Fed Declares War

PEAK CAPITAL MANAGEMENT

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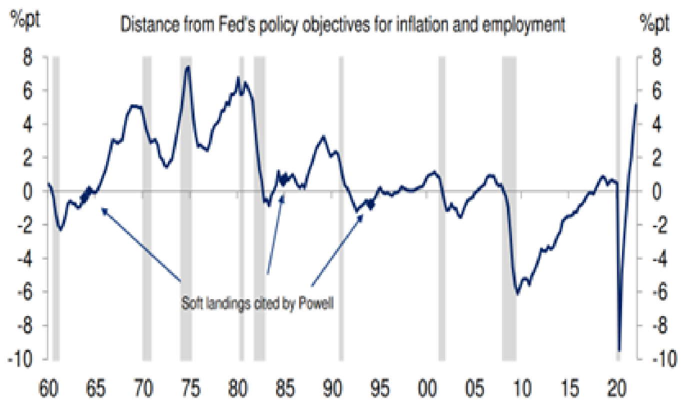
It is hard to imagine that the group of people with the greatest access to real-time data and analytics on the domestic and global economies could be caught off guard, but appears to be exactly what has occurred. I am referring to, obvious to many, the Federal Reserve and their policy-making decisions regarding interest rates and bond purchases. There have certainly been exogenous events outside their control - there always are - but the level at which they put themselves in a no-win situation is astounding. By leaving rates so close to zero for so long, continuing to purchase billions of bonds expanding their balance sheet, and incompetently referring to rising inflation as transitory, they have created a situation where the only way they will be able to gain control over inflation is to force the economy into what will likely be a prolonged recession.



Note: The chart shows the sum of core PCE inflation minus 2% and NAIRU minus the unemployment rate. The latest data point is estimated for Q1 using our adjusted view of NAIRU near 5.5%. Source : BLS, BEA, CBO, Haver Analytics, Deutsche Bank

You do not have to be a market historian or economist to know the Fed was targeting stock prices when they initiated Quantitative Easing. The markets were tanking, and the Fed stepped in to provide the Put, creating the necessary excess liquidity to cause risk assets to rise. Be certain of this, Quantitative Tightening will also target stock prices, only not in a way that most investors are prepared for.

I do expect we will soon arrive at a place where Fed policy (i.e., rate hikes) will cause the economy to enter a recession. If the Fed blinks and pauses their fight against inflation, it is very likely the result will be a long battle with the silent killer. Why would the Fed pause you might ask? Contrary to those who suggest the Fed is apolitical, the Fed is very political and clearly acts in a way that continually demonstrates it. Few economists, even with their dismal track records on predicting economic growth, would reject the idea that if the Fed hikes rates as much as advertised, it will lead to a recession. Recessions have political consequences; typically, the party in power loses when we encounter a recession. A recession before the mid-term elections would likely create a political tidal wave that some, not all, on the Fed would probably like to avoid.

History is not on the Fed's side right now. Never before has inflation fallen 4% or more in a year without a recession occurring. The Fed is fixated on making policy decisions using lagging indicators; it is why they missed this spike in inflation so badly. They are trying to guide the economy into the future by looking in the rear-view mirror and that will likely result in "accidents". Too often the Fed is convinced the economy will respond as predicted in a textbook on economic theory and gets it entirely wrong. The economy is far more dynamic and unpredictable than theory would suggest.

What does this mean for investors? To start with, the near 20% correction of the S&P 500, far higher with the Nasdaq, is likely still in the early innings of the ultimate decline that will happen. Do not be surprised if the drop so far ultimately proves to be half or less of the ultimate drop in stock prices. Second, inflation is likely to be far more persistent than many are predicting. Rate hikes alone are unlikely to bring inflation down to acceptable levels even though it will make credit far more expensive. Supply chain disruptions mean there will be scarcity of supply for many items and the Fed's ZIRP (zero interest rate policy) and QE created so much asset price inflation that people will pay increasingly higher prices to get what they want, regardless of how high rates go.

