fIRST® | word on the market
by Yellow Cardinal Advisory Group

MARKET UPDATE
December 2022

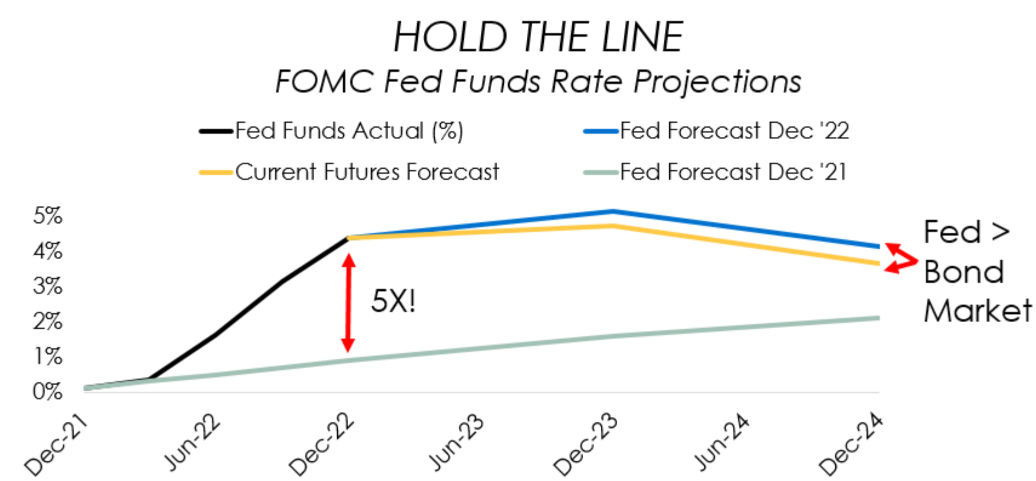
Hold The Line

"It's not in the way you look or the things that you say that you'll do. Hold the line, ~~love~~ (THE FED) isn't always on time."

– *Hold The Line* by TOTO (1978)

The rock band TOTO – formed in LA back in 1977 and named after the Wizard of OZ's famed dog – has sold more than 40 million albums worldwide and worked on others as famous as Thriller. This year, the band recently celebrated the 40th anniversary of its biggest hit (#1 Billboard 100) *Africa*. Meanwhile, this month's inspiration comes from the band's first hit (#5 Billboard 100), *Hold The Line*, recorded in 1978.

In the month of December all eyes were focused on the Fed as they held their eighth and final meeting for the year. While their first meeting – back in January – was status quo, all the rest have come with rate hiking activities including multiple hikes in each of the last six meetings. As can be seen in the chart below, it's hard not to say that the Fed wasn't way behind the inflation curve to begin the year. In fact, the Fed's own interest rate forecast (Fed Forecast Dec '21) one year ago was almost 5 times lower than where the actual Fed Funds rate finished this year! WOW!



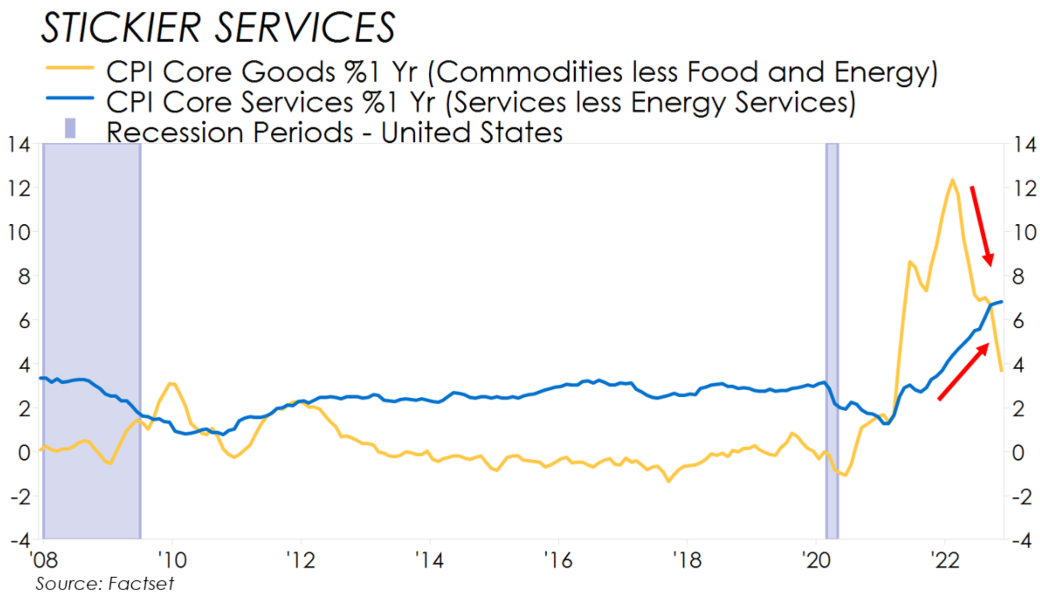
Source: Factset and FOMC; Actual Fed Funds and Fed Forecasts are the value of the midpoint of the target range for Fed Funds. Fed projections are based on Fed forecasts at the December 2021 meeting (smoothed) and December 2022 meeting. The Futures Forecast is based on futures contract pricing 12-24-36 months out as of 12/31/22.

