

MARKET MATTERS: 3RD QUARTER 2023

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“The greatest danger in times of turbulence is not the turbulence—it is to act with yesterday’s logic.” – Peter Drucker

TAKEAWAYS

- The Easy Money Era is over.
- Let (less recent) history guide but not dictate.
- Economic risks could become perils in concert.
- The onus is on credit, not equities, to outperform.

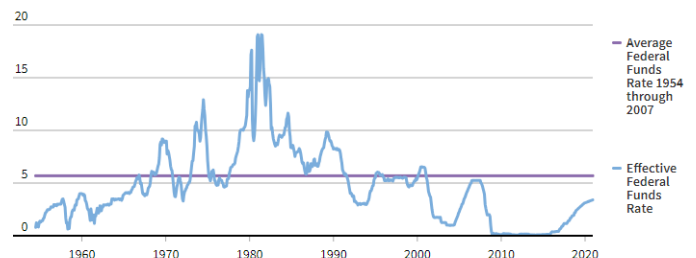


THE END OF AN ERA

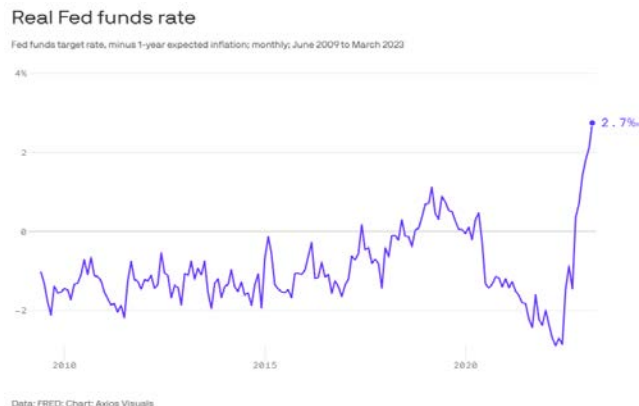
The end of the last economic cycle was punctuated with the exclamation point of a global pandemic. The corresponding market cycle, lasting from after the Great Financial Crisis (GFC) in 2008 to the Covid crash in March of 2020, was the longest expansion in modern market history. With rock bottom interest rates and extensive quantitative easing, money was cheap and available, real yields were nonexistent, and multiples expanded with inflated asset prices while in the real economy, prices were slow to rise. As the economy began to heat up, the Fed gradually raised rates starting in 2016 (2.25% over 3 years) and then began slowly cutting in 2019 as things looked to be cooling. Talk of yield curve inversions and recession abounded, but what actually came next was the swiftest bust and boom in market history, as Covid-19 sent much of the world into lockdown and businesses had to either close, pause, or pivot to entirely new models. Government action infused the economy again with free money, including 0% policy rates from the Fed, generous quantitative easing, direct payments to consumers and “loans” to businesses with no repayment. The stock market rose again to all-time highs in less than a year. Now, with the U.S. economy stabilized, inflation receding, recession risks continually knocking at the door but not intruding, market participants are faced with a newness that feels uneasy. Much attention has been paid, (including in this quarterly letter) to cyclical forces that pull and push the economy through phases of contraction, recovery, acceleration, deceleration, and again contraction. Market participants spend enormous time and energy on the timing of these forces. But then there are trends that overarch the business cycle, sometimes referred to as financial “regimes”. There is consensus now that we are settling into a new trend, or a new financial era. The longest chapter of developed world economies, 14 years of free money and zero real yields, has come to a close. A new chapter has begun.

NEW NORMAL OR RATE RENAISSANCE?

The last time the U.S. saw interest rates above 5% was 2007, but prior to that time interest rates around that level would have been the norm. Prior to the GFC, the U.S. had *never* seen 0% policy rates. The median daily rate from 1982, after a tumultuous period of inflation and recession, until the crisis in 2008 was 5.25%, with total historical averages extending back to the 1950’s also at that level - right around where we find ourselves today.



