

# Is The Bill Coming Due?

*“That only delayed the presentation of the bill. The bill always came.”*

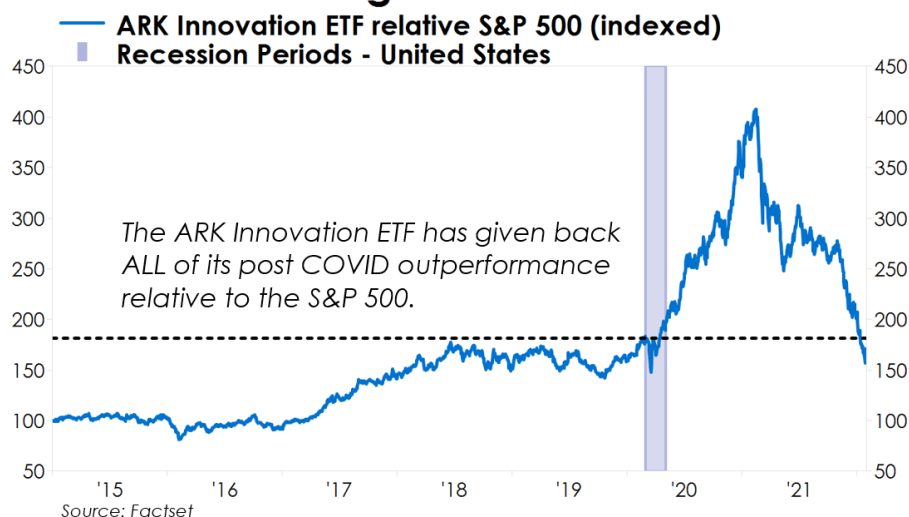
– Earnest Hemmingway *The Sun Also Rises* (1926)

BNPL...“Buy Now Pay Later” is a type of payment plan offered by an increasing number of retailers that allows one to complete a transaction with an installment plan over a specified time (subject to varying terms and conditions). These plans have been around for a while but became especially popular during the pandemic as shoppers shifted to online purchases. The opposite of layaway plans, BNPL is ubiquitous with using credit up front to make a transaction.

We mention this as a way to draw a parallel with the volatile equity markets to begin the year. Post COVID, there was an inordinate amount of attention placed on the “Innovation and Disruptor” companies, those that were seen as transforming the landscape and changing the way the world works through new technologies. Many of the themes tied to these revolutionary technologies (cloud computing, blockchain, artificial intelligence, robotics, autonomous vehicles, space exploration, etc.) were in vogue prior to 2020, but the stocks became particularly desirable as COVID was seen as accelerating end user demand for these services.

There was, perhaps, no better poster child for this than the ARK family of ETF’s. Investors bought up these ETF’s and the hype that ensued. As can be seen in the chart at right, the ARK Innovation ETF (ARKK) dramatically outperformed the S&P 500 immediately following the pandemic induced recession. However, starting back in February of last year, the reversal began. The ETF started to underperform in rather dramatic fashion and, by the end of this month, it gave back ALL of the relative gains that it enjoyed post COVID.

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How did this happen? We think the lesson here is one of behavioral finance – where emotions end up superceding the fundamentals. One could argue that while a perfect storm ushered in ARKK’s outperformance, a perfect storm also took it away. With trillions of dollars in stimulus needing to find a home (along with the social media hype in the post pandemic world), these underlying stocks were bid up to sky-high valuations. But as inflation began to take hold, as is historically the case, the most expensive stocks became the most vulnerable, thus, the proverbial bill started coming due. As one hall of fame investor put it, “you have to separate the story from the stock”. When ideas become so widely adopted it doesn’t make them untrue, it just makes the underlying stock unlikely to live up to the expectations supporting their valuations. The dramatic price action in this ETF is eerily similar to the Nasdaq 100 back in 2000. From here, tactical rallies can ensue as some investors may be willing to step in, but the bloom is off the rose.

