

# Speeding Up to Slow Down

**“Turn right to go left. Yes, thank you! Or should I say, NO THANK YOU!!! Because in Opposite World, maybe that really means thank you.”**

– Lightning McQueen (Cars - 2006)

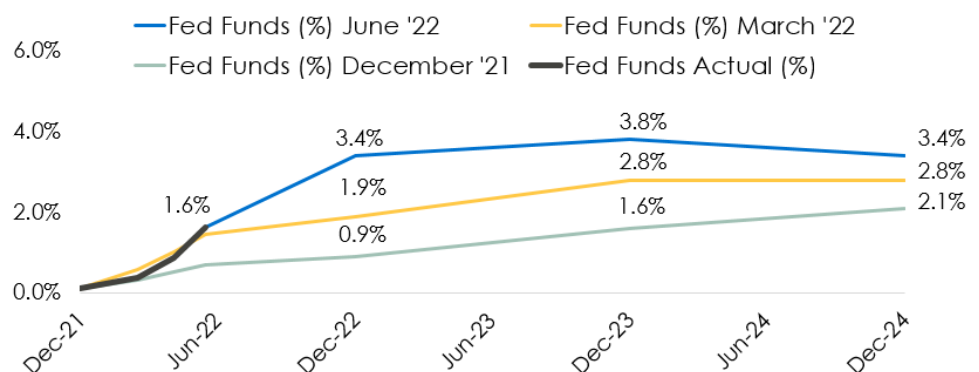
Disney Pixar’s movie Cars – a golden globe award winner for best animated film in 2006 – is famous for personifying cars from all walks of life. If you’ve had kids or grandkids in the past 20 years, you’ve likely not escaped all the film’s merchandise. In one particular scene in the film, modern race car celebrity Lightning McQueen struggles to take a lesson from retired race car legend Doc Hudson on how to speed up and drift into a turn on an old dirt race track.

The Fed may have recently dusted off an old copy of the movie to channel those same lessons as they try to speed up rate hikes to slow down inflation while still staying on the economic circuit. One of the more notable events in the month of June was the Fed meeting in which they announced a historic 75 basis point (0.75%) increase in the Fed Funds rate – the largest such boost since 1994. This followed a 25 basis point rate hike in March and a 50 basis point rate hike in May.

As can be seen in the chart at right, the Fed has also been upping the ante on their forecasts. Rate hike projections have steadily increased from the December FOMC meeting of last year to the most recent meeting held this past month. In just six short months, policymakers have almost quadrupled their projected level for the YE22

Fed Funds rate! This is an indication of just how far the Fed has fallen behind the inflation curve in acknowledging that they have some catch up work to do. With inflation the most elevated in approximately

FOMC Fed Funds Rate Projections



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

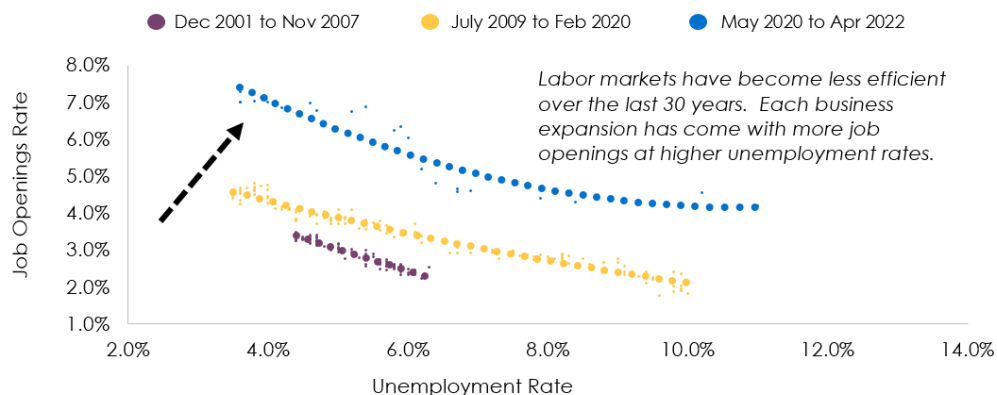


forty years (by most measures), the Fed has now closed the gap between their rate hike forecasts and the bond market's projections. Following the FOMC meeting, the Fed's projection for the peak Fed Funds rate (3.5-4.0%) is now above the market's forecast (3.0-3.5%). Essentially, policymakers are front loading rate increases in order to slow down inflation without disrupting the economy. Of course the trick is in the balancing act between inflation and demand. Can the Fed thread the needle to engineer a soft landing in taking down inflation without roiling the labor markets and thus disrupting demand?

