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Investment Commentary / Q2 2022

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Elevated levels of inflation combined with a Fed policy error during the early months of 2022 has led to substantial market volatility and a drawdown on global asset prices. Through the end of the second quarter of 2022, most global equity markets were down approximately -20% and “safe” asset classes like high quality, long duration, bonds had traded off -15%. The volatility has been both steady and prolonged. Other than the global energy sector, there have been few places to hide over the past six months. Markets have punished participants and asset prices for the Fed’s lack of action in addressing increasing inflationary pressures. From a market perspective, the 2022 springtime of volatility has transitioned into the 2022 summer of discontent.

The causes of the inflation are numerous and well-documented. The Fed acted early and boldly when the pandemic hit in 2020, but excessive monetary and fiscal stimulus during late 2021 led to an explosion in the Fed’s balance sheet. In March 2020, the Fed’s balance sheet was approximately $3.9 trillion; today it stands closer to $8.8 trillion. The pandemic and subsequent lockdowns crimped personally spending in 2020 and consumers built up their level of savings. Deposits in the U.S. banking system have grown by more than $4 trillion over the past two years. The U.S. money supply grew by more than +40% over two years; a level of growth never seen. And a shortage of labor has resulted in supply chain issues throughout the manufacturing sector. The inflation embedded in the recent Consumer Price Index data notes inflation in every major area of spending, ranging from used car prices to housing to food and energy. Too many dollars chasing too few goods equals inflation.

While the inflationary data certainly warranted higher bond yields, the market’s recognition that the Fed was behind the curve expedited a swift and dramatic move higher in global bond yields. The Fed is now trying to slow the pace of inflation by raising interest rates while simultaneously attempting to shrink their $9 trillion dollar balance sheet. The Fed is trying to execute on all of that while also trying not to push the U.S. economy into recession. That is a very, very difficult trick to pull off. Financial conditions have tightened this year. Mortgage rates are higher, credit spreads are wider, and risk-free interest rates have increased over the artificially low levels seen last summer. The Fed does not have a great track record of playing from behind but that is where they find themselves. The market is now pricing in a series of +75bps rate hikes for the next several Fed meetings. The recent inversion of the yield curve implies an on-going aggressive Fed dedicated to arresting inflationary pressures and destroying economic demand. The Fed does giveth and the Fed does taketh away.

The current inflation backdrop and a tighter Fed monetary policy have several implications for the capital markets. First, the 40-year bull market in bonds is likely officially over. The Fed has now swapped it’s program of quantitative easing for a program of quantitative tightening. Last summer the 10-year U.S. Treasury traded at a yield of just 1.15%; today it yields approximately 3%. The period of artificially low bond yields is over. Second, higher bond yields have ended speculative investing behavior in areas ranging from long duration, high quality bonds to emerging, high-

flying fintech companies to cryptocurrency. Last summer the financial press was fixated on the likes of Robinhood, SPACs and Bitcoin. These very risky, very speculative assets are down a lot in 2022 and unlikely to recover in a world that now competes with higher interest rates. And the probability of recession has gone up a lot. While we continue to believe that any recession will be short and shallow in nature, its impossible to ignore the warning signs. The Fed is raising rates and trying to destroy demand. Financial conditions have tightened a lot. The corporate cost of capital has risen a lot. And while tougher credit conditions haven't yet resulted in a wave of high yield bond defaults, it is almost impossible for that not to ultimately occur. The 2yr US Treasury yield is now greater than the 10yr US Treasury yield. The yield curve is now inverted, and lending will get both tougher and more expensive.

Amid all this volatility and change, opportunity will present itself. It always does. Active investment management performs best in a world of higher rates. When there is a true cost of debt for companies, both unlevered and levered alike, differentiation can exist. That is a very healthy thing for the capital markets. Also healthy for the capital markets is eliminating speculative investment behavior, and higher interest rates do just that. In a world of tightening financial conditions, quality companies and quality sectors will recover their value the quickest. We preach diversification, quality, and patience all the time. In markets such as today's, it's not enough to just preach such. Now is the time to practice such.

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