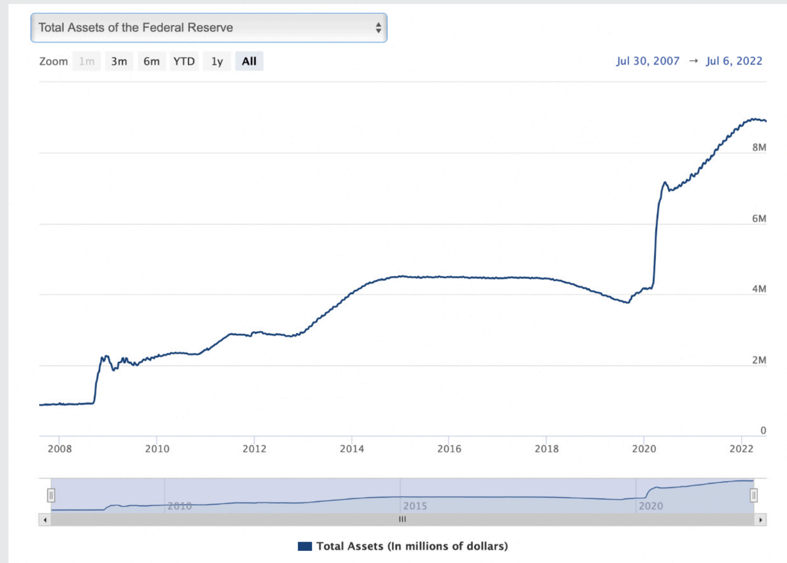
# Newsletter and Capital Markets Review

## Second Quarter 2022

Q2 of 2022 came to a close, ending a poor first half for US markets not seen since 1970. The difference this time may be there is little that would give reason to believe we will experience a second half rally like the market enjoyed in '70. The headwinds are entrenched. For now.

The growth in the US money supply is decelerating rapidly, which is problematic for the economy and capital markets. To be absolutely clear, the money supply itself is not shrinking – the rate of growth is. It is no secret that the US Federal Reserve is reining in liquidity by raising policy rates and decreasing the size of its $8.9 trillion balance sheet. Pre-pandemic, the Fed's balance sheet was $4.2 trillion, less than half the current level. The reason why this is important is the Fed has largely been responsible for the explosive growth in the money supply over the past two years, which peaked at an annual pace of 26.9% in February 2021. To place that in context, the 30-year average annual growth rate of M2 is 6.4% while the current pace as of May 31st is 6.5%. But, examine the included chart. Barring the extraordinary, the current trace will crash right through the long term trend and keep going.




The 30-year average nominal US GDP growth is 4.6% according to the US Bureau of Economic Analysis. Over the long-term, M2 grows faster than nominal GDP in order to bolster economic activity, and when it slows, so does the economy. The level of M2 peaked at the end of March at $21,809 trillion, and has only grown 1.26% year-to-date. Given the receding liquidity in the US economy, it is no wonder why Q1 2022 was an anemic -1.6% (and revised down). What is critically important to us is that the Fed has been the most dominant force in money supply growth in this cycle. In more normal times, banks create money from their deposit bases, but this has been overwhelmed by the Fed's quantitative easing programs. And so, navigating the path back to normal involves the Fed stepping back to its more traditional role.

It is difficult to envision a scenario wherein the Fed engineers a "soft landing" while simultaneously reining in 40-year high levels of inflation and supporting economy and employment. GDP growth for the first half of 2022 will be reported on July 31st and we would not be surprised if another weak reading confirms that we are in a recession. Even so, the Fed has little choice but to maintain a less-than-dovish monetary stance given current inflationary trends here and abroad.

