PCM
PEAK CAPITAL MANAGEMENT

Data Dependent Investing

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Fed Chairs famously communicate to the markets that their policy decisions are solely based on the data at a given point in time. This premise is often challenged leading to speculation the Fed is a buyer of last resort on distressed assets in support of financial markets (not part of their dual mandate of stable prices and full employment). Who can forget the whispers of the Plunge Protection Team as the Fed was referred to by investors who expect the Fed to act to support falling stock prices. Investors who have placed their trust in the Fed to protect their portfolios against massive losses are likely to be disappointed when the Fed is shown to be toothless in certain market and economic environments. We think investors today should be adopting a data dependent approach to portfolio allocations.

Data is typically reported through 'statistics' which have been shown to be as likely to mislead investors as to lead them in the right direction. The apparent conclusion is that data points simply tell you what happened in the past and are not instructive for making decisions about the future. Still, certain data can be very helpful in identifying where portfolios should be allocated.

Take Consumer Confidence as reported by the Conference Board. This has been a reliable data point for interpreting how consumers feel about the economy, now and in the near future. The importance is obvious, consumers who are confident about the economy, and their jobs, are very likely to spend more freely supporting the overall economy. When confidence in the economy faulters, spending decisions have often been paused and economic slowdown is the result. Digging into the current data suggests a recession is both imminent and unavoidable regardless of what rabbit the Fed may try to pull out of their collective hats.

> **The average drop, peak to trough, of the S&P 500 during a recession has been approximately 40% over the last 70 years.**

The 'wealth effect' has a disproportionate impact on how confident consumers feel about the economy. When home prices are rising along with 401k balances, consumers have tended to be comfortable spending, lifting GDP. The opposite is true as well and we appear to be in the early stages of seeing home and retirement accounts fall after years of appreciation. Virtually every survey conducted by the Conference Board shows a decline in consumers confidence about the future. The sole exceptions appear to be vehicle purchases, more consumers plan to purchase a vehicle than in recent months, and the labor market where employees feel confident in job prospects.

If data suggests the likelihood of a recession, what should investors be doing proactively with their portfolio allocations? It is a more complicated question than many realize. Attempting to time the stock market has generally resulted in subpar results for investors. Markets are complex neural networks that can change rapidly and history has shown that being out of the market when markets rise can be just as costly to long-term performance as being in the market when they decline.

Rather than moving out of the market, our position is that investors should be focused on ensuring appropriate hedges are in place to protect against catastrophic losses. Hedges are typically assets that move in the opposite direction as stocks although it can also mean an asset class that offers far less volatility than stocks. The average drop, peak to trough, of the S&P 500 during a recession has been approximately 40% over the last 70 years. It can take decades to recover from a drop of that magnitude in a retirement portfolio. Hedging is designed to limit the drawdown potential so that recovery is achieved in a shorter time period.

Data dependent investors also look for opportunities in market cycle. We are seeing that many investors are just beginning to position their portfolios for inflation with mixed results as commodities and real estate, typically effective inflation hedges, have underperformed expectations. However, if the Fed succeeds in hiking rates sufficiently to slow the labor markets, the recession that follows will likely have analysts discussing the risks associated with deflation next year.

There is no perfect portfolio allocation strategy that works in every market environment. For data dependent investors, we think consideration should be given to allocating a portion of their portfolio to tactical strategies designed to rapidly change as market trends change. This priority should be to identify asset classes that are negatively correlated to the broad markets in order to maintain a level of diversification. Do not assume that what worked well in prior recessions will necessarily work well this time around, especially with the Fed committed to tightening credit conditions and removing accommodation. Lastly, data dependent investors do not panic when markets are moving against them. Getting whipsawed is part of being an investor and history shows being prudent and patient is far more achievable than trying to be continually right.

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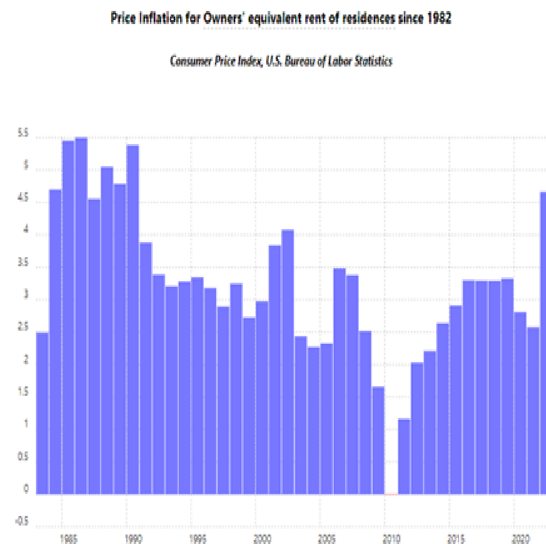
To Xi, or not to Xi

