Stuck in the Middle with You

Song by Stealers Wheel
Well, I don't know why I came here tonight
I've got the feeling that something am not right
I'm so scared in case I fall off my chair
And I'm wondering how I'll get down the stairs
Clowns to the left of me
Jokers to the right
Here I am stuck in the middle with you
Yes, I'm stuck in the middle with you
And I'm wondering what it is I should do
It's so hard to keep this smile from my face
Losing control, yeah, I'm all over the place
Source: Musixmatch

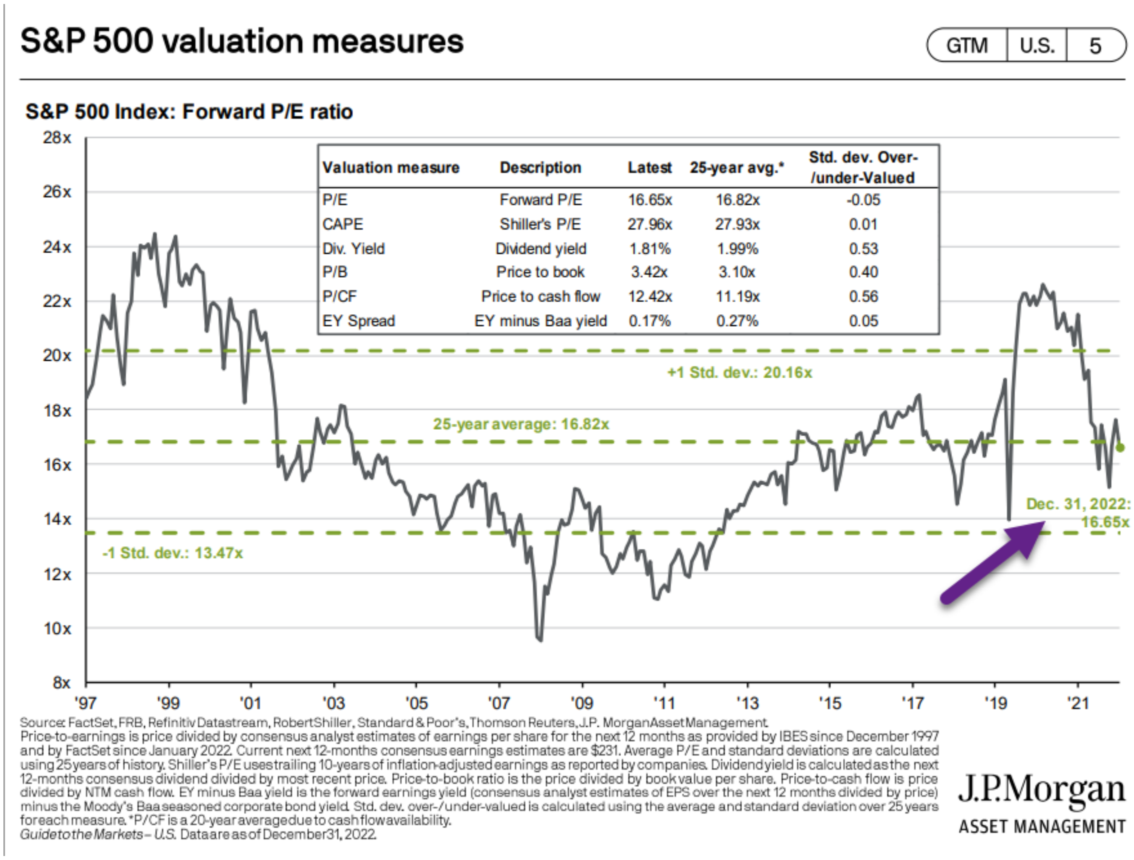
Introduction

Investors need to be careful about all the historical comparisons to 2022 because the markets are experiencing several unique events such as the global pandemic, the first global yield curve inversion ever, the Fed raising interest rates in a slowing economy, S&P stock concentration peak, a conventional war on European land, and the fastest pace of rate raises in modern times.

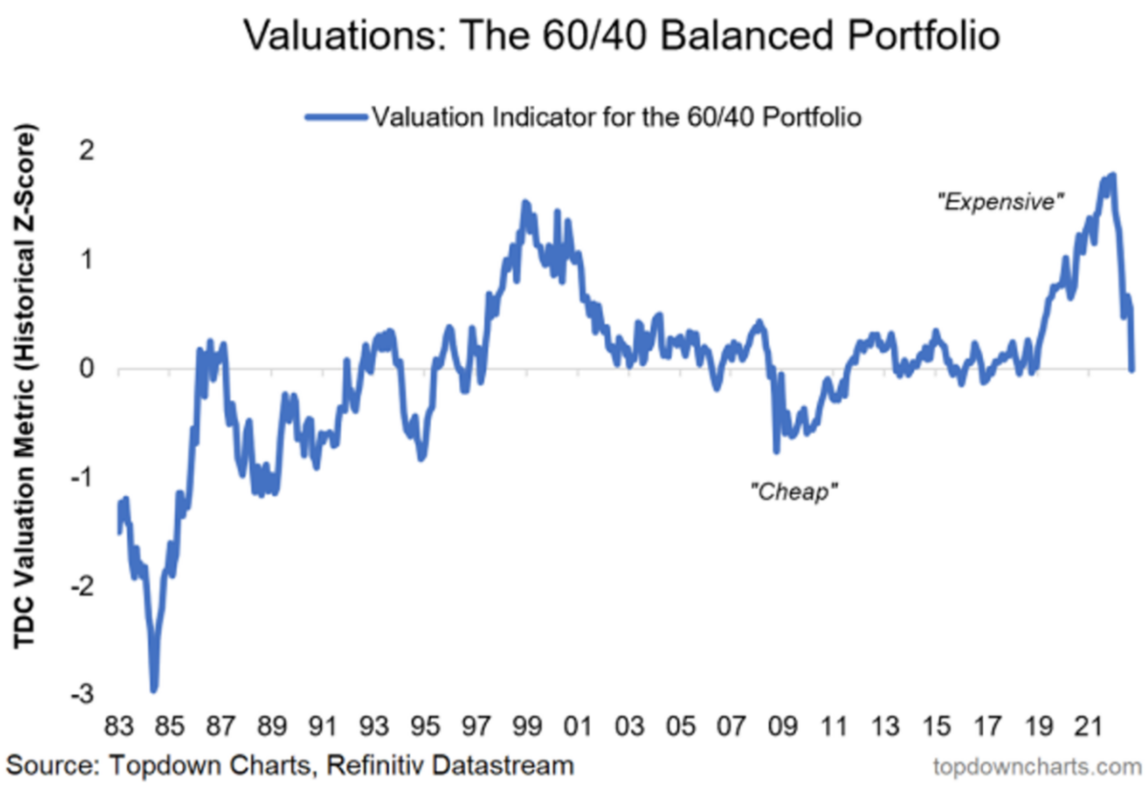
Those expeditious rate raises by the Fed accomplished the dual mission of popping bubbles and reducing inflation. This has left the stock market "Stuck in the Middle with You." The following chart from JP Morgan shows the S&P forward P/E ratio sitting right in the center of the 25-year average. If you remove FAANG stocks the P/E ratio falls closer to the bottom of the band 14x earnings.

