PCM
Peak Capital Management

Land of Confusion

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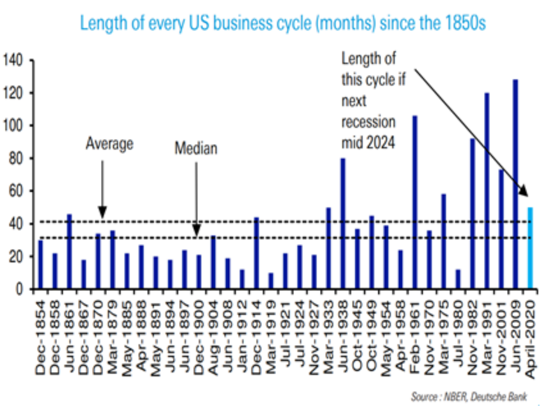
The Fed has boxed themselves into a corner and are now in an entirely untenable place as a result of past policy actions. They had plenty of opportunities to stop QE when the economy roared back after COVID lockdowns, but instead maintained pumping excess liquidity while real interest rates went increasingly negative. Inflation data is now giving them little choice other than to hike rates while at the same time reducing bond purchases. The damage done to the economy will likely feel like self-inflicted wounds when reviewed in hindsight.

Fed policy today reminds me of the great Phil Collins song, Land of Confusion. Look at some of the lyrics from the song:

> *There's too many men, too many people*
> *Making too many problems*
> *And there's not much love to go around*
> *Can't you see this is the land of confusion?*

Recessions are part of the business cycle and a healthy way for the economy to eliminate excesses without experiencing a more catastrophic depression. When the next recession hits, the imbalances created by Fed policy will make recovery far more complicated. Given the prior recession ended in April 2020, we normally would not expect another recession to occur prior to mid -2024. Watching the yield curve over the last month suggests the next recession might come much sooner. If the Fed follows through on their plan to hike short term rates, with some analysts predicting four hikes, we will likely see long duration rates fall on slower economic activity by consumers. A prominent recession indicator over the last many decades is an inverted yield curve, and we could see that happen in 2022.



There is also a lot of confusion about policy surrounding the pandemic. There are countries removing all mask and vaccine mandates while others are increasing restrictions. Some states have eliminated COVID restrictions while others, like New York, are requiring all employees to be vaccinated simply to go to work. It seems clear that the about 30% - 35% of people who are not yet vaccinated are not going to get the jab. A significant number of people who received the initial jab are hesitant to keep taking booster shots as the efficacy of the vaccine against Omicron is uncertain. Nobody knows if and when the next variant will come and how it will impact the economy and ability for people to move about freely.

Lastly, geopolitical risks are creating uncertainty at a very bad time for the Biden Administration, whose approval rating is hovering in the low 40's. Even the mainstream media has turned on the President with NBC's Chuck Todd recently stating that Biden is 'no longer seen as competent or effective.' When the Administration's supporters publicly criticize the President, he appears weak and vulnerable when dealing with foreign policy. The timing of Russian aggression into Ukraine suggests Putin feels emboldened and given his track record, he will press the issue as far as he believes he is able. Geopolitical risks, whether Russia or China, are often the subject of worry but seldom materialize into market moving events. The chance current unrest results in disrupting the markets is elevated, as many investors simply need a reason to sell and sit on the sidelines given the shift in Fed policy.

We are definitely living in a land of confusion with not much love to go around. There are too many people causing too many problems for investors to be comfortable remaining long only in equities as the markets retreat. Volatility spiked in late January with the VIX index topping 30 for only the third time since February 2020 when news of the pandemic first hit. Traditional safe havens like Treasury bonds have done little to provide protection against equity risk as interest rates are slated to move higher. Real estate is softening based on the last four months of the Case Shiller index and interest rates have barely moved off the floor. Gold is traditionally considered a safe haven and inflation hedge and has held up well as stocks have corrected. It takes courage to be a contrarian in times like this, but there is a compelling argument to hold very long duration Treasury bonds -- 20 or 30-year maturities -- right now. If the long end of the curve moves lock step with the short end it would not be a good trade, but if higher short-term rates lead to higher financing costs and consumers reduce spending we will have a recession, and long-term rates should fall back to cycle lows.

