

Money for Nothing, Risk for Free?

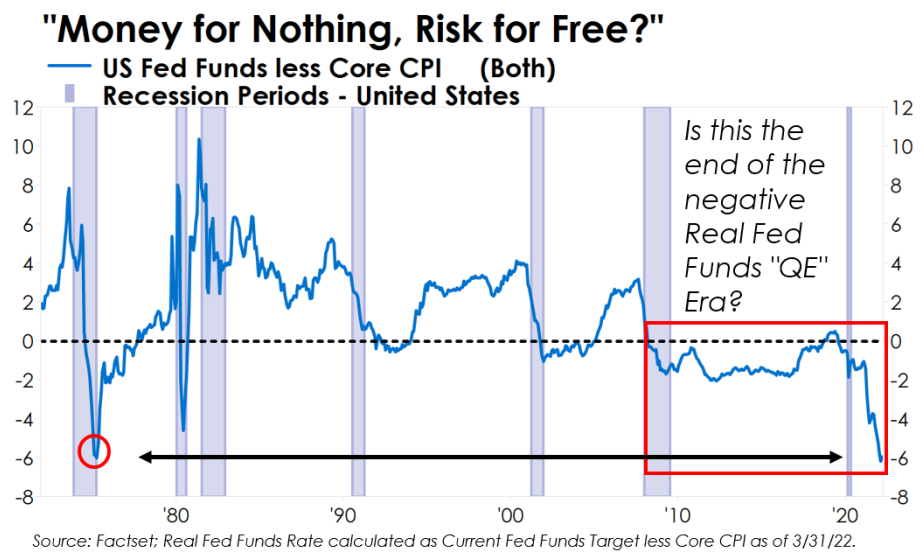
“It was a bright cold April day, and the clocks were striking thirteen.”

– Nineteen Eighty-Four (George Orwell - 1949)

George Orwell’s novel “Nineteen Eighty-Four” opens with the above quote as a way of invoking the provocative thought that, perhaps, the world wasn’t what it appeared to be. In many ways, if one reflects over the past two years it seems like the present day has shifted underfoot. Many things just feel different.

While the market has often been seen as the best forecaster of the future, we often find ourselves looking to the past for answers on how things may play out. While we were initially drawn to more recent decades for answers, we’re finding ourselves having to look back to even earlier analogues – in the ‘60’s and ‘70’s – to identify similarities.

To be clear, we’re not suggesting the absolute level of rates and inflation is comparable, but there are similar dynamics at play. History doesn’t repeat but it does rhyme, as they say. In the ‘70’s, for example, we had the oil embargos which similarly disrupted supply chain subtleties and the Fed got caught behind the inflation curve. As can be seen in the chart at right, the last time we saw the real Fed Funds rate (short-term interest rate controlled by the Fed after subtracting out core inflation) this deeply negative was in April of 1975.



After the Fed’s epic battle with inflation and two recessions later, the stage was set for a structurally higher cost of capital over the ensuing 30 year period. Note that the real Fed Funds rate stayed in positive territory the majority of the time right up until the so called “QE” Era. Over this more recent decade, the Fed has operated



with a negative real Fed Funds rate by keeping the nominal level of Fed Funds mostly near zero amid low and stable inflation. But now policymakers are waking up to the fact that the world may be shifting underfoot and inflation needs to be addressed.

As can be seen in the table below, the late 1970's witnessed core inflation (Core CPI % 1 Yr – middle column) skyrocket from 6% to 14% which forced the Fed to hike aggressively to try and corral it. This culminated in two episodes of aggressive Fed moves where the real Fed Funds rate peaked at 8% in 1980 and then later at 10% in 1981 (inflation re-accelerated after the Fed cut rates forcing them to hike again). We aren't viewing today as entirely the same but we do find enough similarities in the analysis to consider the following potential outcomes.

