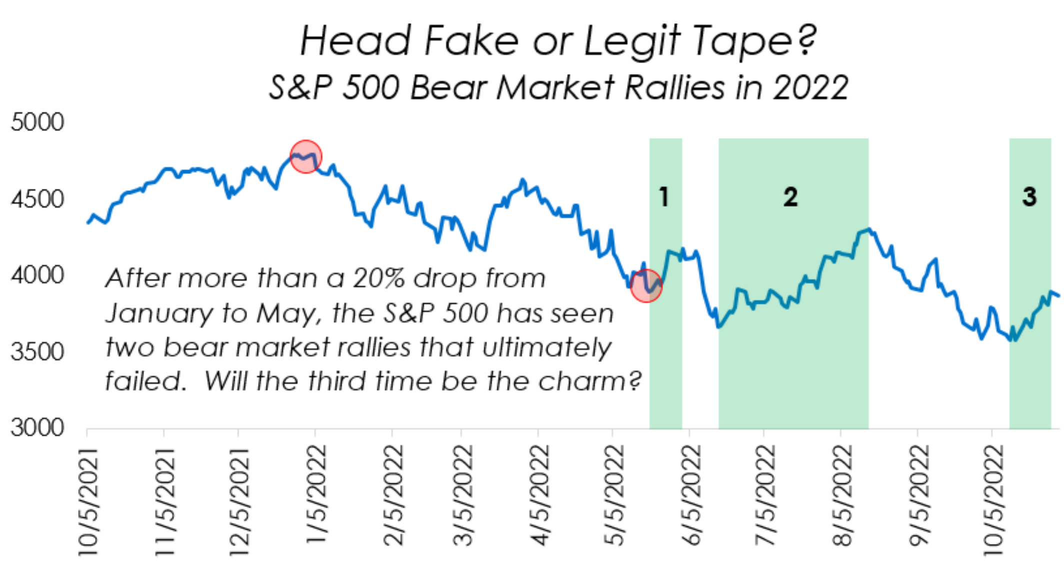
Head Fake or Legit Tape?

Head Fake: "The best way to teach somebody something is to have them think they're learning something else." – Randy Pausch ("The Last Lecture" 2007)

In most team sports, the art of trickeration is a constant companion. It's hard to beat a good play action pass in football, a well timed shot fake in basketball or a sneaky-quick move to first in baseball. At the highest of levels, the strategy of deception is seemingly always a part of the game plan. Perhaps, former Duke coach Mike Krzyzewski said it best, "I have a plan of action but the game is a game of adjustments"...and adjustments on top of adjustments.

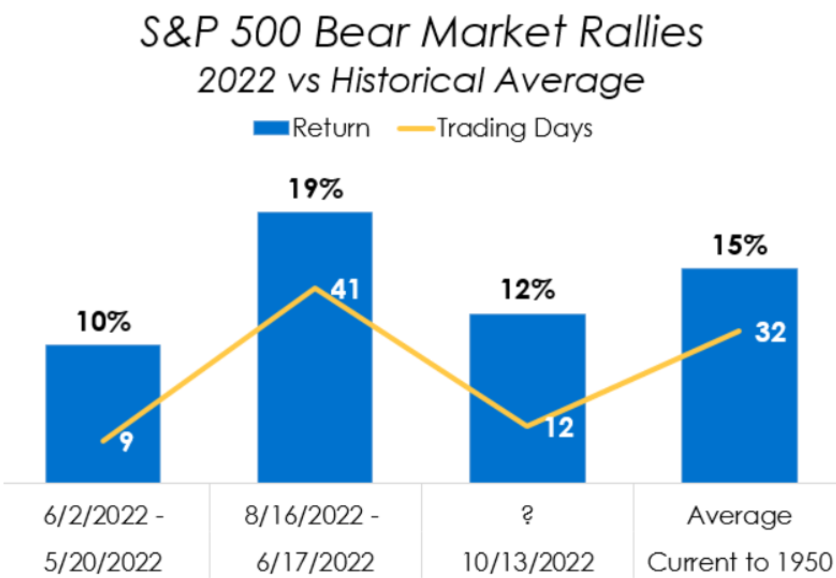
Understanding the ebbs and flows of financial markets can be thought of in much the same way. To the casual observer, it might always seem like Mr. Market is a master of deception. Thinking a little deeper about things might reveal that Mr. Market is made up of many investors – each influenced by differing degrees of factors that may include things like time horizons, risk tolerances, emotional biases, fundamental views, tax impacts, etc. All of these different perspectives can make it challenging to separate the signal from the noise.