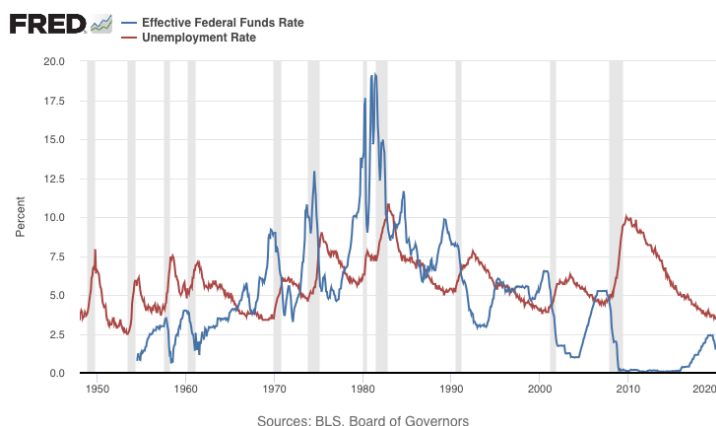
When rates plunged to 0% in 2008 and didn't budge for 7 years, this was the easiest money era the financial markets had ever seen, and it lasted the longest of any previous economic stage. There were 12 years between recessionary troughs and not much movement over the course of the cycle. Easy money was something that investors came to count on during the ZIRP (Zero Interest Rate Policy) period. It also meant that the real interest rate, after taking into account inflation, was negative. This prompted investors to search for return elsewhere, inflating not only cheap debt on balance sheets but also asset prices. Corporate debt, much of it low-grade, expanded 3x from 2010-2019. In contrast to this (see right) real interest rates are now solidly positive for the first time in decades. And the new trend, PIRP (Positive Interest Rate Policy), could stick.



When “higher for longer” gets uttered with increased frequency, we should bear in mind this is relative to the ZIRP era, and this chapter of market history may not be revisited any time soon. The current environment feels starkly new, but the uneasiness that investors are feeling is also a little bit of déjà vu.

YESTERDAY’S CONSEQUENCES, TOMORROW’S LOGIC

Consensus was that the last business cycle, the longest expansion in modern history, was slowing down long before the shock of a pandemic abruptly hit the brakes, but the economy was still growing. Looking at the chart to the right, the unemployment rate traditionally lags a spike in interest rates, with rates going up, then unemployment rising but peaking after rates begin to come down. In 2020, unemployment spiked and rates plummeted in unison, responding to a common systemic shock instead of each other. Government intervention then took the economy from 0-60 mph in mere months. These swings left us guessing where we stand presently all the while trying to figure out what the new financial cycle is going to look like in the future. Coping with these together is an uncomfortable challenge. Higher rates for now, or for good? Correctionary or contractionary asset pricing?



First, it's important that when looking at history as a guide, we temper the importance of the last decade and a half. Things that occurred in the wake of a different crisis and during the ensuing era of cheap money are unlikely to occur in the same manner again. What lies ahead of us may be more “back to the future” than back to “normal” (if normal is recall of the recent), whereby we revisit some of the trends in the decades prior to the GFC, albeit with enhanced market efficiency (and volatility), technology, globalization and informational prowess. Looking at averages when there have been significant changes underpinning the economy can be misleading. Not only are markets always unlikely to behave exactly like the **average** of past behaviors, when a financial regime has changed, the reasons for market behavior have changed, as well. If some market behaviors persist it will likely be for different reasons.

Second, forecasts for future growth or future returns will most likely show high variability, not in the least because expected market volatility is also likely to be high. From 1990 to the end of 2019, including the highest-ever market volatility expectations at the end of 2008, the CBOE VIX volatility index averaged 19.1; since 2020 it has averaged 23.3. Higher for longer doesn't only apply to interest rates, it also applies to the magnitude of market swings that we are likely to experience. Investors will benefit by focusing on what they **can** control – staying invested and looking for opportunities to put any available capital to work based on intermediate-to-long term capital market expectations. A dislocation may provide an opportunity over the long term, but transactions always have a cost, and there are rarely shortcuts to get from a long-term strategic allocation to one's investment goals.



