

The End of Magical Thinking¹

Annual Letter



January 24, 2023

1.0 2022 Recap: The End of Magical Thinking

If one had to define 2022, we would say it was the year "magical thinking" ended! Economic reality set in. Many of the ideas that had gained wide acceptance, even though they defied logic and traditional economic principles, came to a sudden end:

¹ We borrowed the term "magical thinking" from an article by Harvard Business School Finance Professor Mihir A. Desai that appeared in the *New York Times* on January 16, 2023. The article discusses the concept in relation to the recent trend of investment in cryptocurrencies, particularly among younger generations. The author argues that this phenomenon is a manifestation of a broader culture of magical thinking that has infected a generation that grew up in the aftermath of the Great Recession. The author defines magical thinking as the assumption that favorable conditions will continue forever, without regard for history, and an exclusive emphasis on positive outcomes and novelty. He argues that this mentality is a product of factors such as low interest rates, excess liquidity, fast-changing consumer-facing technology, and disappointment with traditional politics. The unwinding of this magical thinking will be painful but ultimately restorative.

- The idea that governments could spend unlimited money without any consequences (Modern Monetary Theory).
- The idea that negative nominal interest rates globally would last forever.
- The idea that crypto currencies would replace fiat money and bypass governments.
- The idea that unprofitable companies can trade at ultra-high multiples of sales based on wishful plans to change the world.
- Lastly, the idea that a company that focuses primarily on doing good for society can perform better than one that aims at maximizing value for its stakeholders.

2022 was a challenging year for investors as both stocks and bonds experienced double-digit declines. According to BlackRock, 2022 was the worst year ever for bonds and the 7th worst for stocks. The aggressive monetary policy pivot by the US Federal Reserve, aimed at reining in inflation, played a significant role in these market declines. The Fed increased policy rates at the second fastest pace on record, raising them from 0% to 4.5% in a matter of months.

TABLE 1 – Bond and Stock Returns
Worst year for bonds and 7th worst for stocks

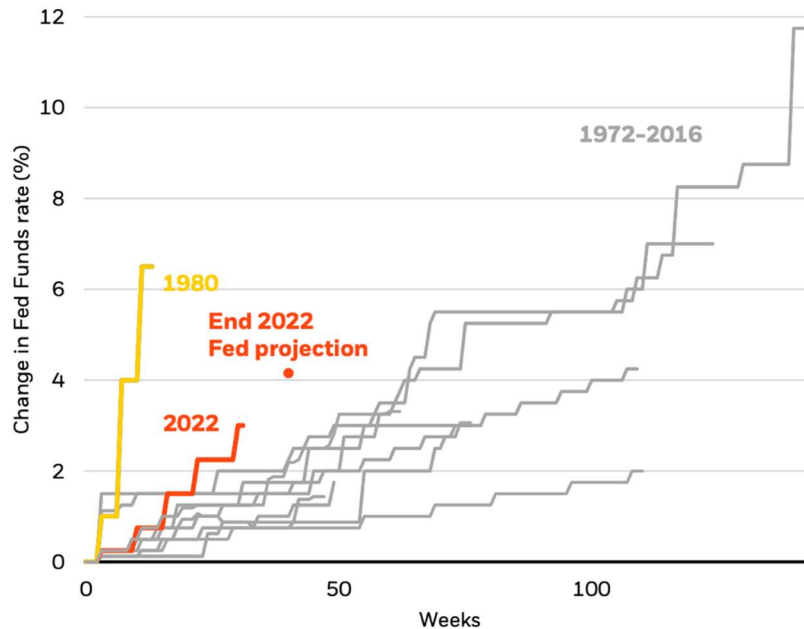
Worst years for U.S. Bonds Since 1926, total return for each period			7 th worst ever year for U.S. Stocks Since 1926, total return for each period		
Year	Return	Next 12 months	Year	Return	Next 12 months
2022	-13.0	?	1931	-43.3	-8.2
1994	-2.9	18.5	2008	-37.0	26.5
1931	-2.3	8.8	1937	-35.0	31.1
2013	-2.0	6.0	1974	-26.5	37.2
2021	-1.5	-13.0	1930	-24.9	-43.3
1958	-1.3	-0.4	2002	-22.1	28.7
1999	-0.8	11.6	2022	-18.1	?
1969	-0.7	16.9	1973	-14.7	-26.5
1955	-0.7	-0.4	2001	-11.9	-22.1
1956	-0.4	7.8	1941	-11.6	20.3
Avg.	-2.6	6.2	Avg.	-24.5	4.9

