

# The Music That Wouldn't Stop

**“When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.”**

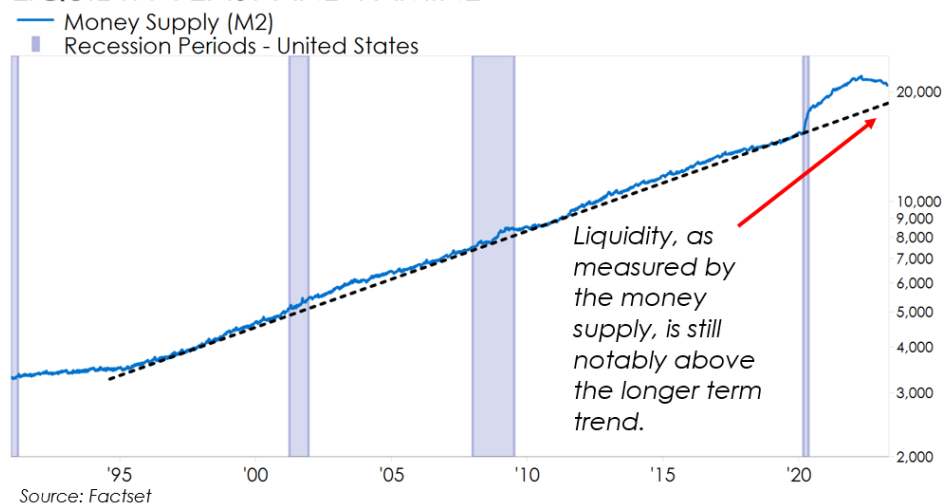
– Chuck Prince (former Citigroup CEO, July 2007)

The iconic 1984 film *Footloose* chronicled a small, conservative town where music and dancing were banned. While we wouldn't suggest the Fed is that extreme, we do think policymakers are trying their darndest to stop the music by taking away the proverbial punch bowl. As such, we couldn't help but be reminded of the dubious quote above that effectively marked the troubled lending environment as a *fait accompli* back in 2007.

To be clear, we're not drawing comparisons to suggest those times will repeat – thank goodness. We're simply suggesting that the liquidity environment continues to transition to the beat of its own drum while policymakers try to deaden the noise.

The Fed's job remains difficult given that the amount of excess liquidity fueling inflation was exceptionally large and, thus, takes time to be sopped up. As can be seen in the chart at right, the Money Supply (M2) – a measure tracking the amount of

