PCM
PEAK CAPITAL MANAGEMENT

To Infinity and Beyond

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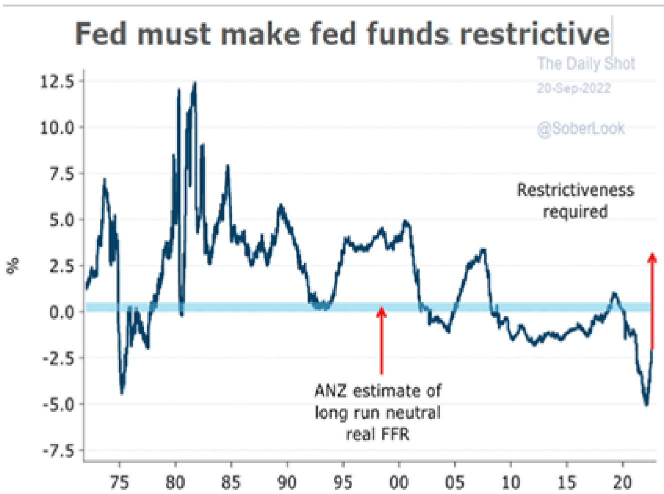
Fed Chair Powell has taken on the persona of Buzz Lightyear in recent comments regarding Fed interest rate hikes. Using an animated children's movie to describe the actions of Powell of the Fed seems reasonable given that years from now people may be asking if an 11-year-old was running the Fed from 2018 to 2023. Powell and his cohorts have realized that inflation is anything but transitory and they now have no choice but to break the economy to get inflation back in check. The pain they have caused, and will continue to cause, will be seen in hindsight as mostly avoidable in my opinion.



Source: BEA, Fed, Bloomberg, Macrobond, ANZ Research

GDP in the U.S. grew at 5.6% in 2021 but the Fed left interest rates near 0% and continued Quantitative Easing that added liquidity and incentivized buying risk assets. Few economists doubt that if the Fed only modestly tried to normalize interest rate policy when the economy was growing after Covid lockdowns inflation would not have reached the levels we are seeing today. The Fed has now come to the conclusion that the economy, markets and even jobs must be sacrificed in order to bring inflation back to their long-term target of 2%.

We may only be in the early stages of the impact higher rates will have on the economy. In June, the FOMC (Federal Open Markets Committee) median GDP forecast for 2022 was 1.7%. As of September, the forecast has fallen to 0.2%, a drop of 90% in just 3 months. Powell has stated the Fed will hike rates until it achieves a "restrictive rate" that portends a hard landing with the economy.

In times of crisis, it is said that "Cash is King" and I believe we are returning to that reality.

Housing is likely to be the most impacted sector of the economy because of the Fed's missteps. Housing affordability is at levels not seen since 1986 according to WSJ data and is likely to get worse as mortgage rates climb faster than home prices are falling. It is even worse in metropolitan areas. Powell has stated that real yields need to be significantly positive across the yield curve before inflation will start trending towards their target so expect a lot more pain.

There could be a large number of unintended consequences in the Fed's fight against inflation. As borrowing costs rise exponentially, corporate downgrades are likely to spike as companies struggle just to service debt. I expect a surge in bankruptcies as companies fail to generate enough profit to remain solvent. There should also be a massive drop in Mergers and Acquisitions as capital to complete deals is no longer available. Sadly, small businesses that employ the greatest number of Americans will be negatively impacted if credit conditions tighten and lending becomes scarce.

I believe the Fed has failed miserably in their dual mandate. The Fed was created with the mandate to maintain stable prices and full employment. By remaining overly accommodative and not recognizing the impact that fiscal policy was having (paying people not to work), they kept rates too low for far too long allowing inflation to surge to levels not seen in 50 years. The Fed has proven they cannot walk and chew gum at the same time. They focused on economic growth and low unemployment to the point of allowing inflation to rage. They now turn their focus to reducing inflation and risk destroying the economy in the process.

