

RESETTING PERSPECTIVE:

From Abundance to Scarcity

Picture it: it's August 2020, and the S&P 500 has just reached an all-time high. If this had occurred in February 2020, we would have chalked it up to a typical day in the tremendous 2009 bull market as it was approaching its 12th year. However, from where we stand in August, the preceding six months have been quite the roller coaster ride: the pre-pandemic peak occurred in February 2020, then later that month through March, the S&P 500 crashed 34% due to concerns about the possible effects of the COVID-19 pandemic, and now, in August, the market has rebounded to 50% above the pre-pandemic peak.

The story gets even better: by the time the stock market peaks at the end of December 2021¹, it has experienced the greatest burst off a bottom in post-WWI history with a return of 119%, or **3.8% per month** on average. And lest we think the story ends there, household net worth has exploded higher on the back of strong stock market gains, the value of consumer real estate has soared, and bank accounts are flush with cash. In fact, even in the face of the pandemic, the 2020 recession ends up the only recession to date where net worth *increased*.

Fast forward twelve months, and 2022 could be considered the worst combined year in history for equities and fixed income in capital markets — it is only the fifth time in the last 100 years² that both equities (as measured by the S&P 500) and fixed income (as measured by 10-year Treasury securities) have exhibited negative total return in the same calendar year, as shown in Figure 1. This has occurred in response to the highest inflation the U.S. has experienced in the last ~40 years. So, how could something so right go so wrong? And what does this mean for the outlook in both the near term and over the next cycle?

Figure 1: Same-year declines in both stock prices and bond prices are quite rare

Year	S&P 500	10-Year Treasuries
1931	(43.8%)	(2.6%)
1941	(12.8%)	(2.0%)
1969	(8.2%)	(5.0%)
2018	(4.2%)	(0.1%)
2022	(16.1%)	(16.5%)

Source: FactSet and Balentine

The Federal Reserve's Tightening Campaign

To understand how we arrived at our current uncertain, inflationary environment, we need to go back. Our story begins not with the pandemic in 2020, but with peak interest rates in late 1981-early 1982. Over the last ~40 years, the Federal Reserve (the Fed) has supported asset markets in the quest to stabilize not just asset prices but also the economy, the so-called “Great Moderation.” Falling interest rates were the major market driver during this period; the secular decline of interest rates was an extremely powerful tailwind in creating more value and wealth than there otherwise would have been.

Low interest rates couldn't last forever. Following many years of strong stock market gains and relatively solid economic growth without inflation, the Fed's 2020 monetary experiment³ to battle anticipated economic headwinds from the pandemic led to a burst in liquidity and, consequently, consumer demand. This extreme demand, when combined with pandemic supply shocks, led to an explosion in inflation for the first time in decades. Despite the Fed's assertion that the inflation was likely transitory, by the end

of 2021, it became apparent that this was not the case. As a result, the Fed has implemented policy action and jawboning to normalize price level growth over the longer run and ensure that inflation expectations do not become completely unanchored, sacrificing capital market assets of all kinds in the short term — including but not limited to stock, bond, and housing markets.

Though the target of the Fed's tightening campaign has been domestic inflation, its actions have had a global impact: the value of the U.S. dollar has surged due to the Fed's hawkish monetary policy compared to that of other global central banks and international asset prices have struggled as a result. Because the Fed is intent on preventing a stop-and-go monetary policy like that of the early 1970s, it likely will not stop tightening monetary policy until its job is done, regardless of the effect of higher-than-tolerable unemployment or credit stress on capital markets.

¹~16 months after reclaiming the pre-COVID highs.

²along with 1931, 1941, 1969, and 2018

³The Fed's actions were a true experiment — unprecedented in the history of monetary policy.



Resetting Perspective

How will this tightening campaign affect capital markets over the next seven years? Looking in the near term, though equity markets have dropped significantly in the past year, the peak decline so far is commensurate with prior “garden variety” declines. The difference for investors today is the environment surrounding this decline.

For 15 years, the Fed employed a policy uber-supportive of asset prices, but in March, it did an about-face and began a rapid tightening campaign, with the rate hikes in May being greater than 25 bps for the first time since 1995. The investment-friendly interest rate and liquidity policies experienced during the “Great Moderation” era and the aftermath of the Global Financial Crisis is likely over; as a result, the tailwind that pulled investors along for the ride is no longer going to be there. Moreover, that tailwind has likely turned into a headwind as money and credit will be in lower supply. **With this context in mind, we believe investors will need to reset their perspectives from a mindset of abundance to a mindset of scarcity for the next seven years. Within this scarcity mindset, it becomes important to practice discernment when selecting stocks because there will be more dispersion among their performance.**

Having said that, though we can never know for sure what is ahead in the markets, history suggests to us that we can look for patterns to help us make projections — in fact, our data-driven investment model is grounded in this principle. In recent years’ forecasts, we would note that when assets have corrected, it generally leads

to better opportunities looking forward. So, while the reader of our prior forecasts may have expected us to speak more optimistically about future returns given 2022’s declines, our study of the market leads us to believe that this new regime will likely be more modest, though there will be both opportunities and challenges posed by the uncertain environment ahead.