		Real Fed Funds			Core CPI % 1 Yr			10 Year Yield		
		Trough	Peak	Difference	Trough	Peak	Difference	Trough	Peak	Difference
1975-1980	Date Level	4/30/1975 -6.0%	2/29/1980 8.0%	14%	10/31/1977 6.0%	6/30/1980 13.6%	8%	12/31/1976 6.8%	2/26/1980 13.7%	7%
1980-1981	Date Level	6/30/1980 -4.6%	5/31/1981 10.4%	15%	6/30/1980 9.4%	9/30/1981 11.8%	2%	6/20/1980 9.5%	10/1/1981 15.8%	6%
Current	Date Level	2/28/2022 -6.2%	? -5.9%	0%	6/30/2020 1.2%	? 6.5%	5%	3/9/2020 0.5%	? 2.9%	2%

Source: Factset. Real Fed Funds rate defined as Fed Funds less Core CPI as of 3/31/22. 10 Year Yield as of 4/30/22.

- If inflation doesn't naturally moderate back to where it was in the decade preceding COVID, then the Fed will likely have to close the negative real Fed Funds rate more aggressively. Note that Fed Funds futures is currently pricing in a 3-3.5% rate which would result in neutral real Fed Funds if core inflation moderates back down to the 3-3.5% range (vs 6-6.5% today).
- Policymakers may eventually have to move above the neutral rate (Fed Funds 4-5%) to pull inflation back into a lower and more preferred range (2-2.5%).
- The Fed's two battles with inflation from '75-'81 didn't witness a peak in the 10 Year Treasury Yield until the real Fed Funds rate peaked. In other words, the market needed to be convinced that the Fed had truly stymied inflation before long-term rates moved persistently lower. Even then, it wasn't until the early '90's that a structurally lower level of inflation took hold.
- Ultimately, the economy reset to a structurally higher cost of capital as Fed Funds stayed largely above inflation for the next 3 decades – a consequence of policymakers finding it important to stay ahead of inflation. Money was no longer for nothing; risk was no longer for free.



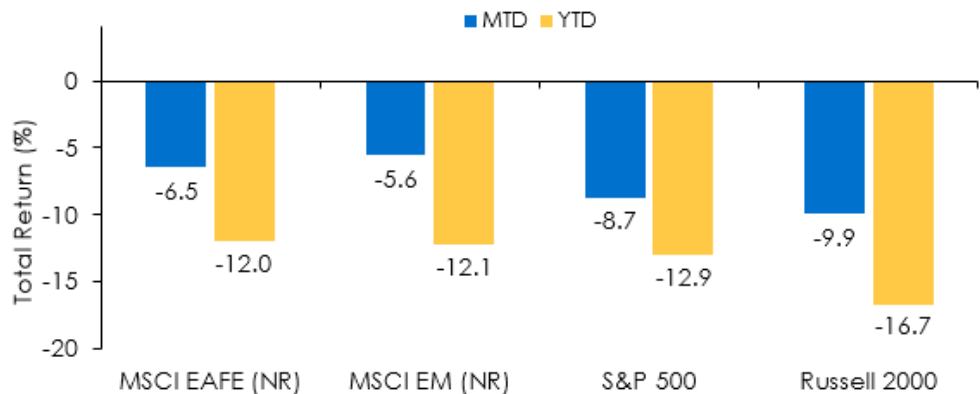
After such heady returns for risk assets in 2021, performance reversed course in most of these areas to begin the year. As such, the S&P 500 suffered its worst year-to-date return since the introduction of COVID. Commodities were the lone bright spot while Stocks and REIT's saw continued valuation compression. Meanwhile, Bonds remained pressured given high inflation and rising interest rates.