Source: Morningstar as of 12/31/22. U.S. bonds represented by the IASBBI US Gov IT Index from 1/1/26 to 1/3/89 and the Bloomberg U.S. Agg Bond TR Index from 1/3/89 to 12/31/22. U.S. stocks are represented by the S&P 500 Index from 3/4/57 to 12/31/22 and the IASBBI U.S. Lrg Stock Tr USD Index from 1/1/26 to 3/4/57, unmanaged indexes that are generally considered representative of the U.S. stock market during each given time period. Past performance does not guarantee or indicate future results. Index performance is for illustrative purposes only. You cannot invest directly in the index.

Source: BlackRock Investment Institute

The inflationary pressures, initially ignited by Covid-19 related dislocations and supply disruptions, were further aggravated in 2022 by the war in Ukraine and the consequent energy crisis. These pressures took on a life of their own, as it often happens with spiraling prices.

**GRAPH 1 – Current Fed tightening cycle is the second fastest on record
U.S. interest rate tightening cycles, 1972–2022**



Source: BlackRock Investment Institute

Macroeconomic indicators such as the inverted yield curve and LEIs (Leading Economic Indicators) began to point to a potential recession, further depressing equity valuations. As a result, a significant rotation took place out of growth and into value stocks. The US dollar strengthened dramatically versus most currencies (over 9% in 2022), while credit markets just yawned (perhaps the best hope for only a modest recession).

In addition to stock market declines, the cryptocurrency market experienced a massive reset, with the largest crypto exchange/custodian, FTX, collapsing altogether. Luckily, the sudden demise of the crypto giant did not have any systemic consequences.

On a more positive note, amid these challenging market conditions there were several breakthroughs in science and technology, including the first successful example of nuclear fusion producing a net energy gain, advances in hydrogen-powered vehicles, and progress in generative artificial intelligence. These advancements have the potential to drive long-term economic growth, but their impact on markets may not be seen for some time.

Overall, the year 2022 was challenging for investors, as both stocks and bonds experienced significant declines. The potential for a recession in 2023 added to the uncertainty. Based on historical statistics, however, it is highly improbable that 2023 will be a repeat of 2022.

2.0 2023 Macro Outlook

Inflation dynamics and the Federal Reserve's responsive actions will continue to dominate market outcomes in 2023. Our base case scenario is for a moderation in inflation, Fed hikes to peak in Q2, and a mild recession in the second part of the year or early in 2024.

Based on similar historical occurrences, inflation may take from 3 to 10 years to be controlled. At best, this would result in a 2% target inflation rate in 2024.

The post-Covid resolution of supply chain disruptions, combined with a weaker demand caused by the Fed's actions, will bring about moderating prices. However, recent de-globalization trends in manufacturing, combined with a structurally tight housing market and shrinking workforce in the US, are likely to slow down this normalization process.

Investors are underestimating the resolve of the Federal Reserve, which is unlikely to backpedal anytime soon. The Fed is expected to continue to hike interest rates in the first half of 2023 as inflation pressures abate only gradually. The monetary chiefs' communicated intent is to bring policy rates to 5% (at least 0.5% above the current level).

As the economy slows in the year's second half, the Fed is expected to pause its rate hikes. However, the US central bank will need to maintain its inflation-fighting credentials and is unlikely to cut rates significantly as soon as the first signs of economic weakness emerge.

The US economy will likely experience a mild recession in 2023 or early 2024 but possibly a longer-than-usual one due to the Fed's inflation-fighting commitment. It is impossible to predict the shape of a recession. However, we think the next recession may be mild because the US does not display the typical large economic imbalances generally associated with deep recessions.

- The strength of the US consumer and the fact that most households and corporates have refinanced their debt at low rates during the last decade (a prolonged period of very low-interest rates) will help mitigate the impact of the recession.
- The labor market is likely to remain tight because of demographic issues; a large section of the US population is leaving the workforce due to age and retirement.
- The housing market is structurally tight and banks are well capitalized.
- The worst of the energy crisis is likely behind us.
- Finally, the reopening of the Chinese economy after a long period of zero-Covid policies should also help improve the fortunes of the global economy (especially in Europe).

