JOHN K. LOHRENZ

THE INVESTOR'S PLAYBOOK

to the Recession Ahead

Introduction

The future for investors is one of more volatility and less accommodative institutional support from the U.S. Government and the Federal Reserve.

This means the easy monetary conditions are no longer in the cards for us and that the "easy money" has been made. We will have to work harder for the returns we earn in the future. Our recommendation is that investor's keep a very open mind to education and financial literacy on areas they may not have considered in the past. There has never been a more robust set of choices for retail investors and they really have a universe of options that was only available to the Wall Street institutions and Ultra High Net Worth investors not that long ago. The list includes but is not limited to:

Private Equity-Structured Products-Annuities-BDCs-REITs-Closed-End funds-Floating Rate-ETFs-Mutual Funds-Dividend Paying Stocks-MLPs-Private REITs-Long/Short Strategies

Combining a diversified allocation with an eye towards risk mitigation and management is the prudent path for investors as we move further into this Fed rate raising cycle. Recession is looking like it is already arriving despite the discussion of what the "new definition" might be. These conversations will be quite interesting to look back on in the years ahead just as it is interesting to look back at the financial crisis and the quotes in the news then.

Current Economic Outlook

The current economic outlook for the world has become highlighted by the forecast for a global recession by many thought leaders in the market.

The Fed thought that inflation was going to be “transitory” coming out of the pandemic and waited too long to begin its tightening of financial conditions to slow it down.

They have been playing catch up by increasing their fed funds rate by 75 bps at multiple meetings and it has started to cause the desired effect of demand destruction. This is another way of saying they are slowing down consumer spending and is beginning to have a major impact on real estate as mortgage rates have doubled to over 7%.

The current tightening is the equivalent of slamming on the brakes to the economy and they have stated this will be their priority until inflation is under control.

"The current tightening is the equivalent of slamming on the brakes to the economy."

- Fed Funds Rates increased

- Consumer Spending Slow Down

- Mortgage Rates Doubled

A Future Shaped by the Past

The playbook has been shaped by outsized moves by institutions over the last 3 years.

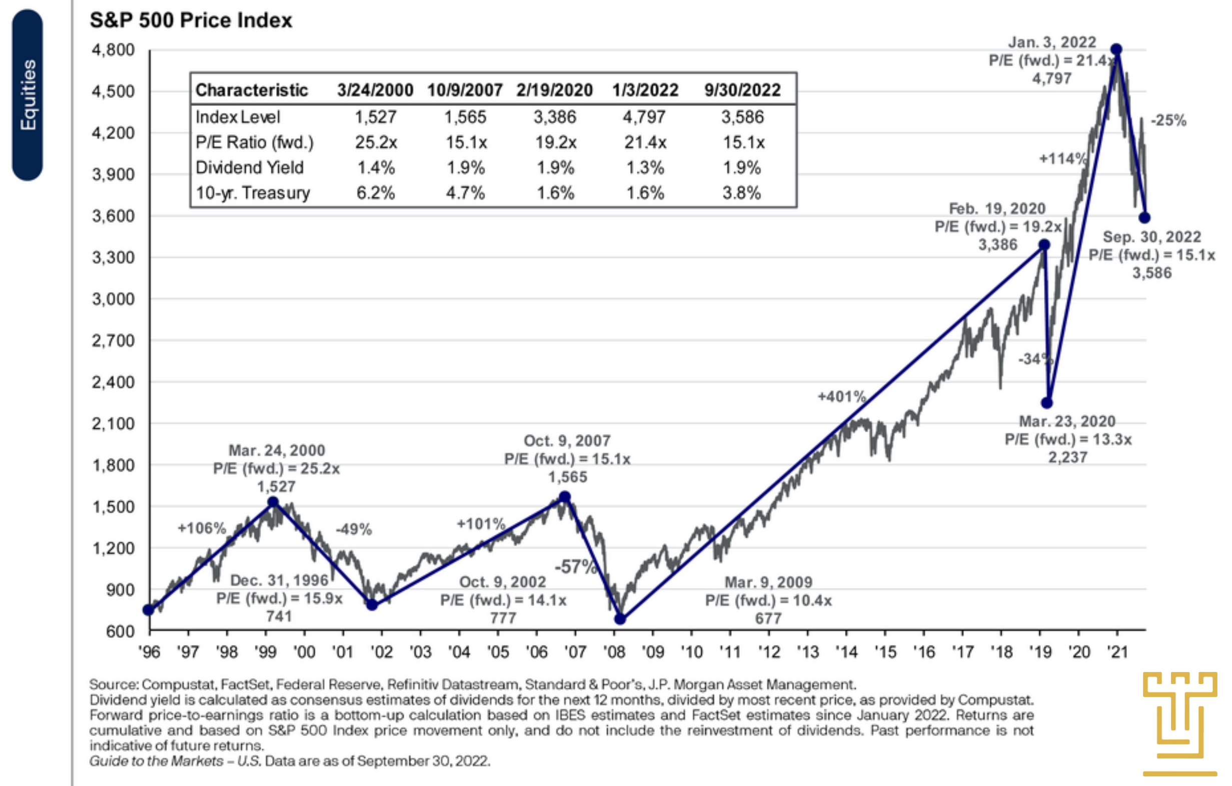
It is as we speak the single most observable contributor to investment results both good and bad in getting where we are now and where we are going into 2023.

