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CIO Strategy Bulletin

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Patience and Fortitude

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SUMMARY

- For many investors, periods of uncertainty -- in particular, inflection points when markets turn volatile and pundits theorize about why equities “must” fall -- are when they begin doubting the wisdom of staying invested.
- So when the Fed threatens to upend a nascent recovery, it's tempting to back out of the market to avoid the downside risk. But this would be self-defeating. Trying to time the market risks missing out on some of the best days for stocks.
- Over the past few weeks, we have been assessing just what kind of fight the Fed aims to start: how far and how fast does the Fed plan to tighten monetary policy? We posited that the Fed's stance is bold and may not act to end inflation even if it is enacted. And we warned that “too much Fed” is now a risk for the economy and markets.
- We have maintained our 6% overweight in equities, and we believe bonds will underperform until there is more certainty about rates and Fed policy.
- We continue to favor higher quality income-generating growth assets for an expansion that should continue as a base case view.
- We will not fall into the market timing trap of making very large reallocations on speculation. That's why we prefer holding long-term overweights in “unstoppable trends” than negative real yield bonds. We've trimmed some higher risk and lower risk positions to buy Cybersecurity and Fintech shares on early 2022 weakness.
- Amid high levels of expected market volatility, a few options are possible for investors to take prudent action beyond tactical and strategic asset allocation when attempting to manage risks.

PATIENCE AND FORTITUDE

Financial markets lead the economy, anticipating its growth, future corporate earnings and the path of inflation. The economy leads the Fed from accommodative to restrictive policies over the course of a full economic expansion. “End-of-cycle” periods occur once an economic expansion is well-extended and are typically characterized by excessive growth or shocks that cause an end to the expansion. There are rare periods when

the Fed itself tips the economy into recession to slow inflation. 1982 was just such an example. Yet, there are also times like 1994-1995 when the Fed was able to slow inflation and prolong an expansion.

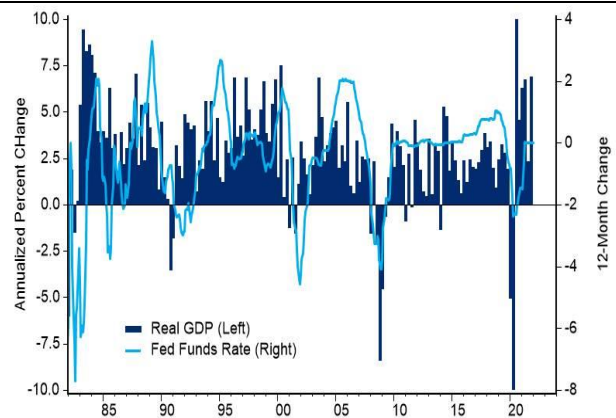
We have written before that we are in a “mid-cycle” environment when interest rates typically normalize after accommodative periods. But this is no typical “mid-cycle” given the tailwinds and market anomalies caused by \$8+ trillion of stimulus poured into the US and global economy to forestall a depression from Covid. The most recent comments from Fed Chairman Powell reflect a level of regret that the Fed may have eased too much by keeping rates too low for too long and buying more bonds than it needed to.

History demonstrates that during most of the periods in which the Fed is tightening, the US economy is growing. And during most of that time, the US equity market is rising (see Figure 1 and Figure 2). But now investors are skittish because a regretful Fed sees inflation as a major threat and may use a “double reverse” strategy to address it. Not only will it raise rates, but it will contract credit perhaps as soon as mid-year. And as we wrote here ([CIO Bulletin – The Rational Mr. Powell](#)) there is not much precedence for the use of both tools to normalize policy while leaving the expansion intact. As recently as 2018, the Fed came very close to causing a “tipping point” where similar policies would have induced a recession.

Figure 1: Fed funds rate Y/Y difference vs. S&P 500 Y/Y % change



Figure 2: Fed funds rate Y/Y difference vs real GDP Y/Y% change



Source: Haver Analytics as of February 4, 2022. Past performance is no guarantee of future results. Real results may vary.

