Oh No, Not Another "New Normal"

ERIK MOSHOLT, CFP®
Chief Investment Officer

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Boom! Pow! Investors were hit with a one-two punch in the first few months of the year as both Stocks and Bonds sold off sharply. With both core asset classes stumbling, risk management opportunities were rare, and diversified portfolios declined in value across the entire risk spectrum.

It's worth starting the conversation with Core Bonds. For years, we warned of the "return-free risk" profile offered by Core Bonds as yields declined lower and lower, and then lower still. The 10-year U.S. Treasury has yielded less than inflation for much of the past two years – highly unusual. With several catalysts starting late last year, Bond prices finally succumbed to reason and the Core Bond index declined 5.9% in the first quarter – its **worst quarter since 1981**. Bonds' decline exceeded that of Stocks, so ironically, conservative stock/bond portfolios declined more than aggressive portfolios.

The S&P500 Index finished the quarter down only 4.6%, but that figure masks volatility that saw the index drop as much as 12.5% for the year in early March before rallying 9% in just the last three weeks of the quarter. Tech stocks were the big losers – The NASDAQ's decline from last summer's highs exceeded 20% and the index finished the quarter down 9.1%. The only major asset class that was up was Commodities, with the S&P GSCI Commodity index skyrocketing 29%. You're likely familiar with the reasons for such miserable performance from core asset classes, the major culprits being:

- The First Fed rate hike since 2018.
- The highest inflation in 40 years.
- Europe's largest military conflict since WWII.

Space doesn't permit an in-depth analysis of the Ukraine conflict, but we probably don't need a lot. In summary, we don't think Vladimir Putin thought this invasion and war would take very long. But Mr. Putin badly miscalculated in two respects: 1) He did not anticipate the Ukrainian's effectiveness in defending their country, and 2) He did not foresee the strongly coordinated Europe and U.S. response, both economically (through sanctions) and militarily (through supplying Ukraine with weapons). But here we are. And regardless of how and when this war ends, Putin's miscalculation will result in largescale changes to the global world order. COVID probably started it, but one result of this conflict is likely yet another "new normal" for some of the world.

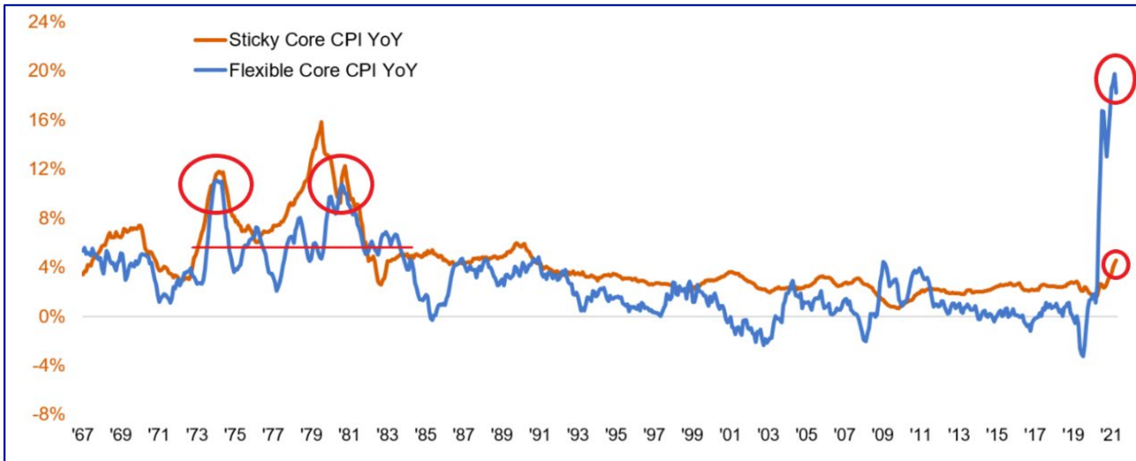
For one, the impact of the war on the rest of the world is clearly inflationary, both for the short-term and the long-term. Ukraine and Russia are two of the world's five largest exporters of wheat. In March, global food prices jumped 12.6% - by far the largest increase ever. Russia is also a major exporter of oil, natural gas, and industrial metals like nickel. At this point, much of the world would prefer to sever all economic ties with Russia, but that's hard to do when you need to eat and heat your house.

> Soviet customer: "I would like two loaves of bread."
>
> Soviet shopkeeper: "Sorry. This is the store that is out of fish. The store that is out of bread is across the street."

Nonetheless, the long-run impact on Russia's economy is likely disastrous. One perspective on the war's outcome…Vladimir Putin wanted to put the old Soviet Union back together. He didn't realize it meant getting back the old Soviet economy too. In other words, "*play stupid games, win stupid prizes*".