The Federal Reserve has always played a large role for investors and especially so since the financial crisis in 2008-2009. They have been providing stimulus and injecting liquidity at every turn. Anytime the markets have had any difficulties it has been bailed out by the Fed either lowering rates or injecting liquidity through QE programs.

This has made risk taking by equity investors widely spread and such terms as TINA “there is no alternative” and FOMO “fear of missing out” common descriptions by the talking heads on bubble vision.

The Standard and Poors 500 hit a bottom of 677 on March 9 th 2009 with a forward P/E of 10.4. Note the peak March 24, 2000 at 1,527 nearly 9 years earlier which translates to over a 50% drawdown in that window of time.

This time in my career was one I would rather forget but drew a wide number of lessons to apply to markets going forward.



Characteristic	3/24/2000	10/9/2007	2/19/2020	1/3/2022	9/30/2022
Index Level	1,527	1,565	3,386	4,797	3,586
P/E Ratio (fwd.)	25.2x	15.1x	19.2x	21.4x	15.1x
Dividend Yield	1.4%	1.9%	1.9%	1.3%	1.9%
10-yr. Treasury	6.2%	4.7%	1.6%	1.6%	3.8%

Source: Compustat, FactSet, Federal Reserve, Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management.
Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by Compustat. Forward price-to-earnings ratio is a bottom-up calculation based on IBES estimates and FactSet estimates since January 2022. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of September 30, 2022.

The Post-Stimulus Economy

Massive stimulus during the pandemic caused many investors to look on in awe as the stock market rose dramatically while the entire U.S was shut down and we were fighting through Covid.

Equity scenarios: Bull, bear and in-between

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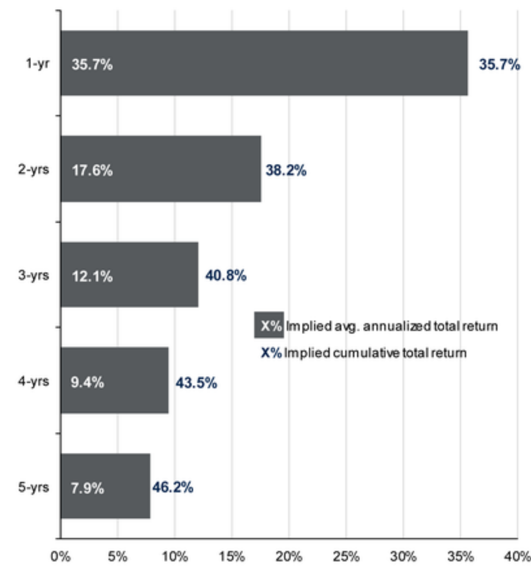
Equities

