Davenport Asset Management: New Year's Thoughts

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We doubt many investors will be very upset about waving goodbye to 2022. Indeed, it was a tough year for stocks as evidenced by declines of 18.1% and 20.4%, respectively, for the S&P 500® Index and Russell 2000® Index. The NASDAQ® Composite was even worse with a 32.5% swoon, and the top four technology companies (Apple, Microsoft, Alphabet and Amazon) lost roughly $3 trillion of value. Of note, this was the worst year for the major indices since 2008. Was all this to be expected after an impressive multi-year run? Some moderation certainly seemed warranted, but it was painful nonetheless.

Let's take a walk down memory lane. We started 2022 expecting a year of transition as COVID receded, consumer behavior normalized, government stimulus waned and monetary policy began to tighten. We were then dealt a curve ball with Russia's invasion of Ukraine, which caused prices for oil and other commodities to spike. This dynamic, coupled with pandemic bounce back demand and associated supply chain challenges, caused inflation to reach 40-year highs and ultimately prove stickier than expected.

Consequently, the Federal Reserve embarked on an aggressive campaign to quell inflation and raised interest rates seven times. Ultimately, rates reached their highest levels in 15 years, putting a major damper on stocks as economic growth started to slow and bonds became a much more attractive alternative for investors. As the cost of borrowing increased, investor speculation waned and companies began to place much more of an emphasis on cost cutting than growth. Gone were the days of cheap money, limitless borrowing and investors' willingness to pay seemingly infinite multiples for "story stocks". Not surprisingly, beneficiaries of prior years' speculation fared much worse than the broader market indices.

As we enter 2023, inflation and Fed policy are still front and center. Inflation remains uncomfortably high. Yet, there are signs it has peaked. We expect inflation to recede as commodity prices normalize, home prices fall, supply chain issues abate, inventories rebuild and we begin to lap lofty Consumer Price Index (CPI) readings from 2022. The Fed remains very vigilant and has signaled their intent to continue raising rates and keep them elevated for the sake of winning their war on inflation. But, the pace of rate hikes is slowing and we believe we are closer to the end than the beginning of this tightening cycle.

More subdued inflation and slowing rate hikes should be good things for markets. The lingering question, however, is the health of the economy. Many fear we are on the cusp of entering a recession as the full effect of Fed policy takes hold. Growth is clearly slowing as evidenced by weaker retail sales, softer manufacturing data and slackening corporate profit growth. Not surprisingly, a recession seems to have become the consensus prediction among CEOs, economists and Wall Street strategists. Should one occur, it may be the most well-advertised recession in history.

Any good news to consider? There is still a chance we see a "soft landing". This outcome would entail the Fed threading a needle by engineering a slowdown in growth without tipping us into recession. Such a rosy scenario currently seems implausible to most. However, just because we are seeing a slowdown doesn't mean the economy will be in shambles. For one, the economy enters this next economic chapter at near full employment with corporate and consumer balance sheets in relatively good shape. Furthermore, expectations for economic and profit growth have been adjusted downward and sentiment is quite dour. Perhaps we will see a manageable slowdown and widespread trepidation will prove unwarranted. Stocks could do okay in this scenario, especially after having already discounted a fair degree of duress.

This brings us to current valuation levels. The S&P 500 currently trades at a price-to-earnings (P/E) multiple of roughly 17x forward earnings estimates, down from 21.4x at the beginning of 2022. The former multiple was justified by near zero percent interest rates, a condition that no longer exists and likely won't anytime soon. In our opinion, stocks are clearly a better deal than they were a year ago; however, current valuation levels seem fair (i.e. not overly cheap or expensive) in light of new interest rate levels and growth expectations. As such, we would still argue equity investors could attain decent returns in coming years, but a moderation from the turbo-charged "cheap money" era.

What are we doing in this environment? As noted in our last letter, we remain focused on buying businesses with structural, long-term advantages that trade at attractive prices even when considering the potential for slowing growth. We've seen some opportunities appear as investors have broadly fled risk and think we can earn respectable returns even if the near term gets choppy. Remember, we are investing for more than one year. 2023 may indeed be a tough period for the economy. Over time, however, we believe Gross Domestic Product (GDP) and earnings will continue growing and stocks should yield solid results as they have for many decades. With that in mind, we intend to use our long-term time horizon to our advantage should volatile market conditions ensue. Happy New Year, and thank you for your trust.

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