Here in the U.S., February's inflation (CPI) number was 7.9%. This is our highest figure in 40 years and **higher than all but seven of the top 32 countries in the world**. It's not pretty - the only countries with inflation currently running higher than ours are Russia, Spain, Brazil, Poland, Argentina, Turkey, and Venezuela. While the COVID and War-induced disruptions to the global supply chain and energy markets affected nearly all countries – why is inflation running hotter here than elsewhere? Blame our politicians and policymakers who threw money around like a drunken sailor the last two years. By some measures, over $5 Trillion. All this money had to go somewhere. To wit, even though there are 1.6 million fewer employed Americans than pre-COVID, retail sales are up over 25%!

While COVID, our own policy responses, and the Ukrainian war have triggered levels of inflation that were unimaginable only a year or two ago, we remain confident that we are not going back to a 1970's type of inflation regime where inflation remains "high" (let's say over 5%) for long. Why? Demographics were very different back then, as our population was growing much more each year than it is now, and the baby boomers were in their 20's and 30's – prime spending years. The U.S. was not an energy powerhouse (like we are today). Globalization was limited and technology was an 8-track cassette. To see how different inflation was then, let's look at this chart which graphs "sticky" inflation in orange and "flexible" inflation (like food and energy) in blue. As you can see, in the 1970's and early 80's, both "sticky" and "flexible" inflation rose over 10% twice and "sticky" inflation stayed over 5% for 10 years. Today, while "flexible" inflation has spiked to 18%, "**sticky" inflation is only up 4.5%.**



Source: LPL Research, Federal Reserve Bank of Atlanta 4/17/22

Also keep in mind that inflation is a rate of change calculation. Once prices go up, if they then plateau at higher prices, while things would still be more expensive, the inflation rate would be zero. If prices come down somewhat after spiking, that would technically be deflationary. One current example – used car prices which shot up by 50% during the first year of the pandemic, have now started declining in price. Consider gas prices – do you think a gallon of gas will be 25% higher than today in 3-5 years? 25% lower seems more likely to us. Overall, we suspect demand for "things" will wane after two years of peak stimulus-induced spending, higher mortgage rates will cool the housing market, supply chains will continue to evolve, energy prices will moderate as more supply comes online, and the simple math of inflation will cause inflation to decline from currently stratospheric levels.

Not surprisingly, the inflation spike and the Fed's recent action has triggered unusual patterns in the bond market, some of which are affecting the outlook for the stock market. Recently, many market watchers have been spooked by fluctuations in Treasury yields that produced what's known as an "inverted yield curve" - a phenomenon whereby some short-term interest rates exceed long-term rates. In Pavlovian fashion, much of the financial media has been quick to proclaim that a recession and bear market are inevitable. **Not true**. An inverted yield curve *could be* a harbinger of a recession and bear market, but recently only parts of the market inverted for a short period of time - the signal is much stronger when the duration and breadth are greater than today. It's also worth remembering that sometimes a recession starts long after a yield curve inverts, and stocks can do very well in the meantime.

2-Year/10-Year US Treasury Yield Curve Inversions and Near Inversions: 1976 - Today

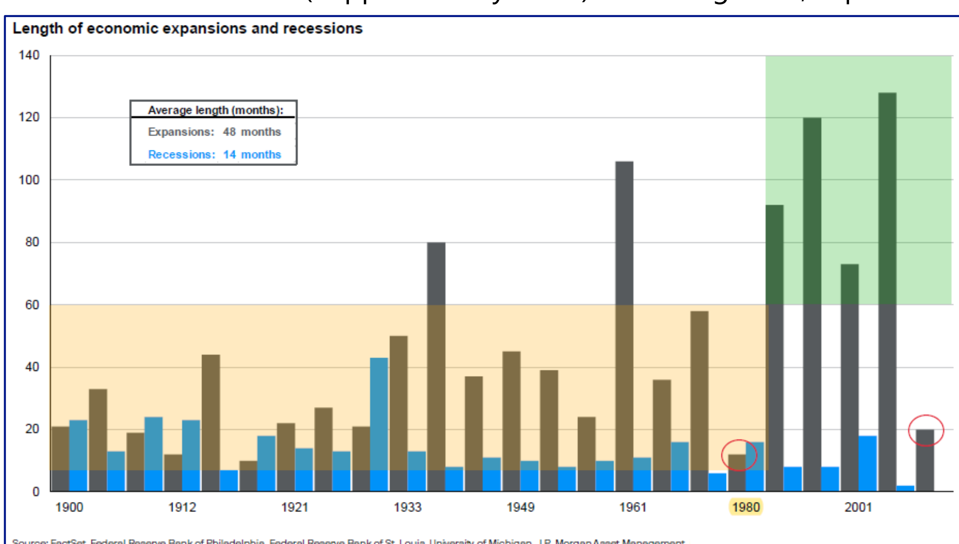
	S&P 500 Performance (%)			
Date	One Month	Three Months	Six Months	One Year
8/17/78	-0.91	-10.14	-6.10	3.06
12/14/88	3.11	7.20	17.62	27.47
12/27/94	1.71	8.81	17.29	32.88
5/26/98	3.58	-0.90	8.49	19.26
2/2/00	-1.94	2.64	2.10	-4.23
12/27/05	2.16	3.59	-1.38	13.55
8/26/19	3.45	9.11	8.27	20.86
3/28/22				
Average (Ex 1994)	**1.57**	**1.92**	**4.83**	**13.33**
Median (Ex 1994)	**2.64**	**3.11**	**5.18**	**16.41**