But now that inflation looks to have peaked (based on the last two months of inflation data), many investors are shouting at the Fed to stop its frenetic pace. To be fair, the Fed did slow the rate hike trajectory at its recent December meeting by raising rates 50 bps (0.50%) instead of the 75 bps (0.75%) pace that it announced at each of the prior four meetings. However, it also raised its forecast for the terminal rate (peak Fed Funds) from 4.5-4.75% to 5.0-5.25%. That implies another 75 bps (0.75%) of rate hikes still to come. In short, the Fed is "hold(ing) the line" on its rate forecasts in trying to re-establish its inflation fighting credibility after its recent poor performance.

Meanwhile, after forecasting a higher terminal rate than the Fed earlier in the year, the bond market is now starting to price in a quicker and steeper Fed pivot. As indicated in the chart on the prior page, the futures contract pricing for Fed Funds (Current Futures Forecast) now projects a lower peak rate of 4.75-5.0% with cuts anticipated sooner than policymaker projections (Fed Forecast Dec '22).

We think the Fed's current "hold the line" sentiment stems from being slow to the inflation trigger along with being loathe to repeat the mistake of the '70's – where a premature easing led to inflation coming back with a vengeance. Effectively, policymakers have been left "once bitten, twice shy" as they say.

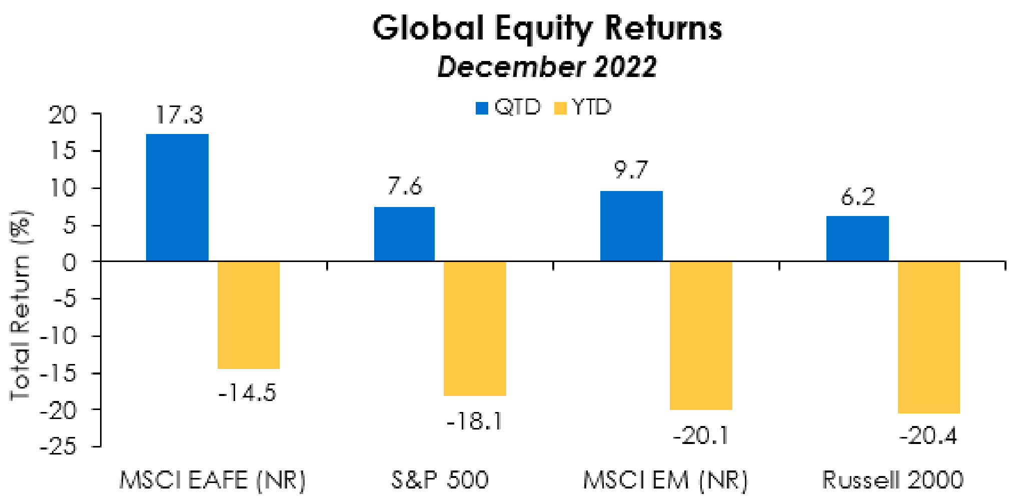
Fitting this narative is also the Fed's view that service inflation might be stickier than goods inflation due, in part, to the recalibration post COVID along with the lingering residual impacts from a structurally tighter labor market. More specifically, as consumers reorient purchases back towards services and as supply chain issues improve – seen in shortened delivery times and reduced import prices – goods inflation should be eleviated. In fact, that's exactly what we see in the chart above with core goods inflation moderating notably since its peak back in February. But also noteworthy is that service inflation has continued to remain elevated – and rising – given its higher sensitivity to labor market conditions (with today's unemployment rate near historic lows) and longer run inflation expectations (which remain anchored but elevated). In short, we think the Fed is keenly aware of this dynamic – inflation has peaked but not everywhere – which has also played an influential role in their stance to "hold the line" on interest rate policy.



