Not for the "FAIT" of Heart

"Don't settle. As with all matters of the heart, you'll know it when you find it."
– Steve Jobs (Stanford Commencement Address; June 12, 2005)

Cold feet, weak knees, chicken little, scaredy-cat, nervous nellie. These are all words one might use to describe the phrase "faint of heart", which is said to have originated in the medical field to describe a patient with a weak heart so as not to be exposed to undue stress.

Recently the market started to test the Fed's medical condition as it relates to its FAIT (Flexible Average Inflation Target) policy. Starting early last year in response to the COVID pandemic, the FOMC had been communicating that it would remain ultra-accommodative in promoting economic recovery. In fact, in August of last year, the Fed changed its policy on inflation. Instead of previously targeting to keep inflation below a stated rate of 2%, FAIT policy suggests that inflation should be allowed to move "moderately above 2% for some time" so as to average out to around 2% over a full cycle. This becomes especially important within the context of inflation running below 2% for much of the past decade (Core PCE pre-pandemic 10-year avg. of 1.6%).

The Fed's dual mandate of full employment and price stability was in congruence for much of last year and earlier this year. Recently that mandate has gotten more challenging. While job losses are still prevalent, inflation (in April and May) has started to rear up to levels we haven't seen in quite some time.

Fed "FAIT" of Heart?

Date	Months to Recover Job Losses	Peak Core PCE % Yr	Peak Chg in Core PCE	Beg Core PCE % Yr	End Core PCE % Yr	Period Chg in Core PCE
4/60-12/61	21	2.0	2%	2.0	1.2	-41%
8/69-4/71	21	5.0	8%	4.7	4.9	6%
7/74-2/76	20	10.2	24%	8.2	6.3	-24%
3/80-1/81	11	9.8	5%	9.3	9.8	4%
7/81-11/83	29	8.8	0%	8.8	4.5	-49%
6/90-2/93	33	4.4	7%	4.1	2.7	-33%
2/01-2/05	49	2.4	29%	1.9	2.2	17%
1/08-5/14	77	2.3	7%	2.1	1.7	-19%
*2/20-?	?	3.4	82%	1.9	?	?
Average	33	5.6	10%	5.1	4.2	-17%
Median	25	4.7	7%	4.4	3.6	-21%

*Source: Factset; Job losses are measured by nonfarm payrolls. Dates are determined from the beginning of multi-periods of job losses and ending upon full recovery. Core PCE is defined by the Personal Consumption Price Index less Food and Energy. *Current period lists peak Core PCE as of the latest May reading.*

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At this past month's Fed meeting, some of that indigestion was witnessed among policymakers. Up to this point, policymakers had emphasized that inflation was transitory and, with still almost 7 million jobs lost last year as of yet to come back, policy would need to remain easy. Yet in the face of a two-month acceleration in inflation (to levels not seen since the early 1990's), more Fed governors started to call for rate hikes in the so-called Fed "dot plot" for '22 and '23. This, in turn, created a market rotation back in favor of long duration assets (and growth) as the market's interpretation was that the Fed had turned more hawkish and was set to roll back accommodation quicker than anticipated.

In short, inflation has started to test the Fed's resolve to FAIT policy. Interestingly, post pandemic inflation – even with the recent inflation spike – has averaged out to be at the same 1.6% level that it was pre-pandemic (both well below the Fed's 2% intended target). Even if inflation, as measured by the core PCE, remained at these recently high levels for the remainder of this year and moderated back to 2% next year***, post pandemic inflation would still only average out to be a modest 2.1%.*** So, what's giving the Fed heartburn?

Note the table on the previous page which examines periods of recession induced job losses as well as subsequent changes in inflation. The dates indicate the beginning of multi-period job losses and end upon full recovery of those losses. We'd note the following observations:

- Recession induced job losses take on average about 3 years to fully recover from though the range is wide and has lengthened in the two most recent recessions (4-6 years).
- Inflation tends to initially peak, on average, about 10% higher than where it began. ***This time around has been the clear outlier with a massive 80% spike*** – dwarfing all other periods including the mid '70's (though admittedly off a much lower base).
- Upon full job recovery, inflation tends to reset lower by about 20% from where it began. This supports the Fed's "transitory" inflation view though creates a mixed message when viewed in combination with the dot plot calling for more rate hikes of late.
- Finally, this inflation reset lower hasn't always meant that inflation has stayed low through the entire economic cycle. The '70's and some of the '80's are good examples of rising inflation tendencies after the initial reset lower (the beginning of the next period often started with a higher inflation rate than at the end of the prior period).

