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Investment Insights Monthly

From The Desk of Bill Hornbarger, Chief Investment Officer

September 2022

High Versus Higher

Federal Reserve Chairman Jerome Powell's speech at the Jackson Hole Economic Symposium left little doubt of the Fed's resolve to fight inflation and has led to another round of repricing expectations on interest rates, bond yields, and inflation. By any measure, inflation remains elevated, and the Fed has indicated higher interest rates will be necessary to combat it. That leads to the question of how high rates might go, and whether there is a difference between "higher" and "high" in terms of market reactions. Our thoughts on inflation, monetary policy, and bond yields follow.

Inflation

Of the two common measures of inflation in the U.S., the Consumer Price Index (CPI) gets more press, but the Fed states its goal in terms of the Personal Consumption Expenditures (PCE). CPI and PCE are highly correlated, but they do have some differences. They include different representative baskets of goods, each with different weights. Additionally, the PCE tries to account for substitution when a good gets more expensive. The result of the differences between the two price indices is that CPI has generally (but not always) been higher than PCE, usually by slightly less than 50 basis points on average.

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The Fed reaffirmed 2% as its "target" earlier this year (using PCE) and went further by stating that it seeks to "achieve inflation that averages 2% over time, and therefore judges that, following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time." In other words, they are looking for a 2% average, not a steady 2%. Until recently, PCE had been below 2%, which would argue that the Fed might be comfortable allowing it to be above 2% for some period (although probably not the most recent 6.3%).

The accompanying table shows the average annual inflation rate by decade using PCE. Since 2010, PCE has averaged 1.65%, with a low of 0.08% and a high of 6.8%. There were periods over that timeframe where there were concerns that the Fed would not have sufficient tools to fight too low a rate of inflation.

Period	Average rate (yearly)
1960-1969	2.14%
1970-1979	6.43%
1980-1989	5.03%
1990-1999	2.32%
2000-2009	2.14%
2010-current	1.65%
Most recent	6.30%

Source: Haver

There are several reasons to believe that inflation is in the process of peaking. The economy is visibly slowing as evidenced by negative GDP in the first half of 2022, energy prices have fallen from recent highs (oil is currently $87/barrel vs. $114 in June), supply chains are healing (the number of ships waiting at anchor at the Port of Los Angeles has declined 88% since January), and the base effect (comparing current prices to a year ago) could impact the rate of change. Since 1990, the average annual monthly change in the PCE has been 0.17%. We recently looked at what would happen to inflation over the next 12 months if it increased at 0.2% or 0.4% monthly and found the year-over-year rate would decline to 2.4% or 4.9%, respectively.

While there are certainly no guarantees that inflation will follow one of those paths, the examples do help provide some context. The current elevated rate of inflation is unsustainable for policymakers, and the Fed is clearly committed to using the tools it has at its disposal to fight it. While the rate will not decline in a straight line, we would suggest that it will, through time, retreat to a range that will be higher than the previous decade but lower than where it is today. If the period from 1990 to 2021 was generally spent in the 2% to 3% range, we would suggest the next inflation regime will be in the 3% to 4% range.

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Monetary Policy

When discussing monetary policy, investors typically think of it in terms of easy, neutral, or tight, with the biggest determinant of which environment we find ourselves in being where the target Fed funds rate is relative to inflation. Prior to the Global Financial Crisis (GFC), the Fed funds rate was generally higher than inflation. The spread between the two expanded when Fed policy was tight or neutral, and the Fed funds rate typically fell in a range centered around 1% to 1.5% above CPI. Post-GFC, and again after the onset of Covid-19, the Fed dropped the Fed funds rate to 0% – and below the rate of inflation – for extended periods. This has been very stimulative for the economy and also for financial and real assets. At various times, the Fed also purchased bonds (quantitative easing), providing further stimulus.

Going forward, we believe the Fed will define “neutral” differently. The Fed is currently shrinking its balance sheet (quantitative tightening) and increasing the target Fed funds rate. Both the futures markets and the Fed’s projection materials indicate a terminal rate for this cycle in the 3.75% - 4% area, which would be lower than all but the most recent tightening cycle. Looking at the longer-term projections from the Federal Open Market Committee, it appears to us that neutral monetary policy will mean the Fed funds rate is slightly higher than inflation (by 25 to 50 bps). The Fed is forecasting and targeting the long-term rate of inflation at 2% and the latest projection materials indicate a longer run Fed funds rate at 2.5%, higher than recent years but lower than what it was prior to the GFC.

Bond Yields

A more patient Fed, coupled with other factors such as demographics and foreign yields, also lead us to believe that bond yields will be “structurally” lower going forward, and investors might not receive the compensation above inflation that high quality bonds offered prior to the GFC. Low yields (both nominally and relative to inflation) have been one of the biggest investment challenges of the past decade. We do believe the term-structure will be higher as/if Fed funds settle into the Fed’s forecasted range but, as is the case with Fed funds, we believe they will provide lower compensation above inflation than history suggests.