Stocks

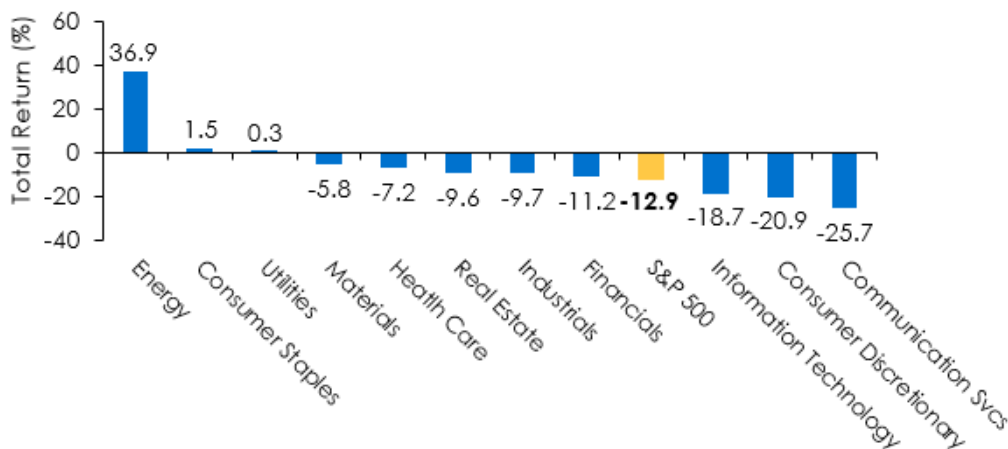
Stocks traded lower to begin the year with notable losses in April. Year-to-date, domestic markets (S&P 500 and Russell 2000) underperformed international markets (MSCI EAFE and MSCI EM) as expensive

valuations (and rate sensitivities) in the former more than offset geopolitical risk in the latter. Only three sectors 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) 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).

Global Equity Returns
April 2022



S&P 500 Sector Returns
April 2022 - YTD

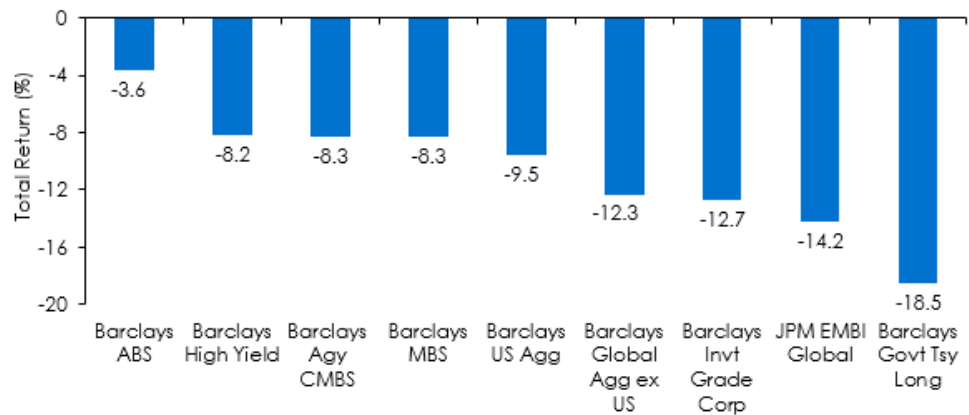


Bonds

Bond returns remained in negative territory amid the continuation of an upward rate bias consistent with elevated and persistent inflation. Long-term rates began trending higher in August of 2020, then traded sideways since April of last year before taking another leg higher year-to-date. Since October, shorter term rates have moved up more quickly as rate markets are pricing in a more aggressive Fed response to the inflation backdrop. As a result, bonds that carried shorter durations – namely Securitized Assets (ABS, MBS, CMBS) – were better insulated. While credit spreads held steady for much of the past year, they began to move wider in November (Omicron) and again year-to-date (Fed and Russia) to levels not seen since late 2020. High Yield outperformed given less credit spread widening 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).

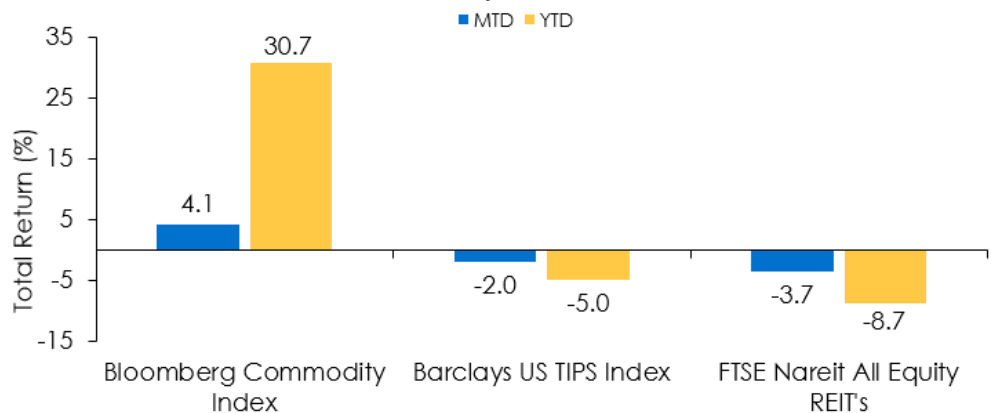
Global Fixed Income Returns
April 2022 - YTD



