Refilling the Punch Bowl?

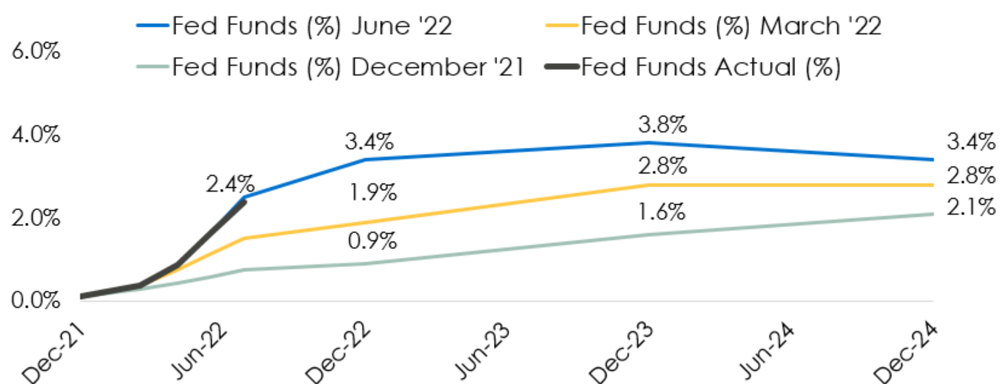
The job of the Fed is "to take away the punch bowl just as the party gets going."

– William Chesney Martin (Fed Chair 1951-1970)

Everyone likes a good party. That is everyone, historically, but the Fed. The FOMC Chair with the longest running tenure – William Chesney Martin – was credited with aptly describing this policy making body as being the responsible adult at the party (see quote above). As many people debate this Fed's sensibility, one well known strategist recently quipped they have become both pyro-maniac and firefighter alike.

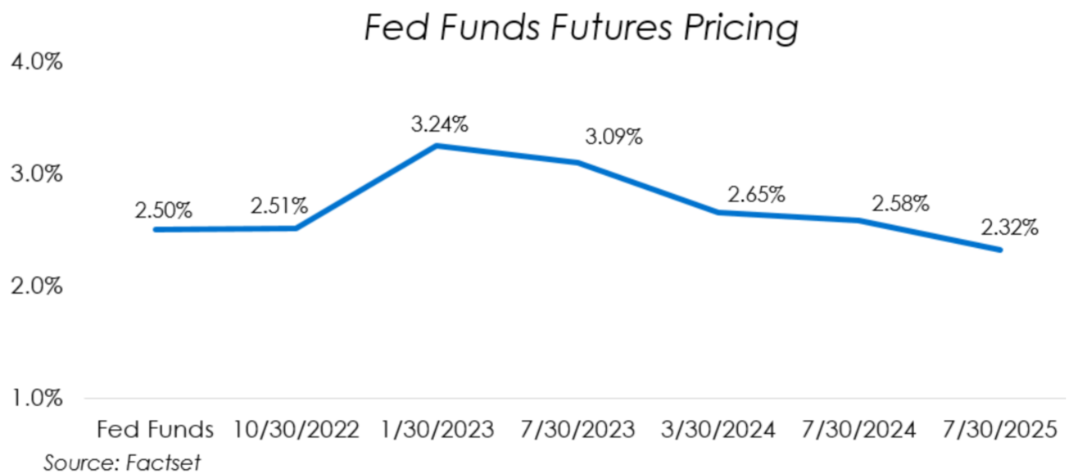
Recent action in the financial markets are suggesting that the Fed is likely to refill the proverbial punch bowl. This would seemingly mean the Fed's "put" is back in play – a phrase often used to convey when the Fed has pivoted to a loosening of financial conditions, thus, providing a floor for risk assets.