FUTURE FORECASTS

As we mourn the loss of free money and its ascendant impact on financial assets, we need a new framework for the new frontier. Cyclical pressures are increasing: government appropriations, deficit spending and the debt ceiling, oil prices, labor union strikes, and the resumption of student loan payments all threaten to inhibit economic growth and cause a (mild?) recession. If multiple forces compound in unison, the risk of recession in the near term goes from questionable to likely. We hope, of course, that this doesn't materialize, but let's take stock of the risks below (from Bloomberg with emphasis and additions):

* **Auto Strike:** The United Auto Workers union has called a walkout at America's Big Three auto firms, the first time they've all been targeted at the same time...The industry's long supply chains mean stoppages can have an outside impact. In 1998, a 54-day strike of 9,200 workers at GM triggered a 150,000 drop in employment. The UAW is the largest, but not the sole, strike threat. Labor unions reacting to stagnant wages and feeling shortchanged by fewer benefits and technological innovation are mobilizing in other sectors.

* **Student Loans:** Millions of Americans are getting student-loan bills again this month, after the 3 1/2-year pandemic freeze expired. The resumption of payments could shave off 0.2-0.3% from annualized growth in the fourth quarter.

* **Oil Spike:** A surge in crude prices – hitting every household in the pocket book – is one of the handful of truly reliable indicators that a downturn is coming. Oil prices have climbed from their summer lows of <\$70/bbl, pushing above \$90.

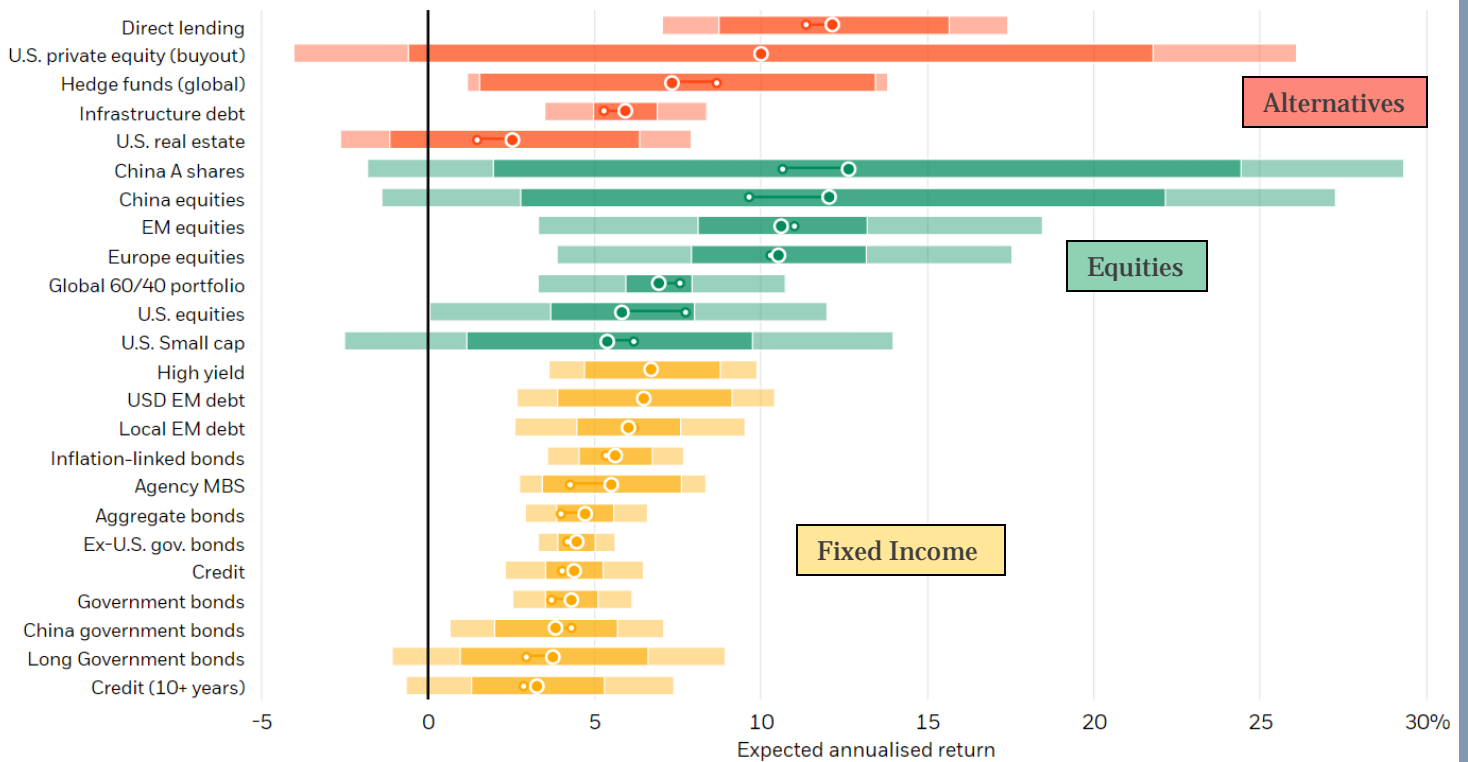
* **Yield Curve:** The yield on 10-year Treasuries moved to a 16-year high of almost 4.8%. Higher-for-longer borrowing costs have tipped equity markets into decline. They could also put the housing recovery at risk and deter corporate investment.