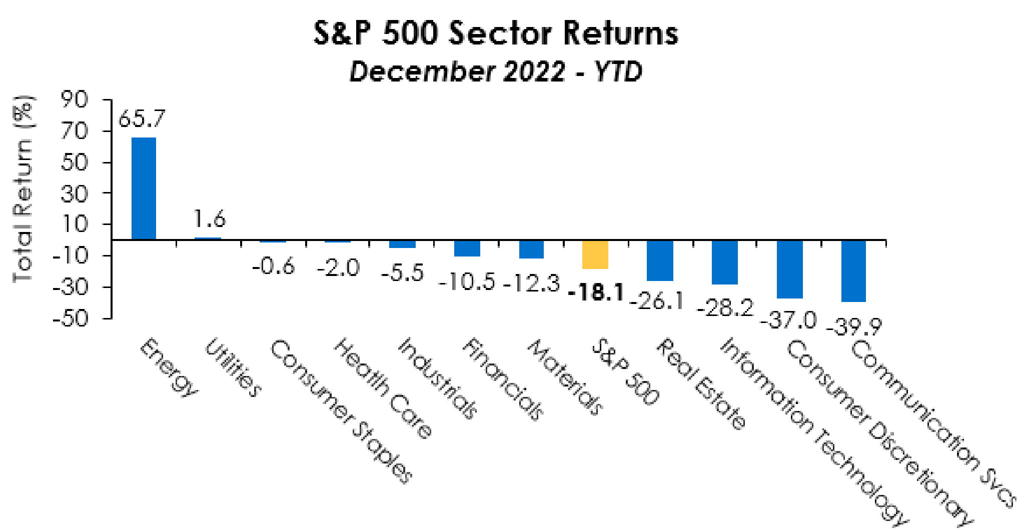
Ultimately, should economic/inflation conditions show more deterioration, the question remains whether the Fed will stay disciplined or truly pivot on rates. We think labor markets will be a key area to watch. We're staying tuned in.

Perhaps the best thing to say about 2022 is that it's now in the books. While the S&P 500 index just turned in its best three month stretch of the year, this was still its worst calendar year performance since 2008. Similarly, the US Bond Aggregate index suffered its worst annual returns dating back to the mid '70's. Rising rates and inflation have been the story while Commodities were the lone bright spot for the year.