Below the S&P chart is the classic moderate portfolio of 60% stocks and 40% bonds also sitting right in the middle at a 25-year median valuation.

Q4 2022 Letter – Stuck in the Middle with You



https://am.jpmorgan.com/content/dam/jpm-am-aem/global/en/insights/market-insights/guide-to-the-markets/mi-guide-to-the-markets-us.pdf›



https://chatstorm.substack.com/p/weekly-s-and-p500-chartstorm-9-october

Part I - Inflation Drop

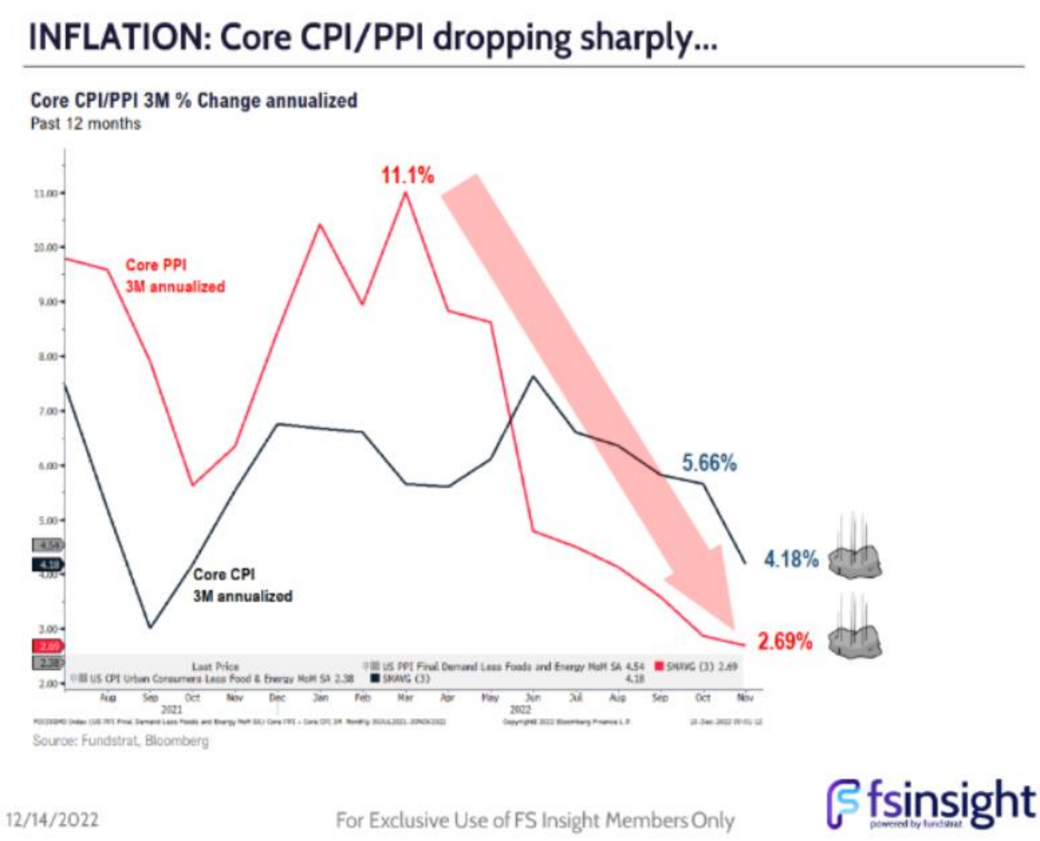
As a follow-up to my Q3 letter, inflation is not just dropping, it's down 50% from highs according to CPI/PPI numbers. Rents are now falling which has a lagged effect on overall inflation data so this number should move even lower. This leads to our skepticism regarding the historical comparison to the runaway inflation of the 1970s. Paul Volcker’s name was mentioned more than Lebron James in last 6 months - that may work for the shock factor but the economic comparisons of the 1970s to 2022 don’t hold up.

I will leave it to the academics to write white papers on this topic but just the drop in energy as a percentage of GDP and a far less labor-intensive economy destruct the 70’s style inflation thesis.

Reuters *Oil intensity -- the volume of oil consumed per unit of gross domestic product -- dropped 56% between 1973 and 2019, according to Columbia University's Center for Global Energy Policy. <u>Oil averaged more than $100 a barrel between 2010 and 2015 and the global economy and markets held up fine</u>, note JPMorgan strategists Marko Kolanovic and Bram Kaplan.*

<u>So, if in 1973 it took a little under one barrel of oil to produce $1,000 of economic output, that figure has fallen to less than half a barrel.</u>

https://www.reuters.com/business/energy/why-todays-economy-can-handle-oil-100-barrel-or-higher-2021-10-21/



From Josh Brown https://theirrelevantinvestor.com/2022/12/20/the-compound-and-friends-5/

Gasoline prices at the pump are reverting to the 5-year mean. This oil intensity data is not even counting the U.S. shale boom that could leave our nation a net oil exporter in 2023. To put things in perspective, the price of natural gas in Europe is down -70% from highs at the start of the Ukraine invasion.

US 2022 avg. gas price chart per gallon vs. avg. since 2018

Source: Original data set: Gasprices.aaa.com, Analysis/charts: Finder.com • Embed
finder

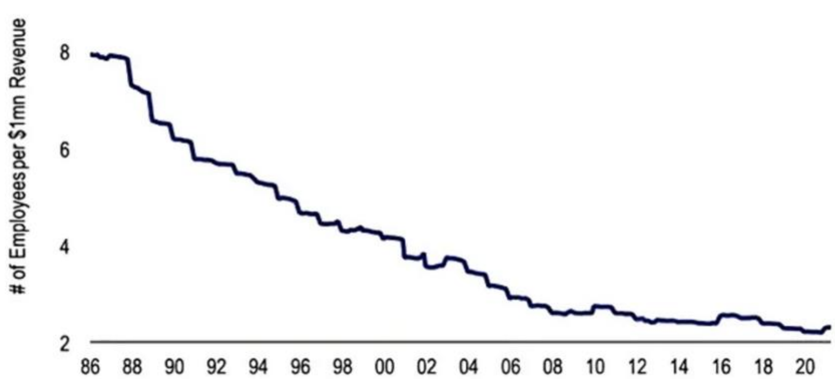
While the current national average of $3.25 is a far cry from the 2022 peak of $4.99 a gallon, it's higher than the average cost of gas since 2018: $2.90 a gallon.
This means what you'll pay at the pump in 2022 is about $0.36 more expensive than the national five-year average.

https://www.finder.com/gas-prices

Labor Intensity of S&P 500 Down 70% Since 1980

This is a stunning statistic but due to technology, labor intensity of the S&P 500 has collapsed. "In 1986, it took 8 employees to generate US$1 million in revenue. Today, the S&P 500 is 70% less labor intensive than it was in the 80s" This is not counting the robot revolution coming to the world economy.