* **Global Slump:** The second-biggest economy, China, is mired in a real-estate crisis. In the euro area, lending is contracting at a faster pace than in the nadir of the sovereign debt crisis – a sign that already-stagnant growth is set to move lower.

* **Government Shutdown:** A 45-day deal to keep the government open has kicked one risk from October into November - a point where it could end up doing more damage to the fourth quarter GDP numbers. Bloomberg Economics estimates that each week of shutdown takes about 0.2 percentage point off annualized GDP growth, with most *but not all* of that recouped once the government re-opens.

We continue to tune in to present day risks while being mindful of new paradigm risk and reward characteristics. Evolved capital market forecasts are now relevant for shaping portfolios.

CAPITAL MARKET ASSUMPTIONS: 5 YEARS (BLACKROCK)



- Central expected return June 2023
- March 2023
- Central return uncertainty
- Interquartile range

Some notable features of these expectations: Bonds are earning a real return, even those that have *no* credit risk premium. Nonetheless, credit risk looks attractive. High Yield, both above and as forecast for the longer term by Northern Trust, is neck-and-neck or outperforming developed equities. U.S. equities look more muted than in recent history, and international equities hold a high inherent level of risk (represented by the wide range of the bar surrounding the category's expected return). Infrastructure is expected to outperform real estate in the real asset class. And, interestingly, direct lending is expected to outperform private equity, with less risk, while private equity itself is expected to start generating a higher illiquidity premium again over the long-term (3.3% premium, Northern Trust). The considerable dispersion of potential returns in PE indicates that investors should be careful to choose skilled, top quartile managers.

In line with these expectations, we favor overweight to credit, direct lending, and private equity, while underweighting real estate and emerging markets. Overall, the emphasis is on credit to fare well on a risk-adjusted basis, a stark departure from the fast and furious stock market rallies and the ever-expanding multiples during the latter stage of the free-money era. Investors who are diligent will be compensated in the intermediate-to-longer term, even if markets are turbulent, asset classes behave differently, and growth is slower in the new market paradigm.

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