INVESTMENT STRATEGY OUTLOOK

THE ECONOMY

September 2022

The “Things Are Not Always As They Seem” Economy

"Things are not always as they seem; the first appearance deceives many.” Okay, so maybe Phaedrus wasn’t ruminating on the nature of economic data, but it fits nonetheless. Even in the most normal of times, the economic data can send often conflicting and confusing signals on the state of the economy. Since the onset of the pandemic, however, the signals being sent by the economic data have been even harder to decipher. The disruptions stemming from the economy coming to a sudden stop and the distortions caused by what in the U.S. was an extraordinarily aggressive policy response have yet to be fully unwound. One implication is that what for decades were normal seasonal patterns in a wide swath of economic activity have been cast into disarray, such that the headline numbers on a given data release are now often at odds with the underlying details. Clearly, the U.S. economy has slowed under the weight of elevated inflation and rising interest rates. What is far less clear, however, is the extent to which the economy has truly slowed and the likelihood that this slowdown will progress into recession.

The second estimate from the Bureau of Economic Analysis (BEA) showed real GDP contracted at an annual rate of 0.6 percent in Q2, compared to the initial estimate of a 0.9 percent contraction. While some have taken the contractions in real GDP in each of the first two quarters of 2022 as “proof” that the economy is in recession, we’ve been on record with our view that the GDP data have said more about the quirks of GDP accounting than the underlying health of the U.S. economy. For instance, because they grew at a slower pace in Q2 than was the case in Q1, business inventories knocked 1.83 percentage points off the quarterly change in real GDP in Q2. Moreover, the readings on real GDP are at odds with the readings on real Gross Domestic Income (GDI). Real GDI expanded at annual rates of 1.8 percent in Q1 and 1.4 percent in Q2, not great by any stretch, but neither is this a sign of a contracting economy.

In theory, GDP and GDI are measuring the same thing, simply from different vantage points; GDP is an expenditures-based measure of all final goods and services produced in a given period, while GDI measures the income generated in the production of those final goods and services. When the two measures have diverged in the initial estimates, revised data have tended to lean toward where the initial estimate of GDI was, and we won’t be surprised if that is the case this time around. Our premise will be put to the test on September 29, when the BEA releases their annual comprehensive revisions to the recent historical GDP data.

Even if the revised data show real GDP tracking real GDI more closely over 1H 2022 than has thus far been reported, that will still leave a decided disconnect between the GDP data and the employment data. Total nonfarm payrolls increased by 2.663 million jobs over the first half of 2022 as real GDP is reported to have been contracting, but the disconnect is even more pronounced than has appeared. The Bureau of Labor Statistics (BLS) released the preliminary results of its annual benchmark revisions to the data from its monthly establishment survey, the basis of the BLS’s estimates of nonfarm employment. Each year, the establishment survey data are benchmarked to comprehensive counts of employment based on payroll tax returns, which all employers must file, as of the month of March. Based on the preliminary 2022 results, the level of nonfarm employment as of March 2022 will be revised up by 462,300 jobs, equivalent to 0.3 percent of total nonfarm employment and much larger than the average revision (0.1 percent) over the past ten years.

The upward revision is not a surprise. Given how the dynamics of the labor market have shifted since the onset of the pandemic, particularly the meaningfully higher degree of turnover, we’ve suspected the errors associated with the initial estimates of job growth have been larger over recent quarters. Still, while the direction of the revision to nonfarm employment isn’t surprising, the magnitude of the revision is, with one implication being an even larger disparity between the GDP data and the employment data. While the pending revisions to the GDP data may narrow that disparity, they won’t eliminate it.

As the GDP data now stand, nonfarm labor productivity is reported to have declined at annual rates of 7.4 percent in Q1 and 4.1 percent in Q2. With the revised employment data yielding a meaningful upward revision to the estimate of aggregate hours worked, the declines in productivity over 1H 2022 figure to be even larger than first reported, which is hard to fathom. Unless of course you believe that firms were taking on workers at a break-neck pace in order to have them sit idle all day every day. Or, it could be that “quiet quitting” is really a thing and the only people who haven’t caught on to it are the bosses who don’t know their subordinates aren’t really working.

Looming revisions to key data have the potential to re-shape perceptions of the economy’s path over 1H 2022. Then again, it may be that the revised data offer no more clarity than did the initial estimates, particularly since the more recent data have been just as muddled. For instance, a “surge” in labor force participation pushed the unemployment rate up to 3.7 percent in August from 3.5 percent in July despite a sizable increase in employment. A substantial portion of August’s increase in the labor force, however, is no more than seasonal adjustment noise, leaving a much smaller actual increase in the labor force. This is no trivial matter given the extent to which depressed labor force participation remains a drag on job growth and an accelerant to wage growth. While the ISM Manufacturing Index held steady at 52.8 percent in August, the survey details show more industry groups reported declines in new orders and production than reported increases, the takeaway being that the expansion in the factory sector is slower and less broadly based than had been the case. Finally, while lower gasoline prices have led to significantly smaller monthly changes in the Consumer Price Index, the over-the-year change remains above 8.0 percent.