The aggressive interest rate hikes impact the U.S. dollar as well. The dollar index is at 20-year highs having risen almost 20% year-to-date. A strong dollar helps if you are traveling to Europe or Asia but not if you are a business trying to export to those markets. Europe and Asia buy much of their energy priced in U.S. dollars becoming a large impairment to their economies. It is much worse for Emerging Markets today, where much of the growth in the global economy comes from. EM's tend to borrow in U.S. denominated debt making repayment extremely difficult when their local currency falls against the buck.

In times of crisis, it is said that "Cash is King" and I believe we are returning to that reality. Interest rates are likely to rise to a point where money funds will pay a yield equal to, or greater, than the expected return on equities. This will cause massive selling of risk assets for many investors. Traditional 'safe havens' have not worked as expected. U.S. Treasury bonds have experienced their worst returns in a generation and commodities, like gold and silver, have not protected portfolios like in prior inflationary periods. Those who think the market turmoil is close to being over could be in for a rude awakening.

Sky's the Limit for USD

The greenback has been surging as the Fed has aggressively pushed rates in the U.S. higher. My preferred metric is the Trade Weighted Index because it provides insight to how the strong dollar is impacting global trade. The DXY chart shows a similar 20% YTD increase in the USD against a basket of other currencies. There are benefits of the strong dollar, especially if you are traveling abroad, but also strong drawbacks for the U.S. economy. At the top of the list is the headwind created for companies who rely on foreign exports. Massive flows are coming into the U.S. as money goes to where yields are the highest and currency the safest. Assuming the U.S. continues to lead in rate hikes, expect the trend to remain in place.

- According to S&P data, 30% of revenues of S&P 500 companies comes from outside of the U.S. with China, Japan and the UK being the largest contributors of foreign revenues.
- The top sectors for exports include: energy exploration and refining, pharmaceuticals, and automobile manufacturing. It is the car companies that will be most impacted by a strong USD.
- A strong dollar should help bring inflation down as imports are less costly. Highest imported items include the volatile minerals and oil, followed by pharma and medical equipment.

Housing—Where to Live

For many Americans, the "dream" of home ownership is untenable. The combined headwinds of stimulus COVID handouts from the federal government, and zero interest rates from the Federal Reserve have pushed home prices through the roof. However, we are on a different path today. We have reversed course. Higher interest rates have stalled the refinance business, which until 2021, was highly lucrative. The chart to the left exhibits the fixed rate borrowing cost for a 30-year mortgage going back 10 years. While there remains a limited supply of affordable housing, potential first-time homeowners are now faced with dual headwinds – limited supply and higher interest rates.

- The financing costs for a mortgage are exponentially higher today compared to the past decade. The 30-year mortgage rate has soared from roughly 2.5% at the end of 2020 to approximately 6.1% today.
- With such headwinds, we could be on the precipice of a generation of renters. Younger generations can no longer afford a home. While employed, they lack the disposable income to afford a mortgage payment. For decades the average home price has risen faster than the rate of inflation. While wages, on average, have risen, they can't foot the tab on a monthly mortgage payment.

Failure to Deliver

Earlier last month, FedEx (FDX) made a surprise announcement that they had processed fewer packages due to "weakening economic conditions" during Q2. Because FedEx can be considered a reflection of the current state of everyone's businesses (business activity and inventory movement), the company has historically been used as a reliable indicator of what is potentially soon to come. However, should the current state of the economy be to blame for such a poor earnings miss and uncertain outlook for the future? BoA analyst Ken Hoexter noted the possibility the situation FedEx currently finds themselves in is more of a result of unrealistic goal setting by executives, than the current state of the economy. While there may be debate on who's the real culprit, many agree that there is plenty of uncertainty in the economy and should alarm investors of the possibility of what is to come.

