VIEWPOINTS
WHARTONHILL

SEPTEMBER 2022

“In my songs, the spiritual part, the hope part, is in the choruses. The blues and your daily realities are in the details of the verses.”
- Bruce Springsteen

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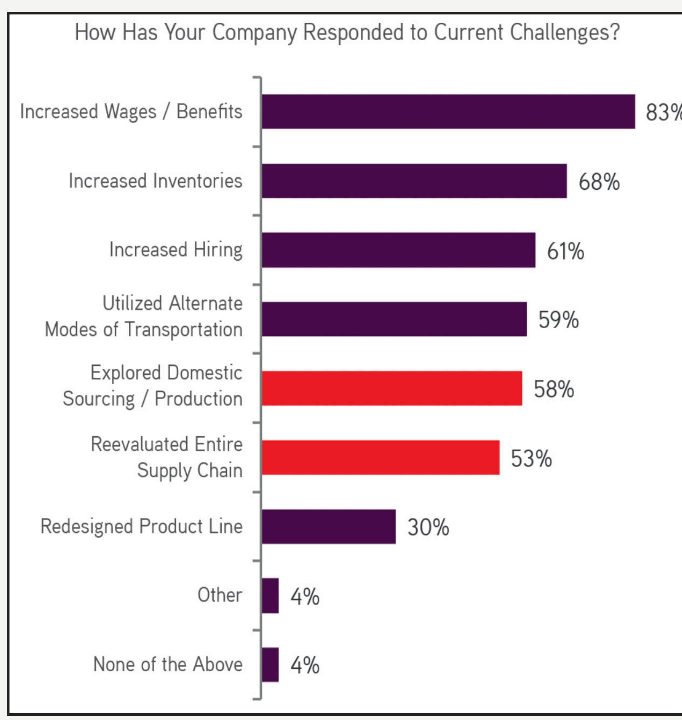
When you think of the song “Born in the USA,” what comes to mind? A triumphant chorus, brimming with pride for the fatherland? Or the verses, steeped in imagery of the uphill battle that Vietnam veterans faced upon their return to the fatherland? Perhaps you didn’t expect a Rorschach test in this month’s edition of Viewpoints and frankly neither did I when I set out to write this, but this is where 2022 has brought us. After many years of investment market returns that have been like a Springsteen chorus, triumphant and ascendant, we have screeched back into the melancholy verses this year, with volatility and negative returns abounding.

Like the dualist nature of a Springsteen song, this year has us wrestling with both the risks that are seemingly around every corner and the potential opportunities that could come out of tension. One of those opportunities centers on the theme of onshoring - that is bringing back production, manufacturing, and parts sourcing to the United States from abroad. Given that over the last two and a half years, one of the most ever-present problems has been supply chain difficulties, it is not surprising that U.S. companies are looking to simplify and streamline their production and sourcing. Over the summer, Barron’s noted that “Morgan Stanley surveyed more than 400 executives of large corporations that range around the world from the U.S. to Germany to Japan. The most important factor in supply chain decisions proved to be geopolitical stability, followed by skilled labor, physical infrastructure and a developed supply-chain ecosystem. On nearly every count, the U.S. outranked Europe, China and Mexico.” You can see in the graphic to the right that 58% of manufacturing executives are exploring domestic sourcing and 53% have reevaluated their entire supply chain[1].



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With China's zero-COVID policy putting enormous pressures on production, combined with geopolitical tensions between the West and the East, there is a continued push for North American sourced goods, be it in the U.S., Canada, or Mexico.

What does all of this imply for an investment strategy? We think there are a few takeaways:

- First, the Russian invasion of Ukraine, followed by the crippling financial market sanctions was the lynchpin for us to eliminate our emerging market investment exposure across client portfolios in April of this year. If China moves similarly with respect to Taiwan, it would seem to be an accelerant for companies to further move manufacturing away from Asia. While globalism's acceleration caused extended outperformance within EM stocks in the early aughts, the deceleration seems poised to continue and to bring added investment to U.S. companies.

- Second, mid- and small- cap U.S. stocks have been out of favor this year and are trading at relative discounts to historic valuations. The Russell 2000 index (small cap stocks) fell over 30% from its peak in November last year to its recent trough in June of this year. Small cap stocks are also more focused on domestic business than large caps and could stand to benefit from onshoring. 83% of small cap revenue is generated in the U.S., compared to about 70% for the S&P 500[2].

While we have given up a bit of the "value trade" that one can find by owning emerging market or international stocks, we have refocused that allocation to U.S. companies that, due to the sharp drawdowns in markets this year, are also now trading at attractive valuations. While our experience in the markets has taught us that diversification across geographic holdings often benefits the long-term investor, our research tells us that the tailwinds that led to those trends playing out in the past are shifting towards the U.S. and away from globalization. Whether this is expressed through quality, dividend paying blue chips, or small cap companies that are a part of secular growth trends, we think a domestic focus should be prioritized in these trying times. The verses we are going through this year may be melancholy, but a chorus will come and with it a more hopeful path forward.

Current P/E vs. 20-year avg. P/E

	Value	Blend	Growth
Large	13.2 / 13.7	16.6 / 15.5	22.7 / 18.6
Mid	13.1 / 14.4	15.2 / 16.3	21.8 / 20.3
Small	14.5 / 16.9	18.4 / 21.3	24.9 / 35.5

Current P/E as % of 20-year avg. PE

	Value	Blend	Growth
Large	96.6%	107.6%	122.6%
Mid	90.6%	93.3%	107.5%
Small	86.0%	86.2%	70.1%

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1: Chart and data via KKR - https://www.kkr.com/global-perspectives/publications/walk-dont-run-mid-year-update-2022
2: Data via Royce Investments - https://www.royceinvest.com/insights/2022/3Q22/pounding-the-table-for-small-caps
3: Chart on asset class valuations from JP Morgan - https://am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/guide-to-the-markets/