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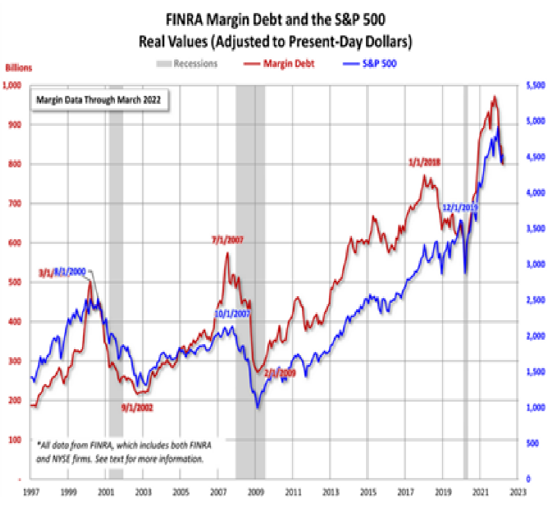
Not all investments are going to suffer in the manner that FANG stocks and other high P/E have suffered. Many areas of the energy sector still look attractive at current valuations and benefit from governments around the world doing their best to create a scarcity of energy. Healthcare is another area where you can find reasonable value and growth rates that should hold up well. Lastly, financials have not participated in the run up in valuations and would be attractive if not for the fact that the yield curve appears likely to invert by this Summer, and that is bad for banks' net interest margins. Banks will likely be the best sector to buy coming out of the recession. Expect value and low volatility to continue to outperform momentum and growth for the next 12 months. Stay diversified, own assets not correlated to the stock market, and be patient. We will get to the other side and may see opportunities that only bear markets can create.

Slowdown in China



Source: Advisor Perspectives

Economic growth in China has long been key to maintaining global GDP growth rates, but we are in the process of determining what happens when China becomes a drag on global growth. As the chart indicates, China's Zero Covid policy is forcing many manufacturing workers to stay home in regions known for manufacturing output. Exports have fallen in China and the manufacturing index has dropped precipitously, falling well below 50, suggesting contraction. There is little data to allow us to know if the lockdowns are actually making a difference with many of the new, highly contagious variants of the virus. Most of the world has determined a policy of Zero Covid is unattainable as epidemiologists suggest most people will eventually be exposed and have at least mild symptoms.

- Covid lockdowns may not be the entire reason for the sharp slowdown in manufacturing output in China. Energy prices have spiked globally, and China has experienced rolling blackouts as a result.
- China's reported growth rates have fluctuated significantly with 2021 above 8%, the highest since 2011, but forecasted in a range between 4% and 5% for the coming 5 years.
- China's reduced exports are having an impact on the global economy as many critical components for products are manufactured in China. Falling exports mean supply chain issues for many.

Are Cryptos Diversifying Your Portfolio?

In a market where all asset class returns seem to be positively correlated, investors have turned to cryptocurrencies (cryptos) as a way to diversify their portfolios. Have cryptos met client expectations? Based on results so far this year, the answer is likely no. The chart to the left illustrates the NYSE Bitcoin Index year-to-date compared to the S&P 500 Index (equities) and the Bloomberg Core Aggregate Index (bonds). For the year, losses in Bitcoin, among other cryptos, have outpaced declines in traditional stocks and bonds. Furthermore, the volatility of Bitcoin is more than double the volatility of the S&P 500 Index based on historical daily returns for the year, and the return correlation of Bitcoin to both stocks and bonds has been generally positive.

- The fact that cryptos like Bitcoin have likely not met investor expectations has raised some eyebrows. Touted as an alternative asset class that can diversify a portfolio, cryptos have generally failed to deliver, especially as an inflation hedge and store of value.
- The volatility we are experiencing in cryptos is the byproduct of speculative behavior in a market that, for the most part, is not well understood by the general public. Investors must determine what utility, if any, that owning cryptos provides to an overall asset allocation strategy.

Not so "stable" after all

While financial markets have been nothing but volatile over the course of this year, an area of the market that is supposed to be "stable" collapsed earlier last month. The Terra blockchain has two coins under its system: Terra (LUNA) and TerraUSD (UST). Unlike other "stablecoins" such as USD Coin or Tether, UST is not backed by actual US Dollars, but is backed by what is known as an algorithmic stablecoin through the use of Bitcoin in reserve. On May 7th, UST began to de-peg from the US Dollar, but was then quickly restored to the peg. However, just a few days later, UST once again lost its peg and then in turn, created a massive selling frenzy. Now at the time of this writing, TerraUSD, once pegged to the USD at $1, is currently trading around $0.0545, nearly a 95% decline.

