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CIO Strategy Bulletin

HIGH-QUALITY PORTFOLIOS ARE THE BEST MEDICINE NOW

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SUMMARY

- Last week, we wrote that the Fed would not choose to put the US economic recovery at risk to force inflation down. It appears we were wrong.
- We knew the Fed was ready to start a new rate-hiking cycle in March. But the Fed Chairman surprised us by broadening the range of the Fed's policy tightening options to essentially "anything." It's most unusual for the Fed to be considering immediate rate hikes -- and elect to communicate the need for a tightening of financial conditions - while simultaneously expanding its balance sheet to the end of Q1 with Quantitative Easing.
- In our view, Powell's current inflation-fighting mode makes it more likely that a new policy error will occur.
- That said, however, the balance of new economic information being printed has not changed our view that the economic recovery that began in 2020 can endure and outlast present threats. Our Global Investment Committee (GIC) acted to further focus our risk capital on high conviction long-term potential opportunities, strengthen our diversification, and add further to high-quality income-producing assets when it met last week.
- We have increased our core portfolio exposure to global dividend growers, where we already have a 10% overall portfolio allocation. We also increased our small overweight to China, which is preparing for greater macro easing and growth support. See the Global Investment Committee's revised asset allocation recommendations herein.

MR. POWELL’S INFLATION INFLECTION

Last week, in The Rational Mr. Powell, we wrote that the Fed would **not** choose to put the US economic recovery at risk to force inflation down. It appears we were wrong.

We noted that inducing a collapse in demand would do little to address many transient aspects of causing the high levels of current inflation. Specifically, we wrote that curtailing “excess demand” for certain goods at the expense of services is not addressable with monetary policy. And we cited four reasons why the Fed was likely to be “rational” in its assessment of the post-Covid economy: COVID stimulus has ended, a supply recovery was underway, Covid itself was in decline allowing for goods/services to rebalance, and that crushing the economy to address distortions induced by Covid and the Fed itself was likely to cause more personal sacrifice that was acceptable.

After listening to Fed Chair Powell answer questions at his press conference this week, we are now concerned that in an attempt to “attack inflation” the Fed put the economy in jeopardy. For decades, the Fed argued that monetary policy works with “long and variable lags.” This acknowledges that a huge economy responds slowly to policy shifts and that the Fed, therefore, had to act judiciously and carefully to assess the impact of its decisions before taking further steps. This is why we were especially concerned when Powell said**, “There’s quite a bit of room for rate hikes”** without hurting the US labor market. So much for gradualism.

At the press conference, Powell confirmed what investors had been assuming for months: with US inflation at 40-year highs, the Federal Reserve is ready to lift US interest rates – now at near-zero – beginning in March. But he surprised investors (and us!) by broadening the range of policy tightening options to essentially “anything.” When asked about the prospect of a 50-basis-point rate hike, or rate hikes at every Fed meeting, he did not rule them out. Investors understood this to mean that the Fed intended to act aggressively in the face of a “historically tight” labor market and “too-high” inflation.

Powell’s about-face in less than two months is likely to generate more uncertainty. We expect quantitative readings of US monetary policy uncertainty to soar when data are released (see figure 1). But markets have already assumed Powell meant what he said (see figure 2).