Policymakers argue that the answer to a soft landing lies in the number of job openings relative to the number of unemployed. Incredibly, today there are about twice the number of job openings (11.4 million) as there are unemployed workers (5.9 million) – a record that was set back in March of this year. Fed governors suggest that there's room for the number of job openings to fall – and in so doing cooling inflation – without materially leading to job losses. A soft landing occurs due to that large buffer.

The relationship between job openings and unemployment was developed back in 1958 and is often referred to as the Beveridge curve. As can be seen in the chart at right, this curve highlights the negative relationship between job openings and the unemployment rate. Generally speaking, the greater the number of job openings the fewer the number of unemployed workers. That general relationship has held true over time, however, the curve has been shifting up and to the right over the past three business expansions that span over the last 30 years. This signifies that the sensitivity that job openings have to the unemployment rate is dampening.

### The Beveridge Curve Job Openings vs Unemployment



Source: Factset; Job Openings Rate is defined as the number of job openings divided by the total number of job openings and nonfarm payrolls. Each series is defined by dates associated with business expansions and is plotted using trend series analysis.

In other words, labor markets have been getting tighter or less efficient over the recent past. There have been multiple reasons cited for this dynamic; including a skills mismatch, demographics, immigration policy, unionization, etc. The broader point is that tighter labor markets suggest another argument for structural inflation tendencies that might be harder for the Fed to break.

The Fed is certainly speeding up to slow things down. In so doing, can they engineer a soft landing by shifting the Beveridge curve back down and keeping it there for the next expansion? The answer likely depends on the degree to which the above labor market dynamics are structural or cyclical. We're staying tuned in.



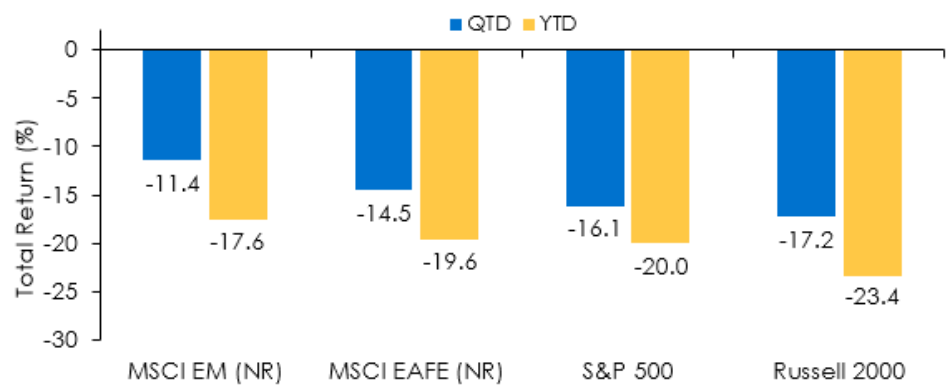
After such heady returns for risk assets in 2021, performance reversed course in most of these areas in the first half of 2022. As such, the S&P 500 suffered its worst six month stretch since March of 2020, the worst twelve month stretch since August of 2009 and the worst first half of a year since 1970. Commodities were the lone bright spot while Stocks and REIT's saw valuation compression. Meanwhile, Bonds were pressured given high inflation and rising interest rates.

## Stocks

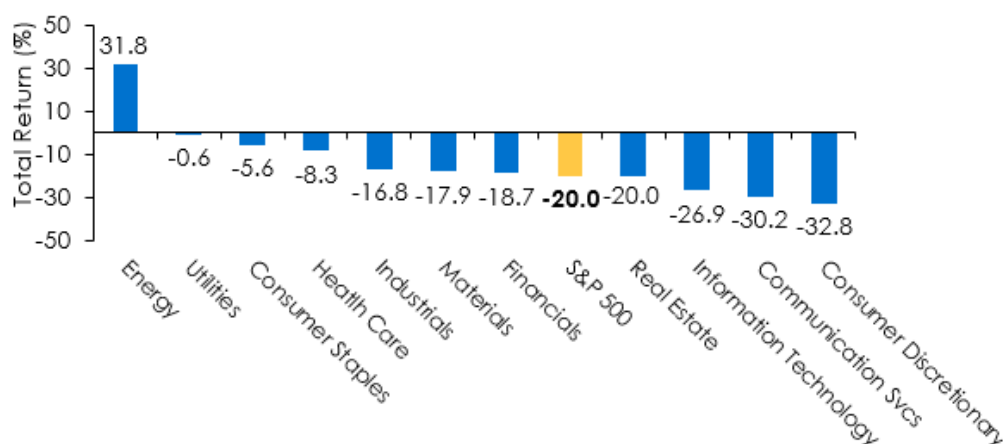
Stock returns suffered in the first half of the year, including a difficult second quarter. Year-to-date, domestic markets (S&P 500 and Russell 2000) underperformed international markets (MSCI EAFE and MSCI EM) as expensive valuations (and rate sensitivities) in the former