Exhibit 10: S&P 500 is 70% less labor intensive than it was in the 80s
S&P 500 total # of employees to total revenues ratio



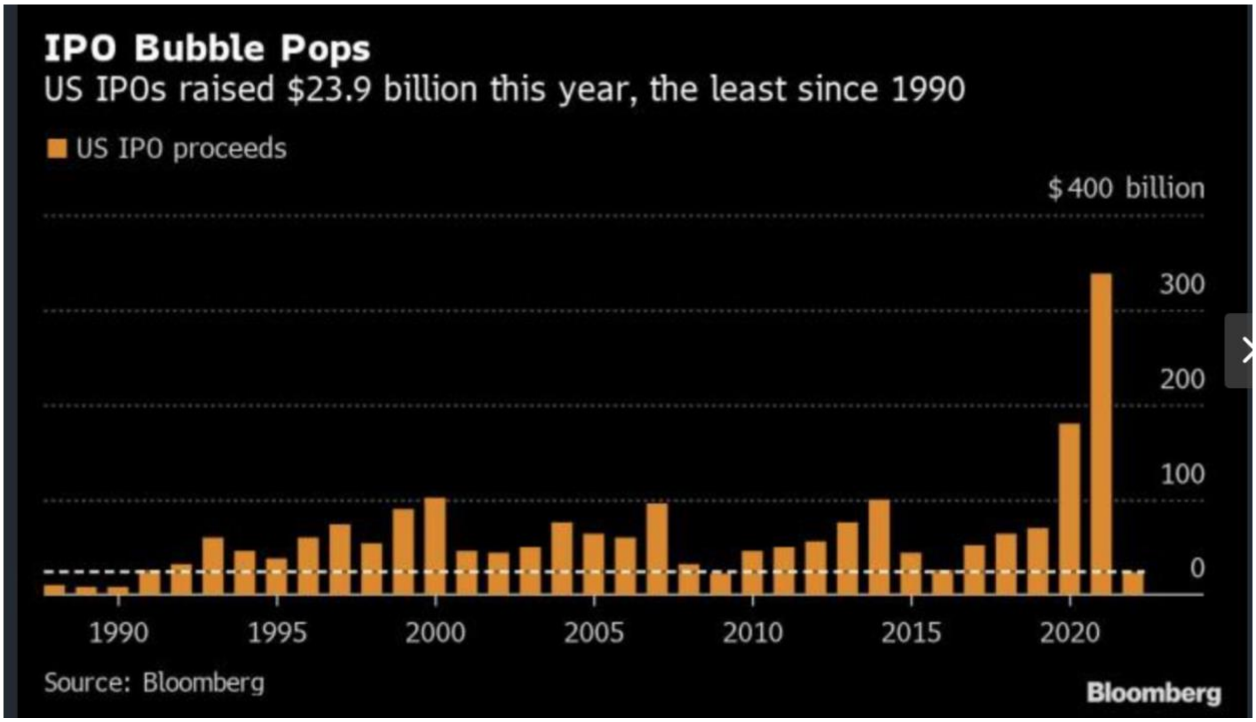
Source: BofA Global Research

CallumThomas Chart Storm Source: @ISABELNET_SA (ChartStorm 20 June 2021)https://chartstorm.substack.com/p/weekly-s-and-p500-chartstorm-24-december

Part II - The Fed Popped the Bubbles

The last years of the bull market took on the title of “the everything bubble. Well the Fed burst most of those bets - IPO, SPAC, Disruptor stocks, Crypto, and FAANG+.

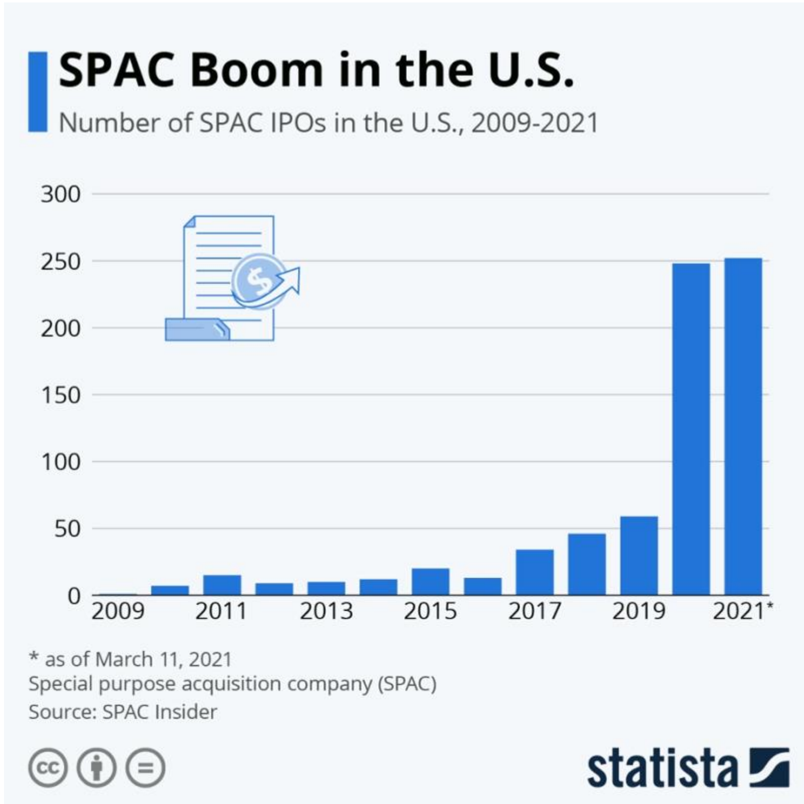
IPO Market Boom to Bust - IPO Market Raises Least Amount of Money Since 1990-Initial Public Offerings in Stock Market