Source: Factset

<u>This year investors have been frustrated with the art of the head fake.</u> As can be seen in the chart above, following a 20%+ drop in the S&P 500 from early January to late May – the definition of a bear market – investors have witnessed two separate recoveries that failed to regain the prior peak and, ultimately, led to new lows. These are often referred to as bear market rallies. <u>Another rally attempt has just begun in mid October and investors are hoping the third time might be the charm.</u> The chart on the following page compares both the magnitude and

duration of each of these rallies in comparison to the historical average of the 28 bear market rallies since 1950. So far, the recent move has already surpassed the first rally attempt (late May to early June) on both accords. So is this a "head fake or legit tape"?



Source: Factset; Strategas Research Partners

Bear market rallies, in the moment, can be very difficult to distinguish from the beginning of new bull markets. That's because some bear market rallies have lasted almost as long as three months and delivered more than 25% upside – only to eventually give back. Technical conditions around bear market bottoms can often be used for clues. Generally, technicians like to see extreme bearishness on the way down amid signs of positive divergence (exhaustive selling). Rally attempts are also monitored for signs of strong underlying momentum and broadening breadth (overwhelming buying). While the pronounced selling in September was extreme, it failed to trigger the conditions that we often look for to suggest a complete flush out at the bottom. Meanwhile, the recent rally has showed some signs of improved buying activity but there's still plenty of resistance overhead.

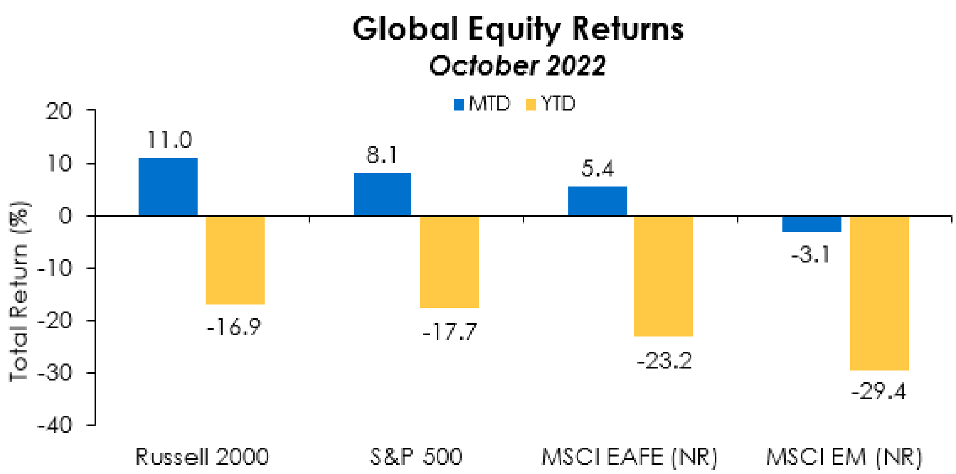
Just as important as monitoring the technicals can be tracking the more traditional measures of the market for such clues. We keep track of a multitude of metrics each month and categorize them in terms of fundamentals, sentiment or liquidity. In keeping up with the sports analogy, the way one might think about these catergories is similar to the phrase *"driving is for show, but putting is for dough"*. Sentiment (i.e. valuations) – which describes how investors feel about risk assets – can provide sharp rallies higher for a time, but without a favorable liquidity and fundamental backdrop, the birdie putt might fall short.

