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The Prophet Named Consensus

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A prophet gains notoriety by their ability to accurately forecast future events. The economy and markets are filled with people making forecasts about what the future holds and how to invest accordingly. The sum of the "forecasts" becomes what we commonly refer to as Consensus.

The problem is that consensus is rarely accurate and often drastically wrong. Famed economist John Kenneth Galbraith was quoted as saying, ***"There are two kinds of forecasters: those who don't know, and those who don't know they don't know."*** Taking this as a true statement, it follows that most portfolios are constructed using data that is flawed at best, allocating using forecasts that that are rarely accurate.

You might think that the Fed, of all groups, should be able to forecast near term events with some accuracy given that they actually control many of the items like interest rates and reserve requirements. The Fed is also home to more than 400 PH.D economists whose roles are to guide the decision makers with what is happening in the economy in real time. The reality, however, is that the Fed's forecasting track record is abysmal. The Fed provides forward guidance to supposedly help the markets know what they are planning to do with interest rate policy. Lately, however, the accuracy of their guidance has been so wrong, Chairman Powell is considering discontinuing the guidance.

Current consensus on the economy is that we will experience a recession mid-year 2023 as the Fed continues to hike rates to bring inflation down. It is thought that the recession will be relatively mild because corporate and household balance sheets are relatively strong and not over-extended. If we take as a given that consensus is wrong more than it is right, investors should be considering at least two alternative scenarios: (1) no recession occurs in 2023, and (2) the recession comes and turns out to be steep and lengthy.

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There are a number of diverging data points that suggest to me what occurs in the economy this year will not fit into existing definitions for recessions. There may be more of a rolling recession that occurs on a sector-by-sector basis rather the entire economy contracting at the same time. We are currently experiencing contraction in housing and manufacturing while consumer spending on services continues to grow. In my opinion, housing is likely to remain weak and under pressure until interest rates and mortgage rates begin to fall, and that may coincide with weakness in consumer spending. The net effect of some sectors contracting while others expand could be flat growth rather than an actual contraction.

Consensus for the markets include stocks being broadly lower over the first half of 2023 as equities remain under pressure from Fed rate hikes. It is believed the Fed will finish hiking rates at the end of Q1 and is likely to be cutting rates in the 2nd half of the year leading to a rally in the stock market. Many still believe the stock market will rise 10% on the year.

There is a reason why so few predictions about what the markets will do turn out to be accurate. There are so many known variables that impact how stocks will trade and no way to know which variables will matter at different points in time. There are also the unknowns that cannot be forecasted but always seems to occur, think Ukraine, pandemic, N. Korea, etc. The markets often trade in ways that are counter intuitive. For example, stocks often rise before the economy shows strength and fall before the economy contracts. Some of the strongest return periods of the S&P 500 have been when consumer sentiment is falling, and GDP is weak. Numerous studies have shown that stocks tend to be negatively correlated with economic growth at least in the near term.

What seems clear in the midst of murkiness is allocating a portfolio on the basis of consensus forecasts is a poor strategy. Having a model that is capable of taking in real time market data and making allocation decisions based on actual volatility or risk has a much better track record than relying on the opinion of so-called "experts". Many of the high growth companies that surged from the middle of 2020 through the middle of 2022 have seen their valuations cut in half and are likely near prices that that can be supported. Other sectors, like energy, have held up amazingly well the last 6 months and could be nearing a point of overvaluation. History does teach one reliable truth: just because something worked well in the past does not mean it will continue.

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Receiving a Downgrade

Investment grade bonds have always been a good volatility hedge for portfolios with very low default rates on bonds rated BBB or higher. Demand for IG bonds have been strong because of the higher yields they provide compared to similar duration Treasury bonds. With the yield curve inverted and short duration bonds paying higher yields than long duration bonds, the yield spread for IG bonds has diminished to almost zero. It is forecasted that when the Fed finishes their planned rate hikes in late March, cash will be providing equal yields to IG bonds. If accurate, the demand for bonds will likely wane if you can generate as much yield with cash that has no duration and pricing on IG bonds could face weakness as traders adjust portfolios.