Stocks

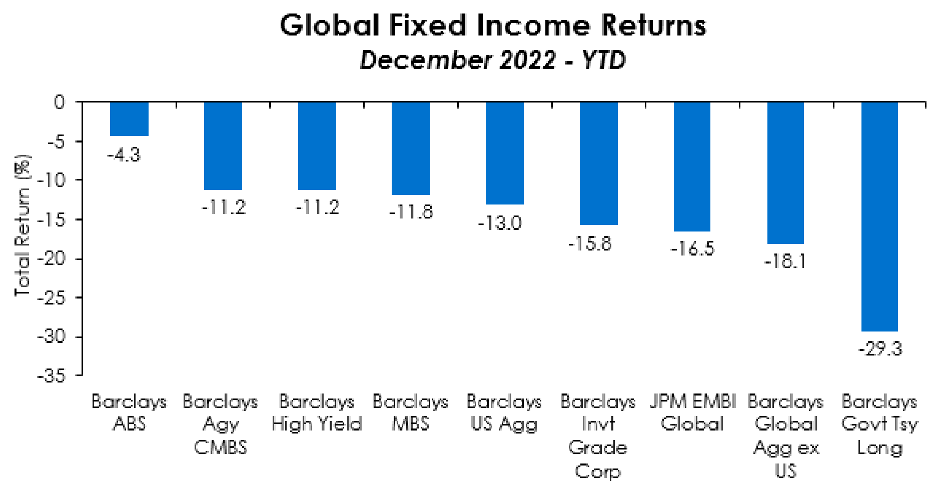


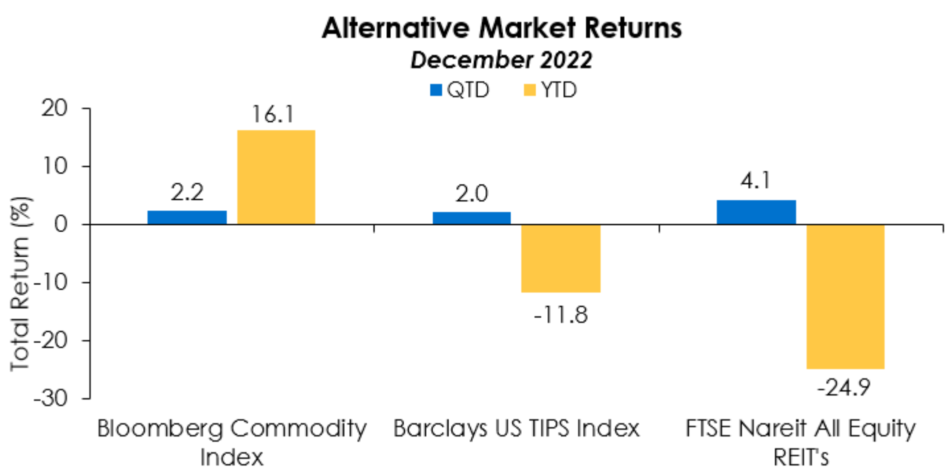
Stocks saw a nice bounce back in October-November with hints of cyclicality followed by renewed defensive undertones in December. Perhaps the biggest change to close out the year was the weakness in the US dollar which led to much improved performance in International markets (MSCI EAFE and MSCI EM) in the final quarter of the year. The fourth quarter also saw positive returns in all but two sectors in the S&P 500 (though this still only left two sectors in the black for the year). Sector performance generally favored the less expensive, late cycle cyclicals (Energy, Industrials, Financials and Materials) along with the more traditionally defensive areas (Utilities, Consumer Staples and Health Care). Higher priced, early cycle sectors (Technology, Discretionary and Communication Services) along with Real Estate were underperformers (trends that held both for the quarter and for the year).



Bonds

For the year, bond returns finished 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 425 basis points (to 4.25-4.5%) and continues to reduce its balance sheet. While the Fed fights inflation as growth expectations slow, the yield curve has inverted and rates have recently moderated off their cycle highs. Meanwhile, Fed Fund futures pricing (~4.75-5.0%) is now back below Fed forecasts (5.0-5.25%) as policymakers continue to "hold the line" on rate policy. Year-to-date, bonds that carried shorter durations – namely Securitized Assets (ABS, CMBS, MBS) – were better insulated. Credit began to move wider last November (Omicron) and into this year (Fed and Russia) to levels not seen since late 2020 – though finished the year off their wides. High Yield outperformed relative to Investment Grade corporate bonds – helped by 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. International bonds (Global Agg ex US) were also materially hit – given the strength in the dollar – though have posted among the best returns within bonds to close out the year given the greenback's reversal.





Alternatives

Alternatives generated the most disparate of returns year-to-date. Publicly traded Real Estate (REIT's) remained under pressure though saw a nice bounce quarter-to-date. Meanwhile, Commodities posted among the best (and positive) returns for the year – acting as a strong inflationary hedge with particular strength in Energy and Agriculture – though these areas finished softer to close out the year only partly offset by better pricing in precious and industrial metals.

