

Whistling Past the Graveyard?

“There’s no such thing as a free lunch.”

– Nobel Laureate economist Milton Friedman (1912-2006)

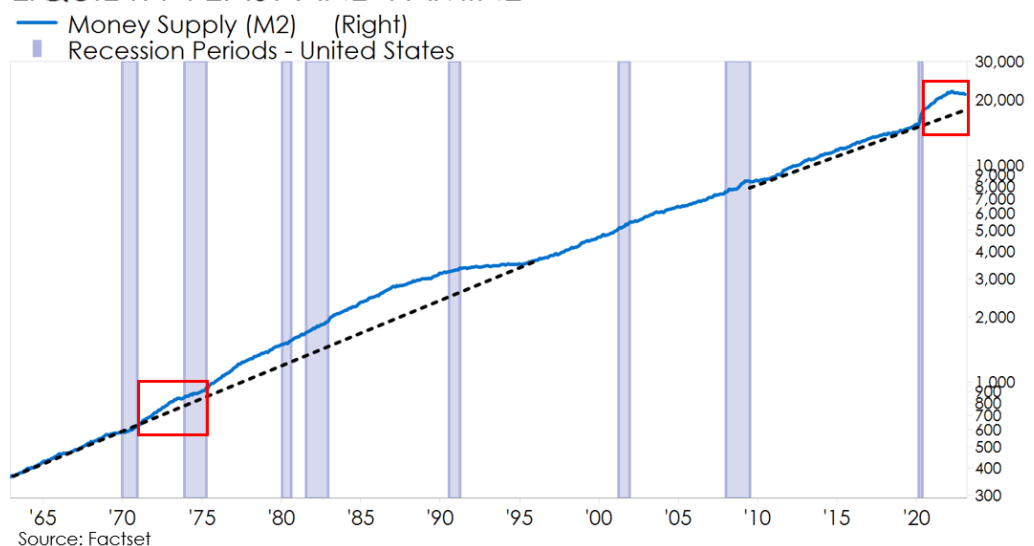
According to *Eat This Not That*, the cost of a Big Mac back in the 1970’s was advertised at just \$0.65. That compares to today’s price of \$5.15, according to *The Economist’s Big Mac index* as of July 2022.

In a speech back in the 1970’s, the famous 20th century economist Milton Friedman explained the “Free Lunch” myth as the notion of government being able to spend money at nobody’s expense. Over the last several years, the “Free Lunch” myth took the form of a new moniker – so called Modern Monetary Theory (MMT). This theory postulated that the US had the luxury of printing and spending money because we had the backing of the dollar as the reserve currency of the world. In other words, speeding up the printing press was not a problem. On the contrary, the inflation data over the past 18 to 24 months has reminded us, “that lunch ain’t free”.

As we’ve dusted off the annals of history, we continue to find the analogue of the 1970’s particularly interesting. Over the last 50 years, the early ‘70’s was the last time we ramped up the printing presses to any

similar degree to which we did in 2020-21. The chart at right plots the pace of that printing press on a logarithmic scale as measured by the money supply (M2) – which is defined by the amount of cash in circulation or deposited in checking accounts, savings accounts or money

LIQUIDITY FEAST AND FAMINE



market vehicles. As illustrated, the last time we had a notable deviation from the established longer term trend

