gmag

investment perspectives

July | 2022

Q3 2022 MARKET OUTLOOK

Executive Summary

Inflation has been highly elusive during the past year due to heightened volatility of supply-side conditions which was catalyzed by the pandemic and then exacerbated by the war in Ukraine. However, the combination of rising inventories, slowing demand, falling commodity prices, and steepening base effects suggest that inflation has likely peaked. We expect inflation fears will transition to growth fears as elevated prices combined with hawkish central bank policies constrain economic activity and increase the risk of a US recession. As a result, we believe a defensive posture is prudent.

Economic Data Check

Inflation has been red hot, but we expect it to slow alongside growth in the coming quarters.

- Rampant inflation roiled equity and bond markets, causing the US 60/40 portfolio to decline **-11.5%** in Q2, recording its worst quarter in history, dating back to 1976[1].
- Although inflation is at a four-decade high, data suggest it will likely slow alongside growth in the coming quarters.
- The US may have entered a technical recession in Q2 due to slowing exports, but we are much more concerned about a broader based recession defined by declining domestic consumption and rising unemployment. Although consumption and employment remain strong today, we are seeing early signs of stress that could be a harbinger for a broad-based recession.

Equities

Favor being underweight equities as growth slows but be cognizant of upside risks if the Fed pivots.

- Global equities declined **-15.7%** in Q2 as valuation multiples were pressured by higher interest rates.
- We expect equities to remain volatile as the US economy transitions from the late-cycle phase of the expansion to the recession phase, and we are keying on our market bottoming signals to identify a major buying opportunity in stocks. So far, only 1 of our 10 signals have triggered, suggesting that stocks likely have more downside ahead.
- However, stocks could rally in the near-term if inflation pressures ease and the Fed is able to pivot from its aggressive hawkish policy. Historically, major pivots in Fed policy have sometimes been able to prolong the economic expansion for 6- to12-month periods while boosting equity prices by 20–30% before they decline to new lows. Although, such pivots are not always effective.

Fixed Income

Favor transitioning from underweight to neutral in fixed income in anticipation of inflation peak.

- The US Aggregate Bond Index fell **-4.7%** in Q2 after declining **-5.9%** in Q1, completing the worst first half of any year in its history.
- Bonds have struggled while growth and inflation have accelerated during the past two years, but if inflation has peaked, bonds should perform well going forward.

Commodities

Favor being overweight commodities via gold.

- The Goldman Sachs Commodity Index gained **+2.0%** in Q2, finishing the first half of 2022 up **+35.8%**.
- Disrupted supply chains combined with a shift in consumer preferences from services toward goods have provided a tailwind for commodities during the past two years, but we believe those trends have run their course.
- We favor remaining overweight commodities as a hedge against this view, but mostly via gold, which generally outperforms other commodities when growth is slowing.

Summary

Slowing growth and rising recession risk favor a more defensive investment approach.

- We have **three red lights**: (1) near-term outlook is poor, (2) medium-term outlook is poor, and (3) liquidity is poor. This dictates a very defensive investment posture.
- We favor being underweight equities, overweight cash, and increasing bonds to neutral. Will favor moving to overweight bonds upon confirmation of inflation peak.
- A Fed pivot could catalyze a near-term rally in stocks but positioning for such a scenario is risky.

POSITIONING HIGHLIGHTS:

UNDERWEIGHT	NEUTRAL	OVERWEIGHT	OVERWEIGHT
Global Equities	Fixed Income	Commodities	Cash

Note: *This document, including important disclosures on Page 11, is meant to be read in its entirety.*

[1]the US Aggregate Bond Index was incepted in 1976.

Second Quarter Review

Red-hot inflation spurred volatility in both the equity and fixed income markets, catalyzing the worst ever quarterly decline (**-11.5%**) in a portfolio consisting of 60% US stocks and 40% US bonds.

Quarter-over-quarter (QoQ) real GDP growth was negative in Q1, and the Atlanta Fed forecasts it will be negative again in Q2. If realized, this would satisfy the criteria for a technical recession, defined as two consecutive quarters of negative QoQ real GDP growth. However, this is misleading because the negative print in Q1 was driven by a severe decline in net exports that was characterized by strong domestic consumption versus weak foreign consumption. We believe the weakness shown in that GDP report is simply a testament to the relative strength of the US consumer, and we remain far more concerned about a broad-based recession that pushes unemployment higher.

There is little evidence that we are at this stage today, but data suggest that conditions could materially worsen in the coming quarters.

Global equities declined **-15.7%** in Q2 as valuation multiples continued to contract. Earlier stage tech stocks—which are most vulnerable to multiple compression—declined sharply (**-37.1%**) for a fourth consecutive quarter, and they now trade about **-70%** from their 2021 highs.

Bonds struggled as increased expectations for future rate hikes pushed yields higher and prices lower. Long-term treasury bonds have returned **-31%** since they reached their high in March 2020.

Commodities performed well (**+2.0%**) while demand remained strong and supply constraints persisted. However, we believe these tailwinds will begin to fade in the coming quarters. Gold declined **-6.4%** as real interest rates rose due to rising nominal rates and declining expectations for long-term inflation.

