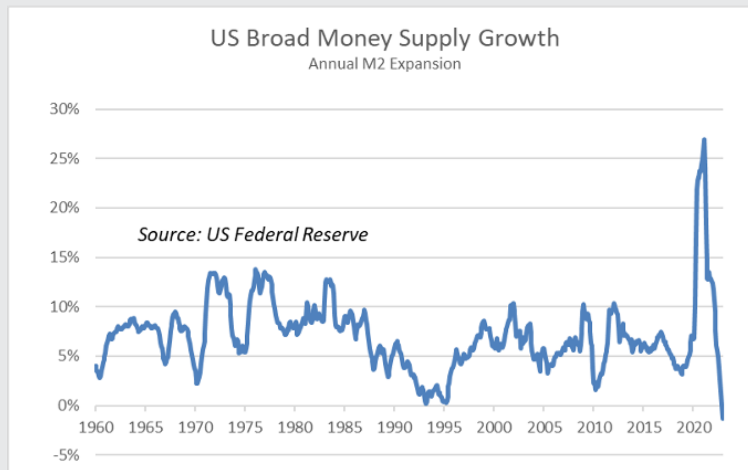
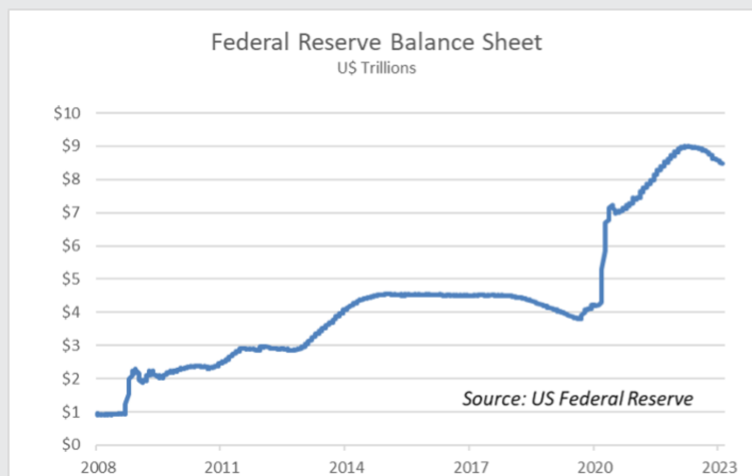
Newsletter and Capital Markets Review

January 2023

The annual growth rate of the US broad money supply (M2) as of December 31, 2022 contracted for the first time since Fed records began in January of 1959 and yet the US stock market posted one of its strongest January returns in several years. Market participants appear to be looking past the Fed's most recent rate hike decision and the central bank's posture, supported by comments that they intend to maintain tighter monetary conditions for the foreseeable future. Some are hoping that the end of the tightening cycle is approaching, yet the data suggests that the Fed could be understating inflationary forces and therefore those rays of hope may be at best premature.





It has been nearly three years since the onset of the pandemic, and growth in M2 resulting from monetary and fiscal programs through the end of last year was nearly 14% annualized. The cumulative effect is more astounding -- 40% in total over that period. The explosive growth in the money supply dwarfs the pre-pandemic average annual rate of 7.4% calculated on data back to 1959. US money printing was the highest ever during the throes of the pandemic, growing over 20% annualized from May 2020 to the end of March 2021. M2 growth never surpassed 15% annually even during the energy crisis and high inflation era of the 1970s. With this past year's modest contraction, there are still simply too many dollars in the system chasing too few goods, inflationary pressure that could persist for some time.

Meanwhile, the Fed continues to shrink its bloated balance sheet, which swelled by nearly $5 trillion in response to the pandemic to more than double pre-pandemic levels. The Fed is unlikely to deviate from its plan to let approximately $1 trillion per year roll off the balance sheet in an attempt to drain excess stimulus liquidity from the system. Chairman Powell has stated that every $1 trillion of balance sheet contraction is the equivalent of 25 basis points in higher fed funds target rates. Given Powell's comment, the effect and length of the tightening cycle is sobering and could take years of tighter policy to return to "normal" whatever that is nowadays. Changing course would likely add to inflationary pressures in the economy and complicate their efforts in the long run.

[Chart by Wilde Capital Management LLC from data from US Federal Reserve (c)2023]

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Market Review [cont'd]

There is a more positive way to think about this tightening trajectory using Powell's reasoning though – every trillion drained from the system is 25 basis points in rates avoided to obtain the same net effect. Seen from that perspective, that is an enormous advantage in terms of the impact on the cost of capital.

