PCM
PEAK CAPITAL MANAGEMENT

Flashing Red Indicators

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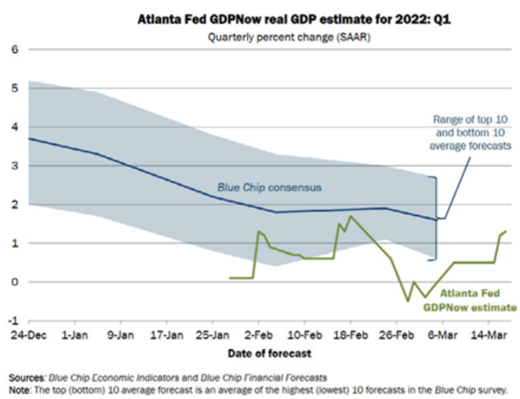
Trouble appears to be brewing at the macroeconomic level while investors appear to be hiding their heads in the sand. Volatility was expected entering 2022 with the Fed signaling they would finally stop quantitative easing and begin hiking rates in response to the highest inflation readings in nearly 50 years. That alone would be plenty for investors to account for. But then Russia decided to invade Ukraine, not only leading to pundits suggesting we are on the brink of WWIII, but causing an energy shock with oil hitting $120/ barrel.

The S&P 500 fell around 12% from the beginning of 2022 until early March but has since rebounded 7% as investors appear to shrug off geopolitical and economic risks. The Atlanta Fed publishes a real-time gauge of where GDP will be for the quarter with their GDPNow survey. The forecast had GDP in negative territory in late February before rebounding to suggest growth of around 1% in 1Q2022. Russia invaded Ukraine on February 24th and countries began announcing economic sanctions on Russia that include agricultural and energy products. The economic impact of those sanctions are just beginning to be seen in the data used by the Atlanta Fed, so I would not be surprised to see the chart turn lower at the end of the quarter.



Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

Source: *Federal Reserve Bank of Atlanta*

One of the most accurate recession indicators over the last 60 years is the ratio of Leading Economic Indicators to Coincident Economic Indicators. As the titles suggest, the LEI is forward looking using what economists expect to happen, while the CEI measures what is taking place in the economy today, such as employment and real wage data that is collected weekly. When the forecasted future economic indicators fall below the coincident indicators it suggests the economy is in the process of slowing, and suggests we could be in the early stages of recession. The LEI/CEI ratio fell in January and again in February and appears to be headed for a drop in March. There are very few instances since 1960 where this ratio fell for three consecutive months without signaling a recession was approaching.

Rising energy prices are also concerning as it relates to consumer spending, which represents nearly 70% of US GDP. The issue of $5 or $6 per gallon gas prices and high home heating oil prices may be as much psychological as economic. Consumer savings is strong right now after record-breaking government stimulus spending, so gas prices would likely have to remain elevated for an extended period before actual economic damage is done. However, consumers often spend based on how they feel or their confidence in the future than their actual economic condition. This is particularly true of non-durable items like cars, appliances, and home improvements that are often financed at increasing interest rates.

The residual inflationary impact on supply chain disruptions from COVID remain while the inflationary impact of sanctions against Russia are just beginning to be felt. The Fed is going to have very little wiggle room to try and manufacture a soft landing with the economy when rates move higher. The market shrugged off the initial 25 basis point hike in rates by the Fed and even took in stride Chairman Powell's insinuation that the hike in May is likely to be 50 basis points. The Fed already knows they will have to overshoot on interest rates to quell inflation, and the yield curve would be inverted today if you factored in another 50 basis points of hikes. What is surprising, in my opinion, is that the markets do not seem to be worried about the impact a recession will have on equity prices. Market valuations came down from near-record setting levels in 2021 but the trailing P/E ratio is still more than 50% above its long-term average of 15.5. Not exactly where you would expect to see stocks priced when the risk of recession is high.

