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Capital Management, LLC

Known Unknowns

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There are known knowns; there are things we know we know. We also know there are known unknowns…

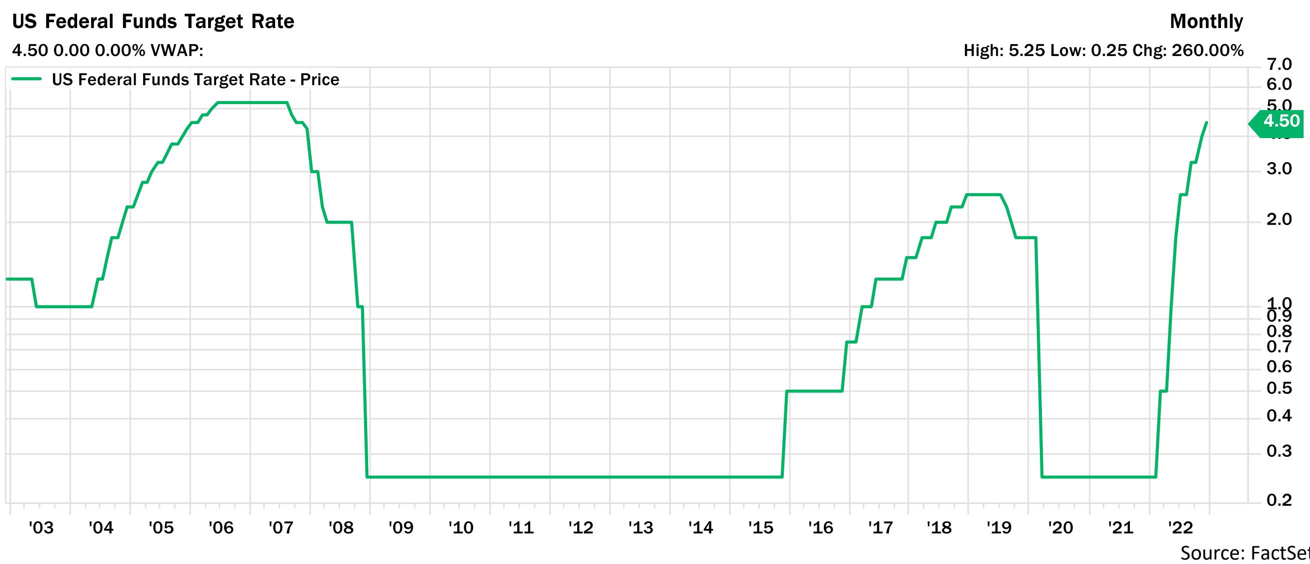
"There are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know."

This quote is from a former U.S. Secretary of Defense in 2002 who was discussing intelligence regarding a potential military conflict. The framework of existing facts (known knowns), known events with unknown variables and outcomes (known unknowns) and completely unknown risks (unknown unknowns) is as applicable to investing as it is to foreign policy. In managing your portfolio at Osborne Partners, we are constantly trying to balance the various known and unknown risk factors, constantly incorporating and refining them when building the risk-to-reward estimates for our investments. For known unknowns such as earnings revisions or the risk of a recession, we utilize internal research and historical precedent to inform our estimates about the severity and probability of the risk. Risks from unknown unknowns is ameliorated by our multi-asset class investment discipline as evidenced last year with the Natural Resources and Alternatives asset classes posting positive returns during a bear market for nearly every other asset class.

Last year was one of the worst years in history for most asset classes, fraught with numerous known unknowns and unknown unknowns that confounded and punished markets. Known unknowns that dominated the market were questions such as: when would China reopen their economy?, how high would the Fed raise short-term interest rates?, when would inflation peak?, how low would equity valuation multiples fall?, and how far would equity earnings drop? These questions whipsawed the markets as estimates about the unknown part of the risks changed on a seemingly weekly basis, moving the markets up and down in unusually rapid fashion. The Russia/Ukraine war represented the largest unknown unknown to shock the markets. The conflict quickly evolved into a known unknown with potentially catastrophic consequences as fears that the war would escalate into a broader conflict peaked during the summer. All of these major risks surfaced and evolved in 2022, resulting in most asset classes experiencing serious price and valuation resets. As we enter 2023, investor sentiment is generally negative and fearful. However, an advantage entering 2023 is that the known unknowns of 2022 are now more well known with the risks and range of possible outcomes better understood.