In conclusion, 2023 is expected to be a year of moderating inflation, stable interest rates, and possibly a mild recession.

3.0 Investment Strategy

3.1 Cash

If our working assumptions of high short-term interest rates and moderating inflation hold, cash is once again an interesting asset class to add to portfolios. The main problem with cash is reinvestment risk. **Money markets funds** and **US T-bills** will work well until the Federal Reserve once again decides to start cutting rates.

3.2 Fixed Income

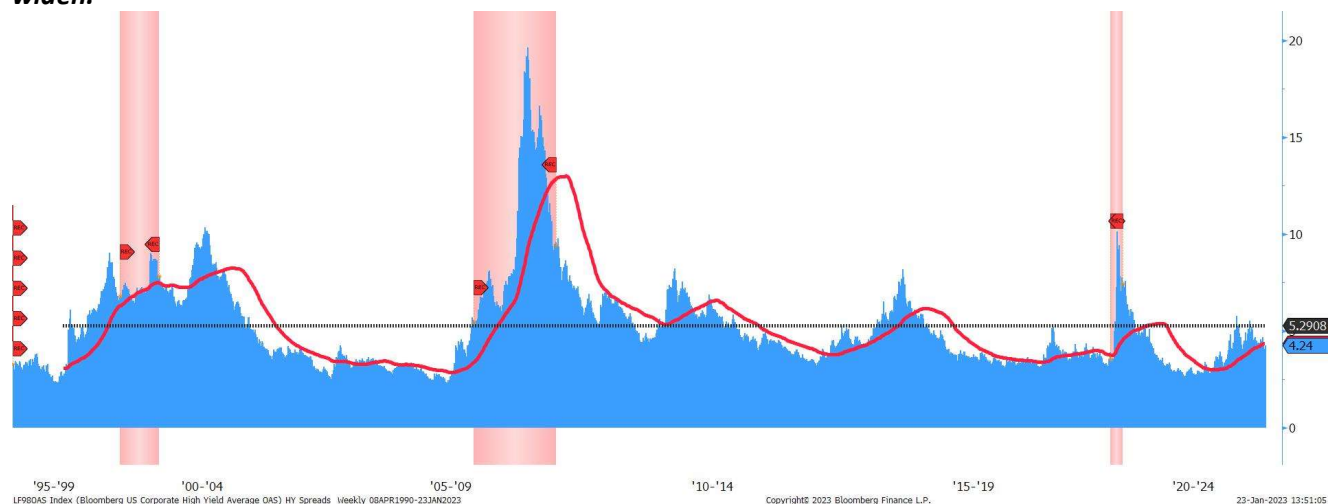
Considering the speed at which bond yields moved in 2022 and the fact that inflation may be moderating, we see value in **highly rated investment-grade bonds** (such as US Treasuries bonds.)

Historically, intermediate and long-dated bond yields normally peak before Fed fund target rates. This speaks in favor of investing in longer-dated bonds, as they tend to be more positively affected by interest rate declines and can provide a stable source of income. The duration extension should be a gradual process. Our favored approach is through a bond ladder (or similar technique) combined with an index fund.

We also note that in 2022, the credit markets (corporate bonds) suffered a much milder blow than equities. As encouraging as this may be for the US economy, **the high-yield and investment-grade corporate bonds may not yet sufficiently price the economic weakness expected in 2023**. To that extent, we remain more cautious about the near-term prospects of credit and favor high-quality bonds.

GRAPH 2 – High Yield Bond Spreads Compared to History

High yield bond spreads remained below their historical average in 2022. These spreads typically rise in conjunction with recessions (highlighted pink areas). If one occurs in 2023, spreads are likely to widen.



Source: Bloomberg Professional Services

As for **foreign and emerging market bonds**, 2022 was a very difficult year. Not only did a major war start in Europe while the Chinese economy showed signs of faltering, but a rapid appreciation of the US dollar imperiled the fate of many countries with large debt balances denominated in the greenback. 2023 will be a year of excellent returns for the bonds of those countries that have managed their finances responsibly and a year of reckoning for many weaker emerging countries.