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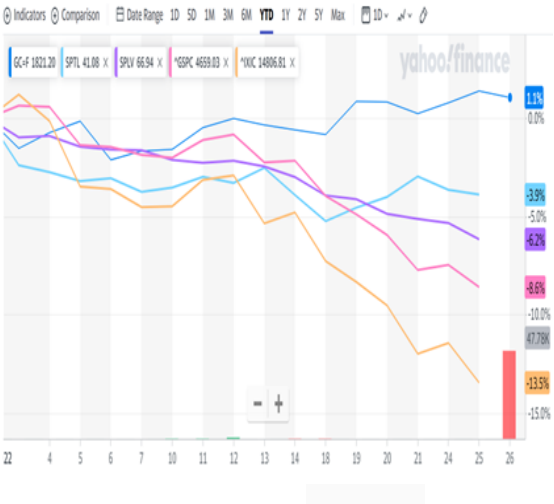
Searching for Safe Haven



It has been a difficult start to 2022 for investors in risk assets with the S&P 500 dropping about 9% and the Nasdaq down over 13% through late January. While every correction is different, there are traditional safe havens that tend to provide shelter during equity market storms. The most common safe haven has been U.S. Treasury bonds, because when equity markets correct there is typically a flight to safety reaction by investors. Long-duration Treasuries have only provided partial shelter from the storm, falling just less than half of the S&P 500 year-to-date. The best performing safe haven has been gold that has traded up over just 1% in 2022. Many investors are expecting the Fed to step in and change the narrative to quell concern over rate hikes.

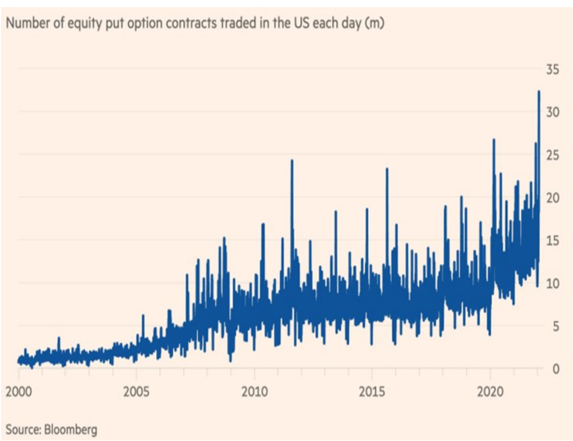
- While gold has held up relatively well during the volatility sell-off in 2022, the precious metal is essentially flat over the last year and remains almost 5% lower than the high achieved in August 2020.
- The performance of long-duration Treasuries during the prior two bear markets suggest they may again be a safe haven against equity volatility as they climbed over 20% in each instance.
- There are occasions where investors rotate out of growth stocks and into value to reduce portfolio risk. This is occurring today as evidenced by "value" stocks dropping about half the broad market.

Meltdown of QQQ

To say that the technology sector is in a selloff would be an understatement. The prospect of rising interest rates and a slowing economy has led investors to flee the once high-flying, and seemingly overvalued, technology sector. The current selloff is reminiscent of the wind down of the dot com bubble nearly twenty years ago. Based on the Invesco NASDAQ 100 ETF (QQQ), the tech heavy index is down approximately -13% from its high achieved last year. Some of the larger names in the index are down over -20% from their all-time highs. The chart to the left illustrates the price return of QQQ over the past year along with the 50-day and 200-day moving averages.

- As the chart indicates, QQQ is now trading below two technical support levels. As interest rates rise, the present value of future cash flows declines. Many of the growth names in QQQ were valued based on long-duration cash flows. Coupled with the prospect of a slowing economy, rising rates and slower growth have been a dual headwind.
- Investors from twenty years ago remember how long it took to recover from the deflated dot com bubble. However, for investors with long time horizons, the current decline could prove to be a buying opportunity.

Options Volatility



Over the last few weeks, major indices have been under significant pressure. The recent volatility comes as investors brace for tighter policy from the Federal Reserve. In order to combat this volatility, traders bought put options, which have the potential to protect investors when prices decline. According to Bloomberg, traders bought 31.3 million equity put options on the 24th of January, just shy of the all-time high of 32.3 million on the 21st. The massive number of options traded, puts as of late, show how the options market has changed over recent months. While options may have contributed to the most recent volatility, they are not the only driver of stocks. However, the increase in retail investor participation and rising hedging by institutions has spurred an increase in activity.

- At the time of this writing, the S&P 500 was down 9.72% from its previous high of 4,818.62. the Nasdaq Composite Index has fallen 16.46% from its previous high of 16,212.23, 11.6% of which came over last two weeks of trading.
- Data from CBOE Global Markets indicated $53.7bn of options traded in the U.S. on Monday compared with the monthly daily average of $25.3bn.
- On January 24th, the CBOE Volatility Index (VIX) hit its highest level of 38.94 since October 30th, 2020.
- Some now speculate the relationship between stocks and options has been upended, with derivatives now driving the equity markets.

