

August 16, 2022 – Investment Commentary

Elated Markets

Stocks rallied after data showed signs that inflation, while still elevated on an annualized basis, had started to slow, supporting the view that the rise in consumer prices may have peaked. Federal Reserve officials reiterated that the central bank still had work to do in taming inflation, but the market still appeared to lower its expectations for a 75-basis-point rate hike in September. Chicago Fed President Charles Evans remarked that the central bank may need to raise rates to as high as 4% by the end of 2023.

The large-cap S&P 500 Index advanced but did not gain as much ground as the S&P MidCap 400 Index and the small-cap Russell 2000 Index. All the sectors in the S&P 500 advanced, led by energy stocks where consumer staples lagged and value outperformed growth across all market capitalizations. These types of sector performance are more typical trends associated with an economy at the beginning stages of a recovery rather than recession. Last week, the VIX, the so called “fear gauge”, traded below 20, closer to its long-term average, for the first time since April 2022.

The narrative that inflation may have peaked appeared to also help fuel a risk-on rally in investment-grade corporate bonds. Here, credit spreads tightened to levels that are largely below recession levels and the high yield market advanced 1%.

European shares rose as fears of more aggressive interest rate hikes eased. In local currency terms, the pan-European STOXX Europe 600 Index ended the week 1.18% higher where Emerging Markets were 1.6% higher. The spike in coronavirus infections coupled with a continued housing market slowdown are considered among the largest risks to China’s economy in the near term absent escalating tensions with Taiwan. The broad, capitalization-weighted Shanghai Composite Index added 1.5% and the blue chip CSI 300 Index, which tracks the largest listed companies in Shanghai and Shenzhen, inched up 0.8%

Recession Rates

The recession signals of the 10 year – 2 year yield curve spread is -42bps, where the 10 year – 3 month yield curve has declined year to date to 25bps suggesting the direction of travel is towards a recession (an inverted yield curve means that a short-term U.S. treasury is paying a higher interest rate than long-term U.S. treasuries where the inverted yield curve is viewed as a lagged recession indicator). The European spread stress test of Italian 10 year BTP vs. German 10 year Bund rose 2bps to 2.09%. The 5 year and 10 year breakeven inflation expectations were largely unchanged from the week before at 2.24% and 2.48%, respectively.

The Investment Office is cautious about taking a victory lap based on the recent combination of a stronger-than-expected jobs report and better-than-expected inflation numbers. The economy is a considerable distance from a 2% percent Fed target, assuming they don’t adjust their 2% goal and accommodate a higher level due to persistent shelter, wage, medical and food price growth.

If we lean on history, bear market rallies are common. During the 2000 tech bubble and 2008 Great Financial Crisis (GFC) there were several bear market rallies that interrupted an overall downtrend in equity markets. After the .com bust, there were six rallies of 10-20% during that two-year downturn period. During the GFC, the market rallied five times between 8-25% before the market bottomed with a decline of ~60%. Finally in both bear markets, rallies mostly grew larger each time providing a false sense of comfort that the bear market scenario was over.

Portfolio Implications

Our portfolio construction contemplates the possibility the Fed will successfully battle inflation without a deep or extended recession, proverbial soft landing. It's worth remembering that the Fed typically plays a role to help "bail out" a recession and market decline where now it is likely the cause of a recession. More than 90% of companies in the S&P 500 have now reported Q2 earnings, and some 78% of those names have posted better-than-expected profits, according to Bloomberg. Those results have put overall S&P 500 earnings on pace to have grown by 9.7% from the year-earlier period. However, forward P/E multiples across many market capitalizations are largely above or similar to the 20-year averages indicating the markets are not inexpensive.

The "benign" 8.5% inflation report does not eliminate a recession scenario especially where the baseline market expectation is the Fed-funds rate will be at its highest level in 14 years, and continue to rise, while the balance sheet continues to shrink (likely increasing rates) and inflation levels decline from 40 year highs. These dynamics are complicated by a slowdown in China, the world's second-largest economy, where Europe's growth engine Germany is highly dependent on China for its exports and is already having to cope with large Russian energy-supply cuts.

In light of the Fed's apparent commitment to fighting inflation at the cost of economic growth, a modest recession remains the Investment Office base case. In such an environment we think it's prudent to search for investment opportunities where portfolio allocations can be rewarded appropriately for the various macro regimes including stagflation, recession and soft-landing. For example...

- In fixed income, municipals and investment grade credit with healthy credit fundamentals and appropriate risk adjusted yields.
- Within equity markets, we continue to favor U.S. large caps, with exposures to high-quality growth companies, select values stocks and companies growing their dividends.
- We also suggest looking beyond the traditional 60/40 equity/fixed income portfolio, using alternative strategies such as real assets including single family rentals to provide potential inflation hedges via predictable cash flows and increase exposure to credit managers with stressed/distressed European investment expertise.

Disclosures

Investment Commentary Sources: Bloomberg and Morningstar

Investment advisory services offered through Robertson Stephens Wealth Management, LLC ("Robertson Stephens"), an SEC-registered investment advisor. Registration does not imply any specific level of skill or training and does not constitute an endorsement of the firm by the Commission. This material is for general informational purposes only and should not be construed as investment, tax or legal advice. It does not constitute a recommendation or offer to buy or sell any security, has not been tailored to the needs of any specific investor, and should not provide the basis for any investment decision. Please consult with your Advisor prior to making any Investment decisions. The information contained herein was carefully compiled from sources believed to be reliable, but Robertson Stephens cannot guarantee its accuracy or completeness. Information, views and opinions are current as of the date of this presentation, are based on the information available at the time, and are subject to change based on market and other conditions. Robertson Stephens assumes no duty to update this information. Unless otherwise noted, any individual opinions presented are those of the author and not necessarily those of Robertson Stephens. Indices are unmanaged and reflect the reinvestment of all income or dividends but do not reflect the deduction of any fees or expenses which would reduce returns. Past performance does not guarantee future results. Forward-looking performance targets or estimates are not guaranteed and may not be achieved. Investing entails risks, including possible loss of principal. Alternative investments are only available to qualified investors and are not suitable for all investors. Alternative investments include risks such as illiquidity, long time horizons, reduced transparency, and significant loss of principal. This material is an investment advisory publication intended for investment advisory clients and prospective clients only. Robertson Stephens only transacts business in states in which it is properly registered or is excluded or exempted from registration. A copy of Robertson Stephens' current written disclosure brochure filed with the SEC which discusses, among other things, Robertson Stephens' business practices, services and fees, is available through the SEC's website at: www.adviserinfo.sec.gov. © 2022 Robertson Stephens Wealth Management, LLC. All rights reserved. Robertson Stephens is a registered trademark of Robertson Stephens Wealth Management, LLC in the United States and elsewhere.