Lost Half-Decade

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We've labeled the beginning of 2022 through today as the "Wilderness" years, drawing an analogy between the Israelites wandering through the desert for 40 years before ultimately entering the "Promised Land," a land flowing with milk and honey. For us, the wilderness is the amount of time it will take until markets and our account balances go back to record all-time highs. While it may not take 40 years, stocks have still not recovered to their December 2021 levels, when the S&P 500 Index traded at 4,766 and the Dow traded at 36,338.

In recent history, markets have recovered nearly as quickly as they've corrected. March 2011 to April 2012, May 2015 to October 2016, October 2018 to July 2019, and even COVID, one of the sharpest drops in history, stocks recovered their losses in a few months. Currently, the S&P 500 is trading for roughly 4,100 points, 14% lower than it did nearly 18 months ago. As we predicted, 2023 has not been the doom and gloom year many economists anticipated. While choppy, markets have not plummeted back to all-time lows because corporate profits have not been nearly as bad as analysts expected. However, stock prices are a function of both earnings and some sort of earnings multiple, so while earnings are better than expected, those earnings are worth less today with 5% interest rates.

With near zero interest rates during COVID, earnings became worth 25 times, far too overvalued in the short run. Today, those same earnings are valued at 18 times, not radically outside their 10-year average. When rates are low, we get most of our return from growth-oriented companies that reinvest their profits back into expansion. During higher rates, we get more return from companies that pay us cash now, in the form of stock buybacks and dividends. In short – 5% returns completely change the capital allocation decision for investors. To buy a stock in this environment, we need a reasonable chance of earning much better than the 5% risk-free treasury rate, hence why we think we'll be in the wilderness for a few more years.

We've been in the wilderness a few other times in the past, each which happened to be when the Fed was raising interest rates. In November 1968, the S&P 500 Index peaked at 928 points and didn't return to that level until 1993. While the bottom didn't fall out, the market basically produced no price return for 25 years. The saving grace of the 25-year wilderness was S&P dividends which provided 3-6% annual yields. Bonds provided some additional return, especially as the Fed started cutting rates between the early 1980's and late 90's.

Similarly, we experienced a lost decade from 2000 to 2010 when the S&P 500's annualized total return (including dividends) was negative 0.9%. The saving grace during this time was a diversified portfolio focused on dividend income and commodity linked stocks. While the broad market produced no return for 10 years, energy stocks returned 9% per year, real estate returned 5% per year and basic materials returned 4% per year. Chinese stocks during that period returned about 6% per year, which is why some portfolio managers point to the need for geographic diversification. We believe this is somewhat of an anomaly because China had just earned favored nations status in 2000, growth not likely to be repeated unless the CCP collapses. While we haven't invested internationally since 2018, we are undergoing significant due diligence on India, a major benefactor of the U.S./Chinese trade war. India has over 1.4 billion people, a birth rate nearly 70% higher than China and per capita GDP up 56% compared with 32% in the U.S. the past decade. We aren't ready to jump in yet, but India could represent a significant long term growth opportunity for investors.

Until the Fed changes its tune on interest rates, the wilderness could continue into late 2025. This would represent nearly a half decade of no return on the broad U.S. stock market, especially a risk for investors who do not regularly rebalance and pivot towards dividend paying, commodity linked companies. We never want to over-allocate to one sector or company, but we certainly want to overweight towards industries and stocks that will pay us cash today, rather than in the future. Stay tuned for more pain ahead in the regional banking world, small-cap stocks, and bond market. We'll get through this choppy time but may continue bouncing around for a while.

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