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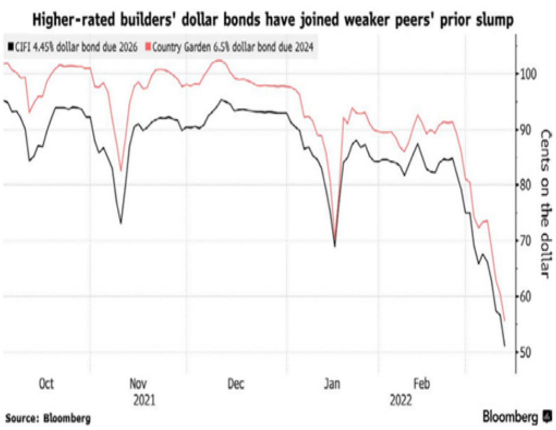
Russia's actions in Ukraine are creating economic challenges outside of the impact of sanctions that most countries have imposed on Russia. Wars often result in battle lines being drawn with different countries taking sides. While that is unlikely in terms of military conflict, there are economic battle lines being drawn, predominantly by China. The Asian economic power is increasingly aligning itself with Russia economically (and with military aid) that could result in even greater supply chain disruption, rising prices, empty shelves, and chaos.

Portfolios tilted towards tactical management, real assets, non-correlated yielding assets, and other hedges will likely outperform market beta in the coming months.

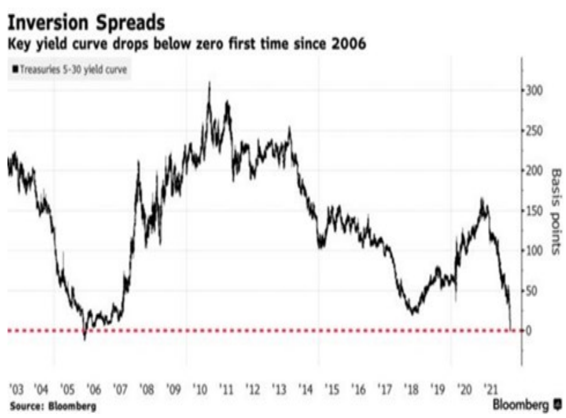
China Construction Implosion



It has only been 3 months since the Evergrande debacle when the largest Chinese developer defaulted on certain obligations with more than $300 billion in debt, including $20 billion in international bonds. Evergrande has stated they intend to finish all construction projects already started in order to pay off remaining debt, but with the market pricing their bonds at $.15 skepticism is rampant. Recently the bonds of two other major developers with investment grade credit have seen their bond prices go from above par to below $.60 over the last quarter. The government has stated they will not bail out over-leveraged builders at a time when the bloated Chinese real estate market was deleveraging, making the bonds unattractive to investors.

- Official China stats suggest residential real estate is still growing at 1.2% annually, but unofficial data, such as massive discounts developers are offering and vacancy rates, suggest otherwise.
- Country Garden bonds (see chart) are trading at a 40% discount to late 2021 levels after the company announced they are experiencing between 14-40% lower prices from January 2021.
- Speculators are trading bonds from developers at a frenzied pitch with yields to maturity often topping 30% on bonds, with maturities in under 3 years potentially showing a gambler mentality in this segment of the fixed income market.

Yield Curve Inversion



What's been a concern voiced by the investment media for some time continues to happen. According to data from Bloomberg, the yield curve for Treasuries continues to invert. Earlier in the month, the yield for 5-year Treasury notes surpassed the corresponding yield for the benchmark 10-year Treasury bond. Now, for the first time since 2006, the yield on the 5-year note has surpassed the yield on the 30-year Treasury bond. Likewise, we are near an inversion on the 2-year Treasury yield and 10-year Treasury yield. While not a perfect indicator, historically an inverted yield curve tends to proceed a recession.

- What is the bond market telling us? Higher rates for shorter and intermediate term Treasuries are not a surprise given the Fed's commitment to fighting inflation. The longer end of the curve remains somewhat anchored (hence the inversion) given the expectation that higher inflation will be somewhat transitory, although likely longer than initially expected.
- There's speculation about how high rates will need to go in the near term, given that current rates across the curve are well below the current rate of inflation. Real yields are negative across all maturities. There will likely be a continued inversion of the yield curve in the near term as the Fed continues to tighten.