From a broader perspective, this past month saw the S&P 500 suffer its first correction (10% drop from recent highs) since September of 2020. As can be seen in the table at right, this is the ninth such correction during the Fed’s “QE” era – so named by a new demarcation whereby Fed policymakers started using their balance sheet

### QE Era Corrections - Is the Bill Coming Due?

Peak Date	Trough Date	S&P 500 % Chg Peak to Trough	10 Year Yield % Chg Peak to Trough (bps)	S&P 500 Growth versus Value Performance	S&P 500 Market Weight versus Equal Weight Performance
4/23/2010	7/2/2010	-17%	-83	1.2%	0.8%
4/29/2011	10/3/2011	-19%	-153	7.0%	3.8%
4/2/2012	6/1/2012	-10%	-73	2.5%	1.3%
7/20/2015	2/11/2016	-15%	-71	1.6%	1.9%
1/26/2018	2/8/2018	-10%	23	0.3%	-0.2%
9/20/2018	12/24/2018	-20%	-33	-1.4%	0.4%
2/19/2020	3/23/2020	-35%	-81	5.5%	5.2%
9/2/2020	9/23/2020	-10%	3	-4.2%	-1.8%
1/3/2022	1/27/2022	-11%	15	-10.1%	-2.3%

Excluding the September '20 and January '22 Periods				
Average	-18%	-67	2.4%	1.9%
Median	-17%	-73	1.6%	1.3%

Source: Factset

to purchase bonds in exchange for cash being introduced in the system (in lieu of rate cuts below the zero bound). With massive fiscal and monetary stimulus injected into the US economy post COVID (nearly \$10 trillion dollars), the shift to a higher inflation regime has led to a different makeup in these two most recent corrections relative to the rest. We think it’s noteworthy that these last two corrections have not led to any notable decline in long-term interest rates while at the same time, both higher priced Growth stocks and the top heavy S&P 500 Market Cap Weighted index have failed to outperform the respective Value stock universe and the S&P 500 Equal Weighted index.

While bounces are certainly likely to happen in some of the most oversold areas of the market, we can’t help but wonder if the above signals a paradigm shift of sorts. Is the bill coming due for the especially high priced areas of the market and, along with it, a more durable change in leadership?



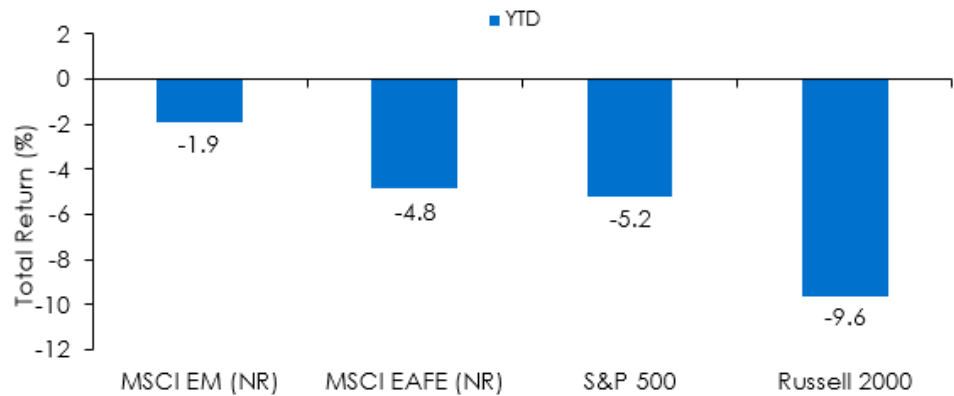
After such heady returns for risk assets last year, it didn't take long for investors to take profits in some of these areas to begin this year. As such, the S&P 500 suffered its worst start since January of 2009 and its worst monthly performance since March 2020. Stocks, Bonds and REIT's finished the month with negative returns while Commodities were the lone bright spot.