3.3 Equities

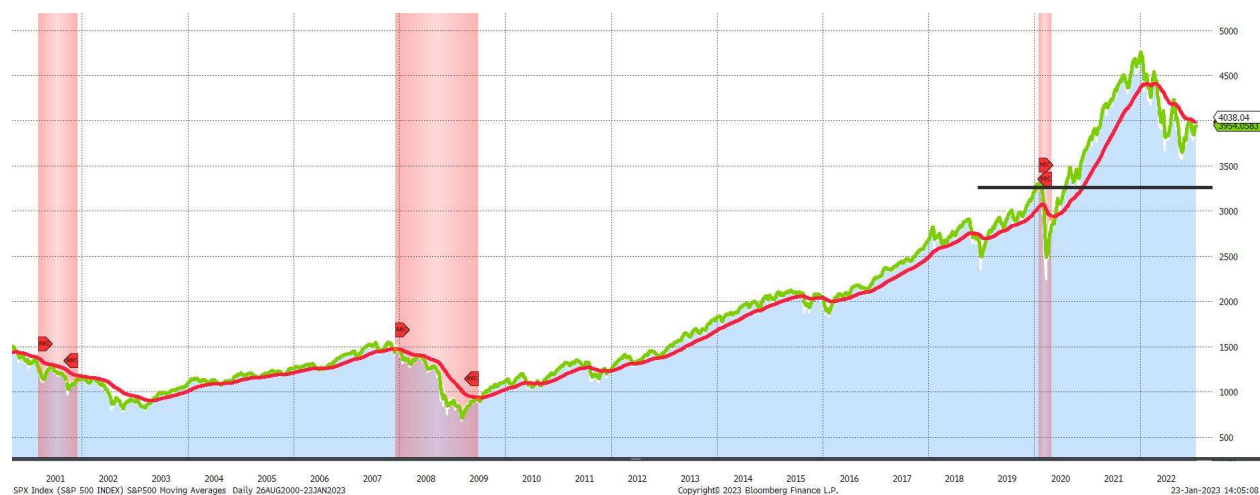
Equity markets will likely remain under pressure for the first part of this year. Stocks tend to drop before a recession and bottom out during a recession. The stock market is already pricing in a modest contraction in earnings. However, the severity and duration of a recession and its impact on corporate profits are hard to predict. Given that markets are currently driven mainly by inflation and monetary policy, episodic volatility will continue into 2023 until the macro-economic variables stabilize.

Our gauge of the stock market is threefold: **technical**, **fundamental**, and **sentiment**.

From a **technical** perspective, the current market formation remains **bearish**. Some encouraging signs of trend reversal may be brewing, though, especially in the small-cap space and international. Trend reversal may occur very rapidly regardless of the underlying economic circumstances. If we get a technical confirmation, we will adjust our expectations accordingly.

GRAPH 3 – S&P500 Index, 200-day and 10-day exponential moving averages

The S&P500 index remains in a “down trend” and has not corrected enough to meet historical market drops during a bear market (black horizontal line).