Continued Bond Market Headwinds

Source: Investopedia

Bond Investors had a rough 2021. The Bloomberg U.S. Aggregate Bond Index (TR), which measures the performance of the domestic investment-grade bond market, lost 1.54% last year and is off to another dismal start to 2022. At the time of this writing, the index is down 6.89% YTD. A combination of high inflation and expected rate increases by the Federal Reserve has the index on track for one of its worst quarterly performances since 1980, according to Bespoke Investment Group. A rough start to the year does not necessarily mean that we will finish the year negative; however, given current market sentiment and the Fed's willingness to aggressively tamp down inflation, fixed income may be in for another less than stellar year.

- According to Forbes, after historically poor bond market performances to start the year, only 22% of the time were bonds in the red to end the calendar year. This shows the importance of staying invested and not trying to time the market.
- Government bonds are on pace this year to produce their worst returns since 1949, according to a note on Friday from Bank of America, which tracked global bonds weighted by world gross domestic product.
- In a speech to the National Association for Business Economics, Powell said inflation "is much too high," and that the Fed would move "more aggressively by raising the federal-funds rate by more than 25 basis points at a meeting or meetings" if appropriate.

Macro View – Billionaire Tax 2.0

On Monday, President Joe Biden released the $5.8 trillion budget for the fiscal year 2023. One of the components of the budget calls on Congressional members to pass a minimum tax for billionaires. The proposal would impose a minimum tax of 20% on households worth more than $100 million. The tax could generate about $360 billion in revenue over 10 years and is set to reduce federal deficits by $1 trillion, according to the White House. This isn't the first time the Biden administration has floated the idea of a tax on billionaires. Democrats previously tried to pass a similar measure within Biden's "Build Back Better Act," but it eventually died in the Senate. Like before, this proposal is expected to face significant pressure from both sides of the political aisle.

Source: Investopedia

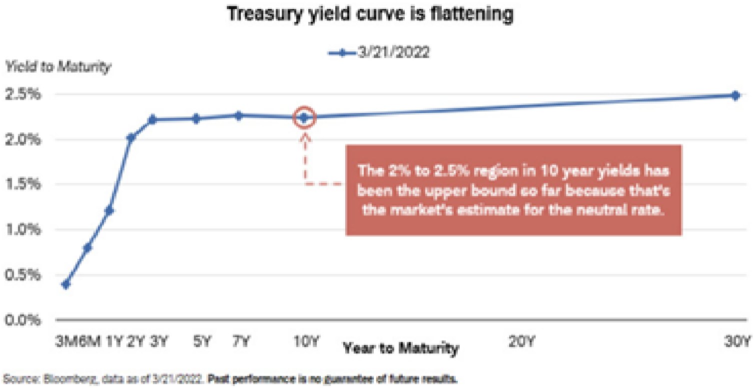
Taking Stock – Tesla Split

On Monday March 28th, Tesla Inc. (TSLA) hinted at another potential stock split. As the news broke, the stock was up 6.8% at about $1,080 in early market trading. In September 2020, Tesla had a 5-for-1 stock split, making the potential split the second in less than two years. Since the first split in September, Tesla has soared more than 118% at the time of this writing. The news came in a regulatory filing with the Securities and Exchange Commission which indicated that Tesla is set to request approval from stockholders during its upcoming annual meeting to increase the number of authorized shares of common stock. Another 5-for-1 split would put shares at around $200. At that price, Tesla's stock could be potentially included in the Dow Jones Industrial Average, but it is merely speculation at this time.

Source: ABC News

Fixed Income - Flat as a Pancake

After just a single ¼ point hike by the Fed in March, the Treasury yield curve is flashing worrisome signs that trouble awaits the economy. An inverted yield, when the yield on a 2-year note is higher than the yield on the 10-year bond, is a reliable signal that a recession is pending. This has been the case virtually every time the yield curve remains inverted for more than a very short period of time. As this is being written, the 2-year is at 2.13% and the 10-year is at 2.34%, only .21% higher. The 10-year is currently trading at a lower yield than the 5-year Treasury. Banks lend based on long-term rates and pay interest based on short-term rates. At a rudimentary level, when banks pay more on deposits than they can charge on loans they stop lending and the economy shrinks.