As they attempt to assess the economy’s capacity to absorb further increases in interest rates, FOMC members are trying to process incoming economic data that continue to send decidedly mixed messages. What does seem clear is that, while the economy has slowed, the labor market remains notably robust, with the unemployment rate still well below what many FOMC members would associate with full employment, while inflation remains far above the FOMC’s 2.0 percent target rate. All of which leads us to expect another 75-basis point hike at this month’s FOMC meeting.▲

Source: Bureau of Economic Analysis; Bureau of Labor Statistics; Institute for Supply Management

STOCKS

Central Bankers, Currencies, And Calendar Unkind

Septemberhas historically been a challenging month for equity investors. The S&P 500 has generated an average monthly loss of 1% during the month since 1928 and September also has the distinction of being the only calendar month in which the S&P 500 has closed with a loss more times than it has ended with a gain over that time frame. While the S&P 500’s bounce from mid-June into mid-August was welcome, there was a give back of gains into month-end and this month could be poised to live up to its historical billing. September has proven to be a pitfall-ridden spot in the calendar and may prove to be so again due to tightening monetary policy, a strong U.S. dollar, and negative seasonality effects magnified by equity weakness in late August.

The S&P 500 traded at 18.2 times expected 2022 earnings and 16.8 times projected 2023 earnings as September began after rallying from mid-June into the Fed’s Jackson Hole symposium in late August. Equity valuations now appear ‘full’ given our expectation that the Federal Open Market Committee (FOMC) will stay on course and tighten monetary policy into a weakening U.S. economy as it attempts to decrease demand to match limited supply. Global economic growth should slow due to tighter monetary policy and geopolitical unrest, and we expect U.S. dollar strength to persist, all headwinds for U.S. multinationals. Companies in the S&P 500 may be challenged by a ‘stronger for longer’ U.S. dollar, but our bias toward quality, profitable, free cash flow generating companies returning capital to shareholders leads us back to that index as a port in the storm. Domestic small and mid-cap (SMid) stocks could fare relatively well as beneficiaries of a stronger dollar and have minimal exposure to weaker economies abroad. However, higher interest rates and widening credit spreads will act as hurdles, leaving us with a neutral allocation to SMid as a result.

Commodity prices rolled over in mid-June, leading to optimism surrounding the path forward for equities as, in theory, the FOMC would have the cover to make a dovish pivot in the back-half of ‘22. FOMC Chair Jerome Powell dashed hopes of such a policy shift at Jackson Hole in late August, spurring a sell-off in equities. However, despite rising recession fears, West Texas Intermediate (WTI) crude oil and natural gas prices held up as supply fears dominated. Recession probabilities rising acts as a headwind for commodity prices due to lower projected demand but will be offset to some degree by geopolitical uncertainty. OPEC announced a symbolic 100k barrel per day supply ‘cut’ in early September, showing a commitment to support prices, while civil unrest in Iraq/Libya and talks between the U.S. and Iran stalling could lead to ongoing supply worries and price volatility. Fears of commodity shortages should persist alongside geopolitical uncertainty, a backdrop that leads us to a constructive outlook on real assets and companies levered to sustained higher prices for energy and agricultural commodities.

Higher energy and electricity prices are weighing on the euro area and are likely to lead to economic pain throughout the balance of this year and well into 2023 as businesses close and unemployment rises. These issues could be compounded by the European Central bank (ECB) entertaining the idea of a

75-basis point hike to key deposit rates later this month as Eurozone inflation data remains worrisome. As the energy/electricity situation remains tenuous, government support/bailouts appear to be a likely path forward, which is an expensive short-term solution likely to generate additional weakness in the euro. The European Union (EU) could still balk at following through on harsh sanctions against Russia to get the natural gas spigot turned back on, avoiding the worst-case scenario, but Russia would likely only do so with 'expensive' stipulations. In-fighting and political dysfunction are the norm in Europe, and an underweight to international - developed market stocks is warranted as a rough winter likely lies ahead for Europe's economy and Eurozone equities.