Figure 1: US Monetary Policy Uncertainty index

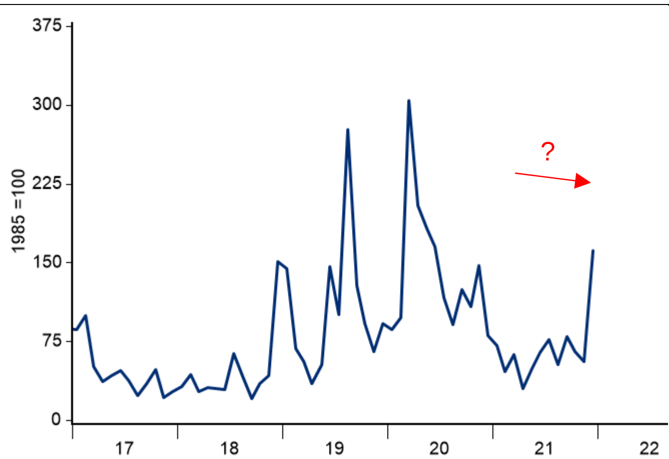
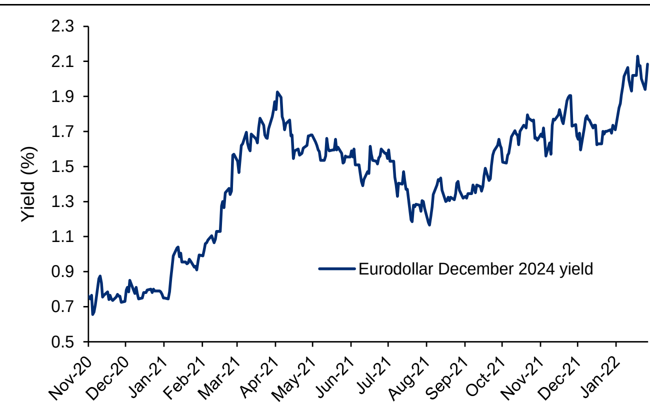


Figure 2: Expected Fed funds Rate End 2024



Source: Haver analytics as of January 27, 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

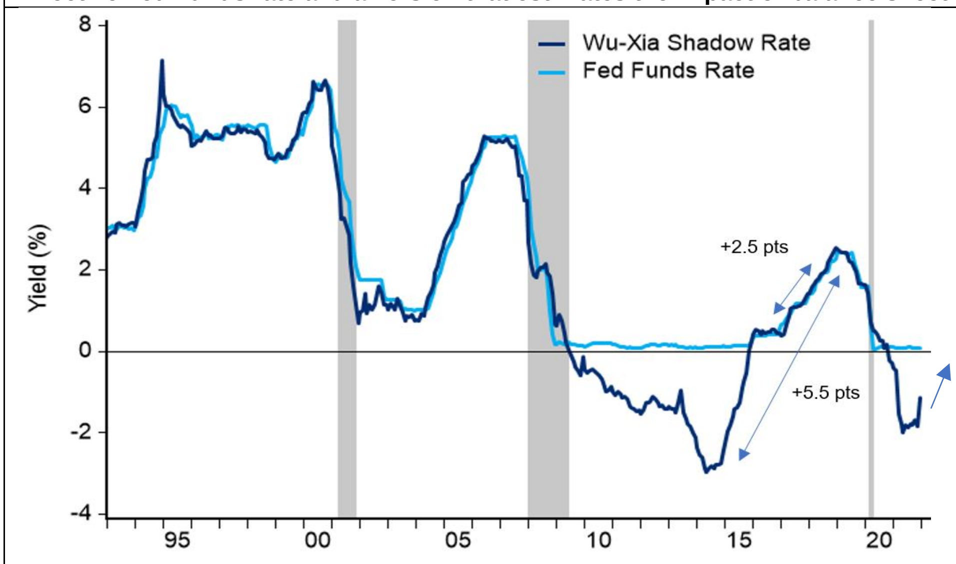
UNPRECEDENTED

It is unprecedented for the Fed to be contemplating immediate rate hikes - and its chairman to deliberately communicate the need for a tightening of financial conditions - while the Fed is *expanding* its balance sheet to the end of Q1 with Quantitative Easing. When asked about reducing the Fed's bond portfolio as a monetary policy tool, Powell said: It's "a relatively new thing for the markets and us." Major reductions in the Fed's balance sheet are the same as a rate hike, but with less accuracy. The combination of ending Quantitative Easing, balance sheet reduction (Quantitative Tightening) and four 25-basis-point-rate hikes over the course of 2022 may be compared to moving from a 0% policy rate up to a 2% policy rate by our estimates.

This appears to be a "full Fed pivot", not just Chairman Powell. There is no apparent dissent among any of the FOMC members. Given how negatively inflation is perceived among voters, the Fed's unilateralism could explain much of the tough talk. Though the Fed can pull back should inflation come down, this is a dangerous game particularly with respect to real assets like housing and capex spending.

