

DIAMOND HILL

INVESTED IN THE LONG RUN

January's Rally: More Speculative Euphoria Than Fundamentally Driven?

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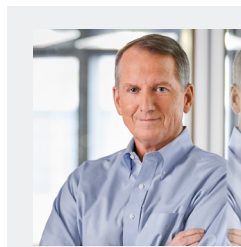
In looking back on the 2022 investment year, we are struck by the change in both valuation and tone of the market. The market peaked in early January 2022 and proceeded to sell off aggressively as rising interest rates and tightening Federal Reserve policy caused investors to question the growth of corporate earnings as well as the valuation that should be placed on those earnings. By October, the market was down over -24% – decidedly a bear market. Of course, the selloff in many areas of the market was even more severe.

By year end, the market had experienced at least a partial recovery but was still down meaningfully from its peak. As we examine our portfolios, we have looked for opportunities created by the selloff to provide the best risk/reward for our clients. Many of these decisions were guided by our past experiences in bear market recoveries, and we have used this experience to help guide our decision-making process. One of the most important decisions encompassed not only where to invest but equally importantly where not to invest.

We have observed over the years that bear markets define a change in market leadership. This makes perfect economic sense. Often the effect of the preceding bull market is excess capital flowing into the portions of the economy achieving excess returns. This new capital leads to increased competition and reduced economic returns. As a result, investors become disappointed, valuations contract and other areas of the market become much more attractive to investors.

Having begun my investment career in 1982, I was fortunate to experience the end of the 1980-1982 bear market. The bull market of the preceding years had been defined by strength in the energy sector. Outsized returns earned by those companies were driven by high and rising energy prices. However, the increase in capital that drove the energy bull market finally led to the sector's decline. For our purposes, the important point to recognize is that the energy sector was unable to sustain its market leadership for decades. While there were short-term rallies from time to time, this was not a sector that provided on-going market leadership. Rather, the sector led to serious disappointment. The energy sector was best avoided during the recovery that followed the 1982 bear market.

Like the dominance of the energy sector in the early 1980s, the strength of the technology sector defined the bull market that ended in 2000. This was the strongest market rally of my career, and the strength in the technology sector drove the bull market throughout much of the late 1990s. However, capital flooded into the sector as the emerging internet economy attracted significant levels of new capital. This increased level of competition led to disappointment for investors and a transfer of market leadership to other areas of the economy as the market began its recovery in 2002. It was important for investors to recognize this trend and direct their investment away from the large capitalization technology sector in order to participate in the subsequent market rally.



Chuck Bath, CFA
Portfolio Manager

If there was one area that defined the bear market of 2008-2009 it was financial services. The financials sector thrived in the bull market that ended in 2007. However, the bear market was particularly severe for financial stocks as asset quality deteriorated and financial companies scrambled to raise capital to stay solvent or meet regulatory requirements. As the market began to recover, financial services companies would occasionally rally as investors became relieved the point of greatest stress for the sector had passed. However, the sector was not able to lead the market as it had in the past. In fact, the relative underperformance of the financial services sector did not end until 2012, approximately three years after the bear market had ended.

Having learned from these past experiences, our focus has been on areas of the market where valuations have contracted but long-term fundamentals have remained robust. As such, we are also avoiding those areas of market excess that defined the preceding bull market. Those stock prices may be down, but valuations aren't yet attractive. We are particularly skeptical of the many emerging technology companies with checkered earnings histories and unproven business models. Many of those companies performed incredibly well in the preceding bull market, but if our experience has taught us anything, it is that this is exactly the area where we do not wish to invest in 2023. We expect the end of this bear market, like others, to be defined by a change in market leadership.

With this background, we are disappointed to see the January 2023 recovery in what we perceive to be the most speculative areas of the market. Many of these companies were the leaders of the last bear market. Even though many of these stocks have declined 60% to 70%, investors seem eager to purchase them with the hope there will be a strong market recovery. We are skeptical. In our opinion, this is not how a healthy market recovery develops. The Federal Reserve tightening was meant, in part, to reduce market speculation. It defeats the purpose of raising interest rates if investors immediately return to speculating once they sense the Federal Reserve tightening cycle is ending.

As 2023 begins, we are optimistic the market valuation provides good opportunities for investors. Long-term interest rates have stopped increasing and 10-year Treasury yields are approximately 3.5%. Earnings have generally held up well even as the economy slows such that the market's valuation seems reasonable. Most importantly, we are finding many companies whose valuations seem quite attractive.

However, it is a bit discouraging to see the apparent increase in speculative activity in the market. In our opinion, this is not how bear markets usually end. The normal course is for chastened investors to return slowly and cautiously to the market. The severity of the recent market decline should have been sufficient to meaningfully affect investor behavior. It is our expectation speculative activity will again subside. If it does, we will view this as a healthy sign for long-term investors even if the near-term result is a decline in market prices. A strong speculative recovery would probably be the worst possible long-term outcome as it would require a meaningful response from the Federal Reserve in the form of quantitative tightening and increased interest rates. We hope this does not become necessary.

It is also interesting to note the recent rally has taken place at year end. It is not uncommon for investor behavior to change with the calendar. Investors frequently behave as if a new year provides new opportunities, coincident with the end of December's tax loss selling season. However, it is rare for economic fundamentals to change simultaneously with the change in the calendar. We have learned from experience to be skeptical regarding sharp January market moves. Usually, the same opportunities that are available in January are the ones that were available in December.

Finally, I want to emphasize we have found many opportunities in the most recent bear market to invest in high-quality companies at attractive prices. Equally important, we have taken advantage of the opportunity to add to some of our current positions. Our large-cap strategies are heavily exposed to the financial services, health care and consumer durables sectors. These are typical of the opportunities we are finding in the market. We feel these investments provide the best opportunity to earn attractive returns in a market where valuations improved meaningfully in the 2022 bear market.

As always, we are grateful for our clients who have been with us through a variety of market cycles. We have invested through many bear markets, and while each is different in its own way, the most recent bear market was not terribly unusual, and we look forward to new opportunities in 2023.

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