A skew toward the U.S. within equity portfolios will likely be rewarded over coming quarters as developed and emerging markets abroad face even more substantial headwinds, with few easy fixes. Europe's struggles have been well documented, but Japan is dealing with yields on Japanese Government Bonds sitting at uncomfortably high levels for the Bank of Japan (BoJ), forcing them to print yen to buy bonds as they implement yield curve control. Rolling lockdowns continue in China, pressuring global supply chains and pushing prices for goods higher, weighing on consumer confidence and contributing to a sense of global economic angst. The wall of worry global equities are scaling is likely to grow taller leading up to mid-term elections in the U.S. and a defensive posture remains warranted ▲

BONDS

Higher Yields A Global Phenomenon

The U.S. Treasury yield curve shifted higher during August, driven by forces at home and abroad. Stateside, FOMC members were out in full force early in the month, making a coordinated effort to push back on a potential dovish pivot, a narrative that made the rounds in the wake of the Committee's late-July meeting. Bond investors initially doubted the FOMC's inflation fighting resolve but were forced to buy in after FOMC Chair Jerome Powell's decidedly hawkish, pointed, and carefully worded speech at the Fed's Jackson Hole symposium on August 26. The 2-year Treasury yield jumped 56 basis points during the month to close at 3.45% while the 10-year yield rose 48 basis points to 3.15%, leaving the yield curve still inverted as the market took the FOMC at its word that it would inflict economic pain and accept a recession to curb demand and tamp down inflationary pressures.

Post-Jackson Hole Fed funds futures shifted from a coin-flip between 50 and 75 to pricing in a 70% chance of a 75-basis point hike in September. With balance sheet runoff ramping up from $47.5B per month to $95B this month, some Committee members could push for a more measured half-point hike, but our base case calls for another 75-basis point hike mid- month. Volatility in the rates market is likely to persist as market participants adjust to the Fed running down its balance sheet in a more aggressive manner, which, when combined with slowing economic growth, should lead to higher yields/wider credit spreads for most segments of the fixed income market over coming quarters.

Warm weather generated greater demand for electricity in the Eurozone in August, leading to a price spike as fears of natural gas shortages into the winter months grew. Higher energy and electricity prices put upward pressure on Eurozone inflation and euro area sovereign bond yields, and business closures, layoffs, and loan defaults are likely to follow. Coming quarters will pose a challenge to the EU's united front related to Russian sanctions as the gulf between the haves and the have nots at the country level within the euro area widens. Upward pressure on euro area sovereign yields is likely to persist as the European Central Bank (ECB) tightens monetary policy, potentially much more aggressively due to high inflation, as recession/stagflation fears remain and concerns surrounding a sovereign debt crisis build.

Issuance of corporate bonds often picks up in September as CFOs try to front-run potentially sluggish demand in the 4th quarter of the year. Supply of high yield corporate bonds could accelerate in a big way this month as high yield issuance year-to-date through July came in at just $80.6B, well short of the $328.3B issued in the first six months of 2021. We remain neutral on high yield bonds as we expect defaults to remain relatively low into '23. Security selection will be of paramount importance, benefitting active managers relative to index-linked exposures as credit spreads should widen as global economic growth slows and monetary policy tightens, reducing liquidity and risk appetite.

We maintain an underweight to international fixed income but maintain an exposure to U.S. dollar denominated emerging market debt as we see significant opportunity in the asset class over the intermediate term, despite facing near-term pressures from a stronger U.S. dollar, elevated commodity prices, and a global economic slowdown. We recommend a portfolio duration in-line with that of the Bloomberg Aggregate Bond index and favor U.S. Treasuries and short duration investment-grade corporate bonds as we expect volatility in the rates market to be with us for quarters to come. ▲

Source: SIFMA

ALTERNATIVES

Tailwinds From Rising Interest Rates, Volatility

Liquid alternatives, broadly speaking, fared well on both an absolute and relative basis during August. The HFRX Global Hedge Fund Index, a representation of broad exposure to liquid alternative strategies, turned out a 0.9% monthly gain and is now lower by 3.6% year-to-date, easily outpacing the S&P 500 and Bloomberg U.S. Aggregate Bond Index during the month and year-to-date. August was a particularly good month for event driven strategies and trend following managed futures, both areas we continue to allocate to within our Diversified Strategies portfolios.

The HFRX Merger Arbitrage Index rose just shy of 1.4% during the month, while the HFRX Macro: Systematic Diversified CTA Index rebounded from a weak July, returning almost 3.2%. Both merger arbitrage and managed futures receive tailwinds from a rising fed funds rate as a higher risk-free interest rate boosts the collateral return component for managed futures strategies, and merger arbitrage strategies benefit from wider deal spreads as a higher risk-free rate leads investors to require a larger premium or required return to take on the risk of a merger or acquisition failing to close.

Amid a backdrop of elevated economic and geopolitical uncertainty, we expect volatility to persist over coming quarters, potentially benefitting trend following managed futures strategies as well as global macro managers, specifically. Both strategies tend to fare best during periods of rising volatility as a broader opportunity set allows them to quickly shift to take advantage of dislocations across global stocks, bonds, currencies, and commodity markets.

A challenging backdrop for investors in stocks and bonds is likely to persist over coming quarters and heightened volatility should drive dislocations and present opportunities for more flexible/nimble managers along the way. Additional portfolio diversification is likely to remain beneficial for portfolios of long-only stocks and bonds by 'smoothing out the ride' in the environment we expect. ▲

Source: Hedge Fund Research (HFR)

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