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Investment Strategy Outlook

April 2023

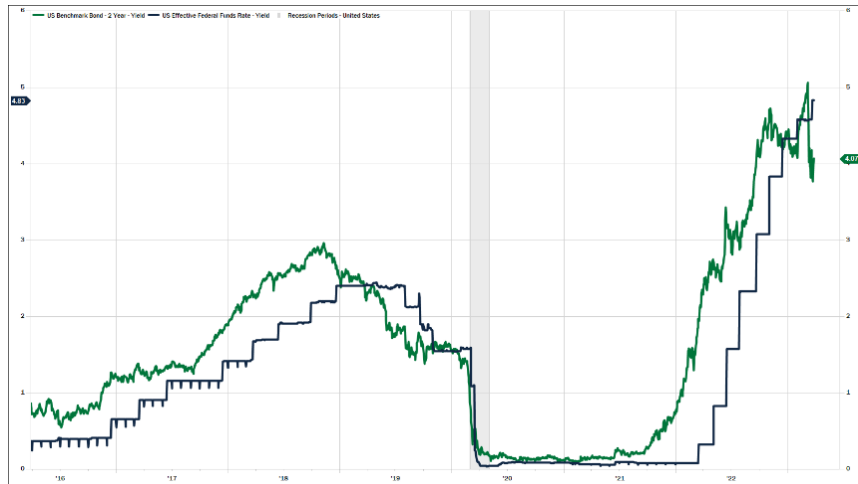
The Waiting Game

Since the last time we formally wrote in mid-December, there have been some significant changes to the investment landscape. Most notably of course is that we recently experienced the largest bank failures since the Great Financial Crisis. Many investors are using this as evidence that we are at the stage of the interest rate hiking cycle where “things are beginning to break.” In turn, it is now largely consensus to believe that the Fed has achieved a restrictive monetary policy stance.

Unfortunately for the Fed, the bond market does not believe interest rates will be able to stay here for long and is now pricing in several Fed rate cuts before the end of this year, which is a drastic change even from a month ago. The entire yield curve is trading at levels below the Federal Funds Rate, and 2 Year Treasury yields might be sending the clearest message of all trading roughly 1% below the Federal Funds Rate. Historically, a significant inversion of 2-year yields vs. the Fed Funds Rate has not been a friendly economic signal, and there is no shortage of additional economic data giving investors similar negative indications.

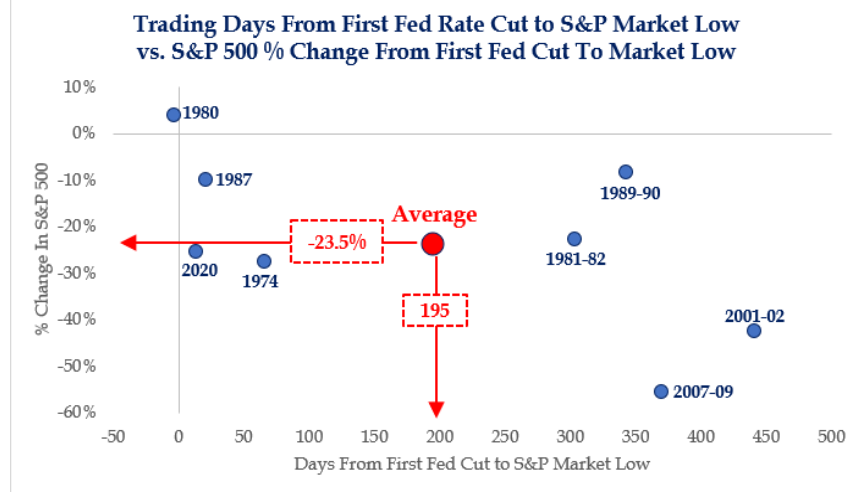
The chart below helps depict the long history of 2 Year Treasury Yields leading the Fed Funds Rate. 2 Year Treasury Yields have been a far more reliable indicator of the future path of the Fed Funds Rate than forecasts from the Federal Reserve itself. The 2 Year Treasury yield is screaming that the Fed is going to have to reverse course sometime soon, and historically, the beginning of Fed rate cuts is often problematic for risk assets, serving as a “be careful what you wish for” dynamic.