WHAT “DON’T FIGHT THE FED” MEANS... AND WHAT IT DOESN’T MEAN

“To win 100 battles is not the height of skill, to subdue the enemy without fighting is.”
The Art of War, Sun Tzu

Taking the fight to inflation risks the whole economic recovery. Sun Tzu proposes that the best tacticians are those who are able to defeat the enemy by other means. So, the Fed’s threat of using both rate increases and quantitative tightening could be effective in forcing financial market speculation down while waiting to see if the enemy (inflation) abates. In short, more often than not, engaging the enemy in a conventional manner is sufficient.

For many investors, periods of uncertainty, especially transition points where markets become volatile and “pundits” begin to make pronouncements of why equities “must” fall, are times to begin to doubt the wisdom of staying invested. So, when the Fed threatens to upend a recovery that is barely 21 months old, it appears tempting to “get out of the way”, to avoid the fight and believe one will come out ahead. This would be self-defeating.

Over the past few weeks, we have been assessing just what kind of fight the Fed aims to start (see our last bulletin, [High-Quality Portfolios Are the Best Medicine Now](#)) – to assess just how far and how fast the Fed

plans to tighten monetary policy. We have posited that the Fed's stance is bold. It's policies may not quickly quell inflation even if enacted. We have warned that "too much Fed" is now a risk for the economy and markets.

What has the guidance been in reaction? Well, for one thing, we have **maintained our 6% overweight in equities**. We also believe that bonds will underperform until there is more certainty about rates and Fed policy. But we have made changes to the composition of portfolios emphasizing quality, dividends and diversification.

THE BEST DAYS AND THE WORST DAYS HAPPEN SIDE BY SIDE

True to form, the equity market's largest daily declines and largest daily gains have been painfully close together (see Figure 3). Identifying a particularly good year is hard enough. Trying to pick a good day from 251 trading days is impossible.

We are talking here about market timing. Financial theory suggests being wholly in or out of markets only increases performance risk in line with the frequency of the attempts to do so. In fact, it's a worse "bet" than playing blackjack at a reputable casino. As Figure 4 shows, missing the two single best days per year during the past decade would have reduced the portfolio returns of an investor in US equities by about 9 percentage points **per year**. Longer periods show the same. In order to capture the growth of the economy and the corporation income that comes from it, you cannot assume that markets are rational for anything but long periods of time.

Figure 3: S&P 500 Daily % Change

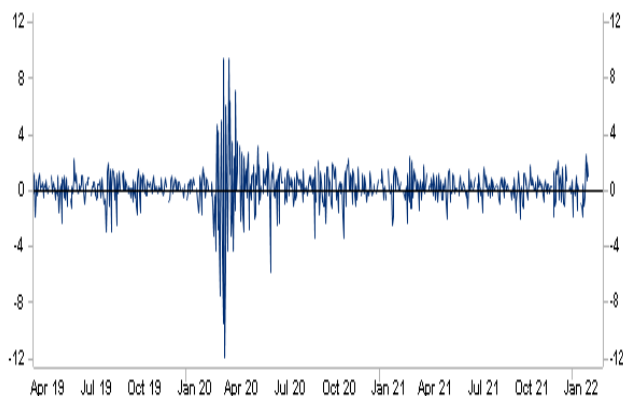
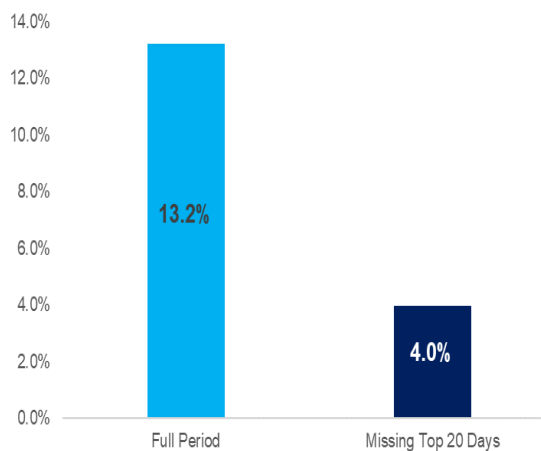


Figure 4: S&P 500 return and excluding two best 20 days per decade



Source: Haver Analytics, as of February 4, 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.

