# R Thoughts

Morgan Stanley

The Diamond Peak Group
at
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> "The Essence of Investment Management is the Management of Risks, not the Management of Returns."
>
> Benjamin Graham

Benjamin Graham, widely known as the "father of value investing," is the author of the famous book, The Intelligent Investor (1949). His work has directly influenced more current acolytes such as Sir John Templeton, Peter Lynch, Warren Buffet, and Charlie Munger.[1]

We here at the Diamond Peak Group use this quote as the cornerstone to our investment process and philosophies. We'd say it is in our DNA.

We consider ourselves risk managers first and then return managers. To say it another way, if we manage the risks in our portfolios the returns will take care of themselves. It does, however, take the last six months of increased volatility and negative market performance at the index level to appreciate the concept of the "management of risks."

In our experiences it takes very little skill to achieve decent returns in a generally increasing stock market cycle. Beginning after the Great Financial Crisis which ended in March of 2009 and up until the start of 2022—U.S. Large Company Growth stocks, which predominately comprise the S&P 500 Index—experienced returns significantly above their long-term averages.

Through the end of the year (2021) the S&P 500 Index provided a compounded annual return of about 16% since the end of 2008 compared to its historic annualized average return of around 10.5% since its 1957 inception.[2]

That made it pretty easy to stay fully invested and make money over this time frame.

But, regrettably, stock markets do not always move up in a straight line. And as we discussed in the Winter 2022 edition of *RThoughts*, "we have always been advocates of the term 'regression to the mean' which states that all returns—over time—tend to revert to their long-term averages."[3]

It is often quoted that "stock prices tend to take the escalator on the way up but take the elevator on the way down." We like to use the analogy of a roller coaster, which is slow and deliberate as it begins its way up to the top and then eventually declines at a fast and furious pace. At the bottom, when the ride ends, participants disembark—much like the way many investors do at the bottom of the market cycle. We have certainly witnessed the decline phase of the market cycle during the first six months of 2022.

It is unfortunate that in order to truly prove and appreciate the value of the "management of risks" over the "management of returns" strategies, it takes difficult markets like we have experienced so far this year or in the spring—Covid period—decline of 2020.

Our asset management goal has always been to provide returns consistent with S&P 500 over an entire market cycle. An entire market cycle is analogous to the roller coaster—from the starting point, through the ride up and then the inevitable journey back down. (See Chart 2 embedded in The Stock Markets section.)

More importantly, however, is our goal to provide "risk-adjusted returns" which, over the entire market cycle, approximate the overall market return of an index with significantly less risk or volatility. To do this, we need

to effectively manage risks during difficult phases of the markets as well as managing returns when appropriate. Currently—as it has been for almost a year now—our portfolio management emphasis has been on the strict management of risks.

## The Bond Markets

It proved to be another difficult quarter in the bond market as interest rates again increased which brought additional losses to bond investors. As interest rates increase bond values generally decline.

As the Federal Reserve aggressively tightened monetary policy this year to quash the worst inflation in four decades, financial assets turned in one of their worst performances in more than 50 years. Bonds, measured by the Bloomberg U.S. Aggregate Index, were down more than 14%, the largest loss since 1970.[4]

U.S. Corporate bonds declined 6.8% in the second quarter bringing year-to-date declines to 13.8%. U.S. High Yield bonds declined 9.0% for the quarter and down 14.6% YTD. Longer dated U.S. Treasuries didn't fare much better with the 10-Year U.S. Treasury declining 5.2% for the quarter, 11.5% for the year so far and the 20-Year Treasury down 13.7% for the quarter and an astounding 23.2% year-to-date.[5]

Unlike other periods of stock market turmoil, longer dated fixed-income assets provided little or no ballast in the preservation of assets or in managing volatility.

What has happened so far this year in the bond markets with rising interest rates and the rising cost of money is truly extraordinary. The yield on the 10-Year Treasury note nearly doubled YTD after the first six months of 2022, rising from 1.496% as of the close of trading on 12/31/2021 to 2.973% as of the close of trading on Thursday 6/30/2022.[6]

Over the last 60 years (1962-2021), the yield on the 10-year note has never doubled over the course of an entire calendar year.[6] The 10-Year Treasury achieved a temporary cycle high in mid-June trading with a yield of 3.40% on Wednesday, June 15th.[7]

If rates again approach 3.0% on the bellwether 10-Year Treasury bond, we might begin to see some value and opportunity in longer dated fixed-income assets. It might be a starting point to deploy some small percentage of cash assets presently earning negative real returns—below the inflation rate—as we feel the risk/return relationships would have significantly improved at that point. Last month, when 10-Year Treasury yields were above 3.25%, we made small commitments to this space investing in mid- and longer-dated Treasuries in our Tactical Growth, Dividend and Balanced models.