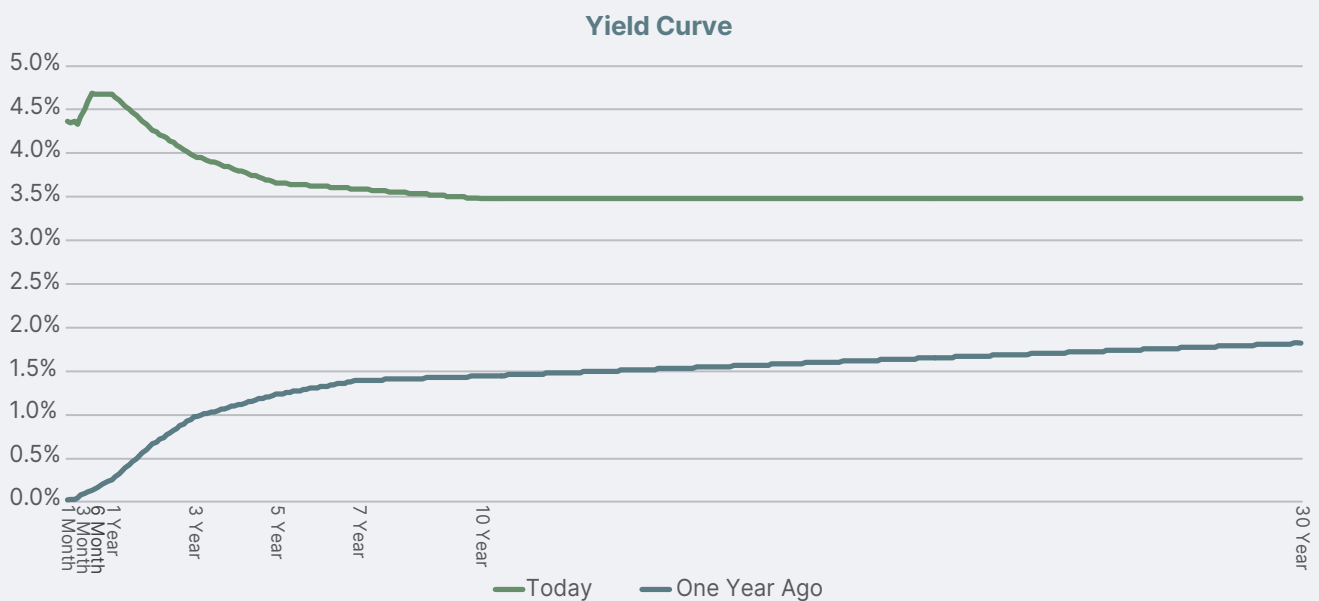
Expect both Equities and Fixed-Income Securities to Adjust Secularly

As mentioned earlier, 2022’s declines would seem to suggest that both equities and fixed-income securities are in a better position to generate returns over the long run after declines in 2021.

- **Equities:** On the equity side, valuations as measured by both the cyclically-adjusted P/E (i.e., CAPE) and forward P/E ratios declined by ~25% during 2022, driving equity valuations to their lowest level since 2017 (excluding the ephemeral equity valuations after the pandemic market crash).
- **Fixed Income:** Securities are yielding more across the entire yield curve, as can be seen in Figure 2. Right now, an investor can earn ~4% per annum without taking any risk in duration or credit. Additionally, there are municipal securities with taxable yield equivalents of 6% that come from cities and counties with solid credit; it has been over 15 years since we saw fixed-income returns that compelling.



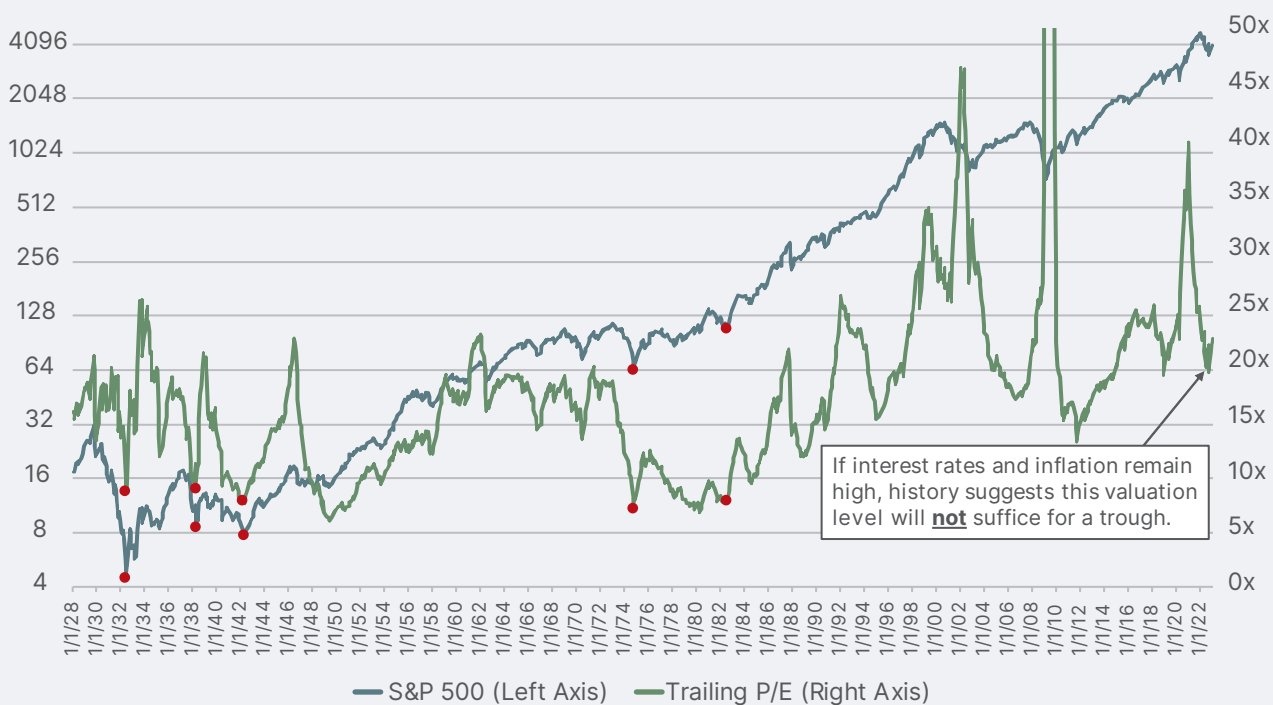
Figure 2: A vast difference in today's yield curve from the yield curve a year ago