Source: Bloomberg Professional Services

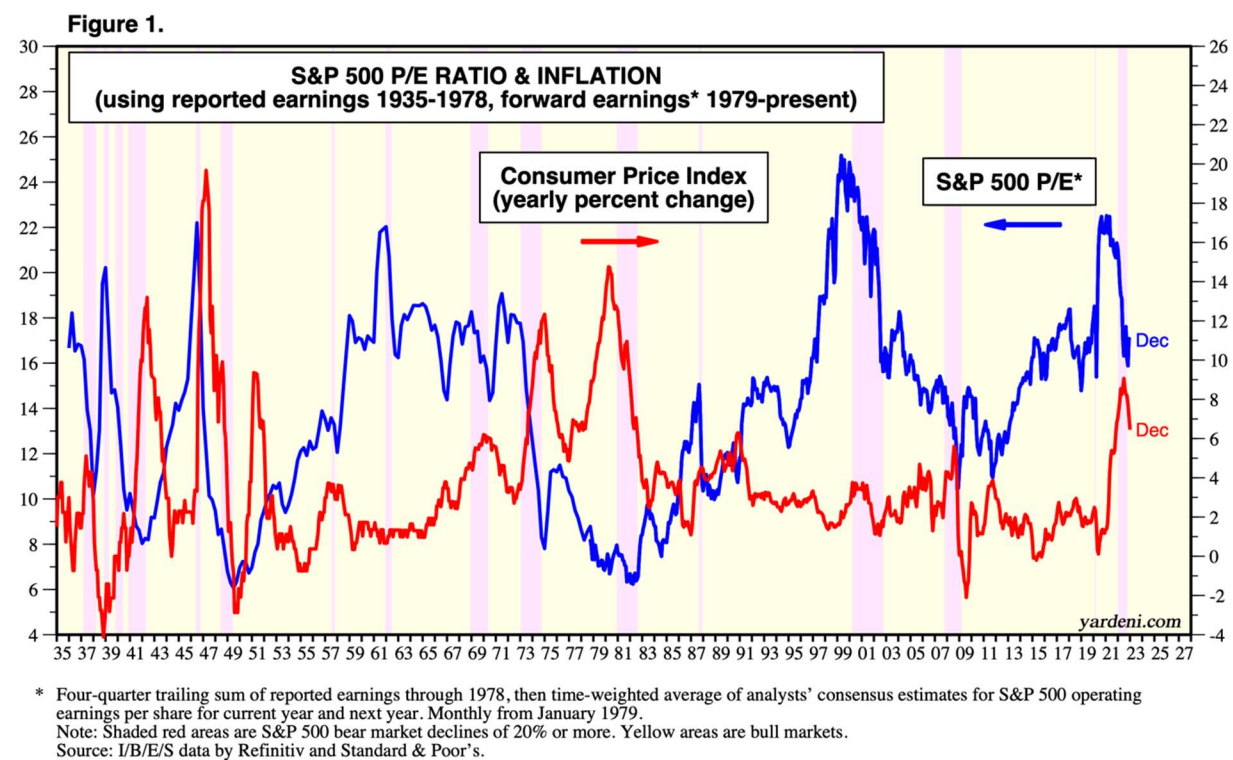
As a result of last year's sharp drop, **valuations are now much fairer but still higher than historical norms**. Additionally, the overall market may still be significantly overvalued when considering interest rates and inflation. The S&P500 Index forward price-earnings ratio at 17.6x

stands above its long-term historical average of 15x. This valuation is high if one compares it to the inflation rate and bond yields. Furthermore, equity valuations are predicated on future earnings growth that may be overly optimistic (especially, in the event of a significant contraction of economic activity.)

The stock market's most promising aspect is the highly **pessimistic prevailing sentiment**. This is generally a **strong contrarian indicator**, especially when at extreme levels. It suggests that the market may already present opportunities for investors.

GRAPH 4 – S&P500 P/E (left axis) and Inflation (right axis)

At 17.5x forward earnings, the S&P500 is trading at above historical valuations, especially if one considers inflation. Inflation rate will need to drop significantly and earnings will need to rise significantly to justify these valuations.