In examining these previously "unknown unknowns," today we have improved confidence that each are toward the tail-end of their unknown status. First, China is now actively opening their economy after being in some form of lockdown for the majority of the past three years. Second, the Russia/ Ukraine war appears to be isolated, with a low probability of the war spreading to neighboring countries. Next, when analyzing the economic unknowns, they have largely morphed into "known knowns" as we enter 2023.

For the economic unknowns, the Federal Reserve increased the Fed Funds rate at a historically rapid pace, moving the rate from essentially zero to 4.50% in less than one year (20-year history shown below).



Although the Fed Funds rate increased to 4.50% from 0% in 2022, at the time of this writing, market implied probabilities indicate that the tightening cycle is likely near its end. Markets assign a 65% chance that the Fed Funds does not peak above 5.00%, and nearly 0% odds that the terminal rate reaches 5.50%. While at this time last year, it was nearly impossible to gauge where Fed Funds would peak, this previous unknown points to a terminal rate only about 0.50% above where it presently sits.

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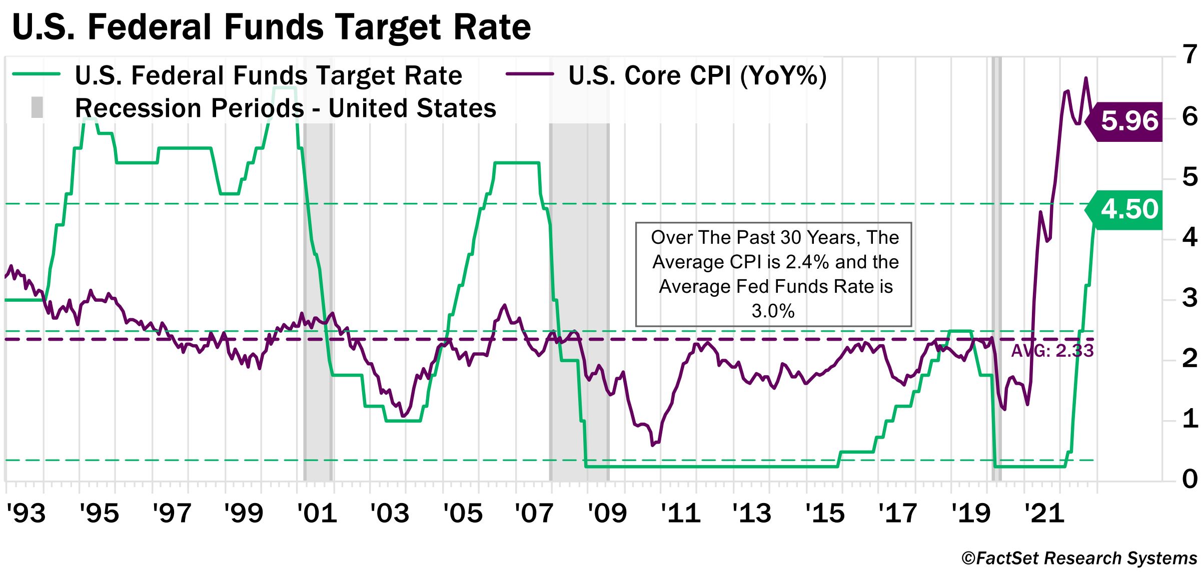
On the inflation front, after bottoming in February 2021 at 1.3%, core CPI began a torrid and relentless rise. By December 2021, core CPI had risen by over 4x to a multi-decade high of 5.5%. At the beginning of 2021, there was not a peak in sight and many prognosticators were calling for core CPI to rise above 8% with headline CPI potentially piercing double digits. Fears of a stubborn 1970's style stagflation cycle caused fear and confusion across asset classes. However, once headline CPI peaked in June at 9.1% and core peaked in September at 6.6%, it appeared inflation was starting to normalize. As seen below, the Fed raised interest rates (green) mainly in response to core CPI inflation launching (purple). As CPI continues to fall, the odds are high that the Fed Funds rate will follow in the future, resulting in another known unknown.