Source: FactSet and Balentine

However, it could be argued that opportunities in both fixed income and equities look compelling only in comparison with the dreadful opportunities presented to us at the end of 2021. Although the bulk of the equity market declines to date have taken place within longer duration, higher valuation stocks — especially those with little to no earnings — we believe all equities will need to adjust further downward to account for the new environment. For fixed income, a higher inflation environment in tandem with the Fed’s balance sheet runoff will likely hamper bond appreciation moving forward. In addition, further tightening by the Fed would lead to additional declines in fixed income while equity valuations are still elevated compared to valuations at prior equity market bottoms (Figure 3). Put another way, if the Fed keeps up its tightening campaign, then today’s compelling valuations really won’t seem so compelling in hindsight.

Figure 3: Valuations at prior historical bottoms would suggest that October’s low would be anomalous



Source: FactSet and Balentine

Inflation & Interest Rates

When the Fed raises interest rates, what are the implications on investments? Classic theory suggests higher interest rates, all else equal, means lower stock prices.³ Most of the time, this is true — stock prices decrease because there is competition for capital, and all else equal, investors are less likely to choose stocks if risk-free interest rates are higher unless they are getting compensated for the risk in the form of higher risk premia. Generally, this occurs during periods of rising rates accompanied by sharp inflation. As a result, equity valuations will structurally decline, which generally manifest themselves in the form of lower valuations. In Figure 4, we can see how the valuation of stocks declined in the 1970s, as inflation became structural and embedded.