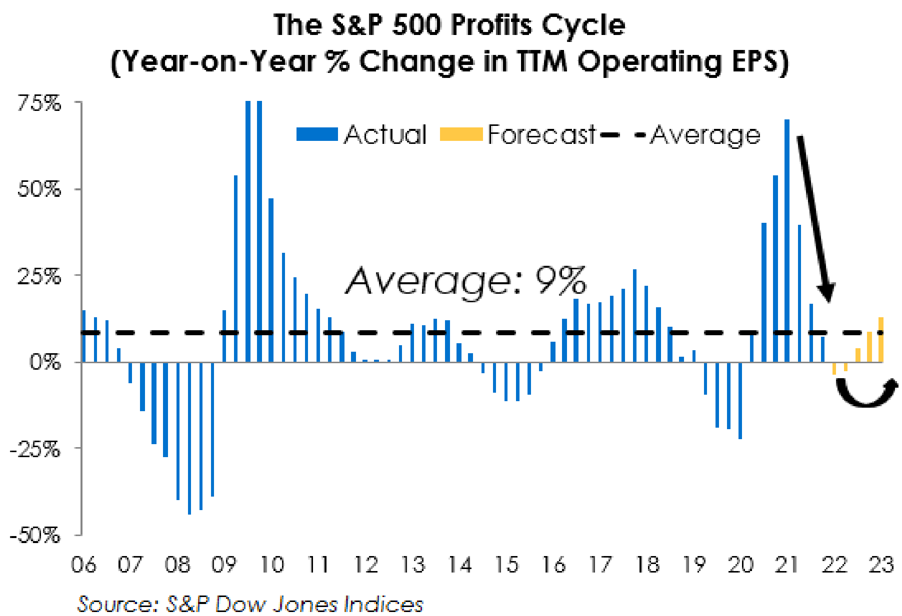
Market Outlook

"Woods are not like other spaces…Stand in a desert or prairie and you know you are in a big space. Stand in the woods and you only sense it."

– Bill Bryson, *A Walk in the Woods* (1998)

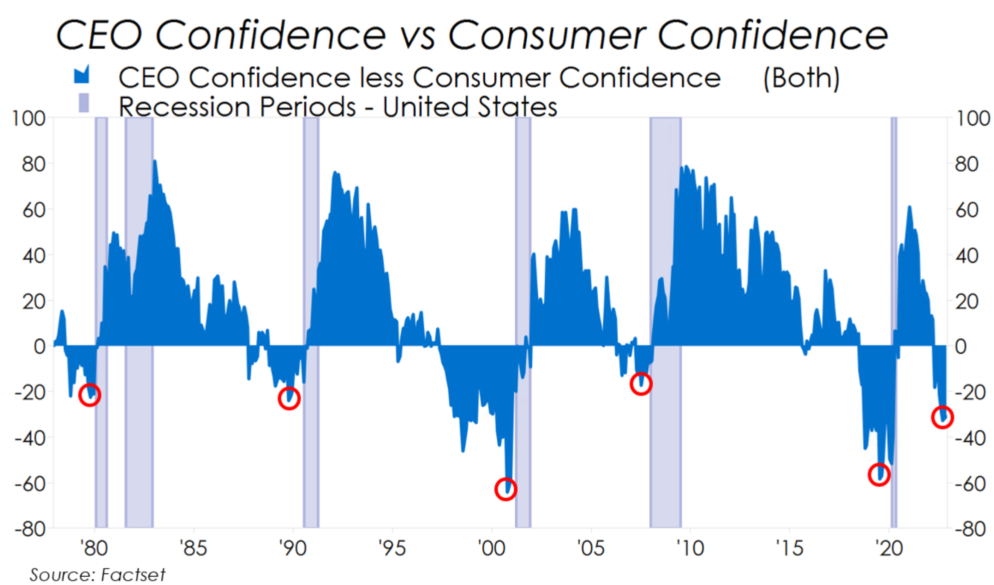
We're dubbing our main theme for 2023 as "Seeing both the Forest AND the Trees". As such, we think it's especially important to have two frameworks for managing portfolios – the cyclical (shorter-term) and the secular (longer-term). The cyclical perspective is an attempt to assess where we are in this particular business cycle while the secular perspective evaluates where the structural tendencies might be over multiple business cycles.

From a secular lens, we remain sympathetic to the notion that the economic paradigm is changing to one that ushers in the potential for more persistent inflation which is likely to result in a higher cost of capital world. We find historical parallels today to the higher inflation regime that existed back in the '60's-80's and we think the Fed is re-learning the painful lesson of falling behind inflation – one that it doesn't wish to repeat any time soon. Additionally, we believe there are structural considerations that exist today that might also support this changing paradigm including; a step change in the money supply, contracting globalization as well as structurally tight labor markets and the energy complex.



