PCM

PEAK CAPITAL MANAGEMENT

Does the ‘Fed Put’ Still Exist?

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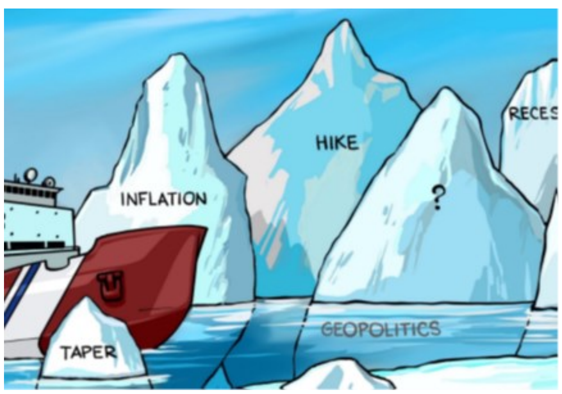
Events have moved quickly in late February with Russia launching a full-scale invasion of neighboring Ukraine, creating global upheaval. Equities had just barely moved into correction territory, defined as down 10%, when Russia launched its attack. Dow Futures dropped almost 1,000 points on the news and investors pulled their belts low and tight expecting a bumpy ride only to see virtually all losses reversed by closing. I do not believe many investors are naïve enough to think we are out of the woods in terms of volatility and drawdown.

As the world digests Russian aggression, many are wondering if the rhetorical Fed Put will save the day for those long in the stock market. In past periods of high uncertainty and volatility, the Fed has stepped in to take actions to support the stock market and mitigate potential losses by investors. We are in a very different environment today with inflation at multi-decade highs, interest rates still near 0%, and the Fed in a quandary. The US Federal Reserve has very dangerous waters to navigate and the events unfolding in Ukraine only complicate their task.



Virtually everyone understands that the Fed has two mandates: maintain stable prices (manage inflation) and full employment. The Fed is not charged with protecting stock market investors from losses but has often used rate-setting policies to accomplish just that. Their rationale has been the ‘wealth effect’. If consumers’ investments and 401k accounts fall precipitously, they are not in a mood to spend, negatively impacting economic growth. With the Fed so far behind the inflation curve with respect to policy, any Fed backstop for investors seems unlikely at best.

Geopolitical events are not helping the mood of investors, but historically these events have had a very muted impact on markets, especially when the events are far from home (expect much more of an impact in Europe). Most concerning to many investors is the fact that the markets had corrected 10% before the Fed even announced its first rate hike. The adage, “Don’t Fight the Fed” has historically been good advice, and the Fed is clearly intent on tightening monetary policy.

The data on stock market corrections over the last 25 years might surprise some readers. When the S&P 500 dropped 10% or more, this typically resulted in strong returns over the following 12 months. In fact, two-thirds of the time when the S&P hit correction territory it was positive over the next year. The average return in the year following a correction is +9.3% according to S&P data, so bear markets do not always follow a correction.

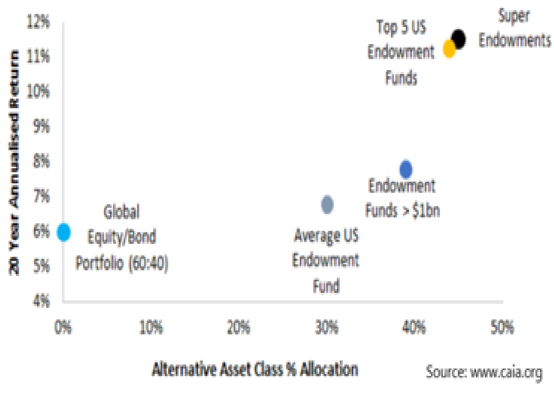
> **The Fed may have saved the day in the past, but it may take a well-diversified and tactical approach to navigate the waters that we currently face.**

There are also signs that suggest markets may rebound as quickly as they corrected. The COVID-related restrictions that have negatively impacted the economy for two years are mostly being lifted, suggesting economic activity may return to some level of normalcy. It also appears that while stimulus is being withdrawn in the U.S. with the end of quantitative easing, new rounds of stimulus are set to begin in China, potentially fueling higher global economic growth.