- Stablecoins are supposed to be a source of assurance in a world of volatility and act as the foundation of trading and lending activities. These coins are used extensively by individual traders, funds, and market makers to support liquidity in the crypto markets.
- Since UST's de-pegging from USD, prominent coins such as Bitcoin and Ethereum are down 17% and 25% respectively.
- Terra had a market cap of $30 billion at the beginning of May, but as of this writing, it now only has a market cap of $1.12B.

Macro View – CBO Budget Projections

On Wednesday May 25th, the Congressional Budget Office (CBO) published a report estimating that real gross domestic product (GDP), will grow by 3.1% in 2022. The growth, according to the CBO, will be “driven by consumer spending and demand for services”. The COB also raised its 2023 and 2024 GDP growth estimates to 2.2% and 1.5% respectively. Additionally, the CBO provided estimates for inflation in the coming years, all of which remain above the Federal Reserve’s historical 2% target (22’: 4.7%, 23’: 2.7%, 24’: 2.3%). In order to combat inflation, the CBO believes the Fed will need to raise the federal funds rate to 1.9% in 2022, much less than the predicted 2.85% by the Federal Reserve Bank of Atlanta. Yet, Wharton School of Business professor Jeremy Seigel, a critic of the Fed for not doing enough to combat inflation, is now growing concerned about a possible “overreaction” by the Fed, due to what he mentioned was the “2nd largest monthly decline in money supply in 60 years”.

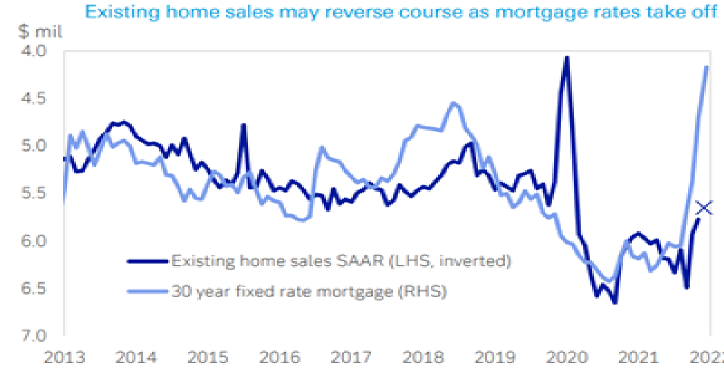
Source: CBO

Taking Stock – Snap Inc.

Last week, Snap Inc. (SNAP) CEO Even Spiegel warned Wall Street that “the macro environment has deteriorated further and faster than we anticipated when we issued our quarterly guidance last month.” Snap, which had previously projected second-quarter growth of 20% to 25%, plummeted more than 43% after Spiegel’s comments and is now down more than 72% year-to-date at the time of this writing. Analysts at JMP Securities noted that “Macro headwinds are likely to extend to all of digital advertising”. Competitors in the social media space such as Meta (FB), Google (GOOGL), Twitter (TWTR), and Pinterest (PINS) were not immune to losses and finished the day down 7.64%, 4.94%, 6.18%, and 23.46% respectively. Spiegel’s comments come after Meta Inc. warned investors in April that second quarter year-over-year revenue could decline instead of the double-digit growth they are accustomed to.

Fixed Income – Rates and Home Sales

Fed rate hikes are projected to slow down the economy at large but might impact the housing market more than any other sector. Existing home sales have remained strong for years but are taking a breather as mortgage rates move sharply higher since the beginning of the year. In January, well-qualified home buyers could qualify for 30-year fixed mortgages around 3% making even high home prices somewhat affordable. With mortgage rates now rising above 5.5% in most areas, the housing affordability index has fallen dramatically. There is a lot of ancillary employment associated with the housing market so as it slows, some will have difficulty finding or keeping jobs. Expect to see higher mortgage rates impact consumer spending in the coming months. As families who purchase homes at higher rates, or who have adjustable-rate mortgages, are forced to allocate more income for housing, it will reduce what is available for discretionary spending that ultimately reduces GDP.



