Market Commentary

September 30, 2022

ADVANCED ASSET MANAGEMENT ADVISORS

Searching For The Proper Metaphor...

"Throw in the towel" seems most apt, yet it trivializes the significance. "Throw in the towel" means to quit or give up. It originated from boxing. The trainer/manager literally throws in the towel as a signal that their fighter has given up. In the case of the Bank of England, the phrase is even more poignant because they threw in the towel before the bout even started.

Central banks around the world spent 12 years repressing interest rates and pushing liquidity into the financial system with asset purchases. They have now embarked on concerted inflation-fighting expeditions with two tools—raising short term interest rates and reducing their balance sheets... or, at least they have announced intentions to reduce their bond holdings.

On September 28, The Bank of England, which is hardly the largest central bank, but important nonetheless, essentially said: "Nevermind. We will be buying bonds again because the market is too disorderly". Apparently, they are intending to rescue $1.4 Trillion of pension funds that owned leveraged positions in long Gilts.

Investors often implement riskier portfolios and employ leverage to bolster returns during long periods of repressed interest rates. Large pension plans in the U.K. are no exception and are now fighting to maintain collateral in support of their leveraged positions.

The Bank of England may be a clue for the rest of the world. Can central banks truly implement quantitative tightening (selling bonds) without "unacceptable" levels of disorder in the bond market? We suspect there are other large pockets of leverage around the world that will be exposed should central banks continue raising rates. As we said in June: "...if the Fed continues to raise rates and commences a meaningful balance sheet shrink, they will break something before inflation comes down to their 2% target".

Essentially, central banks are in a box. Backing away from the inflation fight to support markets suggests that inflation may remain moderately elevated (in the 3% - 4% range) over the foreseeable future.

Bringing this home to the United States, the Federal Reserve owns $2.7 Trillion of mortgage-backed securities, which it purchased to hold down mortgage rates. They have not reduced their holdings during the last six months tightening scheme, yet mortgage rates have increased from 4.5% to 6.5%. What would happen to the housing market if the Fed systematically sold their mortgage bond holdings? Clearly, it would not have a positive impact.

> ***...if the Fed continues to raise rates and commences a meaningful balance sheet shrink, they will break something before inflation comes down to their 2% target.***

The last numbers published by the IMF in 2020 indicate that global debt was 256% of GDP. The last two years of debt-funded fiscal stimulus has certainly raised the ratio significantly. It is a safe bet there are more "leveraged U.K. pension funds" lurking out there. Redeploying our metaphor; the global monetary tightening project is like trying to land a Boeing 767 on an aircraft carrier. There are bound to be issues.

Interest Rates

If we are correct with the leveraged fragility of the markets and our inflation expectations are reasonable, the yield curve will flatten. Short rates will moderate as central bankers acquiesce and longer-term rates will gradually rise as "higher for longer inflation" becomes baked in. If we are correct, it makes sense to maintain our short-term, high-quality bond portfolios and look to extend maturities as the curve flattens.