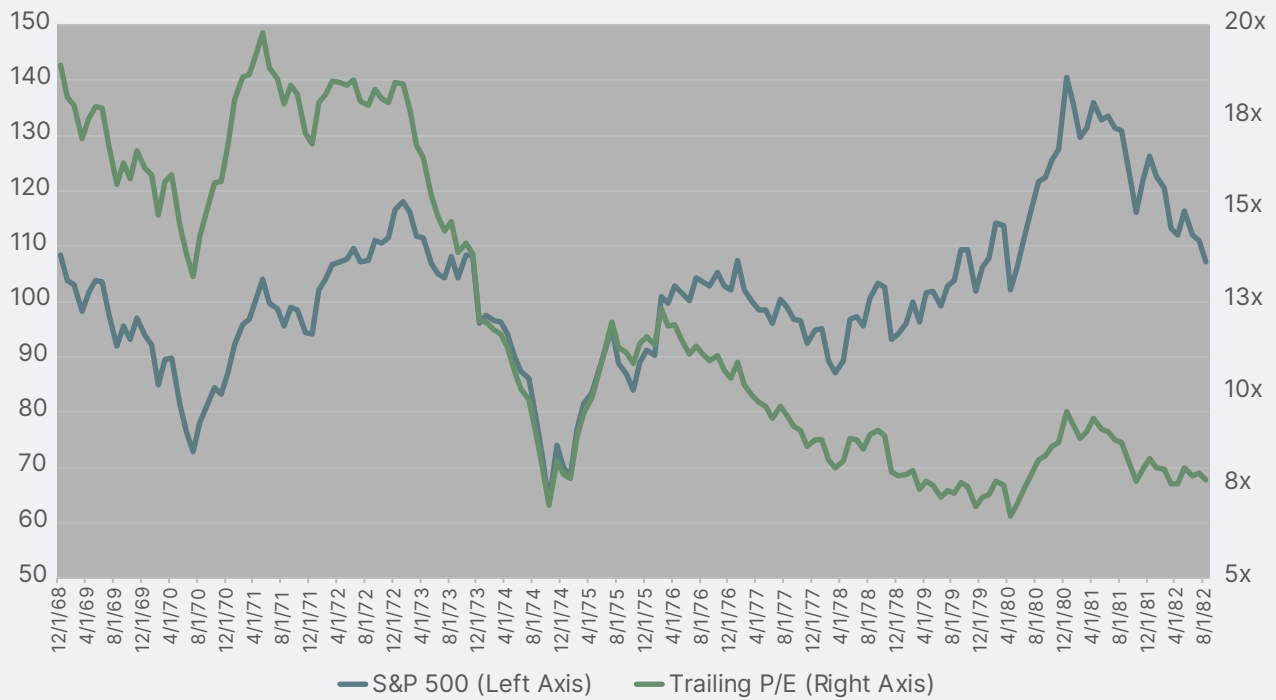
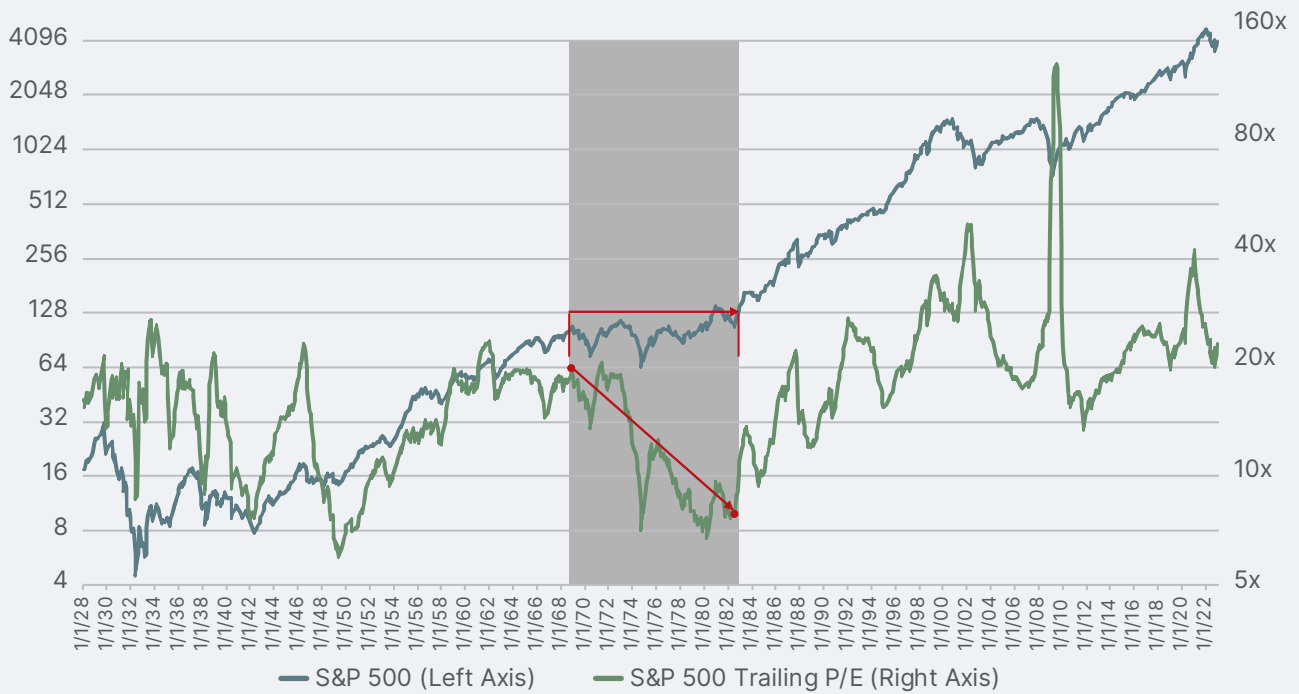
However, stock prices sometimes increase within higher interest rates. If rates are rising because the economy is improving and, as a result, demand for capital is driving up the price of capital via higher interest rates, then stocks will likely view the rising rates as a positive and will likely rise as a result. This happened, for example, in the 1950s and 1960s after WWII finally pulled the economy out of the grips of the aftermath of the Great Depression several decades earlier, as shown in Figure 5.

Overall, the impact of interest rates on stock prices is mitigated by the rate of inflation. In the 1970s, rising rates accompanied sharp inflation and led to decreased stock prices. In the 1950s and 1960s, rising rates accompanied low inflation and led to increased stock prices.

³The value of a financial asset is measured by discounting future cash flows back to the present value. Increased interest rates create a higher overall discount rate — and the financial asset value therefore decreases.