Preferred setups are ones that are characterized by expanding liqudity (often acts with a lag), improving fundamentals and poor sentiment. Essentially, this describes an environment where things are getting better but investors fail to believe it. Unfortunately, we don't see these conditions shaping up quite yet. Liquidity continues to contract and fundamentals still suggest a slow down. Most of the recent move has been driven by improving sentiment. In our view, conditions are still worsening and investors are still hopeful.

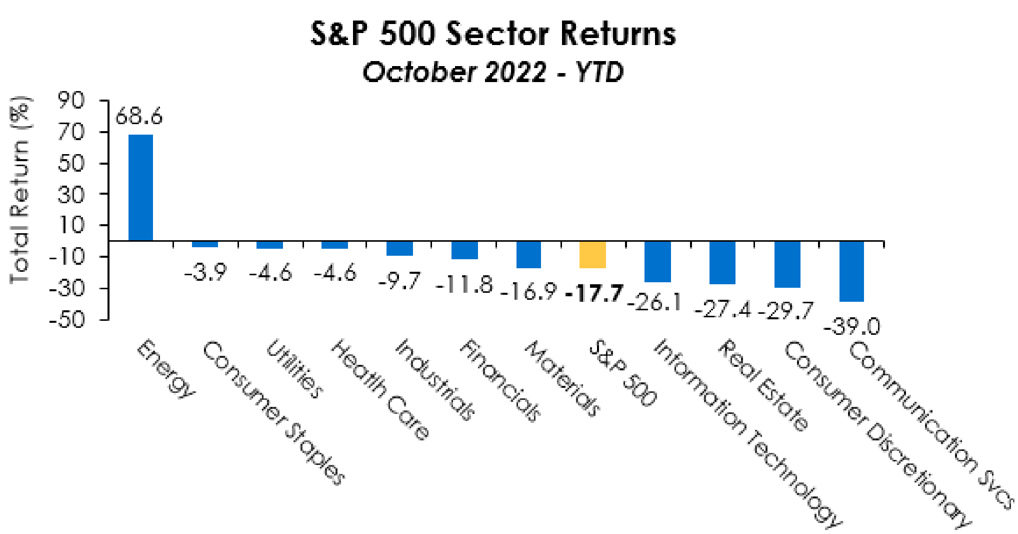
As always, we'll continue to remain laser focused on the data which we use to dispassionately inform our views.

After heady returns for risk assets in 2021, performance reversed course in most of these areas in 2022. While the S&P 500 just turned in its best October since 2015, coming into this month Stocks had suffered their worst 12 month stretch since 2009. Similarly, Bonds have seen their worst intra-year drawdown dating back to the mid '70's. Rising rates and inflation have been the story while Commodities have been the lone bright spot year-to-date.