Since the Fed meeting, Fed Chair Powell has tried to tamp down the hawkish tone so as not to squelch inflation entirely and growth expectations along with it. Nowhere is this more evident than in inflation expectations and the yield curve. These are two areas that we'll remain focused on in determining if the market has already diagnosed the Fed to be "FAIT" of heart.

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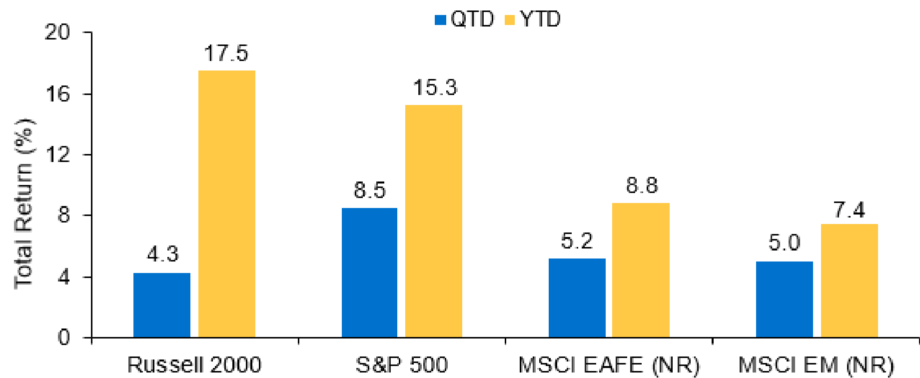
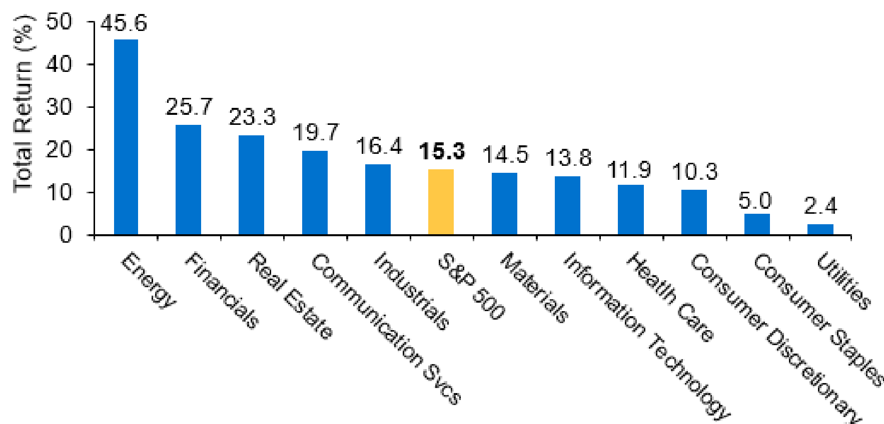
While some market trends reversed in the second quarter, the first half of the year generally still indicated a reflationary bias. Real Assets outperformed Stocks and Stocks outperformed Bonds. Commodities, Real Estate, Small Cap companies and Cyclical Value sectors did the best while interest rate sensitive Bonds suffered the most.

Stocks



Global equities posted positive returns in the second quarter to tack on to their strong year-to-date totals. US markets and Small Caps (Russell 2000), in particular, have taken the prize YTD. International markets (MSCI EAFE and EM) have lagged for the year as vaccinnation rollouts (and COVID case improvements) have been slower than that witnessed in the US. As vaccines become more widely available, we wouldn't be surprised to see improved performance for international markets in the second half of the year – especially if this comes on the heels of a weaker dollar. Meanwhile, for the year, S&P 500 sectors reflected an investor preference for Cyclical Value exposure with outperformance in Energy, Financials and Industrials. Conversely, more traditional Defensives (Health Care, Utilities, Staples) and pandemic beneficiaries (big cap Tech and Discretionary) were still positive but lagged (though this started to reverse in June as yields backed down).