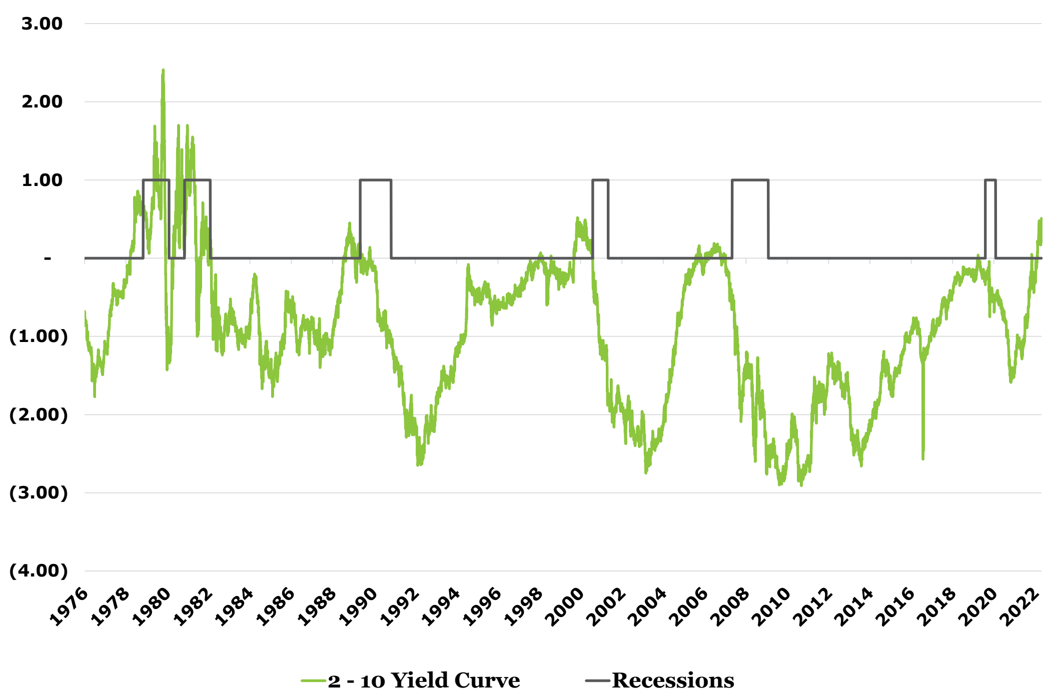
The Yield Curve

By most measures, the U.S. Treasury yield curve is now inverted. When any selected short-term rate is higher than a selected long-term rate, the curve is "inverted". Most indicative in our work is the 2 year versus the 10 year, which is currently inverted by 0.51%.

The yield curve typically inverts during periods of central bank tightening as policy rates are increased to fight inflation while longer term rates remain anchored by expectations for longer run inflation and economic growth. Today is no exception, as the Federal Reserve policy rate has increased by 3.0% since March.

Yield curve inversions have historically been a reliable indicator of economic recession. As indicated in the following chart, the 2-10 inversion usually occurs 8-20 months before the recession arrives (officially). Today, we are just 3 months into the recent inversion. However, the economy is in a slow growth mode, if not already declining over the last 9 months.

Yield Curve: 2 Year Minus 10 Year



An inverted yield curve, per se, does not necessarily guarantee a recession. It does, however, indicate the trend of central bank policy relative to longer term expectations.

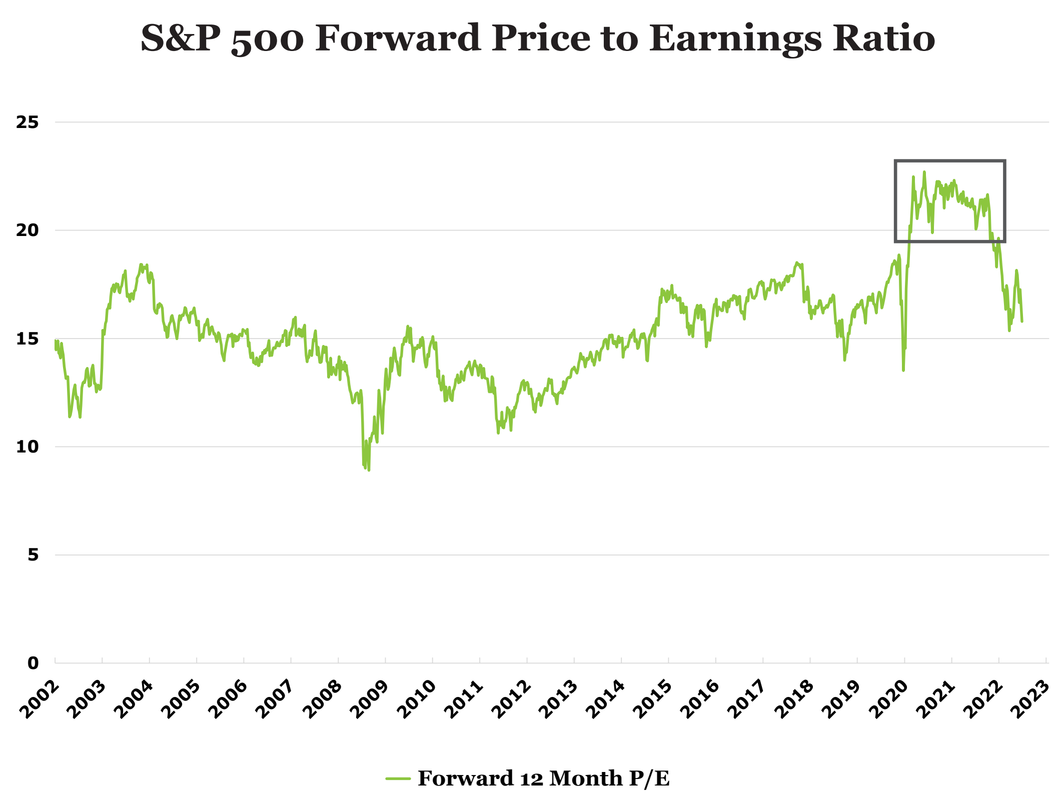
When the trend is persistently moving towards less accommodation (monetary policy tightening), it is a headwind for growth. Higher interest rates will eventually affect economic activity and financial markets. Capital spending, hiring plans – essentially any business expansion – becomes more costly to finance and less likely to occur on the margin. As rates increase, investors may be more attracted towards safe, short-term investments than stocks and other risk assets.

