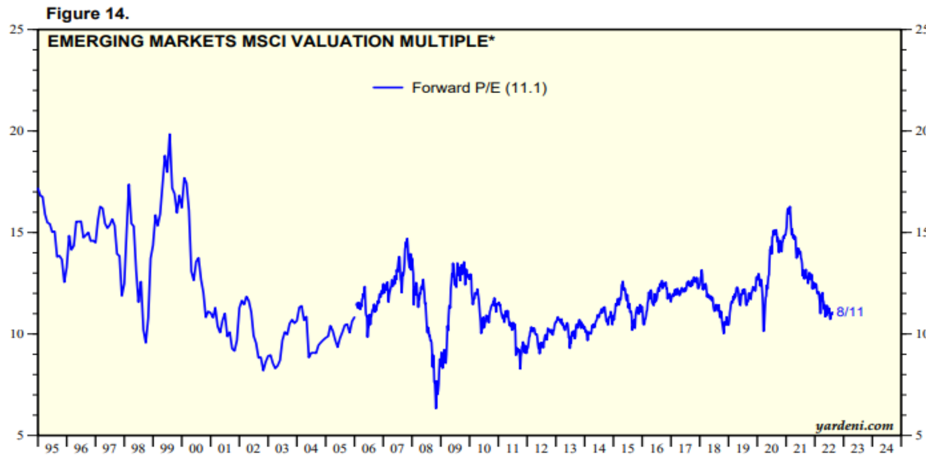
12m Fwd. P/E across key geographies

	Current*	2021 high	Current vs 2021 high	20Y Median	Current vs Median
Italy	7.5	15.0	-50%	12.1	-38%
UK	9.5	14.9	-37%	12.5	-24%
Germany	9.7	16.4	-41%	12.4	-22%
Spain	9.7	16.6	-42%	11.9	-18%
Eurozone	11.1	18.1	-39%	12.8	-13%
Japan	12.7	18.7	-32%	14.5	-12%
France	11.2	18.4	-39%	12.8	-12%
EM	11.1	16.5	-32%	11.1	0%
World	15.2	21.2	-28%	15.0	1%
US	17.3	22.9	-24%	15.7	10%
Switzerland	16.7	20.6	-19%	14.8	13%

Source: IBES *as of cob 31st Aug 2022

LONG TERM VALUE: EMERGING MARKET STOCKS

Emerging market stocks are attractively valued, but investors need to be patient and relative performance may need a catalyst…



The U.S. Dollar Is a Key Variable for EM Equity Returns Over Time

The Dollar Is Flagging

RESPECTED FIRMS ESTIMATED RETURNS STOCKS AND BONDS

Note: some of the returns below have different time horizons and some returns are nominal vs. real, please the footnotes for details.

Forecaster	Forecast Date	Time Horizon	U.S. Stocks Forecast	U.S. Bonds Forecast	International Equity	60/40[2]
GMO[1]	June 2022	7 Years	-1.0%	-1.7%	2.5%	-0.58%
Research Affiliates[1]	July 2022	10 Years	1.5%	-1.0%	7.5%	1.7%
Morningstar	June 2022	10 Years	5.8%	3.6%	8.8%	5.52%
Vanguard[3]	March 2022	10 Years	4.0%	2.5%	7.1%	4.02%
Blackrock[4]	April 2022	10 Years	6.7%	2.0%	9.8%	5.9%
AWM[5]	August 2022	5 Years	5.0%	3.0%	8.5%	4.9%

[1]GMO and Research Affiliates forecasts are real returns (adjusted for inflation).
[2]60/40 allocation is either specific from expert predictions or calculated based on a 40% U.S. Bond, 40% U.S. Equity, and 20% International. AWM estimates based on a 40/40/20 mix
[3]Returns are annualized nominal return projections.
[4]Return estimates are median values.
[5]AWM forecasts are derived from using the estimates of many of its institutional contacts including the above and others such as Goldman Sachs, JP Morgan, BCA, Ned Davis, etc.

CLOSING THOUGHTS

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Cash:

- Money market yields have risen to their highest level in years, close to a 2% current yield
- The value of cash is as a hedge against higher rates and "optionality" if corrections occur.

Bonds:

- Real yields on core bonds are still low and nominal return prospects have improved but remain limited by the level of interest rates.
- Active management is likely to add value over a full market cycle.

U.S. Equities:

- Large-cap stocks are down close to 17% YTD and their valuation has improved but remains relatively high which will limit future returns to below average levels.
- High inflation/interest rates and a tightening monetary cycle are headwinds for stocks in the near term. Outlook should improve when Fed policy peaks and inflation trends down.
- Long-term: dividend growing strategies are well positioned; cyclical and value bias; small-cap stocks have lagged this year and have higher long-term expected returns.

International Equities:

- Attractive relative stock valuations compared to the U.S. and likely to outperform over a 5-year horizon.
- Emerging markets are relatively cheap compared to U.S. stocks.
- Long-term investors will profit from overweighting foreign stocks relative to the U.S, including emerging markets. May need a catalyst and a lower $ for relative performance to improve.

Alternative strategies:

- Provide diversification and a source of return independent from traditional stock and bond markets; we expect returns to be in between bonds and stocks with a lot less volatility than stocks and better returns than bonds over a full market cycle
- Provide a hedge against increasing inflation and generate real returns; commodities, hedged equity, etc.
- We would likely eliminate alternative strategies if/when stocks became broadly undervalued and bonds had attractive real return prospects

Risks:

- Higher inflation and interest rates than the market anticipates; Fed policy mistakes and a deep recession; valuation; geo-political; energy crisis; cyber-attacks; tax; etc.