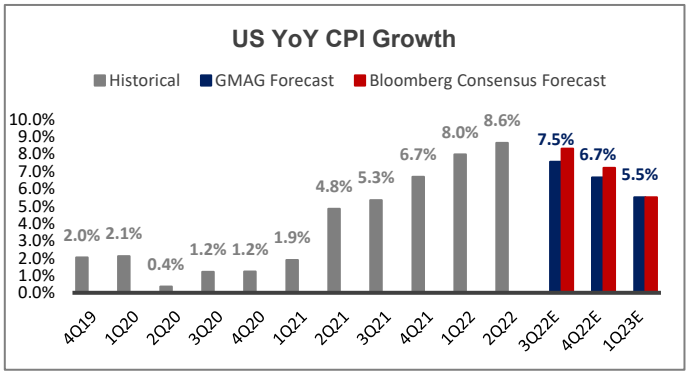
MARKET REPORT CARD – June 30, 2022

Performance Reported in US Dollars	2Q22	YTD	Trailing 1-Year
Equities			
Global (MSCI All World Equity Index)	-15.7%	-20.2%	-15.8%
United States (Russell 3000 Index)	-16.7%	-21.1%	-13.9%
International Developed (MSCI EAFE Index)	-14.5%	-19.6%	-17.8%
Emerging Markets (MSCI EM Index)	-11.4%	-17.6%	-25.3%
Bloomberg Barclays US Aggregate Bond Index	-4.7%	-10.3%	-10.3%
Long-Term Treasuries (Barclays 20+ Year)	-12.7%	-22.3%	-19.2%
Investment-Grade Bonds (Barclays US Corp)	-7.3%	-14.4%	-14.2%
High-Yield Bonds (Barclays US HY Corp)	-9.8%	-14.2%	-12.8%
Commodities (S&P GSCI Index)	+2.0%	+35.8%	+45.0%
Crude Oil (S&P Crude Oil Index)	+10.0%	+54.9%	+65.2%
Gold (LBMA Gold PM Price Index)	-6.4%	+0.6%	3.1%
Hedge Funds (HFRX Global Hedge Fund Index)	-3.8%	-5.1%	-5.1%

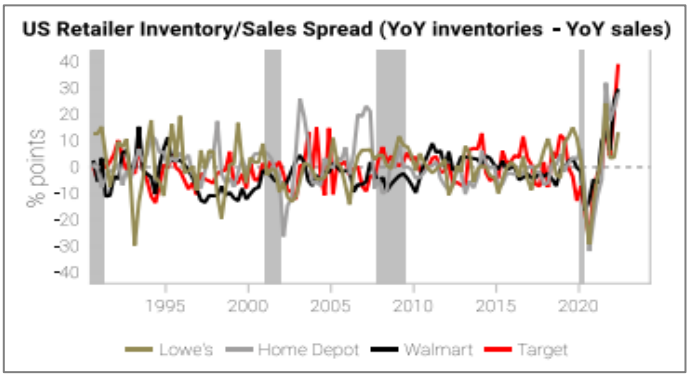
Source: Bloomberg, GMAG Research

Economic Data Check (1): Inflation is running very hot, but we believe it peaked in June and will begin to slow in the coming quarters.

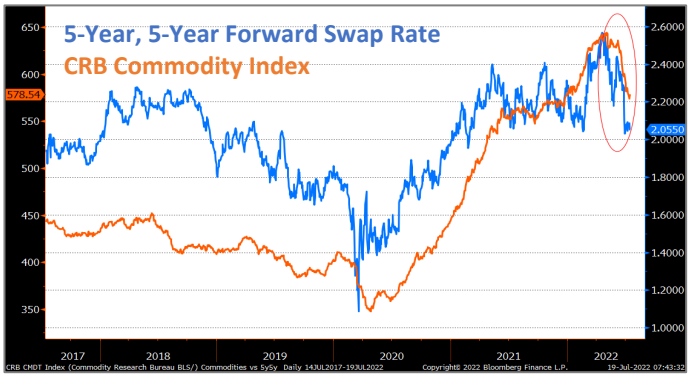
- US inflation has proven highly elusive, beating consensus estimates in 13 of the past 15 months on its way to eclipsing 9% for the first time since 1981. This has kept the Fed steadfast in pursuing its aggressive tightening path while disrupting equity and fixed income markets along the way. However, data suggest that inflation may have peaked in June (**Chart 1**). Below are the primary reasons why:
  - Supply chain pressures are improving as demand begins to wane (see commentary with respect to the bullwhip effect on page 5), and retail inventories have transitioned from shortages to gluts (**Chart 2**). This excess inventory should exert a disinflationary force on the economy as retailers (1) lower prices to reduce excess inventory and (2) order fewer goods in the future because they are already stocked.
  - Market expectations for long-term inflation have broken the bullish trend that has persisted for the past two years (**Chart 3**), and currently trade between 2.0% to 2.5%. Inflation expectations matter because prices end up reflecting, in part, what people expect them to be—click here for more details on this paradigm.
  - Commodity prices have also started to fall, and the participation has been broad across food, metals, and, most importantly, energy. Rising energy costs have contributed to 45% of the total increase in inflation since 2020, and that is likely understated after taking into consideration the indirect impact that higher energy prices have on the cost of other services, like transportation, for example. Sometimes the best cure for high prices is high prices because when gas prices double or triple, at some point, consumers will decide to use less of it. If consumers make fewer trips to the pump, that would have a material impact on demand for crude oil, because in 2020, motor gasoline (which excludes diesel fuel and heating oil) accounted for 44% of total US petroleum consumption.
  - Base effects will increase by more than 50% (from 2.6% to 4.0%) through year-end. Higher inflation readings in one period (base) generally result in lower readings in the subsequent period (**Chart 4**).