The Stock Market

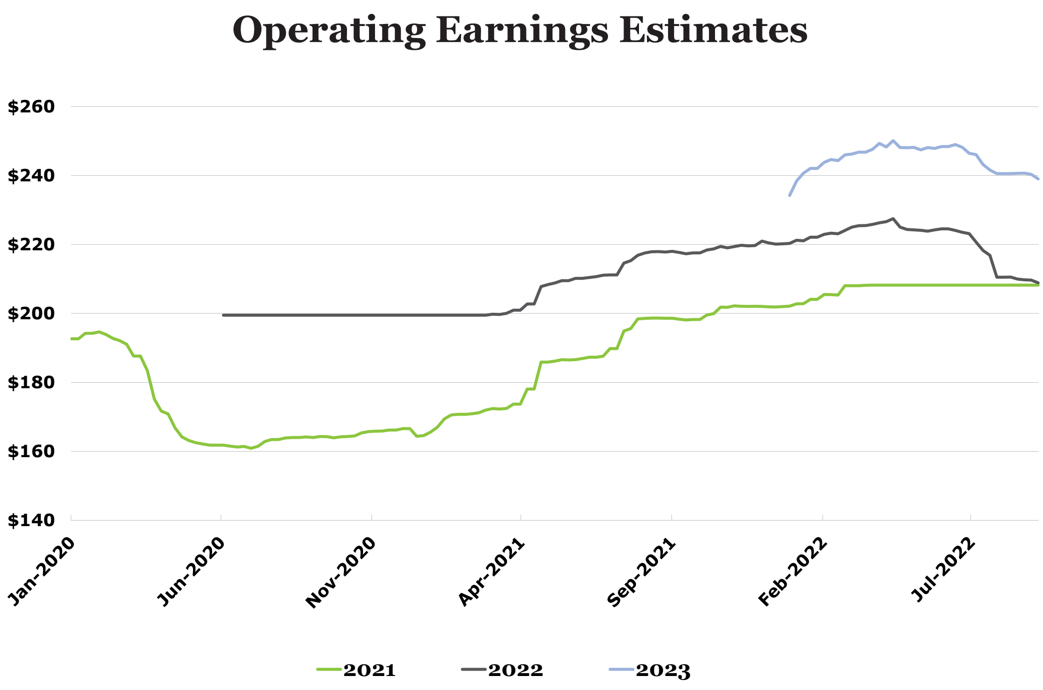
The decline that started in January was discounting higher interest rates and a slowing economy. The decline has been punctuated by sharp rallies and swift declines. These correlate very closely to Federal Reserve press conferences, economic reports, and speculations.

The Fed may come across as "dovish" and the market rallies. The Fed reasserts its inflation fighting fortitude and the market declines. Economists speculate that the CPI will decline due to falling gas prices, the report is bad, and the market declines. The Bank of England announces the "throw in the towel" and the market rallies. It has been a nervous market to say the least.

The value of stocks is based solidly on corporate earnings. Lower stock prices with relatively stable earnings expectations have brought the forward P/E for the market into the reasonable range – down from the bubble levels last seen in January.



Expectations for earnings growth have remained remarkably resilient until the last couple of months. Note how estimates for this year and next have fallen over the last 3 months. Estimates for 2022 have "caught down" to last year's results (so no growth this year). Current estimates for 2023 indicate growth of 14%, however, we have 18 months to go and a lot can change.



Current stock prices represent reasonable valuations assuming earnings can stabilize.

Moving Forward

The equity market declines from the January highs have been significant. The lower stock market prices have brought the valuation measurements of the market down from over-valued levels to reasonable levels. While declines like we have experienced are extremely unfortunate, they give us opportunities to re-position sector allocations to potentially benefit from upcoming market expansions. Your team at AAMA continues to monitor the markets and our positions to take advantage of market expansions at reasonable levels of risk.

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