- After that announcement, FedEx's stock price fell more than 21% and has continued to fall an additional 6.85% since then as of the time of this writing.
- FedEx also says it faces "service challenges" in Europe, where a recession looks likely, and "macroeconomic weakness" in Asia, which continues to struggle from strict COVID lockdowns, as well.
- FedEx CEO Raj Subramaniam said he expects the economy to enter a "worldwide recession" in the near future.

Macro View – Quick Reversal

On September 28th, the Bank of England announced that it was going to begin to purchase additional long dated bonds with maturities of at least 20 years. This comes as just a week prior the bank announced its plan to sell those very same long dated bonds. Now why would the Bank of England make such a quick reversal in its policy decisions? The U.K Central Bank communicated these purchases were in an effort to provide "financial stability" to their economy. They also noted that without doing so, it could "lead to an unwarranted tightening of financing conditions and a reduction of the flow of credit to the real economy". The announcement carried over to the US Equity markets causing stocks to break a six-day losing streak and the 10-year treasury yield to fall more than 6.5%.

Source: Reuters

Taking Stock – Cash Management

Over the last decade, short term rates have been below 1.00% and banks paid individuals next to nothing to custody those assets. However, as of this writing, 1-year Treasury bills are currently yielding 3.985%, nearly a 4,944% increase from a year ago. For so long, investors needed to over-allocate to equities in order to obtain their desired rate of return. Now, with the rise in rates, many of those who had been quick to disregard the thought of investing in these type of products are now inquiring about how to utilize them within their portfolios. Because these Treasury instruments carry nearly zero credit risk, the combination of short-duration Treasuries and equities now allows for investors to obtain their desired rate of return while also reducing the overall risk in their portfolios.

Fixed Income – Spiking Yields

In our August PCM Report, we noted that it was reasonable to believe that the 10-year Treasury Yield would bounce off of its previous historical trend level. The chart below shows the 10-year treasury yield going back to 1982 where it bounced at 2.525% on August 2nd off of its 40-year historical trend level. On September 27th, it then accelerated to 3.992% or a 58% increase. Many who had originally predicted the 10-year yield would be around this level in March of 2023 are now predicting we could go as high as 4.7% early next year. As the Federal Reserve attempts to combat inflation, it is not outlandish to believe we have the potential to reach these levels in the soon to near future as markets continue to digest inflation data.

Technical – How much Downside is Left?

Last week, the S&P 500 briefly dropped below its June 17th low of 3,636.87 to 3,623.29. Ray Dalio, billionaire investor and founder of the Hedge Fund Bridgewater Associates, predicted that he estimates a "rise in rates from where they are today to about 4.5% will produce about a 20 percent negative impact on equity prices." Consequently, a 20% decline in equities to 2,918.75 would bring us down to a historical trend line going back March of 2009. If Dalio's assertions are correct, this would be a decline of 39.43% from the market peak in early January at the time of this writing. And while the S&P 500's forward P/E multiple is below what it was at the beginning of the year, many investors believe valuations many still have farther to fall in order to reflect rising bond yields and a looming recession.

Asset Valuations and Interest Rates

Clint Pekrul, CFA

Years ago, I remember my great uncle preaching to me about the value of saving money and investing for my future. At the time, the wise course of action was to put my savings into a certificate of deposit, or CD, at the local bank. Earn an interest rate every year and roll the returns into another CD and compound the interest. I was young and didn't really understand what my great uncle was talking about. It wasn't until many years later that I understood his wise guidance.

My great uncle endured the Great Depression of the 1930s and was leery of any investment advice, particularly with respect to the stock market. A safe, guaranteed return was paramount and the only entity capable of providing this security was the local bank. The FDIC, or Federal Deposit Insurance Corporation, helped him sleep at night, knowing that his money was safe.