Source: Bloomberg, GMAG Research



Source: Variant Perception



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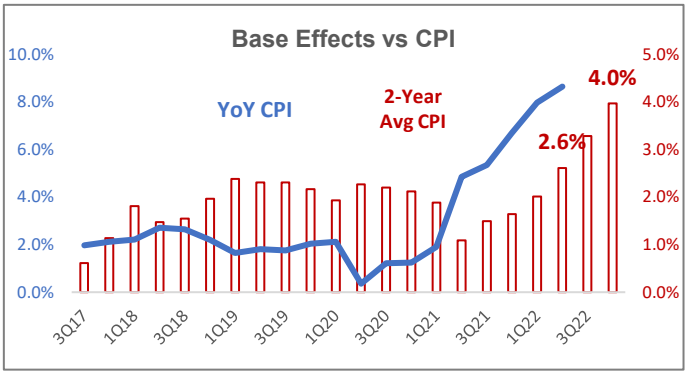
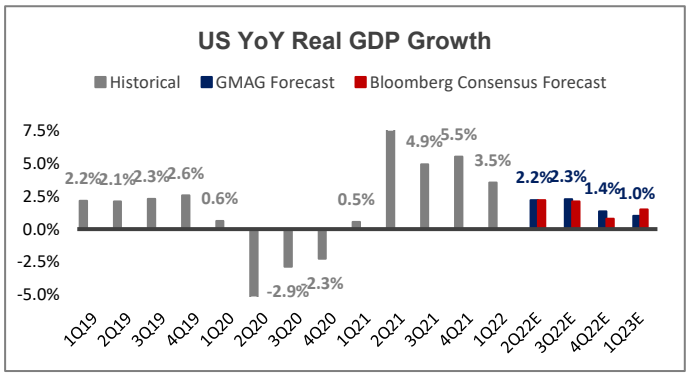


Source: Bloomberg, GMAG Research

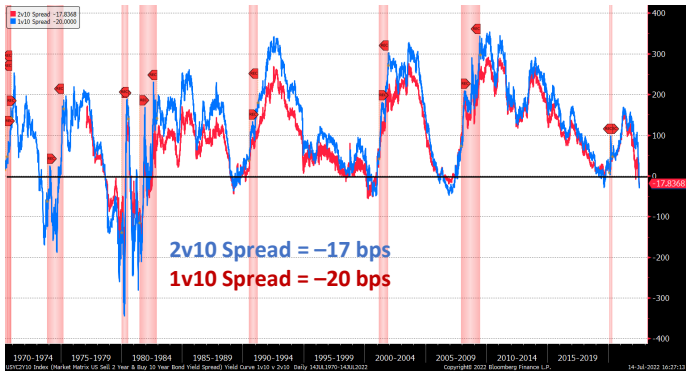
Economic Data Check (2): We expect inflation fears will transition to growth fears as higher interest rates slow economic activity.

- The US economy is strong today. However, we expect growth to decelerate in the coming quarters (**Chart 1**) as the impact from tighter Fed policy flows through to the real economy. Growth may reaccelerate in Q3 while base effects ease, but the trend looking out over the next few quarters is likely lower.
- The market expects the Fed Funds Rate to reach 3.5% by year-end. Higher interest rates increase the cost to borrow capital which, in turn, slows economic activity. The Fed hopes it can slow the economy enough to get inflation under control without tipping the economy into a recession. However, this is difficult to do, and now the yield-curve has inverted (**Chart 2**), signaling that the market believes a soft-landing scenario is unlikely.
- Two signals in our recession model have triggered, which indicates that recession risk is material. Historically, the S&P 500 has generally peaked within 6 months from the time that two of our signals have triggered (**Chart 2**). However, given that the S&P 500 is already trading **-18%** below its high, it is possible that stocks have already peaked.
- Consumer sentiment and the outlook for small businesses have declined to all-time lows, and, historically, sentiment has not deteriorated to such levels outside of recessions (**Chart 3**). Sometimes, a decline in soft data, like sentiment surveys, front-runs a decline in hard data.
- One of the most obvious signs of economic strength today is the labor market. Currently, the unemployment rate is at 3.6%, which ranks in the 94th percentile since 1948. However, there are early signs that this strength may be peaking:
  - Initial jobless claims have climbed 47% since mid-March, and continuing jobless claims are no longer descending (**Chart 4**).
  - Some of the largest corporations, including Tesla, Microsoft, JP Morgan, and now Apple, have either rolled out layoffs or are anticipating hiring freezes.

  Once unemployment begins to rise it can be difficult to rein in, and when this happens it can have a cascading effect on economic activity.



Source: Bloomberg, GMAG Research



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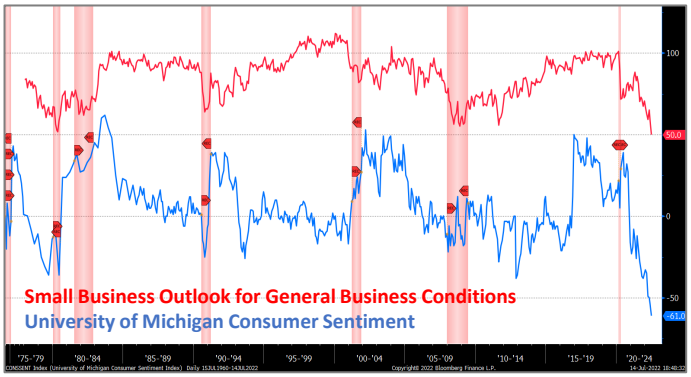