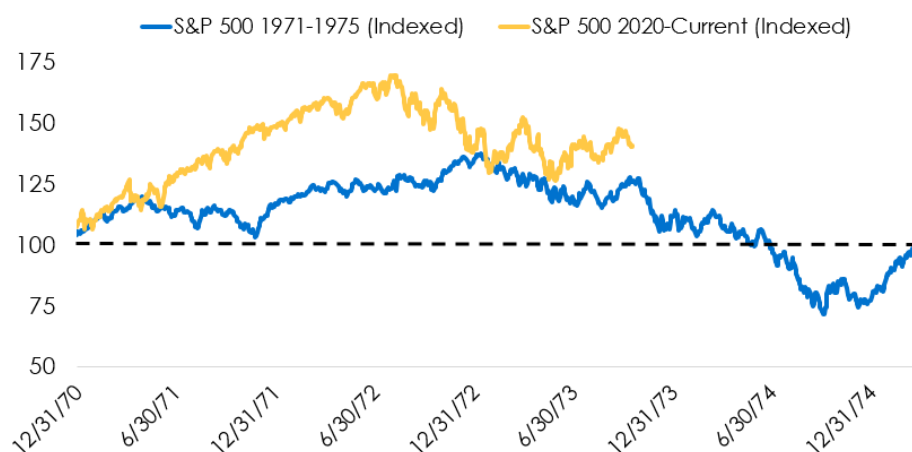


(like today) was the start of the '70's. While there were a multitude of differences included in that '70's analogue, the ramping up of cash was the same. Back then, like today, too many dollars chasing too few goods translated into higher prices. As the money supply ramped up from mid single digits to low double digits from 1971 to 1973, inflation began to ramp up from 1973 to 1975 coinciding with a recession. During that time, the Fed hiked rates on nineteen occasions; then cut prematurely only to have to hike rates four more times in sizeable increments. This leveled off the money supply near the longer term trendline. But as the unemployment rate went from roughly 5% to 9%, the Fed cut rates all the way back to where they had started and the money supply quickly ramped back up again fueling another bout of worsening inflation in the latter part of the decade. It took until the early '80's to find the political will (along with two more recessions) to cure the inflation disease and twenty years before M2 ultimately reconnected back to trend.

The good news bad news about the disease of inflation is that it's mechanically easy to cure but incredibly difficult to have the willingness to do it. That's because it's a divisive issue. It's (initially) good for folks selling their wares but bad for those buying them. Because we're all consumers, in the long run, everyone pays the inflation tax. And the regressive nature of inflation means that those with less income pay the largest relative share. The issue in solving inflation is that many of the bad effects are felt first (higher unemployment, slower growth) before the good effects are felt later (lower prices, stable growth). Taking a lesson from history suggests having the political will to cure it early saves a lot more severe pain in the longer run.

In the mean time, the cure of taking the punch bowl away might require more pain for risk assets. As can be seen in the chart at right, the 1971-75 analogue suggests that we might make a round trip for stocks as they come off their sugar high. Back then, the S&P 500 – indexed to 100 – ultimately finished where it started the journey. After suffering material downside last year, investors have taken a much more aggressive tone to begin this year perhaps under the pretense that the medicine has already been taken. Inflation has come off the highs and recently some of the fundamental data has seen improvement. But with money supply growth still well above trend and some pockets of inflation proving to be “stickier” – given a still very tight labor market – we can't help but wonder if the healing is not quite over and the lunch is not yet paid.

WHISTLING PAST THE GRAVEYARD?



Source: Factset; "1971-1975" indexed as of 12/70-4/75. "2020-Current" indexed as of 5/20-2/23.

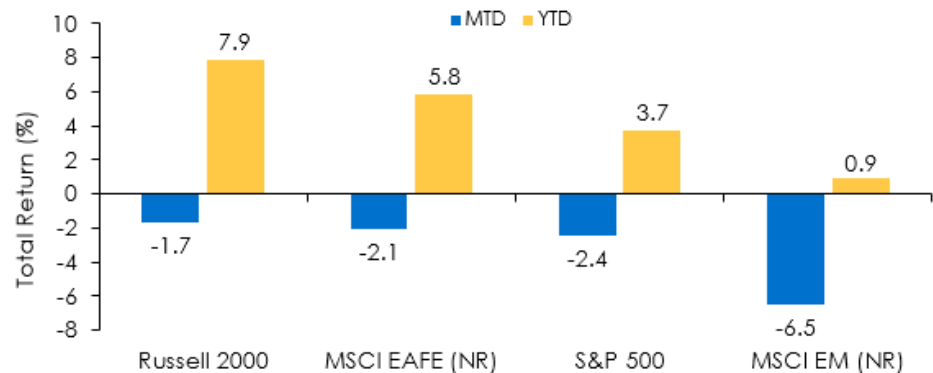


“The January Effect” gave way in February as every major asset class finished lower. However, the markets still retained their cyclical tone as the more aggressive segments generally outperformed on a relative basis. Year-to-date performance still looks like a mirror image of 2022 as January’s strength and continued cyclical leadership was enough to offset this month’s weakness allowing Stocks, REIT’s and most Bond segments to be up year-to-date while Commodity markets finished lower.