Stocks

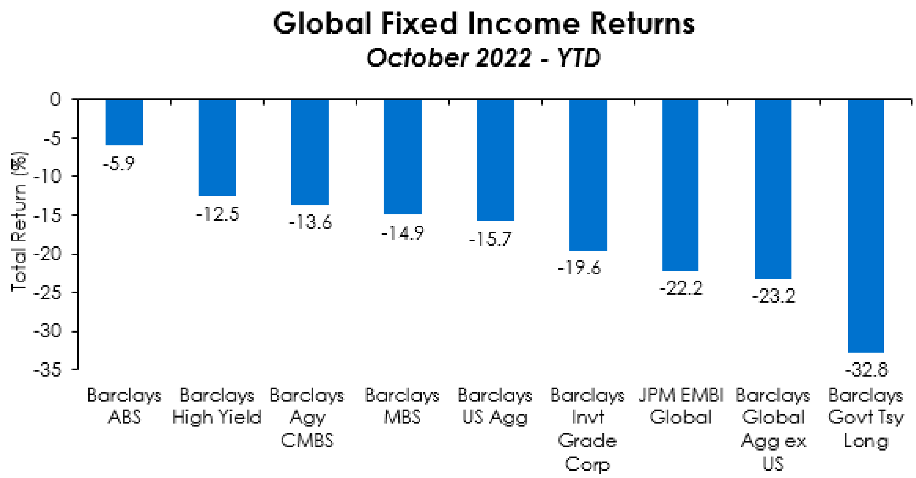


Stocks followed up an especially weak Sepember with a nice bounce back in October amid hints of cyclicality (by market cap and sector). Domestic markets (S&P 500 and Russell 2000) outperformed international markets (MSCI EAFE and MSCI EM) – a trend that has continued year-to-date – as signficant appreciation in the dollar and geopolitical risk have been incremental headwinds in the latter. While positive returns were seen in every S&P 500 sector for the month of October, only one sector has been up year-to-date (Energy). Sector performance has generally favored the less expensive, late cycle cyclicals (Energy, Industrials, Financials and Materials) along with the more traditionally defensive areas (Utilities, Consumer Staples and Health Care). Higher priced, early cycle sectors (Discretionary, Technology and Communication Services) along with Real Estate have been underperformers (up less on the month and down more year-to-date).



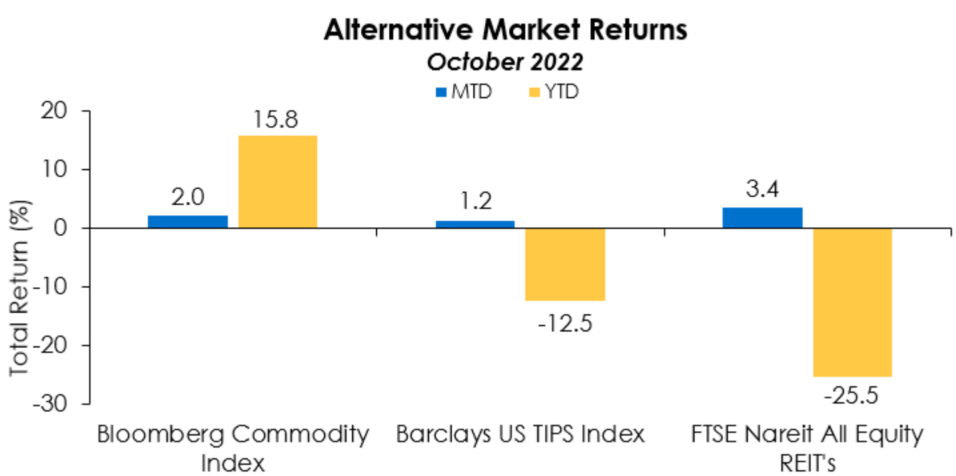
Bonds

For the year, bond returns remained in negative territory amid the continuation of an upward rate bias consistent with elevated and persistent inflation. As such, the Fed has hiked short term rates by 375 basis points through early November (to 3.75-4.0%) and continues to reduce its balance sheet. While the Fed fights inflation as growth expectations slow, the yield curve has flattened with an inversion between the 10-2 Year. Fed Fund futures pricing (~5.0%) has now moved higher than Fed forecasts (4.5-4.75%) for a peak Fed Funds rate. Year-to-date, bonds that carried shorter durations – namely Securitized Assets (ABS, MBS, CMBS) – were better insulated. After holding steady for much of last year, credit began to move wider in November (Omicron) and again year-to-date (Fed and Russia) to levels not seen since mid to late 2020. High Yield outperformed relative to Investment Grade corporate bonds given higher carry and shorter duration positioning along with a tightening of spreads of late. 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. Long duration Treasuries remain most sensitive to Fed policy and inflation while International bonds have been hit by the material strength in the dollar.



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.

