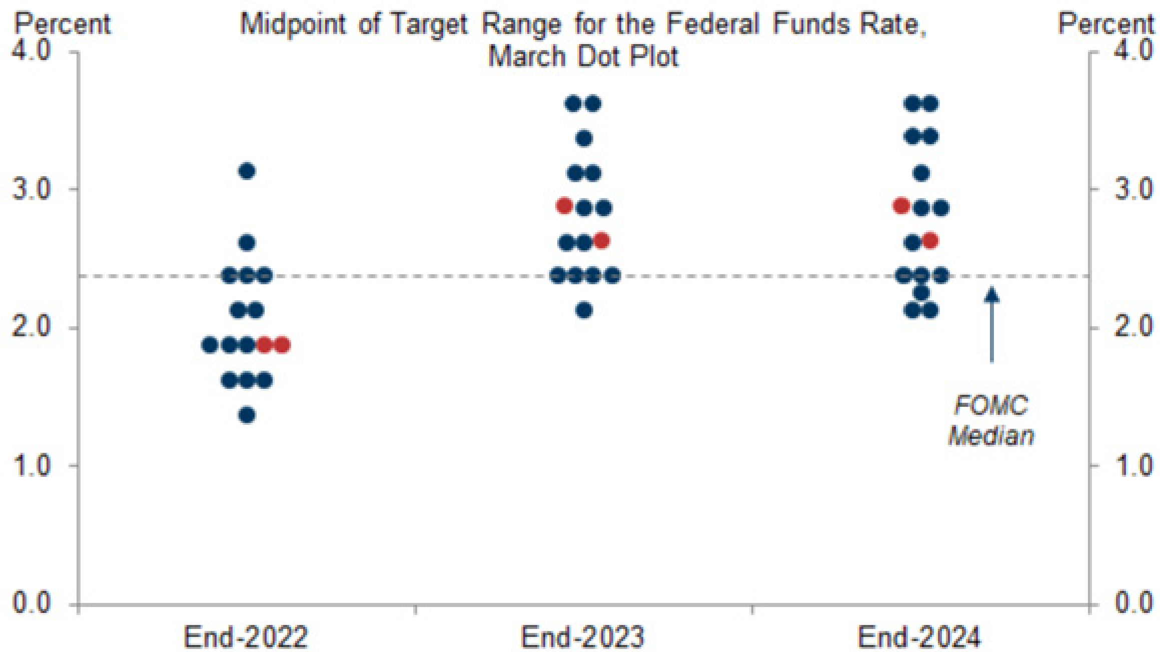
Week in Review

Friday, March 18th, 2022

1. Federal Reserve Raises Rates

The FOMC raised the target range for the fund's rate off of the lower bound for the first time since the pandemic began and delivered a somewhat hawkish message in terms of future policy at its meeting this past Wednesday. The median dot, representing the outlook for the Federal Funds rate by each of the Federal Open Market Committee (FOMC) members, rose more than expected to show seven hikes total in 2022, three and a half more in 2023, and a terminal rate of 2.75%. Notably, the terminal rate is above the median neutral rate estimate of 2.375%. The neutral rate represents a level above which policy is deemed to be restrictive and below which is deemed to be accommodative for the economy.

Federal Open Market Committee's Federal Funds Rate Expectations



Source: Federal Reserve, Goldman Sachs Global Investment Research

Chair Powell reinforced the hawkish tone of the policy release by acknowledging the seriousness of the inflation situation in his press conference and by emphasizing the strength of the economy and the labor market, as supportive of embarking on a more restrictive policy. However, given the high level of inflation, 7 projected 25 basis point rate rises through 2022 is not necessarily overly hawkish given real interest rates (long term treasury rates less inflation) remain negative.

