Alley Company Quarterly Letter
<u>What's Priced In?</u>

October 13, 2022

Rising interest rates have dented mark-to-market investment results in 2022 for *both* stocks and bonds. As a result, the often-referenced 60/40 balanced portfolio is experiencing one of its worst years on record. Exhibit 1 below displays annual total returns dating back to 1928 for a portfolio allocated 60% to stocks (S&P 500) and 40% to bonds (10-Year U.S. Treasury). While negative returns are not unheard of – occurring 22% of the time over the past 95 years – the magnitude relative to history of 2022 results is what begs the question: what's already priced into markets?

Exhibit 1: 60/40 Portfolio (S&P 500/U.S. 10-Year Treasury): Annual Total Returns

Year	Return	Year	Return	Year	Return	Year	Return	Year	Return
1928	26.6%	1947	3.5%	1966	-4.8%	1985	29.0%	2004	8.2%
1929	-3.3%	1948	4.2%	1967	13.6%	1986	20.8%	2005	4.0%
1930	-13.3%	1949	12.8%	1968	7.8%	1987	1.5%	2006	10.2%
1931	-27.3%	1950	18.7%	1969	-7.0%	1988	13.2%	2007	7.4%
1932	-1.7%	1951	14.1%	1970	8.8%	1989	26.0%	2008	-13.9%
1933	30.7%	1952	11.8%	1971	12.4%	1990	0.7%	2009	11.1%
1934	2.5%	1953	0.9%	1972	12.4%	1991	24.1%	2010	12.3%
1935	29.8%	1954	32.9%	1973	-7.1%	1992	8.2%	2011	7.7%
1936	21.2%	1955	19.0%	1974	-14.7%	1993	11.7%	2012	10.7%
1937	-20.7%	1956	3.6%	1975	23.6%	1994	-2.4%	2013	15.6%
1938	19.3%	1957	-3.6%	1976	20.7%	1995	31.7%	2014	12.4%
1939	1.1%	1958	25.4%	1977	-3.7%	1996	14.2%	2015	1.3%
1940	-4.2%	1959	6.2%	1978	3.6%	1997	23.8%	2016	7.3%
1941	-8.5%	1960	4.9%	1979	11.4%	1998	23.0%	2017	14.1%
1942	12.4%	1961	16.8%	1980	17.8%	1999	9.2%	2018	-2.5%
1943	16.0%	1962	-3.0%	1981	0.5%	2000	1.2%	2019	22.6%
1944	12.4%	1963	14.2%	1982	25.4%	2001	-4.9%	2020	15.3%
1945	23.0%	1964	11.3%	1983	14.7%	2002	-7.1%	2021	15.3%
1946	-3.8%	1965	7.7%	1984	9.2%	2003	17.2%	2022	-21.0%

Source: S&P Global. NYU | Stern. Annual total return statistics are 60% S&P 500 Index and 40% 10-Year Treasury Bond. 2022 performance is year-to-date through 9/30/22.

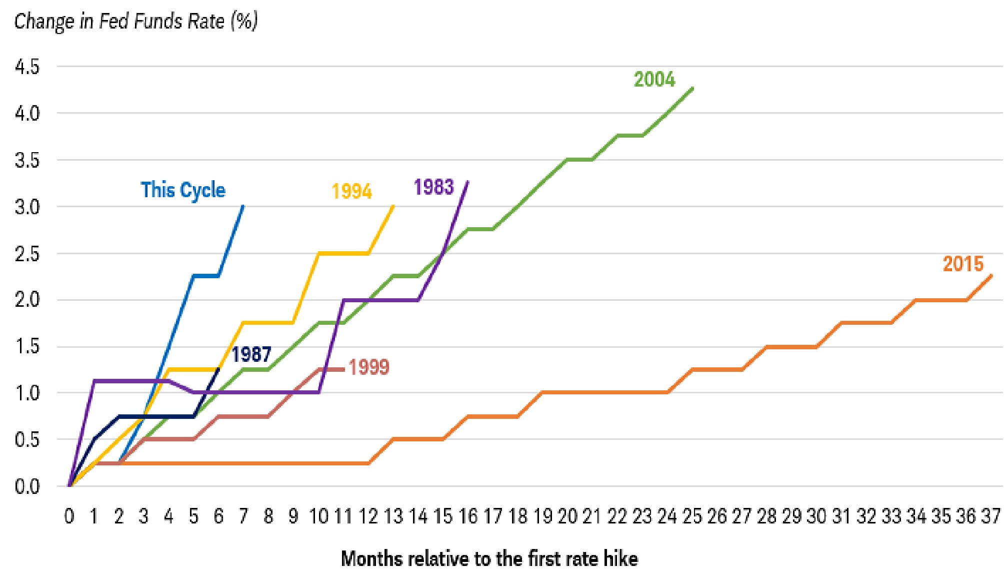
Alley Company
585 Bank Lane, Suite 2400
Lake Forest, IL 60045
Phone 847-482-0938
Fax 847-482-1237
www.alleycompanyllc.com