The election of Xi Jinping to lead the Chinese Communist Party for a 3rd term is having a resounding effect on the Chinese and global markets. While no one was surprised the leader was re-elected, the manner in which Xi loyalists have been appointed to key roles has caused many global market participants to question whether too much power is being placed in his hands. Government leaders who were viewed as less than fully supportive of Xi have been quickly replaced with loyalists. The first trading day after Xi's election showed the Hang Seng Enterprises index falling nearly 6% to lows not seen since the 2008/2009 Great Financial Crisis. Observers are noting that Xi's agenda as a generational leader seems to be shifting focus away from being an economic growth engine to transforming China from inside out.

- The Hang Seng Technology index is the Chinese equivalent to the Nasdaq. That index soared during the pandemic but has fallen from 11,000 in early 2021 to below 3,000 today.
- The real estate bubble in China is being rapidly deflated as witnessed by the drop in the Hang Seng Properties index of more than 50% since the start of 2020 with further weakness expected.
- China has dramatically reduced published economic data since Xi was first elected in 2010. The number of economic indicators from the Bureau of Statistics has fallen from 80,000 to 10,000.

Owner's Equivalent Rent



With all the attention given to the Consumer Price Index (CPI) and inflation, it is worth examining one of the major components of its calculation – owner's equivalent rent, or OER. The CPI index tries to capture the change in the price of a basket of goods and services consumed by the average individual. Rent is a significant input into the CPI calculation (roughly 40%). However, rent is not just confined to what a tenant pays to a landlord. It also includes what a homeowner would expect to pay to rent their own property. The Bureau of Labor calculates CPI and surveys homeowners to estimate OER.

- The goods component of CPI (i.e., the price of raw materials) has more-or-less stopped rising and in some areas has come back to pre-pandemic levels. However, the service component remains stubbornly high. This is primarily due to the lag effects of rental estimates in the CPI calculation (6-9 months). OER is a part of the rental estimate.
- Homeowners could be slow to admit that they would pay less to rent their own homes. The lag effects of OER can be significantly sticky. This could be why CPI is not coming down more quickly, given what we have seen in the goods sector. This has implications for the Fed, which uses the CPI to set interest rates.

Big Tech Slump

Technology stocks slumped last week after a series of disappointing earnings reports from the industry heavyweights. Among those who reported earnings last week were Meta Platforms (META), Microsoft (MSFT), Alphabet (GOOGL), and Amazon (AMZN). Microsoft (-7.72%) and Alphabet's (-9.14%) disappointing earnings release on the 26th were major contributors to the NASDAQ's decline of -2.04%. The following days contributed to further declines in the index as Meta and Amazon lost significant market share. As of the time of this writing, the NASDAQ was down more than 31% YTD, compared to just over a 20% decline on the S&P 500. Tech companies have experienced significant volatility this year, and the major players have been no exception. Unfortunately, tech companies will likely continue to struggle with elevated interest rates as companies and investors brace for the likelihood of a possible recession in the near future.

- After the markets closed, Meta Platforms, already down more than 61% YTD, released earnings showing a second straight quarterly revenue decline and forecasted an additional drop in the fourth quarter and shares finished the following trading day down by an additional 22%.
- Apple Inc. (AAPL), one of the few companies that has shown some resiliency in this market, reported earnings beating Wall Street expectations, finishing the following trading day up by almost 8%.

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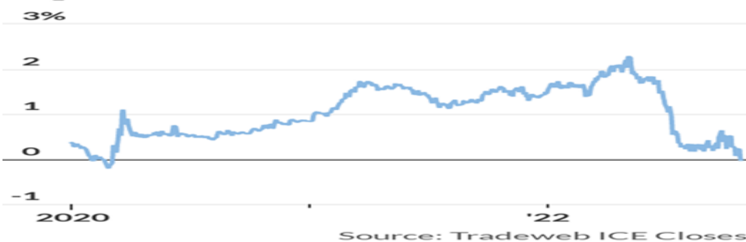
Macro View – Back on Track, For now...