This is, however, very much a tactical trade, one in which we are looking for a specific potential result and in absence of that, we would not anticipate being long-term investors in such Treasuries.

We continue to believe the long-term trend in interest rates is still higher with short-term lower adjustments along the way. In our view, inflation will continue to be an issue, both with investors, consumers, and businesses. While we see it moderating somewhat over the next year inflation will remain significantly higher than comfortable and above what we have become accustomed to the past few decades.

The term stagflation may begin to enter the lexicon of popular investment terms again. Stagflation, last witnessed in economies worldwide in the 1970's, is the coincidence of weak economic growth and elevated inflation. We see recession possibilities increasing but, at this point, by no means certain.

With growth slowing—but still positive—and with inflation higher for a longer period, the more likely result is stagflation. In this case, the Federal Reserve will not be able to curtail its tightening program. At the same time, the labor market is strong, household cash balances are solid and capital spending is resilient. We envision a stagflationary stall being as probable as an outright recession.

## The Stock Markets

In the fall 2021 edition of *RThoughts*—written nine months ago in mid-October—we opined, "Into this

increasing interest rate environment, we believe the U.S. markets could correct 10–20% at the index level. And we believe this potential decline would present opportunities to buy. Thus, our cautious optimism."

Stock markets globally and here in the U.S. proved this true during the second quarter of 2022. The Dow Jones Industrial Average declined 10.8% in the quarter, bringing its Year-to-Date decline to 14.4%. And that's the good news . . . The S&P 500 Index gave back -16.1% in the quarter, and -20.0% for the year so far, the worst start to a year since 1962.

The NASDAQ market—whose excessive valuation and concentration issues we highlighted in our last edition of *RThoughts*—declined 22.3% over the course of the second quarter and lost almost one-third of its value or 29.2% so far in 2022.[8]

When we take into consideration the effects of inflation the return numbers become more hideous.

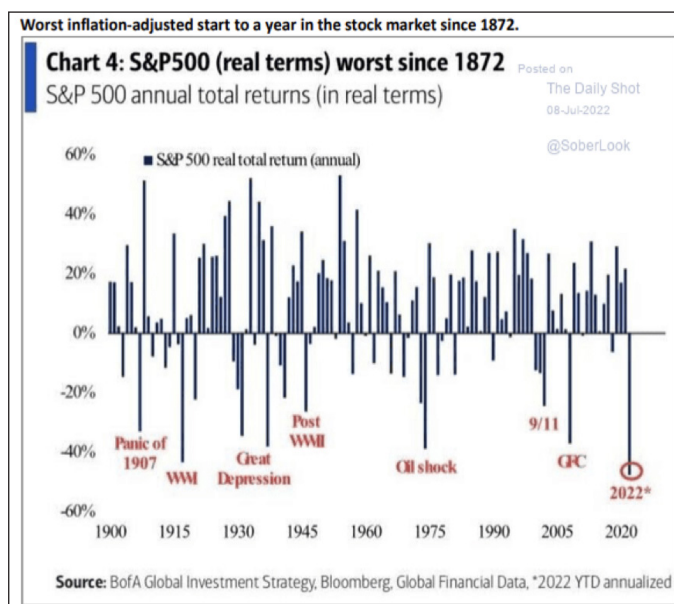


Chart 1[i]

As depicted in Chart 1, the S&P 500 suffered its worst annualized start of the year—in real terms (after inflation is deducted)—since 1872.[9]

Lisa Shalett, the Chief Investment Officer for Morgan Stanley, recently described the equity markets as, "a rollercoaster to nowhere" and believes "the bear market bottom may still be 5% to 10% away."[10] We would not disagree.

We currently see the following four headwinds as potential obstacles to higher U.S. equity prices in the near-term.

First, we expect corporate revenues and profits to slow somewhat with pay-back from the excess government fiscal policies and cash sent out to individuals and companies which lead to pent-up demand throughout the Covid pandemic. We are now observing inventories starting to build leading to discounts at the retail level.

Next, no surprise here, but corporation input costs—the cost of producing products—have risen dramatically potentially cutting into profit margins. From labor, energy, commodities, etc. inflation is taking its toll on companies' costs of production.

Third, as inflation continues to pick-up (July CPI at 9.1%—the highest since 1981) the concept of Demand Destruction starts to take place. For example, as gasoline prices increase people make the choice to drive less. More costly restaurant prices lead to folks eating out less often. As housing mortgage rates increase leading to lower housing affordability and potentially lower demand for home construction and improvement products.

Lastly, the U.S. Dollar has recently achieved new highs against a basket of currencies. On July 12, the U.S. Dollar hit parity against the EURO, the first time that has happened in 20 years.[11] Although it might be a wonderful time to plan a European vacation, it is a difficult time for U.S. multinational companies which derive revenues from international markets as they convert from the local currency back into U.S. Dollars.