Source : Freddie Mac, National Association of Realtors, Bloomberg Finance LP

Technical – Skating to the Puck

Investors would do well to follow the advice credited to the greatest hockey player of all-time, Wayne Gretzky, who quipped you need to skate to where the puck is going, not where it is. Technical analysis tools are designed to identify trends allowing investors to anticipate where the markets, or puck, is headed. Coming out of the Covid-driven slowdown in 2020, technology dominated the markets posting oversized returns. As interest rates have moved sharply higher, selling in growth sectors like technology has accelerated. On a year-to-date basis, only the Energy sector has been able to post positive returns at the sector level. Energy prices have spiked in the inflationary environment, but also because many areas of the world have energy policies driven by political goals rather than production goals. Materials and real estate tend to hold value in rising inflation periods while high P/E stocks tend to suffer.

Market Valuations

Clint Pekrul, CFA

With a hawkish Federal Reserve determined to quash inflation through tighter monetary policy, investors are trying to determine a reasonable valuation for the equity markets. The consensus is that after years of easy money, it is now time to pay the piper through asset repricing.

The days of valuing equities based off top line revenues or lofty growth expectations are waning. Investors want to see profits. In particular, they are gravitating to companies that can not only generate earnings but can also pass through higher costs in an inflationary environment.

At a time when monetary policy and inflation expectations are at an inflection point, it is helpful to evaluate where valuations are today compared to longer-term trends over multiple business cycles.

The chart below plots the cyclically adjusted historical S&P 500 Price-to-Earnings ratio (CAPE*) versus the historical average since 1950:

*The CAPE is calculated by dividing a company's stock price by the average of the company's earnings for the last ten years, adjusted for inflation. These figures are aggregated across companies in the S&P 500 to calculate the index CAPE.

The chart above is scaled to illustrate how far above or below the CAPE ratio is compared to the long-run historical average CAPE. We can generalize that when the black line is above the average, the market is "overvalued" relative to historical levels. Conversely, when the black line is below the average, the market is "undervalued" relative to historical levels.

Current Valuations

Despite the pull back in equities we've experienced so far this year, compared to historical CAPE levels, we could argue that the S&P 500 still looks expensive. As of May 20th, 2022, the CAPE for the S&P 500 is roughly 50% above the long-run average, which suggests we might have further downside risk in the near term as the CAPE converges to the historical average.

Obviously, the CAPE is not a perfect measure, but it does provide a picture of where we are today within a historical context. If we think about the CAPE in relation to interest rates, it reveals an interesting pattern. The last time we had a serious bout of inflation in the late 1970s and early 1980s, the CAPE fell well below the long-run average. At the time, Fed chairman Paul Volker raised interest rates aggressively to combat runaway inflation.

The Fed's hawkish policy coincided with the CAPE moving from an average valuation in 1970 to roughly half the of the average by 1980. While we're not suggesting that Fed policy today will match the extreme measures from 40 years ago, the decline in the CAPE ratio over this period illustrates what can happen to equity valuations when the Fed is fighting inflation.

Once interest rates peaked in the early 1980s, we embarked on a secular bull run in equities that culminated with the Dot.com bubble in 2000. Investors who entered the market at cheap valuations in the early 1980s were handsomely rewarded over the next twenty years. This period coincided with generally lower trending interest rates.

Investors who entered the market in 2000 – when the CAPE was a lofty 130% of its long-run average – bore the brunt of three consecutive annual loses for the S&P 500. Valuations in the early 2000s were at an extreme, and ultimately could not be supported.

Roughly a decade later, the global financial crisis unfolded, and earnings collapsed across the global economy. This in turn sent the CAPE down to roughly half its long-run average. In hindsight, this proved to be a buying opportunity much like in the early 1980s. To avert collapse, the Fed adopted a zero-interest rate policy coupled with quantitative easing.

As a result, investors who essentially bought a discounted CAPE in 2009 have been handsomely rewarded over the past 12 years. In the process, however, we have again pushed the CAPE to an extreme overvalued level. While we are no longer two standard deviations above the long-run CAPE average, we are still overvalued.

The path forward is highly dependent on inflation expectations and the Fed's policy response. The year-over-year consumer price index (CPI) as of April 2022 was 8.3% (not seasonally adjusted). The Fed's current target rate is roughly 1%, suggesting that meaningful rate hikes in the near term are possible.

Investors are contemplating a repeat of what we experienced 40 years ago, when markets tumbled amid slow growth and persistently high inflation. There is a genuine sense that this time around, the party might be over as the Fed removes the punch bowl of easy money.