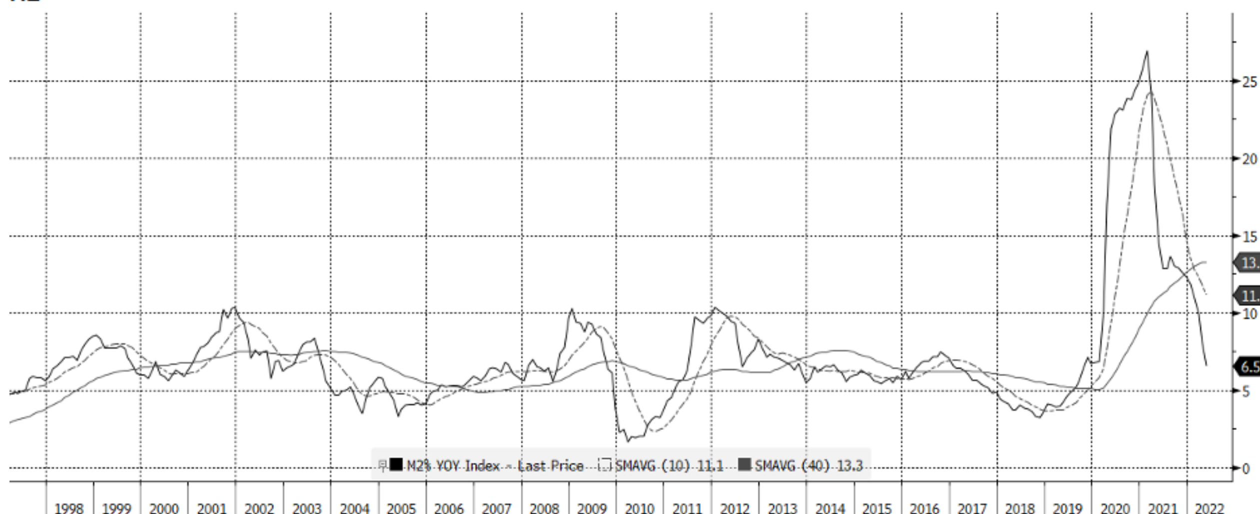
Against this backdrop we remain extremely cautious regarding risk assets and are currently holding much higher cash levels than normal.

***[Chart from Federal Reserve System as of July 6, 2022]***

***From the Board of Governors of the Federal Reserve System:***

*M1 consists of (1) currency outside the U.S. Treasury, Federal Reserve Banks, and the vaults of depository institutions; (2) demand deposits at commercial banks (excluding those amounts held by depository institutions, the U.S. government, and foreign banks and official institutions) less cash items in the process of collection and Federal Reserve float; and (3) other liquid deposits, consisting of other checkable deposits (or OCDs, which comprise negotiable order of withdrawal, or NOW, and automatic transfer service, or ATS, accounts at depository institutions, share draft accounts at credit unions, and demand deposits at thrift institutions) and savings deposits (including money market deposit accounts). Seasonally adjusted M1 is constructed by summing currency, demand deposits, and other liquid deposits, each seasonally adjusted separately.*

*M2 consists of M1 plus (1) small-denomination time deposits (time deposits in amounts of less than $100,000) less individual retirement account (IRA) and Keogh balances at depository institutions; and (2) balances in retail money market funds (MMFs) less IRA and Keogh balances at MMFs. Seasonally adjusted M2 is constructed by summing small-denomination time deposits and retail MMFs, each seasonally adjusted separately, and adding the result to seasonally adjusted M1.*