Source: Yardeni.com

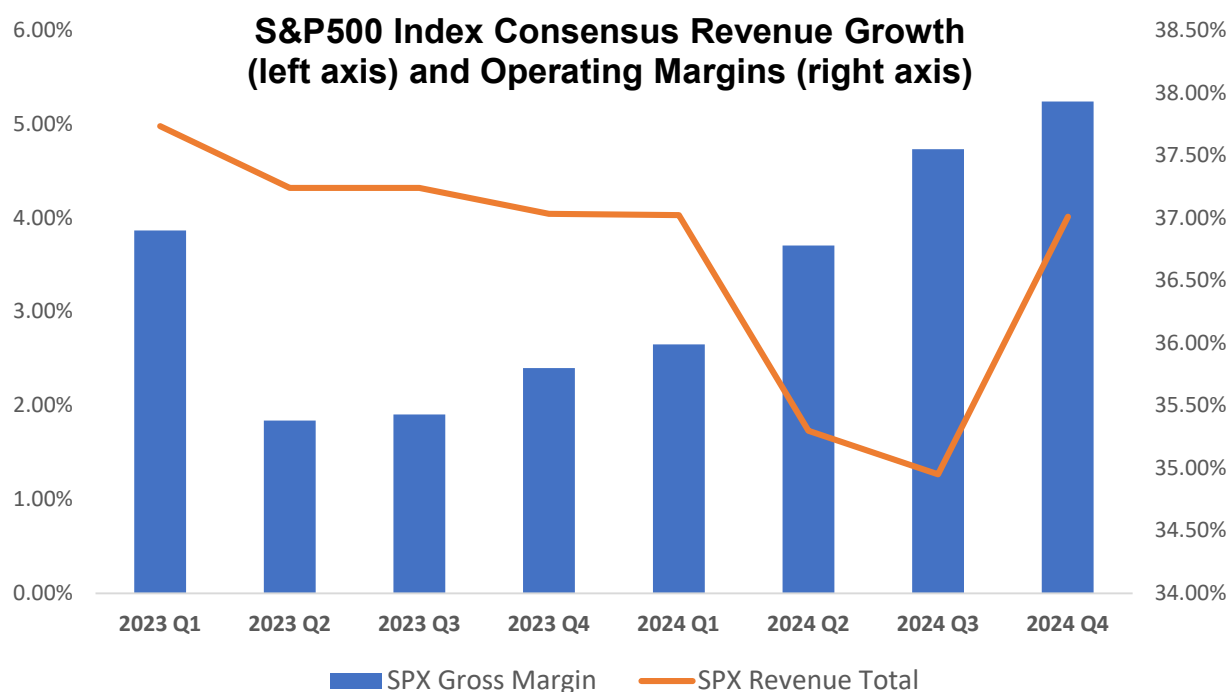
In terms of specific market areas, we note that despite **value equity** style's strong run in 2021-2022, valuations still favor value over growth. **Small-capitalization stocks** and **international equities** are particularly attractive from a valuation perspective for long-term investors.

From a company fundamental perspective, after a resilient year for the S&P500 index earnings in 2022, analysts are expecting a normalization of margins in 2023, with a decline in 1H23 and a possible rebound in 2H23, due to a weakening global business cycle, tightening financial conditions and rising risk of a consumer led recession.

Corporate guidance in early 2023 will give us a better sense of the different dynamics that may play out this year. One thing that is certain is that since 2022 investors have been increasingly focusing on margins vs. “growth at all costs”, which was the mantra of the last twelve years. Margins, however, can be sustained long-term only by a positive turn in revenue growth and not only by cutting costs. Analysts expects a reacceleration of S&P500 revenue growth in 2024, which may start to be priced in by the markets later this year.

GRAPH 5 – S&P500 Index consensus revenue growth and operating margins

Analysts expect revenue growth to dwindle in 2023 and reaccelerate in 2024. There is a limit to how much margins can be protected by cutting costs. Ultimately significant margin expansion will only occur with revenue acceleration.



Source: Bloomberg Professional Services and internal calculations

Given the diverging indications of valuations, technicals, and sentiment metrics we remain cautious and **for the time being will avoid increasing our exposure to stocks**. However, we also acknowledge that equity market trends may change abruptly and stay ready to add exposure to our clients' portfolios.

In conclusion, equity markets are expected to remain volatile for a while longer. The current market is pricing in a mild contraction in earnings, but it is uncertain how bad a potential recession may affect them. A sustained recovery is more likely later in the year and will be anticipated by a turn in the market technicals. From a valuation perspective the value style, small capitalization stocks and international equities hold the most promise.

3.4 Alternative Investments

In a world of low yields and expected returns, many investment categories, in addition to stocks and bonds, became interesting for investors in recent years. This is partially a result of recent financial innovation that made alternative investments more transparent and accessible to the average investor. We have been very selective and conservative in approaching this topic. Alternative investments in our opinion fulfill one of two functions: either they diversify risk (REITs, managed futures, commodities, ...) or enhance returns (private equity and credit).