## Stocks

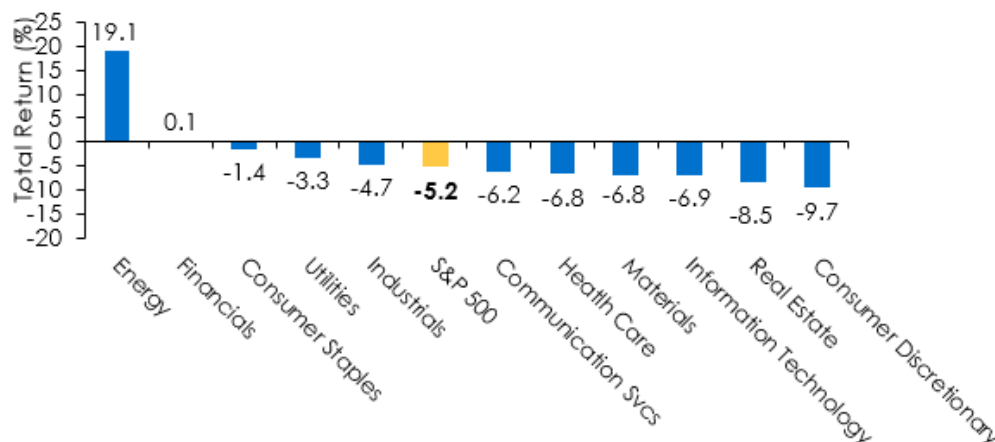
Stocks traded lower across the board to begin the year. Domestic markets (S&P 500 and Russell 2000) underperformed international markets (MSCI EAFE and MSCI EM) – as high P/E stocks become the most valuation sensitive to

softening sentiment due to elevated inflation conditions and the likelihood of more restrictive policies (both fiscal and monetary). All but two sectors within the S&P 500 finished in negative territory. Sector performance was influenced by valuation sensitivities as well. Higher priced Cyclical Growth sectors (Discretionary, Technology and Communication Services) were down the most followed by the Defensive sectors (Consumer Staples, Utilities, Health Care and Real Estate). Meanwhile, the least expensive Cyclical Value sectors (Energy, Financials, Industrials, Materials) held up the best.

**Global Equity Returns**  
January 2022



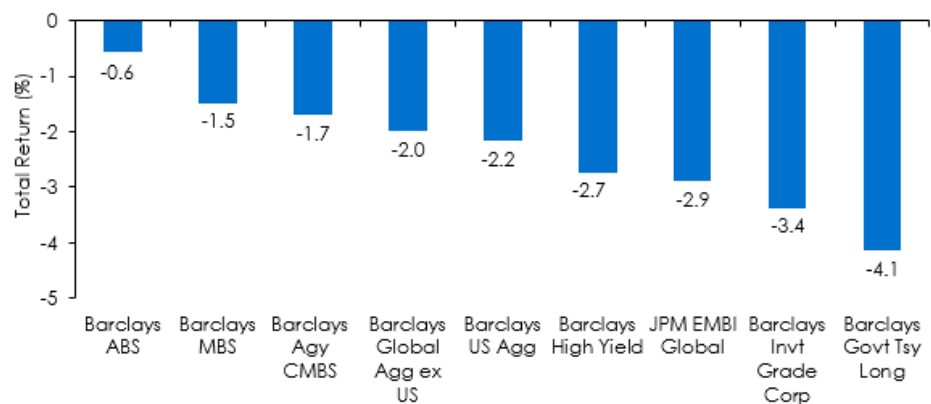
**S&P 500 Sector Returns**  
January 2022 - YTD



## Bonds

Bond returns started the year in negative territory amid the continuation of an upward but uneven rate bias. Long-term rates began trending higher in August of 2020, then traded sideways since April of last year before moving up again this month. Since October, shorter term rates have moved up even more notably as rate markets are pricing in multiple Fed rate hikes this year. While credit spreads held steady for much of this past year, they began to move wider in November and again this past month. As a result, bonds that carried shorter durations – namely Securitized Assets (ABS, MBS, CMBS) – were better insulated. Conversely, both High Yield and Investment Grade corporate bonds and more duration sensitive areas (Govt Tsy Long) were harder hit. A moderately stronger dollar to begin the year pressured International Fixed Income (Global Agg ex US) though to a more modest degree.

