Is 12:00 AM Late or Early?

"It gets late early out there."

– Yogi Berra (Professional baseball player and coach 1925-2015)

Early innings or late innings? First quarter or fourth quarter? Sports fans and investors alike are often interested in knowing the context of the situation.

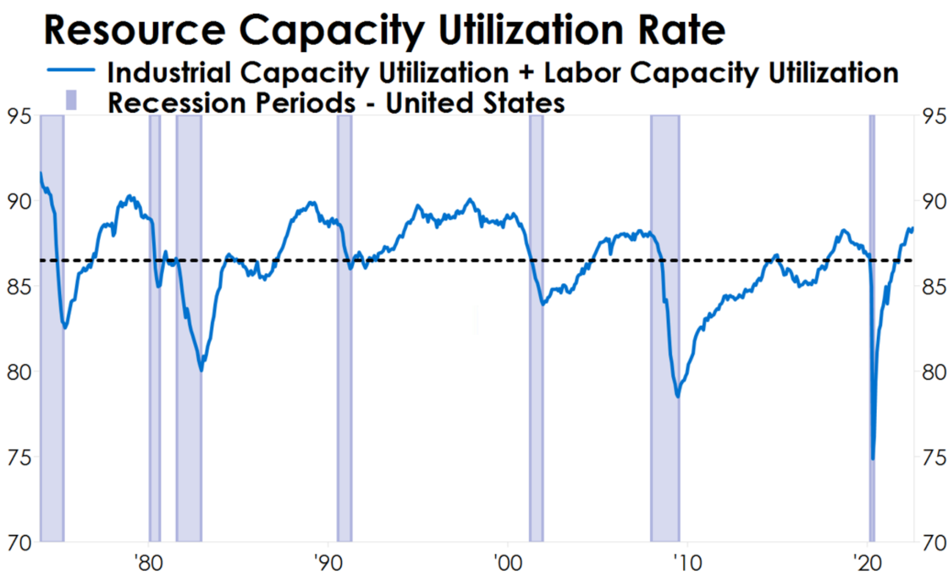
The S&P 500 rallied about 20% off the lows from mid June to mid August, which left many a market enthusiast hopeful of a durable market bottom and the beginnings of an early cycle emerging. On the surface, things looked promising as risk assets outpeformed and were led by the most cyclical sectors. As we wrote about last month, a big part of the rationale for this move was based on the hope of a shift in Fed policy ("Refilling the Punch Bowl") breathing renewed life into the business cycle.

Date of Easing Cycle	# of Fed Rate Cuts	Max Drawdown	Drawdown (Mo of Cycle)	Length of Cycle (Mo)	Recession Y/N
4/80-8/80	3	-4%	1	5	Yes
6/81-5/83	12	-23%	15	23	Yes
8/84-4/87	14	-9%	27	35	No
5/89-2/94	20	-20%	18	61	Yes
7/95-6/99	6	-19%	41	52	No
1/01-6/04	13	-43%	23	46	Yes
9/07-12/15	9	-57%	19	108	Yes
8/19 - 6/22	5	-30%	8	35	Yes
Average	**10**	**-26%**	**19**	**46**	**Hit Rate**
Median	**11**	**-22%**	**19**	**41**	**75%**

Source: Factset; Easing cycle defined as beginning when the Fed lowers rates in three or more consecutive occurrences and ends when the Fed raises rates in three or more consecutive occurrences.

We've been a bit more cautious coming to that conclusion for several reasons. For starters, the beginnings of business/market cycles often occur AFTER the Fed is at least halfway through its EASING cycle (defined as beginning with three or more rate cut occurrences and ending in the reverse). Lowering interest rates is a way of providing economic fuel to propel the start of the recovery process but liquidity acts with a lag. As can be seen in the table above, over the past 40 years, easing cycles have been associated with recessions 75% of the time. Stocks may initially cheer Fed rate cuts only to recognize that Fed easing is often occurring because of poor fundamentals. As evidenced, S&P 500 drawdowns of 20% or more often occur about halfway through the easing cycle. It's generally not until after the fundamentals and sentiment have been flushed out that the early cycle process can begin anew. With the Fed still on the path of hiking interest rates to address stubbornly high inflation – confirmed by Fed Chair Powell's recently delivered speech at Jackson Hole – it would appear that early cycle conditions are still a ways off.