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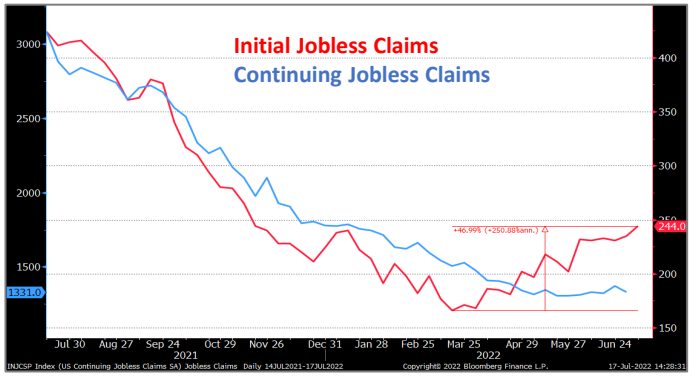
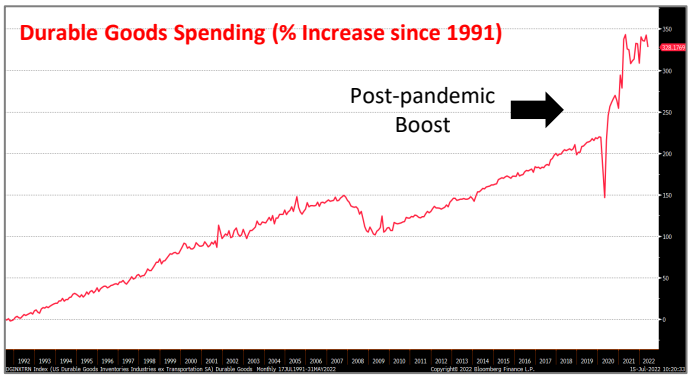


Source: Bloomberg, GMAG Research

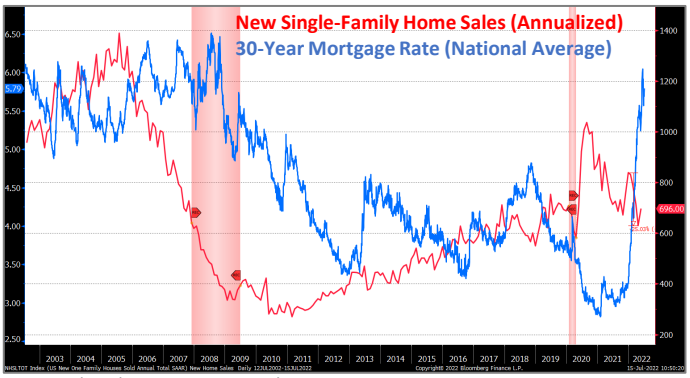
Economic Data Check (3): The reversal of the bullwhip effect, slowing housing demand, and a deteriorating wealth effect present additional risks to growth.

- **Bullwhip effect set to reverse.** The combination of government stimulus and lockdowns provided an impulse to durable goods spending unlike anything we have experienced before (**Chart 1**). This helped catalyze supply shortages as supply chains were not equipped to meet this level of demand. As a result, stakeholders along the supply chain ordered more goods than they needed in fear that the goods would not arrive in time to fulfill customer orders, which caused the shortages to persist even further. However, as the pace of demand has started to slow, retailers have been left with a surplus of inventory. This distortion is referred to as the bullwhip effect, and, in this case, it essentially pulled forward economic demand from the future. However, as consumption slows from an extremely elevated level, we expect goods orders and prices will decline materially. Manufacturing activity has been slowing for several quarters now, and we expect it will slip into contraction (i.e., <50) territory soon (**Chart 2**).
- **Housing activity set to reverse.** Mortgage rates have eclipsed 5% for the first time since 2011, materially slowing housing demand (**Chart 3**). YTD, the pace of new single-family home sales has declined by -17% while sentiment w/r/t housing market conditions has fallen by -34%. If mortgage rates do not reverse quickly, demand will likely deteriorate further. This presents a risk to home prices, which are already at extreme levels—the average US home price is up +40% since the start of the pandemic, which is equivalent to ~4.7x the annual rate of appreciation during the preceding 33 years.
- **The wealth effect set to reverse.** Individuals and families tend to spend more when their net worth increases and vice versa—a paradigm known as the wealth effect. From 2020 through 2021, increases in portfolio and home values flowed through to the real economy, helping to boost consumption. We expect that impulse to reverse course in the coming quarters as growth of portfolio and home values slow, or even turns negative (**Chart 4**).



