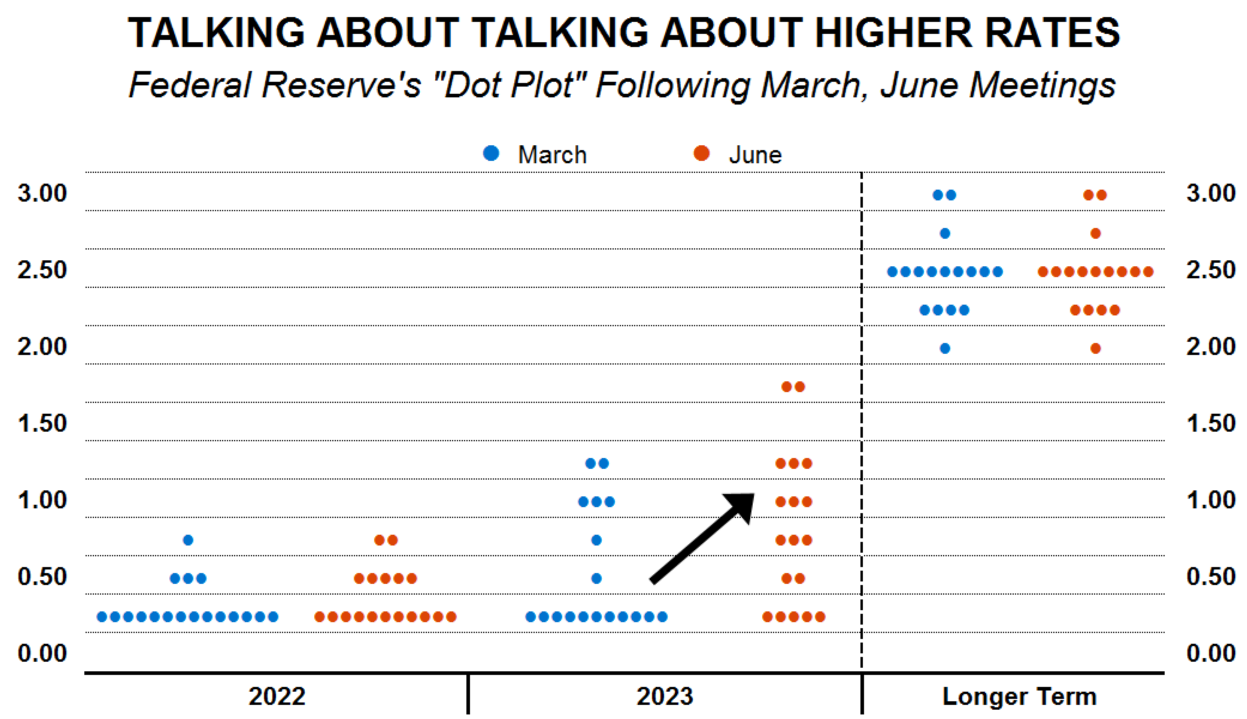
Look Who's Talking

"You can think of this meeting that we had as the "talking about talking about" meeting."
- *Federal Reserve Chairman Jerome Powell*

After their most recent meeting, Federal Reserve officials announced that they have shifted from "not even thinking about talking about talking about" tightening policy to "talking about talking about" eventually raising interest rates. Evidenced by a shift in "the dot plot" (which visually depicts where Fed governors feel policy rates could be in the future), it now appears that the Fed is planning to begin raising interest rates in 2023.