We think that the Fed's simultaneous overall push for higher rates and quantitative tightening may create a "portfolio balance effect" that could impact the real economy. An example would be a reduction in the availability of financing (or a change in the cost of financing) for areas like housing. Investor purchases of homes were 18% of the market in 3Q21, 50% higher than in 3Q20, according to Redfin. Given that we are seeing home price appreciation and homebuilder stocks fall as mortgage rates jump, the Fed's proposed actions may add economic risk.

Figure 3: Rate Hikes + Quantitative Tightening = More Rate Hikes
Effective Fed Funds rate and a version that estimates the impact of balance sheet actions (Wu-Xia Shadow Rate)



Source: Haver as of January 27, 2021. Notes: Shaded regions are recessions. The Wu-Xia Shadow rate is published by the Federal Reserve and estimates a Fed-Funds equivalent rate that is not limited by the zero lower bound based on other market rates. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantee of future events.

The Fed's unilateral overconfidence is based, in part, on corporate profits. Strong corporate profits are sustaining tight credit spreads, despite the recent selloff in US growth shares as interest rates rise (see figure 4). Certainly, the US yield curve, while flattening, is far from signaling the next recession (see figure 5).

Figure 4: US High Yield spreads vs S&P VIX

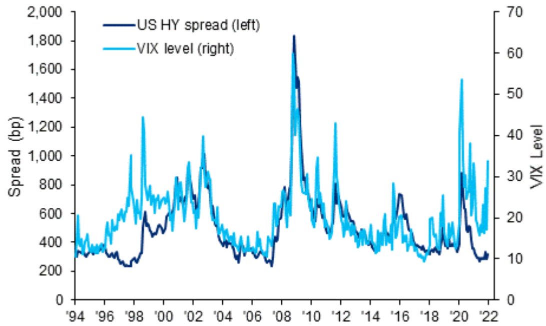
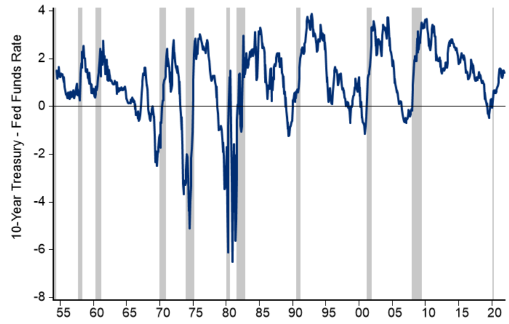


Figure 5: US 10-year yield less Fed policy rate



Source: Haver analytics as of January 27, 2022. Note: Shaded areas are recessions. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

IS SUCH HARSH MEDICINE NECESSARY?

In our view, what is worse than the Fed's aggressive approach is the fact that we may not need very much of the Fed's harsh medicine. We see signs of supply/demand normalization everywhere. Though Chairman Powell suggested little progress in supply recovery, US imports surged 20% in the year through December. An increase in inventories in the fourth quarter already was one of the largest in history (see figures 6-7). Fuller inventories mean less future growth.

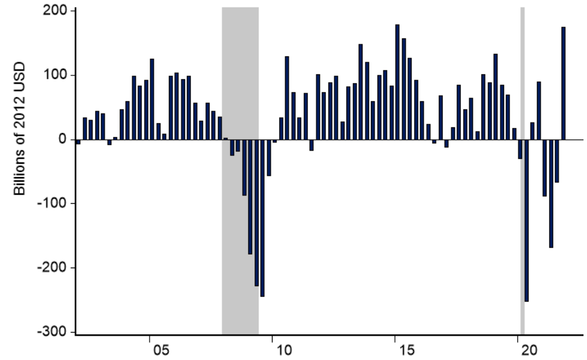
US semiconductor imports are surging. This should help the US auto industry to accelerate new vehicle production after shortages caused the largest spike in used car and truck prices in history (see figures 8-9). And US ports are now showing significant progress working through the backlog of surging container shipments (see figure 10).

While we can imagine there will be oil shocks in the event of a Russian invasion of Ukraine, the pace at which global oil supplies are recovering is well in excess of the 3.2% growth rate in crude oil consumption we expect to see in 2022-2023 (see figure 11). In fact, historical trends suggest the persistence of high crude oil prices will result in an acceleration in US oil output even after prices peak.

