

August 22, 2022 – Investment Commentary

Markets Dominated by the Macro

Paul Volcker, during his tenure as Federal Reserve chair (1979 to 1987), is viewed by many as the economic warrior who defeated double-digit inflation. Quoting Volcker, “Vacillation and procrastination, out of fears of recession or otherwise, would run grave risks.” While the Investment Office agrees with many market participants that the direction of travel for inflation will be lower, the path from 9% to 5% may be easier, and faster, than the journey from 5% to the Fed’s goal of 2%.

Some have criticized Powell's Fed for not moving sooner to tackle inflation, now running at 8.5%. But Powell is raising rates to conquer high inflation. However, this time is different from Volcker's regime for several reasons including our belief the markets aren't adequately focused on the consequences of a \$9 trillion balance sheet runoff or potential outright sales. Volcker did not implement Quantitative Easing (injecting liquidity and buying bonds) or Quantitative Tightening (reducing the supply of money in the hopes of slowing inflation and raising rates). This concern increases especially as the Fed starts ramping up in QT in September as currently planned. As a result, the Investment Office anticipates higher volatility as QT is going to take liquidity out of the system.

Markets whacked by the Fed's rate increases in the first half of the year have recently been moving upward. The S&P 500 is up ~ 17% from its mid-June low. The yield on the 10-year U.S. Treasury note, which is used to help set rates on debt such as mortgages and influences attractiveness of risk assets is down more than half a percentage point from its June peak. Even pummeled cryptocurrencies, speculative tech and meme stocks have appreciated. The market rebound reflects a belief in part that inflation has peaked and rates will go down sometime next year. We believe an expectation the Fed will start cutting interest rates in the first half of next year may be too optimistic. Ironically, the decline in credit spreads and appreciation of stocks is leading to looser financial conditions, slowing the central bank's efforts to tackle inflation.

For decades, investors have put their faith in the “Fed put,” the belief that when markets fall substantially, the Fed will lower interest rates, purchase bonds or otherwise increase liquidity in the financial system. The belief dates to the 1980s and by the time Chair Greenspan left the Fed in 2006, investors had come to expect the Fed would always be there to provide support. We see the Fed eventually pivoting on policy, but not as quickly or as much as the market is expecting.

Portfolio Implications

In such an environment we think it's prudent to search for investment opportunities where portfolio allocations can be rewarded appropriately for the various rapidly changing macro regimes including stagflation, recession and soft-landing. For example...

- In fixed income, focus on 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

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