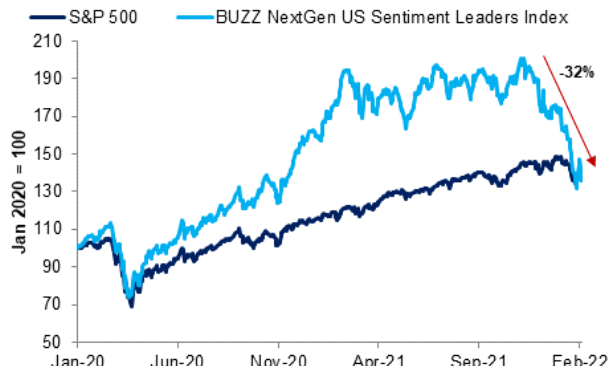
2022 IS JUST ANOTHER PROOF POINT

In 2022, it may not be the Fed moving markets as much as speculators betting on them. As Figure 5 and Figure 6 show, options volumes were surging into the New Year just as the most speculative shares were losing upward momentum. In hindsight, the data suggest that growth shares were due for a short-term correction driven by momentum investors, irrespective of anything said or done by the Fed. Momentum investors are, for the most part, market timers.

Figure 5: US call and put open interest 12-month change



Figure 6: Sharp decline for most popular internet/chat recommended shares



Source: Factset as of January 22, 2022. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. 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. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

For us, such conditions are opportunities, with correlated trading activities bringing down nearly all share prices to varying degrees. Was there any great disappointment in the 2021 4Q earnings season? No. 77% of US firms beat their estimates in the quarter, as expected. Analysts are raising their near-term profit estimates further (see Figure 7), even as the pace of growth is expected to slow.

Therefore, from our point of view, it would take a “very angry Fed” to crush this year’s expected single-digit EPS gains into declines instead (see Figure 8).

Figure 7: Analyst upward revisions to EPS estimates as % of S&P 500 Index

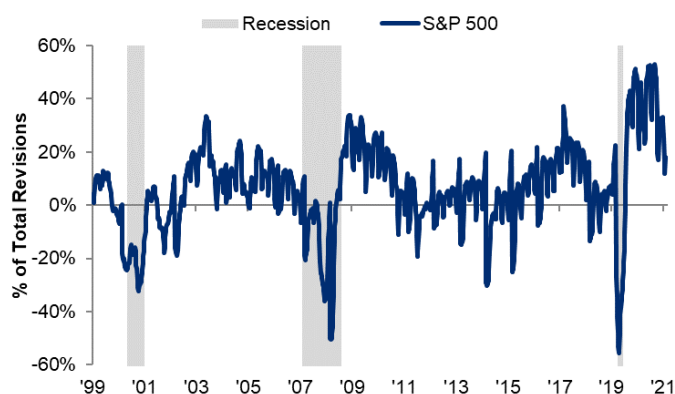


Figure 8: Slower growth isn’t decline: S&P 500 and EPS Y/Y % with our 2022-2023 estimates



Source: Factset as of January 22, 2022. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. 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. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

WATCH INFLATION SURPRISES, NOT JUST INFLATION LEVELS

Inflation is a lagging indicator, but in the present context, we believe inflation surprises – beats or misses versus consensus expectations – could be strongly predictive and an increasing driver of markets (see Figure 10). We strongly expect certain key drivers of today's inflation to decelerate. Supplies of goods are beginning to catch up with demand refilling woefully short inventories across the world. Yet the immediate direction of inflation may be decisive for the Fed. Positive inflation surprises would test the Fed's patience and invite a harsher tightening response.