Source: Bloomberg

Source: Variant Perception



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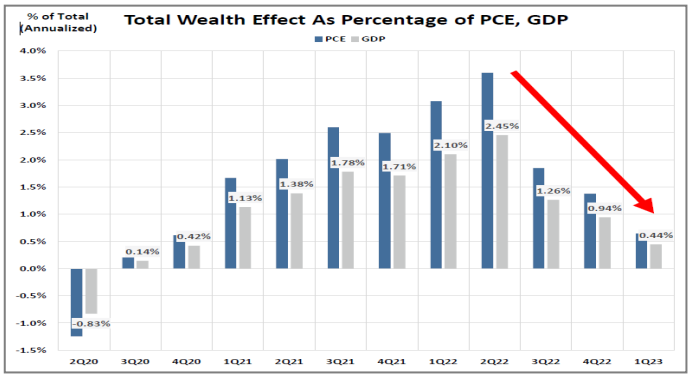
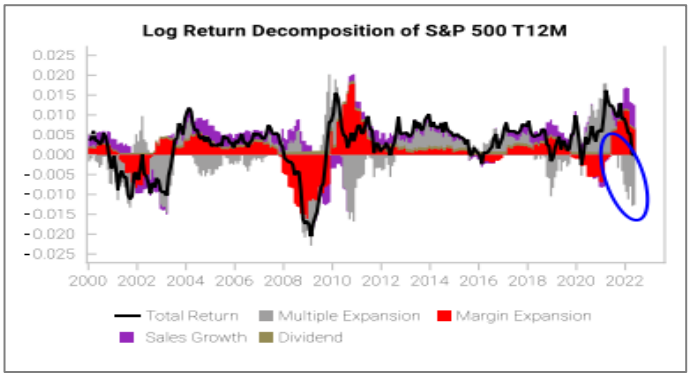


Source: Hedgeye Risk Management

Equities (1): Favor Underweight

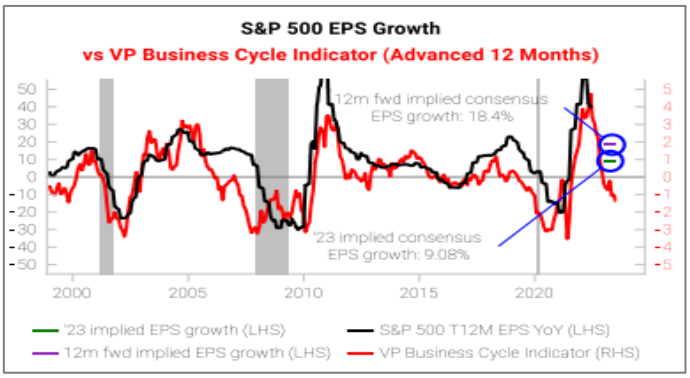
We expect stocks to remain volatile as focus shifts from valuation to earnings, and liquidity exits the system. Our market bottoming indicators suggest there is likely more downside ahead for stocks.

- **Multiple compression has driven equity returns.** Until this point, the decline in equity prices has largely been driven by multiple compression, which has occurred as a result of higher interest rates (**Chart 1**)➔ all-else equal, rates▲, valuations▼. However, if our view that inflation has finally peaked is correct, then interest rates have likely peaked also, which should provide relief for equity valuation multiples going forward.



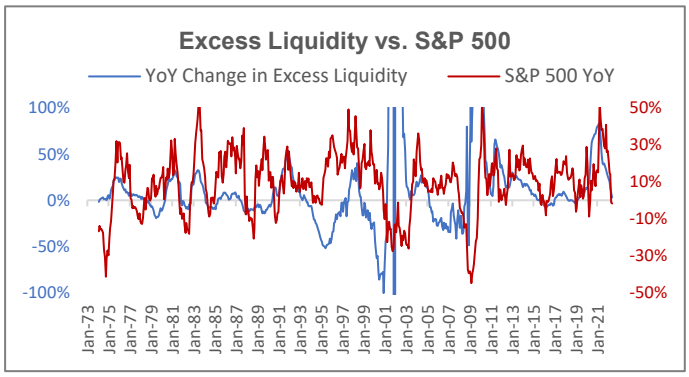
Source: Variant Perception

- **Earnings to step-in as primary risk factor**. We believe market participants will shift their focus from valuation multiples toward earnings as a negative cyclical backdrop presents a risk to corporate profits. Consensus analyst estimates imply 18% earnings growth over the next 12 months whereas we believe earnings growth could be negative (**Chart 2**). There will likely be downward earnings revisions in the quarters ahead which present additional risk to stocks, irrespective of whether the inflation outlook improves.



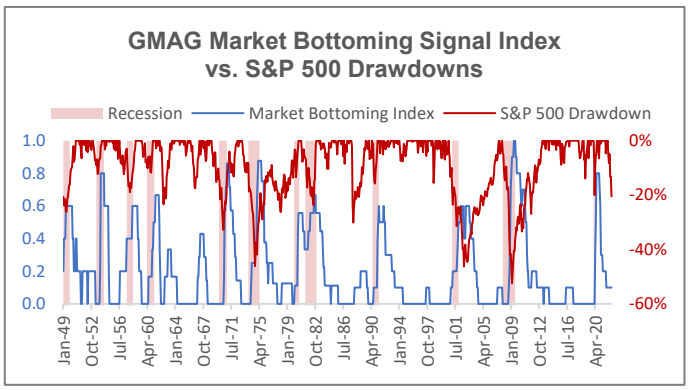
Source: Variant Perception

- **Liquidity remains a headwind.** The excess liquidity that was injected into the financial system in response to the pandemic helped propel stock prices into 2021. However, that liquidity has since been fading (**Chart 3**), providing a headwind to stocks, and particularly those that are on the high-end of the risk spectrum, like profitless technology stocks and digital assets. If the Fed tightens its balance sheet to the extent it has provided guidance, this headwind could amplify in the coming quarters.



Source: Bloomberg, GMAG Research

- **Market bottoming signals have not triggered.** If the US economy enters a recession, equity market conditions will likely worsen before they improve. We are monitoring our market bottoming signals (**Chart 4**) to identify a major buying opportunity in stocks, and our research suggests that such opportunities tend to form when 50% of our signals have triggered. Currently, only 10% of our signals have triggered, which implies that stocks likely have more downside if we enter a recession.