Turning to U.S. equities valuation, after falling to under 13x during the pandemic in 2020, the forward P/E multiple of the S&P 500 rose strongly for four straight quarters, even with earnings normalizing higher. By 2021, the S&P 500 forward P/E had reached the highest level since 2000 (see the following chart). According to our research, for the S&P 500 to achieve a 23x multiple, interest rates would have to be close to 0%. As soon as the Fed started tightening by raising interest rates, it was nearly impossible for the S&P 500 to trade at that multiple. The known unknown became – how far would the S&P 500 multiple have to fall to achieve a fair valuation? To hypothesize how low the multiple could sink, one would need to have an educated guess about interest rates and know the history of bear markets.

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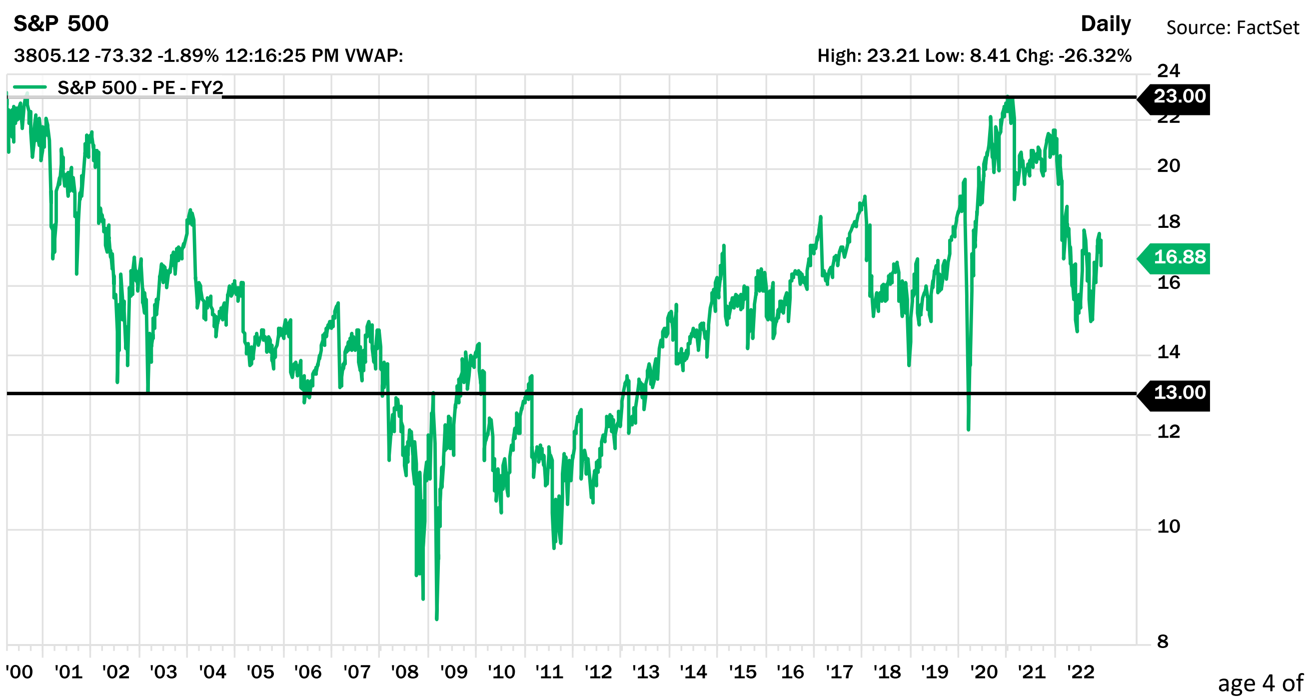
In January of 2022, when the Fed Funds was tethered at 0% and the 10-year U.S. Treasury was yielding 1.50%, attempting to pinpoint where interest rates would be toward the end of 2022 was nearly impossible. However, in analyzing the history of bear markets, the Investment Team knew a number of characteristics about all 14 bear markets since 1950. First, the forward P/E multiple has compressed by 32% on average. The only four instances when it compressed more than 32% were during the Global Financial Crisis, the Internet Bubble, the Nifty-Fifty bubble in the 1970s, and briefly during the Crash of 1987. In 2022, a 32% compression would result in a forward P/E multiple bludgeoning from 23x to under 16x. Additionally, the average trough in a bear market was in the 14.5-15.5x area with Osborne's proprietary interest-rate adjusted multiple bottoming at 14x. The result is all of these bear market statistics pointed to the P/E multiple bottoming just under 16x and 14x on an interest rate adjusted basis.