2 Year US Treasury Yields vs. Effective Federal Funds Rate



Source: FactSet & MBL Advisors

The S&P 500 Usually Declines After the First Interest Rate Cut



Source: Strategas Research Partners

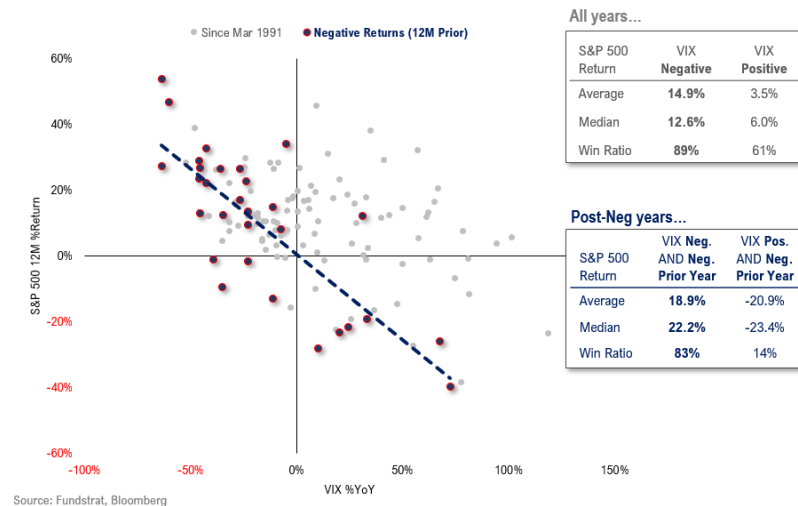
Even though recession probabilities seem to be rising by the day, global equity markets remain relatively firm as the S&P 500 continues to “hug” the 4000 level. For perspective, the S&P 500 reached 4000 for the first time ever in April 2021, when 2-year treasury yields were 0.1%. After running up to 4800, the S&P 500 then proceeded to break 4000 to the downside in May 2022 with 2-year treasury yields around 2.6%. Since then, the 4000 level has continued to be a magnet for the S&P 500, regardless of 2-year treasury yields briefly trading above 5%, just prior to the banking issues of the last month.

The bullish case for stocks is never as “obvious” as the bearish case, and we can’t think of many instances in the last 15 years when this was more accurate than it is right now. Having said this, the few remaining bulls have noted that some of the prior bearish catalysts seem to be fading. Last December we wrote that we didn’t believe upside surprises to inflation / interest rates would drive equity markets to new lows, and this seems to have been solidified in the wake of the recent banking turmoil. In addition, a couple of notable bank failures were not enough to even take the S&P 500 back to its December 2022 lows (which was above THE lows). In other words, markets will likely need a new negative catalyst(s) to emerge (there are no shortage of candidates) to break the S&P 500 through the lower end of its fairly pronounced 3800 – 4200 trading range.

As we begin the second quarter of 2023, we are surprised to note that the VIX is trading below 20, which is signaling that equity markets are pricing in a fairly “normal” volatility environment. Most investors probably feel as though current market conditions are anything but “normal” and even potentially combustible. But regardless of our opinions, the volatility gauge for equity markets is saying something different, at least for the time being. Tom Lee has written extensively this year about how the Year-over-Year change in the VIX has a higher statistical significance in explaining S&P 500 returns than several other variables (including S&P 500 earnings or 10-year bond yields). Said another way, for the year after (2023) a negative return year (2022) in the S&P 500, if the average VIX reading (in 2023) is below the average VIX reading in the prior year (2022), then there is an 83% chance the S&P 500 should have positive returns this year. Conversely, if the VIX has a higher average this year relative to last year, there is only a 14% chance that the S&P 500 will have positive returns in 2023. For additional perspective of just how statistically significant this is, there is a 78% chance that the S&P 500 will have positive returns this year if earnings growth is positive on a Year-over-Year basis (after a negative return year). While there is still a 70% chance that the S&P 500 has a positive return year in 2023 if earnings growth is negative on a Year-over-Year basis (not a major difference) (*source: FSInsight & Tom Lee*). Thus, equity market volatility (VIX) could be the most influential variable on equity market returns in 2023.