Other fundamental conditions suggest a late (as opposed to early) cycle setup as well. Take the Resource Capacity Utilization Rate (RUR). Don't let the fancy name fool you. It's simply a measure of economic capacity. The RUR is calculated by taking the average of the Industrial Capacity Utilization Rate (a measure of equipment and factory usage) and the Employment Rate (a measure of labor usage). The higher the RUR climbs, the later business cycle conditions generally are. When this measure has moved above its 50 year average – headed toward 90% – it's historically been a pretty good indication of an economy running near the red line. Conversely, early cycle conditions happen after a notable decline as economic capacity is reset lower following the fallout from a recession. With a current reading of 88% (well off the cycle lows of 75%), the US economy is running at or near full capacity – another indication of a late cycle setup.



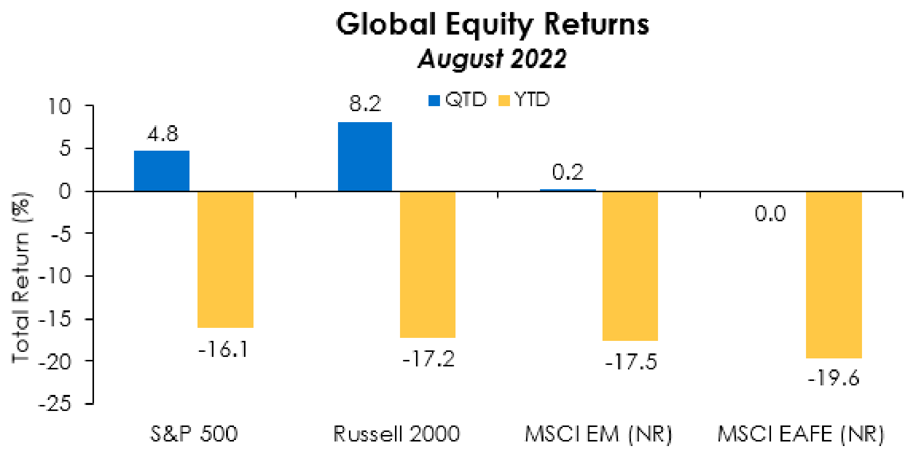
Source: Ed Yardeni, Factset; Resource Capacity Utilization Rate calculated as the average of the Capacity Utilization Rate and the Employment Rate.

All of this is to suggest that when one looks at both the liquidity (Fed tightening) and fundamental (nominal growth slowing) backdrop, the evidence would imply that early market cycle leadership may be a bit premature. Late cycle conditions can persist prior to a downturn, but to us, the backdrop continues to skew towards taking less as opposed to more incremental risk.

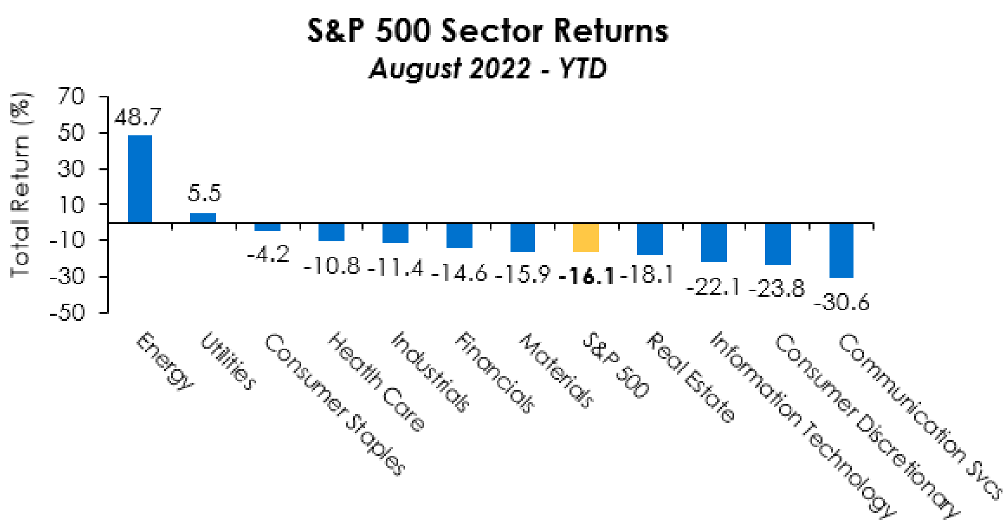
As such, we continue to look more skeptically upon this most recent risk asset rally and rely on the wisdom of others. As many a coach has told his/her players a time or two; "nothing ever good happens after midnight". In the meantime, rest assured, we'll be watching for signs of daylight.