For the equity markets, rate increases remove the tailwind enjoyed during the pandemic period of loose monetary policy but are not necessarily an insurmountable headwind if companies can continue to grow, particularly as valuation multiples have pulled in closer to long term norms. The bond markets will likely see ongoing headwinds, although yields on shorter term duration fixed income will become more attractive for new money. Real assets such as real estate should be in a better position to offset inflation and higher rates than other fixed-income investments.

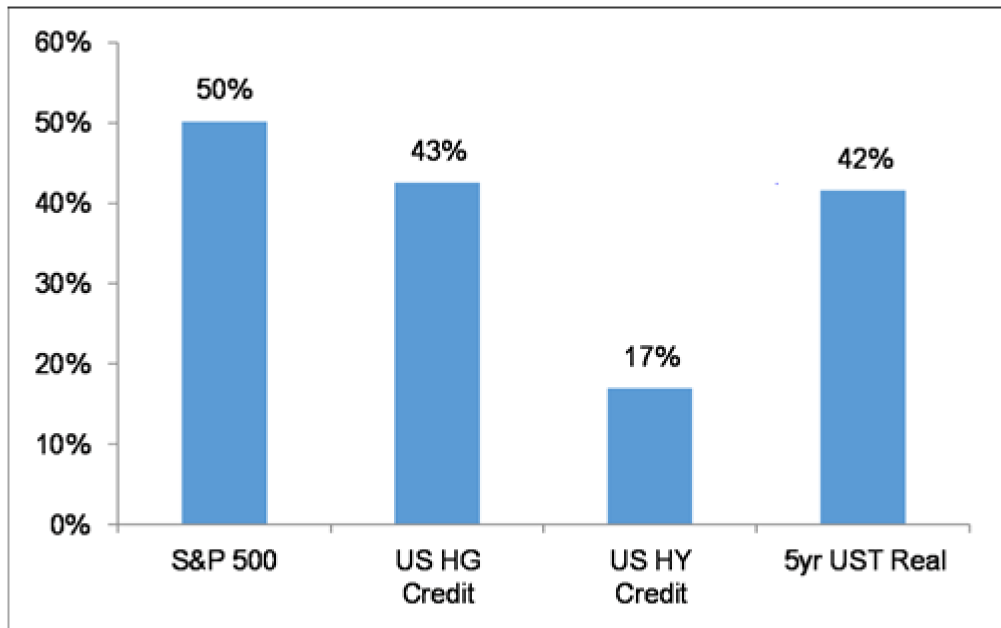
2. Market Indicators are Reflective of Cautious Sentiment

Elevated inflation and the Ukraine War have depressed expectations for economic growth and financial markets. Illustrating this decline, the yield curve, discussed in last week's Week in Review, has further flattened post the Federal Reserve's announced lift off this week. The 2-year to 10-year Treasury yield gap fell to 19 basis points this week from 30 last week, while the 5-year to 10-year yield inverted on the Federal Reserve's announcement.

Yield Spread Between 5-Year and 10-Year Treasury

As we discussed last week, a negative yield curve is viewed as being a precursor to an economic recession and the narrowing of the spreads is reflecting a heightened probability of recession. This probability is currently priced across U.S. equity, credit, and rate markets according to a recent JP Morgan analysis.