*[chart and data courtesy S&P, Bloomberg LP © 2022]*

**Portfolio Positioning**

Earlier in the first half of the year, we took steps to reduce our exposure to equity risk as the capital markets digested their nearly unprecedented run- up since the pandemic nadir in March of 2020. Our feeling has been that signals of transient inflation are becoming more systemic and, combined with a regime change from the Federal Reserve from stimulating to tightening, the short-term prospects for equities are less attractive. Since that time markets took a brief respite and even rallied a bit before continuing to grind and sometimes lurch lower. We subsequently took a further incremental step away from equities in both US and foreign markets as we look for the catalyst that will define the bottom of this downward trajectory, the recent bear market rally in US equities notwithstanding. Within our ETF models, we made the shift primarily in US large cap growth and in Developed Europe equities, and in our ESG models through core and growth-biased large cap equities and broad international equities. All proceeeds were committed to cash and cash equivalents for the moment.This further reinforces our underweight allocation to equities overall as well as keeping a modest underweight in fixed income, with cash now even more overweight. Within global equities, we materially lowered US exposure, kept an underweight in Emerging Markets, and established an underweight with respect to Eurozone stocks while continuing an underweight in Japan. Within fixed income, we are overweight in the US with a preference for mortgages and investment grade corporate credit. We have little to no exposure to non-US fixed income except through Green Bonds in our ESG series portfolios. All portfolios holding fixed income maintain lower duration than the benchmark.

**Risk Outlook**

- **Inflation –** What once was episodic is being reinforced by ongoing and new challenges turning small concentrations of inflation into a system-wide problem in the US and abroad. Price rises are becoming more prevalent across global economies, and the Russia-Ukraine conflict just adds insult to injury as energy markets ran up to levels not seen since the bubble preceding the Financial Crisis. In many regards it is surprising, maybe even astonishing, that inflation has not been more of a concern for years now. We are more than a decade in to post-Crisis easy monetary policy and a booming stock market only briefly interrupted by the pandemic and now inflation, the Fed and the Russia-Ukraine conflict. The coordinated government response to the economic damage of the pandemic was massive. Had all of that stimulus settled into the "real" economy, inflation would be on a tear. We observe that the capital markets have served as a pressure relief valve, with stimulus settling out of the real economy and into the markets inflating asset prices. Correlation does not equal causation, but there seems to be a relationship of some sort between the magnitude of the stimulus and the increase in aggregate value in just the public markets. The challenge now is distinguishing between inflationary hotspots with very clear causal links and pathways to resolution, and more systemic inflation with no focused direct causes and therefore no clear tools for fixing. We have seen spikes in prices of building materials and scarcity of new cars for purchase as examples. But, while we cannot discount those observations entirely, we principally see them as graphic examples of how interdependent world economies and supply chains are and how fragile they were with just-in-time inventory management. While investors have extolled just-in-time since Toyota popularized it, it introduced an inelasticity into global supply chains that was not capable of absorbing the blow of COVID. We liken this to everyone on the highway cruising at 70 Mph riding bumber-to-bumper and doorhandle-to-doorhandle. It works fine until somebody swerves or stamps on their brakes. This was further exacerbated by climate-related issues, international conflict, and ongoing concentrated lockdowns in China. The results were issues such as a microchip shortage affecting the ability of factories to finish automobiles for delivery. We believe as major parts of the global economy get back in order that the current focused situations like cars, appliances, chips and building supplies will self-correct, but by then it may be too late as inflation becomes widespread and entrenched. The global sanctions regime surrounding Russia will also play in, challenging energy markets and holders of Russia debt, which will almost certainly add volatility to the inflation situation. In the meantime, as investors and market watchers, we are looking at the confluence of business practices that are not sustainable, resilient or adaptive and externalities like global health, territorial conflict and climate change which can and will disrupt businesses and markets again.

- **Rates –** The Fed has been increasingly aggressive at raising rates to try to choke off inflation, but the long term path is not entirely certain given competing forces like energy prices, an emerging rent crisis, and war. Even a slight normalization of the rate environment has had historic effects in fixed income markets, severely dragging down assets like 30-year Treasury Bonds which are normally seen as safe harbors from risk. Global financial instability may actually moderate that some as the US T Bond is the world's mattress for protecting personal, sovereign and corporate wealth, which will pin down rates to some degree. Wall Street has been cautioning about the risk of rising rates since the end of the Financial Crisis in 2009, but we have yet to actually have to live with those risks because a slow grind recovery followed by a series of crises including COVID have conspired to hold central bank policy where it has been – accommodative. We can observe that rising rates, which are now upon us, are not welcome in markets that have enjoyed easy money for more than a decade now. This compels us to think about risk in globally diversified portfolios differently, where the traditionally more conservative parts of asset allocations may actually represent more material risk in the nearer term.