Source: Kathy Jones

Technical - Falling Knife Trend

Technical analysis pays close attention to correlations between indicators as over longer periods of time they become helpful in forecasting the direction of a chart. Given that the average drop in the broad stock market from peak to trough is approximately 40% during recent recessions (see red arrows), it makes sense for investors to closely track growth in the economy. We highlighted several macroeconomic risks in the Introduction, and the latest ISM data is another troublesome indicator. ISM Manufacturing PMI recently dropped from the upper 50s to mid-40s, a level that suggests contraction in manufacturing. The correlation of these two data series is very high at 65%. More than 90% of the time over the last 25 years, the two data series move in the same direction, suggesting caution.

Are Treasuries Still a Hedge to Equities?

Clint Pekrul, CFA

Combining stocks and bonds to form balanced allocations for growth and income has been the cornerstone of portfolio construction for decades. For the most part, the approach has worked reasonably well. A broad, diversified allocation to equities, such as the S&P 500, combined with a diversified allocation to bonds, such as Treasuries and corporate debt, has generally provided an attractive real rate of return.

What has made the balanced portfolio attractive is that the return correlation between stocks and bonds has historically been low to negative. When equities valuations fell, bond prices tended to rise, and vice versa. The result was a smoother return stream that allowed for the compounding of long-term returns.

Today's environment poses a challenge, however. With elevated inflation and the prospect of materially higher interest rates, the return prospects for a core bond portfolio are diminished. Likewise, equity valuations could come under pressure if earnings don't offset the effects of higher inflation.

Moreover, today, real yields are generally negative given the current rate of inflation. It is little wonder that investors have looked beyond the traditional bond market for income opportunities, such as private real estate or structured credit.

Should investors abandon traditional bonds completely as an asset class? In other words, should investors make a blanket assumption that bonds, in any capacity, no longer serve a purpose in the portfolio construction process?

Our view is that bonds, particularly longer duration Treasuries, can provide a hedge (i.e., a negatively correlated source of return) to extreme equity volatility, despite the current headwinds in the bond market.

From a total return standpoint, or when you consider both income and changes in price, the volatility of long duration Treasuries can potentially be negatively correlated with the volatility of equities at market extremes.

The chart to the right illustrates the total return of the iShares 20+ Year Treasury Exchange Traded Fund (Ticker: TLT) going back to inception in 2002. The long-term price reveals a particular pattern. Historically, the price of TLT has spiked during periods of heightened equity volatility. The chart is illustrated in a logarithmic scale to show percentage changes over time.

Some of the most obvious moves for TLT came during the onset of the global financial crisis of 2008 and, more recently, during the outbreak of COVID in 2020. Likewise, there are spikes throughout the history of TLT that generally correspond in a negative way to declines in the overall equity market.

While it is true that the secular decline in interest rates over the history of TLT has driven the long-term trend higher – a trend that might be coming to an end – it is also true that risk off trades have had a meaningful impact on performance. Risk off trades, by definition, are unpredictable.

For example, consider the onset of COVID, which sent the benchmark 10-year Treasury yield to 0.25% in 2020. Only two years prior, the Fed was on a course to begin raising interest rates. The plunge in yields over this period had nothing to do with monetary policy or an inflation outlook. It represented a flight to perceived safety when the global economy began shutting down.

To assume that a position in long duration Treasures is guaranteed to deliver negative returns, given the inflation and interest rate outlook, is to also assume that we will go an extended period with no exogeneous, unpredictable events that roil the global markets. If history is any guide, these events would likely push Treasury yields lower.

There are, of course, other ways to hedge equity risk in a portfolio. For example, there are timing models that seek to move to cash when equity volatility rises. Successful timing can be difficult, however, particularly in a sideways market.

Investors can also purchase put options on a broad index such as the S&P 500 to provide measured protection to the downside on an existing equity allocation. However, the cost of purchasing this insurance can be costly over the long run.

In our portfolios, we include long dated Treasuries as one of multiple hedges to equity risk. We size our position based on volatility and correlation estimates to equities and make periodic rebalances as market conditions change.

Q: Is the war in Ukraine the end of Globalization?

