

October 3, 2022 – Investment Commentary

Market Volatility

As noted in many prior weeks, market volatility has been a prominent feature. And while volatility is a characteristic of the equity market, investors are now anxious about the elevated volatility in sovereign debt (e.g., U.K. Gilts) and U.S. Treasury markets. We believe the Fed will continue its path of raising rates until it tackles inflation and will only pivot beforehand if there is deep foreign financial market contagion, massive market liquidity issue, or material credit market disruption. September was a challenging month for financial markets. Last week started with a fresh reminder about the geopolitical energy situation in Europe after leaks in the Nord Stream 1 and 2 pipelines. It was a volatile week for U.K. Gilts, particularly at the long end. The 30yr Gilt hit an intraday high above 5% (Wednesday) for the first time since 2002 (and at a level it has not consistently been above since 1998), before a statement from the Bank of England (BoE) confirmed it would effectively restart purchasing its debt via quantitative easing (Q.E.) to help yields to recover. The 30yr Gilt yield ended the week at 3.83%, more than 130bps below the high.

The intervention from the BoE seemed to help sovereign bonds across the world. Yields on 10yr Treasuries had been trading just above 4% immediately before the intervention. They fell as low as 3.68% before ending the week at 3.83%, with Wednesday seeing the largest daily move lower since the large intraday swings we experienced in March 2020 when the Fed stepped in to buy Treasuries and mortgage-backed securities (MBS) in unlimited size.

In terms of data releases last week, **Eurozone CPI hit double-digits for the first time ever**, coming in at 10% (vs. 9.7% expected). A major contributor to the higher figure was September's German CPI, which rose to +10.9% (vs. +10.2% expected). **This marks the first time since 1951 that German inflation has been running in double digits.** Earlier in the day, the German government announced that it will borrow another €200bn to cap gas prices. These elevated inflation levels will keep the pressure on the ECB, with markets continuing to price in another 75bps hike as the most likely outcome at the October meeting.

Equities finished last week down for a third consecutive week. While the S&P 500 had a brief reprieve mid-week as government bonds rallied, it finished the week down nearly 3% and at its lowest level since late 2020. In Europe, the Stoxx 600 ended the week off from the lows but was still down on the week (-0.65%). U.S. equities finished the month down 9.3%, developed ex-U.S. equities declined 9.5%, and emerging market equities retreated 11.5%. Also, for the month, the two-year Treasury yield increased 0.79%, and the 10-year Treasury yield jumped 0.64% as investors expected increasingly more rate hikes. Stickier-than-expected inflation (e.g., wages, services, rents) and hawkish central bank rhetoric, along with concerns about slow economic growth, drove stock declines.

The S&P has dropped 25% year to date. This has happened twice in the last 15 years, during the Global Financial crisis (~50% drawdown) and the pandemic (~35% decline). Equity market volatility also remained elevated, with the VIX "fear gauge" index closing above 30 every day last week. **The VIX has finished above 30 on nearly 19% of trading days this year, the fourth most in the last 20 years, only behind the crisis years of 2008, 2009, and 2020.** The count hides how skewed the distribution is where in ten of those last 20 years, the VIX never once finished a trading day above 30.

Let's Keep it Real

As previously published by the Investment Office, markets have been retreating, partly due to the sharp increase in rates based on the combined inputs of the nominal 2-year and real 10-year. **Global equities doubled in value between the March 2020 shock of the pandemic and the end of 2021, as real rates went negative. Global equities are down almost 35% from their peak and many speculative long-duration tech growth stocks that are most exposed to rising rates are down 70% or more.** As a reminder, a real interest rate equals the observed market interest rate adjusted for the effects of inflation.

The headwinds of tighter liquidity conditions (e.g., higher risk-free rates) are depressing P/E multiples and widening credit spreads complicated by slowing growth expectations weighing on margins and earnings. At the core of the market volatility is the question of how much to reprice risk with the return of positive real rates. In terms of the housing market, rising rates encourage homeowners with lower rates to stay in place. According to Redfin, 85% of all homeowners with mortgages had rates below 5%. An increase in mortgage rates to 7% or above would further shrink the number of owners with a financial reason to move. Therefore, we believe the anticipated dramatic decrease in home sales volume will not necessarily translate to an equivalent percentage decline in home prices.

Investment Outlook and Portfolio Implications

Currently, the Investment Office does not anticipate a change in the Fed policy response. As a result, we do not anticipate a change in market dynamics, including yield curve inversion, where short-term rates are higher than long-term rates. Markets are realizing that Powell's muse seems to be Clubber Lang (Mr. T) from Rocky III where his prediction for the fight was "pain," and the Fed is no longer your friend providing extraordinary policy support like the Global Financial Crisis (GFC) and Covid pandemic uncertainty periods. The environment is different this time with a stronger economy, stronger consumer, and stronger corporate demand.

We continue to remain cautious. From a tactical perspective, we favor a more modest risk profile and a more defensive posture in the near term. This includes high-quality bonds and equities that can potentially generate positive cash flow, current dividends, and resilient growth in a slowing environment. We also believe that, for qualified purchasers, certain alternative strategies may be suitable complements to the traditional core public holdings.

It's only natural for investors' behavioral biases to seep into their decisions. However, amid volatile times like these, it's essential to temper these inclinations with a historical perspective and sound outlook grounded in a rigorous, process-driven portfolio construction framework. Remember that volatility is a feature of investing and that markets have bad months, quarters, and years. **Current conditions matter, but history is typically a good starting point for evaluating where things may go over longer time periods. For example, the average one-year S&P 500 equity return since 1950 when the drawdown range year is between -25% to -30% (measured from the highest level in the past year) is +19.6%.** These are averages, and there's a big range of individual outcomes around each one, but the historic averages help the case to "stay invested." **Additionally, there is now "income" in fixed income where certain quality municipal portfolios offer positive 5-6% tax equivalent yields.** Ultimately, we believe investors need to recognize portfolio performance will be more dependent upon fundamentals when compared with the past decade when portfolios were supported by fiscal and monetary excesses.

Disclosures

Investment Commentary Sources: Bloomberg and Morningstar

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