FIRST word on the market

by Yellow Cardinal Advisory Group

MARKET UPDATE

September 2022

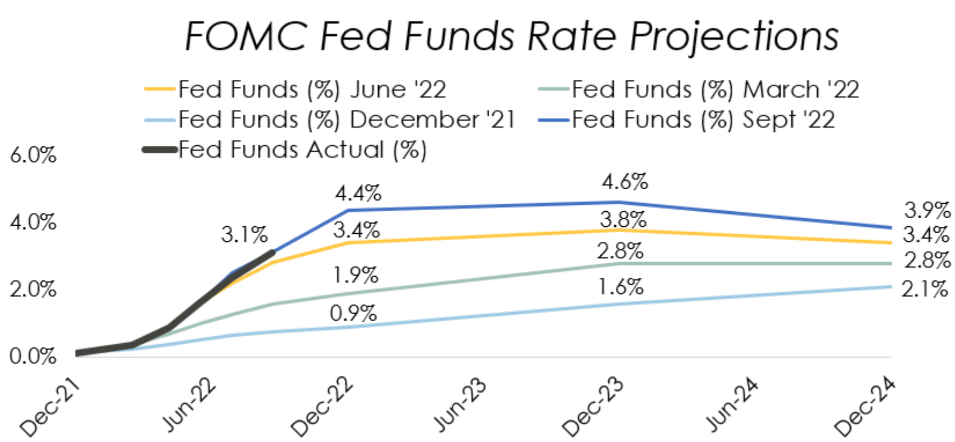
From Fire Bug to Fire Fighter

"...We have got to get inflation behind us. I wish there were a painless way to do that, there isn't." – Jerome Powell (FOMC Press Conference 9/21/22)

In the forestry service, controlled burns are often used to rid a forest of dead leaves and debris that can help prevent a more destructive wildfire in the future. In so doing, controlled burns can breathe new life into the ecosystem by reducing pests and invasive plants, returning nuturients to the soil and creating space for more sunlight. More proaction leads to less reaction.

A well known investment strategist has previously referred to the Fed as both pyromaniac and firefighter alike. While its easy to be a Monday morning quarterback, its hard not to argue that the Fed overstayed its welcome in being ultra-accommodative in light of the fiscal backdrop. Filling the punch bowl when the party is dull also means taking it away before things get out of hand. We think the Fed's mistep was less the former and more the latter. <u>In essence, the Fed failed to clear the debris before the wildfire of inflation erupted and is now working hard to existinguish it.</u>

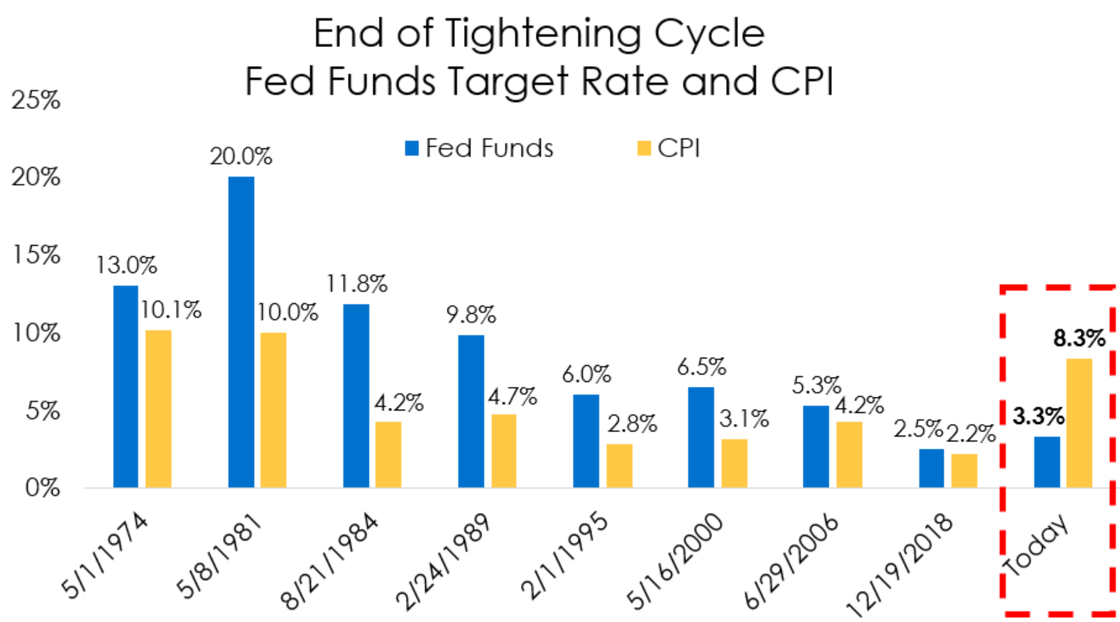
This was on display in September when the Fed announced another 75 basis point (0.75%) rate hike taking its Fed Funds rate to 3.0-3.25% – a level not seen since January 2008. <u>The Fed's forecast for additional rate hikes was effectively raised by another 100 basis points (1.0%) to a peak Fed Funds of 4.5-4.75% expected by YE23.</u>