The Fed is dealing with the consequences of their pandemic policy decisions and is being compromised by enormous Federal fiscal deficit spending which has fortified inflationary pressures. During the pandemic, supportive monetary and fiscal policy were reinforcing one another, but now the end result is neutral at best with monetary and fiscal policy pulling in largely opposing directions. This puts more of the onus on the Fed to take steps of a magnitude necessary to rein in inflation. Acting largely alone, it is difficult to envision a scenario where the Fed succeeds in delivering a "soft landing" with limited disruption given the reality of the current macro environment. But for the time being, markets seem to have (unearned?) faith in their ability to stick the landing.

Portfolio Positioning

Our outlook and portfolio decisionmaking in early 2022 has, regrettably for the capital markets, proven correct, and we are maintaining that stance as the markets continue to swoon. 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.

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Risk Review

We are continuing with our "dirty dozen" factors that continue to challenge the real economy as well as the capital markets. Some areas have evolved slightly, and we have adjusted our thoughts to recognize the pig working its way through the proverbial python.

Inflation – Energy, Commodities, Housing

Even with signs of moderation, mostly emanating from declining oil prices, inflation is locked in and it is global. When we first started talking about inflation during the pandemic, we saw it as localized around specific circumstances related to the pandemic from the now almost-cliché supply chain disruptions to worker shortages in service-related businesses to dislocations in very specific industries like the "crack spread" between lumber at the stump vs. milled and ready for use. These economic kinks did not have an opportunity to work themselves out before trillions of dollars of stimulus and new money were poured into the economy driving increased appetite, and as a result there is demand and price pressure exceeding a still-disrupted global economy's ability to satisfy from microchips to chicken. Add in the effect of the Russia-Ukraine war and related sanctions regime on gas, oil, grains, steel, etc. and we anticipate some extended inflationary pain until global economies can work off the pandemic spending that compounded latent problems with overly accommodative policy since the Financial Crisis. Supply chain issues are not what they were earlier in the pandemic cycle, but consumer price inflation is now baked in. We have seen energy markets adjust and housing is heading for a historically large setback while automobile and other inventories build, so watch this space.

Reduction in monetary expansion

The proverbial punchbowl has finally been taken away. Central banks are printing less, quantitative easing is giving way to neutrality or even quantitative tightening, and policy rates are rising. There is less money (M2) being created and the cost to borrow it is going up. Even though it can be credibly argued that central banks, and in particular the Federal Reserve, remained expansionary for too long and this is a healthy and necessary change, it is still a regime change that has consequences after a decade-and-a-half going the other direction, and the steepness of the rate of change is inflicting meaningful short-term pain, particularly for those closest to the economic fringe. More ideal would have been the Fed moving much sooner and more incrementally instead of having to slam hard on the proverbial brakes and bang everyone's foreheads on the dashboard. Or, as Professor Steve Hanke of Johns Hopkins University has repeatedly pointed out, if those with control of the presses had printed less new money from the beginning of this crisis, inflation would not now be the entrenched problem it is with the only real solution being an undershoot on money creation to bring us back to normal.

Rising interest rates

Which brings us to rates more specifically. To put the clamps on inflation the Fed and other central banks will continue to withdraw stimulus and raise rates. There is certainly a benefit to savers that, for the first time in nearly a generation, savings accounts, time deposits, CDs and money markets are paying decent rates rather than just providing stability and safekeeping. But, inflation is more than doubling those rates so real returns are still negative. At the same time, the cost of capital to individuals, businesses and governments is rising which will make debt service more expensive and slow new borrowing. That is the intended effect, slowing economic activity and cooling inflation. But, higher rates will filter down through the economy and make goods and services more expensive and put housing further out of reach for many families while making variable rate debt like credit cards more expensive and more likely to tip borrowers into default or bankruptcy. For those with greater wealth security, the idea of bonds as an investable safe harbor is sorely challenged and will force a change in ownership patterns. Collective vehicles like mutual funds and exchange traded funds investing in bonds will be treated as riskier because of price volatility when not holding individual issues inside the funds to maturity.

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Risk Review [cont'd]

Widening US High Yield interest rate spreads

Low-quality debt (junk) issuers have enjoyed an extended period since 2017 of economic advantage where it has been fairly inexpensive to borrow as the market has not demanded a significant risk premium for lower-rated issuance. All of the many strains on economies and markets are forcing a re-rating of junk bonds and a return to a historical spread over investment grade corporate or Treasury bonds to pay for the additional risk. This will become more of a self-fulfilling prophecy as rates continue to climb and it becomes harder for risky enterprises to borrow at interest rates they can sustain without default. In some cases the environment will force companies to clean up their balance sheets to lower their cost of borrowing, and in other cases Warren Buffett's maxim "It's only when the tide goes out that you know who's been swimming naked" will be in effect.