Figure 4: In the 1970s, equity stagnation, valuations slowly declined as inflation become more entrenched



Source: FactSet and Balentine



Figure 5: Rising rates, in themselves, do not necessitate equity weakness

S&P 500 Performance When the 10-Year Treasury Rises by at least 1%

Starting Date	Ending Date	Starting Yield	Ending Yield	Return
1/1950	6/1953	2.3%	3.1%	80.9%
7/1954	10/1957	2.3%	4.0%	60.7%
4/1958	1/1960	2.9%	4.7%	40.4%
5/1961	9/1966	3.7%	5.2%	70.8%
3/1967	5/1970	4.5%	7.9%	(1.9%)
11/1971	9/1975	5.8%	8.4%	2.8%
12/1976	3/1980	6.9%	12.8%	18.4%
6/1980	9/1981	9.8%	15.3%	11.4%
5/1983	6/1984	10.4%	13.6%	(1.5%)
1/1987	10/1987	7.1%	9.5%	6.7%
10/1993	11/1994	5.3%	8.0%	2.2%
10/1998	1/2000	4.5%	6.7%	39.5%
6/2003	5/2006	3.3%	5.1%	39.1%
7/2012	10/2018	1.5%	3.2%	127.2%

Source: FactSet and Balentine



Liquidity

In past cycles, the Fed's monetary policy, both loosening and tightening, has focused on setting interest rate levels, which tend to affect businesses and economic growth directly and Wall Street indirectly. However, given the extreme conditions in 2008 that were not responding to the usual policy of lowering short-term interest rates, the Fed took the unprecedented step to purchase assets. These actions to ease monetary policy beyond the ability of merely lowering interest rates was dubbed "Quantitative Easing" (i.e., QE). Because of this, the Fed's tightening campaign this time around is also focused on decreasing the assets on the central bank balance sheet and the amount of money in the economy, or Quantitative Tightening (i.e., QT), in addition to standard interest rate hikes. Decreasing its balance sheet will serve to reduce the monetary excesses assumed over the last 14 years. While interest rate hikes tend to affect the economy more than capital markets, balance sheet reduction will have a more direct effect on capital markets than on the economy (though both will be affected to a degree) via removal of liquidity in the system. Balance sheet growth was a big reason asset prices rose so sharply over recent years in the absence of huge productivity gains in the economy, a dynamic that is likely now to run in reverse.

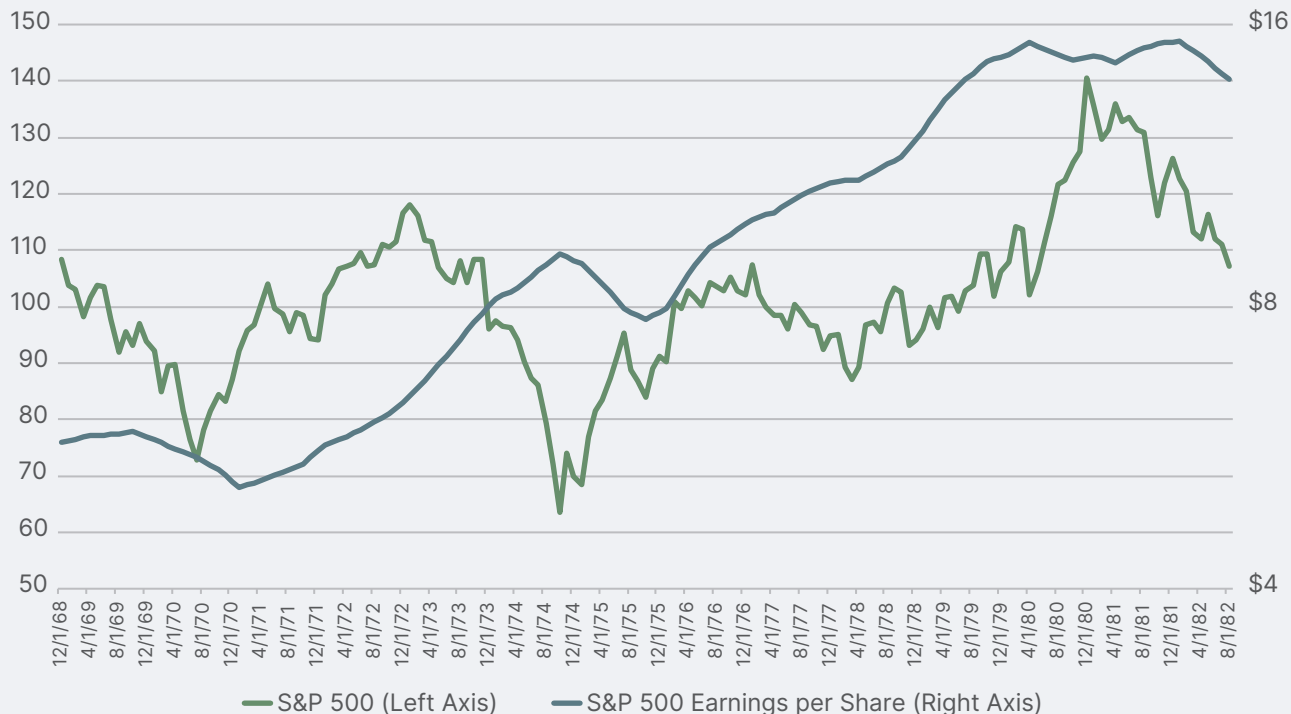
OUTLOOK:

Trends we foresee in the next 7–10 years

These opportunities and challenges could cumulatively impact the market in a few ways over the next 7–10 years:

Bifurcation in Economy and Asset Prices. Asset markets can deviate from the real economy; in fact, capital markets tend to lead the economy. However, there is another possibility that demonstrates an even more extreme dynamic between the markets and the economy than mere time lag: it is not far-fetched that we will see a larger bifurcation in magnitude or even the economy and asset prices move in disparate directions. This dynamic, similar to what was experienced in the 1970s (as shown in Figure 6) and a reversal of the 2009–2021 market dynamic, could mean that while the economy experiences decent nominal growth, stocks may struggle — sometimes the stock market rises faster than growth in both GDP and earnings per share, which is a function of multiple expansion⁵. This is often a function of increased liquidity in the system burning a hole in investors' pockets as they watch markets rise, thereby begetting even further buying.