## LIQUIDITY FEAST AND FAMINE

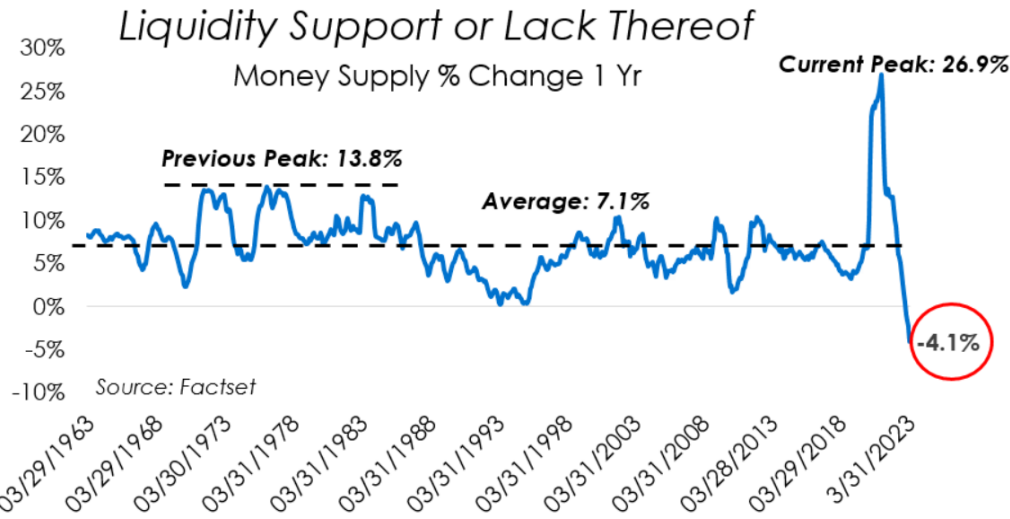


cash in circulation or deposited in checking accounts, savings accounts or money market vehicles – is still notably above its long-term trend to the tune of \$2-2.5 trillion representing about 8-10% of GDP. Arguably, some of this is temporarily inflated due to the Treasury's influx of liquidity attributed to the debt ceiling dynamics, though the point remains the same – excess liquidity has kept the music playing.

One might argue that this kind of environment is constructive for risk taking. While the market action so far this year would sync up with that notion, we think it's important to recognize that the trajectory of liquidity is



headed south and in a hurry – as can be seen in the chart below. In fact, on a year over year basis, M2 has been declining (for the last four consecutive months) – a first for this data series dating back to the early '60's.

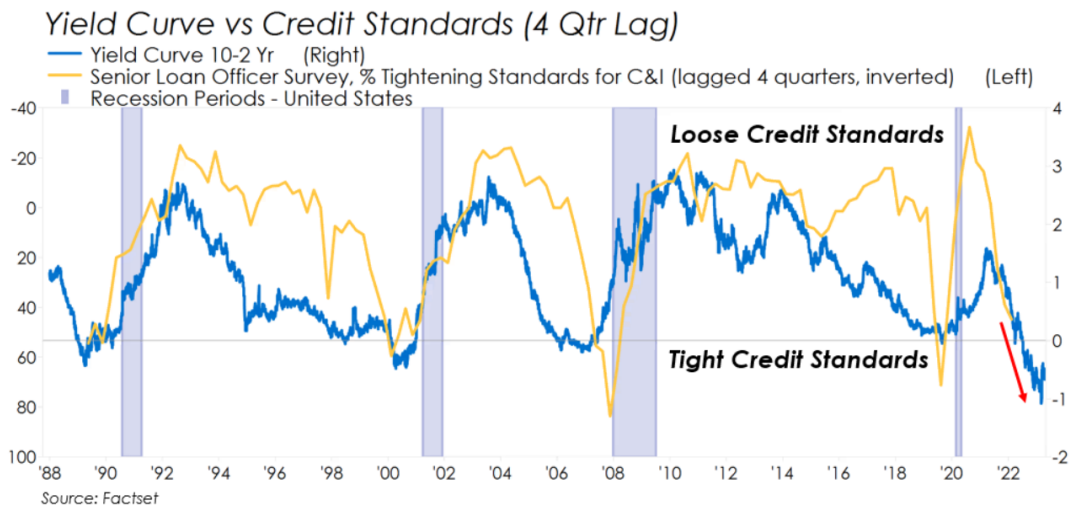


One of the main policy tools at the Fed's disposal is the ability to raise and lower short-term interest rates. A series of 475 bps (4.75%) of rate hikes has had the influence of lifting while also inverting the yield curve (when the level of long-term rates falls

below the level of short-term rates). This is an abnormal condition whereby long-term rate expectations build in lower growth assumptions that eventually anticipate rate cuts yet to be reflected on the short end (due to intentional Fed actions to reign in liquidity). The reason an inverted yield curve matters is because it's generally

seen as a proxy for the banking industry's net interest margin or pricing conditions.

As can be seen in the chart at right, when the yield curve sufficiently flattens and inverts, pricing conditions deteriorate and banks materially



tighten up credit standards (with a lag). As credit standards tighten substantially, loan growth slows sharply and eventually contracts. Essentially, an inverted yield curve shuts down the traditional liquidity mechanism as financing growth becomes more expensive crowding out all but the most attractive projects that require it.