My great uncle's investment approach was simple and easy. Moreover, the interest rate he earned was meaningful – it provided a positive real yield. While he didn't likely understand the concept of duration, he essentially lent his money to the local bank for several years and was duly compensated. He came out ahead of the game and accumulated real wealth over time. He wasn't incredibly wealthy, but he did just fine.

He passed away almost twenty years ago. I can't imagine how he would view our financial realty today. Confusion and distortion best describe the path we've taken financially over the past twenty years, particularly since the 2008 meltdown. Would my great uncle lend money (i.e., make a bank deposit) for a zero percent return? It's not likely.

With the Federal Reserve's current tightening policy, we are reminded of a time that for many has long been forgotten. We are on a path of what many economists call "normalization". That is to say we are entering a new environment that for many might look completely foreign. The notion that as investors we can expect to earn a potential real rate of return on secure, guaranteed investments does really change the way we think about asset allocation and return potential.

So, why has the stock market taken a beating so far this year? When you consider how assets are priced in a fair market, the answer is quite simple. Higher rates today essentially provide competition for every investment dollar. If you are making a decision to invest your money, stocks are no longer the only game in town. For many, this might come as a relief. No longer do you have to accept the volatility of the stock market to fund your retirement, for example.

Assuming that the Federal Reserve doesn't pivot like it did in 2018, we might experience a prolonged period of higher interest rates. Given that their reputation is on the line, and everybody is watching their actions closely, I doubt our central bank will step back and ease again just to support asset valuations. The old playbook said to buy the dips because the Federal Reserve will have your back. When the outlook was unfavorable, we could always rely on our central bank to accommodate with easy monetary policy. Today, the old rules don't apply. Investors who might pull their money out of stocks due to fear can now allocate to cash. This implies that going forward, at least in the near term, any pull back we might experience in the stock market could be more prolonged and severe than what we have experienced over the past decade.

The narrative today seems to be that asset bubbles are going to be popping around the world. Consider it the cost of the easy monetary policy we've enjoyed since the global financial crisis. Rather than having endured the pain inflicted by an over leveraged economy, we chose to kick the can down the road, so to speak. Perhaps now the time has come for us to pay the piper.

Tighter monetary policy can be a good or a bad thing, depending on how you invest. If you are a saver and approaching retirement, higher interest rates are likely a relief. You have been waiting for this moment for quite some time. On the contrary, if you are in a position that requires you to borrow money (a mortgage, for example) the outlook is not so rosy. Financing costs just went up considerably. Likewise, if you are starting a business, the days of accessing cheap credit are likely in the rearview mirror.

The process of normalization – i.e., going from easy monetary policy to higher interest rates – is painful. We have experienced this pain firsthand given this year's stock market returns. The S&P 500 Index, on a total return basis, is down over -20% for 2022. At this pace, we are not too far off the returns we experienced in 2008, when the S&P 500 Index finished lower by -37%. Back then we were grappling with an over-leveraged economy. The Federal Reserve came to the rescue. Today it is our central bank that is primarily to blame for asset devaluations.

So, are we in the early innings of the great asset revaluation, or have markets sufficiently priced in the effects of tighter monetary policy? I believe it is the former. We have enjoyed loose monetary policy for years and unwinding it is likely going to take some time. Today, the S&P 500 Index is trading at a price-to-earnings multiple of roughly 19 on a trailing twelve-month basis. The long run average multiple is about 16. Just to get back to the long-run average would require another leg down for the S&P 500. There are likely more headwinds around the corner.

If you have a sufficient time horizon, today could be the buying opportunity of a lifetime as once expensive assets now appear more reasonably priced. However, thanks to a hawkish Federal Reserve, you have more viable options to invest.

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Q: What's the risk the Fed can't tame inflation with higher rates?

There is no risk that the Fed cannot tame inflation with higher rates in my opinion. History suggests it can be done regardless of the current rate of inflation. The actual risk is if the Fed is willing to bring about the level of economic destruction that may be necessary to bring inflation down to their 2% target. Powell has said the Fed will continue to hike until real rates are significantly positive across the yield curve. Most people interpret "significant" to mean 1% so rates, short-term and long-term, need to be 1% above inflation.