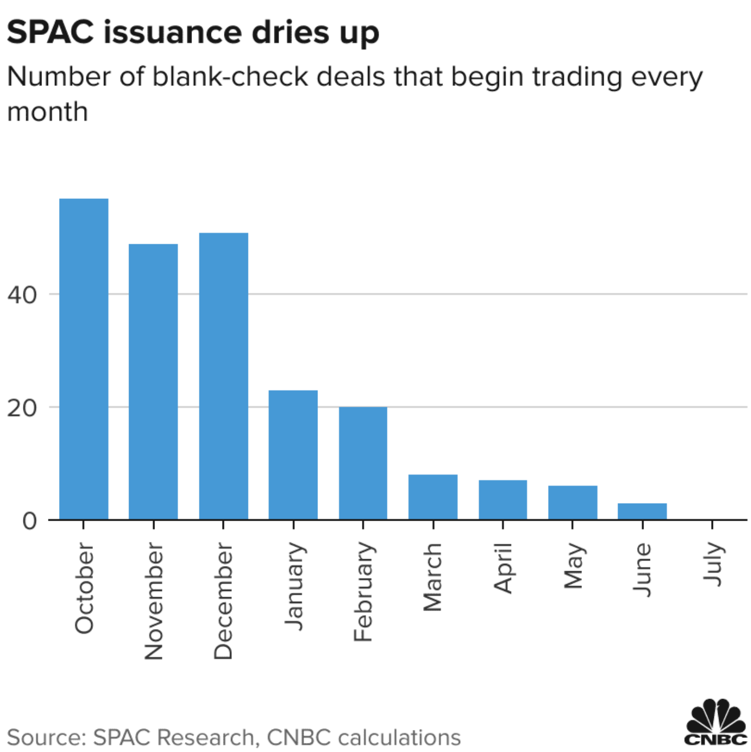
https://finance.yahoo.com/news/ipo-slump-bankers-wary-2023-100000599.html

SPAC Boom - SPACS are IPOs with less regulation and higher fees, so safe to say that if the IPO market shuts down, the SPAC market is toast. Burnt toast in this case with my guess being we will not hear of SPACS again for at least another decade. By July, there were zero new SPACS issued.

<see chart on next page>



SPAC Bust - Zero New SPAC Deals by Summer 2022



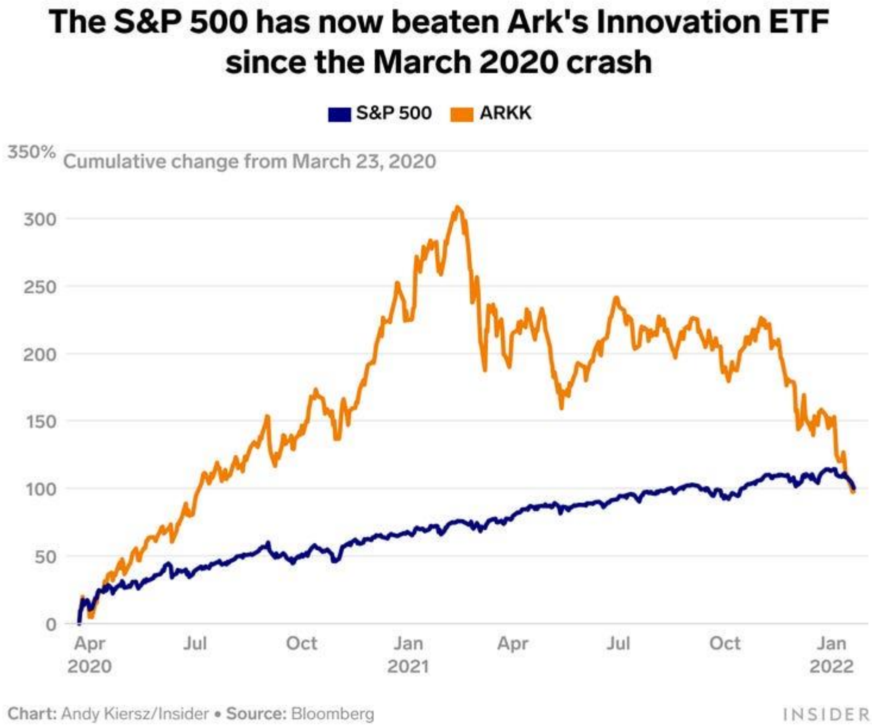
https://www.cnbc.com/2022/08/03/spac-market-hits-a-wall-as-issuance-dries-up-and-valuation-bubble-bursts.html

LANSING STREET ADVISORS
FAMILY OFFICE

Q4 2022 Letter – Stuck in the Middle with You

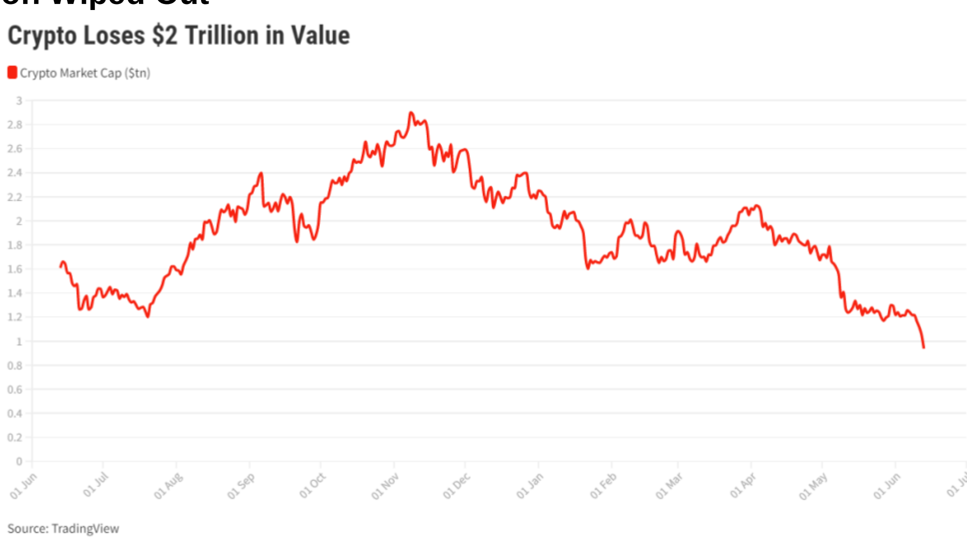
Every bubble has their super stock managers that take on a religious fervor around their stock-picking dexterity. This time around Cathie Wood at ARKK Innovation Fund was hands down the winner. Wood's funds stamped the name disruptor stocks into the American investing language, but her holdings are down 70% from highs giving back 5 years of gains.

Cathie Wood ARKK Innovation Fund Disruptor Stocks-Bust



The bubble star of this bull market was crypto, but as soon as the FED started raising rates, the story imploded - erasing $2 Trillion of its value within 10 months. Currently, Crypto has failed as a currency, a digital gold, and a technology to remove the middleman. For the immediate future, we will be sorting out who goes to jail.