It is a lot for investors and portfolio managers to digest as they attempt to position for the uncertainty of the future. Recency bias has led many to ‘buy the dips’ as even sharp drawdowns have been followed by V-shaped recoveries (think April 2020). The time will come when investors have to navigate a very different recovery path. Let’s not forget that the Nasdaq today is still down more than 50% from the high set in early 2000. More recently, the S&P 500 hit a high in October 2007 and did not get back to the same level until April 2013, almost 6 years to recover the losses caused by the GFC (global financial crisis). Perhaps the most alarming example, the Dow Jones hit 1,000 for the first time in 1966 before experiencing a correction. It was not until 1982, some 16 years later, that the index surpassed 1,000 again.

What should investors be doing today? Avoid becoming myopic with events taking place. If you only focus on the negative, or positive, your perspective becomes skewed and you lose the ability to balance risk and return in decision making. Be aware of your assumptions. Don’t assume that because the last several corrections were buying opportunities that every correction is a buying opportunity. Sometimes recovery from drawdowns can take years, or even decades to recover from. Understand what you are relying on. The Fed may have saved the day in the past, but it may take a well-diversified and tactical approach to navigate the waters that we currently face.

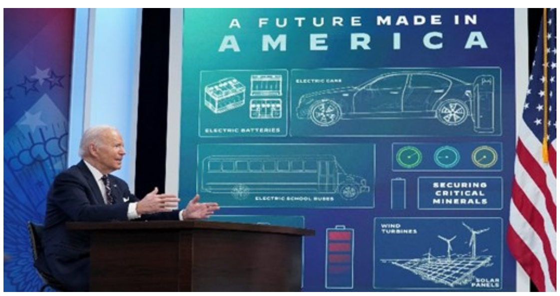
Follow the Money



David Swensen was a pioneer in the Endowment Model of investing that large universities utilize for their investment portfolios. The Yale endowment he managed averaged +13.7% over the 36 years he was at the helm, and many followed his lead of incorporating private market exposure in lieu of public markets. Swensen identified what is commonly known today as the liquidity premium, the amount investors are willing to forego in exchange for immediate liquidity. Traditional equity/bond portfolios not utilizing illiquid investments have annualized returns around 6% over the last 20 years per the chart. As illiquid investments are added to a portfolio, expected returns rise. Endowments often have perpetual time horizons as they are managed for generations, but individual investors typically have much shorter time frames for liquidating their portfolios.

- The 20 largest US Endowment Funds in the U.S. increased their allocation to private investments over the last 2 decades to 45%, an amount 50% higher than the average endowment, according to CAIA.
- The most popular illiquid strategies in 2021 were leveraged buy out funds and venture capital among the top decile of endowments by size, with allocations to real assets following closely behind.
- It often takes a full market cycle for the benefits of illiquid assets to be realized when compared to a portfolio of beta, although ultra-low interest rates have forced many to seek alternatives for yield.