The bottom line is that excess liquidity remains significant, but a determined Fed suggests the clock is ticking. While the music is still playing, risk-playing investors still dancing might find themselves eventually out of step.

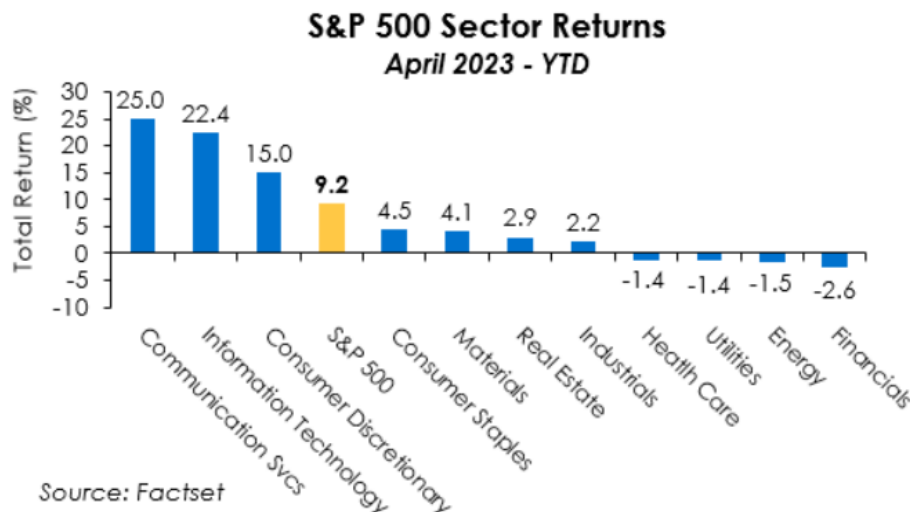
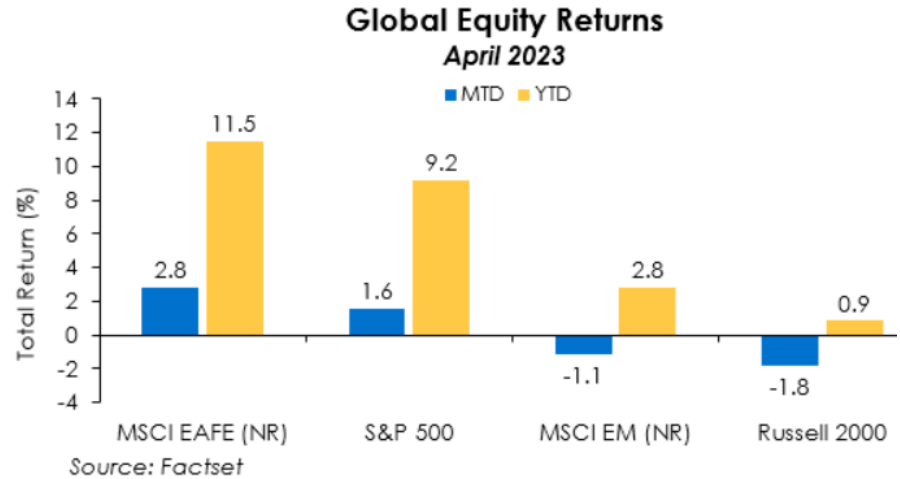


Risk markets continued their YTD rally in April after putting in the best first quarter performance for the S&P 500 since 2019. Despite the headline strength, broader capital markets weren't a monolith as small caps and emerging market stocks lagged while concentrated, US large cap growth stocks outperformed. Fixed Income markets rallied with lower rates and well-behaved credit while Commodity markets had more defensive undertones as precious metals were the only subsector to post positive returns.