Macro View – IMF Lowers Forecast

Last week, the International Monetary Fund (IMF) lowered its economic forecasts for China, the United States, and the global economy. The rationale behind lowering forecasts pertains to uncertainty around the ongoing pandemic, supply chain challenges, inflationary pressures, and Federal Reserve expectations to begin raising interest rates in March. Gita Gopinath, the IMF's number 2 official, noted that "We are certainly living in very turbulent times" and that there is still "tremendous uncertainty" around how much and over what time period the Federal Reserve would raise interest rates, as well as rising geopolitical tensions around the world, most pointedly, between Russia and Ukraine. The IMF also notes that the "most pressing health risk" is the impact of omicron and other future variants, which could potentially pull growth forecasts down further.

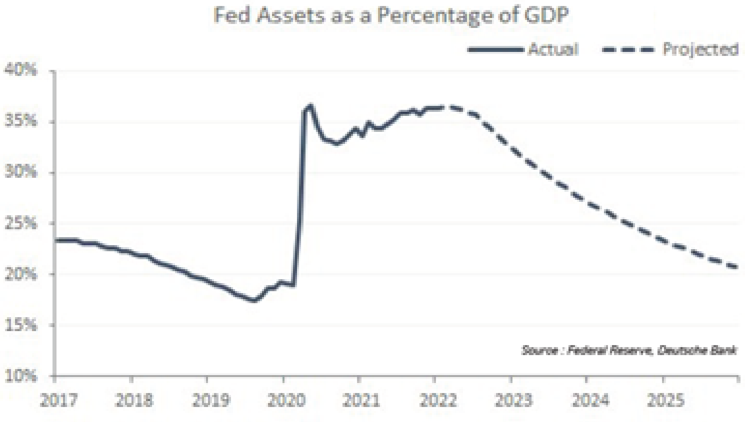
Source: Reuters

Taking Stock – Fall From Grace

Peloton Interactive Inc. (PTON), once a darling of the "stay-at-home" crowd, is now down more than 84% off its 52-week high at the time of this writing. The company's most recent blow came when a CNBC report noted that Peloton intended to halt production for both its regular exercise bike and Tread treadmill in addition to cutting their demand forecast. The report came as the company had already halted manufacturing of the Bike+ model last December. When the news broke, shares of the stock were halted four separate times and traded as low as $23.25 or more than a 27% decline. Peloton, who made its first public debut at $29 in September 2019, finished the trading day on January 27th at just under $24. Peloton, a company who benefited immensely from covid-lockdowns, may never again trade at the levels it once did.

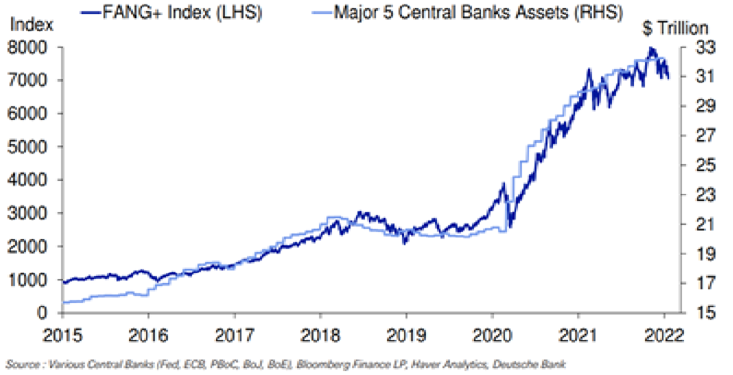
Fixed Income - Buyer of Last Resort

The biggest concern most fixed income investors have given the Feds' pivot to end their bond buying binge, is who becomes the proverbial 'buyer of last resort?' The chart below shows how swollen the Feds' balance sheet has become and their forecast for reducing the balance sheet over the next 5 years to the level it was prior to the pandemic. I am not the first to be skeptical the Fed will ever achieve success reducing their balance sheet as forecasted. First of all, if the Fed steps away from bond purchases entirely, it could create a demand vacuum that if not filled would cause interest rates to move rapidly higher. Not only would this be devastating for the consumption economy, it could require a much larger share of Federal revenue to be used to service future debt issuance.



