

Fall 2022 Edition

By: Henry Pizzutello, Chief Investment Officer

HOW CHEAP IS CHEAP?

The term “value” has a number of different meanings in the investment world. On one hand, it refers to a specific type of equity discipline – the style of buying stocks because they look cheap relative to their fundamentals. It also relates to investment portfolio performance – monetary value is created through long-term investment strategies. The two concepts of value are both very relevant today, as we face one of the more challenging markets since the Financial Crisis in 2008. Paradoxically, the most significant value creation for investors comes from the actions they take in falling markets, not rising ones. If you’re not yet in retirement and not finished putting money into your retirement accounts, every market drop is an increased opportunity for you to buy things that will be worth much more in the future when you eventually sell them. Creating value today that will be realized at some point tomorrow. On the other hand, if you are in retirement, taking assets away from your investments during these periods will create value destruction down the road.

The hardest thing to do in the investment world is to invest when everything looks terrible. As Warren Buffet famously said “*be fearful when others are greedy, and be greedy when others are fearful*”. While the market environment is certainly one that induces fear, almost everything about the current market environment has now gotten better for investors than the environment one year ago today.

In September of 2021, the Fed was thinking that no interest rate hikes would be necessary for the entirety of 2022. “Lower for longer” was the mantra. They didn’t see the need for any rate hikes on the horizon until 2023. As a result, cash was yielding zero and stocks were selling for 24x earnings. Fast forward to today – the market has digested significant rate increases that were unheard of a year ago, stocks have corrected 25%-30% and the market multiple is now 15x forward PE ratio (below the five year average of 18) and cash now yields 4%.

Fall 2022 Edition

All of this raises the question of what it can possibly make sense to buy at this juncture. Despite their strong outperformance to growth over the past 18 months, the answer still seems to be value stocks. Value suffered severely in the decade after the Global Financial Crisis, primarily due to interest rate policy that created what was termed a TINA market (There Is No Alternative). With zero interest rate policies in place, growth stocks looked exceedingly cheap, especially relative to slower growing value. As interest rates increased this year, the discount for that future growth increased much more for growth than for companies that actually made money.

So how cheap is cheap? Well, value stocks are historically cheap to growth but on a global scale, the largest value discount is found in Europe. The U.S. has more fast-growing tech companies that can justify a higher multiple, so it's not necessarily such a bad sign that the U.S. looks more expensive. However, the value discount between the U.S. and Europe is increasing, which suggests that Europe is cheapening excessively. In all cases, the valuation gap between the cheapest and most expensive stocks is at historic levels. On this basis, value in the US has only been cheaper 10% of the time, respectively; for Europe the number is 4%.

Between the two options, we believe the U.S. to be the better value, even though statistically Europe is a better bargain. When valuations reach extreme discount levels, every asset will show above market returns during the eventual recovery, but from a risk perspective, the U.S. is a much higher quality asset than Europe, and a recovery will likely impact the U.S. before Europe.



Of course, with any investment decision, the key component is the timing aspect. Over the past 10 years value performance lagged as a result of the interest rate environment, but the changing climate indicates that trend is reversing and will likely produce above historical returns over the longer-term horizon. Making investment decisions in the current environment based upon rational analysis rather than emotion may not feel good in the moment, but that's why not everyone gets to succeed.

Fall 2022 Edition

PIVOTAL WISHFUL THINKING

We have seen increasing market volatility in recent weeks, and the main culprit seems to be hopeful expectations of a Fed pivot. This was one of the primary factors behind the summer rally, which was ultimately dashed by Chairman Powell's comments at Jackson Hole in August. While it seems like the Fed direction could not be clearer, there is some evidence that the inflation issue may be in the process of resolving itself. A number of leading indicators have moved significantly lower, and except for food and energy, all are lower on a year over year basis. The two indicators that have garnered the most attention, employment and CPI, are both lagging indicators, and may well follow the trend lower.