Full, although declining, equity market valuations

This risk may be declining, although only by virtue of a significant grind lower already in the books interrupted by brief bear market rallies. Valuations are definitely below where they were when we described them as "full", but conditions have also changed (see the 11 other risks) and based on today's macro outlook even priced at a lower valuation equities may still be characterized as full.

Corporate earnings still growing but the pace is slowing

Corporations have been able to capitalize on various price dislocations from food and basic materials to oil, airlines and automobiles to keep the good times rolling even into the current challenging market conditions. But, 15+ years of cheap capital are over with easy Fed policy giving way to QT and rising rates, which combines with rising wages, supply chain costs and less liquidity for consumers to put margins under pressure. Quality will certainly matter more both in terms of how capital is obtained and deployed and how crisp business execution is in order to sustain and even grow earnings.

Negative real wage growth

Wages are rising which is a hard-won victory, but inflation is rising faster, erasing those gains in real terms at the kitchen table. That reality reverberates through the economy as purchasing power for those most likely to spend their paychecks – the middle class and the working poor – declines.

Consumer sentiment – lowest since August 2011

Declining sentiment tracks with inflation overriding wage gains. The various components of inflation as experienced by consumers further aggravates those negative sentiments. Even if a consumer commits personal capital to make purchases, goods have been harder to get and pricing power is currently vested with merchants over consumers, leaving a palpably bitter taste. Automobile supply, for instance, remains tight and has opened the door to almost predatory pricing on dealer lots as even very ordinary and utilitarian vehicles are being sold for thousands over MSRP. This kind of disempowerment of consumers is discouraging current purchasing behavior and is very likely to come back around in the next stage of the economic cycle as the proverbial shoe ends up on the other foot when supply chains catch up and the power is vested back in the hands of those same consumers.

Supply chain issues

We have seen 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 inventory 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. The global sanctions regime surrounding Russia will also continue to 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.

Risk Review [cont'd]

Slowing home sales

As we have been cautioning for some time, we see housing as ripe for a significant correction, compounded by the current state of affairs. This market cycle is unlike any previous one because we have what we would characterize as an unnatural market participant – private equity firms – not present in prior cycles. Where home ownership was concerned, financial products related to homes were largely derivatives of the actual dwelling, like mortgage portfolios. PE firms went a step further and rather than accepting the dwelling as collateral for a mortgage, they purchased the actual home, effectively "productizing" it. Now you have institutional-scale market players that are strictly governed by the economics of the assets (homes), and not the intangible value an individual or family derives. This introduces new opposing forces because an institutional owner is more likely to want to sell the asset when the market is under stress because of economic conditions, while a traditional homeowner is more likely to hunker down in place and use the home as an anchor of stability. At the same time, the pandemic accelerated what we see as five to ten years of outward migration by Millennials and others from the urban cores to suburbia into the two years of the pandemic, which converged with historically low mortgage rates to drive a bubble in home prices. While we do not expect the same kind of damage in housing as was left in the wake of the Financial Crisis, we do anticipate homeowners will be frozen in place because housing values will fall, destroying equity, and rising rates will make it very unappealing to obtain a new mortgage for a different home because the exact same mortgage amount would be substantially more expensive to finance in a new loan.

Waning fiscal stimulus

"Waning" might be too passive a term to describe conditions. The US Congress is likely done with major spending legislation for the foreseeable future, particularly with the House of Representatives changing hands for the new session. The Federal Reserve is aggressively drawing down QE and raising rates to reel in inflation and move us back to some semblance of a historical normal. Easy money for financial institutions, corporations, mortgagees, consumer borrowers and the US Government, States and municipalities is over. This regime change which combines the end of at least 15 years of stimulative support and more than 40 years of declining rates will change the growth dynamics in capital markets for the foreseeable future.