I am in the camp that the Fed created this problem by leaving rates near zero and continuing their bond buying (QE) throughout 2021 when the economy was growing above 5%. They maintained significantly negative real yields for so long inflation was not just likely, it was a virtual certainty. For months economists and analysts commented about the Fed being behind the curve in addressing inflation while the Fed insisted it would be transitory. The Fed is paying the price with their credibility lost and the world will pay the price in terms of economic contraction. Mortgage rates hit 7% as I write this and likely will top 8% in the near future creating even more pressure on a faltering housing market. I expect there is a lot more pain to come before the light at the end of the tunnel is something other than a train.

To the dismay of many investors, the Federal Reserve seems to be lagging in their efforts to tame inflation. Our central bank has been behind the curve. Setting interest rates at zero for too long has consequences, and now the Fed is trying to "catch up" by tightening too quickly. The history of the Fed's monetary policy isn't encouraging. Higher interest rates might quelch demand, particularly in housing, but we are still facing supply chain issues, which the Fed can't address through monetary policy.

Imagine a scenario where our central bank tightens aggressively yet prices (as measured by the consumer price index, or CPI) remain stubbornly high relative to the Fed's target rate of 2%. Under this condition, we would likely see significant downward pressure on asset valuations, particularly for equities, as the Fed would relentlessly raise interest rates but to no avail. Our economy would dip into a recession and unemployment would rise, yet supply chain issues, which the Fed cannot address directly through monetary policy, would persist. The risk is that after all the Fed's action to slow demand via monetary policy, we are left with persistently high prices and deflated asset valuations.

Q: Are equities priced for perfection or destruction?

Given how far both stock and bond markets have fallen, you might think the markets have already priced in the impact of rate hikes and a slowing economy or recession. The chart from Gavekal is staggering as almost $60 trillion in market cap has been wiped out already. That is 5X the lost market cap from the 2020 Covid recession and 6X worse than the Great Recession of 2008-2009, and we are likely not yet at the bottom. Starting with equities, I currently forecast $195 of earnings in 2023 for the S&P 500. At a 15 multiple you have the SPY trading at 2,925 meaning a 20% drop from today's level to get to fair value.

Bonds are more complicated because as short-term rates get to a neutral rate (equal to inflation) it will slow the economy sufficiently into contraction and long-term rates will move lower. The upper bound on the 10-year Treasury I expect to be around 4.50%. The lost wealth in this cycle will dwarf anything investors have seen in a generation thanks, in large part, to Fed malpractice. When the S&P 500 is trading around 3,000 it would be a compelling time to aggressively be long the market in my opinion. Until then, participate but remain hedged.

A generation of investors have never experienced a competitive interest rate on cash (e.g., money market funds, T-bills, FDIC insured deposits, etc.). What the Federal Reserve has essentially done through tighter monetary policy is to give competition, via higher interest rates, to stocks. For the past decade, approximately, investors had nowhere else to turn for an attractive yield. Equities continued to rise as measured by broad indexes like the S&P 500. Investors ignored equity valuations because there was no alternative. Most measures of equity valuations, such as price-to-earnings, reached extremely high levels. Caution was thrown to the wind because interest rates were so low.

However, with the Fed's aggressive monetary policy, cash and short duration investments seem to be an attractive alternative to equities, particularly given the recent drawdown in stocks. The equity markets have largely priced in the anticipation of a tighter, more hawkish Fed. The price-to-earnings multiple on the S&P 500 has come down considerably because investors in general can now turn to cash as a viable alternative. Equities probably have more downward pressure considering that the Fed will likely continue to raise interest rates. Remember, a stock's true value is the present value of future cash flows. Higher rates today imply a greater discount to present valuations (i.e., lower prices).

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