Tactical Allocation Viewpoints

PATHSTONE
THE MODERNFAMILY OFFICE™

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The Macro Picture

After a 125-basis point increase to the Fed Funds rate in Q2, the Federal Open Market Committee (FOMC) continued its rapid pace of interest rate hikes with 150-basis points more in Q3. On November 2, the Fed delivered another 75-basis point increase in Fed Funds. The market expects a slightly higher probability of a 50 vs 75-basis point hike in December.

The Fed and Central Banks in Europe have all made it clear that taming inflation is their top priority, despite concerns that recession risks abound! The Russian invasion of Ukraine continues to disrupt global energy and agricultural markets while Chinese efforts to mitigate COVID remains a drag on their domestic economy and the global flow of goods. These factors combined with a shortage of workers in the U.S. has led to wage increases that are also adding to inflation. How did the markets react in the third quarter? After rallying in the first half of the quarter, equities soured in the second half, ending lower. Commodities were broadly lower for the quarter led by oil prices and a six percent rally in the US Dollar. Global equity markets excluding China once again rallied in October as volatility remained at elevated levels.

Adjusting to a starker near-term reality?

Has the Fed shown us its cards finally? With its September announcement have they finally told us how far they must go? Inflation is still high on a year-over-year basis, but most signs point to it coming down in real time. We are starting to see the impacts of the Fed's policies as consumers and corporations take a more cautious stance. The Fed has warned us that a recession is coming. Are we still holding onto some hope of a soft (non-recessionary) landing? Fixed income and equity markets both signal that investors may still be holding onto some hope of an economic soft-landing, but not by much.

We have not seen Fed policy impacts flow through to corporate earnings just yet, but we have seen some early warning signs. Capital is more expensive; it is harder to come by. Labor supply is not sufficient to fill all the jobs, therefore wages continue to move higher. Input prices remain a challenge as well. All these factors are likely to be headwinds to corporate earnings. Likewise, rising interest rates have led to compression in Price-to-Earnings ("P/E") multiples.

Challenges persist, but the future may be clearer today as equity and bonds markets adjust to a starker reality. It seems that expectations of market participants are much more aligned with the path the Fed has laid out for interest rates. While the Fed's outlook delivered in September showed a Fed funds terminal rate for this cycle in the 4.6% range, markets and now Chairman Powell, confirmed that the level of interest rates necessary to achieve their dual goals around employment and inflation are likely higher than that, suggesting a terminal Fed Funds rate of perhaps 5% or more.

Europe struggling along. The European economy is in the doldrums and equity valuations seem to reflect the anticipation of a recession, with trailing P/E multiples in the low double digits and forward P/Es below 10x in many instances. The cost of energy, hit hard by the Russian invasion and subsequent sanctions, is weighing heavily on households and industry throughout Europe. On a forward-looking basis, Europe is going to be forced to address its future energy needs sooner rather than later and from a global trade perspective should benefit from a significantly weakened Euro. At some point, these become the tailwinds to the next rally. Political stability is always a wildcard as wavering economic environments always seem to invite calls for the break-up of the EU (European Union). The war may give the European people a reason to band together this time around.

Emerging market headwinds. US Dollar strength continues to be a major headwind for Emerging economies. China is the biggest component of the Emerging Markets, and it continues to suffer through a real estate fiasco, not to mention the impact that COVID-related measures have had on the economy. Relations with the U.S. remain chilly leading to more questions of "deglobalization." That may offer a glimmer of hope for Central and South America that could find itself one of several potential beneficiaries of a retooling of the global supply chains. What are headwinds today could flip in the future. China may find itself in a position to recover from its economic slowdown sooner than the rest of the world if it continues to benefit from discounted Russian energy and can find its way past COVID.

Ongoing negative signals. Our Market Cycle Dashboard remains in negative territory, having deteriorated further with the October data. This marks the fifth consecutive month of negative dashboard readings. The recent Fed forecast for interest rates, employment and GDP suggest the probability of a recession continues to climb. Investors will be left trying to guess how low markets can go in the short-term versus playing the long game, where outcomes look more attractive given lower valuations.

The Micro (Bottom-up) Picture

We have been advising clients in recent quarters to position portfolios more conservatively as concerns have grown.

Equities

We continue to recommend underweighting equities relative to traditional fixed income assets. Within equities we are biased towards large companies versus small as we believe large companies will be better positioned to navigate economic stress. We are also tilted toward value stocks where valuations remain more reasonable. We favor actively managed strategies in this environment, especially in areas like U.S small cap and international equities where inefficiencies remain, and the macro picture should create dispersion in outcomes.

Hedge funds may also be well positioned to navigate this market as they are able to modify exposure to the market more dynamically and invest in unique strategies not generally available to conventional portfolio managers.

Fixed Income

We continue to recommend conservative positioning in fixed income. We see value in the safety and optionality of cash and short-duration investment grade fixed income. The Fed has raised interest rates by 300 basis points in 2022, causing the yield curve to flatten as it has shifted higher. In fact, parts of the yield curve are inverted, meaning that yields are higher at the short-end versus the long-end. While we have been incrementally more conservative in our positioning over the last two years, we anticipate that we may be nearing the end of the Fed tightening cycle. This means we will be closely monitoring the opportunity set for when it may make sense to extend duration by rebuilding the core fixed income position and reduce cash and short duration bonds.

Private Markets

While we still have not seen recessionary levels for Earnings or GDP, listed equity and bond prices have adjusted significantly to reflect the greater headwinds. **Private market valuations are just beginning to adjust** with venture capital seeing the most significant change year to date. We expect the pace of distributions from mature funds to slow given the market environment but continue to recommend clients stay disciplined to their pacing programs to maintain vintage year diversification while keeping an eye on liquidity budgets.

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