Out with TINA and In with TARA

TINA, TINA, TINA, how we loved you so. For more years than we can count, you were the apple of our eye but, sadly, now you're gone. Not all is lost. Someone new has come to town and her name is TARA. Who are TINA and TARA you may ask? Well, let's start with TINA.

TINA stands for "There Is No Alternative". Since the financial crisis, the Federal Reserve has kept interest rates extremely low. When investors looked for opportunities, stocks were attractive because they could often provide a dividend yield above short-term fixed income rates, with the added opportunity for price appreciation. However, as the Federal Reserve has aggressively raised interest rates this year, fixed income securities are now more attractive than they have been in many years.

As a result, TINA is now out and its TARA's time to shine. TARA stands for "There Are Reasonable Alternatives" and it means that there is now a bit of competition for stocks. Instead of equities being the investment of choice, some investors may take advantage of higher rates and move more money to fixed income than they had previously.

Currently market participants are trying to figure out fair value for equities but are struggling to do so in the uncertain environment surrounding inflation, future earnings and recession fears. Though there are many outcomes for stocks, here are three possible ones. We could see a "soft landing" scenario for the economy, which means the Federal Reserve has slowed down economic activity and inflation but has not thrown us into a big recession. In recessions, gross domestic product (GDP) shrinks, unemployment rises and inflation declines. Under this "soft-landing" scenario, S&P 500 earnings could slow next year from previous expectations but probably still come in above $230 in aggregate. If you apply a multiple of 15x on Price Earnings, the S&P approaches fair value in the 3400-3500 range.

Under a less favorable scenario, inflation remains persistently high and the Fed must be far more aggressive with interest rate levels. The economy risks a "hard-landing" where a deep recession ensues. 2023 S&P 500 earnings would move lower, and fair value may be reached about 20% lower than current levels, roughly in line with a 3000 target for the S&P.

A more favorable scenario can occur if the market believes that inflation is peaking or about to peak. The stock market is a discounting mechanism and tends to look out 6 months to a year into the future.

11766 Wilshire Boulevard, Suite 845
Los Angeles, California 90025
310.893.6060
www.LSAdvisors.com

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The decline in equities over the last 10 months has anticipated many of the challenges we are facing. Stocks should begin to act better once this bad news has been fully discounted, and we may be heading in that direction. At present, there are signals that the Fed will increase the Federal Funds rate over the next few months to between 4.5%-5%. Getting closer to the end of the current rate hike cycle would, most likely, be seen as positive for investors.

Various economic data points and indicators are slowing and the effect of interest rate increases flowing through the economy comes in long and variable lags. We believe the aggressive rate hikes will slow economic activity. We are already seeing meaningful declines in many economic categories, though inflation has remained stubbornly high in others. As market participants see progress on the inflation front, stocks should act better going forward into 2023. As always, we will stay vigilant and adapt to this dynamic environment.

Ralph Scott
Chief Investment Officer

Craig Weston
Senior Managing Director

Matthew Nussbaum
Portfolio Manager & Senior Research Analyst