As the calendar turned to October, the 10-year U.S. Treasury hit a yield of 4.33%. At that level, and having confidence that inflation had peaked, you could have been confident in a solid risk-to-reward ratio at a P/E under 16x and 14x interest rate adjusted, matching bear market history. At the October lows for the S&P 500, the P/E multiple broke below 15x and 14x interest rate adjusted (shown below; now 16.8x).



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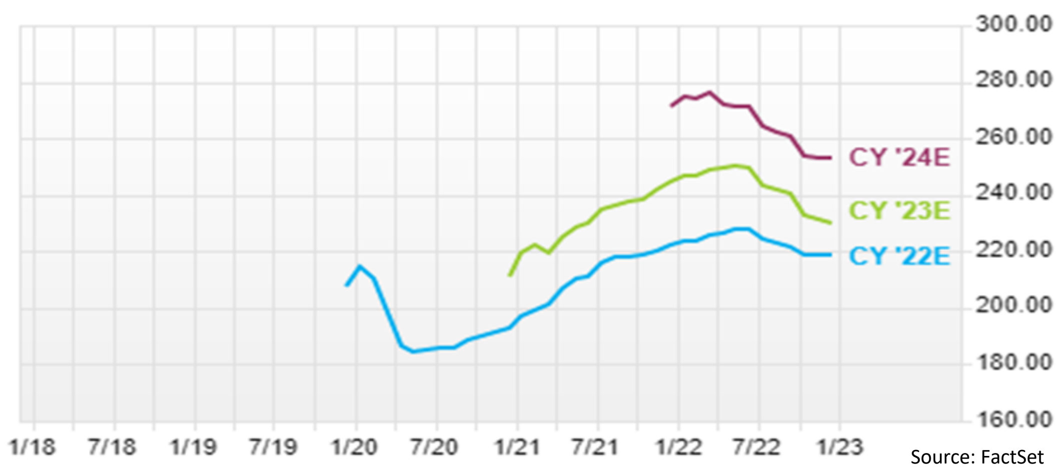
The final unknown from this year is the level of 2023 S&P 500 earnings, although this is gradually coming into focus. In the early summer, 2023 earnings estimates peaked at $251 per share. However, since then, the impact of interest rate hikes filtered through the economy and began to negatively impact corporate earnings, with estimates falling and likely continuing to fall in early 2023 as fourth quarter earnings are released. The latest consensus estimate for 2023 S&P 500 earnings is now below $230, with many strategists estimating they will fall further to $200 (following chart).

S&P 500 ANNUAL EARNINGS ESTIMATES



Source: FactSet

As explained in some of our recent Investment Team videos, we have long felt that investors would shift focus to the major known unknown of 2023, earnings growth, versus other unknowns as 2023 begins. This shift in focus has begun, however we believe the consensus could be making an assumption mistake by being overly pessimistic. We now regularly hear Wall Street strategists say: "If earnings are $200 per share and the appropriate bear market P/E is 15x, then the S&P 500 should trade at 3,000" – nearly 15% below the October low. The math is appealingly simple and logical with this thesis becoming ubiquitous. While making for good CNBC headlines, we believe this theory is inaccurate. History shows that the forward P/E multiple (and markets) bottom before earnings. Examples from the two most major bear markets over the past 15 years are in the following chart.