Ultimate Hedge

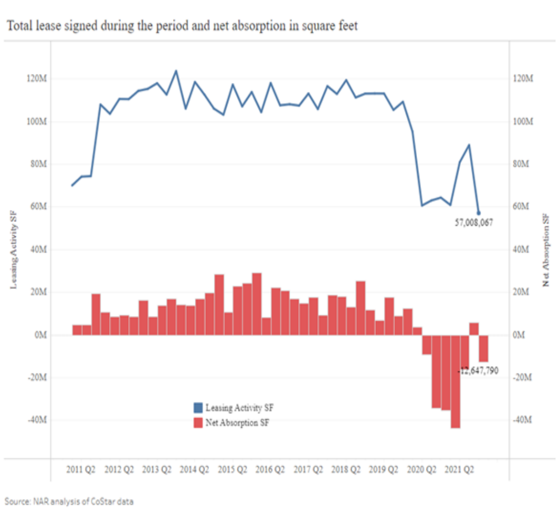


Source: Reuters

Last week, President Biden announced that there would be actions taken by both the federal government and private companies to strengthen the supply chain for various rare earth metals. These metals are critical in producing products such as electric vehicles, cell phones, and computers. As tensions rise in Ukraine, commodities, specifically the price of oil, have been the topic of discussion. Even with the S&P 500 Energy Sector Index (TR) and Bloomberg Commodity Index (TR) up more than 21% and 15% YTD respectively at the time of this writing, many believe that energy and commodity prices will continue to rise and serve as an effective hedge towards market volatility.

- Rare earths are 17 minerals that are difficult and costly to mine and process cleanly. Minerals such as lithium, graphite, and cerium are critical in producing products such as electric vehicles, wind turbines, computers, and batteries.
- According to VOA news, China controls 87% of the global permanent magnet market, as well as 55% of rare earths mining capacity and 85% of its refining.
- Russian incursion into Ukraine has sent European countries into a panic over natural gas shortages and U.S. consumers are bracing for higher gasoline prices as oil surpassed $100/barrel last week.

The Future of Office Real Estate

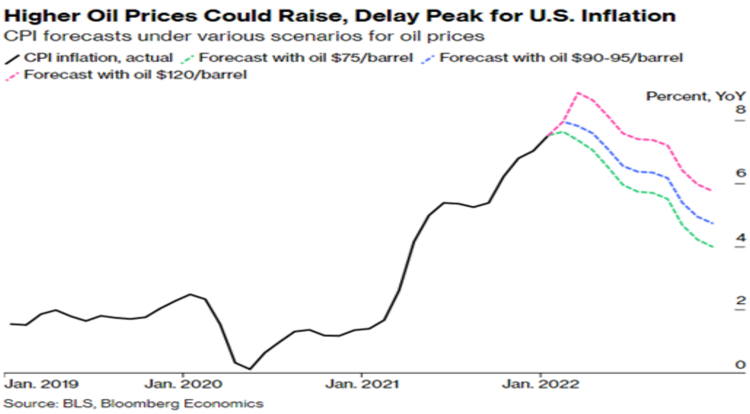


Drive down any highway in any major U.S. city and you are likely to see empty high rises that used to house hundreds of office employees. Corporate office parks seem abandoned and parking lots are empty. Indeed, in a matter of just a few months, the COVID pandemic and the resulting "work-from-home" model has drastically changed the outlook for office real estate. According to data from the National Association of Realtors (NAR), occupancy rates increased modestly in the third quarter of 2021, but then fell 12 million square feet in the fourth quarter. The total net decline in occupancy since the second quarter of 2020 is 145 million square feet.

- The question remains, can occupancy rates get back to pre-pandemic levels, given the fundamental way employees view going back to the office? Is the increase in vacancy in the fourth quarter of 2021 the start of a longer trend downward? According to NAR data, the office recovery remains bifurcated with rent growth in most markets except in the largest metro areas in the country.
- Perhaps one solution is to repurpose office buildings to include residential space. Workers could essentially live and work in the same facility. However, this would likely only be a partial solution. More likely than not, office real estate will come under further pressure.