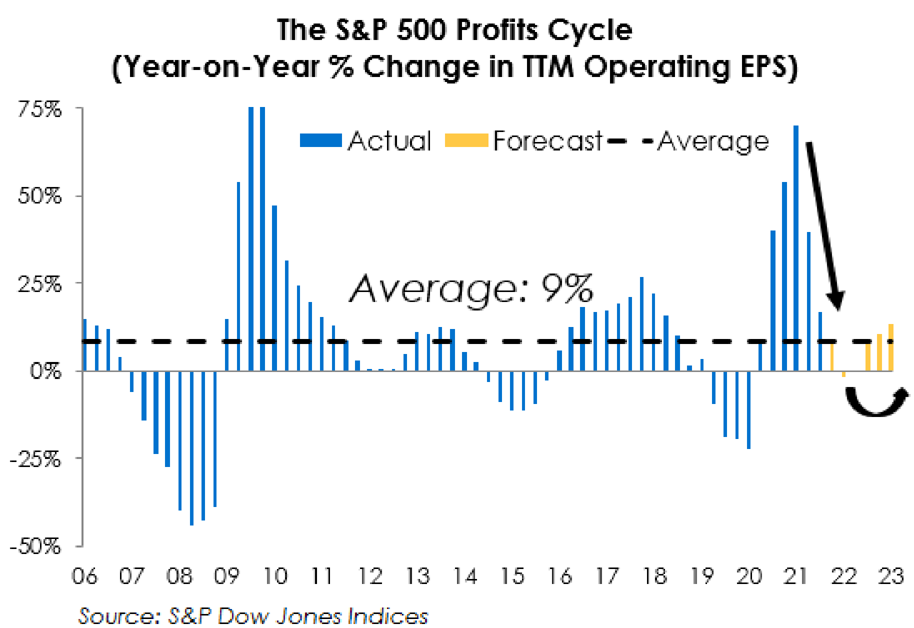


Market Outlook

"It's tough to make predictions, especially about the future."

– Yogi Berra (1925-2015)

We're dubbing our main theme for next year 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. Let's discuss.