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**Risk Outlook [cont'd]**

- **The National Balance Sheet** – Continuing on the related themes of inflation and rates, the Federal Reserve has started winding down the extraordinary measures they have been taking through asset purchases. That has a couple implications – one is telling the markets that the training wheels can come off. The Fed feels like their additional help is no longer as needed. That is positive in tone which should be good for market sentiment, but offset by the disappointment of losing a major bond investor. This does mean a more orderly bond market where institutional investors are not competing with the government for bond inventory. Again, this is good, but it also means less liquidity. This is a slow turn of the battleship of state. They are not really shrinking the balance sheet. Just growing it less fast, so most of the market reaction will be sentiment-driven rather than based on real stresses from lower liquidity.

**Figure 1. Federal Reserve Balance Sheet**

**Source:** Federal Reserve.

- **COVID-19** – We are now looking at the global transition of SARS CoV-2 and COVID-19 from pandemic to endemic, and what that means for progress and prosperity in developed and developing economies. Vaccine deployment continues and close on its heels the promise of new therapies in pill form that may make addressing severe illness as simple for COVID as Tamiflu does for influenza. New strains of the virus are challenging the efficacy of those vaccines, but after two years the world has become more adaptive to the challenge and the need to hit the "off switch" on the world economy is far less than the early stages when the virus represented all danger with no defense. As we have previously expressed, the global community remains vulnerable to a have/have-not dichotomy based on access to virus-fighting resources. Indications are that pricing will be calibrated according to economic capacity, which is a promising development that may help to reduce the gap between developed and developing nations in the same way COVAX is working to do so through access to vaccinations.

- **China and Russia** – One of our long-term risk themes continues to be our focus on Chinese Communist Party actions which have not materially shifted for the better in the COVID era. From aggression in the Asia-Pacific region to military tension along the border with India to suppression of Hong Kong citizens' rights and the interests of the Uighur population and the lack of contrition for their early role in failing to stop COVID-19 in its tracks, all may contribute to China-directed backlash or retaliation. There does seem to be regional coherency in the response as nearly all Pacific nations have aligned with the US against Chinese aggression. From lack of respect for intellectual property rights to involvement in global criminal drug trafficking to financial crimes and human rights abuses bordering on genocide, the country is finding it harder to get the global community to look the other way. We view this as a risk to investment in China and investment in companies reliant on a Chinese supply chain, but likely bullish for other parts of the Asia Pacific interested in usurping China's role as the manufacturing floor for the world. Meanwhile Russia continues to operate from other pages in the same playbook, manipulating natural gas markets in Europe and staging a full invasion of the sovereign nation of Ukraine. This is disrupting agricultural markets and steel markets as the invasion interrupts Ukraine's ability to produce and provide agricultural and industrial products, and the global sanctions against Russia in response severely limit their own access to markets, effectively taking two consequential producers out of global markets. North America is food-independent, but because of the interconnectedness of global commodity markets, this kind of disruption is compounding inflationary pressures in food.

## ESG Considerations

### *The ESG Performance Advantage?*

While ESG under its various guises has been a presence in the market for roughly four decades, the dramatic uptick in adoption really covers less than ten years. That is important because it is ten years that have been marked by markets that, with only brief interruptions, pushed steadily higher. There is a hypothesis around ESG investing that the intense attention paid to quality and to risks not captured in traditional securities analysis would buffer ESG portfolios from severe adverse outcomes, but that hypothesis had not been severely tested since the current broad-based adoption of this type of portfolio management. The challenge with a sweeping generalization like this, however intuitive it may feel, is that it is non-specific as to time frame. It is also naïve to the many other factors that drive security and portfolio performance that can swamp these considerations, particularly over shorter time periods.