EQUITIES: Strong performance when VIX falls

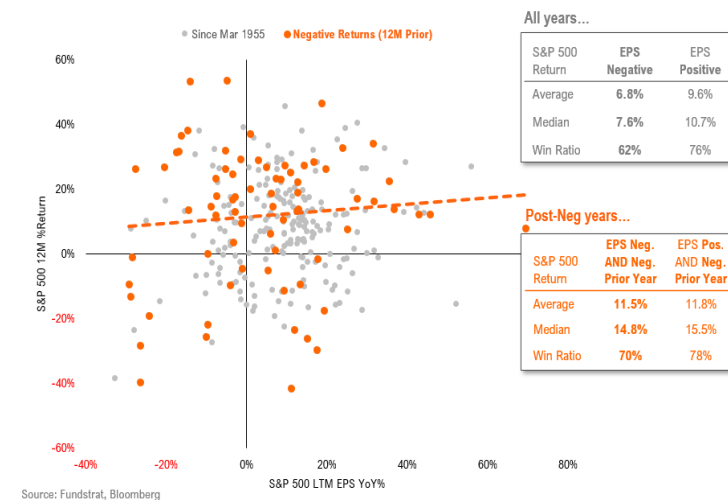
S&P 500 return when VIX %change is positive or negative
Rolling LTM in quarterly frequency since 1991



Source: FSInsights

EPS: Not a differentiating factor in equity return after a neg. year

S&P 500 return when EPS growth is positive or negative
Rolling LTM in quarterly frequency since 1955



Source: FSInsights

A more predictable and significantly less harsh Federal Reserve is one of the key factors that the bulls are relying on to help keep volatility suppressed. In other words, does a Fed that is out of the way due to sufficiently restrictive financial conditions allow for bearish sentiment along with less than optimistic investor positioning to push equity markets higher in the months to come? Michael Hartnett from Bank of America Global Research recently noted:

History of Bears: ain't nothing more dangerous than a bear at the end of a bear market and... inflation set to fall sharply, oil down, rates down, PMIs stabilizing, housing reacting to lower rates, lots of job openings still to fill... bears shouldn't be dogmatically bearish 15 months into bear market; but still... history, positioning, policy & profits reasons we think stock market to attempt new lows next 3-6 months.

Hartnett is almost always on point with his thoughts, and we share his messaging above in all regards. We continue to believe it is difficult to become enthusiastic about equity market return prospects in the short term due to several fundamental issues that likely need more time to resolve. Namely,

- (i) US large cap equities are trading around average valuations, in a most generous scenario;
- (ii) Although inflation is clearly falling from high levels, it remains well above satisfactory levels. Historically, higher levels of inflation have yielded lower valuation metrics for equity markets;
- (iii) There seems to be a lack of organic drivers of earnings growth, and if anything, forward earnings expectations likely remain too high for 2024 as profit margins continue to erode;
- (iv) Unlike the QE era, there are good investment “alternatives” (bonds, gold, etc.) to equities, and equity risk premiums (compensation for investing in stocks over bonds) are around post-2008 lows;
- (v) The money supply (M2) is contracting, which is a massively important variable for risk assets; and
- (vi) Finally, the Fed was still conducting QE in March 2022. March 2022 also marked their first interest rate hike, which was a rather ceremonial 0.25%. This means we have experienced 4.5% of interest rate hikes from May 2022 to March

2023. The full effects of these interest rate hikes are nowhere near fully appreciated yet, as monetary policy acts with long and variable lags.