more than offset geopolitical risk in the latter and despite a stronger dollar year-to-date. Only one sector within the S&P 500 finished in positive return territory. Sector performance was influenced by valuation and inflation sensitivities as well. Higher priced Cyclical Growth sectors (Discretionary, Technology and Communication Services) and Real Estate were down the most while the least expensive Cyclical Value sectors (Energy, Financials, Industrials, Materials) outperformed alongside the more traditionally Defensive sectors (Consumer Staples, Utilities, Health Care). This latter group outperformed in 2Q amid worries of recession.

**Global Equity Returns**  
June 2022



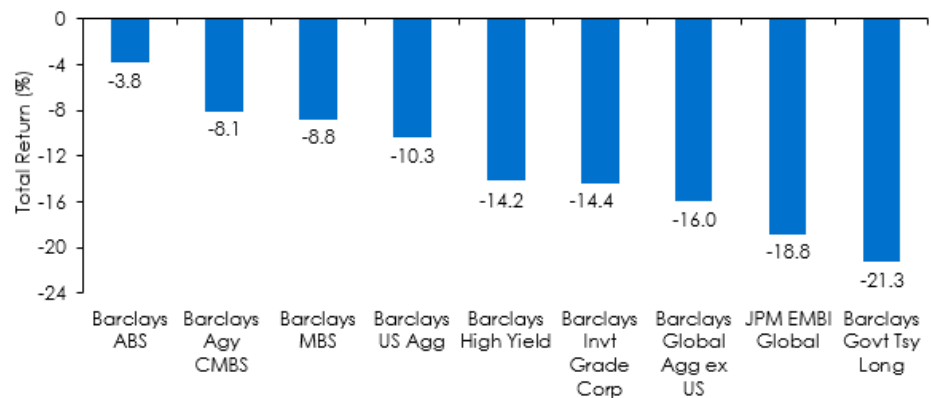
**S&P 500 Sector Returns**  
June 2022 - YTD



## 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 couple of months, however, saw a modest reprieve as inflation data leveled off and inflation expectations moderated. Meanwhile, the Fed has hiked short term rates by 150 basis points (1.50%) and began reducing its balance sheet – both of which have influenced the rate move as well. Year-to-date, bonds that carried shorter durations – namely Securitized Assets (ABS, MBS, CMBS) – were better insulated. While credit spreads held steady for much of last year, they 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 given higher carry and shorter duration positioning relative to Investment Grade corporate bonds. 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 (and given the geopolitical backdrop in the latter) though there was some reversal in longer duration Treasuries in the second half of June.

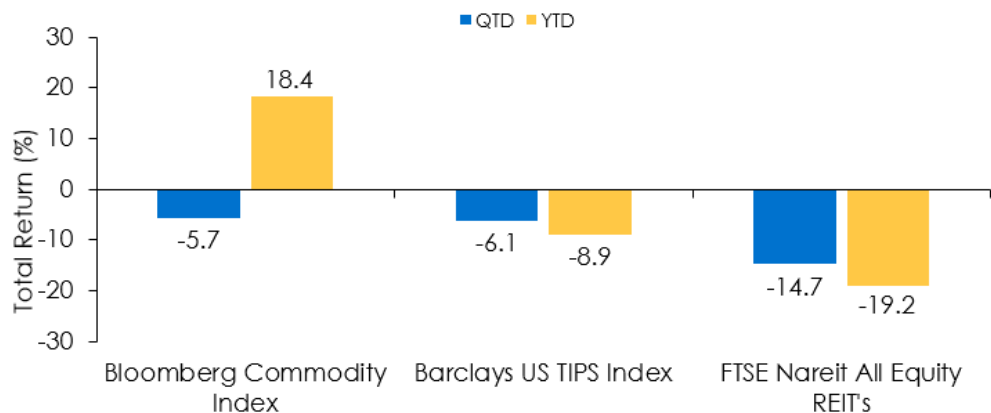
**Global Fixed Income Returns**  
June 2022 - YTD



## Alternatives

Alternatives posted the most disparate of returns year-to-date. Publicly traded Real Estate (REIT's) remained under pressure – 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 started to soften in 2Q on more pronounced profit taking especially in June.