Figure 6: While the 1970s equity market stagnated, nominal corporate earnings were growing

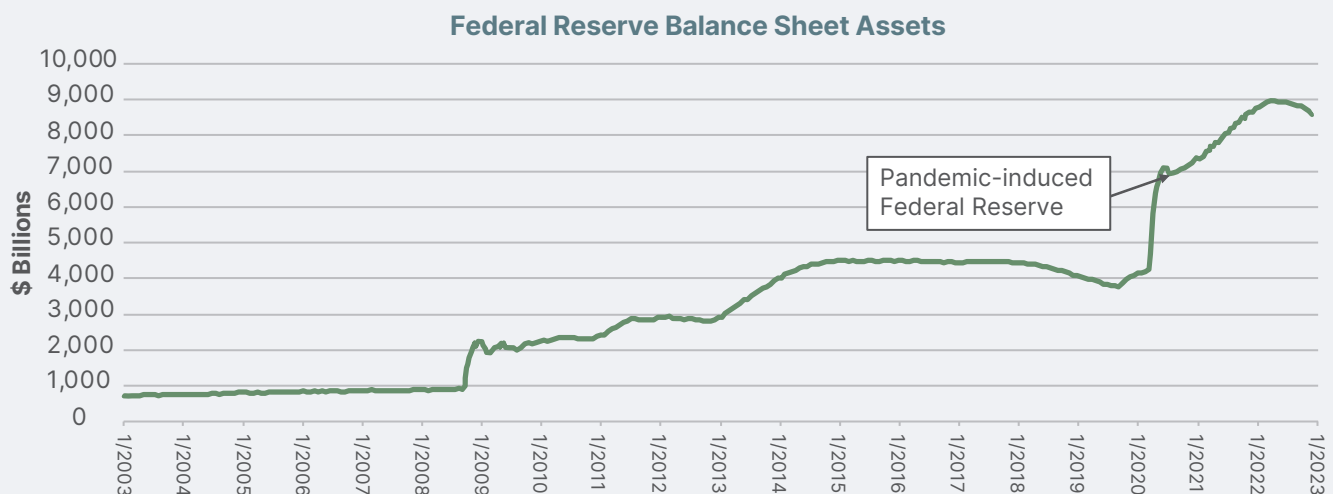


Source: FactSet and Balentine

⁵In multiple expansion, investors are willing to pay more per unit of earnings or cash flow than previously.

Recession. Of course, excess liquidity in the market could also induce a bear market, as it is slowly expunged from the system, perhaps accompanied only by a mild economic or consumer recession. Markets move towards equilibrium, and a bear market is needed to remove the liquidity added to the system in early 2020 to stave off the possibility of a pandemic-induced depression (Figure 7). Recall that during the QE era over the last 14 years, QE was perhaps the primary mechanism to stimulate investment and hiring. Consequently, markets spurred by larger-than-normal multiple expansion, rose robustly, and it is likely the same will be true in reverse during QT. The economy and hiring may eventually slow through reduced corporate investment as the cost of capital rises, but this is by no means a given, just like robust expansion was not a given during QE. Under such a scenario, a more substantial decline in asset prices may be needed to generate a demand slowdown.

Figure 7: There is still a large amount of liquidity in the monetary system remaining from the Fed's pandemic-induced injections



Source: St. Louis Fed and Balentine



Lessons from the 1970s

With the decline we have seen to date in 2022, many pundits continue to suggest that markets are falling due to recession fears, but if the aforementioned 2010–2019 liquidity feedback loop merely reverses itself, it will not be necessary for the economy to slow very much, if at all, for capital markets to stagnate or even fall. This would be at odds with recent history, where investors have seen demand-driven downturns associated with recessions in, for example, 2001 and 2008. In fact, we see many similarities in the present downturn to that of the 1970s. Recall what we showed in Figure 6, that GDP and earnings per share grew robustly for the most part in the 1970s, but equity markets went nowhere, point to point.

In the next 7–10 years, we posit that a similar environment to the 1970s, one in which the slowdown is not demand-driven, could take hold for the following reasons:

- ▶ **Strong Consumer Health.** Even with the Federal Reserve tightening, consumer health could remain relatively strong given:
 - 1) low leverage on consumer balance sheets and many mortgages locked in at very low fixed rates and
 - 2) strong employment markets.
- ▶ **Consistent Government Demand.** Government demand will likely not diminish substantively via fiscal austerity. If anything, deficits may rise as treasury yields rise and transfer payments increase to offset the pain of inflation, which ironically will perpetuate inflation by lessening any decline in demand. Under such a scenario, the demand decline would come from stultifying corporate investment, which would be the only remaining lever outside of consumer and government spending.
- ▶ **Government Deficits.** As government deficits rise to pay for transfer payments in an environment where the Fed is no longer buying—and may even be selling—bonds, a failure to reduce government deficits in proportion with the Fed balance sheet runoff may have a crowding-out effect on liquidity in addition to the direct liquidity pressure coming from the Fed shrinking its balance sheet.
- ▶ **Declining Corporate Investment.** Corporate investment decline would eventually filter to the top lines of corporate revenues (on cuts in capital expenditures) and the top lines of consumers (on cuts in the labor force).