- If the Fed hikes rates .25% at their meeting this week and again in March, cash will yield more than the benchmark for IG bonds for the first time in 35 years.
- Increasing borrowing costs is most worrisome for the high yield markets but rising financing costs for investment grade borrowers will squeeze earnings contract valuations.
- According to Goldman Sachs data, investment grade companies have between $550 and $750 million per year coming due that needs to be refinanced so supply will remain high.

Where Have All the Savings Gone?

The onset of COVID in 2020 ignited a tsunami of government stimulus with the notion that printing money would keep the economy afloat. Suddenly, households who had no savings were flush with disposable income. This chart illustrates the savings rate (i.e., the percentage of wages that remain after paying taxes, food, utilities, etc.) over time since the 1960s. Prior to the onset of COVID in 2020, starting from a previous low in 2008, the savings rate generally increased. The rate spiked (obviously) during the pandemic shutdown with government stimulus. But the sugar high is likely over.

- A low savings rate does not necessarily necessitate a bad economy. Consumption is what drives our economy, but the fact that savings, according to the U.S. Bureau of Economic Analysis and the Federal Reserve, is at nearly an all-time low is concerning, given a projected recession.
- Consumers are stretched – having spent their government inflationary stimulus to the point of delving into credit card debt – and a recession could be costly. Interest rates are no longer zero – there's a meaningful cost to borrowing now. For every dollar that consumers earn, a larger percentage now goes to interest payments on personal debt (e.g., mortgages, car loans, credit cards., etc.).

To pause or to not to pause?

In 2023, the Federal Reserve will gather eight times for its FOMC meetings. The first meeting of the year will take place on Tuesday January 31st and will conclude on Wednesday with Federal Reserve chair Jerome Powell discussing what is expected to be a 25bp increase in the Federal Funds rate. While the modest rate increase is to be expected, all eyes will be on Powell for an indication on whether or not the central bank will press "pause" on its interest rate tightening campaign. Powell has continually maintained that the Federal Reserve will remain data dependent when making monetary policy decisions. And over the last few months the data has shown, while in moderation, that inflation is starting to subside. Many market participants are hoping this will be the final interest rate increase and will look to then lower rates sometime in late 2023 or early 2024.

- According to the CME Group's FedWatch Tool, as of the time of this writing, there is a 98% probability the Federal Reserve will raise the Fed Funds rate by 25bp during the Jan. 31st - Feb 1st FOMC meeting. And to the dismay of some investors, the probability for an additional 25bp increase in the Fed Funds rate the following month is 84%.
- The Federal Reserve raised the Fed Funds rate seven times in 2022 with another rate increase expected this week. If this weeks expected increase is indeed announced, the Federal Reserve will have increased their funds rate from 0%-0.25% to 4.50%-4.75%.

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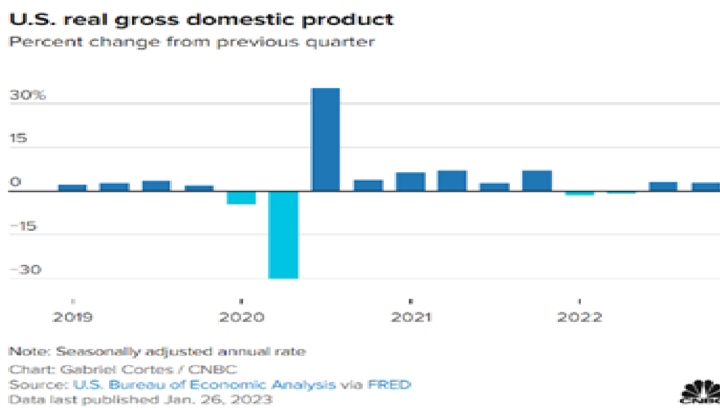
Quinn VandeKoppel