When we look at the many factors driving down market performance in the last six months, what we see is that most of them are not going to treat ESG investments any differently. Last newsletter we outlined our ***dirty dozen factors*** that were beating down markets:

1. *Inflation – Energy, Commodities, Housing*
2. *Reduction in monetary expansion*
3. *Rising interest rates*
4. *Widening US High Yield interest rate spreads*
5. *Full, although declining, equity market valuations*
6. *Corporate earnings are still growing but the pace is slowing*
7. *Negative real wage growth*
8. *Consumer sentiment – lowest since August 2011*
9. *Supply chain issues*
10. *Slowing home sales*
11. *Waning fiscal stimulus*
12. *Geopolitical flash points*

Many of these forces definitely have ESG consequences. Almost all of them are going to exacerbate wealth inequality and threaten the most economically marginalized. Almost all of them are going to pull the focus away from ESG priorities like addressing global climate change. With the possible exception of #1 – Inflation, almost all of them are not going to impact ESG-forward investments differently though. In fact, even incremental advantages that have been gained like a slight benefit in the cost of capital to a company or a municipality borrowing for green purposes are going to be overwhelmed by inflation and changes in rates that are many times the magnitude of those advantages.

Inflation, particularly energy inflation, might be the possible exception. But, how energy inflation plays out is a mixed bag for ESG. For sure, oil doubling and tripling in price and carrying with it the cost of every downstream derivative from fuel to plastics to fertilizers demonstrates how important renewable energy and non-petrochemical materials are to resilient economies. But, in the near term, traditional “dirty” carbon companies are benefiting, which is the flip side of how badly they suffered in Spring of 2020 when there was no bid for oil in the early stages of the pandemic. Most ESG portfolios are at least underweight carbon, so they do not benefit from an integrated oil company’s price climb. There is an adjacency effect, however. As the cost of producing energy at the burner tip goes up, the attractiveness of alternatives also climbs so renewables companies get pulled along for the ride. So, on the one hand an underweight in petroleum and related industries hurts ESG portfolios, but an overweight to renewables and supporting technologies helps. Beyond that, most of the rest of the investments in a typical ESG portfolio are going to be affected similarly to the broader market when inflation is on the march. The cost of inputs has gone up along with the cost of transportation and of course the cost of capital.

One of the performance advantages a number of ESG strategies have carried in the long grind higher has been their progressive bent. This is not meant in the political sense but in the innovation and evolution sense. ESG security selection will very often favor companies that lean in to growth, investing in research and development, creating new products, exploring new markets, and exploiting new technologies, and will similarly avoid legacy challenges in older and dirtier industries that just chug along doing their thing. This past decade has been marked by a massive run in technology, telecommunications, biosciences, and logistics, and ESG strategies have benefited. These industries are also the ones that got taken out to the woodshed for the most severe beatings in the first six months of 2022 when we saw the NASDAQ recede 30%.

**ESG Considerations [cont'd]**

***What are reasonable expectations?***

Our thesis has always been, and continues to be, that the right set of expectations for ESG investing are **market-like returns with market-like risks over full market cycles**. During shorter intervals, the biases that emerge in ESG portfolios, as they do with any active management strategy that differentiates itself from the broad market, will drive differences in performance, both good and bad. Those differences will tend to wash out over longer intervals, and when comparing like for like, ESG and non-ESG strategies will end up in roughly the same place.