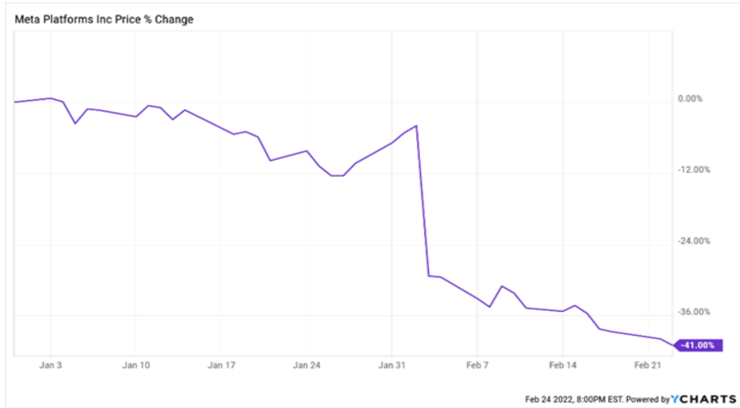
Macro View – Effects of War

As war is underway in Ukraine, Russia's invasion poses significant risks for the world economy. Bloomberg Economics does a fantastic job laying out what they see as three scenarios for the economic impact of the Ukraine Crisis. In the first scenario, they believe there will be a swift end to conflict which will prevent a further upward spiral in commodity markets, keeping U.S. and European economies on pace for further recovery. The second scenario, a prolonged conflict, tougher Western response, and disruptions to Russia's oil and gas exports, would deliver a more pronounced shock to both energy and global markets. This scenario has the possibility to take European Central Bank rate hikes off the table this year. The final scenario is what Bloomberg describes as a "worst-case-outcome" where Europe's gas supply is cut off, which in turn could trigger a recession. The U.S. could see significantly tighter financial conditions, a larger hit to economic growth, and a more dovish fed.



Taking Stock – FAANG Without the F?

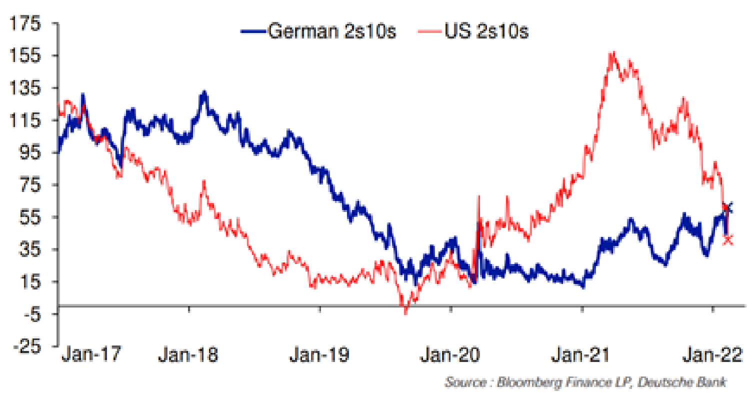
Meta Platforms Inc. (FB), formerly known as Facebook, is one of the most recognizable companies in the world. However, since their transition to Meta, stock performance has been less than stellar. Meta reported earnings at the beginning of February, and since then, the stock has continued to decline. The surprise miss in revenue drove the stock price down almost 26.5% and it is currently down 41% year-to-date at the time of this writing. Just last September, Meta's market capitalization hovered above $1 Trillion. Now, just five months later, Meta's market capitalization has been almost cut in half and is currently sitting at around $550 billion. With other companies such as Roblox Corp. (RBLX), Microsoft (MSFT), and Unity Software Inc. (U) already heavily involved in metaverse, Meta may continue to struggle as more players enter this space.



Source: Ycharts

Fixed Income - Extreme Flattening

The spread between the yield on 2-year government bonds and 10-year government bonds was virtually the same in Germany and the US in 2017. Since that time, there have been very divergent paths with the spread in the US plummeting and even turning negative for a short time in 2019 before rocketing higher. German spreads continued to decline and only began rising modestly in 2021. As the Fed has signaled, they will begin raising short-term rates, some expecting as many as seven hikes in 2022, the US yield curve has flattened dramatically, and the spread is higher in Germany for the first time in two years. You would expect the short end of the yield curve to be more impacted by Fed Funds rate increases, suggesting the yield curve could invert with as little as two rate hikes if the current trend continues.