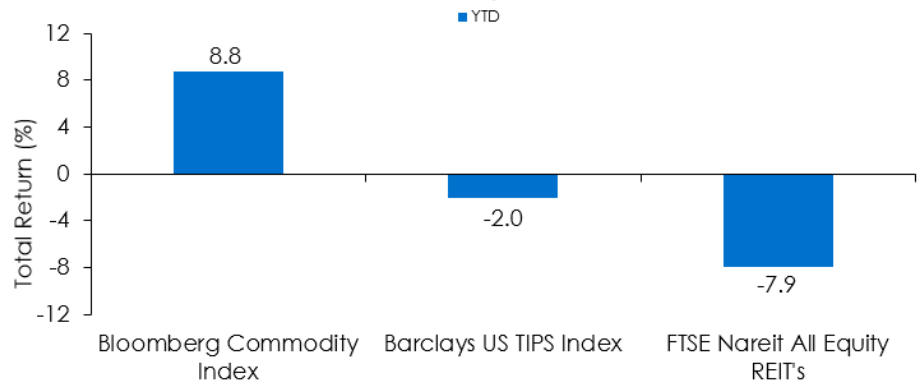
**Global Fixed Income Returns**  
January 2022 - YTD



## Alternatives

Alternatives posted the most disparate of returns to start the year – publicly traded Real Estate (REIT's) was among the hardest hit areas while Commodities posted among the strongest (and positive) returns. The former was viewed as a profit taking opportunity given last year's strength. The latter proved to be more resilient as an inflationary hedge with particular strength in Energy, Agriculture and Industrial Metals prices.

**Alternative Market Returns**  
January 2022



## Market Outlook

**“It’s tough to make predictions, especially about the future.”**

– Yogi Berra (1925-2015)

As we move through the course of 2022, we think the phrase “Moderate Resilience” might best define the environment. Said another way, growth rates moderating from elevated levels might apply to everything from corporate earnings to nominal GDP to inflation. Embedded within that view is the idea that the cycle is maturing, but money supply (a key measure of liquidity) still growing at a well above average level suggests nominal growth might remain resiliently above average for 2022. The vast majority of the time – as can be seen in the table below – nominal GDP has run at an above average pace of 6% or more 12 months following instances when the money supply (M2) has increased at a rate of 10% or more. Considering that M2 grew at 13% year on year in 2021, might nominal GDP growth remain Moderately Resilient as well?

To be clear, first quarter GDP growth is expected to be soft due to the Omicron impact, the shelving of the Build Back Better fiscal agenda and less inventory build than what we saw in the fourth quarter. But if the historical relationship between nominal GDP growth and the money supply continues to hold, then it wouldn’t be unreasonable to expect full year nominal GDP growth conservatively in the 6-8% range (nominal growth averaged

### Nominal GDP % 1 Yr vs Money Supply % 1 Yr (lagged 4 quarters) 1960-Current

	Money Supply % 1 Yr > 10%	Nominal GDP Growth % 1 Yr > 6%
Average	13.1%	10.1%
Instances	31	27