Macro View – Rise in GDP

Last week, the Commerce Department reported that fourth-quarter gross domestic product, which is the sum of all goods and services produced, rose at a 2.9% annualized pace. This was 0.1% above economists' expectations for the quarter. Consumer spending, which makes up for about 68% of GDP, rose 2.1% but was slightly down from the previous quarter. Additionally, while inflation indicators such as personal consumption expenditures increased during the quarter, the readings fell sharply from the previous quarter's number. However, even with the decline in price increases, inflation still remains well above the Federal Reserve's 2% target. The first two quarters of 2022 started off with negative growth, matching a commonly held definition of a recession. However, a resilient consumer and strong labor market helped growth turn positive in the final two quarters and gives investors hope for continued strength into 2023.



Taking Stock – Rise of ChatGPT

Tech companies such as Google (GOOGL), Microsoft (MSFT), Meta (META), and Amazon (AMZN) are some of the most recognizable companies in the world. Unfortunately, in recent months, these companies have laid off more than 50,000 workers, 12,000 of which were laid off by Google just last Friday. So, what could be the reason for these layoffs? These companies provided a variety of reasons, but primarily resulted from the need reduce their costs as economic growth around the world continues to slow. However, with the emergence of ChatGPT, many of these companies like Microsoft and Google are actively investing in AI technology. Google CEO Sundar Pichai even previously described AI as the "most transformational technology of all time". So, did these tech companies truly expand too quickly, or are advancements in AI technology paving the way for machines to replace people?

Fixed Income – Back in Favor?

2022 was a challenging year for all investors. Unless you held commodities in your portfolio, you likely experienced a significant decline. 2022 was especially challenging for fixed income investors as it was the worst year on record for U.S. bonds. Bonds are generally thought to be the non-exciting, relatively safe part of an investment portfolio. Historically, they have been a "shock absorber" to equity risk, helping offset losses when stocks plummet. But the relationship between the two became highly correlated, and in turn, the so called "shock absorber" was nowhere to be found. However, Jeffrey Gundlach, CEO at DoubleLine, recently came out and said that he is recommending a 40/60 stock/bond portfolio compared to the traditional 60/40 portfolio for the time being as he feels bonds are more attractive. With concerns around Fed doing "too much" to combat inflation and an inverted yield curve, bonds could play an important role for investors in 2023.

Technical – Breakout or Fake out?

The S&P 500 index (SPX) finally broke its trendline resistance last week going back to the beginning of 2022 and closed all five trading days above that level. One could view this break as significant as previous market rallies have faced resistance when faced with this trendline. But can this breakout be trusted? Markets on Monday January 30th faced pressure as investors await the much-anticipated FOMC on the 1st. While a 25bp rate increase is expected, all eyes and ears will be on Fed Chair Powell to see if he gives any indication on whether or not the central bank will "pause" future hikes. If the Fed maintains its aggressive stance, the index could pullback but indicators suggest it should be contained around the 3800 to 3850 level. Consequently, if the Fed's stance is more accommodative, we could possibly see a rally continue to around the 4200 to 4325 level before facing more resistance.

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Ensuring a Diversified Portfolio

Clint Pekrul, CFA

A lesson many investors learned in 2022 is that maintaining a diversified asset allocation is not always easy. Simply assuming that historical relationships across asset classes will hold true over time can lead to unintended results. Last year, as the Federal Reserve aggressively raised interest rates, most asset prices were revalued to the downside.

In particular, both stocks and bonds posted negative returns last year. And the losses were not insignificant – the S&P 500 Index lost roughly -19% on a total return basis while the Bloomberg Aggregate Bond Index was lower by approximately -13%. Combining these two indexes in a portfolio, no matter the combination, resulted in double-digit losses.

The standard 60/40 stock-bond portfolio, which historically has delivered attractive risk-adjusted performance, did not hold up well in 2022. In hindsight we began the year with extremely high valuations. The price-to-earnings ratio for the S&P Index was considerably higher than its historical average, while the yield on the benchmark 10-year Treasury hovered around 1.5%.