Alternatives

Alternatives posted the most disparate of returns year-to-date. Publicly traded Real Estate (REIT's) remained under pressure – though outperformed Stocks. Meanwhile, Commodities posted among the strongest (and positive) returns as they've proven to be more resilient as an inflationary hedge with particular strength in Energy, Agriculture and Industrial Metals prices.

Alternative Market Returns
April 2022



Market Outlook

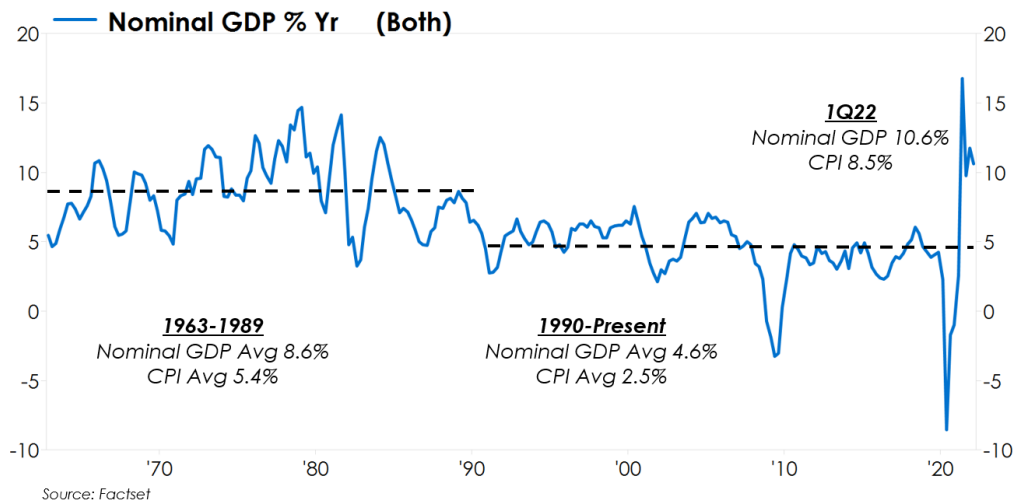
“It’s tough to make predictions, especially about the future.”

– Yogi Berra (1925-2015)

As we move through the course of 2022, we still think the phrase “Moderate Resilience” might best define the fundamentals. Said another way, growth rates moderating from elevated levels might apply to everything from corporate earnings to nominal GDP to inflation. Embedded within that view is the idea that the cycle is maturing, but last year’s well above average growth in the money supply (a key measure of liquidity) suggests some resiliency to nominal growth this year. As can be seen in the chart below, nominal GDP growth has peaked but the resiliency of inflation highlights a fundamental backdrop that’s – so far – more akin to the 30 year period starting in the ‘60’s than the more recent past of the last three decades.

From a cyclical standpoint, our view is that growth is slowing but it’s not necessarily slow, quite yet. Despite the 1Q negative GDP report, we’re still hard pressed to find many recessionary-like data prints in the underlying fundamentals. The negative GDP number was mostly derived from an outsized