Return needed to reach January 2022 peak of 4797
S&P 500 level as of September 30, 2022 is 3,586



Bull and bear markets

Bull markets			Bear markets		
Bull begin date	Bull return	Duration (months)	Market peak	Bear return*	Duration (months)*
Jul 1926	152%	37	Sep 1929	-86%	32
Mar 1935	129%	23	Mar 1937	-60%	61
Apr 1942	158%	49	May 1946	-30%	36
Jun 1949	267%	85	Aug 1956	-22%	14
Oct 1960	39%	13	Dec 1961	-28%	6
Oct 1962	76%	39	Feb 1966	-22%	7
Oct 1966	48%	25	Nov 1968	-36%	17
May 1970	74%	31	Jan 1973	-48%	20
Mar 1978	62%	32	Nov 1980	-27%	20
Aug 1982	229%	60	Aug 1987	-34%	3
Oct 1990	417%	113	Mar 2000	-49%	30
Oct 2002	101%	60	Oct 2007	-57%	17
Mar 2009	401%	131	Feb 2020	-34%	1
Mar 2020	114%	21	Jan. 2022**	-25%	8
Averages	**162%**	**51**	**-**	**-41%**	**20**

Source: FactSet, NBER, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management. (Left) The current peak of 4797 was observed on January 3, 2022. (Right) *A bear market is defined as a 20% or more decline from the previous market high. The related market return is the peak to trough return over the cycle. Bear and bull returns are price returns. **The bear market beginning in January 2022 is currently ongoing. The "bear return" for this period is from the January 2022 market peak through the current trough. Averages for the bear market return and duration do not include figures from the current cycle.
Guide to the Markets – U.S. Data are as of September 30, 2022.

The market peaked at 4797 on January 3rd, 2022 with a forward P/E of 21.4. This is a rise of over 600% in less than 13 years induced by very low interest rates and a unprecedented amount of stimulus provided by the Fed.

According to the Wall Street Journal on October 25, 2022 the Standard and Poors Index is down 20.3% year to date and the Nasdaq down 30.0%.

The U.S Treasury Long is down 32.867% over the last 52 weeks.

There has been no place to hide and the normal 60/40 mix of stocks and bonds has been dismal for investors.

The chart above shows the average return needed to reach the peak valuation as well as average duration and return of historical bull and bear markets.