Notice the S&P 500 (blue) bottomed in March 2009 while earnings did not bottom until six months later.

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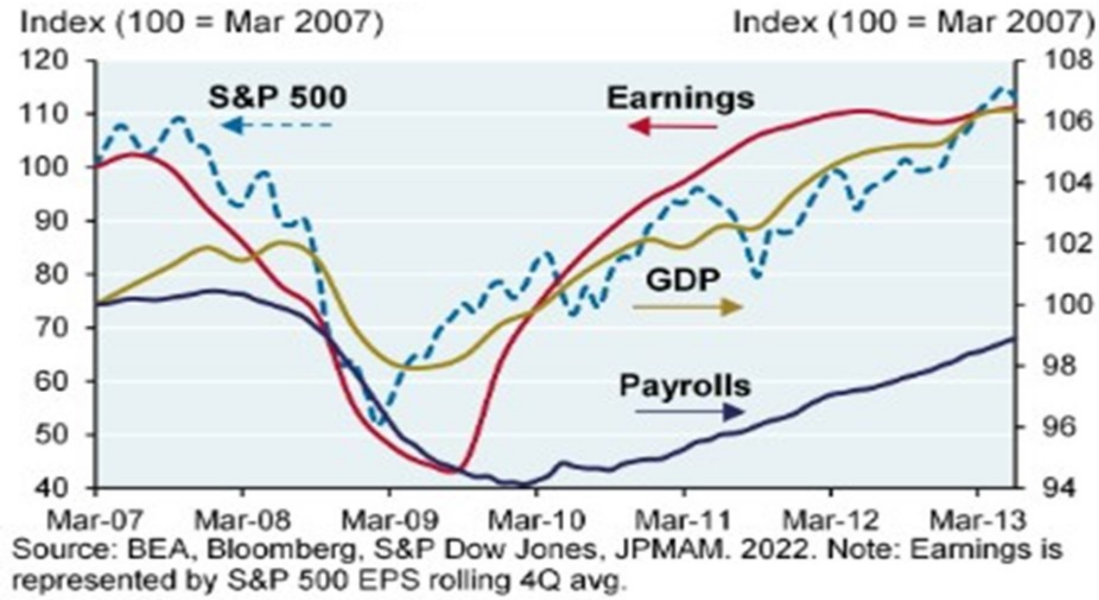
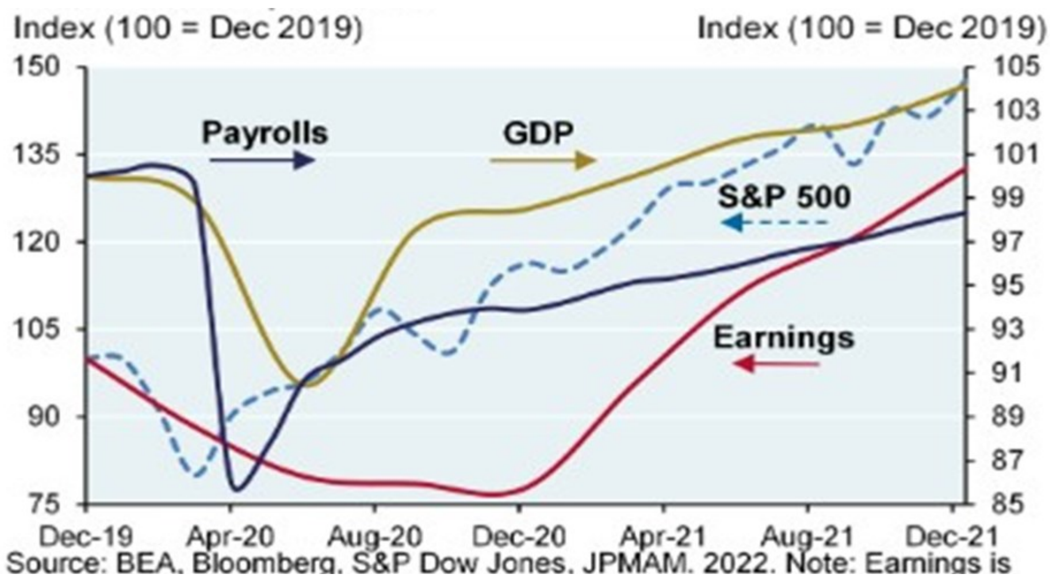


