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VIEWPOINTS

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IN THIS ISSUE OF VIEWPOINTS, WE DISCUSS RISING INFLATION AND MONETARY TIGHTENING.

It is remarkable to consider the economic rollercoaster we have been on over the past two years. In 2021 the world economy was estimated to have grown by more than 6%, the largest rate increase in nearly 50 years. Enter 2022, and according to the World Bank we are now experiencing the sharpest global slowdown in 80 years. Rising inflation and the prospect of further central bank tightening into a slowing economy have sent tremors through the financial system, and where the ride takes markets from here remains unclear. One thing we can say with confidence, though, is that those who aren't puzzled by the current environment are not paying close enough attention. Put simply, what makes the present situation so unprecedented is the combination of inflation, recessionary forces, and heightened financial risks due to the massive build-up in credit since the early 2000s. Near-zero interest rates over the past two decades have enabled disconcerting amounts of leverage: as a share of global GDP, private and public debt levels have risen from 200% in 1999 to 350% today, with a notable spike since the start of the pandemic.

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The Fed and other central banks of the world are tasked with combating inflation through a blunt instrument - interest rate hikes - designed to soften aggregate demand and, in theory, price levels. Given that a technical recession may already be upon us (GDP growth was negative in the first quarter and the Atlanta Fed's widely cited GDPnow model forecasts negative growth in the second quarter), the questions around how quickly inflation will recede and how hard the American economy will land are now front and center. It is the Fed's hope that inflationary pressures diminish rapidly from here, and consequently, the tightening of interest rates will not have to be too severe. To the extent inflation remains stubbornly high and the Fed has to be more extreme with its rate increases, the risk of a hard landing grows. In other words, a rapid normalization of monetary policy will increase the likelihood that highly leveraged "zombie" households, companies, financial institutions, and governments are pushed into bankruptcy and default.

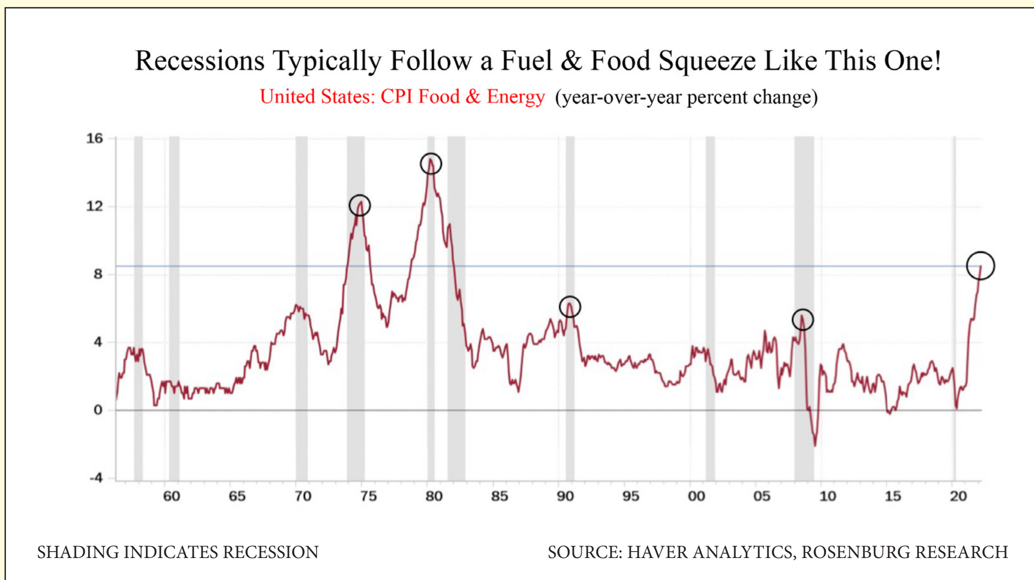
Beginning in the second half of 2021, inflation's initial march higher was driven by energy and other commodities, later reinforced by the surprise Russian invasion of Ukraine. Since then, it has broadened out in nearly all advanced economies. By the spring of this year, 40 percent of the goods counted in the conventional inflation indices were experiencing inflation of more than 5 percent, according to the Bank for International Settlements (BIS). In the US, the largest contributor to inflation has been housing, which also happens to be the main expenditure for American households. Home prices have been curiously resilient to date despite a surge in mortgage rates, and first time homebuyers who have been squeezed out of the market have put upward pressure on rents.