We look more rationally at the data to set our course. The pricing of Fed funds or Eurodollar futures has correctly predicted the Fed's immediate policy decision in 79% of FOMC meetings over the 30 years preceding the COVID shock (see Figure 9). The bond market does not believe the Fed will tighten at every meeting this year (they happen every 6 weeks) because at least at the moment, it views this as inconsistent with the Fed's goals.

Figure 9: Fed funds futures at time of Fed rate decision vs actual (pre-COVID period)

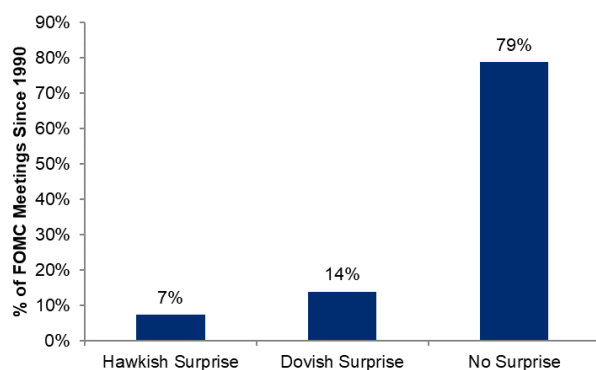
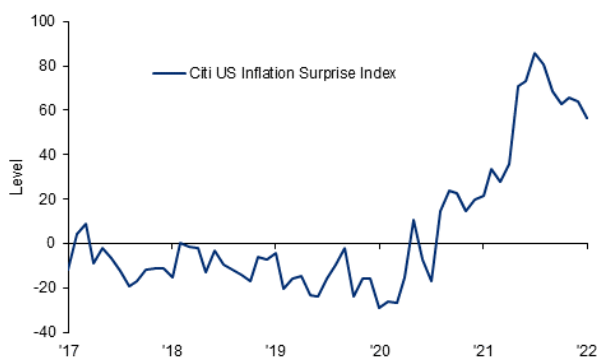


Figure 10: Citi inflation surprise index



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Watch wages, surprise supply disruptions and energy costs for clues about inflation surprises. What could drive inflation surprises upwards? A relapse in COVID supply disruptions is one possibility. Consumer aggressiveness (buying ahead of future price increases) is another. Yet this is the opposite of the behavior we have seen, as consumer demand is waning post stimulus (see Figure 11.) On the other hand, global oil supplies are an immediate potential risk (see Figure 12). If inflation inertia remains stronger than we expect, the Fed would likely take much greater economic risk in tightening.

Figure 11: US retail sales: month/month % change

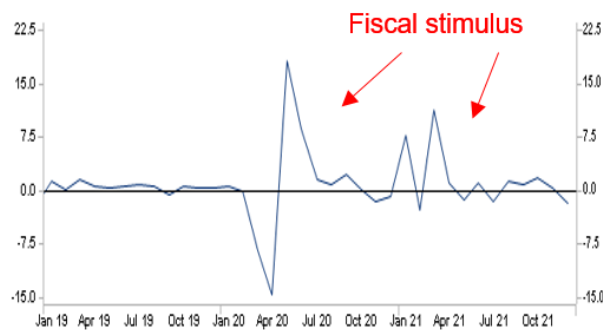
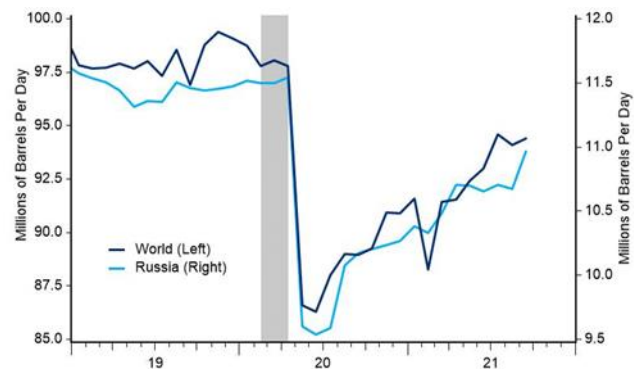