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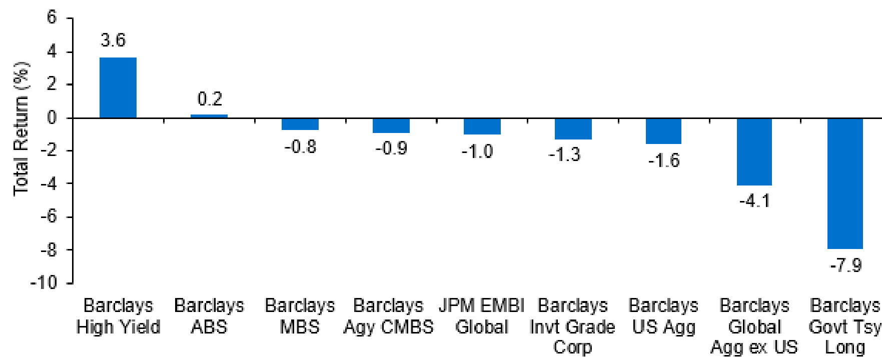
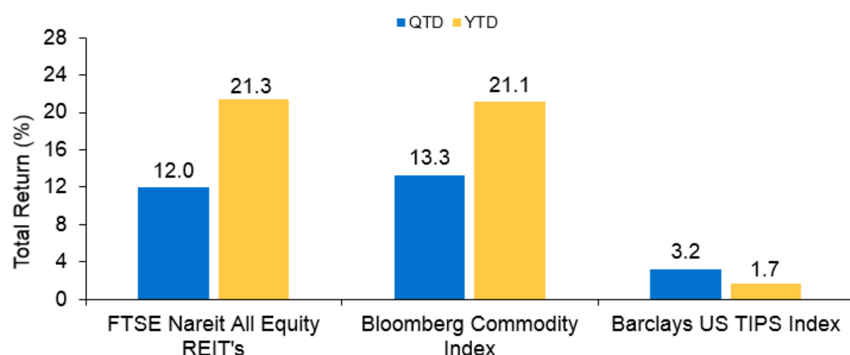
Bonds

Bond returns were mostly negative year-to-date. Long-term interest rates started to trend higher last August with the pace picking up in the first quarter only to consolidate over the past three months. Meanwhile, short-term rates remained mostly anchored by the Fed – resulting in a Yield Curve that steepened to its highest level since mid 2015 – though ended the second quarter off those highs following the Fed's June meeting. Through the first half, the more interest rate sensitive areas of the bond market saw their returns pressured the most – including long-duration Treasuries (Govt Tsy Long), Investment Grade Corporates (Invt Grade Corp) and EM Debt (EMBI Global). A stronger dollar also pressured International Fixed Income (Global Agg ex US). Meanwhile, securities with shorter durations and more sensitivity to equities outperformed, including Securitized Assets (ABS, MBS, CMBS) and High Yield.



Alternatives

Alternatives posted mostly strong returns in the second quarter and for the year. Treasury inflation protected securities (TIPS) were held back by the rise in long-term interest rates though outperformed nominal Treasuries given increased inflation expectations. Both publicly traded real estate (REIT's) and Commodities generated among the best results for the year. The former has been viewed as an attractive reopening opportunity. The latter has benefited from rising Energy, Agriculture and Industrial Metals prices (though prices ex Energy cooled in June as rates consolidated and inflation expectations came off the boil).



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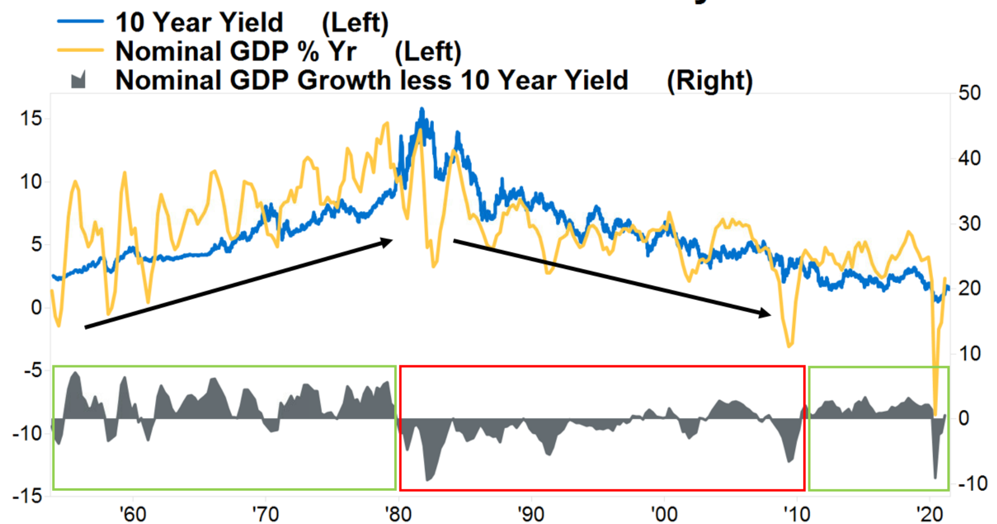
Market Outlook

Coming into this year, our business cycle outlook has continued to be best defined by the phrase "From Red Lights to Green Lights". Having a medical solution to the medical problem is ushering in an economic reopening. This, combined with record levels of stimulus, is expected to generate sizeable GDP and earnings growth in 2021 (see table at right).