After heady returns for risk assets in 2021, performance reversed course in most of these areas thus far in 2022. The S&P 500 posted negative returns in 5 of 8 months this year, leading to the weakest 12 month stretch since August of 2009. Year-to-date, commodities remained the bright spot while Stocks and REIT's saw valuation compression. Meanwhile, Bonds were pressured given high inflation and rising interest rates.

Stocks

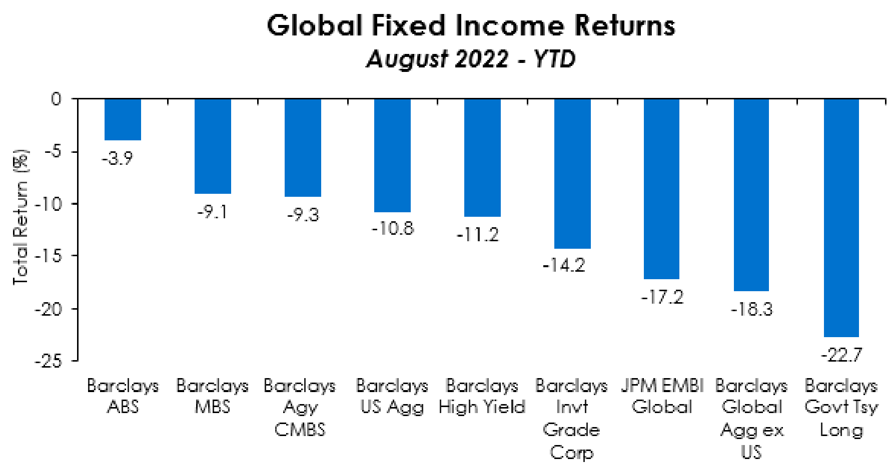


Stock returns posted a mixed quarter to date with upside in July followed by weakness in August. Year-to-date, domestic markets (S&P 500 and Russell 2000) are outperforming international markets (MSCI EAFE and MSCI EM) as signficant appreciation in the dollar and geopolitical risk have been headwinds in the latter. Only two sectors within the S&P 500 have posted positive returns for the year thus far. Outside of the "risk on" rally from mid June to mid August, sector performance has generally favored the less expensive, late cycle cyclicals (Energy, Industrials, Financials and Materials) along with traditionally defensive sectors (Utilities, Consumer Staples and Health Care). Higher priced, early cycle sectors (Discretionary, Technology and Communication Services) along with Real Estate were down the most.



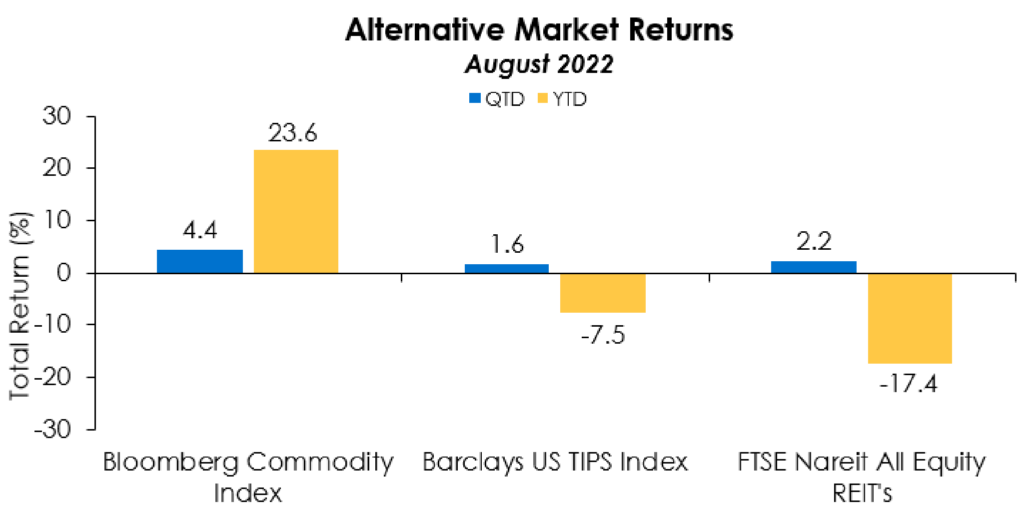
Bonds

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 225 basis points (to 2.25-2.50%) and began reducing 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 now appears to be in line with Fed forecasts for a peak Fed Funds rate between 3.5-4.0%. 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 the second half of 2020. High Yield outperformed relative to Investment Grade corporate bonds given higher carry and shorter duration positioning. 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 – though the 10 Year Treasury yield is off its highs made back in mid-June.