Bitcoin $2 Trillion Wiped Out



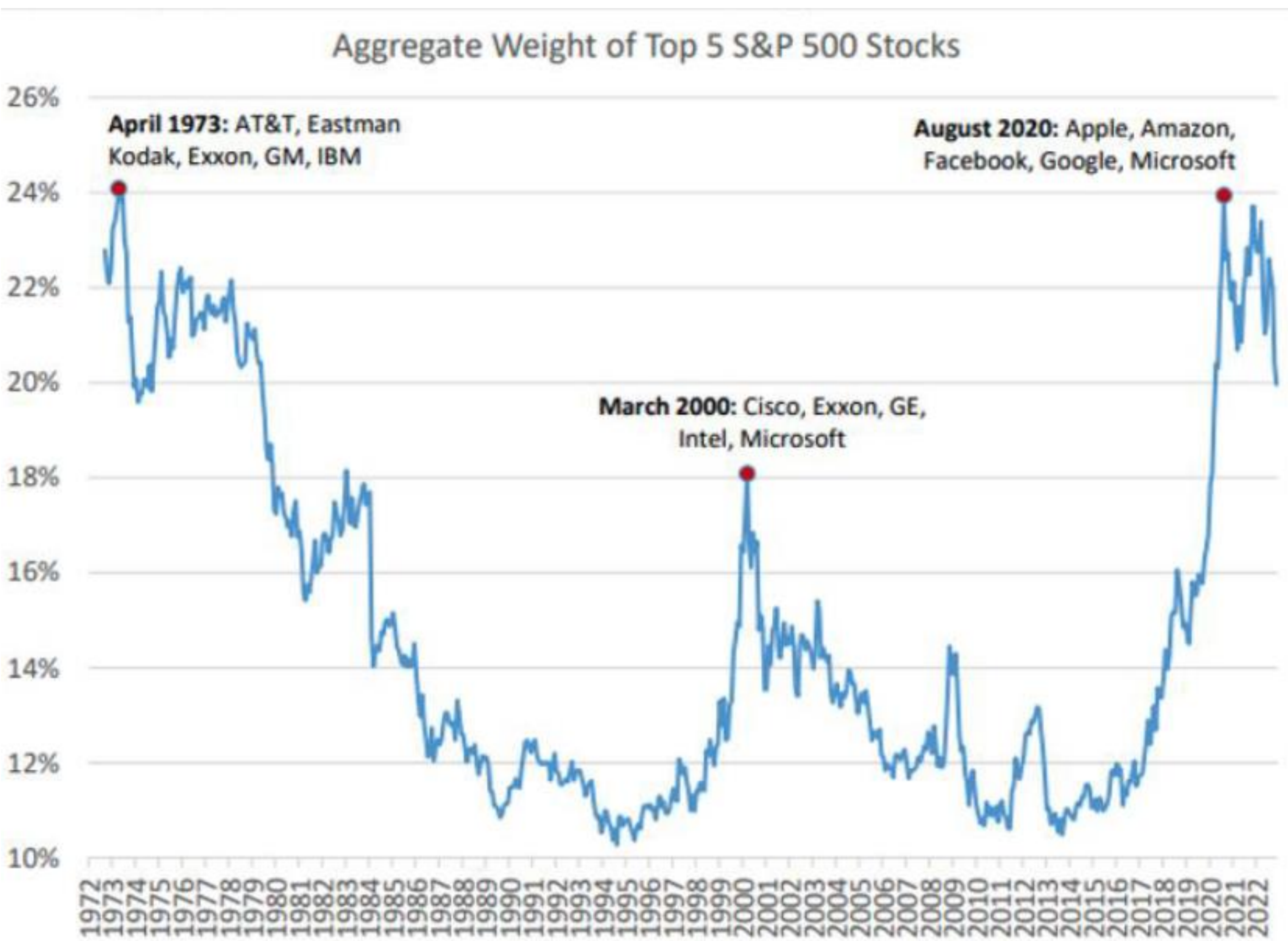
https://www.newsweek.com/cryptocurrencies-lose-trillion-value-since-peak-1715207

The FAANG Plus Stock Phenomenon

This bull market is not the first time there has been a concentration in the S&P market cap. As you can see on the chart, this oversized weighting of 5 stocks has happened two other times in modern market history - both were followed by decades of underperformance. If you think Crypto's $2 trillion wipeout was bad, eight popular tech stocks lost $4.8 trillion of value.

Barron's - *On a combined basis, eight popular tech stocks— [Apple](https://www.barrons.com/) (ticker: AAPL), [Microsoft](https://www.barrons.com/) (MSFT), [Alphabet](https://www.barrons.com/) (GOOGL), [Tesla](https://www.barrons.com/) (TSLA), [Nvidia](https://www.barrons.com/) (NVDA), [Meta Platforms](https://www.barrons.com/) (META), [Amazon.com](https://www.barrons.com/) (AMZN), and [Netflix](https://www.barrons.com/) (NFLX)—collectively lost $4.8 trillion in market cap, roughly equal to the annual GDP of Japan—and 40% of the combined valuation of those eight stocks at the start of the year. Apple was the best performer, losing a quarter of its value in 2022. Amazon, whose valuation fell below $1 trillion, declined 49%, shedding more than $825 billion.*
https://www.barrons.com/articles/tech-stocks-ibm-alphabet-amazon-netflix-meta-tesla-51671740005?mod=past_editions

The chart below shows the spike during Covid that sent FAANG+ stocks to a higher valuation than Internet large-cap darlings topping out at the exact level of 1973 leaders. This is one to watch because retail investors are still buying these popular stocks - but remember my last letter that CSCO and INTC never made it back to 1999-2000 highs.