In 2020, the S&P 500 bottomed in March 2020, yet earnings did not bottom until eight months later.



In examining the bear market of 2022, based on our internal research and history, one could surmise that equities tend to bottom after 1) the P/E multiple bottoms, and 2) after approximately half of the negative earnings revision cycle is complete. If earnings estimates are set to fall from $251 last summer to $200, then somewhere in the $215-$225 area makes sense. This would indicate the dire (and common) calls for the S&P 500 to fall to 3,000 or below are too pessimistic.

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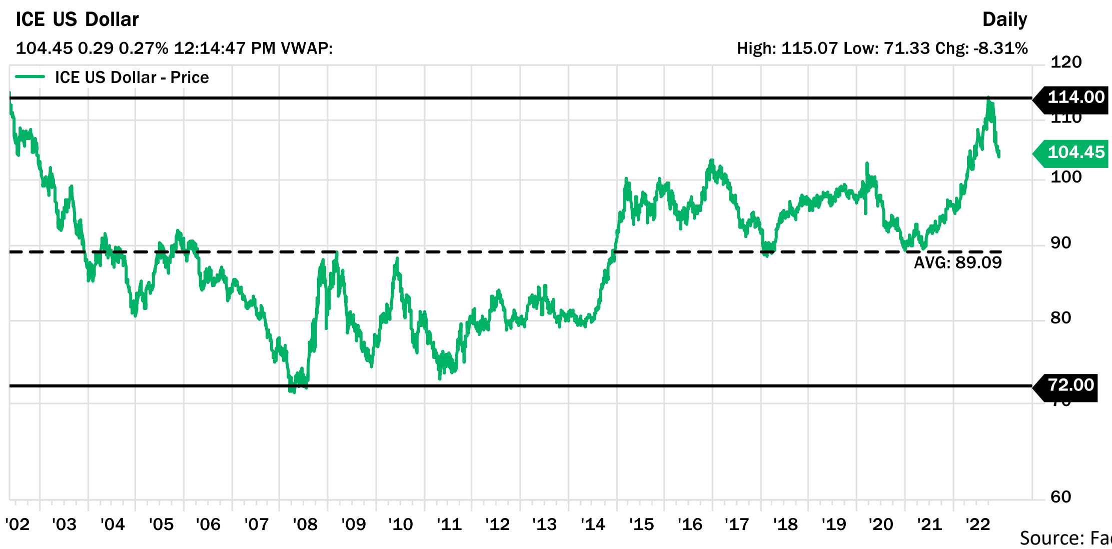
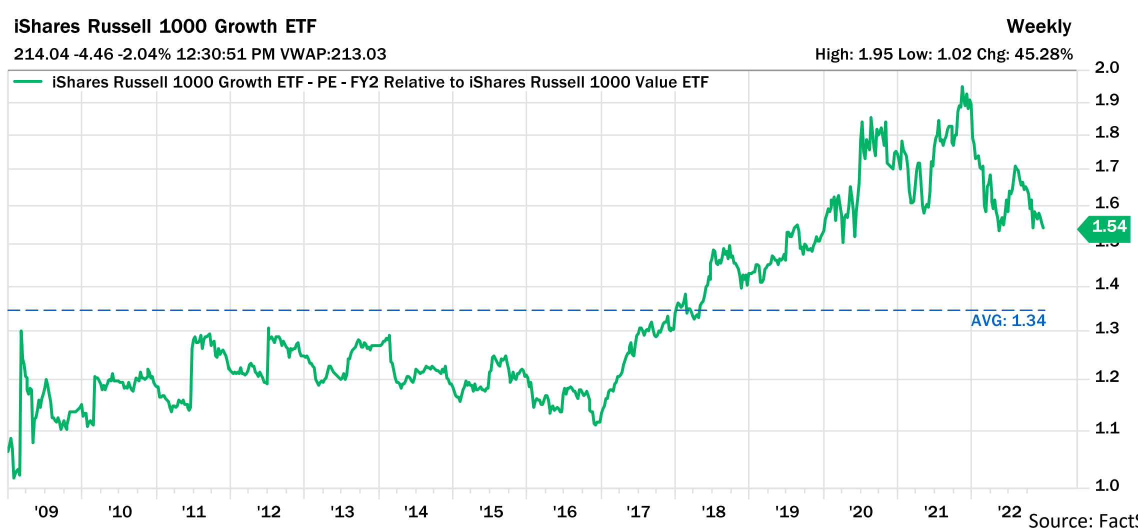
With all of these unknowns becoming more known recently, we also note a few extremes that could be tailwinds to different asset classes in 2023. First, after a strong move of over 25% in just over a year, the U.S. dollar reached a 20-year high (chart below). If a top is in place, a flat-to-down U.S. dollar could be a tailwind to the Foreign Equities asset class (see Jay Skaalen's piece: https://osbornepartners.com/overlooked-but-not-forgotten/).



