Quarterly Market Outlook

July 2022

Fastest Tightening in Decades

Over the past two years, unprecedented monetary and fiscal stimulus created a boom in demand, while Covid lockdowns, supply-chain bottlenecks, and Russia's invasion of Ukraine constrained supply, driving prices higher. In response, the Fed has belatedly declared its "unconditional" commitment to fighting inflation. It hiked interest rates 1.5% in the first half of the year and now expects to end the year well over 3% – a huge increase after starting the year at zero. The Fed also reversed course on asset purchases, ending quantitative easing ("QE") and quickly transitioning to quantitative tightening ("QT") as it looks to unwind its $9 trillion balance sheet. As a result, 2022 has seen the sharpest rate increase and most significant tightening in financial conditions in over 40 years.[1]

Nowhere to Hide

With cash rates rising and the supply of money and credit falling, nearly all asset classes have performed poorly. Markets have been repricing to offer prospective returns that can (a) compete with the higher expected risk-free rate and (b) compensate for the heightened level of risk in this environment.

Global equities fell 16% in Q2 and are now off 20% for the year, with growth stocks leading the decline – down 30% versus only 13% for value. While the S&P 500 had its worst start since 1970, 10-year Treasuries had their worst start since 1788, now down 11%. Corporates and mortgages fared no better, as not only did underlying Treasury rates rise, but credit and mortgage spreads also spiked higher. High-yield spreads doubled to 5.7%, offering a nearly 9% total yield as of June 30 before retracing in July. Mortgage rates are again near 6% after starting the year just above 3%.[2]

These broad selloffs – which are exactly what we'd expect in an aggressive tightening – not only affect asset prices but will impact the real economy, as falling wealth and rising financing costs curb spending and investment.

Inflation Still High

Prices continue to rise at an uncomfortable pace, up 9.1% in the U.S. and 8.6% Europe versus a year ago. Although markets expect inflation to decline rapidly and average in the 2% range over the next decade, labor markets remain "extremely tight," rents and nominal wages are rising, supply-chain bottlenecks persist, and onshoring efforts may continue to push costs and therefore prices higher. While many commodities have pulled back recently, energy production is still near capacity after years of underinvestment, food and energy supplies remain at risk due to the war, and China's eventual emergence from lockdown will likely increase demand – all raising the risk that inflation stays higher for longer than markets expect.[3]

Recent increases in unemployment claims and slowing momentum in the housing market may help price pressures moderate, but a far more significant slowdown is likely needed to bring inflation back to target. For now, real (i.e., inflation-adjusted) short-term interest rates remain deeply negative, and we know of no historical examples where negative real rates brought inflation down and kept it there.[4]

Growth Turning Down

Real economic growth faces headwinds from all sides. For one, inflation hurts growth. Prices for homes, cars, food and gas are rising faster than incomes, curbing demand, while macroeconomic and pricing uncertainty make it harder for companies to plan and invest. In addition, tightening brings down inflation in part by slowing growth, which weakens in response to higher borrowing costs and falling asset values. Zero Covid and a real-estate deleveraging have sidelined China, and Europe in particular remains vulnerable to commodity shocks.[5] While consumer and corporate balance sheets remain healthy, sentiment has now deteriorated, with the Michigan Consumer Sentiment Index reaching all-time lows. The Fed's most up-to-date forecast suggests U.S. real growth has already declined to -1.5%.[6]

Recession Seems Likely

Against a disinflationary backdrop over the past 20 years, the Fed could cut rates and buy assets to offset an economic contraction without fear of inflation. In the current environment, however, easing would only exacerbate inflation, which the Fed seems committed to fighting – even at the expense of growth. Prices will continue to rise as long as demand exceeds supply. And since it can take years to bring new supply online, that means demand must weaken significantly for inflation to abate. We therefore consider a recession likely as the Fed seeks to bring inflation back to target.

Optimistic Pricing

While equity multiples have fallen in response to higher discount rates, earnings expectations have yet to adjust. With profits near peaks and margins at record highs, we see potential for another leg down in equities as margins come under pressure and central banks tighten to slow their economies. Moreover, while P/Es in the U.S. have come in line with their averages, more stable valuation metrics (e.g., price-to-sales and market-cap-to-GDP) are still at or above levels last seen in the dot-com bubble. Perhaps the strongest support for stocks in the near term is that so many managers are already betting against them (i.e., many sellers have already sold).[7]

At the same time, 10-year yields are now back under 3%, with bond markets predicting a quick return to 2% inflation.[8] This also seems unlikely. Inflation may moderate as growth weakens and pressures ease, but risks seem skewed to the upside for all the reasons mentioned. And if growth slows enough to bring inflation down, it is hard to imagine earnings for U.S. equities continuing to grow at double-digit rates as expected. Equity and bond markets appear to be pricing two very different outcomes.