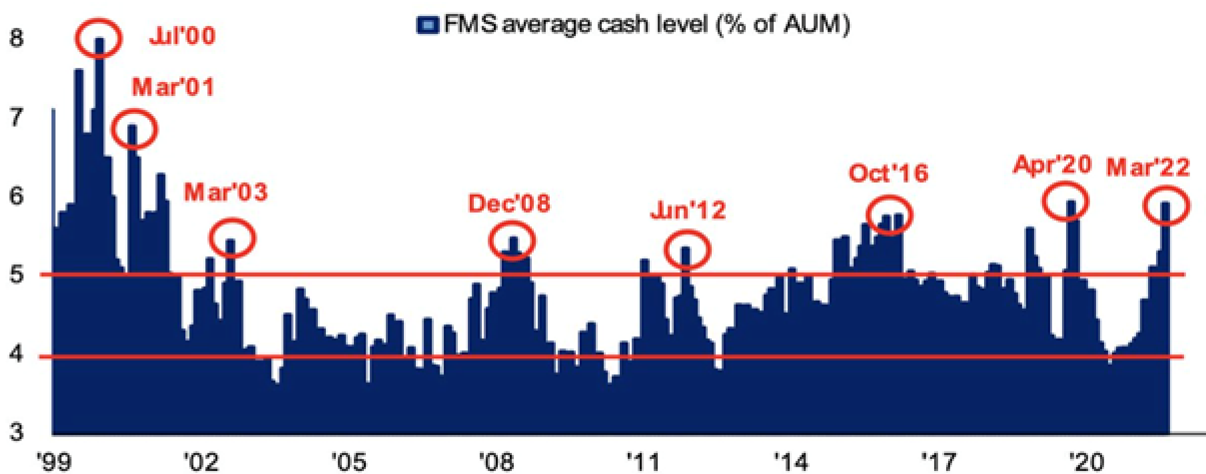
Risk of Recession Reflected in Financial Assets



Source: J.P. Morgan

Another indicator of sentiment, cash levels held by fund managers, are also at elevated levels consistent with historical periods of economic and markets concern.

Fund Manager Cash Levels



Negative sentiment and defensive positioning are understandable as it points to little optimism on growth and concerns over inflation risk. However, negative sentiment is also consistent with historical periods when to reduce the risk of poor returns in the medium term, investors may have to accept more risk in the near term.

From the dates of elevated cash noted in the above chart, equity market returns were notably higher 12 months later except for the "dot.com" derived market bubble in 2000-2001. Even following the dot.com bubble, most quality companies which had not traded at speculative levels performed well over time based on fundamentals.

Perhaps this time the market conditions are different. Notable aspects of the current environment are an expectation of slowing growth (albeit still above long-term trend due to the on-going recovery from the pandemic) and rising interest rates to combat elevated inflation. Equities may continue to face headwinds from growth, margins, and multiple contraction in the current environment, but they have a good chance of beating inflation over the long run, especially after a multiple contraction lowering valuation levels over the past few months. Beyond equities, fixed income will likely see on-going pressure with alternatives such as private real estate providing a potentially better offset to periods of equity volatility.

3. U.S. Leading Economic Indicators Recover in February

On Friday, the Conference Board released its latest measure of Leading Economic Indicators (LEI) from February data. The data showed a 0.3 percent increase in February following a 0.5 percent decrease in January and a 0.8 percent increase in December.

The LEI includes 10 factors:

- Average weekly hours, manufacturing
- Average weekly initial claims for unemployment insurance
- Manufacturers' new orders, consumer goods and materials
- ISM® Index of New Orders
- Manufacturers' new orders, nondefense capital goods excluding aircraft orders
- Building permits, new private housing units
- Stock prices, 500 common stocks
- Leading Credit Index™
- Interest rate spread, 10-year Treasury bonds less federal funds
- Average consumer expectations for business conditions

The overall strength of these factors and trends is seen as a positive indicator for the U.S. economy. However, the Conference Board noted that the latest results do not reflect the full impact of the Russian invasion of Ukraine which could result in slower than anticipated growth in the first half of the year. Given these risks, the Conference Board revised its growth projection for the U.S. economy to 3.0% year-over-year GDP growth. While acknowledging the risks, the trends remain favorable and supports a positive view on the economy which should support financial markets.

Thinking Ahead

The financial markets reflect a complex dynamic of factors such as rising rates in the face of inflation, cautious investor sentiment catalyzed by the Ukrainian War, and on-going growth in U.S. GDP as recovery continues from the pandemic and supply chain constraints. History would suggest that markets tend to react to such complexity by caution in the short term that is inconsistent with medium- and longer-term returns. Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.

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