Source: FactSet

Next, in 2021 we warned about excessive valuations and overly bullish sentiment in growth stocks due to record low interest rates. Growth stocks have strongly underperformed since November 2021 as more value-oriented investments have performed well. However, growth stocks continue to trade at a meaningful premium to value stocks (following chart).



Source: FactSet

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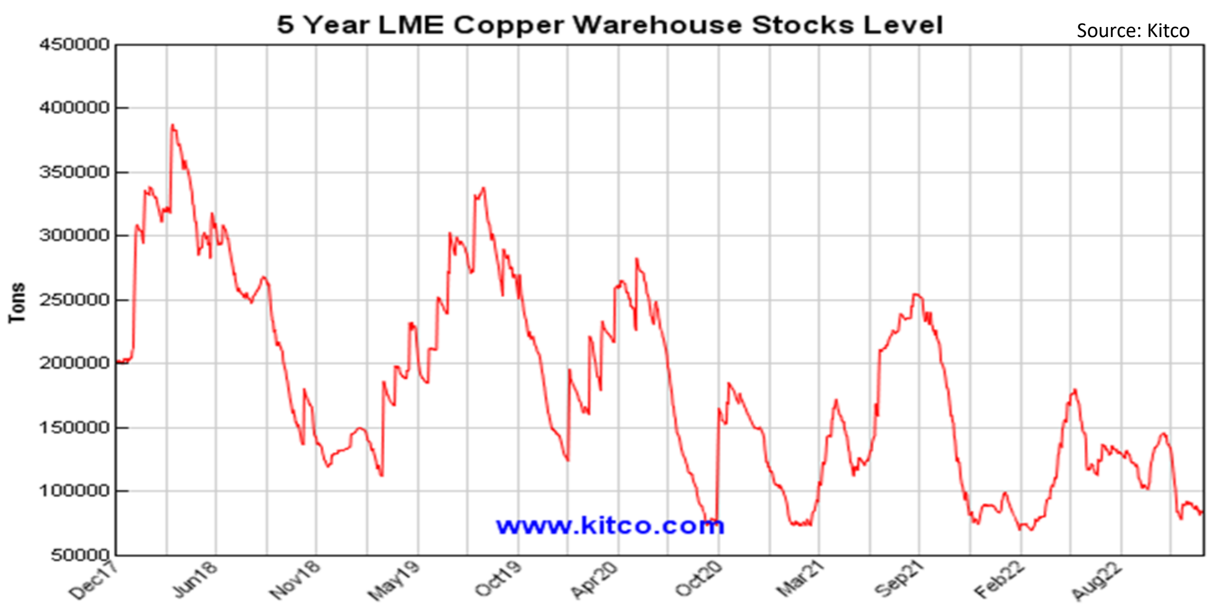
Growth focused managers and their investors have seen their portfolios destroyed over the past 15 months. In contrast, Osborne Partners' style-agnostic discipline has enabled us to purchase the strongest fundamental situations with the best reward-to-risk ratios, regardless of the investment's size or category.