Technical - Discretion vs. Valor

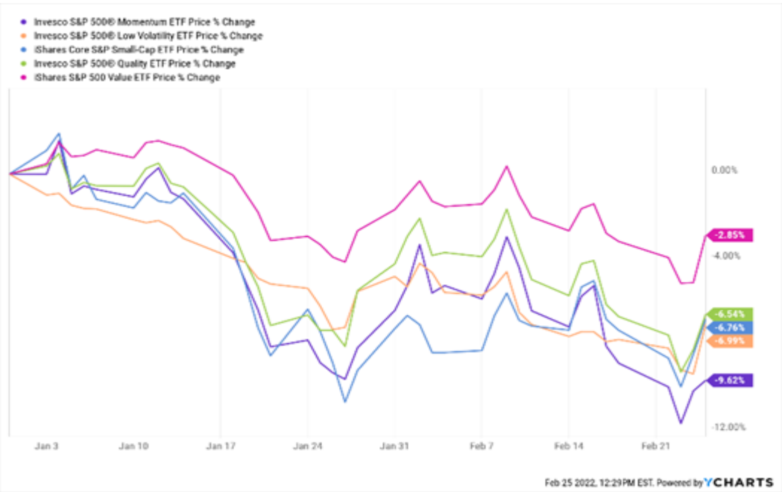
Investors these days may want to consider focusing on discretion as the better part of valor when it comes to the equity markets. This chart, taken before Russia's occupation into Ukraine, paints a picture of caution on the S&P 500 as the markets hover just above key support levels. A popular head-and-shoulders pattern looks to be forming that suggests far more downside risk to equity markets right now. At the time this is being written, the SPX sits at 4254, just 32 points above the January low after breaching the low on an intra-day level. A close below 4222 creates a technical pattern where the next strong support does not occur until 3269, nearly 25% below the current level. Traders are watching closely where markets trade from here for signals that sellers may soon overwhelm buyers and send markets much lower.

Performance Review Year-to-Date

Clint Pekrul, CFA

Given the increased volatility around the Ukraine invasion, inflation, and rising interest rates, we felt it appropriate to provide a performance summary for the major asset classes. In general, most markets have come under selling pressure so far this year given heightened geopolitical risks and the Federal Reserve's monetary policy plans for 2022. Below are performance highlights for the major asset classes:

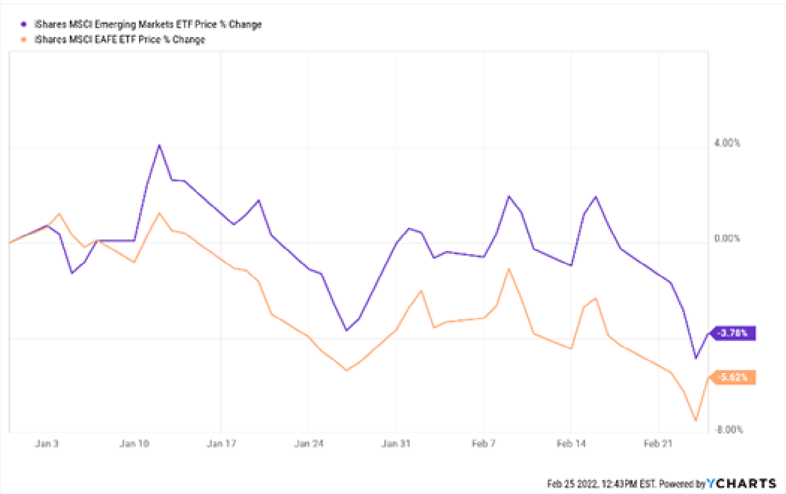
Domestic Equity Factors



By domestic equity factor, value stocks have outperformed on a relative basis. The S&P 500 Value Index is lower by roughly -3% for the year, compared to a decline of approximately -10% for the S&P 500 Momentum Index. Meanwhile, the S&P Low Volatility, Small Cap, and High-Quality Indexes are all lower by roughly -7% for the year.