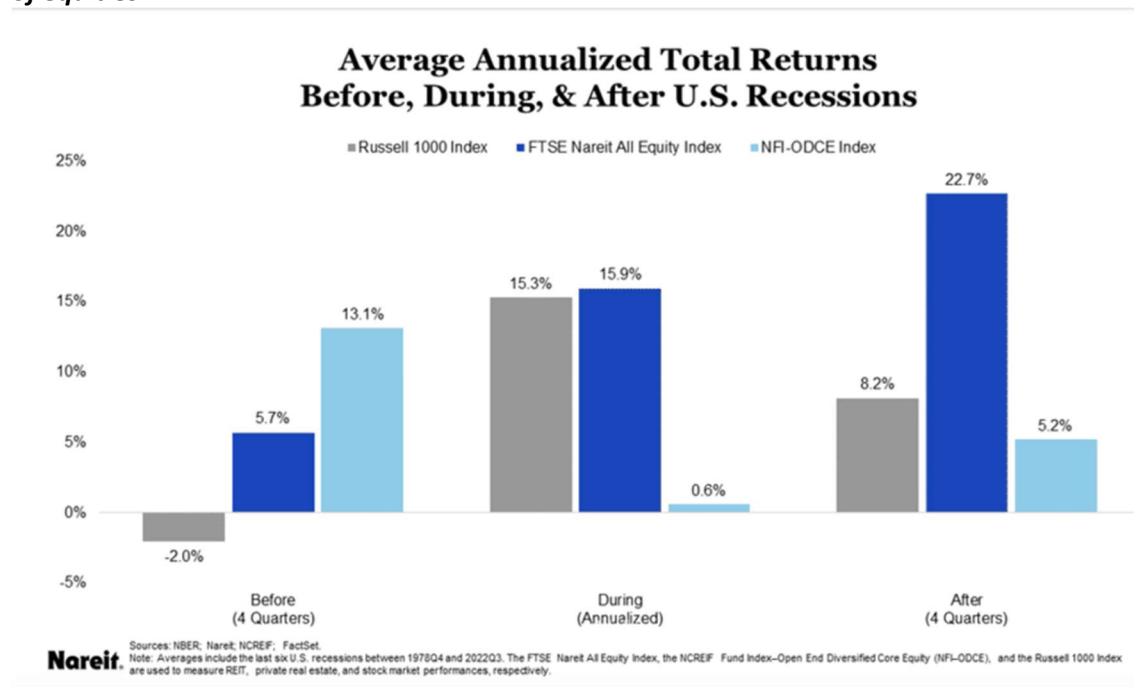
3.4.1 REITs

Sharply higher mortgage rates have adversely affected the overall real estate market (lower affordability) and pushed many households towards renting as opposed to home-buying. Despite rents rising together with inflation, occupancy rates have remained elevated (above pre-pandemic levels) in many sectors, showing demand resiliency. If in the next few quarters, a recession occurs and depresses occupancy rates, valuations may very well follow suit.

The graph below exhibits a relationship to keep an eye on. Historically, publicly traded REITs have outperformed the broader equity market in the years before, during, and after recessions, while underperforming the private market in the year preceding a recession but outperforming during and after. If a recession occurs in 2023, the valuation gap that emerged over the last few years between private real estate and public REIT may narrow, favoring the latter.

GRAPH 6 – Russell 1000 index, Public REITs, and private real estate returns

Through a recession, publicly traded REITs historically outperformed their private peers and other type of equities.



Source: National Association of Real Estate Investment Trusts

We remain constructive on certain alternative investments, especially the more liquid ones.

4.0 Conclusions

2022 was a very challenging year for investors as all asset classes dropped sharply and simultaneously. Traditional safe havens did not work. The main culprits were inflation and an aggressive response by the Federal Reserve to combat the rising prices. 2022 was a year of great reset in which many of the previous years' excesses rapidly vanished.

The Fed will continue to play a pivotal role in the markets in 2023. Nevertheless, inflation is moderating and so will the aggressive posture of the central bank. The question remains, how harmful inflation and the Fed have been to the economy. A mild recession in 2023/2024 looks likely and has already been priced in by the markets during 2022. The depth and duration of a potential economic contraction will determine if markets have further to fall.

After the 2022 declines, many new investment opportunities have emerged for long-term investors. First, cash and cash equivalent are likely to produce satisfactory returns. High-quality fixed income (US treasuries in particular) will likely perform well in the next cycle. However, credit-oriented fixed income may need to correct further before it becomes attractive. Equities will experience more volatility in the near term but offer attractive long-term expected returns, especially value-oriented stocks, small and mid-capitalization companies, and international stocks.

Carefully selected, liquid alternative investments may continue to offer diversification and return enhancement opportunities.

The "magical thinking" ended in 2022, probably because of sharply higher interest rates. We remain optimistic that many great investment opportunities lie ahead of us, but they will have to be examined through some good old-school "rational thinking."

As usual, we remain at your complete disposal for any questions and clarifications.

Sincerely,

Livian & Co. team