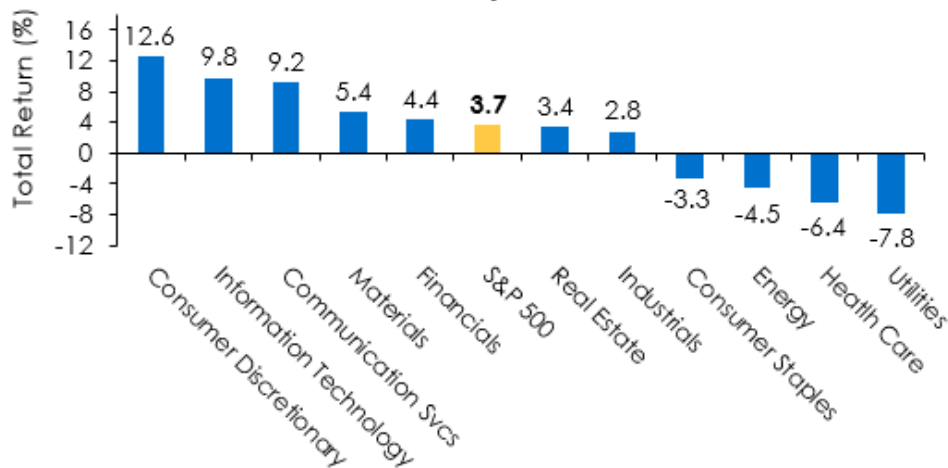
Stocks

Despite finishing lower in February, the most cyclical parts of the equity markets continued to lead. Small Caps outperformed Large Caps and sector performance generally favored higher priced, early cycle groups (Technology, Discretionary and Communication Services). Cyclical value sectors like Financials and Materials led as well. Conversely, defensive equity sectors (Consumer Staples, Health Care and Utilities) were the only group to finish with negative absolute returns in both January and February. Meanwhile, the US dollar bucked the weakening trend after falling for the past several months as rates began to rise. This, along with commodity price weakness, created a headwind for Emerging Market equities (MSCI EM) despite China’s economic reopening following their easing of Covid restrictions.

Global Equity Returns February 2023



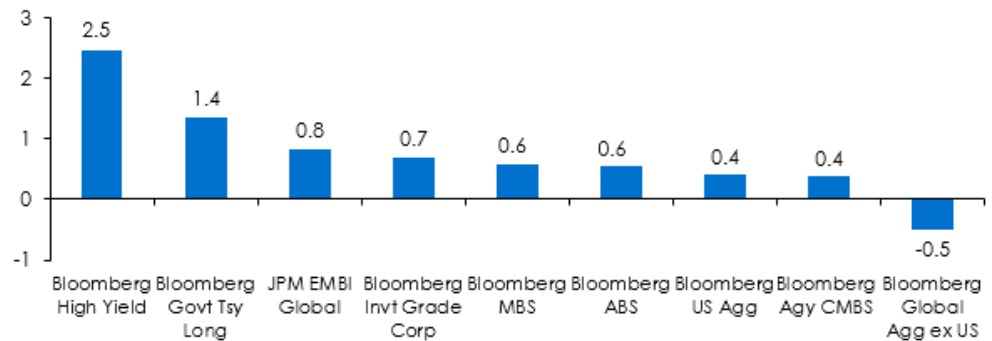
S&P 500 Sector Returns February 2023 - YTD