None of these factors necessarily mean equity markets “need” to fall apart, but it does lead us to believe that sustainable gains might be difficult to come by for now / until we have more clarity regarding several of the issues mentioned above.

More simply, we believe that the economic cycle likely needs to be “reset,” even if that means things getting “worse” before they get “better.” Until something along these lines occurs, fundamentally driven equity market gains are a less intuitive proposition as several reliable macro-economic variables are giving pronounced recession signals (some more strongly than others). These indicators include:

- Yield curve inversions across the entire curve (which are now re-steepening – signaling we are even further into this process).
- US Economic Leading Indicators remaining in deeply negative territory.
- Declining Housing Starts.
- Sideways Retail Sales (which is usually the case in advance of a recession).
- Manufacturing PMI’s steadily below 50 (hitting new cycle lows).
- Average hourly earnings growth persistently above 4% (sign of a mature business cycle & pressures profit margins).

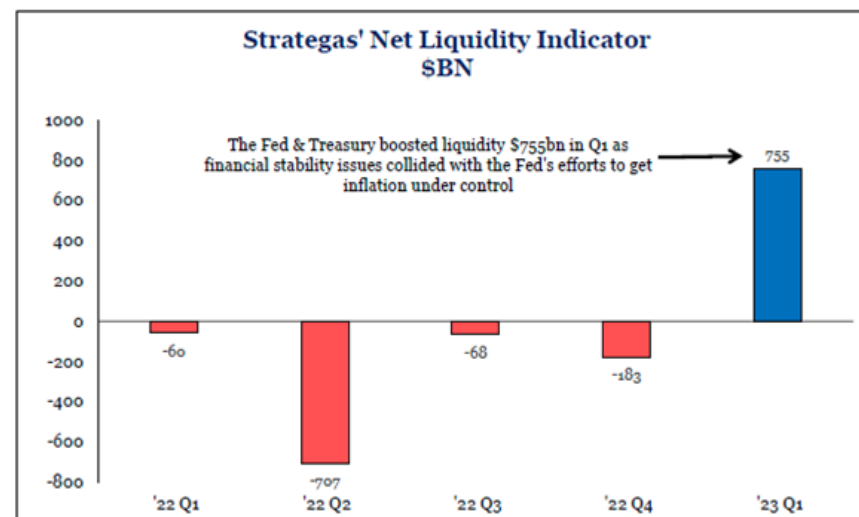
Despite the weakness across a plethora of economic variables, the labor market (and in turn, the consumer to a degree) remains somewhat unflappable, while corporate earnings and credit spreads have yet to meaningfully crack, as they typically do during a recession. Thus, a big question today that did not exist a month ago is if the recent “banking crisis” will serve as a catalyst in beginning to erode the final lynchpins giving hope to the “soft landing” or even “no landing” scenarios.

In our opinion, there are some clear data points pointing to a meaningful tightening of lending standards over the past month. On 4/10/23 Lisa Abramowicz from Bloomberg stated that “there’s been the biggest decline in commercial lending in a two-week span in the data going back to the 1970’s.” At the same time markets have been able to remain firm thanks in large part due to policy makers’ reactions to the banking turmoil. Jason Trennert and Dan Clifton of Strategas Research Partners have pointed out that their proprietary Net Liquidity Indicator increased by over \$700 Billion in the first quarter due to spending from the Treasury General

Account (TGA) along with reverse repo facilities. The positive effects of liquidity injections on asset prices can be seen even more clearly through the lens of market leadership, as the biggest winners from 2020 / 2021 are once again the best performing assets classes year to date in 2023 (Mega cap tech stocks, non-profitable / “innovative” tech (ARKK), crypto currencies, long bonds, etc.).