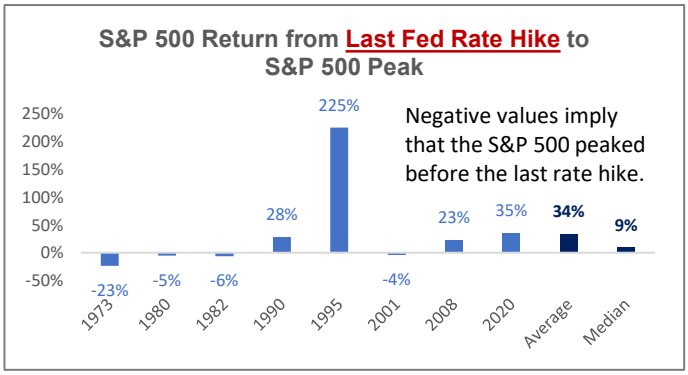


Source: Bloomberg, GMAG Research

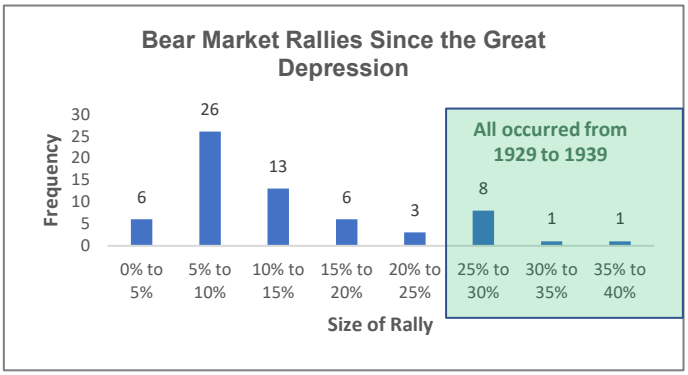
Equities (2): Favor Underweight

Despite a challenging outlook, peak inflation could facilitate a near-term rally in stocks if the Fed is able to pivot.

- If inflation peaked, it could allow the Fed to pivot from its aggressive tightening path, pushing rate expectations downward and stock prices higher.
- **Chart 1** shows the S&P 500 return from the time of the **last Fed rate hike**—we are using this as a proxy for major pivots in Fed policy—to the S&P 500 peak. Here are our observations:
  1. Historically, **major Fed pivots have often helped prolong economic expansion**, sometimes boosting equity prices by 15–30%.
  2. **However, Fed pivots do not always work**. Despite pivoting in 73', 80', 82', and 01', the Fed was unable to prevent the economy from tipping into a recession and stop the bleeding in stocks.
  3. **The year 1995 was the most profound example of a soft-landing.** Part of the reason the pivot worked then was because the unemployment rate was as high as 5.6%, which meant there was plenty of slack in the economy to power economic growth for years to come. In contrast, today the labor market is much tighter (the unemployment rate is at the 94th percentile today vs. the 50th percentile then), interest rates are lower and debt burdens are materially higher. The combination of these factors make **conditions for engineering a soft-landing today much more difficult today than they were in 1995**.
- Nonetheless, even if a Fed pivot does not push stocks to new highs, it could at least catalyze a bear market rally. Historically, 10–20% rallies have frequently occurred during bear markets (**Chart 2**) and stocks may be ripe for a rally today. 135 trading days into the current bear market, the S&P 500 is down **-18%**. When we contextualize this drawdown relative to historical bear markets, we observe that this is on par with the worst start to any bear market dating back to the Great Depression (**Chart 3**). The combination of potentially oversold conditions combined with extremely defensive positioning—the recent Bank of America Fund Manager Survey (**Chart 4**) implies that investors today are as defensively positioned as they were in in October 2008—could provide the backdrop for a near-term rally in stocks, despite fundamental headwinds.



Source: Bloomberg, GMAG Research



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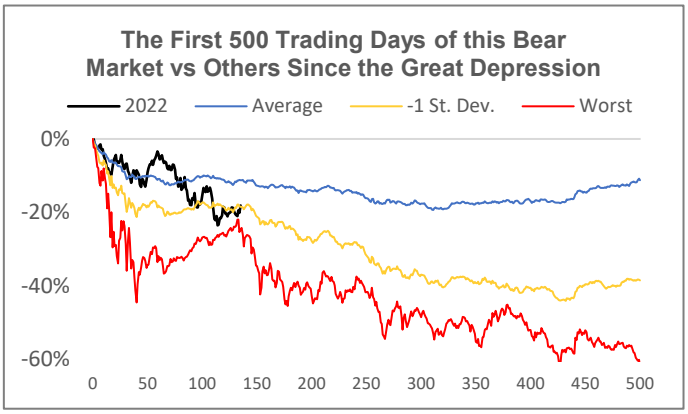