Source: FOMC; Projections for the Fed Funds rate are the value of the midpoint of the projected appropriate target range for Fed Funds at the end of the specified calendar year. Projections are based on the Fed forecasts at the December 2021 meeting, March 2022 meeting, June 2022 meeting and September 2022 meeting. December, March and June meeting projections are smoothed from starting point to 2022 YE projection.

As can be seen in the chart above, the Fed has been racing to catch up to inflation with Fed rate hike projections that have increased significantly from December of last year. <u>Incredibly, policymakers now expect the Fed Funds rate to be 350 bps (3.50%) higher by the end of this year than was initially projected last December.</u>

And yet the current Fed Funds rate is still 500 bps (5.0%) behind the latest headline inflation number. As can be seen in the chart below, we think its noteworthy to reiterate that, historically, the Fed isn't done tightening until the Fed Funds rate is above inflation. That's not to suggest that the Fed Funds rate needs to necessarily move up to 8.3% so much as it is to suggest that we need inflation to cooperate if 4.5-4.75% is the peak in Fed Funds.



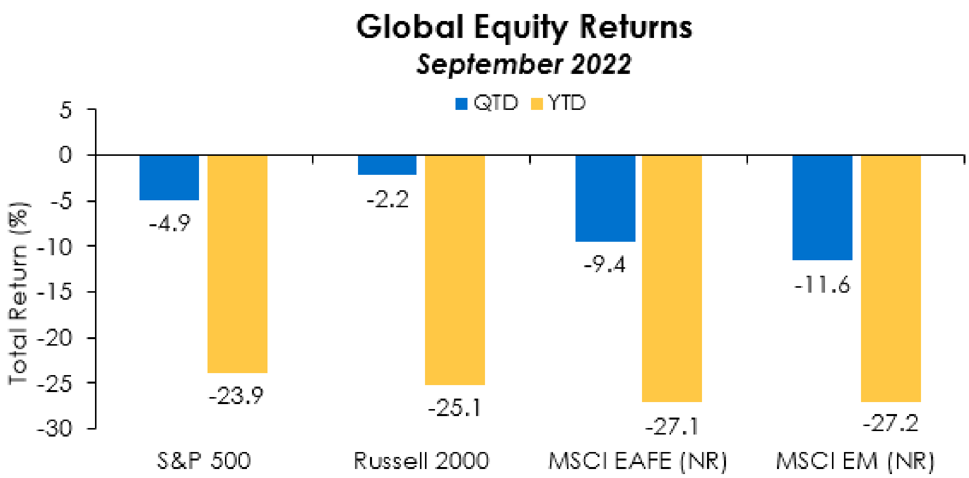
Source: Strategas Research Partners

The key takeaway from the Fed's shift in tone and action of late is that policymakers are more resolved to restore price stability at whatever the economic cost. Gone are the days of tap dancing to a soft landing. In fact, Fed Chair Powell's quote on the prior page was notable in that he more overtly acknowledged that a hard landing is likely required to lower inflation – particularly – in the labor market which remains extremely tight. As markets come to grips with the notion that the cure for pain might be more pain, expectations are being reset with regards to both the growth and valuation framework. Ultimately, some bad tasting medicine is required to make this happen. The Fed is now trying to extinguish the flames.