**Alternative Market Returns**  
June 2022



## Market Outlook

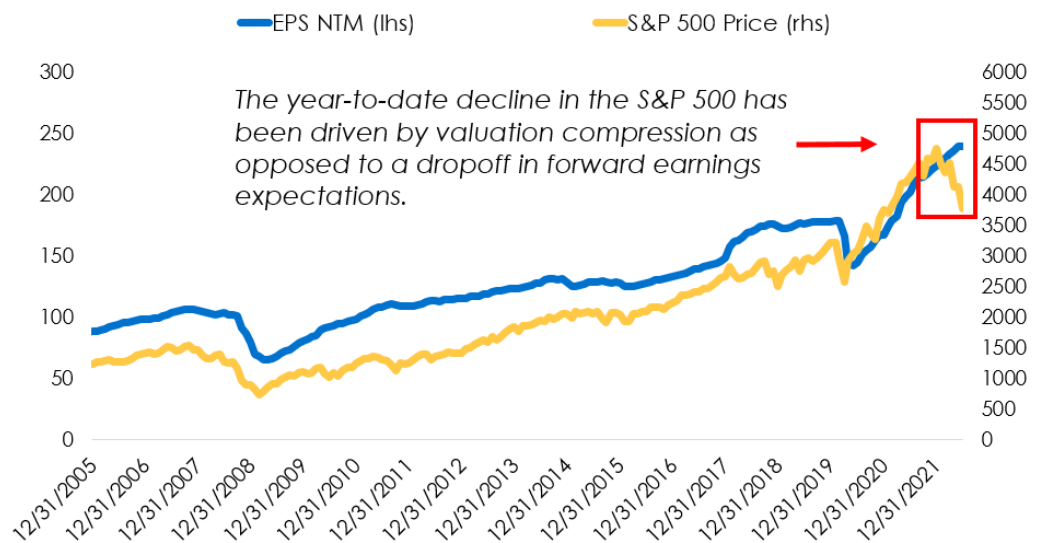
*“It’s tough to make predictions, especially about the future.”*

– Yogi Berra (1925-2015)

As we move to the halfway point of 2022, we still think the phrase “Moderate Resilience” might best define the fundamentals. It’s clear that growth is slowing and is expected to continue to slow as we move through the remainder of the year and as the cycle matures. However, the resiliency of inflation combined with the lagged effect of well above average liquidity from last year suggests that growth, in nominal terms, might still stay elevated for much of this year. In short, we believe that growth is slowing at a quickening pace but its not yet slow to the point of an imminent profits recession.

As such, we would attribute the decline in risk assets, thus far, to be due to a valuation reset to accommodate for a higher inflation backdrop following a period of multiple expansion. As can be seen in the chart below, the S&P 500 (yellow line) has directionally moved very consistently with forward earnings expectations (blue line) over long stretches of time because fundamentals are the most important driver of markets. The price investors are willing to pay for those earnings (in the form of a price to earnings multiple) can be inferred by the gap between the two lines. Note that over the last five to seven years, that gap had closed rather rapidly as the S&P 500 moved ahead of earnings and valuation multiples expanded. As indicated by the red box, that trend has now reversed with valuations needing to reset to account for higher inflation dynamics. Meanwhile, forward earnings expectations have continued to rise. In short, through the first half of the year, fundamentals have taken a back seat to valuations.