	Peak Closing Price Date	Peak Closing Price	Peak Closing Price to Last Close Percent Change	Closing Price YoY Percent Change
Gold	8/6/2020	2,064	-18%	-3%
Silver	8/10/2020	29	-31%	-11%
Lumber	5/7/2021	1,686	-74%	-34%
Iron Ore	6/29/2021	1,387	-45%	+7%
DRAM	7/9/2021	5	-46%	-34%
Baltic Dry	10/7/2021	5,650	-65%	-65%
Copper	3/4/2022	493	-31%	-20%
Oil	3/8/2022	124	-25%	+18%
Corn	4/29/2022	818	-16%	+28%
Container Board* (OCC)	-	-	-	-53%

Source: ARK Investment Management LLC, 2022. Data from Bloomberg as of last close, 10/7/2022.

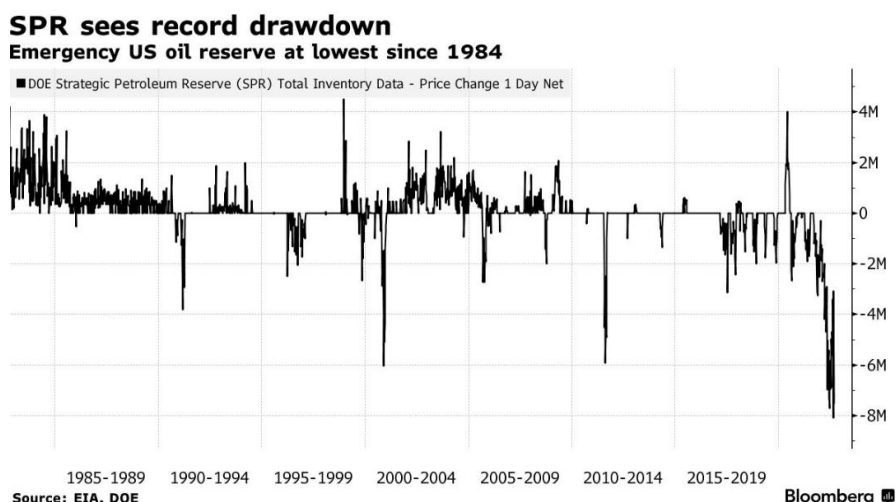
*According to Fastmarkets' RISI Pricing Data, containerboard prices dropped 29% in September and are down ~53% year-over-year. Containerboard correlates to commerce-related shipments.

Markets have taken note – the start of the fourth quarter was ignited by a strong rally fueled by a poor ISM economic survey, sparking hope for a slowing economy and a Fed shift toward easing up on rate hikes. However, later in the week, the strong employment data on Friday brought the market back right back down. Given the unique level of uncertainty in the market narrative, it is not surprising that investors with a **short-term** focus look to every new bit of data to gauge how the economy will look in the future. What history has shown us repeatedly, and what is being made clear today, is that these situations take a longer time than investors anticipate, and the daily “market signals” that are jumped on by traders are ineffective as long-term barometers.

The infamous “Powell Pivot” of late 2018, when the Fed changed course as a result of a severe fourth quarter sell-off may be most to blame. It fostered the impression that the Fed could turn on a dime and protect the markets. Markets remain hopeful that there may be a repeat of those actions, but the Fed has been clear in its intentions, and it may well mean that future data would have to be overwhelming for the stance to change.

Fall 2022 Edition (Continued)

Another potential reason for a pivot is the price of oil. The decision by OPEC to cut production quotas by 2 million barrels per day has been viewed taken as a geopolitical aggression that will increase the price of oil. Meanwhile, there is a growing supply issue with major political implications regarding the Strategic Petroleum Reserve, the country's "rainy day" store of oil that can be released in times of geopolitical need. The war in Ukraine fit that bill perfectly, and helped to stabilize prices during times of increased price volatility, but the drawdown in inventory has now reached historic proportions. The reserve is its lowest since 1983, and less than rest of US inventory for the first time since the early 1980's.



Even accounting for the oil situation, hope of a pivot has been overdone all year. Besides the aforementioned, there have been three clear instances that could have been defined as a "pivot" - the Long-Term Capital Management crisis in 1998, the financial credit crisis in 2008, and COVID shutdown in 2020. Each of these were extreme events that required extra-ordinary measures, and, more importantly, were also executed with a more forgiving national balance sheet. The current twin fears of rising inflation and macro-economic concerns do not make the cut for such action, however painful they may be on current financial markets.