Bonds

Following aggressive moves by the Fed – having now hiked rates by 450 basis points (to 4.50-4.75%) amid ongoing balance sheet reduction – policymakers continue to “hold the line” on rate policy. Longer term rates have been volatile year-to-date as they’ve effectively made a round trip – decreasing in early January as inflation data came off the boil only to bounce back in February amid tight labor markets and concern that inflation might prove to be stickier. With short rates moving up more than long rates, the yield curve has become more deeply inverted – an indication of macro stress as monetary policy restricts to the point of deteriorating growth prospects. Despite these symptoms of stress, credit spreads have rallied – congruent with the more “risk on” market tone. High Yield’s relatively shorter duration and higher carry has resulted in the best return among the bond market sectors. Meanwhile, long-term Treasuries (Govt Tsy Long) were the second strongest performer of the year as the back down in rates in January more than offset the negative impact of rising rates in February. Conversely, international bonds (Global Agg ex US) underperformed due to their relatively longer duration profile and negative impact from the rising US dollar in February.

Global Fixed Income Returns
February 2023 - YTD

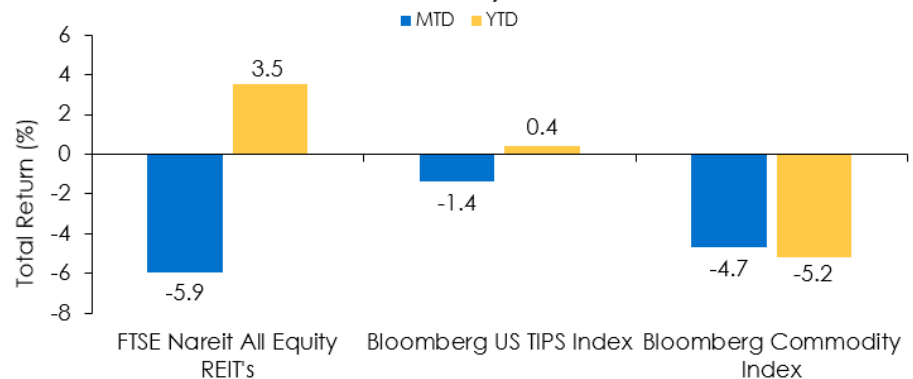


Alternatives

Alternatives continued to have the most disparate of returns YTD. Publicly traded Real Estate (REIT's) gave back a lot of their January outperformance but still led Alternatives for the year. Meanwhile, Commodities posted their second consecutive month of

negative returns in February as weakness was broad based – not just in Energy as was seen in January.

Alternative Market Returns
February 2023



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)

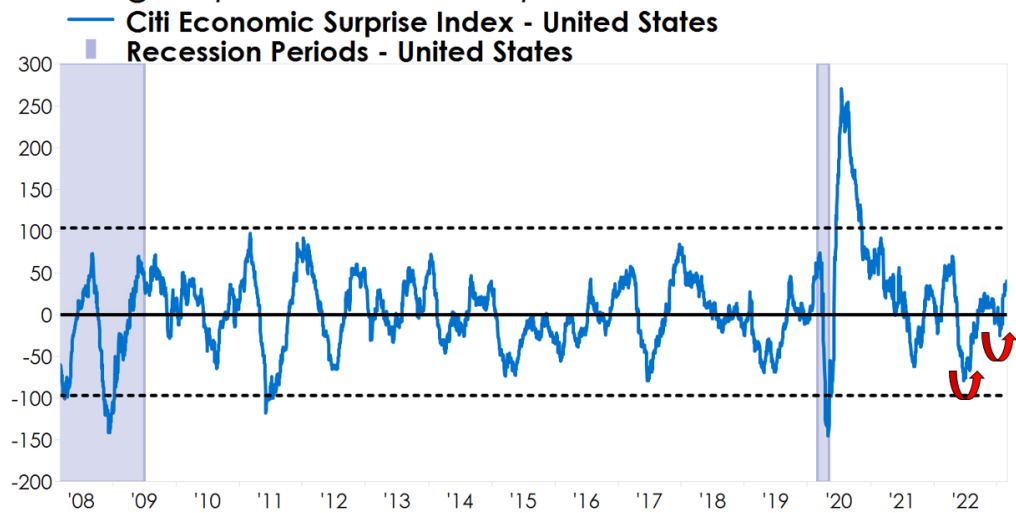
We’re dubbing our main theme for 2023 as “Seeing both the Forest AND the Trees”. As such, we think it’s especially important to have two frameworks for managing portfolios – the cyclical (shorter-term) and the secular (longer-term). The cyclical perspective is an attempt to assess where we are in this 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 hopes not to repeat any time soon. Additionally, we believe there are structural considerations that exist today that might also support this changing paradigm including changes to both aggregate demand (money supply) and supply (de-globalization, labor markets, 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 potential divergence from the secular view – at least for a time. To begin the year, the fundamentals, by and large, have positively surprised. That’s not to say that it’s “all clear and sunny” but it is to say that there’s been enough good news to continue to rationalize a soft landing scenario. As can be seen in the chart above, the Citigroup Economic Surprise Index has now reversed back above the mid point of its