Last week, we received the GDP report for the third quarter. After two consecutive negative quarters of economic growth (-1.6% and -0.6% respectively), and a fierce debate on whether or not the U.S. economy had entered a recession, the economy is now back on track with an annualized growth rate of 2.6%, 0.3% higher than analysts had originally projected. Growth in the third quarter came in large part due to the narrowing trade deficit. Unfortunately, many economists believe this will likely be an isolated event and will not be repeated in the quarters to come. Additionally, GDP gains came from increasing in non-residential fixed investment, government spending, and consumer spending. While the economy showed positive economic growth for the previous quarter, the underlying numbers show that the Federal Reserve's aggressive policy on combatting inflation is taking a toll on the economy. So much so that many economists are projecting a fourth quarter decline in GDP and a recession in 2023.

Fixed Income – Treasury Spread Indicators

Over the last few months since Q2 GDP numbers were released, there has been an ongoing debate on whether we are currently in a recession. While some may disagree on what defines a recession, more and more signs of an impending recession are becoming apparent. One of those signs is the spread between yields on the 3-month U.S. Treasury Bill and the US 10-Year Treasury Note, which turned negative last week. According to Tradeweb ICE, the last time the spread remained negative through the end of a New York trading session was on March 2, 2020, at the onset of the U.S. Covid-19 pandemic. Now is this a telltale sign we are headed for a recession? Not necessarily, as there will likely need to be other parts of the economy that "break", but while history may not always repeat, it often rhymes.

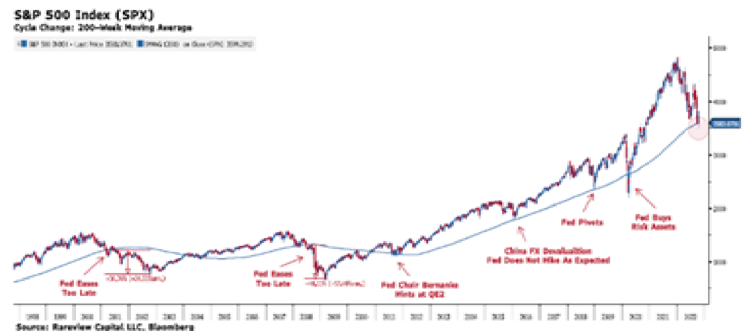


Taking Stock – 4th times a charm?

For baseball fans, October is one of the most exciting times of the year. Now, only the Phillies and Astros are left standing and are set to face off in the world series. However, I heard an interesting fact over the weekend. Over the last 100 years, a Philadelphia based baseball team winning the world series has coincided with a financial crash; 1929 - Philadelphia Athletics, 1980 - Philadelphia Phillies, 2008 - Philadelphia Phillies. Now with Phillies in the world series again this year, and the S&P 500 down more than 20% YTD at the time of this writing, will history repeat itself once again, or will we break the cycle? This is all assuming the Phillies beat the Astros, of course. And while we may not know what the future holds for the financial markets, the series should be entertaining for those who appreciate the sport of baseball.

Technical – The 200-week moving average

Over the last four weeks, the S&P 500 Index has closed below the 200-week moving average twice. The 200-day moving average is close to the number of trading days in a calendar year and has a long history of being used as an indicator for equity technicians. In the chart to the left, Rareview Capital notes various times throughout the last 20+ years that the S&P 500 Index approached the moving average and when the Federal Reserve consequently provided support or was too late. In periods, 2011, 2016, 2018, and 2020, the Fed stepped in and provided support to markets. And as a result, responded positively to the upside. In contrast, the Fed was late to provide support in 2001 and 2008, periods now commonly referred to as the Dot Com Recession, and Global Financial Crisis. As we hover around the moving average indicator, many investors are hopeful the Fed will take a similar stance as before by providing support to markets, but also fear the Fed will do nothing, standing by as a deep recession takes hold.



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Fixed Income Review

Clint Pekrul, CFA

For anyone invested in bonds, it is no surprise that 2022 has been a particularly challenging year. A hawkish Federal Reserve has repriced bonds lower which in turn has resulted in one of the worst years on record for the asset class.

Currently, the benchmark 10-year Treasury yield stands at approximately 4%. Consider that just two years ago, when the full effects of COVID were not fully understood, the 10-year Treasury yield stood at roughly 0.8%. In retrospect, we bonds were vastly overvalued at such low yields.