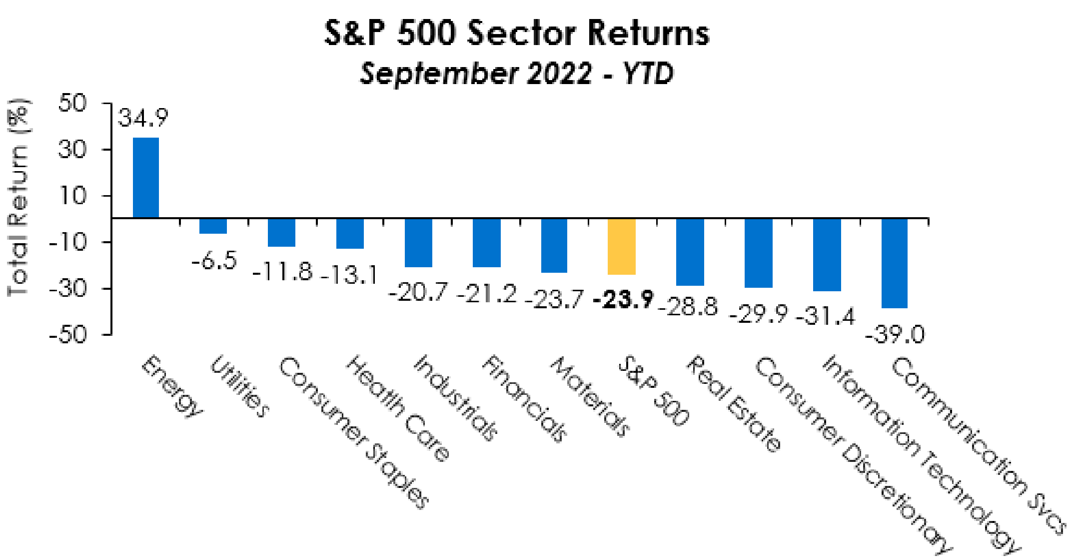
The goods news is that late cycle business conditions are likely to lead to a natural moderation in growth and inflation such that the latter may not be the biggest issue the market faces going forward. The bad news is that the risk of inflation may now be supplanted with the increased risk of recession. Just as a controlled burn has the benefit of breathing new life into a forest, so might a recession lead to an improved inflation and growth setup. We remain of the opinion that we're decidedly late cycle with the potential for a profit and/or economic downturn still ahead of us. At the same time, we're watchful for the green shoots that an early cycle often requires – the combination of a Fed easing cycle with a reset of the fundamental and sentiment backdrop.

After heady returns for risk assets in 2021, performance reversed course in most of these areas thus far in 2022. The S&P 500 posted negative returns in 6 of 9 months this year – including a poor September – leading to the weakest 12 month stretch since August of 2009. Year-to-date, commodities remained the bright spot while Stocks and REIT's saw valuation compression. Meanwhile, Bonds were pressured given high inflation and rising interest rates.

Stocks

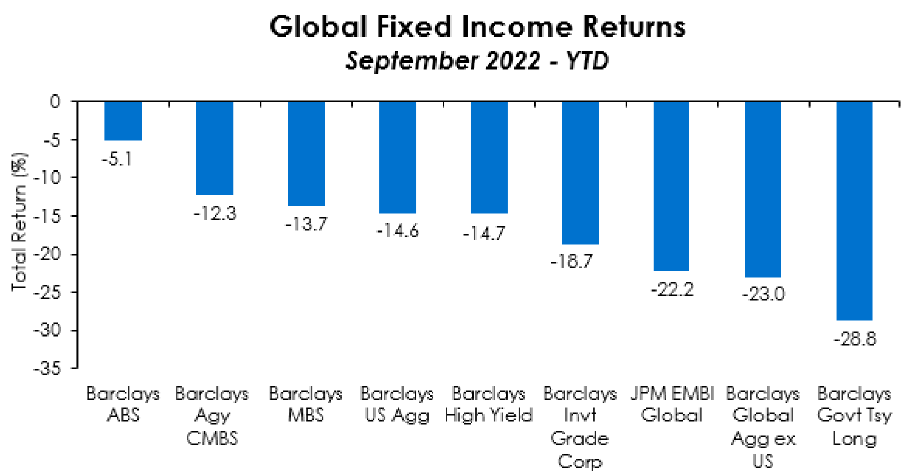


Stocks posted a weak third quarter as upside in July was more than offset by weakness in August and September. Year-to-date, domestic markets (S&P 500 and Russell 2000) are outperforming international markets (MSCI EAFE and MSCI EM) as signficant appreciation in the dollar and geopolitical risk have been incremental headwinds in the latter. Only one sector within the S&P 500 has posted positive returns for the year thus far. Outside of the "risk on" rally from mid June to mid August, sector performance has generally favored the less expensive, late cycle cyclicals (Energy, Industrials, Financials and Materials) along with traditionally defensive sectors (Utilities, Consumer Staples and Health Care). Higher priced, early cycle sectors (Discretionary, Technology and Communication Services) along with Real Estate were down the most.