The consensus forecast for the 10-year Treasury after this tightening cycle ends is in the 3% to 3.25% range, which is higher than most of the period since the GFC but still below what investors were accustomed to prior to 2008. However, with yields for most developed countries below those of the U.S., there is little pressure for yields to move significantly higher until/unless that changes.

We are of the opinion that yields, inflation, and interest rates will be higher than what we have been accustomed to post-GFC. However, higher is different than high. A good analogy might be the decade between 2000 and 2009. Inflation (as measured by PCE) averaged 2.14%, the 10-year Treasury yield averaged 4.5%, and the Fed funds rate averaged 3%. Obviously, there was volatility around those averages, and we are not suggesting that the next 10 years will be a repeat. But one could argue that while those numbers are higher than the most recent decade, many investors wouldn’t consider them high.

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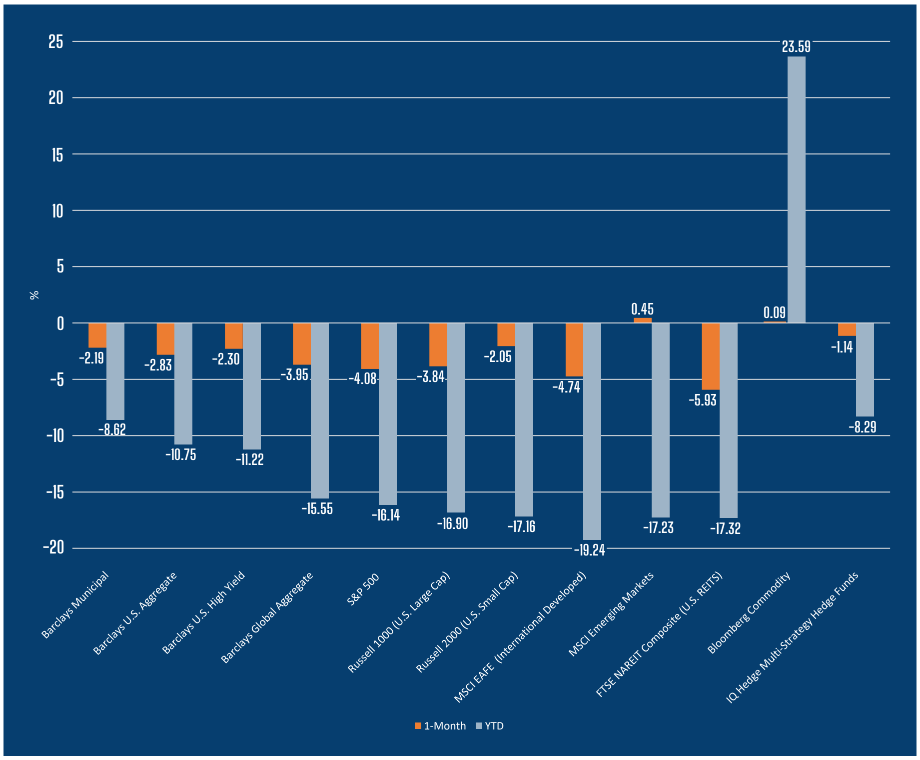
Asset Class Returns as of August 31, 2022

Comparing Recent Month and Year-to-Date Total Returns



Source: Morningstar

Fixed Income

- Yields surged higher during the second half of August on fears of a more hawkish Fed fighting sticky inflation.
- Core fixed income and municipal bonds were hit hard.
- Investment grade and high yield spreads widened out last month while floating rate loans provided a buffer against higher rates.
- Non-U.S. fixed income was hurt by rising rates and the stronger U.S. dollar. Emerging market debt provided some relative outperformance.

Equities

- After starting out positive, U.S. equities fell during the second half of August.
- Large caps lagged small caps.
- Large cap growth trailed large cap value, but small cap growth outpaced small cap value.
- Non-U.S. equities trailed their U.S. counterparts last month, led by particular weakness in Europe.
- Large caps in EAFE markets beat small caps, and emerging market small caps handily outperformed emerging market large caps.
- Emerging markets provided strong relative outperformance in August led by a rebound in China and Latin America.

Real Assets

- Commodities eked out small gains with energy strong and industrial metals generally weak.
- REITS had another poor month and were hurt by overall market volatility and higher interest rates.