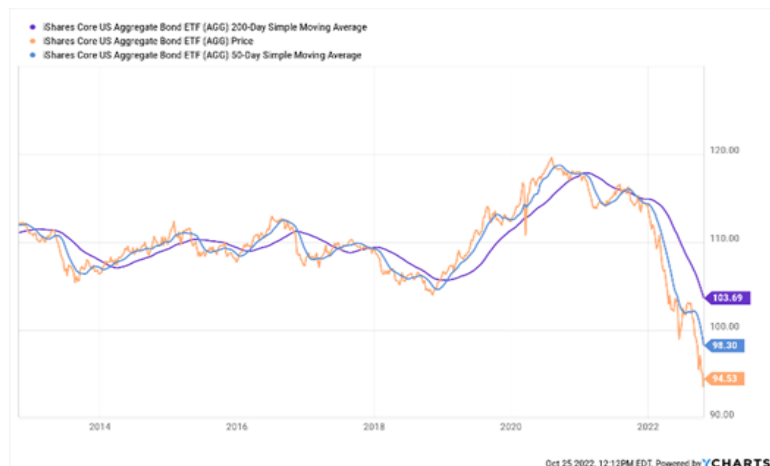
At the time, inflation was just appearing on the radar. However, our central bank assured us that inflation was simply transitory due to the supply chain bottlenecks from the COVID shutdown. As a result, the long end of the Treasury curve (i.e., maturities of 10 years or more) remained fairly anchored. Investors anticipated only a temporary spike in CPI. In the long run, the assumption went, prices would normalize more closely to the Federal Reserve's 2% target.

Fast forward to today, and the picture looks much different. Inflation, while coming down from its peak earlier in the year, seems persistently high and far from simply transitory. The narrative seems to be that the Federal Reserve kept interest rates too low for too long and is now catching up with aggressive monetary tightening (i.e., their forecast was wrong).

This action has subsequently led to a quite severe markdown in asset valuations. For the year, the Bloomberg Aggregate Bond Index is lower by roughly -16%, or about on pace with the major stock indexes. For the average investor, this wasn't supposed to happen. Bonds were supposed to help diversify equity risk and perform well when stocks valuations declined.

However, investors who want to throw bonds out as an asset class entirely might want to think twice as the worst of the selloff could be behind us. At times like this it is helpful to take a long-term perspective about potential forward bond returns.

Technical Perspective



The previous chart illustrates the simple price return of the iShares Bloomberg Aggregate Bond ETF (AGG) along with its 50- and 200-day moving average. From a purely technical standpoint, we could argue that the investment grade bond market is oversold as AGG's current price sits below both its long- and short-term moving averages.

If the inflation picture improves, the Federal Reserve is likely to pause or at least step down its rate increases. If this is the case, the volatility we've experienced in the bond market over the past year will likely subside (i.e., prices will stabilize). The current yield on AGG is roughly 4.2%. If we trade in a fairly narrow range over the intermediate term, data suggest it will take investors roughly four years to recoup their 2022 losses through coupon payments. This assumes that your coupon yield and total return will be similar.

Obviously, if volatility remains elevated the range of outcomes is more uncertain. While we don't know how high interest rates will go, we do know that rates have much further to fall when the next crisis comes around.

Recall how Treasuries responded to the onset of COVID two years ago? Today we are much further away from the lower zero bound in yields. Should we experience a so-called Black Swan event that forces the Federal Reserve to pivot with respect to monetary policy, yields could fall just as quickly as they have risen. Total returns for the bond market could be significant under such a scenario.

Today we are seeing the prices for goods come down from their pandemic highs, which is encouraging with respect to the Consumer Price Index calculation. Likewise, Fed Chair Jerome Powell has hinted that future rate increases might be tempered compared to previous expectations. This is likely why we have seen markets rally somewhat in October.

For investors with new capital to allocate, the risk/reward ratio in bonds is much more attractive now than just a few years ago. Having lifted off from zero, yields on short to intermediate term fixed income provide a competitive yield relative to other asset classes. This could compel investors to de-risk some of their portfolio away from equities, for example.

For decades fixed income investors have relied on the fact that bonds have appreciated in value amid a secular decline in interest rates (i.e., the price component of the total return calculation). We hit the zero bound across the yield curve in 2020 and now we are going in the opposite direction. Falling rates are no longer a tail wind.

From a portfolio standpoint, consider a strategy that tactically allocates to fixed income based on volatility (i.e., manage your duration or overall allocation to the asset class). This approach could help you scale your bond exposure under various scenarios.

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Q: Do the Fed's rate increases today risk deflation in the years to come?