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.



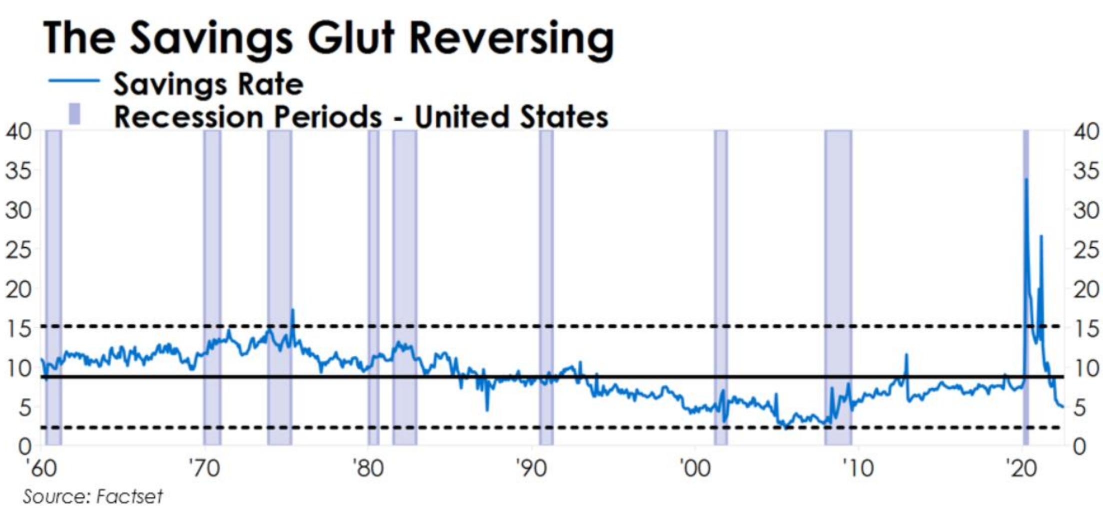
Market Outlook

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

– Yogi Berra (1925-2015)

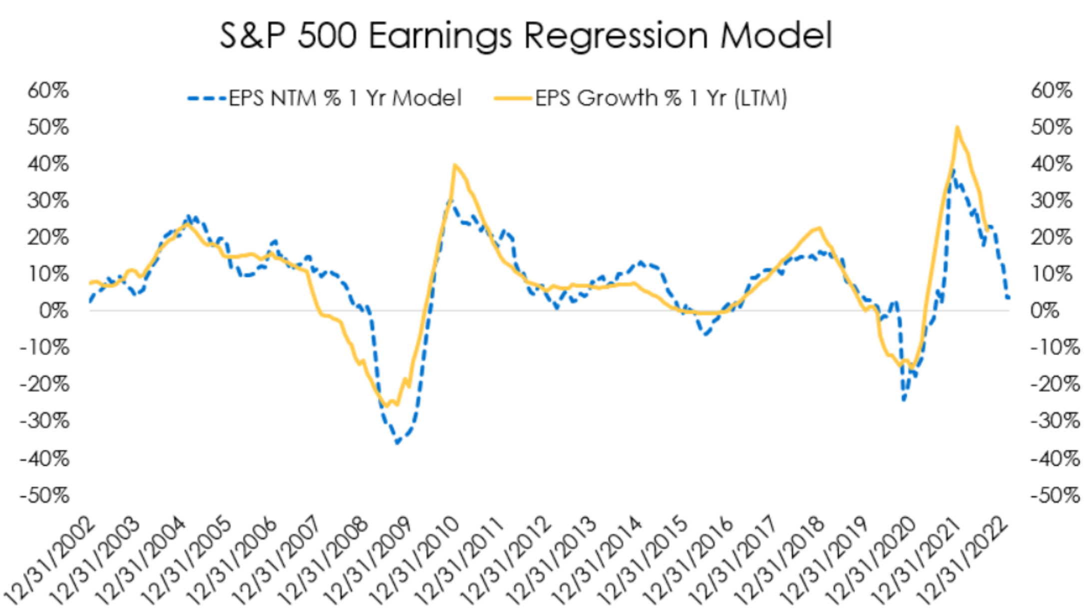
Right now, we think it's especially important to have two frameworks for managing portfolios. The cyclical perspective is an attempt to assess where we are in this particular cycle while the secular perspective evaluates where the structural tendencies might be over multiple business cycles. The cyclical landscape will ebb and flow with the secular one and there may be times – like now – when both views diverge. 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. But as growth begins to slow at a quickening pace, we think the secular view takes a back seat to the cyclical one for a bit of time. Let's discuss.