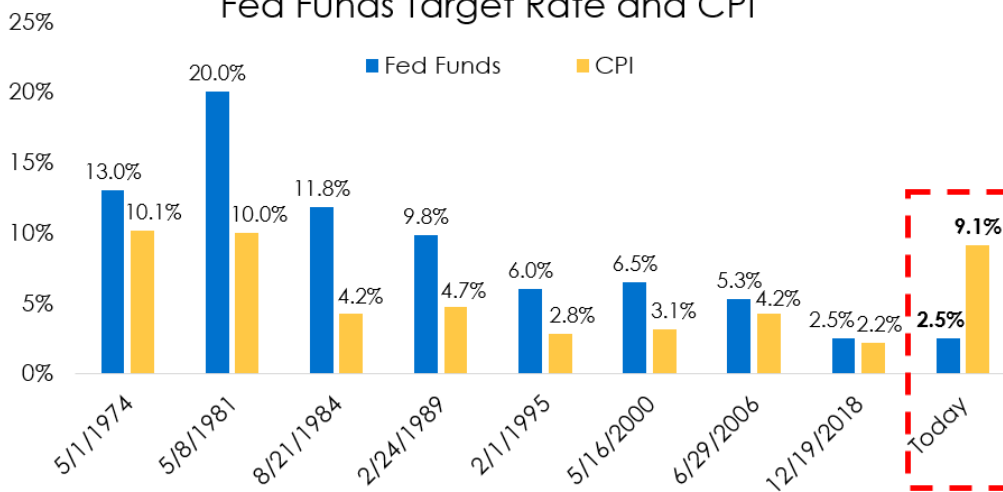
After another 75 basis point (bps) rate hike at the recent Fed meeting this month, many investors are convinced that a Fed pivot might be coming by early next year. This despite the fact that the Fed has aggressively taken up rate projections from their prior forecasts. As can be seen in the chart, the current Fed Funds rate – at around 2.4% – has risen sharply since last year with policymakers still not forecasting a peak rate (of around 3.8%) until the end of next year.



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 and June 2022 meeting. December, March and June meeting projections are smoothed from starting to point to 2022 YE projection.

Signaling in the financial markets in July suggests that investors are questioning the Fed's projections. Following this month's meeting, Fed Chair Powell stated that future rate hikes would be data dependent and at some point it would "likely be appropriate to slow the pace of increases while we assess cumulative policy adjustments." This further emboldened investors to anticipate a reversal in Fed action. Higher priced cyclical growth stocks – more sensitive to rate moves – have rallied and the Fed Funds futures pricing remains less aggressive than Fed forecasts. As can be seen in the chart above, the futures market is projecting the peak Fed Funds rate to be in the 3.0-3.5% range in early '23 with multiple cuts anticipated thereafter. Not only is this below the Fed's forecast of a peak rate in the 3.5-4.0% range, but the market is anticipating rate cuts a year sooner than the Fed.





That seems a little ambitious to us given the chart at left. Per Strategas Research Partners, in all eight tightening cycles since the '70's, none of them have ended until the Fed Funds rate was above the year over year change in the Consumer Price Index (CPI). Considering the wide gap between today's CPI and the Fed Funds rate, it seems aggressive to forecast Fed cuts as early as the 1H23. Furthermore, we wonder if risk assets should be cheering a rate cut move. After all, wouldn't that imply some pretty ugly fundamental economic conditions? It's enough to make your head spin after too much punch at a party.

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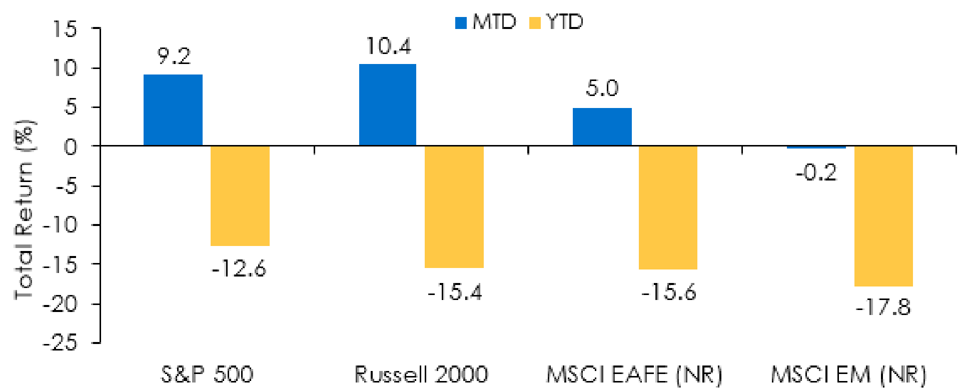
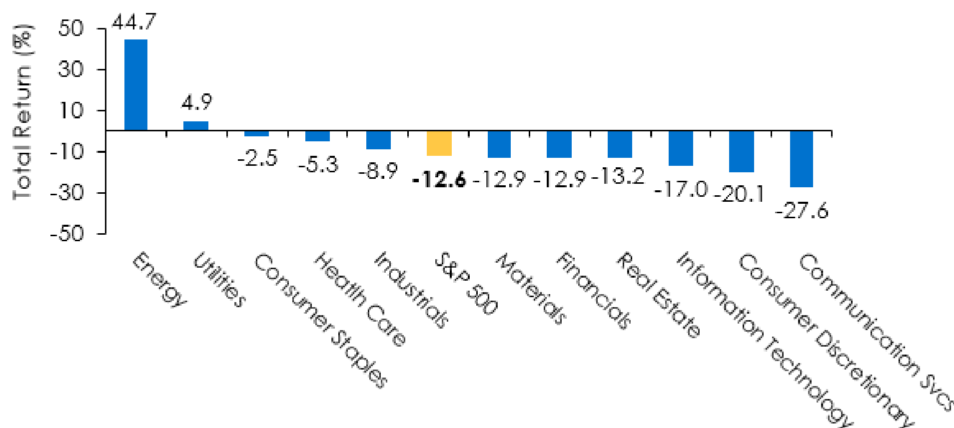
After such heady returns for risk assets in 2021, performance reversed course in most of these areas thus far in 2022. While the S&P 500 turned in its best month since November of 2020, it remains the weakest 12 month stretch since March of that same year. Year-to-date, commodities remained the bright spot while Stocks and REIT's saw valuation compression. Meanwhile, Bonds were pressured given high inflation and rising interest rates.