Geopolitical flashpoints

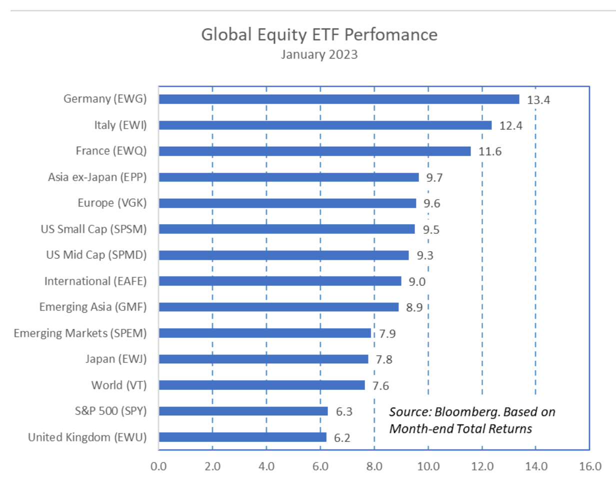
There are too many to count, but the Russia-Ukraine conflict is a leading example of the risks. As we have written previously, neither country is particularly large in terms of GDP when compared to greater Europe, North America, Japan or China. But, cutting off "Europe's breadbasket" and disrupting steel and other industrial materials flowing from Ukraine to Europe and beyond, combined with the consequences of the global sanctions regime against Russia, which is basically a petrostate, have turbocharged inflation in food and fuel globally. China of course is still for the most part the world's manufacturing floor and their flexing over Hong Kong and Taiwan, both significant global economic engines in their own rights, poses military as well as economic risks globally. Looking to the future China's aggressive moves in Africa to secure access to natural resources may become the source of future contests as well. More regionalized but hardly less concerning, a bellicose North Korea poses threats to both South Korea (#13 largest economy by nominal GDP) and Japan (#3 behind the US and China).

January 2023 Capital Market Review

Whistling past the graveyard. To look at January in isolation, one might think everything is fine. Just fine. The US posted decent returns of roughly the same magnitude in both bonds and equities which was a salve for balanced portfolios. European equities boomed, and none of the major asset classes that we track turned in negative returns for the month. Market participants seemed to want to recapture some of the previous intermediate peak after a similarly booming month of November before markets slumped to wrap up 2022. While not necessarily the proverbial “dead cat bounce”, markets have settled into a pattern of short-lived rallies before falling back to roughly the same levels as mid-Summer 2020 (after the first major governmental intercession to respond to the pandemic and before the 18-month runup to the late-November 2021 apex).

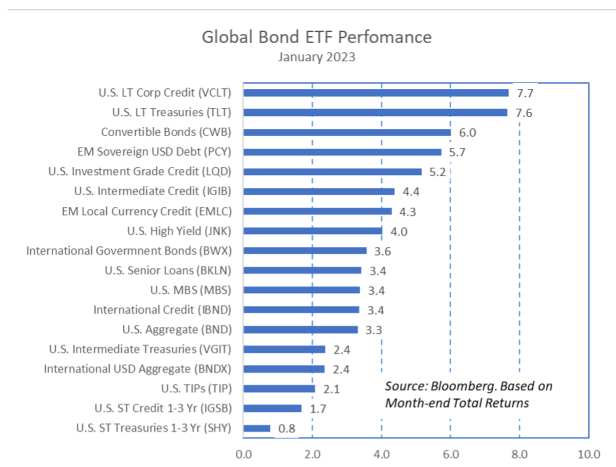
Equity Markets

Europe led the way for a big month, with the biggest European economies (Germany 13.4% EWG, Italy 12.4% EWI, France 11.6% EWQ) driving. Even digesting the effects of China dropping their zero-tolerance COVID regime and their general sabre rattling in the region Asia (ex-Japan) booked a nearly 10% return (EPP). Emerging markets were reasonably strong as well approaching 8% (SPEM). US small and mid-sized companies found a bit of their mojo besting the big companies 9.5% (SPSM) to 6.3% (SPY). And, the UK (EWU), even choking on inflation and lingering supply chain issues more tied to BREXIT than COVID, brought in 6.2%.



Fixed Income Markets

Duration caught a break in January after being pummeled for much of 2022. US long term debt, both corporate credit (VCLT 7.7%) and Treasuries (TLT 7.6%) clawed back some return. Mortgages were positive (MBS 3.4%) but continued to show relative weakness as that whole sector comes under pressure from the rate regime and broader pressures on wages, housing, etc. Quality led as well, with high yield US debt (JNK 4.0%) bringing in positive returns but behind investment grade (LQD 5.2%). Interestingly, although high yield debt tends to be very responsive to equities, they did not bring as much positive lift as assets like convertibles (CWB 6.0%). Not on the chart but of note, time deposits, money markets, and other highly liquid, safe, low duration options are now offering 3+% and 4+% annualized yields.



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

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