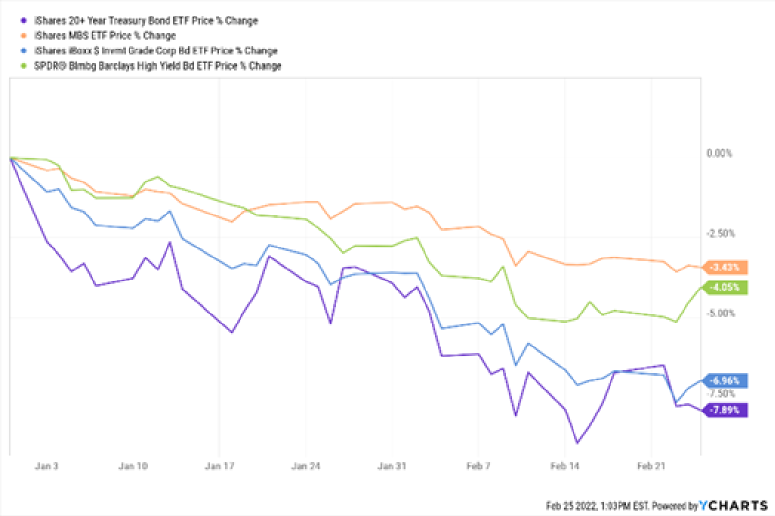
Considering that the CBOE VIX Index is trading at elevated levels of over 30, domestic equity markets have been resilient. The broad S&P 500 Index is down less than -10% year-to-date.

International Equities



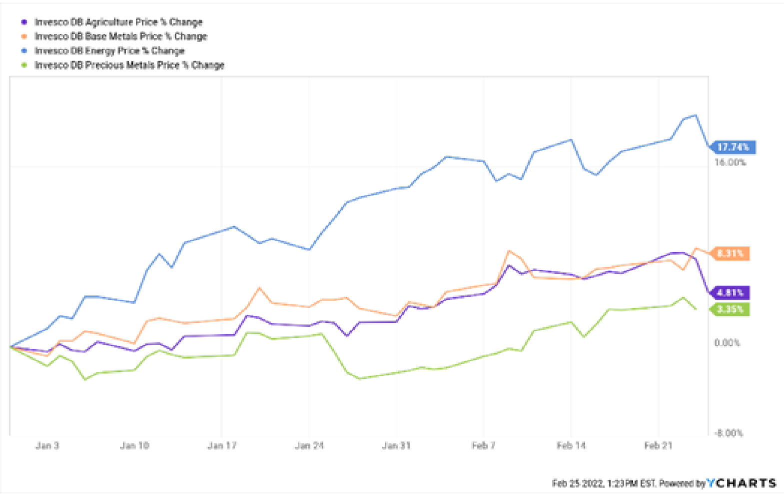
Given the developments in Russia, it is not surprising that emerging markets are lower for the year. The MSCI Emerging Markets Index is lower by roughly -4% in 2022. Still, emerging markets have outperformed most U.S. equity factors over the same period. Developed markets are lower as well, as the MSCI EAFE Index is down roughly -6%. Overall, international markets have held up relatively well versus domestic markets. Valuations overseas were considerably lower than in the U.S. at the beginning of the year.

Fixed Income



Fixed income has come under pressure given the Federal Reserve's plans to tighten monetary policy. Longer-duration Treasuries are lower by approximately -8% based on the Barclay's 20+ Year Treasury Index. Investment grade credit is lower by roughly -7% as measured by the iBoxx Investment Grade Index. However, the Barclay's Mortgage-Backed Bond and High-Yield Bond Indexes have been resilient, having declined only roughly -3% and -4% for the year, respectively.

Commodities



Inflation expectations have driven commodities surging for the year. The Deutsche Bank Energy Index has advanced roughly 18% for the year, while the Deutsche Bank Base Materials Index has gained 8% over the same period.

Q: Is real estate a good investment today?