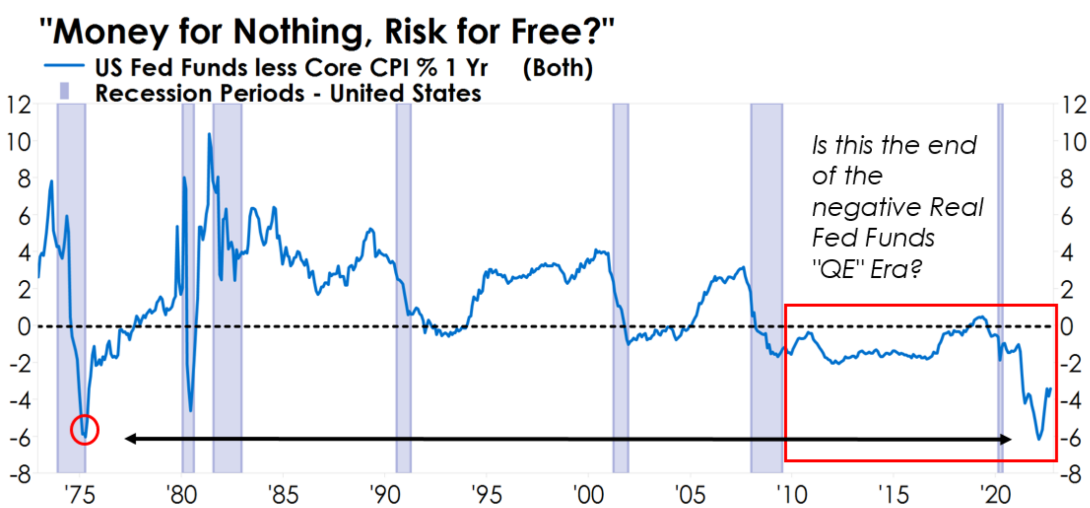


From a cyclical perspective, we've used the phrase "Moderate Resilience" as a way to best describe the fundamentals. It's clear that growth is moderating and is expected to continue to do so as the cycle matures. However, so far this year, growth in nominal terms has been somewhat resilient given the lagged effect of well above average liquidity from last year. In essence, companies have raised prices on goods and services with minimal demand destruction because of the influx of cash from the prior two years. That may be starting to change as the Fed continues to tighten policy and as savings rates have dramatically declined. In short, liquidity is being drained from the system which acts with a lag on growth. As we look into 2023, one question to consider is whether the emphasis will be more on moderation or resilience. In other words, will late cycle conditions lead to a "pause and refresh" or a "profits/economic recession"? As can be seen in the chart above, the consensus believes in the "pause and refresh" story. Given the late cycle setup, we think the risk for earnings estimates is to the downside especially in the absence of an obvious catalyst for growth reacceleration.

To further support that view, most of the macro fundamental data is evidencing a slowdown and our leading profit cycle indicators point to the continuation of a growth deceleration ahead. If forward earnings estimates prove to be too optimistic and need to fall further (NTM EPS is 3% off the highs), then stocks might be more expensive than they appear (17.5-18.5X vs current 16.5X). This comes at a time when stocks have not quite fallen to levels where multiples have typically bottomed over the past thirty years (10-15X). Similarly, more of our leading recessionary indicators are getting triggered suggesting that while recession isn't necessarily imminent, the storm clouds are brewing for one on the horizon.

In short, we think investors have to contend with three headwinds right now (1) valuations that might still have to reset a little further (2) earnings that may prove to be too optimistic (3) and a Fed that is aggressively tightening to catch up to inflation. While investors remain extremely hopeful for a Fed pivot, we can't help but wonder if markets are just trading one cyclical risk (Inflation) for another (Recession). All of this is to suggest that, not surprisingly, it doesn't appear to be a great set up for risk assets from a cyclical point of view.

From a secular perspective, we remain sympathetic to the notion that the economic paradigm is changing to one that ushers in more persistent inflation in a higher cost of capital world. As the chart below shows, the last time the Fed was this far behind the inflation curve was back in the mid '70's. That is to say that the real Fed Funds rate (short-term interest rate the Fed controls less core inflation) recently bottomed at around the same depressed level as that seen back in April of 1975. Back then, that set the stage for an ultra-aggressive Fed tightening policy in order to catch up to and corral inflation. The biggest takeaway for us from that inflation fighting experience is that it led to a structurally higher cost of capital framework for the next two to three decades. In other words, the real Fed Funds rate stayed in positive territory the vast majority of the time for the next 20-30 years. That shift is dramatically different than what the economy and businesses have become accustom to over the past 10-15 years – benign inflation and free money. In summary, if the economic paradigm is changing, we think that has big implications for businesses and financial markets.



Source: Factset; Real Fed Funds Rate calculated as Current Fed Funds Target less Core CPI as of 9/30/22.

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 – *"Do the Opposite"* and *"Buy the Boring"*:

Seeing Both the Forest AND the Trees

Secular View (Longer-Term)	Cyclical View (Shorter-Term)
"Do the Opposite"	*"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 may now offer greater risk in a higher cost of capital world. Conversely, the losers over the past 10-15 years may 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 continued need for pro-inflationary tilts (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. Broadly, this involved (1) reducing risk assets to a modest UW by trimming Stocks and REIT's and adding to US Bonds (2) lowering the beta within US LC Equities by trimming our OW to Cyclical Value sectors and adding to our OW in Defensive sectors (3) lowering the beta within US Bonds by lengthening duration back to a net long posture. In essence, we continue to downshift risk in portfolios with a (more measured) pro-inflationary bias given the late cycle setup.

Within equities, our positioning is modestly UW and continues to favor a pro-inflation preference with 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 modestly OW corporate bonds, though we've recently 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 are more modestly OW to Commodities as a way to bolster inflationary hedges. Meanwhile, Real Estate was trimmed of late as a way to further reduce overall portfolio risk.