## Stocks

Year to date, equity performance continued to favor the larger, more developed markets. Domestically, US Small Caps (Russell 2000) underperformed US Large Caps (S&P 500) and sector

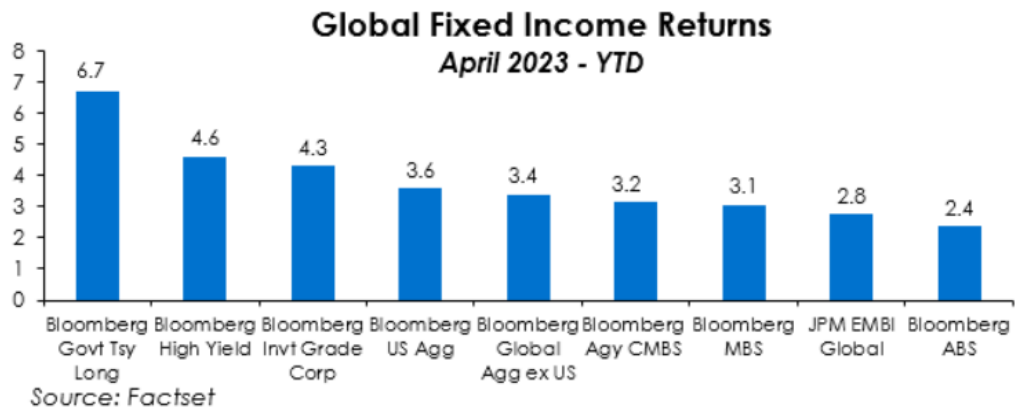
outperformance continued to favor the concentrated and higher priced, cyclical growth sectors (Technology, Discretionary and Communication Services) while cyclical value sectors like Financials and Energy gave way to rising uncertainty. Despite headline strength, cautious undertones were more recently present with defensive sectors like Staples, Health Care and Utilities outperforming over the past two months. Overseas, International Developed Markets (MSCI EAFE) were aided by a weaker dollar which continued to deliver among the best returns year-to-date as financial firms have benefited from a return to positive interest rates and industrials have been helped by warmer weather and the avoidance of an energy crisis.



## Bonds

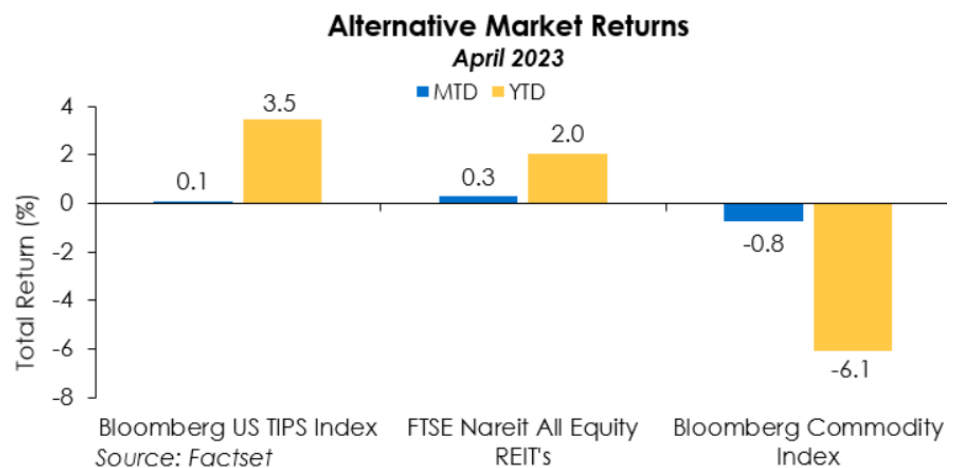
Following aggressive moves by the Fed – having now hiked short-term rates by 475 basis points (to 4.75-5.0%) amid ongoing balance sheet reduction – policymakers continue to “hold the line” on rate policy. Longer term rates have been volatile but biased lower year-to-date – decreasing in early January 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. In March and April, long-term rates fell again as liquidity concerns gripped the global banking sector. Meanwhile, the yield curve remained inverted – an indication of macro stress as monetary policy restricts to the point of deteriorating growth prospects with the entire Treasury curve having moved below the Fed Funds rate. Lower rates benefited the bond market, in total, with positive broad-based returns year-to-date. As such, duration outperformed with Long-Term Treasuries (Govt Tsy Long) leading all other fixed income market

segments. Corporate bonds (High Yield, Investment Grade) remained resilient despite stress in March which stabilized in April. Conversely, securitized credit (MBS, CMBS, ABS) and dollar based Emerging Market debt (EMBI) underperformed.