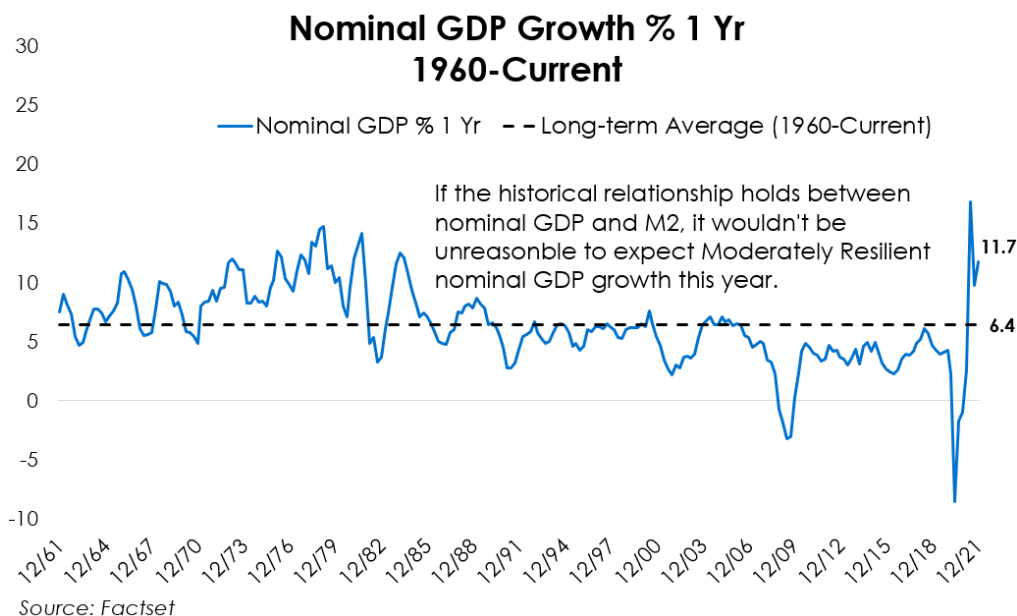
Hit Rate 87%

Source: Factset; Instances tracks the number of times the money supply exceeded 10% and the number of times nominal GDP growth exceeded 6% four quarters later.

10% when M2 was above 10% historically) – please note the chart on the following page. If the underlying real core growth of the US economy has been running between 2.5-3.0% over the last two years (excluding inventories, government spending and trade) then a 6-8% nominal GDP growth environment implies inflation running at 3.0-5.5% – moderating from its current level – but still remaining elevated within the context of the recent past and consensus expectations. The question then becomes how the Fed responds to that scenario. Are policymakers appeased by the moderation in the inflation data or do they tighten more aggressively because the data hasn’t moderated enough?



Given this framework, why the big drop in risk assets in January? We'd argue that the biggest downward influence on stocks to begin the year has been investor sentiment as elevated inflation levels have pressured stock market valuations. As we noted earlier, the most expensive areas of the market are the most vulnerable. The



The magnitude of the decline seen in some of these areas has been so severe that a bounce back is likely. But if inflation remains elevated how durable will this bounce be?

We also think it's worth noting that we do see the cycle maturing, given the expected moderation in growth. The profit cycle has now shifted to the deceleration phase, whereby earnings are still growing but at a slower pace than before. This will become more of a focus for investors as we move deeper into the year. The Fed's response to inflation will likely lead to the question, is earnings growth slowing faster than expected? We think this will have implications for portfolios as we get deeper into the deceleration phase of the profit cycle.

As a result, the Fed and Inflation remain the biggest risk factors in our view though we would also add COVID (given its unpredictability) and Mid-term Elections (renewed volatility) to the list.

With this backdrop in mind, we'd highlight the following takeaways for 2022:

- Market returns are expected to be more moderate on balance with a greater likelihood for more volatility.
- Managing the overall exposure and mix of risk assets will be an important consideration and should reflect a moderating business cycle.
- Maintaining pro-inflationary tilts might continue to make sense especially should inflation linger at resiliently higher levels for longer than expected.
- Avoiding valuation vulnerabilities will be critical especially if the disconnect between rates and inflation is unsustainable.





From a portfolio positioning perspective, we think it will be important to strike the right balance between Moderation and Resilience. To us, that means managing the overall exposure and mix of risk assets (i.e. Moderation) while also being cognizant of the continued need for pro-inflationary tilts (i.e. Resilience). Candidly, this has been something we've been proactively doing in client portfolios for the majority of this past year.

Currently, we are modestly OW risk assets after having trimmed this OW several times in 2021 (via Equities and Alternatives) – including early in September – while having maintained diversification with lower volatility securities (via US Core Fixed Income and Diversified Alternatives).

Within equities, our positioning has moved closer to neutral but continues to favor a pro-inflation bias with a value sector tilt within our US exposure (albeit with a quality bias).

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) but our US Core managers are OW credit and UW (defensive) treasuries. We also continue to carry a shorter duration bias (less interest rate sensitivity). Our US Core Fixed Income exposure remains an OW supplemented by our UW position in International Fixed Income which remains a hedge against a weaker dollar environment.

Within alternatives, we remain overweight Real Estate and Commodities as a way to bolster inflationary hedges while also keeping a more modest OW to Diversified Alternatives which provides some hedge against market volatility.

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