As we have said, we do not expect this to be an exact repeat of the 1970s, but we do expect there to be certain similarities:

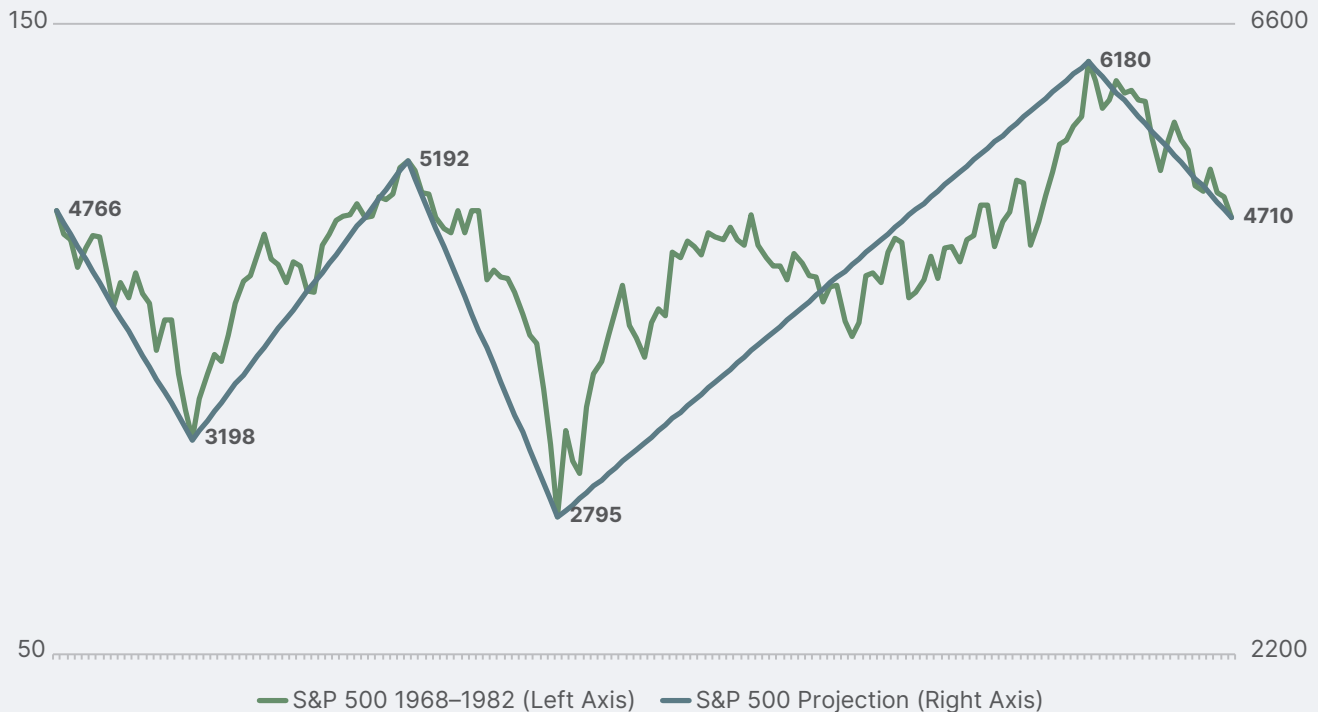
Vacillating Capital Markets. The most important similarity between the potential environment ahead and the 1970s is that, as inflation vacillates and figures out its new range, capital markets are likely to do the same. This is precisely what occurred in the 1968–1982 bear market; when the stock market eventually bottomed in 1982, stock valuations roughly matched the 1968 peak. In other words, for 14 years, stocks experienced many ups and downs as circumstances and levels of certainty changed and evolved; however, the net result was stocks ultimately ended up at the same valuation where they started (Figure 8). If today’s market rose and fell by the same percentages as it did in this period, the S&P 500 would vacillate widely, starting at 4766, hitting a relative minimum at 2795 and a relative maximum at 6180 before settling at 4710 (Figure 9). If the market follows this pattern, it would create opportunities for some trades over cycles but does not present a secular growth opportunity like we saw during the almost 14 years between March 2009 and December 2021. We don’t expect this level of volatility, but we do expect directionally this to be more the case than what we have seen over the last 40 years where there have been more sharply defined bull markets and bear markets.

Figure 8: While the 1968-1982 market did not rise point-to-point, there were pockets of opportunity in a volatile path



Source: FactSet and Balentine

Figure 9: If today's market rose and fell by the same percentages it did from 1968–1982, it could create trading opportunities.