## Alternatives

Commodities finished lower in April after underperforming consistently in the first quarter as strength in Precious Metals continued to be more than offset by weakness in Energy, Industrial Metals and Agriculture. Meanwhile, Publicly Traded Real Estate



(REIT's) stabilized in April after falling for most of the first quarter outside a strong January. Finally, Treasury inflation protected securities (TIPs) continued to benefit from the rate move in bonds YTD.



## Market Outlook

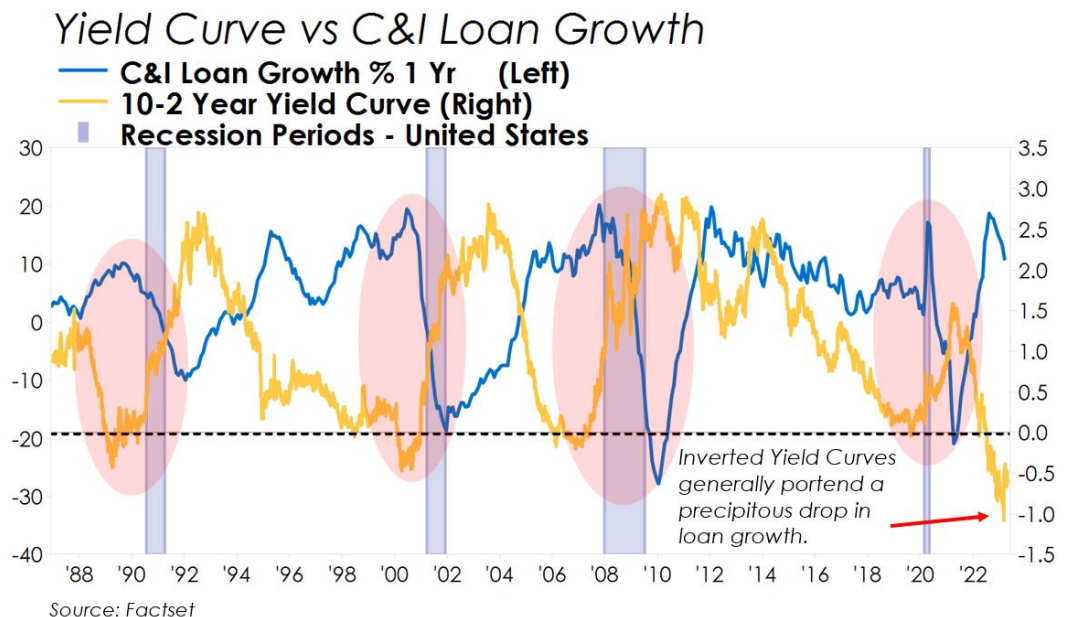
**“Woods are not like other spaces...Stand in a desert or prairie and you know you are in a big space. Stand in the woods and you only sense it.”**

– 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. As can be seen in the chart above (and alluded to earlier), inverted yield curves often portend precipitous drops in loan growth coinciding with recessions. Essentially, the Fed’s ability to influence interest rates leads to a direct impact on