Protecting Against Stagflation

Significant tightening has already been discounted, which has increased expected returns and may give assets some breathing room. But most portfolios remain vulnerable to stagflation – the weak-growth, high-inflation environment we may be entering. If growth weakens, equities likely have further to fall. And if the Fed blinks as unemployment starts to rise, inflation may stay higher for longer, hurting bonds and further fueling volatility. The Fed may well find itself oscillating between an intolerable inflation rate on the one hand and an intolerable economic contraction on the other.

In sum, the range of potential outcomes is wide, and the likelihood of a bad environment for traditional portfolios seems high. We therefore think diversifying across fundamentally different assets and into alternatives is critical. Commodity-producer equities, for example, can potentially do well when inflation rises even if other equities perform poorly. Many energy companies, in particular, seem reasonably valued at current oil prices, with historically high free-cash-flow yields (>10%) and low forward P/Es (<9).[9] In addition, other inflation hedges like TIPS and gold can potentially do well when inflation rises and/or when growth falls, which can provide valuable diversification if equities underperform.

Finally, given that assets may continue to face headwinds, we continue to look to lowly correlated active management to add value. Managers that hedge and trade flexibly across markets can identify and profit from market inefficiencies in more volatile markets. Similarly, we continue to target skilled, experienced managers in the private markets, as the most attractive opportunities often emerge when fear is high and capital scarce.

Notes

[1] https://www.nytimes.com/2022/06/23/business/powell-fed-lower-inflation.html; Bloomberg (DOTS; FEDL01 Index; USGG2YR Index); https://www.bridgewater.com/research-and-insights/the-liquidity-hole-is-expanding.

[2] Source: Bloomberg (SPX Index, M1US00V Index, M1US00G Index, SPBDU1BT Index, M1WD Index, LF98OAS Index, LUACOAS Index, ILM3NAVG Index); https://www.bloomberg.com/news/articles/2022-06-22/deutsche-bank-looks-back-three-centuries-for-parallel-to-us-rout; https://www.cnbc.com/2022/06/29/stock-market-futures-open-to-close-news.html.

[3] Bloomberg (CPI YOY Index; ECCPEST Index; BCOMENTR Index, BCOMINTR Index, BCOMAGTR Index, BCOMLITR Index); https://www.federalreserve.gov/newsevents/testimony/powell20220622a.htm; https://www.eia.gov/todayinenergy/detail.php?id=52879; https://www.nytimes.com/2022/07/08/business/wages-climbed-5-1-percent-a-still-rapid-pace-as-fed-awaits-slowdown.html; https://www.bloomberg.com/news/articles/2022-07-17/when-will-supply-chains-return-to-normal.

[4] https://www.bloomberg.com/news/articles/2022-07-21/us-jobless-claims-rose-last-week-to-highest-in-eight-months; https://www.latimes.com/business/story/2022-07-20/southern-california-housing-market-is-cooling-what-this-means-for-buyers-sellers.

[5] https://www.wsj.com/articles/inflation-has-outpaced-wage-growth-now-its-cutting-into-spending-11658050200; https://www.nytimes.com/2022/07/14/business/economy/china-economy-slows.html; https://www.federalreserve.gov/releases/z1/dataviz/z1/balance_sheet/chart/; https://www.wsj.com/articles/retail-sales-june-rose-consumers-inflation-11657833254.

[6] Source: Bloomberg (GDGCAFJP Index, CONSSENT Index, NAPMNEWO Index, NAPMNNO Index, DFEDGBA Index, RCHSINDX Index).

[7] https://www.yardeni.com/pub/valcapsales.pdf; https://www.bloomberg.com/news/audio/2022-07-18/breaking-down-extreme-futures-positioning-macro-man-podcast.

[8] Source: Bloomberg (USGG10YR Index, USGGBE10 Index, USGGBE05 Index).

[9] Source: Bloomberg (S5ENRS Index RX072, IN113).