Then inflation set in after all the stimulus programs from 2020 flowed through the economy. Central banks began to tighten aggressively to curtail inflation. The result was a one-way path downward for most asset prices. To be sure, there were pockets of opportunity, but by-and-large this was only known in hindsight.

Going forward, the 60/40 portfolio might very well deliver compelling risk-adjusted returns once again. After all, bond yields are much higher now than a few years ago. We might achieve positive real interest rates if the Federal Reserve can hit its inflation target. Likewise, much of the speculative excess in equities that were fueled by easy money have been flushed out. Indeed, the price-to-earnings ratio for the S&P 500 Index is much closer to historical averages today than just a year ago.

However, the experience from 2022 reinforced that we simply can't assume that historical patterns will always hold true. There will be inflection points down the road that we won't be able to predict and that will challenge our assumptions regarding optimal asset allocation policy.

Consequently, it might be beneficial to apply some quantitative construct to your asset allocation policy today to prepare yourself for uncertainty tomorrow. If you observe certain tendencies developing in the market that might not follow your long-term assumptions, have a plan in place to make tactical adjustments to your portfolio.

One such observation is to quantify the degree to which volatility, or the variation of historical or anticipated portfolio returns, is reduced through correlation.

Correlation is a statistical measure that describes the degree to which two variables (e.g., the returns of a stock and bond mutual fund) tend to move together over time. Correlation can range from +1, in which two variables move in perfect tandem, to -1, in which two variables move in opposite direction.

The reason the 60/40 portfolio is so widely accepted is that historically, stock and bond returns are negatively correlated. For example, if the expected return volatility for stocks and bonds is 15% and 5%, respectively, and the expected return correlation between the two assets is -0.75, then the expected portfolio volatility is roughly 7%.

But suppose that the return correlation between stocks and bonds rises to 1.0 like we experienced in 2022? The volatility of the same 60/40 portfolio rises from 7% to 11%, or an increase of 157%. The risk profile changes considerably because both stocks and bonds are moving in unison.

So, what can investors do to help ensure that their portfolio remains diversified with a relatively stable risk profile? One option is to hedge returns using a more-or-less negatively correlated investment, such as a short, or inverse, position to broad indexes such as the S&P 500 Index for equities and the Bloomberg Aggregate Bond Index for bonds (i.e., interest rates).

When both stocks and bond returns correlate to the upside (i.e., their return patterns tend to move in tandem), the standard 60/40 portfolio will become more volatile. Investors could manage this increased volatility with a position to cash. That is to say investors could sell a meaningful portion of their investments and allocate to perhaps a money market investment or short-term Treasury bills. Such a move would certainly reduce volatility but would likely involve significant turnover.

Another option, however, is to utilize a hedge that provides volatility in the opposite direction to stocks and bonds. On the one hand, cash, or cash-like investments, will tamper portfolio volatility but requires a meaningful reallocation of assets. Conversely, a short, or inverse position, to a broad asset class can achieve the same diversification but with a much smaller trade. Why? Because short positions are quite volatile but are negatively correlated to the underlying holdings in the portfolio.

There is no uncertainty that a modest short position to a broad stock or bond index will immediately diversify a portfolio when return correlations tend to approach +1. The use of a short hedge can be impactful with a much smaller reallocation versus a trade to cash.

The concept of a portfolio is to combine assets that deliver negatively correlated, long-term positive real returns. Be sure you remain diversified.

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Q: Does the upcoming debt ceiling debate pose a risk for the markets?

I think there is always a risk to the markets when politicians are empowered in a way that can hurt the economy. If there is one thing certain, regardless of political affiliation or which side of the aisle they sit, politicians are likely to place their interests above those of the country. We have experienced 3 government shutdowns over the last decade where the Treasury department had to employ "Extraordinary Measures" to keep from defaulting on its debt and continue to fund Social Security and the Department of Defense. It is estimated by Treasury Secretary Yellin that the government will be able to pay its bills until June even though we are already at our $31 trillion debt limit.

