Four Thoughts for the Remainder of 2023

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Over the last several years, the capital markets have experienced significant bouts of volatility. The global pandemic, surging inflation, the Russian invasion of Ukraine, a mid-term U.S. election and large-scale interest rate hikes by the Federal Reserve (Fed) are just a few of the issues that have given investors pause. However, the good news is that there are several takeaways or lessons that can be gleaned from the numerous headwinds.

Fighting the Fed is a bad idea. Really.

"Don't fight the Fed" is an adage that dates back roughly a half-century. And while its use among the investment class is perhaps not as commonplace as it once was, the saying still rings true. The monetary policymaking body raised rates at eight consecutive meetings, four of which were 75 basis point hikes (June, July, September and November), representing the largest increment since 1994. These moves put a serious damper on investment sentiment and returns.

Though some market practitioners have called on the Fed to halt or minimize future rate hikes to minimize damage to the broader economy, it remains laser focused on battling non-transitory inflation and hopefully bringing the labor market back into balance. Long story short, though we are likely in the later innings of the rate hike cycle (as there are signs that the economy is indeed slowing), headwinds will remain for risk assets until the Fed concludes its tightening cycle.

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The unknowns should concern us.

While we are confident that the capital markets will ultimately recover from current headwinds (e.g., inflation and growth), there are also several conflicts that should remain on our collective radar screens as they do have the ability to adversely impact markets. The first, as previously mentioned, is the Russian invasion of Ukraine. This conflict has spillover effects on Europe and beyond as this region produces a significant amount of wheat (and other foodstuffs) as well as oil. There is also a concern that other parties may join the conflict or that Russia could use nuclear weapons, which would have unprecedented geopolitical ramifications.

The relationship between the U.S. and China also deserves a mention. The two nations have had a tenuous relationship for the past couple of years, and the recent concerns about "spy balloons" have only added tinder to an already simmering fire. This is on top of a potential conflict involving the sovereignty of Taiwan. China has been adamant about the reunification of the island with the mainland. In an invasion scenario, computer chip scarcity would be of enormous concern, as would the conflict's impact on surrounding waterways which host a significant amount of maritime travel. While conflict may be avoided, the issue will likely remain of concern for the foreseeable future.

Thinking about the home front in the United States, the debt ceiling debate has flared up once again, but this time around, the political parties are arguably more fractured than in the past. Note that in 2011, when the debt ceiling argument raged, and the last time the U.S. dealt with this issue, Standard and Poor's downgraded our nation's credit rating from AAA to AA+, citing dysfunctional policymaking in Washington. With the current speaker of the house being forced to make multiple concessions after a historic 15 votes to obtain the chair position, this does not embolden confidence in an efficient decision-making process and may mean that the debate may linger for a prolonged time at the expense of the capital markets.

We'd be remiss if we didn't also mention Silicon Valley Bank (SVB) and its potential impact. On March 10, the California-based bank failed, and the Federal Deposit Insurance Corporation (FDIC) was named the receiver. SVB had approximately $175 billion in deposits and $209 billion in total assets and was the sixteenth largest bank in the U.S. by assets. It was the first bank failure since 2020 and the second-largest bank failure in U.S. history.

Naturally, the concern now is whether the SVB failure triggers broader system-wide risks in the financial system. While other banks also carry unrealized losses on their securities portfolios, for most banks, and certainly for the larger national banks which are deemed systematically important, their more diversified funding sources and client base make them much less susceptible to a liquidity crisis. While we view the U.S. banking system to be in better health than it was during the Great Financial Crisis (GFC), there is a likelihood that volatility within the sector could become even more elevated. In short, the issue is worthy of continued monitoring.

Finally, another issue that has re-emerged but which seems to receive little in the way of press, revolves around the lingering effects of Brexit. Brexit has been conveniently ignored due to COVID-19 dominating the headlines, but it is now top of mind since COVID-19 impacts on their society have diminished. While the impact on Core Europe is minimal, it seems that the UK is starting to see the difficulties of needing to increase spending for necessary public services in the face of higher rates and inflation.

Valuation mustn't be overlooked.

While many investors seemingly focused on the growth versus value trade last year, this has perhaps caused them to overlook some important nuances. Remember that last year was a "Black Swan" type year, with 2022 being the first time in almost 150 years that U.S. stocks and long-term bonds fell more than 10% in the same year. During Black Swan events, correlations of securities move closer to one. Areas that got hit hard last year entered 2022 with significantly higher valuations than previous years. Areas such as U.S. Information Technology, factor-based investing and real estate investment trusts (REITs) all fell into that bucket.

Since the initial COVID-19 disruption, Price Multiple expansion has been the main driver of returns. Despite the recent upswing in equities in early 2022, it is somewhat baffling because companies are increasingly focused on earnings and cash flow now that cheap leverage is no longer available. However, investors haven't quite made that pivot. Private markets strategies, more specifically Private Equity, have acknowledged that valuations have made it harder to find more bargains which is exacerbated by the "dry powder" in the space which is the amount of allocated capital to the space that has yet to be utilized.

With higher interest rates anticipated in the near term, any investment dependent on leverage to engineer growth could experience headwinds. Over the past couple of years, companies have chosen to either buy back stock or expand their dividend policy. Business investment has also been slowing over the past two years, but it seems that more companies are pushing back and focusing internal cash flow on projects with longer-term payoffs, which will be needed to help combat the labor shortage we are currently experiencing.

The viewpoint of risk should always be challenged.

Risk should be thought of in a relative context, but unfortunately, it is often framed in an absolute context. By investors failing to acknowledge the differences between history and current scenarios, areas that were a boom last year and have better prospects going forward were written off. For example, areas that are typically avoided by investors during periods of extreme volatility, including Energy and domestic high-yield securities, actually did quite well in 2022.

Outside the U.S., the financial sector, which had been a laggard, performed exceptionally well, while both the Mexican Peso and Brazil Real currencies fared well against a strong U.S. dollar. While the point around discounted valuation does creep into the conversation, these areas had changes that were not fully acknowledged nor appreciated by the public. Finally, Treasuries, which are typically thought of as a safe haven, did not perform as well and have had their own headwinds due largely to liquidity constraints and the changing dynamics of the regular market participants.

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Risk also should be looked at beyond the typical correlation and more around the factors that either influence the return of an asset or strategy. When economic growth is a concern stocks struggle, but bonds struggle when inflation is a concern. Over the past 20 years, U.S. stocks and bonds have had a negative correlation, but from what we saw last year when both inflation and growth concerns are coupled with a hawkish Fed, stocks and bonds can move together.

Put another way, even if we think we know the "playbook" based on past markets, consistently thinking about the difference within the drivers makes common sense and can point us in the right direction.

Finally, we would argue that the connection between the ability to bear investment risk has been divorced from the financial health of an organization. Years such as 2022 should remind all of us that we must constantly be aware of how the two are connected and continuously consider how changes both positively or negatively impact an organization. This is an area that boards spend too little time on, but hopefully will start to incorporate more in their ongoing conversations.

Bottom Line.

Though we have endured some very turbulent times in the market over the last several years, the above takeaways can provide investors of all types some solace and be a source of strength and knowledge in difficult and volatile times. Finally, in our view, awareness of macroeconomic and market developments are crucial, but the lens through which risk should be viewed is beyond the numerical number used to define total risk.

To learn more or discuss in greater detail, please contact us:

Floyd Simpson, CFA, CAIA, CFP
Director
simpsonf@pfmam.com