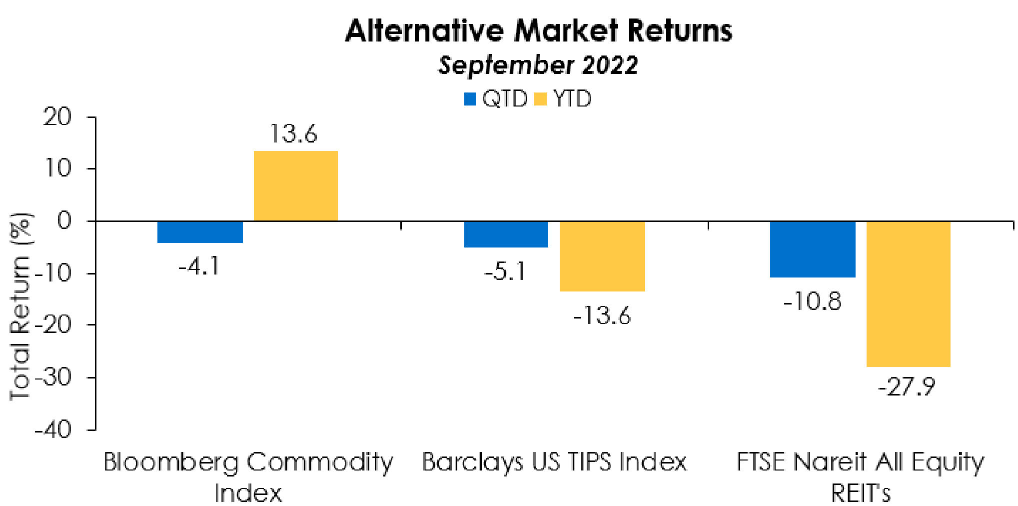
Bonds

For the year, bond returns remained in negative territory amid the continuation of an upward rate bias consistent with elevated and persistent inflation. As such, the Fed has hiked short term rates by 300 basis points (to 3.0-3.25%) and began reducing its balance sheet. While the Fed fights inflation as growth expectations slow, the yield curve has flattened with an inversion between the 10-2 Year. Fed Fund futures pricing now appears to be roughly in line with Fed forecasts for a peak Fed Funds rate between 4.5-4.75%. Year-to-date, bonds that carried shorter durations – namely Securitized Assets (ABS, MBS, CMBS) – were better insulated. After holding steady for much of last year, credit began to move wider in November (Omicron) and again year-to-date (Fed and Russia) to levels not seen since mid year 2020. High Yield outperformed relative to Investment Grade corporate bonds given higher carry and shorter duration positioning. The most duration sensitive areas including long-term Treasury bonds and Emerging Market Debt (Govt Tsy Long and JPM EMBI Global) were among the hardest hit. Long duration Treasuries remain sensitive to Fed policy, inflation and currency flows while International bonds have been hit by the material strength in the dollar.



Alternatives

Alternatives posted the most disparate of returns year-to-date. Publicly traded Real Estate (REIT's) remained under pressure with returns comparable to Stocks. Meanwhile, Commodities posted among the best (and positive) returns – acting as a strong inflationary hedge with particular strength in Energy and Agriculture.