Playing Catch-Up

After being generally well controlled for multiple decades, inflation reared its ugly head as a by-product of the COVID-19 pandemic. A confluence of factors were at play: elevated demand stoked by accommodative fiscal and monetary policy; global supply-chain disruptions; tight labor markets; ongoing lockdowns in China; and Russia's invasion of Ukraine.

With the benefit of hindsight, the Fed was caught flatfooted in 2021 – initially believing that inflationary pressures would be "transitory" in nature. In 2022, the Fed has done an about face, proclaiming "resolve" to fight inflation and thus has been playing catch-up by raising interest rates at the most aggressive pace since the early 1980s.

Exhibit 2: The fastest rate hiking cycle since the early 1980s



Source: Charles Schwab. Bloomberg. Lines represent the cumulative change in the Fed Funds target rate from the start of each rate-hike cycle. For the current cycle, the Fed Funds target rate has risen 3%, to 3.25% from 0.25%.

Nobody Rings a Bell

Rapidly rising interest rates have no doubt had implications for financial assets. For stocks, a higher *discount rate* used in the calculation of present value of future cash flows has compressed valuations. As a result, the price-to-earnings (P/E) multiple on the stock market has moved to 15.1x compared to 21.4x at the beginning of the year.[1] As for bonds, when interest rates rise, prices fall, especially for longer-dated maturities that are most sensitive to rate volatility.

In our last quarterly letter, we contemplated the timing of the next recession. While impossible to pinpoint, we do know that financial markets move *ahead* of the formal evidence. Said differently, markets are discounting mechanisms, always trying to "price in" future fundamentals. For those investors that are waiting on the sidelines to invest new cash in the current environment, they should understand that nobody rings an "all clear" bell at market bottoms. Our view is that moving into the stock and bond markets over a period of time, with a dollar-cost-averaging approach, is a prudent course of action.

Tax-Loss Harvesting

One of the many benefits of Separate Account Management is the ability to control tax management within a portfolio. Tax-loss harvesting is the purposeful act of selling individual positions with capital losses in an effort to offset capital gains taken elsewhere in the portfolio (or to carryforward capital losses to future tax years).[2] We are analyzing portfolios – in particular fixed income positions – to determine where tax-loss harvesting could be of economic value.

A Time for Dividends

Our longstanding belief in the investment merits of high-quality dividend payers is further strengthened in the current environment.

During times of market volatility, cash dividends offer a tangible return on investment and the opportunity to re-invest back into the portfolio at attractive prices. Furthermore, high-quality companies that can sustain and *grow* dividends can provide a hedge against inflation/rising consumer prices.

To paraphrase a John D. Rockefeller quote: "nothing gives me more pleasure than seeing my dividends come in."

What's Priced In?

While the Fed is expected to remain vigilant on inflation, it is possible that softening economic conditions in the months ahead will take the edge off inflationary pressures. Corporate earnings have held up to date, but could soften into 2023. Companies with market leadership positions, pricing power, and robust financial health are best positioned to navigate the choppy waters and could emerge even stronger on the other side of the economic cycle.

Pinpointing exactly what is priced into markets is difficult, but recent market performance and sentiment readings suggest a lot of negativity is already reflected. Higher interest rates have caused bonds, especially shorter maturities, to trade at their most attractive levels in many years and high-quality dividend paying stocks look attractive for the long pull.

[1] S&P 500 Index. Based on forward 12-month EPS forecasts.

[2] Tax, legal, and accounting advisors should be consulted for individual circumstances.