In short, normalization of economic conditions is occurring. That would certainly justify a normalization of interest rates but does not suggest the economy is ready to tolerate a simultaneous reduction in the Fed's balance sheet.

Figure 6: US real goods imports and inventory/sales ratio

Figure 7: Change in US real inventories billions of (2012) US dollars



Source: Haver analytics as of January 27, 2022. Note: Shaded region is US recession.

Figure 8: US semiconductor imports from Taiwan

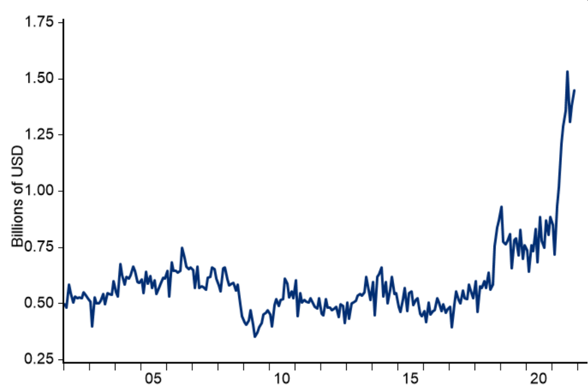
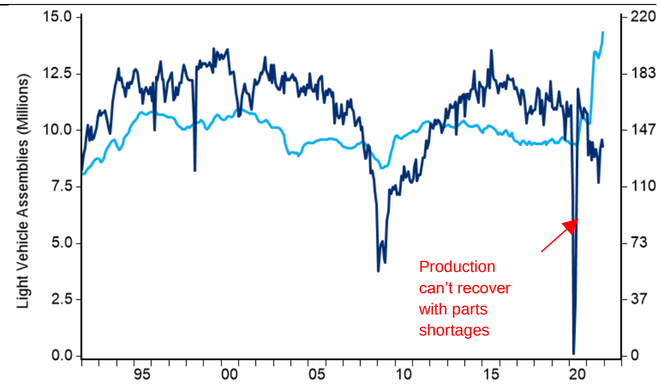


Figure 9: Used US vehicle prices and new vehicle production



Source: Haver analytics as of January 27, 2022.

Figure 10: Easing supply bottlenecks from Asia: Container vessels in Port of Los Angeles

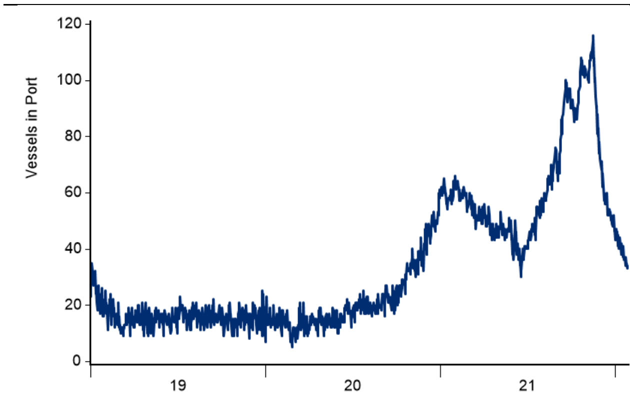


Figure 11: Global crude oil consumption and production

Source: Haver analytics as of January 27, 2022.

2018 REDUX?

We had expected that Powell's own experience in 2018 would cause him to be *more cautious* now. In 2018, Mr. Powell continued to raise interest rates even in the face of a troubled world economy and trade wars initiated by the US. At that time, the Fed was applying pre-2008 rules of thumb about what constitutes "normal" policy and what causes inflation. In 2018, the unemployment rate had been at or below 4% for nearly a year-and-a-half, but prices were not rising at even 2% per year (the Fed's target), In short, we believe the Fed misfired by raising rates too far in 2018 and equity markets dropped by 16% in December 2018.

In our view, Powell's current "inflation fighter" aggression makes it more likely that a new policy error may occur. In fact, Powell's departure from Fed norms and iterative practices makes forecasting what the Fed will do next tricky, the *exact opposite* of what's needed when one is exiting a pandemic. The bond market is telling us that we should not expect interest rates in the United States to rise materially anytime soon. The 30-year Treasury yields just 2.07% implying that trillions of dollars held by global investors sees little likelihood of high rates or long-term inflation.