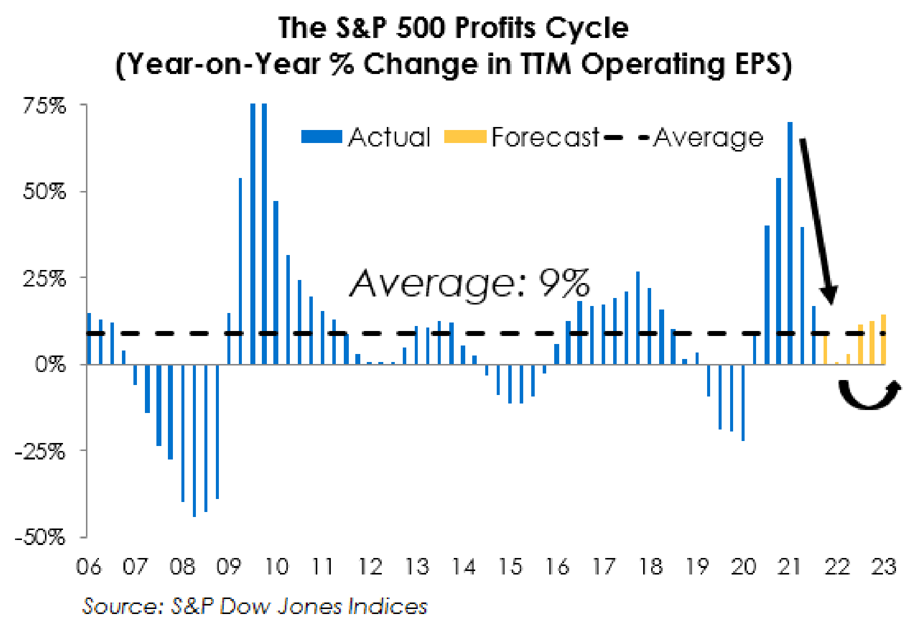


Market Outlook

"It's tough to make predictions, especially about the future."

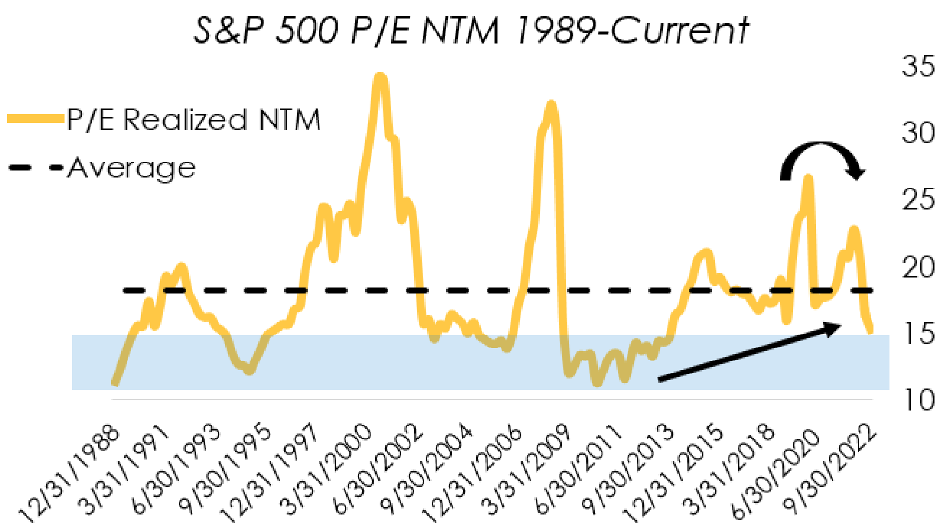
– Yogi Berra (1925-2015)

Right now, we think it's especially important to have two frameworks for managing portfolios. The cyclical perspective is an attempt to assess where we are in this particular business cycle while the secular perspective evaluates where the structural tendencies might be over multiple business cycles. The cyclical landscape will ebb and flow with the secular one and there may be times – like now – when both views diverge. From a secular perspective, we remain sympathetic to the notion that the economic paradigm is changing to one that ushers in more persistent inflation in a higher cost of capital world. But as growth begins to slow at a quickening pace, we think the secular view takes a back seat to the cyclical one for a bit of time. Let's discuss.



From a cyclical perspective, we've used the phrase "Moderate Resilience" as a way to best describe the fundamentals. It's clear that growth is moderating and is expected to continue to do so as the cycle matures. However, in the first half of the year, growth in nominal terms has been somewhat resilient given the lagged effect of well above average liquidity from last year. In essence, companies have raised prices on goods and services with minimal consumer demand destruction because of the influx of cash from the prior two years. That may be starting to change as the Fed continues to tighten policy and as savings rates have dramatically declined. In short, liquidity is being drained from the system which leads to slowing growth at a quickening pace. As we look into 2023, the question might be whether the emphasis will be more on moderation or resilience. In other words, will late cycle conditions lead to a "pause and refresh" or a "profits/economic recession"? As can be seen in the chart above, the consensus believes in the "pause and refresh" story. Given the late cycle setup, we think the risk is to the downside for earnings estimates especially in the absence of an obvious catalyst for growth reacceleration.