Technical - Riding the Wave

If anyone wanted to throw shade on the idea that risk assets have benefitted substantially because of Central Bank largesse, they would have to contend with the chart below. The FANG+ index represents the largest capitalized stocks that are predominately technology companies. As the assets held on the five largest Central Banks have grown exponentially, so has the price of these stocks. When Central Banks create excess liquidity, that money finds its way into risk assets such as stocks and real estate, driving the prices often much higher than fundamentals could justify. Most worrisome for growth equity investors is what happens to stock prices if and when the Central Banks eventually begin to reduce their balance sheets. If correlations hold true, and I expect they will, some of the stocks in this index are likely to come crashing back down to much lower prices.



Finding Market Leadership

Clint Pekrul, CFA

As we have mentioned in prior PCM reports, with the current market environment of possible persistently higher inflation and the Federal Reserve almost certainly on the path to higher interest rates, investors have begun to rotate their asset allocations.

Many of the high-flying growth names of the "stay-at-home" economy that thrived in 2020 are now under immense selling pressure. Just a few years ago, inflation was not the headline topic it is today, and chairman Powell was trying to shore up the economy rather than planning interest rate hikes. Treasury yields had hit all-time lows in the wake of COVID as investors flocked to safe-haven assets.

Fast forward to today, and the story is much different. Supply chain issues have pushed inflation to its highest level in four decades. Now the Federal Reserve is backed into a corner. There are indications that economic growth will likely slow in 2022 (although perhaps not contract). For example, the Treasury yield curve is flattening, which indicates that lenders are not well compensated for making longer-term loans. Likewise, the Purchasing Managers' Index (PMI), which tracks overall business sentiment, has been declining. Furthermore, the International Monetary Fund (IMF) has reduced its global growth forecast.

The Federal Reserve, however, cannot ignore inflation, and is not likely to pivot with respect to monetary policy like it did in 2018. The central bank is tasked with maintaining price stability, which means slaying the inflation dragon. Higher rates will reduce the present value of financial assets. A rising rate environment is particularly challenging for companies with little to no pricing power or long-dated cash flows.

So, we are faced with the possibility of rising rates coupled with slower economic growth. Older investors will likely remember the stagflation economy from the late seventies and early eighties. The so-called "Fed put" might not be the backstop it has been since the global financial crisis. Investors should be mindful of how their portfolios are positioned, because it does seem different this time.

Equity Markets

If we do indeed enter a prolonged inflationary environment, companies with pricing power will likely outperform companies that don't. A firm with pricing power can essentially pass higher costs on to consumers and sustain revenue through the business cycle. These companies tend to be more defensive in nature and maintain stable balance sheets.

Another feature of defensive companies is that many of them tend to pay dividends. A dividend is a short-duration cash flow that is typically paid on a quarterly basis. Furthermore, as these companies through higher costs to consumers, can generally increase their dividends over time. A rising cash flow can help offset the loss of purchasing power due to inflation.

Another sector of the equity market that could hedge inflation is real estate or, more specifically, REITs. By law, REITs must pass through their rental income to investors. In an inflationary environment, cash flow from REITs can rise as landlords increase rents.

In contrast, high growth companies that are valued based on the prospect of future cash flows and profitability are more susceptible to inflation risk. Earnings for these companies might not materialize for years (hence they are long in duration). Any meaningful rise in interest rates could put a dent in their present value. Furthermore, many high growth companies lack pricing power.

Fixed Income

Fixed income and inflation are like oil and water – they don't mix well. For strategic portfolios, shortening duration can help. However, if yields are rising across the entire curve, principal losses are likely in the short run. One option for investors looking for an inflation hedge is TIPs, or Treasury inflation protected securities.

The coupon payments from a TIP will adjust with changes in the consumer price index. Essentially, a TIP owner has a variable cash flow pegged to inflation. If held to maturity, the investor will receive their principal back, plus a series of inflation-adjusted cash flows.

High-yield bonds could outperform investment grade bonds in an inflationary environment with rising interest rates, given their higher coupons and shorter duration. If an investor is willing to accept default risk, an allocation to high yield bonds could outperform traditional fixed income.

Commodities

There are several ways to invest in commodities, which historically have provided an inflation hedge. Investors can allocate to the energy sector, for example, and receive indirect exposure to energy related commodities. This approach typically provides dividend cash flow.

Another option is to buy and hold a commodity directly, such as gold. Precious metals, given their limited supply, have historically provided some protection against a loss of purchasing power.

Finally, commodities can be pooled together and actively traded through long and short positions. For investors wanting a strategic, long-term allocation to commodities, a pooled investment is likely the best option.

Q: Are people losing confidence in Bitcoin?