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August 31, 2022	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Barclays U.S. Treasury Bill 1-3 Month	0.18%	0.27%	0.42%	0.44%	0.54%	1.07%	0.62%
Barclays Municipal	-2.19%	0.39%	-8.62%	-8.63%	-0.83%	1.28%	2.25%
BBgBarc U.S. Govt/Credit Intermediate	-0.78%	-0.26%	-3.36%	-3.98%	-0.02%	0.92%	0.94%
Barclays U.S. Aggregate	-2.83%	-0.45%	-10.75%	-11.52%	-2.00%	0.52%	1.35%
Barclays U.S. High Yield	-2.30%	3.46%	-11.22%	-10.60%	1.03%	2.58%	4.51%
S&P/LSTA Leveraged Loan	1.54%	3.72%	-1.01%	0.37%	3.16%	3.53%	3.89%
Barclays Global Aggregate	-3.95%	-1.90%	-15.55%	-17.61%	-4.39%	-1.46%	-0.28%
JPM GBI EM Global Diversified	-0.14%	0.15%	-14.40%	-19.43%	-5.20%	-3.02%	-1.68%
U.S. Equity Indices							
DJ Industrial Average	-3.72%	2.84%	-12.01%	-9.07%	8.33%	9.88%	11.77%
S&P 500	-4.08%	4.77%	-16.14%	-11.23%	12.39%	11.82%	13.08%
NASDAQ Composite (Price)	-4.64%	7.14%	-24.47%	-22.56%	14.06%	12.95%	14.44%
Russell 1000	-3.84%	5.12%	-16.90%	-12.96%	12.14%	11.61%	12.98%
Russell 1000 Growth	-4.66%	6.78%	-23.19%	-19.06%	14.51%	14.78%	15.09%
Russell 1000 Value	-2.98%	3.45%	-9.85%	-6.23%	8.87%	7.86%	10.52%
Russell Mid Cap	-3.14%	6.42%	-16.53%	-14.82%	9.36%	9.17%	11.61%
Russell 2500	-2.66%	7.41%	-16.01%	-15.54%	9.57%	8.54%	10.96%
Russell 2000	-2.05%	8.18%	-17.16%	-17.88%	8.59%	6.95%	10.01%
Russell 2000 Growth	-0.94%	10.15%	-22.29%	-25.26%	5.93%	6.69%	10.16%
Russell 2000 Value	-3.16%	6.21%	-12.17%	-10.18%	10.37%	6.56%	9.49%
Non-U.S. Equity Indices							
MSCI World	-4.14%	3.50%	-17.50%	-14.67%	9.30%	8.41%	10.05%
MSCI ACWI	-3.64%	3.12%	-17.47%	-15.49%	8.54%	7.50%	9.27%
MSCI ACWI Ex-U.S.	-3.19%	0.16%	-18.02%	-19.10%	3.33%	2.15%	4.96%
MSCI EAFE	-4.74%	0.02%	-19.24%	-19.37%	2.87%	2.12%	5.49%
MSCI EAFE Growth	-6.06%	1.39%	-25.60%	-25.54%	2.64%	3.51%	6.43%
MSCI EAFE Value	-3.36%	-1.34%	-12.85%	-13.26%	2.51%	0.32%	4.29%
MSCI Europe	-6.22%	-1.56%	-21.62%	-21.04%	2.80%	1.83%	5.31%
MSCI Japan	-2.55%	3.01%	-17.70%	-18.66%	2.68%	2.33%	6.57%
MSCI AC Asia	-0.90%	0.30%	-17.29%	-20.45%	3.54%	2.04%	6.00%
MSCI EAFE Small Cap	-4.41%	1.92%	-23.01%	-25.64%	3.25%	1.60%	7.44%
MSCI ACWI Ex-U.S. Small Cap	-2.59%	3.08%	-20.31%	-22.15%	5.64%	2.64%	6.59%
MSCI Emerging Markets	0.45%	0.29%	-17.23%	-21.48%	3.10%	0.96%	3.29%
MSCI EM Asia	0.40%	-0.79%	-17.71%	-21.82%	5.03%	2.11%	5.65%
MSCI China	0.23%	-9.24%	-19.39%	-28.07%	-2.06%	-2.20%	4.85%
MSCI EM Eastern Europe	-10.23%	-9.92%	-85.07%	-85.65%	-43.03%	-26.15%	-13.77%
MSCI EM Latin America	2.81%	7.19%	6.83%	-6.57%	-1.10%	-1.32%	-1.26%
MSCI EM Small Cap	2.54%	5.52%	-15.43%	-15.86%	10.52%	3.85%	5.00%
MSCI Frontier Markets	1.85%	3.19%	-17.91%	-16.30%	1.58%	1.39%	5.42%
Hedge Fund Indices							
IQ Hedge Long/Short	-4.38%	-0.52%	-15.14%	-16.12%	2.44%	2.31%	--
IQ Hedge Multi-Strategy	-1.14%	1.03%	-8.29%	-9.46%	0.43%	1.11%	2.22%
Real Assets Indices							
FTSE NAREIT Composite	-5.93%	2.33%	-17.32%	-10.12%	3.80%	6.39%	7.98%
Alerian MLP	3.98%	16.96%	28.70%	33.33%	7.51%	3.67%	1.66%
Bloomberg Commodity	0.09%	4.35%	23.59%	27.72%	17.15%	8.75%	-1.15%
S&P Global Infrastructure	-1.52%	2.43%	1.91%	5.21%	4.89%	4.31%	7.28%
Other							
Oil Price Brent Crude	-9.73%	-13.50%	27.68%	35.28%	18.01%	14.32%	-1.26%
CBOE Market Volitility (VIX)	21.28%	-9.89%	50.23%	56.98%	10.87%	19.56%	4.00%

Source: Morningstar

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