Stocks



Stock returns have suffered for the majority of this year, despite turning in a strong month of July. Year-to-date, domestic markets (S&P 500 and Russell 2000) are now outperforming international markets (MSCI EAFE and MSCI EM) as signficant appreciation in the dollar and geopolitical risk have been major headwinds in the former. Only two sectors within the S&P 500 have posted positive returns for the year thus far. Sector performance was influenced by valuation and inflation. Higher priced Cyclical Growth sectors (Discretionary, Technology and Communication Services) and Real Estate were down the most while the less expensive Cyclical Value sectors (Energy and Industrials) outperformed alongside the more traditionally Defensive sectors (Utilities, Consumer Staples, Health Care). As financial markets anticipated a Fed pivot, however, many of the year-to-date trends reversed in July leading to a counter trend cyclical growth rally.



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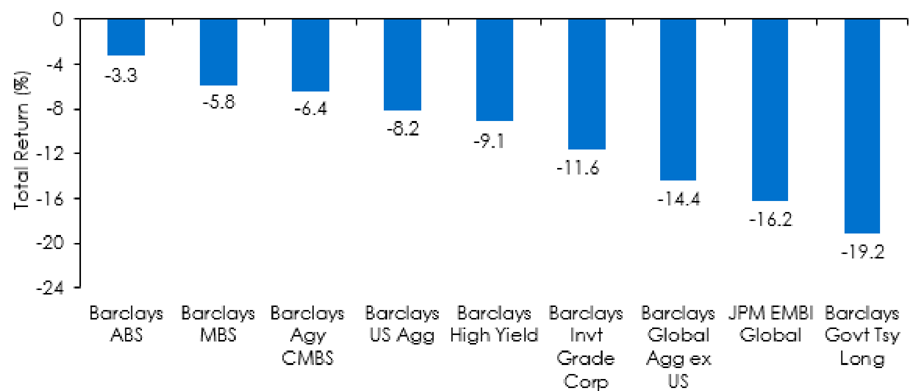
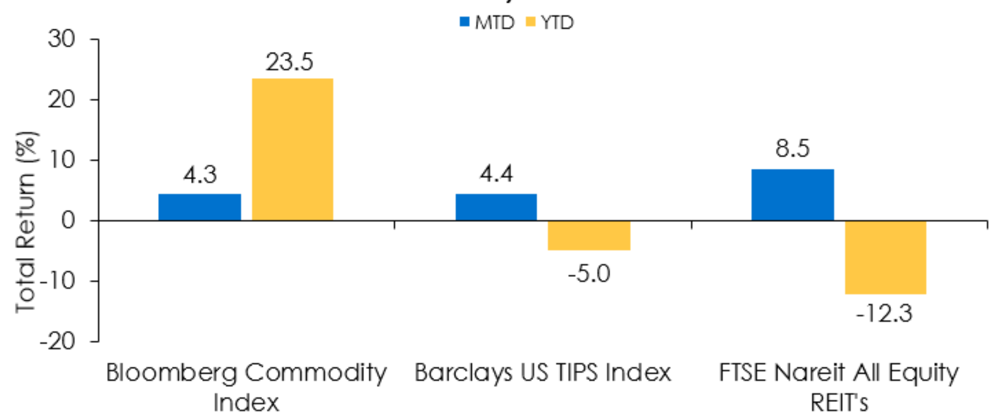
Bonds