There are likely people who are not ‘true believers’ that have lost confidence in cryptocurrencies when you get 25% pullbacks like Bitcoin and Ethereum are experiencing, but not the majority of crypto holders. In fact, it is my opinion that when Bitcoin corrects it reinforces most crypto investors’ thesis on why they own the alternative currency. Consider the financial news cycle of late -- look at how much influence the Fed exerts over the markets by what they say and what they don’t say. At a time when inflation is the highest in decades, you still have many politicians who are calling for trillions of additional government spending funded by debt. The Senate was within 1 or 2 votes of approving a multi-trillion spending package in an attempt to transform the economy into what critics derided as a socialist nirvana. It is easy to see why people would develop a belief that the dollar and other major currencies will eventually fail and a currency that is not controlled by Central Banks will keep rising in value. It is positive that the development of blockchain technology, smart contracts (and perhaps NFTs) are able to decouple from the cryptocurrencies and become mainstream. The governments of the world will do their best to discredit Bitcoin and others, but it is more likely those efforts only embolden the true believers in crypto and add to their numbers.

I think another way to answer this question is to consider whether bitcoin, or any cryptocurrency for that matter, is truly an asset class. To me an asset class must meet some baseline criteria. It must represent some economic value. For example, stocks are considered an asset class because successful companies generate profits, which in turn accrue to shareholders. Long-term equity owners are generally rewarded with attractive real rates of return (i.e., equity owners tend to beat inflation in the long run). Likewise, a bond, whether issued by a sovereign like the U.S. or a corporation, pays interest to the owner. Higher rates of interest are paid in return for assuming credit risk. A bondholder can achieve a positive real rate of return over extended time horizons.

To me, bitcoin resembles a commodity. It has no inherent value in that it pays no dividend or interest and does not make a profit. It generates no earnings. Its price is simply determined by supply and demand. As such I view bitcoin as any other commodity. To simply buy and hold bitcoin doesn’t seem like a viable long-term investment strategy. If you’re going to invest in cryptocurrency, I think it’s wise to actively trade it either through a pooled investment like a CTA or through a momentum-based strategy using long and short positions. In the long run I think that’s the only way to achieve an attractive rate of return.

Q: How concerned should we be with Russian aggression in Ukraine?

There is a sense that Russia’s latest aggression toward not only Ukraine, but NATO and the West, could escalate beyond what occurred when Russian troops amassed in Ukraine territory in 2014. The U.S. and the West seemed more capable of providing a deterrent and strong response to Russia’s actions in 2014 than today’s leaders do. Russia’s influence largely comes from their energy production and the dependency Europe has on Russian oil and gas. Sadly, policies of the West over the last couple of years have only strengthened Russian influence and made Europe more dependent on Russian energy. Without an alternative to Russian oil and gas, the West will largely be all bark and no bite when it comes to dealing with Russia’s rogue behavior, and Putin understands this.

I do not expect WWIII to come out of the current conflict as some are suggesting could happen. It is more likely that Russia’s intrusion into Ukraine will be resolved politically in a way that increases Russia’s influence and benefits them financially. Putin’s falling popularity at home is likely the motivation to take the actions he is undertaking. The S&P 500 gained 13.69% in 2014 and there was no discernable uptick in volatility during the period Crimea was being resolved. The equity markets certainly have enough headwinds that they are facing without geopolitical upheaval, but I do not expect Russian actions to be major market moving events.

If tensions escalate, the Russian and Ukrainian situation could bring volatility to the equity markets. Investors need only to look back to 2014 when Russia annexed Crimea from the Ukraine. At the time markets experienced a brief selloff but were mostly unaffected. However, if conditions deteriorate into a full-blown military conflict, I would expect a negative reaction in the equity markets, particularly for emerging market economies, but any volatility would likely be short lived. We would likely see a spike in commodity volatility, particularly for natural gas prices (Russia is a major supplier of natural gas to western Europe). As a major energy exporter, Russia would have some leverage with the western powers like the U.S. and the European Union.

From an investment standpoint, Russia is not typically a large component in most emerging market allocation. For example, within the MSCI Emerging Markets Index, which is the industry standard for measuring the performance of emerging markets, the Russian Federation is only a 3% weight. However, investors should be mindful of the contagion effect should Russia invade the Ukraine. The spill over effects would likely disrupt developed markets. Another consideration is what might happen if a conflict in eastern Europe coincides with a disruption at home, such as an acceleration in inflation expectations or a surprise from the Federal Reserve. There could be a perfect storm of volatility, so be prepared.

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