Source: FRP, FactSet; as of 11/1/22

Q4 2022 Letter – Stuck in the Middle with You

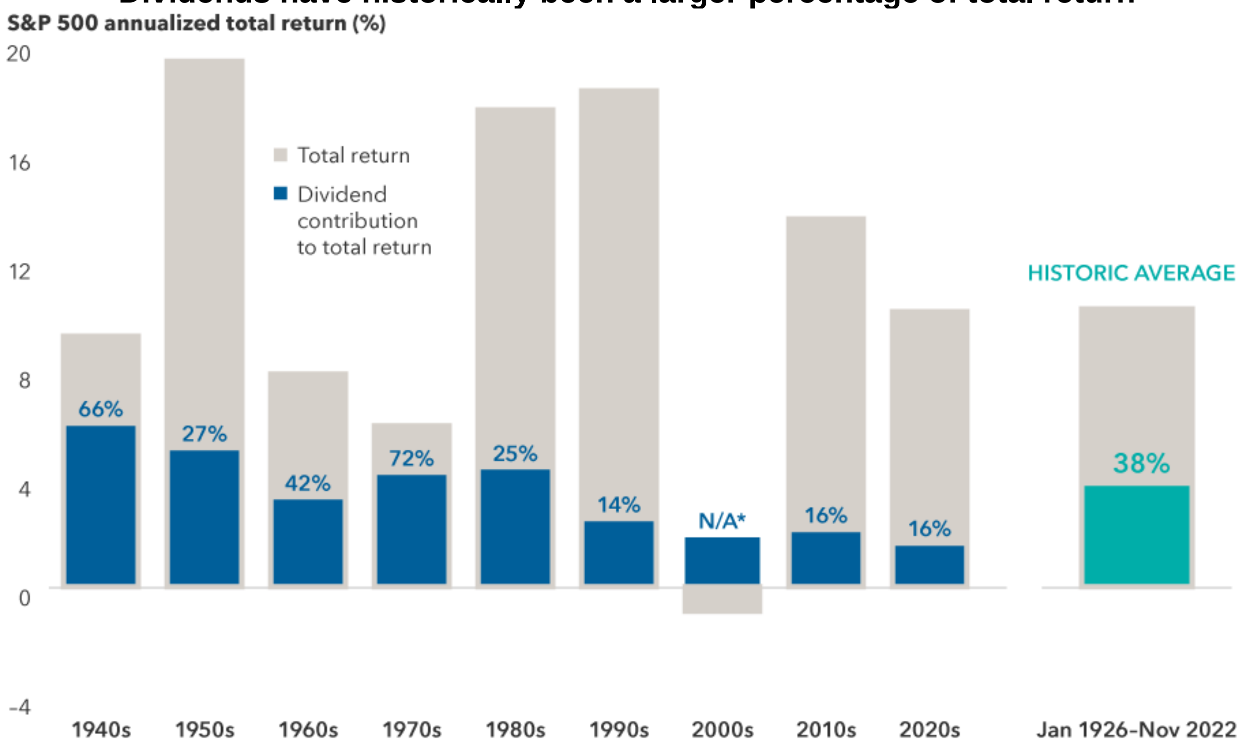
Part III - What Comes Next?

First, huge capital gains in stocks due to low-interest rates and growing revenue while losing money on the bottom line, is over. Keep in mind that tech stocks did not bottom until 3 years after the internet bubble popped. This leaves us with options for the safety of principal and a reasonable rate of return.

Reversion to Mean…Dividends Historic Average vs. 2010-2020

Capital Group-*While dividends accounted for a slim 16% of total return for the S&P 500 in the 2010s, historically they have contributed an average 38%. In the inflationary 1970s they climbed to more than 70%. "When you expect growth in the single digits, dividends can give you a head start," Wagner adds. "They may also offer a measure of downside protection when volatility rises, but it is essential to understand the sustainability of those dividends."*

Dividends have historically been a larger percentage of total return

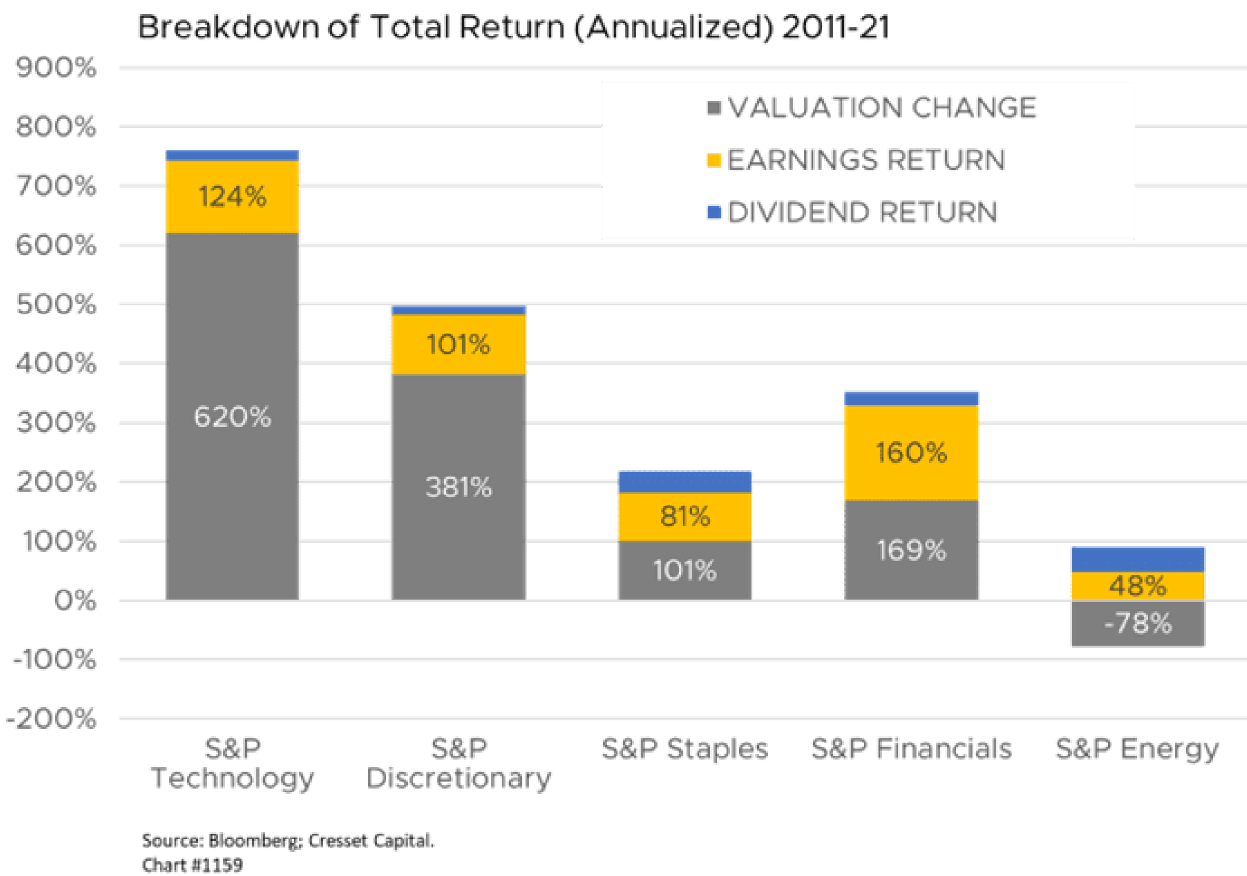


Source: S&P Dow Jones Indices LLC. 2020s data is from 1/1/26 through 11/30/22. *Total return for the S&P 500 Index was negative for the 2000s. Dividends provided a 1.8% annualized return over the decade. Past results are not predictive of results in future periods

https://www.capitalgroup.com/advisor/insights/articles/2023-us-market-outlook.html?sfid=1988901890&cid=80895830&et_cid=80895830&cgsrc=SFMC&alias=A-btn-LP-2-CISynCTA

Q4 2022 Letter – Stuck in the Middle with You

From Jack Ablin, Cresset Capital - *Between 2011 and 2021, the technology sector delivered a cumulative 760 percent return to investors, or about 24 percent annualized. Of that, 620 percentage points was attributable to valuation expansion, leaving 140 percent, or about 9.1 percent annualized, attributable to earnings growth and dividend yield. As we have pointed out repeatedly in our research, it's unlikely investors will have the luxury of valuation expansion over the next 10 years.*



https://cressetcapital.com/post/q3-earnings-will-show-damage-from-rates-inflation-dollar/

Second, bonds will act like bonds again giving us a cash buffer, reasonable coupon, and lowering the overall volatility of investors' capital markets portfolios. In 2022, this did not happen as we had zero coupon return and bonds followed stocks down double digits.