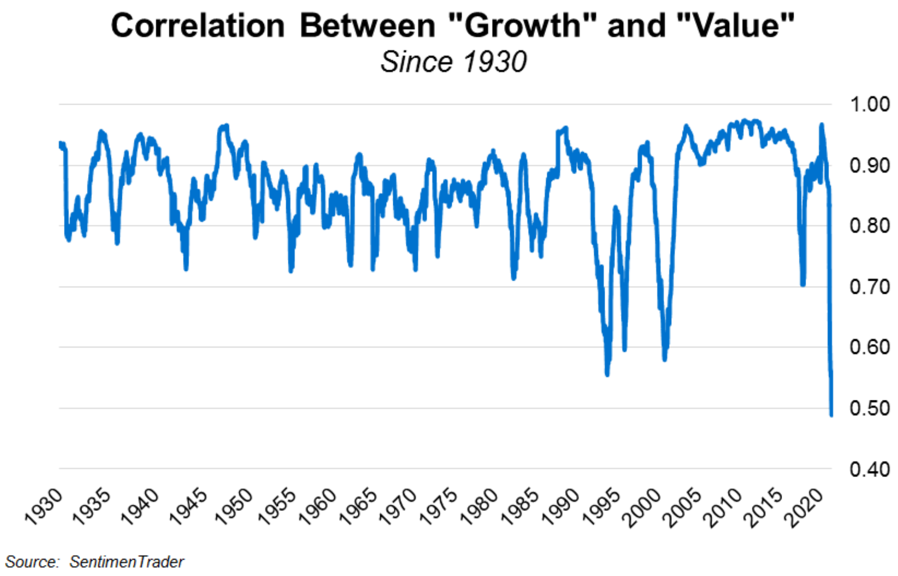


Source: Federal Reserve

This timeline, apparently, is quicker than some investors were anticipating and many took this as a sign that a) inflation is peaking now and b) long-term interest rates should therefore remain low. In turn, this caused "long duration" growth stocks – those whose value is closely tied to the present value of future earnings – to catch a bid. You see, when long-term interest rates are low, the discount rate used to value future cash flows is also low. Thus, if rates are believed to remain low, "growth" stocks should gain in popularity.

We believe that chasing "growth" stocks at this point isn't in our clients' best interests for several reasons. First, we can't help but think that interest rates are going higher, not lower. Historically, the trend in nominal GDP growth (economic growth including inflation) has exhibited a correlation with the trend in long-term interest rates. In periods of decelerating economic growth, interest rates have typically fallen. When growth picks up, interest rates typically follow suit. With economic growth expected to be 10% in 2021 and 7% in 2022, the 10-year US Treasury bond should be yielding much more than ~1.5%.

Another reason we're continuing to avoid heavy exposure to "growth" stocks is that the extent to which "growth" has outperformed "value" is at all-time highs – even more so than during the Tech Bubble of the early 2000's. Relative performance trends tend to mean-revert, especially when the data becomes so extreme in one direction.



Correlations between "growth" and "value" have also hit a historical extreme. Since 1930, one-year correlations between daily returns for "growth" and "value" have generally fallen between 0.80 and 1.00. Currently, the correlation has been less than 0.50, another extreme reading that harkens back to the days of the Tech Bubble. Looking at the eleven times that the trailing one-year correlation dropped below 0.75 (1942, '54, '62, '70, '82, '85, '92, 2000, '17), the performance of the broader market on average was fairly normal, with a median return of 9.1% over the subsequent year. However, relative performance between "growth" and "value" was a different story. Following those same eleven signals, "value" outperformed "growth" by a median 10% over the next twelve months and by 15% over the next two years.

What all this means is that we wouldn't be surprised to see a little choppier markets in the coming months, with – if history is any guide – "value" outperforming "growth" on a relative basis. In addition, the second year following a major market bottom is usually much less robust than the first year. We are also entering the weakest part of the calendar for the stock market. Also, breadth within the market is waning. Even as the market has been hitting new record highs, less than 50% of stocks are trading above their 50-day moving averages, more than 25% of stocks qualify as "oversold" and on June 18 over 25% of the S&P 500 stocks traded at a three-month low. Weakening breadth is generally a sign of looming volatility for equities, and with "growth" as extended as it has been we view it as a prime candidate to get hit first.

Currently, what we own reflects our belief that the macroeconomic picture is one of rising growth, rising interest rates and rising inflation. This "reflationary" environment has historically benefitted cyclical "value" stocks which should lead the market higher from here, though with the potential for some volatility along the way. In preparation, we recently trimmed our overweight allocations to riskier areas of the market in order to manage total portfolio volatility. Overall though, our client portfolios maintain their cyclical orientation.

Within equities, we previously increased our clients' exposure to larger, more developed international markets. We've also made moves to increase exposure to smaller companies in the US and have added targeted exposure to more cyclical areas of the US large cap space. We believe that, as we enter the second year of the current Bull market, earnings growth will be more important in driving returns rather than expansion in valuation multiples. This just reinforces our position that cyclical "value" stocks should benefit more than expensive "growth" stocks.

In the fixed income area, we remain focused on more credit-sensitive securities (with less exposure to the more cyclical areas of the market) with shorter maturities as a hedge against potentially rising interest rates. Within the alternative market segments, we recently increased our exposure to “real assets” (think commodities and real estate) as a hedge against the potential for higher inflation. We have maintained our exposure to the diversified alternative sector as a hedge against potential market volatility.