Nominal GDP Growth



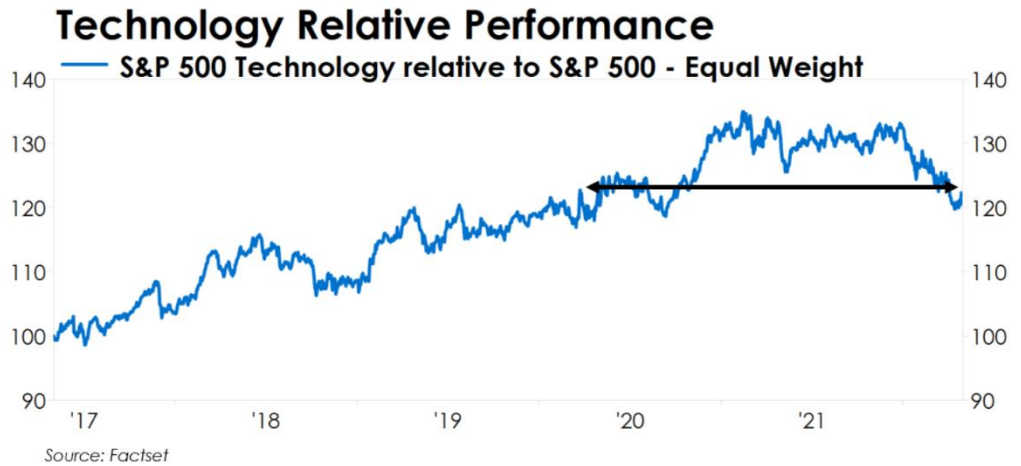
negative trade balance while core growth (personal consumption, capital expenditures, housing) was around 3%. As we look forward, much will depend on how the data evolves along with how the Fed responds – which will influence the trajectory of the slowing growth trend. At this point, however, we think more of the broad based weakness across the expanse of financial markets has to do with valuations needing to reset to a very different inflationary setup.

Coming into this year, valuations were elevated across the board, but particularly in certain areas that benefited from low and falling interest rates. Because many of these areas were the outperformers over the past decade (and longer), they’ve taken on a more structurally positive psyche in the minds of investors.



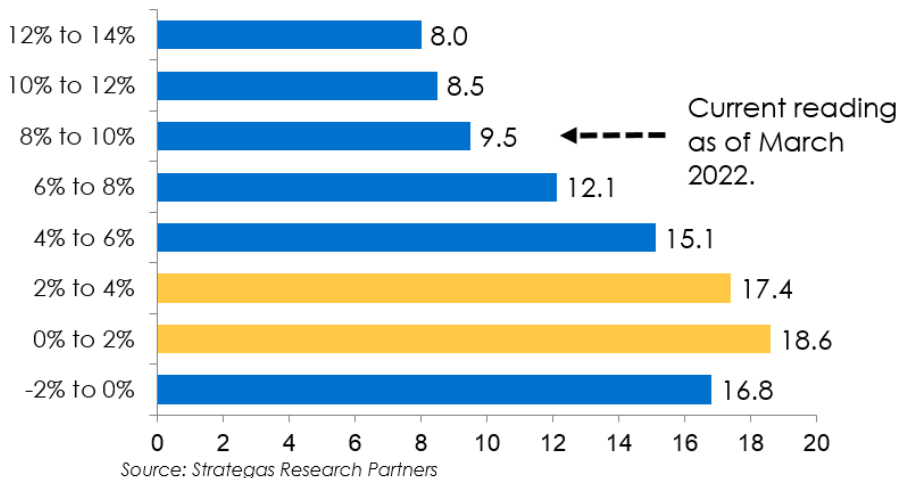
COVID fanned the flames further entrenching these views. But now that the world is changing, valuations are clearly resetting.

The Technology sector – being a home to high valuations – is a good example of this. As can be seen in the chart at right – on an equal weighted basis – Tech’s relative performance has rolled over and all of the COVID outperformance has now been given back.



It’s important to note that there’s historical precedence for this. When inflation has been especially elevated, valuations for stocks have felt the pressure – as noted in the chart below. That’s because in a higher inflationary world, investors are less willing to pay as much for every dollar of earnings that a stock generates because earnings growth is viewed as lower quality in nature. As a consequence, stock valuations have been feeling the pressure particularly in the most expensive areas.

Average S&P 500 LTM P/E By CPI Tranche
1950 - Current



So what are the implications and key takeaways for portfolios?

At the beginning of the year, our expectation was for more moderate 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. 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.

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 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 neutrally positioned with a pro-inflationary bias.

Within equities, our positioning is neutral to 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 OW's in both cyclical value and defensive sectors) and an OW to Developed versus Emerging Markets.

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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