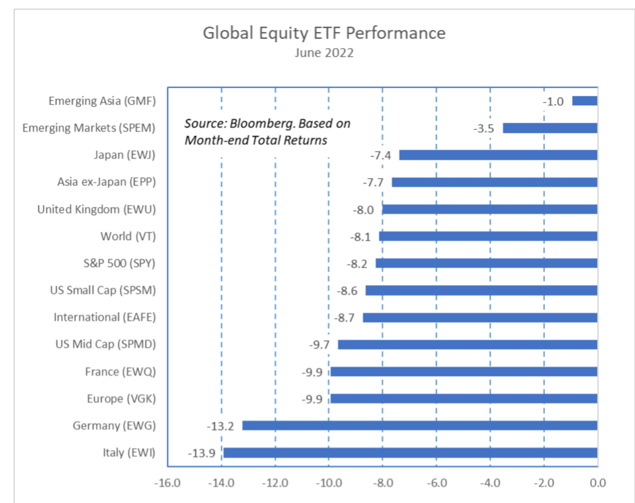
But, and this is a big but, over even longer periods of time we believe the advantages of ESG investing will manifest in terms of both risk and return. Many of the environmental, social and governance-related factors unfold over years and even decades. That aligns well with our patient capital approach to investing. The risks and the opportunities are material, but we seem them as systems-level and deeply structural. Yes, there are absolutely quality and other considerations that can and do emerge in the shorter term like oil companies with exploding offshore rigs that impact portfolio outcomes, but those effects tend to be muted through diversification. When we look across portfolios and markets over long periods though, that is when we see fundamental shifts like industrial decarbonization and regenerative agriculture impacting entire industries, sectors, and markets and not just individual companies.

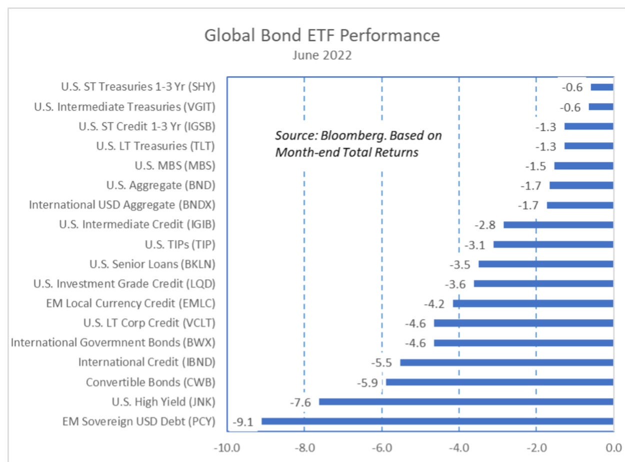
# Q2 2022 Capital Market Review

The WCM “dirty dozen” factors pressing down on markets remain in full effect, and we are observing similar patterns emerging around the world. Europe is under particular pressure because they are contending with armed conflict on the NATO frontier and tit-for-tat sanctions that are disrupting access to Russian energy on top of similar supply chain, housing, labor and other challenges. Traditional diversification in liquid assets has not favored balanced portfolios, with bonds continuing to draw down alongside equities. The quarter saw several brief bear market rallies, but the overall trajectory remained downward to deliver the worst opening six months for listed markets in almost 50 years.

### Equity Markets

Industrial Europe took it on the chin to finish the quarter, feeling the full weight of the Russia-Ukraine conflict in several regards, from industrial supply to the cost of energy and the global sanctions regime against Russia. The economic situation is so dire that Italy’s government is teetering on the edge of collapse and Mario Draghi has already offered his resignation. Germany and Italy turned in the worst performances for developed Europe and led our selection of global markets on the downside at more than 13% each. Curiously, emerging markets, particularly emerging Asia did relatively OK, booking negative returns but outperforming their developed market counterparts by hundreds and in a couple cases more than a thousand basis points. US markets were on track to finish worse than they did, but a late-quarter rally, even partially fizzling out at the end, saved results from the mid-month trough.




### Bond Markets

If there was any good news in the bond market for the month, it was that the spread of returns looked like it should. Uniformly terrible, but the riskiest assets, like EM sovereign debt and US junk bonds, performed the worst and the most conservative assets like short and intermediate Treasuries held up the best. Other asset types with a stronger relationship to equities also were hurt, including Convertible bonds. And, unlike the resiliency of emerging market equity, EM sovereign debt (US dollar denominated) turned in the worst performance of the group. In general the strength of the US dollar against global currencies has amplified the challenges with non-US bonds for US-based investors as the low coupons are swamped by currency effects and then further aggravated by rising rates.

*The returns cited reflect total return performance of exchange traded funds listed in the corresponding bar charts*

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