When analyzed with hindsight, I believe the beginning of the end of globalization occurred with Brexit when the British people decided their sovereignty was more important to them than following the dictates out of Brussels. This was further seen in the election of Trump and his “America First” priority, along with elections across Europe and Asia. More than the war in Ukraine, I think the COVID pandemic was the final nail in the coffin of globalization as we previously knew it.

The loss of globalization is not necessarily a bad thing. At the core of what made America work so well was a level of accountability elected leaders had to their constituents. The rise of globalization meant bureaucrats overseas could set climate policies like how many MPG US cars were required to achieve, with no accountability to the American people. The reality is that countries are different, and a one-size-fits-all approach would never work long-term.

There are drawbacks to lost globalization that will be felt in the global economy. I believe growth will lessen, as providing goods and services will likely become more expensive with ongoing disruptions to global supply chains. Companies maximized profits and consumers benefitted from low-cost goods with outsourcing, but now the focus needs to be on supply chains that are safe and sure rather than cheap and easy. As Atlanta Fed President Bostic stated, “just-in-case inventories will replace just-in-time.”

It’s a timely question given what has happened over the past two years with COVID and now the heightened geopolitical risks surrounding the Ukraine. We’ve heard recent comments from prominent investors like Larry Fink, who oversees Blackrock, that companies and governments are about to reevaluate their dependencies on globalization. These events have greatly disrupted global supply chains that in turn have thrown a wrench into many companies’ operations. From a manufacturing standpoint, companies might be more inclined to shun the cheap labor and resources from outsourcing to sourcing locally with fewer risks. While I don’t think globalization will necessarily come to an end, the perceived risks of outsourcing might begin to outweigh the benefits.

There should be consequences though if we pursue a path of de-globalization. Part of the appeal of outsourcing was the ability to tap cheap labor markets overseas. Sourcing locally means tapping domestic labor markets that command higher wages. These higher costs will be passed on to the end consumer, so expect higher prices (i.e., inflation). For the Federal Reserve, this will likely mean persistently higher interest rates. At any rate, a move away from globalization would be a divergence from a path we have pursued for decades and will likely change consumer behavior in a meaningful way.

Q: Does it still matter what Warren Buffett buys?

While it is not the only data point an investor should consider when managing a portfolio, it seems foolish not to at least watch from a distance what the most successful investor of our generation is doing. It seems like every time the investing public believes it is time to dismiss the Oracle of Omaha, he doesn’t understand technology, internet, blockchain . . . something happens with the economy or markets that makes him look like a genius still.

Large investors like Berkshire Hathaway are required to file Form 13-F with the SEC on a quarterly basis showing what they bought and sold with a 3-month lag. Berkshire’s 13-F is closely followed by investors, small and large alike, and the stocks that show up as buys often get what is referred to as a Buffett bounce. The latest quarterly filing showed some interesting transactions.

The largest purchase was Bank of America, suggesting Buffett and his team were bullish on financials. Rising interest rates are typically good for banks’ earnings so this made sense, however, at the same time he slashed his holdings of Wells Fargo. Turns out it was astute stock picking as BOA outperformed WFC by a wide margin since the trade. Buffett sold drug maker Merck but took an initial position in Royalty Pharma, a company that funds late-stage trials in exchange for a share of the future royalty payments.

It’s hard to ignore the investment decisions of who many consider to be the greatest investor of all time. Warren Buffet’s holding company – Berkshire Hathaway – has had an incredible run over several decades. Interestingly, Buffet tends to add the most value when the overall markets are in the doldrums. Just go back to 2000 or 2008 and compare Berkshire’s performance to the broader S&P 500 Index. His outperformance during these periods is a direct result of his investment discipline. He doesn’t pay high multiples for companies with questionable earnings or long-term prospects. On the one hand, his discipline might mean periods of underperformance, particularly when growth investing is in vogue. But when valuations (e.g., price-to-earnings multiples) revert to the mean, his performance tends to shine.

To be certain, technology has changed the investment landscape over the past several decades. The edge that Buffet had early on was that he knew in detail the fundamentals of certain companies that the general investing public either didn’t have access to or didn’t bother to fully understand. Now that information is available to anybody. So, I think this has taken a bit of the edge away that Buffet had years ago. Plus, it’s more difficult to add alpha given the sheer size of Berkshire Hathaway.

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