From a cyclical perspective, we still think the phrase "Moderate Resilience" might best define the fundamentals. It's clear that growth is moderating and is expected to continue to do so as the cycle matures. However, in the first half of the year, growth in nominal terms has been somewhat resilient given the combination of inflation with the lagged effect of well above average liquidity from last year. In essence, companies have raised prices with minimal demand destruction because of the influx of cash from the prior two years. That may be starting to change. This might best be illustrated in terms of the personal savings rate – the percent of one's disposable income that is saved each month. As can be seen in the chart at right, the savings glut was apparent with the dramatic spike in the savings rate in '20-21. This year has exhibited just as dramatic a reversal as government stimulus efforts ended. Higher prices have led to a savings rate that has now fallen below the long-term average. In short, the savings glut is now reversing as consumers are using excess savings to fuel consumption. To us, this points to a draining of liquidity and slowing growth conditions ahead.



Another way to frame up this perspective might be to consider it a tale of two halves with the first half focused on valuations and the second half focused on the fundamentals. We think it's noteworthy to highlight that virtually all of the S&P 500 market decline in the first six months of this year was attributed to a valuation reset. Forward earnings estimates were resilient but the high inflation backdrop resulted in the need to take valuations lower. Within the context of history, this is very normal. Since 1950 there's been an indirect relationship between the inflation tranche and the S&P 500 Price to Earnings (P/E) ratio. That's because investors typically aren't willing to apply the same (lower) multiple for a stock when inflation is higher given that earnings growth is often viewed as lower quality in nature. While valuations have come down from where they were to begin the year, we still think multiples have further to go if history is any guide. Note that inflation is still currently running at levels that imply an S&P 500 multiple of 11X (LTM) compared to today's 18X (LTM). To be clear, we don't expect inflation to stay at these nosebleed levels – as we think it's likely to moderate given our comments below. But we also don't think it's likely to go back to the low levels (0-2%) implied by current market valuations given our secular view.

So what about the fundamentals? As the cycle matures, we think nominal growth is set to slow at a quickening pace in the back half of the year. Most of the macro fundamental data is evidencing a slowdown. As can be seen in the chart below, our leading profit cycle indicators point to a noteable growth deceleration ahead.



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.

Meanwhile, forward earnings estimates have stayed fairly resilient in the first half of the year with consensus currently expecting 8% growth for next year. If earnings estimates begin to peak in the back half of this year, that means that consensus earnings may be too optimistic for next year and the equity markets might have to do more work to hold down the P/E ratio.

Heavier Lifting Ahead

	NTM EPS	NTM P/E
-10%	$215	18.4
-5%	$227	17.4
Current	**$239**	**16.6**
5%	$251	15.8
10%	$263	15.1

Source: Factset; NTM EPS based on ishares S&P 500 ETF.

As can be seen in the table at left, current next twelve month (NTM) earnings estimates for the S&P 500 may have peaked as numbers have recently come down from $241 to $239. The NTM P/E ratio is currently around 16.5X – compared to last year's 21-22X. That's improved, but if earnings estimates fall 5-10%, valuations go back up to 17.5-18.5X. In a stickier inflationary environment, that might require the market to do more to keep valuations down especially when one considers that the S&P 500 multiple (based on next twelve month realized earnings) has typically bottomed at around 14X over the past 30 years.

So what are the implications and key takeaways for portfolios?

<u>From a portfolio positioning perspective, we continue to believe that it's important to acknowledge both the cyclical and secular perspectives.</u> 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). <u>More recently, we've given an increased weight to the cyclical over the secular as we've further reduced portfolio risk of late.</u> At the end of this month, we took another cut at reducing risk in our strategy portfolios. 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 neutral to net long posture. <u>In essence, we continue to downshift risk in portfolios with a (lessened) pro-inflationary bias.</u>

<u>Within equities,</u> our positioning is modestly UW and continues to favor a pro-inflation preference with a value sector tilt within our US LC exposure while also leaning toward the more traditionally defensive sectors (Staples, Health Care). We continue to be decidedly UW the most expensive, cyclical growth areas (Tech, Discretionary, Communication Services).

<u>Within fixed income,</u> 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.

<u>Within alternatives,</u> 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. 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.