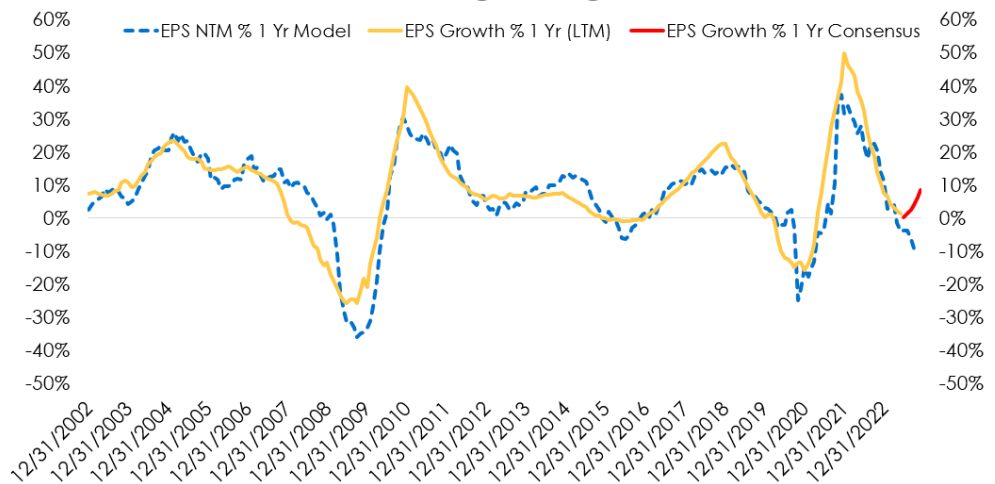


the traditional lending mechanism in the economy. Said another way, monetary policy works with a lag. Today's steep inversion of the yield curve suggests a credit crunch on the horizon – further evidence that implies additional stress might be present. As such, we remain laser focused on our balance of leading indicators which point to the following more cautious set of conditions:

- We remain in the latter stages of the business cycle. What inning we're in remains up for debate, but a combination of liquidity, labor market, capacity and confidence measures all support the conclusion of being late cycle.
- 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 (\$885b off the peak), a dramatic decline in the savings rate and credit standards that are the tightest since 1Q09 (ex Covid) with additional tightening likely.
- 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. Meanwhile, the leading economic indicator composite is suggesting deteriorating real GDP growth. Finally – as can be seen in the chart below – our leading profit cycle indicators are pointing to earnings

growth still deteriorating six months out. This remains at odds with the consensus forecast for an earnings reacceleration. We think such a forecast is predicated on a soft landing scenario – probable but less likely, in our opinion, given the confluence of the above factors. Investors might look through a shallow recession though, according to Strategas Research Partners, that would be highly unusual as the S&P 500 historically bottoms nine months, on average, into a recession.

**S&P 500 Earnings Regression Model**



Source: Factset; S&P Dow Jones; 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. EPS Growth LTM actual earnings is based on iShares S&P 500 ETF (IVV) from Factset. EPS Growth Consensus based on S&P Dow Jones bottom up operating estimates over the next 6 months (smoothed intra-quarter).

With all of this in mind, 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 (~18X) well above levels where multiples have typically

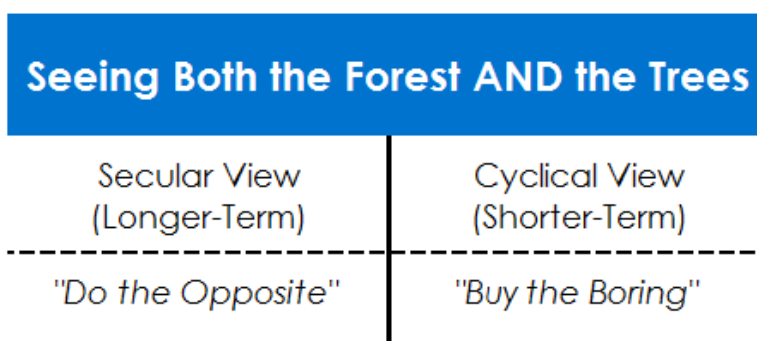


bottomed during major valuation corrections over the last thirty years (10-15X) at a time when earnings are biased downward and inflation is still elevated. And with bond yields notably higher, there's now a real alternative to stocks (i.e. skinny equity risk premium). To us, this still doesn't appear 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 make 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 maintained an underweight to 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.

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