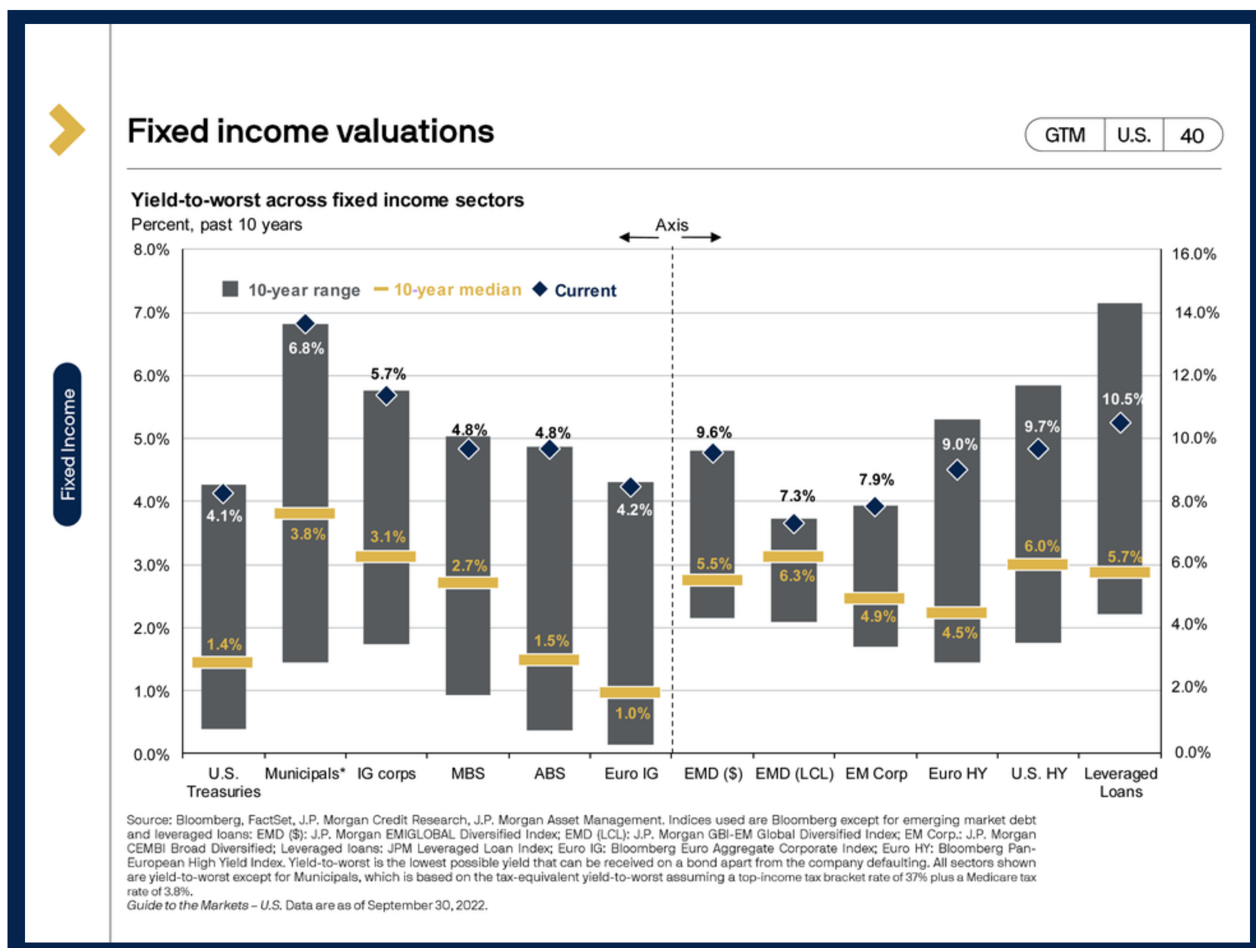
Recommendations

The current bear market is about halfway in duration for the average bear market as we are approximately 9 months into this and average is 20 months.

The conclusion from this data is we have further to go in this bear market and the likelihood of a recession globally adds risk to the downside for stocks. The allocation an investor has to stocks is going to be the key driver of risk over the next 2 years and we recommend conservative investors reduce the exposure to stocks and increase the fixed income weighting.

The current fixed income valuations are very attractive when looking at the past 10 years as depicted in the chart below.