I think it entirely depends on the geography and type of real estate you are considering investing in. Starting with residential real estate, many geographies can likely be considered to be in a bubble based on affordability. The price of single-family homes in many jurisdictions have risen far in excess of the increase in income of potential buyers, creating large imbalances. This has been facilitated, in some cases, by very large institutional investors buying residential real estate sight unseen for investment purposes. Historically, residential properties were acquired by people wanting to live in the home or for purposes of long-term rental income. Investment firms like Blackrock are purchasing homes with the intent to sell at higher prices. I expect this to create a major dislocation in the future as publicly traded investment firms liquidate holdings, creating a shock to supply and demand equilibrium. Commercial office space is in flux resulting from COVID restrictions and many people determining they can work from home. No one really knows how demand for office space will recover post-pandemic. I speculate that fewer people will work from offices, but the space per employee ratio will expand, making demand roughly equal to pre-pandemic levels. Until excess capacity is removed, pricing on commercial space will likely remain soft. Industrial real estate may be attractive in growing regions, although historically low cap rates could lead to concerns as rates move higher.

It is hard to bet against real estate as an asset class in the long run. However, I think you must be highly selective about your exposure. On the one hand, there is the inflation aspect to real estate. It is well established that real estate investments can provide a hedge against inflation risk. In general, property values will tend to at least keep pace with the Consumer Price Index (CPI) in the long run, which can preserve purchasing power. Likewise, having indirect exposure to property through an investment such as a Real Estate Investment Trust (REIT) can provide rising income to help mitigate inflation risk.

In the long-run, residential real estate should likely be a part of your overall asset allocation, either through your primary residence or through rental properties. Commercial real estate can be a bit trickier, particularly in the office space sector. With the onset of COVID in 2020, the way people work remotely now could have long lasting ramifications for office space. It will be interesting to see how expiring leases in the coming years will affect property values. I don't see how we ever get back to where we were before the pandemic, given the desire for employees to work remotely.

Q: How will the conflict in Ukraine impact Europe?

As mentioned in the introduction, geopolitical events tend to impact based on proximity, and the conflict in Ukraine is in Europe's backyard. There is a wide disparity of opinion as to what Russia does following taking control of Kyiv. Some suggest Russia has massively overplayed their hand and will face opposition at home over Putin's actions. Others believe the Russian people are in full support and Putin will turn his immediate attention to the Baltic states to occupy in an attempt to rebuild the Soviet Union that collapsed in late 1991. Putin was a mid-level KGB officer in 1991 but quickly rose to power, becoming the prime minister of Russia in 1999 before becoming President in 2012. I think Putin realizes he is nearing the end of his control of Russia and will try to restore the former Soviet Union. This is bad news for Europe, which eschews war as evidenced by the small amount spent on national defense in recent times, although Germany's recent indications that it intends to substantially expand its defense budget may portend new attitudes on this issue in Europe. NATO is unlikely to have the might or will to directly engage Russia's aggression and will pursue sanctions instead. Russia is a major supplier of energy to Europe, particularly to Germany where Russian gas exports represent 55% of German usage. Higher energy prices will occur as a result of sanctions, negatively impacting the economies of Europe. War, or threats of war, provide rationale for government spending that may offset at least in part the impact of higher energy costs.

In response to Vladimir Putin's decision to invade the Ukraine and challenge the region's independence, the European Union (EU) has imposed numerous economic sanctions on the Russian Federation. For example, the EU has restricted Russia's ability to access their financial and capital markets, along with closing European airspace to Russian commercial flights, freezing some of Putin's personal holdings within Europe's jurisdiction, and committing to what has been described as "targeted" blocking of certain Russian Financial institutions from the SWIFT international banking system. Meanwhile, NATO has condemned Putin's aggressive actions and has promised to use additional military forces if needed. Ukrainians seem committed to retain their independence despite overwhelming odds against the Russian military. Putin's strike could prove to become a prolonged civil conflict.

In a sense, Putin is trying to redraw the map of eastern Europe. Furthermore, we don't know what his intentions are, if any, to invade other areas in the east, such as the Balkans. The great unknown for now is whether the Ukraine invasion is just the start of a larger military operation led by Putin's military. There would ultimately be a tipping point where the U.S. would have to respond militarily along with greater involvement from NATO. Drawing parallels to World War II, however, seems to be a bit overblown. Neither Russia nor the Ukraine are developed economies. Developed countries in the EU such as Germany and France could be largely unaffected by what happens in eastern Europe.

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