Source: Strategas Research Partners



Source: Strategas Research Partners

Tighter bank regulation / lending standards leading to a meaningful slowdown of credit creation is a meaningfully higher probability event today than it was just five weeks ago. The banks that seem to be most affected by the recent issues (i.e., everyone except for the mega banks), are also the very banks who generally facilitate a disproportionate amount of lending to the small business community. Small businesses are going to continue to find themselves in a more challenging environment relative to the last several years, and this could eventually lead them to “batten down the hatches” (i.e., cut jobs). As a reminder, small businesses employ 70% +/- of workers in the United States. Thus, in aggregate, small businesses will likely have a much larger effect on the unemployment rate than the “headline” layoffs already occurring in large corporate America. An unemployment rate above 4% and / or a couple of meaningfully negative payroll reports are probably what is “needed” to make the Fed truly pivot and begin to cut interest rates. Although the beginning of an interest rate cutting cycle is historically not a bullish market event, it may serve as an indication that we are at the “beginning of the end” of this bear market and allow investors to begin to look through many of the present

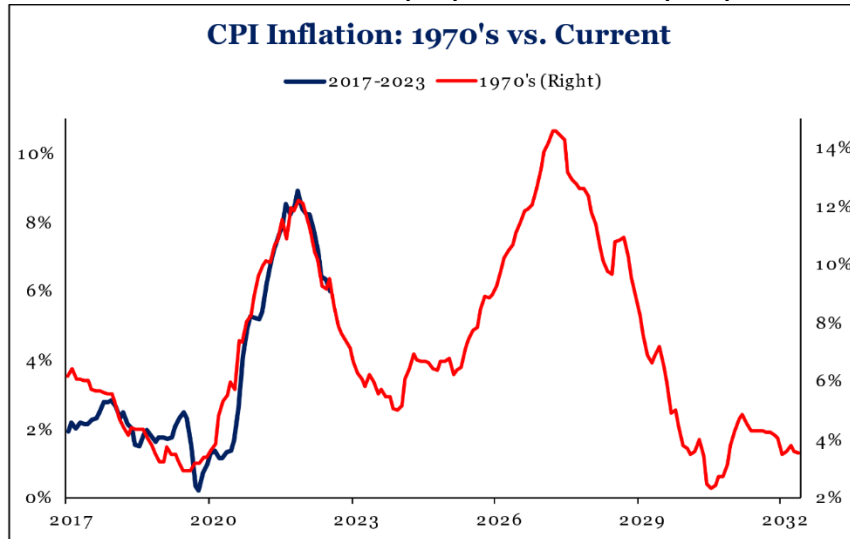
headwinds to better times ahead. We have already seen corporate earnings contract to some degree on a Year-over-Year basis (-5% +/- expected in Q1 EPS), but this could accelerate if the labor market / consumer eventually breakdown.

In our own minds we rarely detail what shorter term events might look like, let alone doing so publicly. Only time will tell how various economic events unfold in the months ahead, but even if the scenario we outlined generally comes to fruition, we have far less conviction regarding how deep the corresponding sell off in global equity markets might be. We feel somewhat strongly that this bear market does not seem “complete.” But whether this means we get a retest of the June / October lows or something more severe, we cannot forecast with any degree of conviction.

What we do continue to believe strongly about are the themes we outlined in our Investment Strategy Outlook last December ([Investment Strategy Outlook - Dec 2022](#)). At the top of that list continues to be to the headline of that report, which was to “take what the market gives us.” April is often a seasonally strong month for equity markets, and we will continue to take advantage of opportunities to marginally de-risk portfolios when equity markets seem to be trading towards the upper end of this trading range. On the other hand, if / when some negative events transpire, we will plan to be buyers of risk assets as we see signs of true panic / capitulation. In the meantime, the 3800 – 4200 range on the S&P 500 continues to hold in a sturdy fashion as investors struggle between “lots of bad news already being priced in” vs. a lack of positive catalysts which justify moving equity markets meaningfully higher.