For the year, bond returns remained in negative territory amid the continuation of an upward rate bias consistent with elevated and persistent inflation. The last few months, however, saw a modest reprieve as inflation data leveled off and inflation expectations moderated. Meanwhile, the Fed has hiked short term rates by 225 basis points (to 2.25-2.50%) and began reducing its balance sheet. Both of these dynamics led to a re-inversion of the yield curve (10-2 Year) as the Fed fights inflation while growth expectations slow. 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 the middle of 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 though there was some reversal in the former in the second half of June continuing into July.



Alternatives

Alternatives posted the most disparate of returns year-to-date. Publicly traded Real Estate (REIT's) remained under pressure (notwithstanding this month's bounce back) – 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 – though returns softened some in 2Q on more pronounced profit taking especially in June.



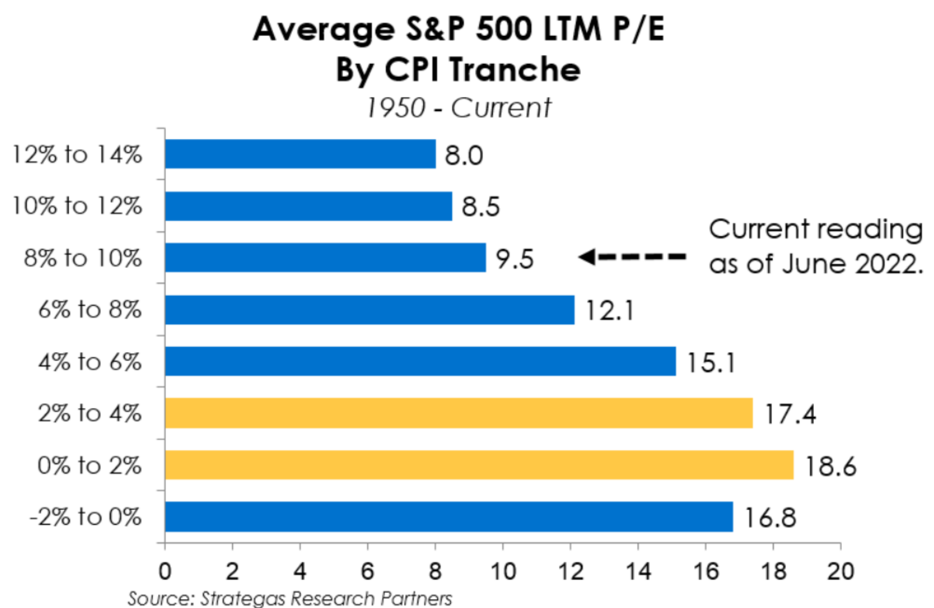
Market Outlook

"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 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 still think the phrase "Moderate Resilience" might best define the fundamentals. It's clear that growth is moderating and is expected to continue to do so as we move through the remainder of the year as the cycle matures. However, in the first half of the year, growth in nominal terms has been somewhat resilient given the combination of inflation with the lagged effect of well above average liquidity from last year.



Another way to frame up this 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 six months 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. As can be seen in the chart above, the higher the inflation tranche, the lower the S&P 500 Price to Earnings (P/E) ratio. That's because investors typically aren't