At the other end of the spectrum is the cyclical perspective, which we think currently carries more weight given its more immediacy and present divergence from the secular view – at least for a time. For much of this past year, we've used the phrase "Moderate Resilience" as a way to best describe the fundamentals. It's clear that growth has continued to moderate as the cycle has matured. However, growth in nominal terms has been somewhat resilient for much of 2022 given the lagged effect of well above average liquidity from the prior year. In essence, companies have raised prices on goods and services with minimal demand destruction because of the influx of cash post COVID. That may be starting to change as the Fed continues to tighten policy and as savings rates have dramatically declined. In short, liquidity is now being drained from the system which acts with a lag on growth. As we look into 2023, one question to consider is 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 on the prior page, the consensus believes in the "pause and refresh" story as indicated by the quick reacceleration of earnings growth shown in the yellow bars. Given the setup, we still think the risk for earnings estimates is to the downside especially in the absence of an obvious growth catalyst.

To further support that view, most of the macro fundamental data is evidencing a slowdown and our leading profit cycle indicators point to the continuation of a growth deceleration ahead. If forward earnings estimates prove to be too optimistic and need to fall further (NTM EPS is only 4% off the highs), then stocks might be more expensive than they appear (18-20X vs current 16.6X). This comes at a time when stocks have not quite fallen to levels where multiples have typically bottomed over the past thirty years (10-15X).



Source: Factset

Similarly, our read continues to be that we are still very much late in the business cycle. We understand that it's become very popular to make the recession call in the business community and we'd be lying if we said it doesn't make us a little uncomfortable that its become this consensus. However, CEO's becoming more bearish relative to the consumer is actually where the smart money tends to be. As can be seen in the chart above – when CEO confidence relative to Consumer Confidence reaches peak bearishness, recessions tend to follow. That makes sense to us because, during downturns, businesses dictate labor market turning points. Business confidence drops which leads to less hiring and more firing which then causes a hit to consumer confidence. Recently, peak relative bearishness was hit back in September and the deterioration is signficant enough to put us squarely in late business cycle territory. To us, this is additional confirmation that late cycle conditions are pointing to nominal growth that looks biased to the downside.

From a market perspective, 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. While investors remain hopeful for a Fed pivot, we can't help but wonder if markets are just trading one cyclical risk (Inflation) for another (Recession). 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.

So what are the implications and key takeaways for portfolios?

With an eye on both the Secular and Cyclical views, we think it might makes sense to keep two simple phrases in mind – *"Do the Opposite"* and *"Buy the Boring"*:

Seeing Both the Forest AND the Trees

Secular View (Longer-Term)	Cyclical View (Shorter-Term)
"Do the Opposite"	*"Buy the Boring"*

- From a longer-term point of view, if the economic paradigm is changing, then it may pay to *"do the opposite"*. In other words, the relative winners over the past 10-15 years may not be the same winners over the next decade. Businesses that took advantage of free money to leverage up their balance sheets in the hopes of high growth payoffs far out in the future might now offer greater risk in a higher cost of capital world. Conversely, the losers over the past 10-15 years might now become the new areas of opportunity. These might include companies built to be a bit more insulated from inflation with more balanced business models, more immediate cash flows and a focus on the bottom line.
- From a shorter-term point of view, late cycle conditions that might suggest we're trading one cyclical risk (Inflation) for another (Recession) argue to *"buy the boring"*. Should growth continue to slow leading to a profit and/or economic downturn, it might be more beneficial to buy the things that people need over the things that people want.

From a portfolio positioning perspective, we continue to believe that it's important to "See both the Forest AND the Trees". 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 potential changing paradigm (i.e. Secular). Over the last several months, we've given an increased weight to the cyclical over the secular as we've reduced portfolio risk. This past month – as the market rally since mid October seemed to fizzle out – we recalibrated portfolios in order to maintain an underweight to risk assets. That adjustment was facilitated by trimming equities and adding to bonds. Additionally, we further lowered our equity beta by remixing more defensively within our US Large Caps as the risk of a profits recession continues to increase. This involved increasing the overweight to the more defensive areas relative to cyclical value sectors while remaining underweight cyclical growth stocks. In essence, we continue to downshift risk in portfolios given the late cycle setup.

<u>Within equities,</u> our positioning is modestly UW and continues to favor 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).

<u>Within fixed income,</u> 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 slightly OW corporate bonds, though we've previously moved up in credit quality by adding some Treasuries and lengthening duration consistent with a downshifting of risk in portfolios.

<u>Within alternatives,</u> 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 (especially in an environment where there's lower correlations between stocks and bonds). We're more modestly OW to Commodities as a way to bolster inflationary hedges. Meanwhile, we're UW Real Estate as a way to further reduce overall portfolio risk.