	Red Lights		Green Lights
Indicator	**2019**	**2020**	**2021 e**
GDP (yoy)	2.3%	-2.4%	7.0%
Unemployment Rate	3.6%	6.7%	4.5%
S&P 500 EPS (yoy)	3%	-19%	38%
COVID Cases	N/A	19.1m	?

Source: Factset; 2020 readings and 2021 S&P 500 EPS growth estimate are as of 1/1/21. 2021 GDP and Unemployment Rate estimates are projections produced by the Federal Reserve as of June 2021. COVID case count from www.coronavirus.jhu.edu as of 12/28/20.

From an investment perspective, we've been believers in the "Reflation Reset" theme, whereby nominal growth improves from a combination of rising real growth and inflation. A federal budget deficit today that only rivals that of World War II, along with de-globalization trends, and the Fed's FAIT policy are all structural reasons to support this theme. At the same time, a cyclical recovery in economic growth and corporate profits is taking shape. While reflationary beneficiaries were underperformers in the second quarter, we still view them opportunistically given that long-term interest rates appear underpriced. Last month, we highlighted the beginning of a disconnect between inflation and the 10 Year Treasury Yield. This month, we're highlighting a similar disconnect between nominal GDP growth and the 10 Year Treasury Yield. As can be seen in the chart above, there have been secular periods of time when



Source: Factset

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accelerating nominal GDP growth pulled the 10 Year higher ('50's-'60's-'70's) and secular periods when decelerating nominal GDP growth pulled the 10 Year lower ('80's-'90's-'00's). Is that recent period changing? Over the past decade, nominal growth has started to exceed the 10 Year Yield as long-term rates have raced to the bottom. What's more is that the Fed recently upped their forecast for both real GDP growth and inflation to 7% and 3.4%, respectively. Taken together, nominal growth is then assumed to be a whopping 10.4% this year (highest since 1984). If that's the case, the current 10 Year Treasury Yield of 1.45% would create the biggest gap (relative to nominal growth) that we've seen on record (dating back to the early '50's). To us, this suggests long-term interest rates need to rise in order to reflect this higher nominal growth backdrop. Perhaps the Fed's tapering of bond purchases could be the catalyst. Should rates rise, duration sensitive securities may come under renewed pressure and reflationary beneciaries might resume their outperformance.

In our view, the divergence between long-term interest rates and nominal growth may resolve with the former moving higher, which continues to set up an opportunity for reflationary assets – an area of emphasis in client portfolios (see table below).

Reflation Reset

Advantaged	Disadvantaged
International Markets	Domestic Markets
Commodities / Real Estate	Fixed Assets
Economically Sensitive Sectors	Defensively Oriented Sectors
High Operating Leverage	Low Operating Leverage

Source: FFWM Research

At the same time, we've been observing what looks to be a peak policy setup. The Fed's balance sheet and the Money Supply (M2) are up over 90% and 30%, respectively from pre-COVID levels, however, both have peaked on a year on year basis. This peaking in liquidity likely suggests that earnings growth will peak as well. That's not imminent but some of our leading profit cycle indicators suggest that to be on the horizon. With valuations extended, weaker seasonality approaching and Year 2 of a cyclical bull market upon us, it would not be surprising to us to see increased volatility in the broader market. Perhaps that may come with the advent of higher rates. As such, we're not sure the broader market makes much headway though we do think maintaining less interest rate sensitivity and more exposure to earnings growth (at less expensive valuations) makes sense. ***In short, we adocate maintaining a reflationary tilt in one's portfolio while managing the degree of that tilt.***

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Consistent with the above, we remain deliberate in emphasizing a reflationary bias in client portfolios while also controlling overall portfolio risk. Accordingly, several times this year we've trimmed some of our OW to risk assets (via Equities) while bolstering our inflationary hedges (Real Assets including Real Estate and Commodities) and maintaining diversification with lower volatility assets (via US Core Fixed Income and Diversified Alternatives).

Within equities, our OW's continue to favor a pro-reflation bias. Previously, we've increased our exposure to a modest OW in International Markets. We've also previously increased our US Small Cap exposure to an OW and have shifted toward more of a cyclical value sector tilt within our (UW) US Large Cap exposure (though recently have shifted some of that value tilt toward higher quality companies).

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 investment grade 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 beneficiary of a weaker dollar environment.

Within alternatives, we previously have added to real assets as a way to bolster inflationary hedges. As such, we are OW to Real Estate and Commodities. Rounding out our exposure, we're also OW to Diversified Alternatives which provide some hedge against market volatility.

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