In the Natural Resources asset class, although the asset class has performed extremely well over the past 18 months, and we reduced exposure earlier in the year when inflation was peaking, certain areas like industrial metals continue to sport strong fundamentals. We show the five-year inventory level of copper on the London Metals Exchange (LME). Inventories are anchored at the five-year low, which could be bullish for copper's already positive long-term secular fundamentals.



Finally, in the Real Estate asset class that is comprised of allocations to global REITs, commercial real estate companies, and residential real estate companies, the inventory situation is not worrisome, especially on the existing home side, despite our reduction in exposure to residential real estate last spring.

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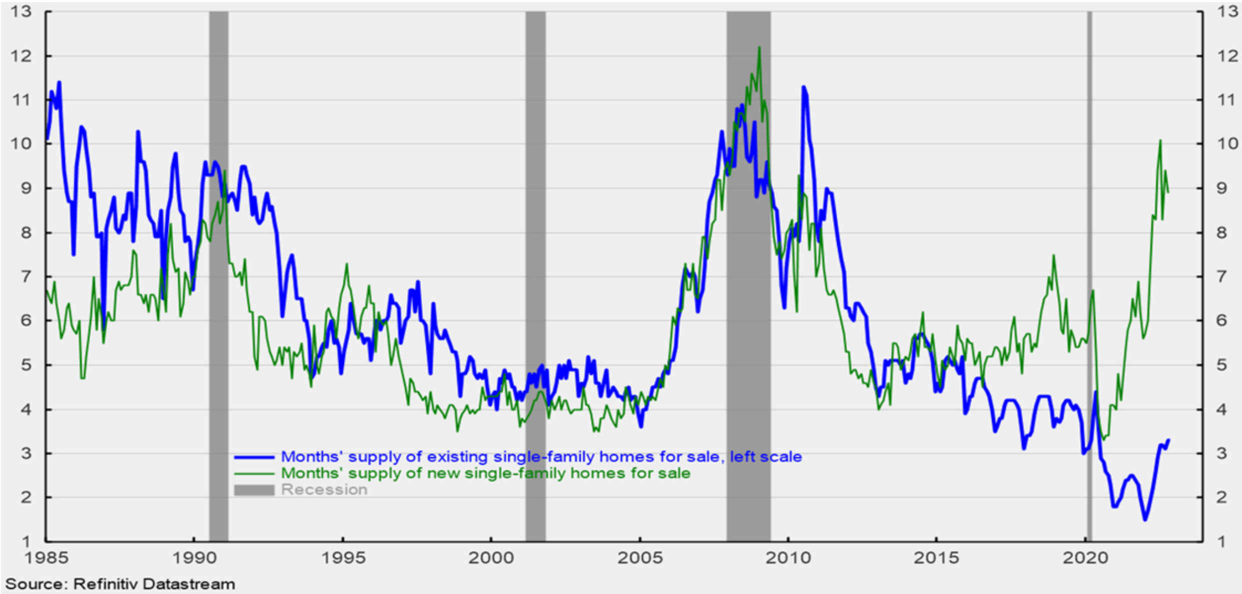

We believe 2023 will likely see a continuation of the elevated volatility experienced in 2022. However, as the unknowns become known, volatility will subside and a clearer path in which to make investment decisions will emerge. Along the way, our style-agnostic discipline will help us avoid being "trapped" in a style that is out of favor. Being style-agnostic has helped our portfolio avoid lengthy periods of underperformance due to the environment not being just right for a particular style.