Blue Chip Partners: Quarterly Edge

Q3 2022

Market Outlook

Against a backdrop of sky-high inflation, rising rates, and growing recession concerns, the S&P 500 Index has had its worst start to the year in over 50 years. What was once the strongest bull market on record, as evidenced by the rapid doubling of the S&P from pandemic lows, has officially ended; the index has declined over 20% from its January 3rd record high denoting a bear market. Safety has not been found in fixed income, with long-dated U.S. government bond prices off more than 25% this year. The shift has been fast and frustrating, as many of the forces of the decline are beyond the control of investors and policymakers alike. This quarter, we find it important to discuss what we think the dreaded "R" word would entail, what a bottom in stocks could look like, and how to position within various forward-looking scenarios.

The "R" Word

Finding A Bottom

Blue Chip Radar

Your Bottom Line

Any reference to the dreaded word "recession" has an uncanny ability to stoke fear among the general public. A recession is just one phase of a normal business cycle. Today, that phase would likely look quite different than those experienced in recent history.

Market timing is a fruitless endeavor for long-term investors. However, it is valuable to utilize historical context to understand how long selling pressure may persist, at what levels meaningful shifts in the equity market could occur, and why adding at these levels may be the best strategy.

We don't have a crystal ball, but we do have a plan of attack. As new information becomes available, we will be watching closely to interpret what factors into the big picture and what is just noise. Regardless of the path forward, the Investment Committee at Blue Chip Partners holds a defined view with regards to how to position client portfolios.

Source: Blue Chip Partners. As of 30 June 2022.

The "R" Word

To be clear, we are not currently in a recession by official measures. By definition, a recession is a temporary economic decline, generally measured by a fall in Gross Domestic Product (GDP) in two successive quarters. A business cycle phase is not dependent on, nor necessarily indicative of, the performance of investable assets in financial markets. However, as is human nature, most individuals assume parallels between a current or future situation and those personally experienced in the past. In this case, muttering the dreaded "R" word invokes fears of economic and financial market turmoil equivalent to the near 15% unemployment rate during the pandemic-induced recession in 2020, the near-collapse of the global financial system through The Great Recession, or the -49% drawdown in U.S. stocks seen during the early 2000s recession. Regarding economics and corporate fundamentals, the current backdrop in the U.S. is vastly different than the three most recent recessions, and our view is that any upcoming recession would be of a much milder variety.

2020 – COVID-19 Recession

The shortest recession on record was unique in many regards. Global lockdowns induced a precipitous halt in both demand and supply and spending on services was virtually nonexistent, grinding labor markets to a halt. A 35% decline in U.S. consumer spending, which accounts for ~70% of GDP, drove an unprecedented economic decline of over -34%. Today, consumers continue to be on better financial footing than during pre-pandemic periods. Although the savings rate has dropped (something to watch in the coming months), individuals are spending at rates significantly above average. Continued cost pressure will likely impact spending preferences over the next six months, but not to a degree that would significantly damage corporate revenues.

2008 – 2009 – The Great Recession

Driven by lax lending standards and minimal oversight, excess leverage and poor liquidity at banks went unnoticed and nearly toppled the global financial system. Today, the health of the system is heavily scrutinized via annual stress tests. In the most recent tests, strength in capitalization levels at domestic banks confirmed an ability to support the economy in even the most severe recessionary scenarios.

2001 – Early 2000s Recession

The "irrational exuberance" displayed by retail investors, brokerage firms, and banks alike in the funding of risky internet start-ups was made possible by excess liquidity created by the Fed, which pushed valuations to extreme levels. Fed chair Alan Greenspan enacted monetary tightening, and the initial beneficiaries soon became victims. Yes, easy monetary policy contributed to the run equity markets displayed starting in 2020, but the level of speculation was nowhere near that of the early 2000s. It is worth noting that the speculative securities that did benefit from elevated optimism have already returned to earth. Further, in this cycle, valuations (price-to-earnings) only appeared at extreme levels due to temporarily depressed earnings and have already compressed significantly given the selloff this year. This indicates further market downdrafts should not be expected to exhibit the severity seen in 2001.

Source: Blue Chip Partners. As of 30 June 2022.