We mentioned earlier we see the risk of a recession increasing—we might put the odds at greater than 50% in the next six months or so. With inflation now running as hot as it is, the Federal Reserve will need to take steps to destroy demand—the excess demand which was created though unnecessary government policies in late 2020 and 2021—to control the inflation genie which is now most

definitely out of the bottle. Once out of the bottle, the genie is difficult to put back in.

In our opinion, to extinguish demand the Federal Reserve will need to finish the job regarding inflation. To do that the economy needs to slow down, perhaps to the point of inducing negative growth, increasing the possibility of a recession. This portends continued difficulty for equity markets—perhaps though the end of 2022.

As we mentioned earlier, this slowing growth scenario might be well suited for longer-dated Treasury bonds because as growth slows interest rates may temporarily decline leading to gains in the market values of the bonds. Again, this is a tactical short-term trade and not appropriate for a buy and hold investor.

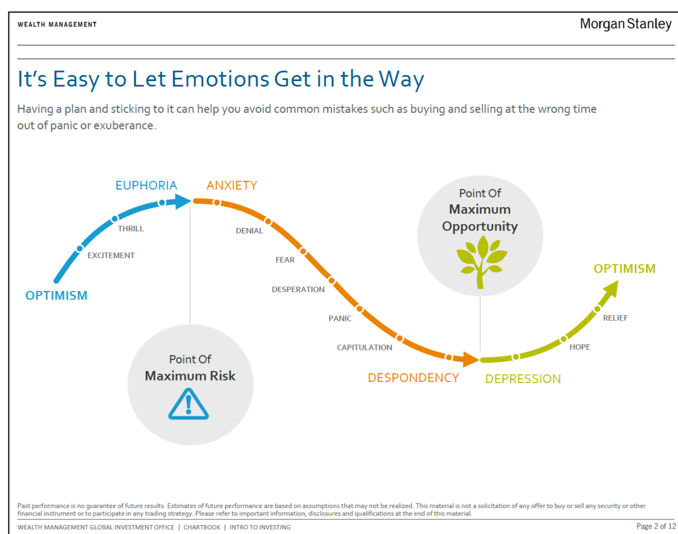


Chart 2[ii]

As we bring back one of our favorite charts—see Chart 2. This shows the entire market cycle—the rollercoaster we discussed previously—with investors psychological interpretations at various points along the cycle. Greed and fear are traditionally investors greatest antagonists at the top and bottom of markets in our view.

In our experience at these opposite ends of the spectrum are where the biggest investor mistakes happen. It's good to take stock of how you might be feeling about your current investment portfolio. We make it our goal—through prudent management of risks—to be emotionally on the far-left side of the cycle.

It is also useful for us to estimate where the collective body of investors worldwide might currently fall psychologically on this scale. In doing so it gives us perspective and potentially anticipate market behavior in the future. We would currently estimate that most U.S. and global equity investors are somewhere between Anxiety and Fear in this cycle. We have not yet noticed anything close to Capitulation or Despondency among our group of clients.

Yet, with the S&P 500 Index now posting 20%+ declines from its all-time high of 4818 achieved on January 3rd of this year[12] we continue to believe it is premature to begin to get remotely more aggressive in purchasing significant additional equity risk assets. We are comfortable with our current holdings but would summarize our short-term market outlook as being, "too late to sell—too early to buy."

As we discussed in the last edition of *RThoughts*—Spring 2022, there are many quality companies that, in our observations, have already experienced price declines of 30, 40, 50% or more from their 12-month highs. We continue to build a "shopping cart" of a select number of these names potentially to be purchased at more favorable levels or at which we consider a more opportunist time.

Currently, we observe a most definite national malaise and what we call a "Depression on Optimism." These are difficult times and difficult financial markets and, in our view, likely to get more difficult before they can get better. It is our view that the U.S. equity markets at the Index level may have additional downside of 5 to 10% in an economic stagflation/soft-landing recession future.

Moving forward—at least for the foreseeable few months—our emphasis will continue be concentrated on the management of risks with the belief that at some point we can shift our focus back onto the management of returns. Remember though, in our experiences, the nature of Bear (declining) markets is they do their best to confound all market participants including, at times, those looking for additional declines.

Please feel free to contact us with any questions, concerns, or issues.

Enjoy the remainder of your summer.

The Diamond Peak Group at Morgan Stanley

*Written: July 12, 13, 14th 2022.*

## Sources and Footnotes

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[3] *RThoughts*—Diamond Peak Group at Morgan Stanley. Winter 2022
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[5] 2022 Q2 World Wrap—Cypress Capital—June 30, 2022
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## Charts

[i] Cypress Capital Market Outlook, July 8, 2022
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[ii] Morgan Stanley Global Investment Office—Chartbook—Intro to Investing
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