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Market Perspective October 2022

Mendel Melzer
Chief Investment Officer, CapAcuity

At this moment, there are many crosscurrents in geopolitics, the economy, and the capital markets. We are in a nearly unprecedented bear market for both stocks and bonds. Everyone is asking whether the worst is behind us and is it timely to add risk to portfolios. While we could examine the various forces that are causing this bear market, history has shown that attempting to forecast political and economic factors is very challenging. I, therefore, prefer to focus on the objective factor of valuation. This quarter's Market Perspective will be brief.

Over the last several years, I have written about what I thought were elevated valuations in the equity (and risk asset) markets. My preferred measure has been the one Warren Buffet favors, the ratio of the Market Capitalization of the US Market as a percentage of US GDP. This measure neutralizes any "noise" from earnings estimates in P/E ratios. During the pandemic, this measure soared. Since the beginning of 2022, it has begun to come back to earth. While it has declined 25% from its early 2022 peak, it remains 22% above its 20-Year median.



Source: Bloomberg

Market pundits attribute this decline to the Fed’s interest rate hikes, concerns over a recession, worries about corporate earnings and the effects of a very strong dollar. All of these are valid concerns, but ultimately, they manifest themselves in lower valuations. No one knows where the bottom will be, but it’s clear from the above graph that we haven’t yet reached an equilibrium level, based on history. We all know that valuation is not a market timing metric. However, multiple studies have shown that the going-in level of valuation is inversely correlated with subsequent returns. (e.g. Tillman, Exploring the Predictive Power of Valuation Metrics on Subsequent Market Returns, The Journal of Wealth Management, Fall 2022)

Today’s 158% ratio is neither extreme to the high side or the low side. However, it remains elevated in comparison to its 20-Year median. For those looking for a “bottom” in valuation of risk assets, we probably are not there yet. For those looking to scale into risk assets, we are at a far better point than the beginning of this year.

The same dynamic holds for fixed income investing. The following graph shows the Federal Funds Effective Rate (in red) and the 10-Year Treasury yield (in blue) over the last 20 years. As of the last FOMC meeting (9/21/2022), the FOMC Members’ “Dot” Projections for the end of 2023 have the Federal Funds rate at 4.6%. As illustrated below, except for two brief periods, the 10-Year Treasury Yield has always been above the Fed Funds rate. (This upward sloping yield curve is the “norm”). As the Fed Funds rate increases from its current level of 3.1% to its FOMC projection of 4.6%, it seems likely that the 10- Year Treasury yield will increase similarly. (As bond yields increase, prices decline)

Federal Funds Rate vs 10 Year Treasury Yield



Once again, for those looking to scale into Duration, this seems as good of an entry point as we’ve seen in over a decade. For those looking for a peak in yields, we probably aren’t there yet.

The perspective on other asset classes can be implied from equities and fixed income. As always, I welcome your questions and observations.

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