Blue Chip Partners: Quarterly Edge
Q3 2022

The "R" Word

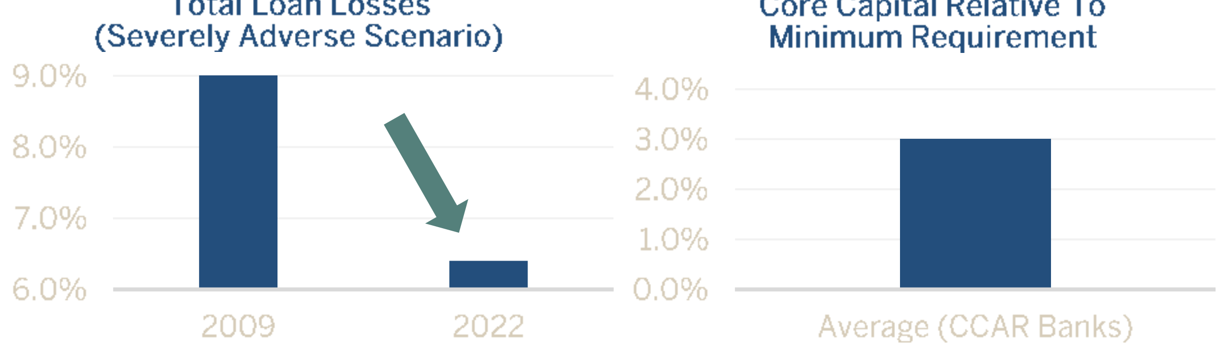
2020 – COVID-19 Recession[1]

Stronger U.S. household financial positioning has supported robust consumer spending.

Metric	Change Vs. Pre-Pandemic
Household Net Worth	+35.68%
Consumer Spending (Goods)	+16.34%
Consumer Spending (Services)	+1.57%

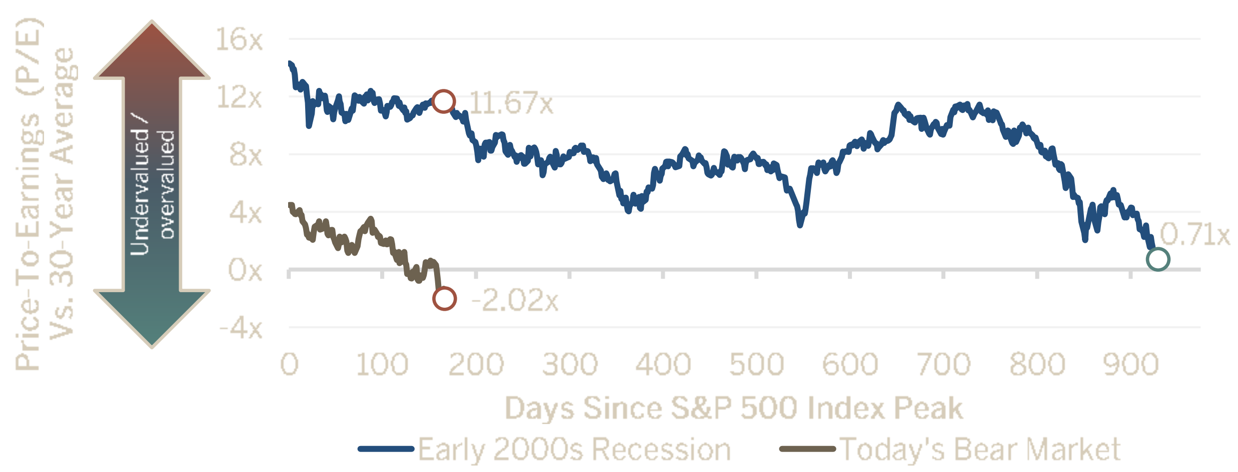
2008 – 2009 – The Great Recession[2]

As shown by the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR), U.S. banks are on sounder footing relative to 2009 from the perspective of loan losses and overall capital levels.



2001 – Early 2000s Recession[3]

The early 2000s recession contained a vastly overvalued stock market and had much farther to fall to return to reasonable, longer-term average level. Today's market is already undervalued relative to its 30-year average.



Source: Blue Chip Partners. See disclosures page for additional citations.

Blue Chip Partners: Quarterly Edge

Q3 2022

Finding A Bottom

Calling for a bottom in the stock market is very difficult, as every cycle is different. However, employing historical context can help identify potential price levels at which selling pressure may subside.

Looking at historical returns in the U.S. through the modern era (post World War II), the average bear market lasted 352 days and exhibited a price loss of -32.79%. Based on the historical average loss and current severity of the drawdown, the implied potential downside to the S&P 500 Index's price as of this writing is -12.09%.

S&P 500 Index Price Declines In Bear Markets

	Peak Price	Trough Price	Number Of Days	% Price Loss
Current Bear Market	4796.56	3666.77	164	-23.55%
Modern Era Average Bear Market	--	--	352	-32.79%
Implied Index Price Downside	3666.77	3223.29	?	-12.09%

Although we can glean information from the past, future returns will not follow a uniform path based on history. Thus, timing the market is a fruitless endeavor, and individuals that remove themselves from the market out of fear often end up missing periods of meaningful returns. Instead of attempting to time a market bottom, deploying cash into U.S. stocks at this juncture in modern era bear markets (164 days in, as of this writing) has provided a three-year total return of 33.59%, or 9.33% annualized. This nearly lines-up with the S&P 500's annualized total return since 1928 (9.39%).