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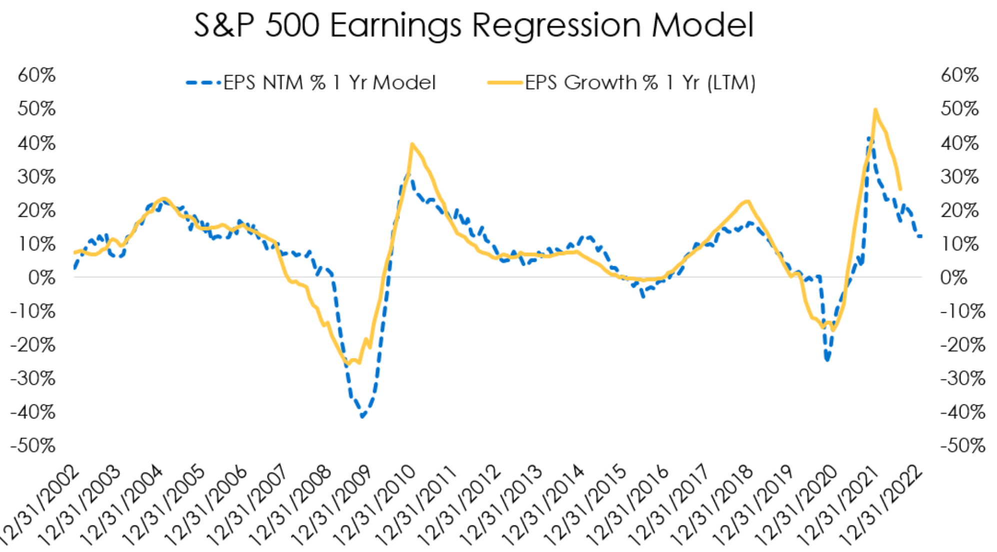
willing to apply the same (lower) multiple to a stock when inflation is higher given that earnings growth is often viewed as lower quality in nature. While valuations have come down from where they were to begin the year, we still think multiples have further to go if history is any guide. Note that inflation is still currently running in the tranche that implies an S&P 500 multiple of 10X (LTM) compared to today's 19X (LTM). To be clear, we don't expect inflation to stay in the 8-10% tranche – as we think it's likely to moderate given our comments below. But we also don't think it's likely to go back to the 0-2% tranche implied by current market valuations given our secular view.

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. As can be seen in the chart at right, our leading profit cycle indicators point to a noteable growth deceleration ahead. Meanwhile, forward earnings estimates have stayed fairly resilient in the first half of the year with consensus currently expecting 8% growth for next year. If earnings estimates begin to peak in the back half of this year, that means that consensus earnings may be too optimistic for next year and the equity markets might have to do more work to hold down the P/E ratio.



Source: Factset; Yellow Cardinal Research. EPS Growth Model is a proprietary regression model based on economic inputs that are found to be good predictors of the S&P 500 profit cycle with a 6 month lead time.

Heavier Lifting Ahead

	NTM EPS	NTM P/E
-10%	$215	19.2
-5%	$227	18.2
Current	**$239**	**17.3**
5%	$251	16.5
10%	$263	15.7

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

As can be seen in the table at left, current next twelve month (NTM) earnings estimates for the S&P 500 may have peaked as numbers have recently come down from $241 to $239. The NTM P/E ratio is currently 17X – compared to last year's 21-22X. That's improved but if earnings estimates fall 5-10%, valuations go back up to 18-19X. In a stickier inflationary environment, that might require the market to do more to keep valuations down especially when one considers that the S&P 500 multiple (based on next twelve month realized earnings) has typically bottomed at around 14X over the past 30 years.

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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 further reduced portfolio risk earlier this month. That adjustment involved trimming back our OW to Commodities and adding to US Core Bonds while also remixing in the latter by moving up in credit quality and lenghthening duration. We also remixed within equities by shoring up our UW to Emerging Markets – where we view China as a countercyclical given washed out equity and economic sentiment combined with stimulative policy. In essence, we're slighlty UW risk assets with a (lessened) pro-inflationary bias.

Within equities, our positioning is slightly UW and continues to favor a pro-inflation bias with a value sector tilt within our US exposure – along with a quality preference given our add to the more traditionally defensive sectors that was executed earlier this year. We continue to be decidedly UW the most expensive areas.

Within fixed income, to mitigate some portfolio risk, we remain UW the most cyclical parts of the bond market (High Yield and Emerging Market Debt). While our US Core Bond managers are OW corporate bonds, we've recently moved up in credit quality by adding some Treasuries. We continue to carry a shorter duration bias (less interest rate sensitivity) relative to the benchmark but we did recently lengthen duration consistent with a later cycle view. Our US Core Fixed Income exposure remains among our biggest OW in portfolios supplemented by our UW position in International Fixed Income which remains a hedge against a weaker dollar environment.

Within alternatives, we are OW in aggregate and are a bit more defensively skewed. We remain the most OW to Diversified Alternatives which provides some hedge against market volatility. We recently lessened our OW to Commodities though still view it as a way to bolster inflationary hedges. Real Estate was trimmed previously – taking advantage of outsized profits last year.

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