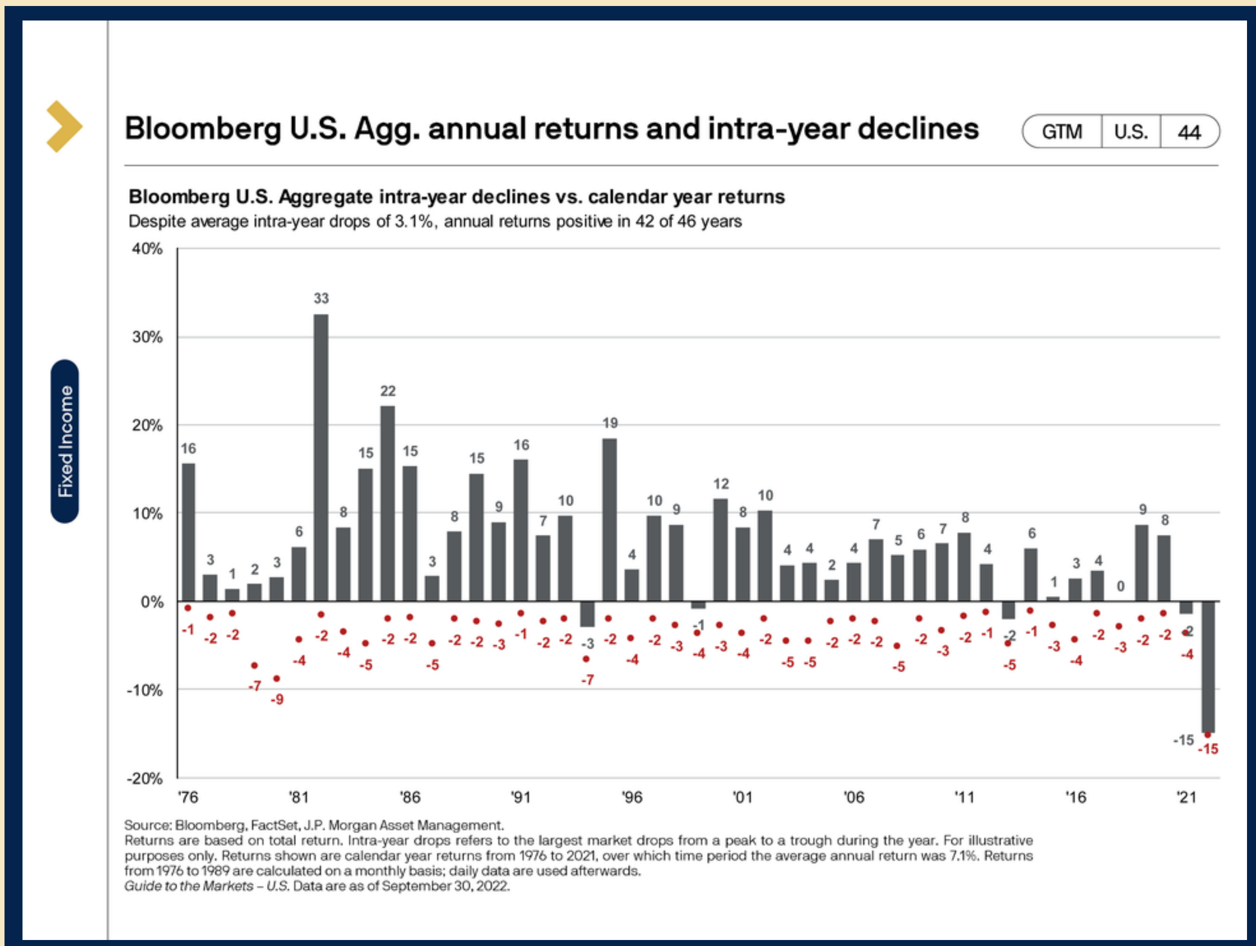
The 10 year median yield is substantially below the current yield and some are saying this is the best buying opportunity for fixed income going back 100 years!

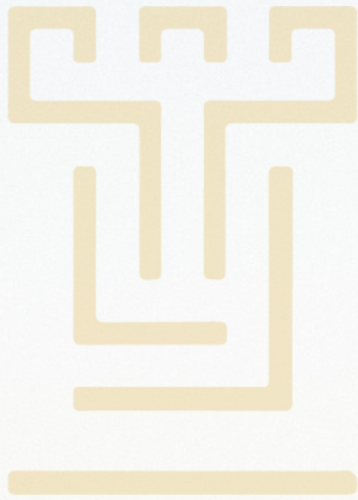


Recommendations

(continued)

US Treasuries showing a 4.1% yield and Municipals at 6.8% represent spreads that have not been available to investors for a very long time and give conservative and aggressive investors something to really think about as they de-risk from the stock market going into a possible recession. The sell off in bonds has been the worst by a factor of 3X going back to the mid -1990s.





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