Figure 12: Global crude oil production level



Source: Factset as of January 22, 2022. Note: Grey shaded area notes recession. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. 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. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

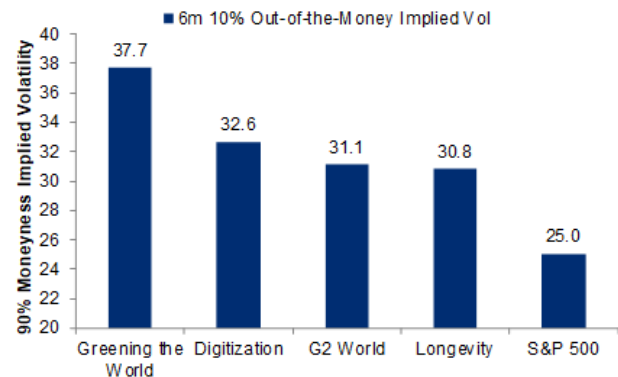
QUALITY, QUALITY, QUALITY

We continue to favor higher quality income-generating growth assets for an expansion that has the potential to continue as a base case view (see Figure 13). We will not fall into the market timing trap of making large reallocations on speculation. That's why we would much rather hold long-term overweights in "unstoppable trends" than negative real yield bonds (see Figure 14). As noted in our January [Quadrant](#), we've trimmed both some higher risk and lower risk positions to buy Cybersecurity and Fintech shares on early 2022 weakness.

Figure 13: US 'Dividend Aristocrats' Index vs Russell 2000 Growth



Figure 14: Implied volatility of S&P 500 and CGWI 'Unstoppable Trends'



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FINDING POTENTIAL VALUE IN CREDIT HEDGING

Given the Fed's unusual sensitivity to "present inflation", we see a potentially good risk/reward in some hedging opportunities. Unlike other periods when the Fed might have looked through "non-core" inflation, a further oil price rally may cause the Fed to act more aggressively. Conversely, an oil price drop that drags down inflation would give the Fed more leeway to raise rates more slowly. *Thus, we see value in more cheaply priced "contingent"*

derivatives that could benefit hedgers if an oil price spike causes the S&P 500 to fall (see **Error! Reference source not found.**).

Another related potential opportunity may exist in credit markets. While rates have risen, equities have underperformed credit markets in the year to date, even when adjusted for their relative volatility. Credit market weakness would be more consistent with larger economic challenges than the growth-stock selloff suggests. With credit spreads tight and equity implied volatility high, hedging credit market weakness seems more attractive than hedging equities directly.

Figure 15: Crude oil and US equities correlation starting to switch to negative



Figure 16: US High Yield credit spread vs VIX Level



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CONCLUSIONS

With market timing a fool's game and the probability of higher EPS growth in 2022 strong, we took this opportunity to improve the "strength" of our portfolios by making reallocations to sectors and equity attributes (i.e dividend payers).

Inflation, and the Fed's response to it, is the greatest threat to the present economic recovery. But we see the challenge as likely to be surmountable. For example, the previous economic cycle had its comparable challenges driven by double-dip fears associated with the European debt crisis in 2011-2013, trade war fears and Fed tightening in 2017-2018. Equities still provided positive returns in 9 of the 11 years of that expansion, similar in ratio to the gains/losses seen since World War II.

We also don't believe every hedge is created equal in value. Amid high levels of expected market volatility, a few options are possible for investors to take prudent action beyond tactical and strategic asset allocation when attempting to manage risks.

Keeping an eye on inflation surprises rather than inflation itself is a good way to see how bumpy the market's ride may be. But to assume that the Fed will crush inflation AND the economy with it may be a far worse strategy.

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