HIGH-QUALITY PORTFOLIOS ARE THE BEST MEDICINE NOW

While the Fed's erratic policy making is a higher concern now, and with certain geopolitical risks rising, the balance of new information this year has not changed our view that the economic recovery that began in 2020 can potentially endure and outlast present threats. Our Global Investment Committee (GIC) acted to further focus our risk capital on high conviction long-term potential opportunities, strengthen our diversification, and add further to high-quality income-producing assets when it met last week.

We have already seen a rapid de-risking in financial markets in early 2022. This has been led in particular by US growth shares and poorly capitalized firms. Bond yields have risen at the same time, generating a tightening of broad financial conditions of historically moderate scope. From our point of view, the rapid repricing of assets has improved some forward-looking returns.

Against this evolving backdrop, our Global Investment Committee (GIC) last week kept its mix of fixed income and equities unchanged (Global Equities 6% overweight, Fixed Income and cash 6% underweight). However, recognizing the policy backdrop, we have shifted some holdings within both asset classes and across regions to account for new risks and potential opportunities.

In 2021, the GIC shifted portfolios to overweight global dividend growers, healthcare shares, Intermediate US Treasuries and Inflation Protected Securities. We enacted a "barbell" strategy of select higher risk and lower risk assets in order to seek sustained returns following the sharp rally in global equities and credit markets that year.

In 2022, we continue to see diversification across regions and asset classes as a potential risk mitigator for core portfolio wealth. Historically low global government bond and cash yields in isolation offer poor inflation-adjusted returns. We are now focused on investments in firms with sufficiently high current profitability and raise payouts to investors as providing a strong, potential long-term core portfolio opportunity. As a result, the GIC increased our core portfolio exposure to global dividend growers, where we already have a 10% overall portfolio allocation. There was also an increase to our small overweight to China, which is preparing for greater macro easing and growth support.

Based on the repricing of tech assets and our view on certain "Unstoppable Trends", we added a thematic overweight position in "Digitization assets." This includes cybersecurity, payments and fintech shares that have fallen nearly 30% from their recent high as a group. To accommodate this allocation, the GIC reduced our position in US small and mid-cap shares further and shifted some international overweights to add greater diversification.

In equities, the GIC eliminated the thematic overweight in US mortgage REITS. These were the last of the assets we held solely to potential benefit from market dislocations from the COVID shock. Since the asset was added in June 2020, the total return has been about 42% through DATE. We also trimmed the size of our healthcare overweight somewhat to allow for the broader thematic investment in cybersecurity and fintech. We continue to seek strong, stable long-term returns in the sector.

In fixed income, the GIC reduced the size of our overweight in US Treasury Inflation Protected Securities (TIPS). We have added to our TIPS weighting over time, with the last substantial increase in March 2021. We reinvested 1% of the total asset allocation in intermediate-duration nominal US Treasuries and Investment Grade corporates. While we still maintain a 5% underweight in global bonds, US intermediate government and IG corporate securities now discount six or more 25 basis point Fed rate hikes, rising 120 basis points in yield over the past year. While their value could fall further, their limited duration seeks to lower price risk and will allow us to add long-duration bond exposure if 10-year US Treasury yields rise above 2%, as we expect.

CONCLUSION

As we noted in **Outlook 2022**, the post-pandemic period will be very different than 2020-21. Normalization after a global event as traumatic and elongated as a pandemic is without precedent. That there is atypical inflation is to have been expected. Yet, the Fed's response is itself both aggressive and unconventional. That argues for diversified portfolios. It is not a cause for market timing.

We have therefore shifted our emphasis from investing in a cyclical rebound to finding potential sustainable sources of return. Our quality global dividend grower position reflects our theme of investing in "Long-Term Leaders." Our investments in healthcare equities seek to benefit from the secular growth of the world's older population and its quest for "Longevity." The new positions in cyber-security, payments and fintech are key potential opportunities within "Digitization" which we believe is an unstoppable long-term trend shaping the world economy. In short, given the change in Fed policy, it is even more important to focus on the assets with the potential for long-term growth, even in the face of higher rates.

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