Our advice is to maintain a diversified portfolio and be tactical with respect to your asset allocation. We are likely entering a period of persistently high volatility as markets reprice for higher interest rates.

Q: What Happened to Energy Independence?

In a word, elections. For the first time in most of our lifetimes, the US exported more oil products than it imported in 2019. That was a period celebrated by the vast majority of Americans after decades of relying on foreign oil and often buying energy from countries that used revenues from energy sales to attack our country. Technological advances in seismology and fracking techniques allowed oil production to surge and the US to no longer rely upon oil imports. This also drove economic activity as low energy prices increased consumer discretionary income and spending.

Both oil and natural gas rig counts rose substantially in 2018 and 2019 as the US became energy independent. Even when oil prices went into negative territory briefly during the Covid lockdowns, production remained in place and grew when prices recovered. The 2020 elections created a dramatic change in policy as power shifted to people who were happy to see fossil fuel production fall in an attempt to move towards renewable energy. There was also an interesting shift in the oil majors who came under intense political pressure related to carbon footprints. As large companies ignore high oil prices and do nothing to increase production, it may create opportunities for small or mid-size energy production firms to grow. If the political changes expected over the next couple of years materialize, the pendulum may swing back.

Americans are paying more, on average, for gasoline today than ever before. At $4 per gallon, family budgets are stretched thin as energy costs have soared. Not long ago the political catchphrase out of Washington was ‘energy independence’ and the notion that the U.S. would be shielded from geopolitical events overseas. This notion is being challenged as events in the Ukraine and subsequent sanctions have roiled the energy markets. I think there was a general assumption that our so-called energy independence meant that we didn’t need to worry about supply and demand disruptions caused by the likes of Vladimir Putin.

What exactly defines energy independence? The U.S. is currently a net exporter of petroleum, implying that in general, we do not necessarily need to import energy to meet domestic demand. This quantity-based rule of independence, however, doesn’t account for the fact that oil is a commodity that’s traded internationally. Prices are set based on global supply and demand forces, and not necessarily our domestic economy. In other words, for us to achieve the energy independence that I think most people understand – where our energy prices are largely unaffected by global supply and demand – we need to have less dependence on energy commodities that are traded internationally. This implies a greater reliance on renewable energy.

Q: Do Walmart and Target Earnings Indicate a Recession?

The wide earnings misses by both Walmart and Target on the same day rightly sent shivers down investors backs and raised the likelihood the negative GDP print for Q1 was not an aberration. Before jumping to conclusions that the sky is falling, there were some interesting observations from the two largest retailers’ earnings reports. There were many inventory issues each company suffered caused by supply chain interruptions. In some cases, this meant the stores did not have the inventory they desired or that shoppers were looking for. Regardless, the poor results do suggest that inflation with food and energy prices may be starting to take its toll on discretionary spending.

Walmart and Target are closely watched as their customers tend to be more economically sensitive than shoppers at Whole Foods or luxury retailers. These shoppers are disproportionately negatively impacted by higher rents and higher financing costs on credit cards. A data point that seems to confirm this is credit card balances are rising dramatically for the lower quartile of income earners. This means lower income earners are increasingly trying to use credit cards to make ends meet. Government programs during Covid provided a tremendous amount of spending money for many households and as those programs have ended spending is likely to continue to be impacted. The likelihood of recession in 2022 is elevated and seems probable by 2023.

Despite increases in revenue, giant retailers Walmart and Target missed their earnings estimates by a wide margin. Essentially, both retailers cited shifting consumer demand as we recover from the COVID shutdowns, and the impact of inflation and supply chain issues on their bottom lines. On the positive side, consumers seem to be resilient, at least for now. Demand is shifting from big-ticket merchandise items to services. Not surprisingly, consumers have shifted their spending behavior compared to two years ago during the shutdown. It will take time for companies to adapt to the more normal post-pandemic world.

A significant problem retailers like Walmart and Target face now is higher costs due to supply chain issues. Likewise, it seems likely that the Federal Reserve is going to act to stifle aggregate demand through tighter monetary policy. The Fed can’t really control the supply side of the equation through higher interest rates. The risk I think the market is trying to price in is a scenario where higher rates sufficiently slow demand, but supply chain issues persist. This scenario would significantly increase the likelihood of a recession and present a further profit squeeze for big box retailers like Target and Walmart. Service-related industries, however, could prove to be more resilient.

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