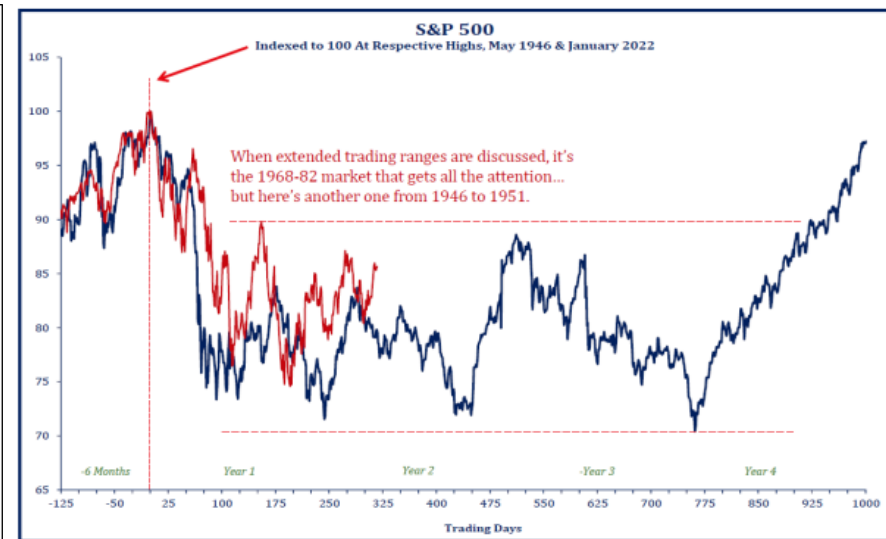
There are several historic examples of range bound markets, most notably in the late 1940's and the 1970's. One common theme between both of these time frames along with today, was entrenched inflation running well above acceptable levels. For months, many people have believed that the Fed had backed themselves into a corner, and the recent banking crisis has only exacerbated this dynamic. Massive unrealized losses on high quality securities held on bank balance sheets are signaling that the Fed is clearly “too tight” for financial system stability, which we believe is their most important mandate, even if it isn't directly one of their two stated mandates. At the same time, it doesn't seem like the Fed is satisfied yet (listen to Fed governors) with their fight against inflation, especially given that the headline CPI number remains above the Federal Funds Rate. The Fed has never begun to cut interest rates with this dynamic in place. If financial system instability does not allow the Fed to fully finish their fight against inflation, the Fed may end up having to face the very thing they stated they wanted to avoid at all costs; the start / stop monetary policy of the 1970s when they had to “fight inflation” on three separate occasions. Dan Clifton and Strategas Research Partners recently published a chart showing that current inflation trends are identically tracking the 1970's. The headaches of “sticky inflation” would only be worsened by exploding interest expenses on the \$31T of national debt – half of which is set to mature in the next three years.

CIP Inflation: 1970's (red) vs. 2017 – 2023 (blue)



Source: Strategas Research Partners

S&P 500 Beginning 1946 (blue) vs. S&P 500 Beginning 2022 (red)



Source: Strategas Research Partners

Investors should not underestimate how impactful levels of inflation and interest rates are to investment environments. As we wrote about last December, a higher inflation, higher interest rate, lower real growth backdrop will warrant a different investment playbook relative to the QE era. We believe that placing an emphasis on a higher degree of portfolio diversification, income becoming a more important factor in equity investing, and more frequent portfolio rebalancing will serve as critical elements to the portfolio management process in the years to come.

While we spent much of this writing detailing no shortage of concerns for investors over the next several months, we regularly remind ourselves that “markets often do what causes the most amount of pain for the most amount of people.” Stock market “bulls” are currently an endangered species, while most people believe the bearish thesis is somewhat “obvious.” Regardless of the next 15% move in equity markets, we continue to maintain our conviction that global equity markets will be higher in five years than they are today (and meaningfully higher over longer time frames). Thus, we must continue to balance our long term, disciplined mindset with the very real “worries” that exist for investors today.

We hope to catch up with you in more detail sometime this spring.

Sincerely,



Brian Gift, CFA

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