Investing In The S&P 500 Index During Bear Markets

	Number Of Days	3-Year Return Investing 164 Days After Bear Market Peak
Current Bear Market	164	?
Modern Era Average Bear Market	352	33.59%

Source: Blue Chip Partners with data from Bloomberg. As of 16 June 2022. Indexes are shown for illustrative purposes only. It is not possible to invest directly in an index.

Blue Chip Partners: Quarterly Edge

Q3 2022

Blue Chip Radar

The last three months exhibited aspects of both the bear and base cases that we outlined in the Q2 2022 Quarterly Edge, but this should be viewed as a 12-month outlook. Many of the underlying drivers of our updated Blue Chip Radar have stayed consistent, but given market dislocations, our preferred positioning in the various scenarios has changed.

Bear Case

> The Federal Reserve overplays its hand via aggressively tight financial conditions, ultimately tipping the U.S. economy into a recession.

> Low consumer sentiment and real wage contraction translate to stalled consumer spending as savings are spent down. Corporations then end up saddled with excess inventory.

> Geopolitical and health-related overhangs continue to suppress economic productivity.

Base Case

> The U.S. central bank enacts measures to curb prices but faces bumps in the road by way of meaningfully slower growth and is forced to temper its overly-hawkish stance.

> Healthy consumer demand persists, but corporations continue to feel pressure on profitability.

> Economic growth is low but still positive; the U.S. experiences natural easing in major drivers of inflationary forces.

Bull Case

> The Fed successfully executes a “soft landing” (i.e., curtails inflation without crashing the domestic economy into a recession).

> Consumer demand remains healthy but moderates from extreme levels; inflation follows suit.

> Domestic corporations have more flexibility and can place greater emphasis on investment for future productivity and margin expansion.

Positioning

Risk-Off, Yet Opportunistic

> Equities: defensive industries, fortress balance sheets, high profitability. Further selling pressure will present opportunities to buy quality at a discount, most notably in tech.

> Fixed Income: prefer increasing duration and government securities, seek eventual pivot point to allocate to high yield.

Positioning

Quality At A Discount

> Equities: maintain preference for value and companies with resilient margins and strong free cash flow generation. Found across all sectors.

> Fixed Income: prefer low duration, given continued uncertainty, and favor investment-grade over high-yield, given risks to low-grade corporations.

Positioning

Balance Growth & Quality

> Equities: growth and innovative companies are rewarded, regardless of cash flow generation and valuation. Quality and value underperform yet still show appreciation.

> Fixed income: borrowing gains speed, default rates remain low, increased risk appetite leads to tighter spreads, benefitting riskier securities.

Source: Blue Chip Partners. As of 30 June 2022.

Disclosures
Q3 2022

Expressions of opinion are as of 30 June 2022 and are subject to change without notice. Any information provided is not a complete summary or statement of all available data necessary for making an investment decision and does not constitute a recommendation to buy, hold or sell any security. There are limitations associated with the use of any method of securities analysis. The information has been obtained from sources considered to be reliable, but we do not guarantee that the foregoing material is accurate or complete. Every investor's situation is unique, and you should consider your investment goals, risk tolerance and time horizon before making any investment. Prior to making an investment decision, please consult with your financial advisor about your individual situation. Past performance does not guarantee future results. Investing involves risk and you may incur a profit or loss regardless of strategy selected. There is no guarantee that any statements, opinions or forecasts provided herein will prove to be correct. Dividends are not guaranteed and must be approved by the company Board of Directors. Indices are included for informational purposes only; investors cannot invest directly in any index.

[1]Sources: U.S. Household Net Worth: Board of Governors of the Federal Reserve System (US). As of 31 March 2022. Consumer Spending (Goods) and Consumer Spending (Services): U.S. Bureau of Economic Analysis. As of 30 April 2022.

[2]Sources: Board of Governors of the Federal Reserve System (US), company data. As of 24 June 2022. U.S. bank holding companies (BHCs), savings and loan holding companies (SLHCs), and intermediate holding companies of foreign banking organizations (IHCs) with $100 billion or more in assets are subject to the Board's supervisory stress test rule. Further information on stress testing results and methodology can be found at the following link: https://www.federalreserve.gov/publications/dodd-frank-act-stress-test-publications.htm.

[3]Sources: Blue Chip Partners with data from Bloomberg. As of 16 June 2022. Indexes are shown for illustrative purposes only. It is not possible to invest directly in an index.