The good news for bond investors is that investing prior to the final rate cut, which we assume comes in the first half of 2023, has been a high-probability bet.

<see chart on next page>

Investing prior to final rate hike has provided strong returns

BLOOMBERG U.S. AGGREGATE INDEX
(Investment six months prior to final rate hike)

Last hike	First 12 months return (dollar cost average)	Annualized total return over five years
6/2006	**4.5%**	**5.9%**
5/2000	**5.3%**	**7.2%**
2/1995	**7.7%**	**6.8%**
2/1989	**10.2%**	**10.6%**
9/1987	**7.0%**	**9.6%**
5/1981	**3.3%**	**15.6%**

Municipal Bond Yields Reached Highest Level in 15 Years.

Sources: Bloomberg Index Services Ltd. As of 11/30/22. Yields shown are yield to worst. Yield to worst is the lowest yield that can be realized by either calling or putting on one of the available call/put dates or holding a bond to maturity.

Muni-Bonds following a Down Year

In years when Munis were down, they averaged a loss of about 4.4%. However, in the five-year period that followed, the sector saw an average annualized return of 9.3%.

History suggests higher Muni returns ahead

Municipal bond index average returns since 1980

Sources: Capital Group, Bloomberg. Returns as of June 15, 2022. Past results are not predictive of results in future

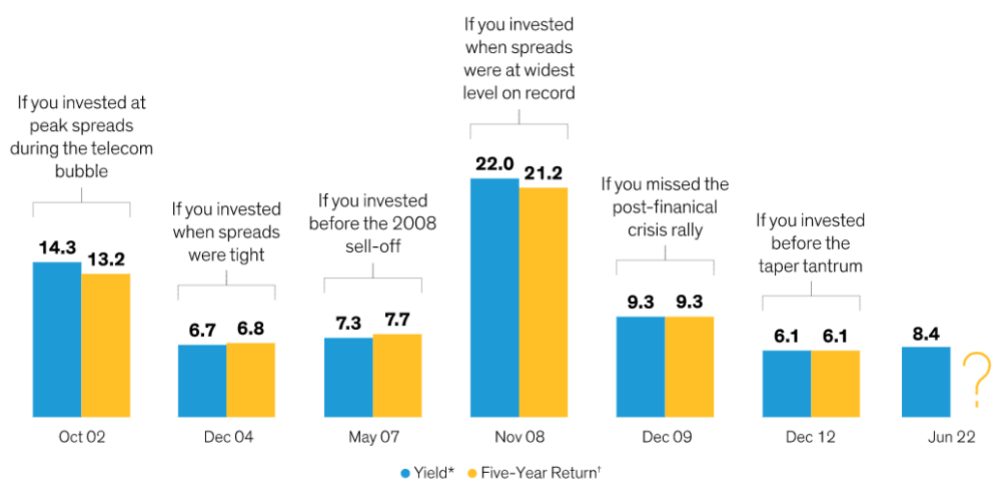
https://www.capitalgroup.com/advisor/pdf/shareholder/MFCPBR-090-1031015.pdf?sfid=1988901890&cid=80904210&et_cid=80904210&cgsrc=SFMC&alias=A-btn-LP-2-CISynCTA

High-yield bond yields are over 8%, leaving them an attractive option versus historical performance. As you can see on the following chart, yields have a high correlation to 5-year returns. As a side note, if we get another down draft in stock market 2023, we may see double-digit yields in junk bonds which would be a historical, maybe generational, opportunity to buy this asset class. Speak to a bond market professional before investing in this space.

Five-Year Returns Have Closely Tracked Yield at Start of Period

Starting Yield to Worst and Five-Year Forward Annualized Return: Bloomberg US Corporate High Yield Index

Percent



Historical and current analysis and forecasts do not guarantee future results. An investor cannot invest directly in an index, and its performance does not reflect any fees and expenses or represent the performance of any AB fund.