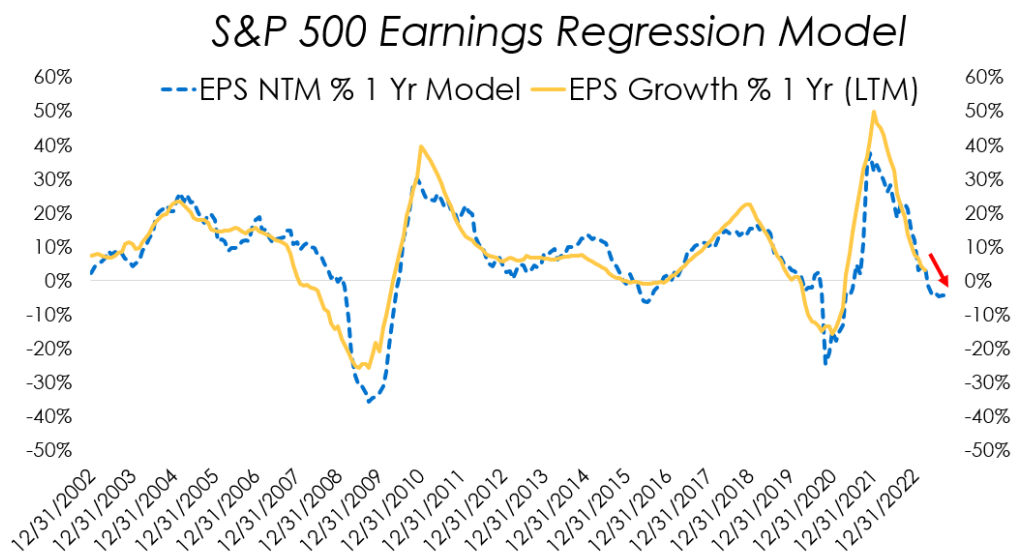
Citigroup Economic Surprise Index



historical range and is climbing toward the upper band that represents positive surprise extremes. A falling dollar along with lower long-term interest rates have historically been tailwinds for economic surprises. We've had both occur for much of the second half of last year though recently these trends have reversed. Additionally, some seasonally warmer weather and social security cost of living adjustments (COLA) have likely aided consumption trends in the first quarter. Meanwhile, the massive liquidity infusion in '20-21 is still being worked off and structurally tight labor markets have continued to contribute to very healthy job gains. Fourth quarter earnings season has not been positive in the sense that this is the first negative quarter over quarter earnings growth seen since 3Q20, though results have generally been viewed as better than feared despite lots of management commentary that have foregone second half guidance due to a lack of macro clarity. A lot of this has to do with the ongoing economic recalibration post the economic shutdown. Imagine snapping a taut string and the sine waves that it creates. The ebb and flow is what we're still experiencing which makes recognizing the normalized trend more difficult for a time. As such, we would agree that macro clarity remains opaque though several conditions seem clearer to us.

