

August 29, 2022 – Investment Commentary

Powell Fed Chair and Chief “Bull Market” Fighter

Amid policy-induced volatility, last week the S&P 500 declined 4.0%, the Nasdaq fell 4.4% and the Dow fell 4.2%, while the Stoxx Europe 600 lost 2.8%. The U.S. 10-year Treasury yield increased 7bps for the week to 3.0% and 2 year yields remained flat. The 3-Month Treasury Bill yield has moved up to 2.78%, its highest level since January 2008. It entered the year at 0.06%. Interestingly, and consistent with the decoupling that has developed between government bond and stock markets, Treasury yields ended the Fed Jackson Hole speech roughly unchanged.

Why have stocks and bonds reacted so differently? One possible interpretation: the bond market does not believe short rates will be lifted much beyond the projected path, however hawkish (means the Fed will prioritize lowering inflation and likely will raise interest rates despite the potential loss of economic growth and increased unemployment) the Fed may sound. The bond market is positioned behind the belief that either inflation had peaked, or the economy will soften enough to warrant a pause and Fed policy pivot to decrease rates in 2023. However, the stock market is disappointed with the lack of a credible Fed policy framework under Chair Powell who over-tightened in 2018, over-stimulated in 2021, and now is trying to emulate Paul Volcker (refer to Investment Office weekly commentary dated 8/22/22). Regardless the reason, the inconsistency between stocks and bonds will be corrected over time and the question is with how much volatility. The Fed initially discussed a soft landing with transitory inflation expectations and evolved its forecast to a “softish” landing and now seems committed to contain inflation, where the markets will need to accept the consequences of that potential hard landing. The Investment Office believes the Fed is likely to err on the side of raising rates too much, rather than too little, because tolerating excessive and persistent inflation would represent a much greater reputational failure for the central bank. The Investment Office is especially focused on the \$9 trillion balance sheet portfolio reduction wild card and its unknown impact on liquidity and rates as September monthly caps increase in the amount of Treasuries and holdings of mortgage-backed securities that it will let mature to \$60 billion and \$35 billion, respectively.

Recession Possibility

On August 15, 2022 the Investment Office published a cautious view “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 ...”. Last week, world stocks slumped as the growing risk of more aggressive interest rate hikes in the United States and Europe pushed the dollar to new 20-year highs, just as recession fears mount. The yield curve recession-watch 10 year-3 month US Treasury spread however narrowed by 8 bps and 10 year-2 year US Treasury spread dropped another 10 bps. The 10 year-2 year is now -36bps, and the 10 year-3 month at 20 bps still maintains its course heading for a recession. The Investment Office continues to monitor the Italian Government BTP vs. German Bund sovereign spread which rose 5bps to 2.32% indicating further European economic stress. The current transmission mechanism of European stress to the U.S. is through U.S. natural-gas futures which skyrocketed to 14-year highs as uncertainty increased about European sourcing. Prices may even go higher with persistent extreme weather and further comments from Saudi Arabia’s Energy Minister which recently announced that OPEC+ may be forced to cut production to stabilize global oil markets.

Portfolio Implications

The long period of low inflation, suppressed volatility and easy financial conditions is ending. This new foreseeable period is a material shift after a decade in which central bankers worried more about the prospects of anemic economic growth and too-low inflation, and used monetary policy to spur expansions. Relative to the past decade, both the U.S. and the rest of the world are still not cheap. The only thing we've really done is go back to pre-pandemic levels. But the macro backdrop is vastly different from then with high inflation, monetary tightening, geopolitical stress, etc. With increasing rates on Treasuries and cash equivalents, we believe investors are now expecting higher returns elsewhere, which would lead to lower valuations on equities and wider credit spreads.

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 private credit managers with stressed/distressed European investment expertise.

Disclosures

Investment Commentary Sources: Bloomberg and Morningstar

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