As of June 27, 2022

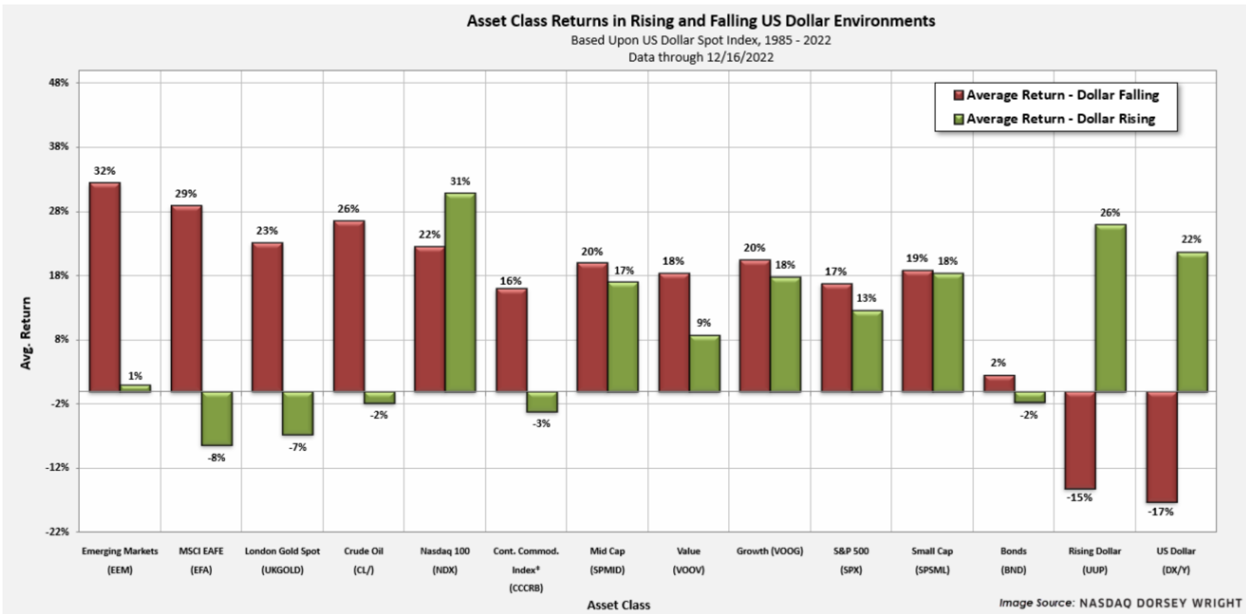
*Yield to worst as of date shown

†Annualized five-year return beginning on date shown

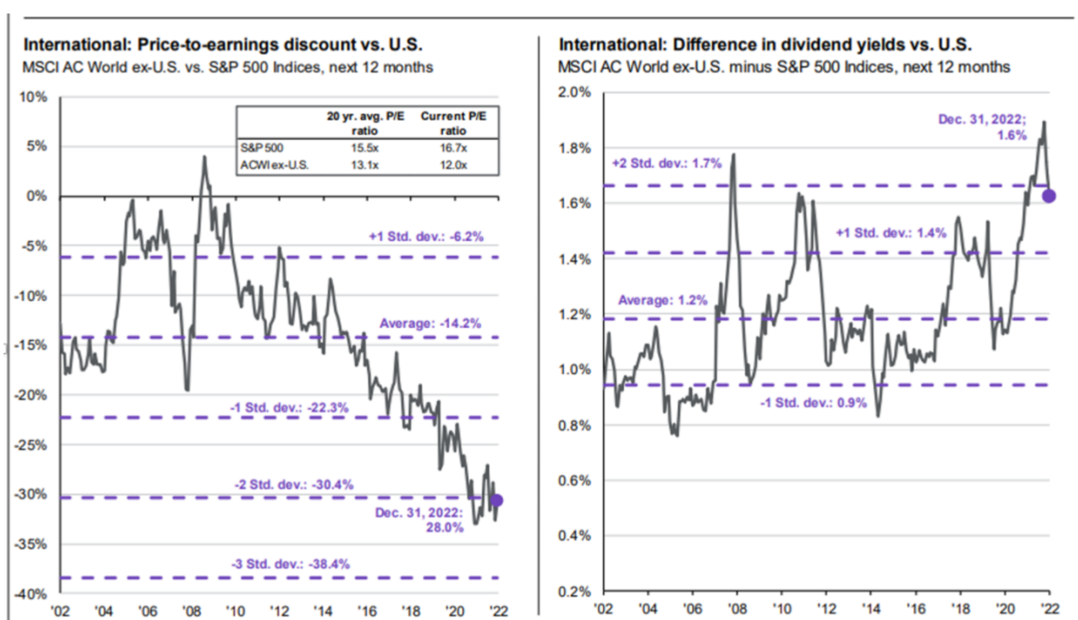
Source: Bloomberg and AB

https://www.alliancebernstein.com/corporate/en/insights/investment-insights/three-reasons-its-time-to-add-high-yield-bonds.html

Third, the U.S. dollar is showing weakness for the first time in 8 years. As presented in the chart below, a weak dollar environment changes the dynamics of asset class returns.



For 14 years the S&P 500 performance has clobbered international stocks, leaving valuations skewed to historical extremes. Below, the JP Morgan chart on the left shows price-to-earnings discounts of international stocks at 20-year record lows - a two-standard deviation event. The chart on right presents another two standard deviation outcomes with the difference in dividend yields. A weakening dollar is a positive for international stocks as their currencies are also cheap vs. U.S. currency. Speak to an investment professional before exploring international equities.



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of December 31, 2022.

https://am.jpmorgan.com/content/dam/jpm-am-aem/global/en/insights/market-insights/guide-to-the-markets/mi-guide-to-the-markets-us.pdf

Last, the continuing theme of Lansing Street Advisors in the last 24 months of quarterly letters is the reversion to the mean. Be prepared for lower but acceptable returns versus the last 10 years. Also, be primed for a change in leadership from the public markets. See below, the constant theme from my letters - Vanguard projected returns based on math for the next 10 years. American growth stock darlings of the last decade have the lowest projected returns on the board - this could change with a bigger sell-off or lower interest rates, but the market Gods are everchanging.

Vanguard-10 Year Forward Asset Returns

Our 10-year, annualized, nominal return projections, as of June 30, 2022, are shown below. Please note that the figures are based on a 1.0-point range around the rounded 50th percentile of the distribution of return outcomes for equities and a 0.5-point range around the rounded 50th percentile for fixed income

Equities	Return projection	Median volatility
U.S. equities	4.1%–6.1%	17.2%
U.S. value	4.4%–6.4%	19.5%
U.S. growth	1.6%–3.6%	18.2%
U.S. large-cap	4.0%–6.0%	16.8%
U.S. small-cap	4.3%–6.3%	22.5%
U.S. real estate investment trusts	3.9%–5.9%	20.2%
Global equities ex-U.S. (unhedged)	6.6%–8.6%	18.6%
Global ex-U.S. developed markets equities (unhedged)	6.5%–8.5%	16.7%
Emerging markets equities (unhedged)	5.9%–7.9%	26.5%

Fixed income	Return projection	Median volatility
U.S. aggregate bonds	3.1%–4.1%	5.1%
U.S. Treasury bonds	2.7%–3.7%	5.4%
U.S. credit bonds	3.7%–4.7%	5.0%
U.S. high-yield corporate bonds	5.7%–6.7%	10.2%
U.S. Treasury Inflation- Protected Securities	2.3%–3.3%	4.9%
U.S. cash	2.6%–3.6%	1.3%
Global bonds ex-U.S. (hedged)	3.0%–4.0%	4.1%
Emerging markets sovereign bonds	5.4%–6.4%	11.9%
U.S. inflation	2.0%–3.0%	2.4%

https://advisors.vanguard.com/insights/article/marketperspectivesseptember2022

Conclusion

In my 25 years plus investment career, the markets express a few things: excellent long-term returns through the power of compounding, a plethora of short-term volatility, a test in psychology not IQ through controlling your emotions, reversion to the mean in valuations, and a path to profitability by going against the crowd.

Outperformance is far from easy. Warren Buffett reads 500 pages a day preparing to invest, is universally accepted as the greatest investor of all time and his firm still goes through 10-year periods of massive underperformance. However, there are some basics that work.

Some of those staple investing rules will come into play in the next 10 years as new leadership sectors and asset classes outperform the winners of 2012-2022. An investor has two choices: follow the mantra that diversifying is the only free lunch in investing or seek professional investment advice in this changing time. Right now, the masses have stopped buying stocks and shifted their purchases to U.S. ›guaranteed 3-month to 12-month treasuries which promise that you won't lose money next year but not that you will outperform inflation for the next 10 years.