**S&P 500 Earnings Expectations vs S&P 500 Price**

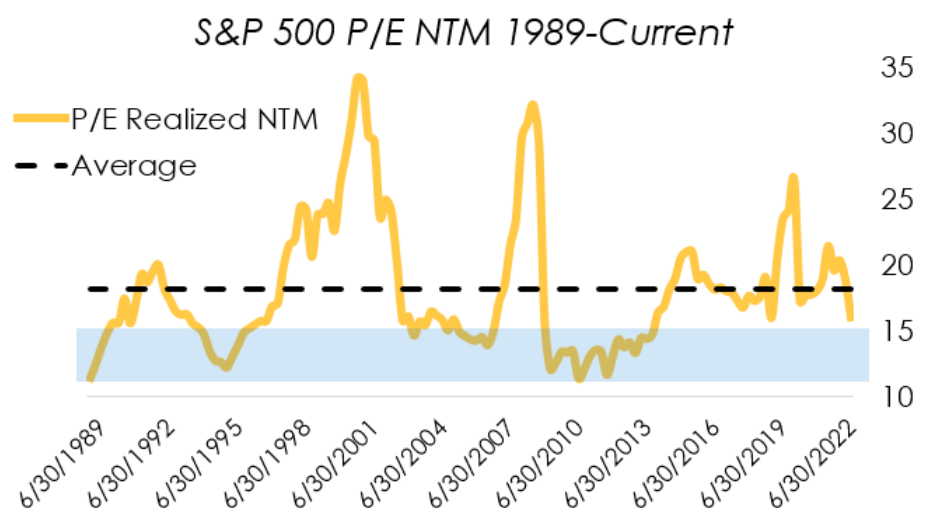


Source: Factset; EPS NTM represents bottom up consensus analyst estimates for S&P 500 earnings per share over the next twelve months.



We think the valuation reset is ongoing with more work to do depending on one's starting point. As we noted in last month's piece, growth stocks have had further to fall relative to value stocks given a widening in valuation disparity over the past decade. By the end of last year, this valuation disparity reached an extreme that had not been seen since 2000. Growth stock multiples are beginning to close the gap relative to value stock multiples, but we still think we're in the early innings as this may take a while to unwind.

In aggregate, S&P 500 valuation multiples (based on next twelve month realized earnings) are in the process of a collective reset. As indicated by the chart at right, based on our next twelve month forecasted earnings estimates, we think there's more work to do to get down to levels where forward multiples have troughed in the past. The market has been working its way to get there with a supportive earnings backdrop. We wonder how long that can hold up.



Source: Factset; S&P Dow Jones Indices. P/E NTM calculated using S&P 500 realized operating earnings over the forward 12 month period. Forecasted earnings are calculated based on Yellow Cardinal's proprietary earnings regression model used in P/E measures beginning 6/30/21.

As rate hikes occur within the context of slowing growth, the interplay between the Fed and inflation will likely dictate the economic landing. As such, we think the focus will turn back to earnings estimates, especially for 2023. To the extent those estimates look overly optimistic, the market may have some heavier lifting to do in order to maintain appropriate valuations.

So what are the implications and key takeaways for portfolios?

Coming into this year, while we didn't anticipate the degree of drawdowns in stocks and bonds, we did have more tempered expectations regarding market returns with an increased likelihood for more volatility. Several conditions led us to that way of thinking including forward returns following a peak in corporate profits growth, above average volatility in mid-term election years, valuation pressures when inflation is elevated and just more modest returns as a bull market ages. That perspective led us to focus on the importance of managing the overall exposure and mix of risk assets within portfolios – with an acknowledgement that the business cycle was maturing and a transition was occurring to the deceleration phase of the profit cycle (i.e. slowing growth). Risk assets needed to downshift accordingly.





From a secular perspective, we're still sympathetic to the view that inflation might linger for longer than expected. While today's inflation is consensus, the persistence of future inflation may not be. Much will depend on the degree to which cyclical and structural inflation factors interact. Inflation may naturally moderate from the elevated levels that are witnessed today, but will structural factors like a step change in the money supply, de-globalization trends, tight labor markets and a global energy transition lead to higher normalized levels? If the inflation paradigm is changing this creates both risks and opportunities in the market. The winners of the recent past – given their valuation vulnerabilities – may not be the same winners in the future. This continues to bias our view towards maintaining pro-inflationary tilts within portfolios while recognizing that the secular view may ebb and flow with the cyclical one.

As noted above, we think that the volatility that we've witnessed in stocks thus far has been driven more by downward pressure on valuations (given elevated inflation) rather than a quick deterioration in the fundamentals (which are slowing more quickly, but not yet slow). Liquidity, however, is coming out of the market which tends to impact the fundamentals with a lag so this bears watching with implications for next year.

From a portfolio positioning perspective, we continue to believe that it's important to strike the right balance between Moderation and Resilience. To us, that means managing the overall exposure and mix of risk assets consistent with a maturing cycle (i.e. Moderation) while also being cognizant of the continued need for pro-inflationary tilts (i.e. Resilience). In essence, we're neutral to slightly UW risk assets with a 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.

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 relative to 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 are OW in aggregate and remain more barbelled. We're OW to Commodities as a way to bolster inflationary hedges while also being OW to Diversified Alternatives which provides some hedge against market volatility. Real Estate was trimmed previously – taking advantage of outsized profits last year.



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