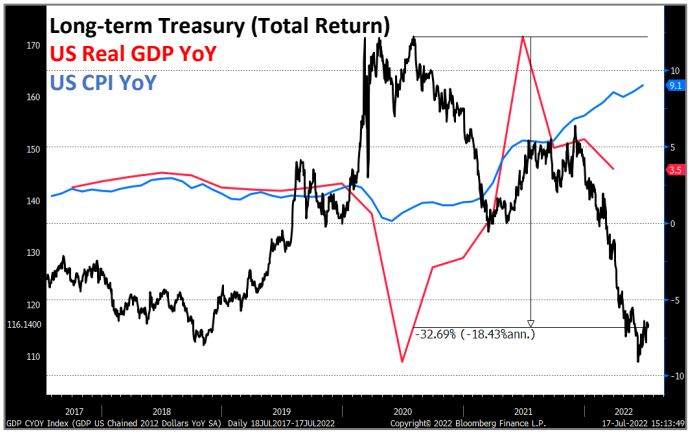
Source: Bloomberg, GMAG Research

Source: Bank of America

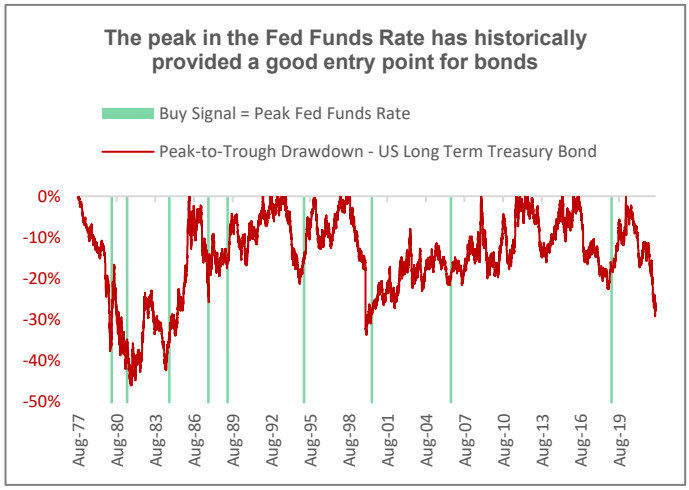
Fixed Income: Favor Neutral. But shift to overweight if, and when, inflation slows.

We expect both growth and inflation to slow in the coming quarters, which should provide a favorable backdrop for bonds.

- Growth and inflation have been very strong the past two years, which has forced interest rates higher, presenting a challenging environment for bonds (**Chart 1**)—the US Aggregate Bond and Long-Term Treasury Bond indexes have returned **-12%** and **-31%** from their respective highs reached in 2020.
- However, with growth and inflation poised to slow, we are anticipating a transition into a disinflationary environment (i.e., growth▼, inflation▼) for the first time in more than 2 years. This should provide a favorable setup for bonds as both factors place downward pressure on interest rates. We expect bonds of higher quality to perform particularly well given the risks to economic growth.
- Historically, the US 10-year treasury yield has often peaked within 3 months of the peak in the Fed Funds Rate. Therefore, the point of the last Fed Rate Hike has generally provided an attractive entry point for investors in treasury bonds (**Chart 2**), and we expect that this time will be no different. Currently, the market anticipates the Fed Funds Rate will peak at 3.5% in February, and we believe that timeline (rate) will be pulled forward (downward) as we see more evidence that the inflation peak is in the rearview.
- Although we favor treasuries, we believe it is too early to lean into credit. At face value, opportunities in credit appear more attractive now as the average high-yield corporate bond has more than doubled in 2022 (from 4.2% to 8.6%). However, history implies that there is plenty of room for credit spreads to widen from current levels if the economy transitions into a recession. Today, the spread between the 10-year treasury and a high-yield bond with the same maturity is 5.6%, whereas that same spread widened by as much as 10.6% in 2020, 20.6% in 2008, and 10.4% in 2002 (**Chart 3**). If the US economy enters a recession, high-yield bonds likely have 10–20% more downside ahead, whereas we expect treasuries to rally from current price levels.



Source: Bloomberg, GMAG Research



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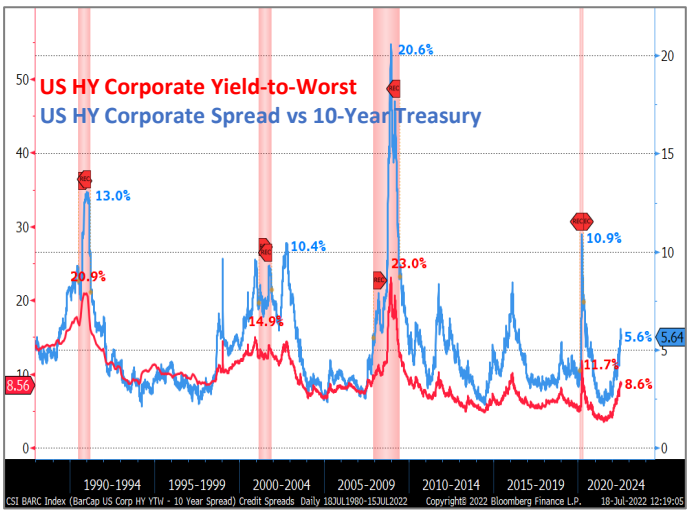
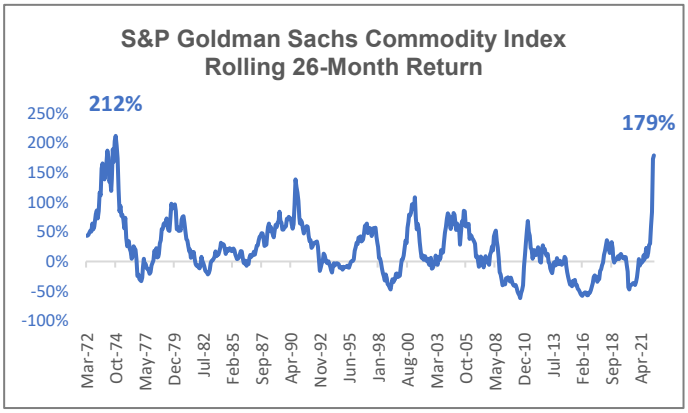


Source: Bloomberg, GMAG Research

Commodities: Favor Overweight. But shift to neutral if, and when, inflation slows.

