Quarterly Allocation Viewpoints

PATHSTONE
THE MODERN FAMILY OFFICE™

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After a historically difficult start to the year, markets have rebounded in the summer months. While it seems some optimism has returned, the economic picture is evolving rapidly. In this quarterly piece, Pathstone's Managing Director of Strategy, John Workman, reflects on the macroeconomic picture and what that means for bottom-up portfolio construction.

The Macro Picture

Consumers have continued their discretionary spending this summer despite higher rents, food, and energy prices. This robust consumption, however, has not been enough to generate positive U.S. real GDP growth in the first half of 2022. The U.S. has now printed back-to-back quarters of negative real GDP and continues to face stiff headwinds as central banks fight vigorously to reduce persistent high inflation worldwide. Savings built up during the pandemic and growing wages have supported higher spending levels, but incoming data suggests this strength may be waning. Meanwhile, from a global perspective, Europeans are facing significantly higher energy costs than the U.S., Japan is struggling to generate growth, and China is facing some significant issues domestically as the housing market threatens an already challenging economic situation resulting from COVID-lockdowns and supply-chain disruptions.

The U.S. Federal Reserve has hiked interest rates 225 basis points in its last four meetings dating back to March in a concerted effort to stifle inflation. While it is still unclear whether inflation may be near its peak, we have seen forward-looking inflation expectations come down from their previous highs. The inflation we have experienced is not just a result of excess demand but also attributable to supply chain disruptions that originated with the COVID pandemic. The concern of many today is that we may be closer to the end of the business cycle, and higher interest rates may expedite pushing us into a recession. Given the risks to corporate profits, we believe that we face an asymmetric return landscape for equities where downside risk outweighs upside potential.

The European economy seems to be at greater risk, particularly because of the threats to its energy supply resulting from the Russian invasion of Ukraine. European equity prices seem to be pricing that risk to some extent, trading at valuations meaningfully below historical averages. A weak Euro offers some respite as their exports become more attractive to outside buyers, and travel to Europe remains relatively affordable. The European Central Bank (ECB) increased its primary refinancing rate from 0.0% to 0.50% in July but is treading carefully as fears that Southern European countries may see their borrowing costs jump if not well-managed/supported by the ECB. The Japanese central bank (BOJ) has elected to let the value of the Yen slide instead of pushing interest rates higher. They have chosen not to risk straining their economic recovery with higher interest rates at this point. Non-U.S. consumers may be in less of a position to support the global economy compared to their American counterparts, who still sit on meaningful savings built up during the pandemic.

One of the most considerable strains on Emerging economies today is the strength of the U.S. dollar. For those countries and companies in Emerging Markets that have borrowed in USD, they face a more challenging road ahead in terms of repaying those loans. In addition, the Chinese economy, critical for the Asia region's economic growth, has continued to stumble this year, falling far short of its growth targets and facing mounting challenges in a year when President Xi faces an election in November. Inflation is a particular concern for emerging economies, where food and energy costs comprise a more significant percentage of spending. Emerging Markets equities, like Developed non-U.S., are priced at Price-to-Earnings multiples below their historical averages, suggesting that some of this bad news may be baked in already.

What would cause our cautious outlook to change? We are seeing evidence of consumer price stability and, therefore, a peak or at least a significant slowdown in the pace of interest rate hikes balanced against sustainable consumption patterns. Alternatively, we could see equity valuations come down to levels that provide greater symmetry between upside and downside potential.

The Micro (Bottom-up) Picture

In light of the economic picture, we have adjusted our recessionary forecast from a 50% probability one month ago to a 60% probability today. Our assessment notes that consumers were generally in good financial shape coming into 2022 but face significant headwinds from inflation and rising interest rates. Likewise, corporations were in quite good shape, but now face wage pressures and higher input costs which should begin to weigh on corporate profits. We also recognize that whether we go into a recession or not, the near-term path for interest rates is higher. As a result, we do not see much benefit to taking duration risk with relatively low interest rates and a mostly flat yield curve.

We have made several shifts over multiple quarters to become more defensive in portfolios. In recognition of the increased risk of recession, we suggest that investors review their portfolios and take advantage of the recent run-up in equities to position accordingly. Within equities, we continue to remain biased towards value stocks versus growth, large caps versus small caps, and short-duration versus intermediate-term investment grade fixed income and credit risk alternatives.

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