2s10s yield curve never inverted.
Source(s): St. Louis Fed, Bloomberg, Bespoke Calculations

This table (above) shows the stock market's performance following six previous inversions and one near inversion (1994) since 1976. Stocks were higher a year later 5 of 6 times after the inversion, by an average of 13%. Our multi-factor recession warning models that consider much more than just the yield curve are not flashing red yet. They indicate "only" a 25% chance of recession in 12 months and 50-60% chance in 18-24 months. Let's call that yellowish. Thus, while we are open minded to the increased recession risk that comes with a hostile Fed, significant disruption to supply chains, low consumer confidence, and higher energy prices, we think today's predictions that suggest a recession is a certainty are quite premature.

This is not to say that we're outright bullish. Frankly, **the Stock Market is currently stuck in no man's land** and our most trusted models are acting schizophrenic. For example - One highly respected quantitative research source is indicating a 67% likelihood that we have seen a short-term <u>bottom</u> *and* a 64% likelihood that we have seen a short-term <u>peak</u>. Other models we track are also split between bullish and bearish. In the past, following volatility like we've seen the past few months, I often comforted clients by saying…"*I don't know which direction the next 5-10% move is, but I'm pretty sure of the next 20% move. Up*." Today, we can't say that. We think **either scenario is possible over the next 4-6 months**. To us, the conclusion is obvious. This is not the time to be overly aggressive or defensive.

But what about the new "New Normal"? Yes, things will change. They must. COVID and the War should force a reset of previous globalization trends including less reliance on Russian energy and Chinese manufacturing. The result will be *somewhat* higher inflation than before, as well as a much more united European Union. But over the long term, the secular deflationary forces of poor demographics, large debt burdens, and technology-enabled productivity gains will remain and thus, we don't think COVID and the war will fundamentally change economic trends that have been in place for forty years. A picture may help reinforce the point. The grey bars on this chart show the duration of U.S. economic expansions since 1900. Prior to 1982, it was unusual for expansions to exceed 60 months (happened only twice). Following 1982, expansions



have all been longer than 60 months, with two being about 10 years! Additionally, until this year, Core Inflation **(CPI) had not exceeded 3.0% since the mid-1990's**. Clearly, our economy today, and for the past 25-40 years, is much different than the more cyclical/volatile economies prior to 1982.

We remain humble with our convictions, however. Today, with the numerous cross currents in the world and the global economy dependent on so many unpredictable variables, the one thing we are very confident about is that we're not very confident. Sure, we have a theory about how things will turn out, and it's reflected in our portfolios. But we're not betting the farm on it. Rather, we've made some adjustments to reflect the heightened uncertainty and range of outcomes facing investors.

In December, we allocated to Managed Futures – an "Alternative Investment" with a mechanical, unemotional, algorithm-based strategy that doesn't try to predict the future or pick sides, but rather it monitors dozens of asset classes and seeks to align positioning, either long or short – with the direction of the trend. This strategy has done well this year, and we have reinforced that position with another, albeit different, Managed Futures strategy, increasing our allocation to about 8% in most portfolios. These strategies have historically done well when markets make big moves in either direction, including inflationary regimes. If our expectations for inflation and the economy are wrong and commodities do well while stocks and bonds continue to suffer, these managed futures strategies may help portfolios mitigate the damage.

We have also reduced our Emerging Market exposure. China and Taiwan alone represent over 45% of core Emerging Market benchmarks and to us, China is clearly facing some issues going forward, including continued COVID risks, poor demographics, and the evolution of globalization. Then there's inflation risk – While Americans spend about 21% of their income on Food and Fuel, many emerging market consumers spend 35-40%.

Finally, volatility has presented some portfolio maintenance and management opportunities. Earlier this month, we harvested some tax losses in portfolios. We also have begun the process of trimming some of our illiquid alternative investments (like Private Real Estate and Private Real Assets) that have done well this year and we will use those proceeds to rebalance portfolios and "buy low" on positions that are down.

So, our take on the new New Normal is that it will feel very different for some, and not different at all for many. It will affect Europe, Russia and China the most. Domestically, office workers will work more from home. Businesses will likely no longer worship solely on the altar of efficiency and will show more respect to the importance of resiliency and redundancy. But in the end, we think we're likely to return to a relatively lower growth and lower, albeit somewhat higher than before, inflation environment. **Getting there will be bumpy however and the road will be clouded by uncertainty.** Our portfolios are designed to ease these bumps, navigate the headwinds, and respect the uncertainty as we hold significant exposures to non-Core asset classes and strategies. This is our new New Normal.