We remain overweight commodities to hedge against inflation but favor reducing exposure upon confirmation that inflation has peaked. We express our overweight via gold, which is more resilient than other commodities when growth is slowing.

- The Goldman Sachs Commodity Index declined by as much as **-53%** during the heart of the pandemic, but it subsequently gained **+179%** during the recovery, recording its best 26-month stretch of performance since 1974 (**Chart 1**). We expect commodities will underperform going forward as economic growth slows. Per **Chart 2**, as strong as commodities generally perform during reflation environments (growth ▲, inflation ▲), they tend to perform equally as poorly during disinflation (growth ▼, inflation ▼) environments.

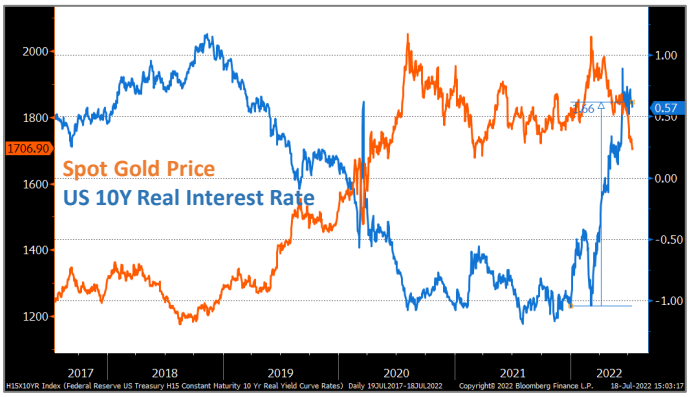


Source: Bloomberg, GMAG Research

- Some market participants believe we are at the start of a commodity super-cycle, defined as a multi-year period of commodity outperformance. Proponents argue that there has been a material shortage of capital investment in legacy energy infrastructure as the world attempts to transition toward cleaner energy solutions, and that this will perpetuate an energy supply shortage for years to come. We do not have a strong opinion on whether or not this will be realized, but, even if it is, we believe commodity prices will likely experience cyclical weakness over the coming quarters as economic activity slows.

	Avg QoQ Return by Quadrant			
Asset Class	**Goldilocks**	**Reflation**	**Stagflation**	**Disinflation**
S&P GSCI Index	1.5%	6.4%	3.0%	-7.5%
S&P Crude Index	1.8%	11.2%	4.0%	-9.7%
Spot Gold Price	2.5%	1.9%	2.0%	-0.4%

Source: Bloomberg, GMAG Research
Disclosure: Data reflects average quarterly returns from Jan. 1992 through June 2022.



Source: Bloomberg, GMAG Research

- **Has gold lost its luster?** Market participants have been disappointed by the performance of gold as inflation has accelerated, and we want to highlight that the reason gold hasn't performed well is because gold is not as much of a hedge against higher inflation as it is a hedge against falling real interest rates (real interest rate = nominal rate less the rate of inflation). All-else, equal, when inflation goes up, real rates tend to fall. However, real interest rates today are not measured using headline inflation but instead by market expectations for long-term inflation. To that point, although CPI is currently 9.1%, long-term inflation expectations have remained anchored between 2 and 3%. The combination of high economic growth, hawkish Fed policy, and anchored long-term inflation expectations has pushed real rates higher by +1.7% in 2022 (**Chart 3**), providing a material headwind to the precious metal. Going forward, if (1) long-term inflation expectations become unanchored (we believe this is unlikely) and/ or (2) nominal interest rates fall (we believe this is likely), that should push real rates lower and gold prices higher. We view gold as a hedge against a more dangerous type of (entrenched) inflation and expect it to outperform broad commodities (also shown in **Chart 2**) as economic growth slows.

POSITIONING SUMMARY:

UNDERWEIGHT	NEUTRAL	OVERWEIGHT	OVERWEIGHT
Global Equities	Fixed Income	Commodities	Cash

Positioning Details:

- **Equities: Underweight**
  We favor being underweight equities given we expect economic activity to slow, and the risk of recession is material. Within equities, we favor being overweight US equities relative to international equities while the conflict in Ukraine and lockdowns in China persist.

- **Fixed Income: Neutral**
  We favor shifting from underweight to neutral in fixed income. We plan to favor adding to this asset class as our thesis that inflation has peaked is confirmed.

- **Commodities: Overweight**
  We favor being overweight commodities, particularly gold, to hedge against inflation, and plan to favor reducing this exposure as our thesis that inflation has peaked is confirmed. We view gold as a hedge against a more dangerous type of (entrenched) inflation and expect it to outperform broad commodities (also shown in **Chart 2**) if economic activity slows.

- **Cash: Overweight**
  We have favored being overweight cash given the rising risk of recession. Cash should help client portfolios realize lower levels of performance volatility and provide them with dry powder to reinvest opportunistically.

As always, we thank you for your ongoing trust and confidence. Please do not hesitate to reach out with any questions relating to our outlook or the management of your individual portfolio. We will keep you apprised of any important developments.

Sincerely,

gmag

Please see below for important disclosures.

Disclosures:

The information and statements provided herein are not intended to provide personal investment advice and do not take into account the specific investment objectives, financial situation, and particular needs of any specific investor.

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