The prior shutdowns did not have a meaningful impact on GDP with the latest in 2019 only reducing growth by 0.02% according to CBO figures. The markets have treated government shutdowns with a bit of a yawn with no meaningful increase in volatility during those periods. The exception would have been in 2011 when the shutdown contributed to a downgrade in U.S. government debt and markets sold off on that news.

It will be interesting to see how the debate over the debt ceiling is resolved this time. There are some debt hawks in the House that have recently been empowered and that will make negotiations more difficult, so it is worth keeping an eye on the debate.

The debt ceiling debate harkens back to 2011. The risk that the U.S. Treasury will default on its obligations is not an issue, based on what the markets are signaling now. We've been here before, but this time the dynamics are much different. When we really grappled with this roughly a decade ago, interest rates, based on the benchmark 10-year Treasury bond, were approximately 3.5%. That is roughly were they are today. But the contrast is that a decade ago, the Federal Reserve was accommodative with dovish policy coming off the credit crisis of 2008. Markets anticipated accommodative lower interest rates which in turn sent asset prices to phenomenal valuations (in hindsight).

Politicians are tinkering with interest rates similar to 2011, but the prospect of higher inflation is a dynamic they did not have to address roughly a decade ago. In 2011, when we had the debt ceiling debate in conjunction with the Euro Crisis, and inflation, as measured by the Personal Consumption Expenditures Index, or PCE, was roughly 1.5%. This reading was well under the Federal Reserve's 2% inflation target. The central bank had wiggle room to address the debt ceiling debate by controlling the money supply. Drawing casual comparisons to 2011 with respect to the debt ceiling debate today could be problematic. Ultimately this is a political chess match, but higher interest rates today combined with a hawkish Fed might lead to significant market volatility.

Q: Will falling inflation bring down energy prices?

Energy prices have been declining somewhat over the last year with natural gas prices about 20% below year ago levels. Oil prices have been hovering around $80/barrel for quite a while and show signs of stabilizing between $70-$80. The drop in oil prices allowed gas prices to fall from very high levels although maintenance at refinery's limited supply causing prices to move higher in the last month. Sadly, for many consumers, I do not think lower inflation is likely to lead to a reduction in their utility bills. Even if prices fall back to the levels of 2 or 3 years ago, utility costs will likely continue to rise, not fall. This is primarily the result of regulation and mandates by many large utilities to switch to renewable energy sources that tend to be less reliable and more costly.

Energy prices are also susceptible to unique market influences that other items such as durable goods are not. For example, California succeeded in using strict water restrictions to force residents to curtail water usage. Water consumption fell by nearly 30% during the drought period but using less water did not necessarily save consumers on their bills. The utility companies saw their revenue falling since fewer gallons of water were being used and had to simply increase the cost of the water still being used. I expect something similar for many as state mandates on energy production will lead to lower usage but at equal or higher costs.

My energy bill to heat my modest home – which is a 1600 square foot abode – is nearly triple the charge from a year ago. Unseasonably colder temperatures have pushed energy demand to higher-than-normal levels. Particularly, natural gas prices have surged based on increasing demand. For many households, budgets are stretched thin just to pay their monthly utility bills.

One of the few places investors could have made money last year was in the energy sector. The S&P 500 Energy Sector Index was higher by approximately 60% in 2022, compared to a loss of roughly -18% for the broad S&P 500 Index. Energy stocks in general pay healthy dividends that increase over time. With the prospect of higher inflation, carefully selected dividend paying stocks, most of which are in the energy sector, can help deliver a real (positive) rate of return. Investors should be wary, however, as energy prices are quite volatile. The question is, will a demand surge against a short supply of energy persist? The political dynamics of the global oil supply are complex, but ultimately, it's a question of supply and demand. I think the question we should ask is how will the supply of energy (i.e., oil) be influenced by politicians?

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Fundamental Technical Discipline

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