- We remain in the latter stages of the business cycle. How late we are in the business cycle remains up for debate, but a record low unemployment rate of 3.4% is just one of numerous metrics that support this view.

- Liquidity is being drained from the economy. Lots of data support this notion including a deeply inverted yield curve, negative year on year money supply growth, a dramatic decline in the savings rate and credit standards that are the tightest since 1Q09 (ex Covid).



Source: Factset; Yellow Cardinal Research. EPS Growth Model is a proprietary regression model based on economic inputs that are found to be good predictors of the S&P 500 profit cycle with a 6 month lead time.

- Growth is slowing. The combination of the above points to slowing growth conditions. We expect nominal GDP growth to be impacted by last year's weakening money supply growth with about a 12 month lag. Leading economic indicators are suggesting deteriorating real GDP growth. Finally, as can be seen in the chart above, our leading profit cycle indicators are still pointing to earnings growth slowing six months out.



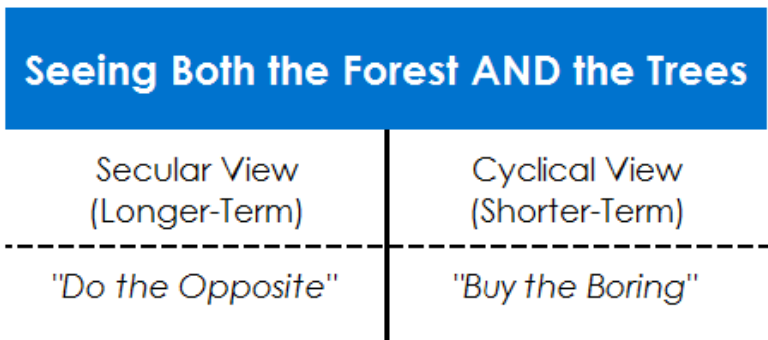
In our view, markets do not seem to be reflecting the above conditions. That's not to say that investors aren't concerned – it's just that the concern seems to be on a hotter than expected backdrop. Sentiment remains volatile as strong labor market metrics and the lagged effect of high liquidity from '20-21 are being countered against sticky inflation and rising rates now acting as a governor on growth. The bond market's pricing of Fed Funds has shifted up materially to a terminal rate closer to 5.5% – which implies three more rate hikes and with cuts not anticipated until mid to late '24 into '25. Inflation expectations have moved back up as well. All of this suggests that inflation still remains the primary risk for markets with investors still hopeful for a soft landing outcome.

But with rates moving higher and liquidity draining more quickly, we can't help but wonder if markets are just trading one cyclical risk (Inflation) for another (Recession). The S&P 500 is still trading (17-18X) well above levels where multiples have typically bottomed during major valuation corrections over the last thirty years (10-15X) at a time when earnings are biased downward and inflation is still elevated. And with bond yields notably higher, there's now a real alternative to stocks (i.e. skinny equity risk premium). To us, this still 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":

- 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. In December 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.

Within equities, 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).

Within fixed income, 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.

Within alternatives, 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.



The information presented in the material is general in nature and should not be considered investment advice, is not designed to address your investment objectives, financial situation or particular needs. Information is gathered from sources deemed reliable but its accuracy or completeness is not guaranteed. The opinions expressed herein may not come to pass, are as of the date of publication and are subject to change based on market, economic or other conditions.

You cannot invest directly in an index. Indexes are unmanaged and measure the changes in market conditions based on the average performance of the securities that make up the index. Investing in small and mid-cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor. Asset allocation and diversification does not ensure a profit or protect against a loss.

Yellow Cardinal Advisory Group, a division of First Financial Bank, provides investment advisory, wealth management and fiduciary services. Yellow Cardinal Advisory Group does not provide legal, tax, or accounting advice. The products and services made available by Yellow Cardinal Advisory Group:

Not Deposits | Not FDIC Insured | Have No Bank or Federal Government Guarantee | May Lose Value