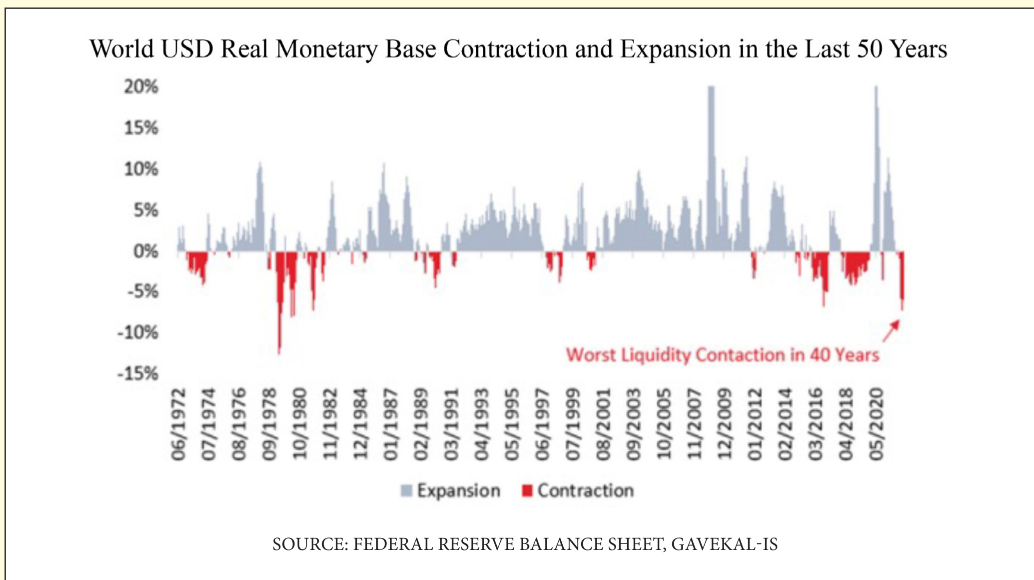
With that in mind, more recent data is indicating that some of these major components of inflation, including housing, are beginning to cool. Mortgage applications to purchase new homes were down 24% last week compared to the same week in 2021. Lumber prices have pulled back over 60% from their peak. On the commodity front, the Bloomberg Commodity Index has fallen to lows not seen since March of this year. WTI crude oil, which hit $119 per barrel in early June, fell below $100/bbl over the 4th of July weekend. Copper, popularly known as the commodity with an economics PhD, has also sold off hard to 17-month lows. The list goes on. If the aim of the Fed's game is to control inflation by bringing about a slowdown, then the evidence we are seeing so far is precisely what we would look for.

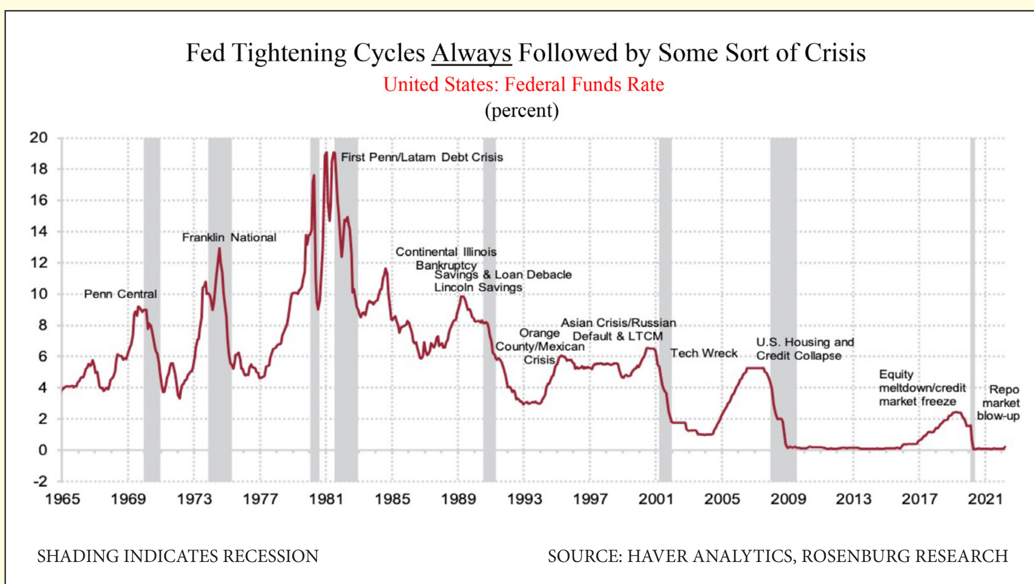
The US bond market has already signaled the growing likelihood of an impending recession. Ten-year Treasury yields peaked near 3.5% and collapsed by seventy basis points before a more recent recovery to around 3.0%. In addition, the commonly cited spread between the 2- and 10-year yields Treasury yields has turned negative. Recent measurements have also revealed that American consumers,

the largest source of demand in the world economy, are in a deeply pessimistic mood. In some respects, this increasingly somber economic outlook has been already reflected in what was the worst first half of the trading year since 1970 for the S&P 500. To some, this environment might be interpreted as an ideal buying opportunity for risk-assets. We're not so sure, and think it's possible that we've only begun to see the full impact that higher rates and slowing growth will have on the more speculative areas of the market.