Another way to frame up the outlook – from a market perspective – might be to consider it a tale of two halves with the first half focused on valuations and the second half focused on the fundamentals. We think it's noteworthy to highlight that virtually all of the S&P 500 market decline in the first half of this year was attributed to a valuation reset. Forward earnings estimates were resilient but the high inflation backdrop resulted in the need to take valuations lower. Within the context of history, this is very normal. Since 1950 there's been an indirect relationship between the inflation tranche and the S&P 500 Price to Earnings (P/E) ratio. That's because investors typically aren't willing to pay as much for a stock when inflation is higher given that earnings growth is often viewed as lower quality in nature. While we've made good progress in resetting valuations, we still think there may be a little more to go. As can be seen in the chart at left, based on consensus earnings, forward earnings multiples are just getting down to the top end of the range where they've typically bottomed over the past 30 years (15X vs 10-15X). Looking back even further suggests that multiples tend to fall near the lower end of the range in higher inflation environments.



Source: Factset; S&P Dow Jones Indices. P/E NTM calculated using S&P 500 realized operating earnings over the forward 12 month period. Forecasted earnings are based on bottom up S&P Dow Jones estimates used in P/E measures beginning 9/30/21.

So what about the fundamentals? As the cycle matures, we think nominal growth is set to slow at a quickening pace in the back half of the year. Most of the macro fundamental data is evidencing a slowdown and our leading profit cycle indicators point to a notable growth deceleration ahead.

As can be seen in the table at right, if forward earnings estimates prove to be too optimistic and need to fall 5-10%, then stocks might be more expensive than they appear (16-17X vs 15X).

Heavier Lifting Ahead

	NTM EPS	NTM P/E
-10%	$213	16.8
-5%	$225	15.9
Current	**$237**	**15.1**
5%	$249	14.4
10%	$261	13.8

Source: Factset; NTM EPS based on ishares S&P 500 ETF.

In short, we think investors have to contend with three headwinds right now (1) valuations that might still have to reset a little further (2) earnings that may prove to be too optimistic (3) and a Fed that is aggressively tightening to catch up to inflation. All of this is to suggest that, not surprisingly, it doesn't appear to be a great set up for risk assets from a cyclical point of view.

We've seen this reflected in the currency markets of late as well. The US dollar has rallied more than 20% over the last twelve months as currencies elsewhere have fallen sharply. Policymakers in these countries are now having to intervene in order to defend their currencies. Nowhere was this on more display than in the UK this past month – where the pound fell in dramatic fashion. Policymakers there exacerbated the situation by announcing stimulative (unfunded) tax cuts which is at odds with the Bank of England's tightening policy to address inflation. Effectively, this is similar to pressing on the gas and brake at the same time – not ideal. We think this is yet another example of why investors should be thinking about ways to reduce risk as a consequence.

So what are the implications and key takeaways for portfolios?

From a portfolio positioning perspective, we continue to believe that it's important to acknowledge both the cyclical and secular perspectives. To us, that means managing the overall exposure and mix of risk assets consistent with a maturing cycle (i.e. Cyclical) while also being cognizant of the continued need for pro-inflationary tilts (i.e. Secular). More recently, we've given an increased weight to the cyclical over the secular as we've reduced portfolio risk. Broadly, this involved (1) reducing risk assets to a modest UW by trimming Stocks and REIT's and adding to US Bonds (2) lowering the beta within US LC Equities by trimming our OW to Cyclical Value sectors and adding to our OW in Defensive sectors (3) lowering the beta within US Bonds by lengthening duration back to a net long posture. In essence, we continue to downshift risk in portfolios with a (lessened) pro-inflationary bias given the late cycle setup.

Within equities, our positioning is modestly UW and continues to favor a pro-inflation preference with a value sector tilt while also leaning toward the more traditionally defensive sectors (Staples, Health Care, Utilities) within our US LC exposure. We continue to be decidedly UW the most expensive, cyclical growth areas (Tech, Discretionary, Communication Services).

Within fixed income, we remain UW the most cyclical parts of the bond market (High Yield and Emerging Market Debt) while our US Core Fixed Income exposure remains among our biggest OW in portfolios. Our US Core Bond managers are modestly OW corporate bonds, though we've recently moved up in credit quality by adding some Treasuries and lengthening duration consistent with a downshifting of risk in portfolios.

Within alternatives, we're OW in aggregate with a bit more defensive skew. We remain the most OW to Diversified Alternatives which provides some hedge against market volatility. We are more modestly OW to Commodities as a way to bolster inflationary hedges. Meanwhile, Real Estate was trimmed of late as a way to further reduce overall portfolio risk.