Let's start with something widely accepted to be economic fact rather than opinion: recessions are always deflationary, full stop. Historically, there is not an instance where rising unemployment and negative growth resulted in broadly higher prices in the economy. To the extent that the Fed, as a result of being so far behind the curve they were on a different planet, will continue to hike rates until the economy rolls into recession, yes, I think the risk will shift to deflation in the not too distant future.

The Powell-led Fed seems to have determined the negative impact of persistent and high inflation outweighs the consequences of recession so rates should move higher until demand is destroyed. It may seem strange to focus on potential deflation when prices remain stubbornly high but a study of economic history teaches us that recessions are common and relatively easy to recover from while deflationary depressions can take decades to heal the economic damage.

I want to be clear about another economic fact. Inflation today is the result of a combination of poor Fed policy making and equally poor monetary policy. The stimulus packages passed by Congress has contributed significantly to today's inflation problem. The unintended consequences of congressional largesse has been dramatically higher labor costs that now require much higher interest rates to contain. Demand has shown signs of weakening but labor markets are remaining stubbornly tight forcing the Fed's hand.

Deflation is probably the furthest thing on investors' minds today. The narrative today is that the Federal Reserve must do everything it can to quelch demand to prevent runaway inflation. Through the FOMC they curtail the supply of money (i.e., credit) and remove liquidity (i.e., quantitative tightening, or QT). If you look at the CPI numbers, however, there is an alternative narrative emerging. In its reliance on the CPI to set monetary policy, the Fed is using a backwards-looking indicator. For example, the goods component of CPI, which generally reflects commodity prices, is coming well off its highs earlier in the year. This part of the CPI calculation is cooling off considerably and is measured in real time. Conversely, the services component of CPI, particularly the rent calculation, has an embedded lag of several months.

The concern is that the Fed will make monetary decisions on lagging data, go too far too fast with their rate increases, and kill aggregate demand in the longer term. The pendulum will swing from inflation to deflation. In a deflationary environment, risk taking behavior is not rewarded. Why make a long-term investment when aggregate demand is shrinking? Perhaps we should let market forces determine interest rates, rather than central bankers.

Q: Why haven't gold and bitcoin hedged inflation?

Individuals have owned gold as a store of value and alternative to fiat currencies for thousands of years because it cannot be printed and has limited supply. That means when governmental policy leads to a loss of purchasing power through inflation, demand and the price of gold rises. There is no data suggesting gold is an inflation hedge. The actual correlation with gold is the U.S. dollar. When the dollar is weak, gold tends to shine and vice-versa.

Economies struggling with high inflation typically see their currency fall against other currencies (or alternatives like gold). In the current case, the greenback has risen dramatically over the last couple of years and is up nearly 15% YTD making the need to hedge with gold unnecessary. You could argue the dollar is technically overbought and could see weakness over the next 12 months suggesting gold's negative performance could reverse. The yellow metal is down about 10% YTD, about half the drop in the equity markets.

I would not put Bitcoin in the same category as gold as a hedge of any type. Bitcoin remains narrowly held and is still more for speculation than defensive hedging. Precious metals are a store of value because there is demand for commercial and industrial purposes. Bitcoin is predominately attractive to millennials and still considered a speculative asset class. If demand for Bitcoin were to disappear, there is no 'replacement cost' for Bitcoin so it could theoretically fall to zero, unlike gold, silver or diamonds.

Any real return manager will tell you that gold is an essential asset for fighting inflation. Its scarcity and demand during inflationary periods suggest gold will retain its value and deliver a positive real rate of return. On a relative basis, gold has indeed outperformed most asset classes in 2022. However, on an absolute basis, gold is lower for the year. Its price decline is likely a source of considerable frustration for investors who just assumed the precious metal would rise on demand, considering that inflation is running hot. There have been two headwinds, however, that have kept gold from behaving as expected. Given that gold, as a commodity, earns nothing and pays no interest, it has considerable opportunity costs when interest rates are rising. Given that we lifted off from zero interest rates to 3% to 4% yields on US Treasuries, investors seem to have largely overlooked gold in favor of higher coupons on fixed income. Likewise, a stronger dollar has been a headwind for gold. As the dollar strengthens, investors can purchase less gold which weakens demand.

As for bitcoin, the narrative that it's an inflation hedge seems flawed. Perhaps this is because it is a nascent concept to many investors. Its utility isn't well understood. To think that such a speculative "asset" could provide a stable return in an inflationary environment seems naive. The fundamental problem with bitcoin is that there is no generally accepted model to determine its fair value.

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