Source: FactSet and Balentine

Falling Asset Price Multiples. In a higher inflationary environment, asset price multiples typically fall, as investor confidence in the sustainability of earnings is lowered, which may lead to investors' reduced willingness to pay for those earnings streams. However, investors over the past 40 years or so have been investing in an environment with low inflation and low cost of capital — generated by a savings glut creating excess capital. Early indicators signal we have transitioned into the opposite environment post-pandemic: higher inflation and an increasing scarcity of capital, driving yields higher and stock multiples lower in a secular bear market that lasts 10–15 years, à la 1968–1982. And we stress again, a secularly stagnant stock market, albeit with cyclical bulls and bears, can happen independently of the state of the economy (as measured by GDP) or earnings (as measured by index earnings per share), especially when multiples and interest rates have yet to fully adjust after an era of tremendous monetary and fiscal excesses.

Of course, we cannot say for sure this will be the case, but the ingredients are there, especially with current multiples well above historical lows (as we saw in Figure 4) and with rates still closer to the lower end of the historical range, as we see in Figure 10.



Figure 10: Despite the rise in yields during 2022, there is still more room to go to reach historical averages and extremes



Source: FactSet and Balentine

Bonds Providing Yield Instead of Smoothing Volatility.

During the last 40 years, bonds provided the necessary offset to equities as their prices rose (i.e., yields fell) while stocks declined, and we do not believe they will be as reliable for investors during this inflationary adjustment period. If you look at the total returns from bonds in the 1970s, the numbers look good on the surface. However, upon deeper inspection, we see that the total return was driven by strong starting yields, which was offset by capital depreciation as interest rates rose. We expect similar price action from bonds now, but the important difference is that starting yields today are much lower. So, although investors lost some principal value as rates rose in the 1970s, they were compensated enough in the elevated starting yields. This is not the case now — 2022, which started from near-zero yields, was the worst year for bonds on record.

Bond prices did not provide the desired volatility buffer during the stock declines in the 1970s. So, while starting yields helped to offset declines in the portfolio, bond prices did not. With the 10-year yield now between 3.5%–4.0%, we are at a point where starting yields are beginning to be attractive enough to dampen portfolio volatility, but unfortunately not likely high enough yet to provide the necessary volatility smoothing for an investor without even higher starting yields.

That is not to say that bonds will underperform stocks; quite the opposite actually — bonds are still likely to outperform stocks. However, outperforming with positive correlation (i.e., going down by less rather than going up) will likely not provide the diversification necessary to smooth the portfolio volatility to the desired level. So, during the time, the role of fixed income in portfolios may now be less about smoothing the volatility of the portfolios and more about receiving yield on the investment while investors look for other ways to smooth volatility.



Recommendations for Investors

So, how does one to invest in such an environment? We think there are three points to guide investing during this time, which are already integrated into our investment process:

- 1. There will be opportunities.** During the 13.5 year period between December 1968 and August 1982, the S&P index went down 36%, up 74%, down 48%, up 127%, and finally down 28%, for a total return of -6%. So even though the market was essentially flat over the period, there were certainly opportunities to generate return, both absolute and relative. This is where our Stocks vs. Bonds process should allow us to take advantage of cyclical upswings within the potential for a structurally stagnant period.



2. Old playbooks are not likely to be relevant;

in fact, it is more than likely that they will be counterproductive, giving a false sense of confidence. Investors will need to think differently. This idea of trying to buy the dip in technology stocks is not going to get it done in an inflationary environment. It will take looking for new ideas, as history suggests that new leadership emerges in new bull cycles:

- ▶ Technology peaked in 2000, bottomed in 2002, but didn't begin to outperform the rest of the index until 2006.
- ▶ Financials peaked in 2006, bottomed in 2009, but didn't begin to outperform the rest of the index until 2020.
- ▶ Energy peaked in 2008, but it didn't bottom or begin to outperform the rest of the index until 2020.

This is where our Equity momentum models should allow us to take advantage of the cycles in new leadership while giving us the ability to quantify when those relationships are no longer poised to outperform.

3. The market will experience a paradigm shift.

Fixed income will likely be more about generating true income and less about lessening portfolio volatility. In a stressed liquidity and likely inflationary environment, it will take owning equity securities with high enough dividend and/or buyback yields that they offset the downdraft of multiples and can be reinvested/compounded, such as, for example, equities of the highest quality factor (which we will flesh out further later in this Capital Markets Forecast). We expect this to be the case even if QT does not bring about a significant credit event like the failure of Lehman Brothers in the U.S.⁶. It is our more recent approaches such as implementing specific U.S. sectors and positioning aspects of certain portfolios toward a more quality bias that should allow us to take advantage of these more granular aspects to this period.

Keeping these three tenets as the core of our playbook should allow our portfolios to weather the tough secular stretch and come out well on the other side while we actively plan for the next secular cycle.

⁶We would note that we will likely continue to see failures such as what almost occurred in British pension plans and what did, in fact, occur with FTX. However, we do not expect anything akin to the 2008 episode, at least here in the U.S. As central banks continue their quest to defeat inflation, would not yet preclude such an occurrence in other areas where there may be risk in, for example, floating rate mortgages, areas with more extreme real estate bubbles, and the old wounds of the fixed currency Eurozone.

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