As previously mentioned, one potential risk is that monetary tightening may produce a wave of bankruptcies amongst stressed debtors, particularly those who borrowed with floating rates, and unleash havoc in the banking system like we saw in 2007-8. Although stricter regulation in the traditional banking business has made the system significantly more resilient now than it was in 2008, the main concern lies with the non-bank financial institutions, otherwise known as the shadow banking system. The collapse of Archegos Capital Management in the spring of 2021, as we discussed in a previous issue of Viewpoints, was emblematic of how reckless behavior by a small number of market participants who are able to skirt regulatory oversight and employ vast amounts of leverage can have widespread and unforeseen repercussions.







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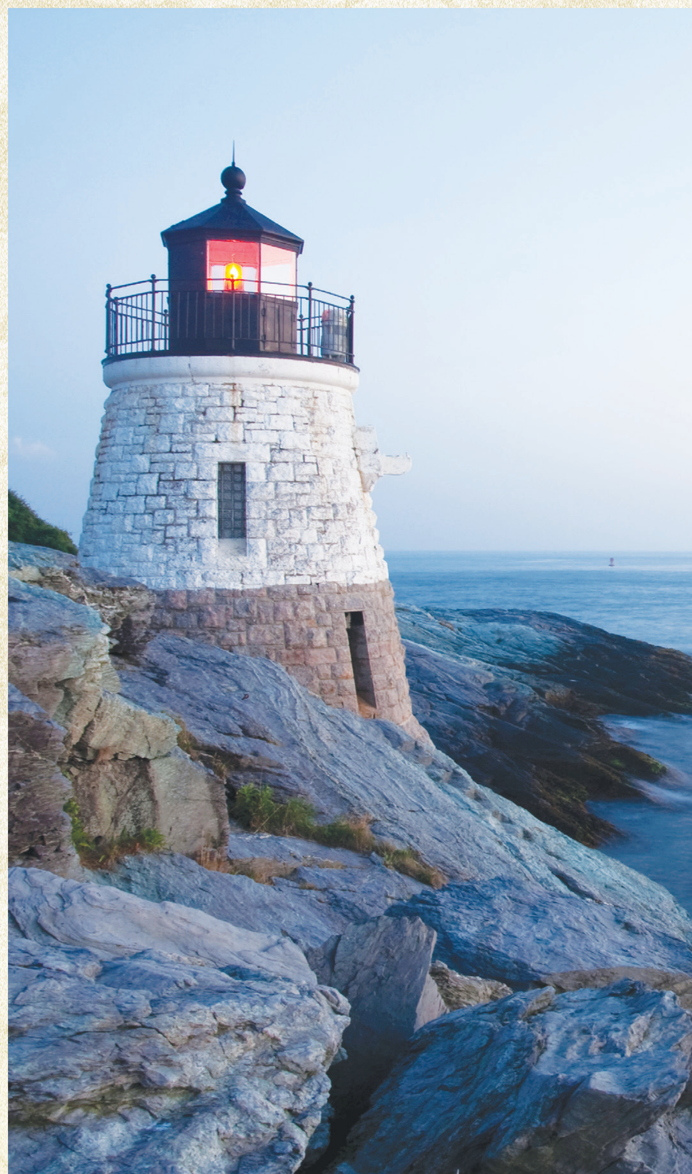
IN CONCLUSION

Our portfolios continue to eschew exposure to those areas which have seen the most selling pressure, including high-yield bonds, leveraged loans, cryptocurrencies, emerging market debt, and consumer discretionary and information technology stocks which were down 32% and 27%, respectively, through the first half of the year. In our experience, the highest-quality companies admit to the challenges their businesses are facing earlier on in a deteriorating macroeconomic cycle, and set expectations accordingly. On the other end of the spectrum, those companies which have been, in the words of Warren Buffett, "swimming naked" under the tide of easy money, are more likely to reveal the true extent of their struggles later on in a downcycle. In our view, much of that fallout has yet to be seen and broad-based earnings expectations continue to reflect a somewhat rosy environment. S&P 500 and Nasdaq 100 forward earnings estimates, for example, are both 20%+ above the post-GFC trend.

In the meantime, as we watch it all unfold, we think that the market will continue to reward the types of companies we favor: those with stable earnings and operations in recession-resistant industries which have fared us so well in what has been an extremely challenging year for most investors. We hope you're all having a wonderful summer.

Peter Hatfield, CFA, CFP®



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