The Advisor

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Market Update - Second Quarter, 2022

INFLATION, INVERSION, STOCKS ARE SELLING, BONDS ARE SELLING, WHAT IS GOING ON?
The U.S. inflation story and hawkish response from the Fed has been well documented. What hasn't received as much attention is the message from bond markets. It is important to understand that fixed income markets are some of the deepest and most sophisticated markets in the world because the participants (such as banks, primary dealers, pension funds and foreign official institutions) are at the center of the global monetary system. These markets are a proxy for central bank monetary policy, growth and inflation expectations and a general pulse on the risk appetite and balance sheet capacity of said participants. Let's discuss the current tenor of the bond markets; it's a perspective worth understanding.

The elephant in the room – the yield curve.
U.S. Treasury yields on the short-end of the curve are rising, and rising quickly. Intuitively this makes sense because short-maturity bond yields will move in concert with where the Fed is telegraphing plans to take the overnight rate known as the Fed Funds rate. Yields on the longer end of the curve are not cooperating with the same degree of upward cadence which is acting as a ceiling that forces extreme compression and inversion.

The question then begs, why wouldn't the long-end stay in line and steepen accordingly if there were expectations for strong economic conditions, higher inflation and rising interest rates? That answer is quite complex but in simple terms the further out on the curve the less influence Fed policy has on yields; therefore, despite the highest levels of inflation in 40 years coupled with what is being billed as a strong economy these safe and liquid, high-quality, longer-dated bonds remain in high demand.

Isn't the U.S. Treasury market distorted because of the Fed's actions?
Debating the Fed's impact can be shelved for another time but we will concede that the UST market does have some embedded structural and regulatory noise so let's look elsewhere to a place beyond the Fed – the Eurodollar market.

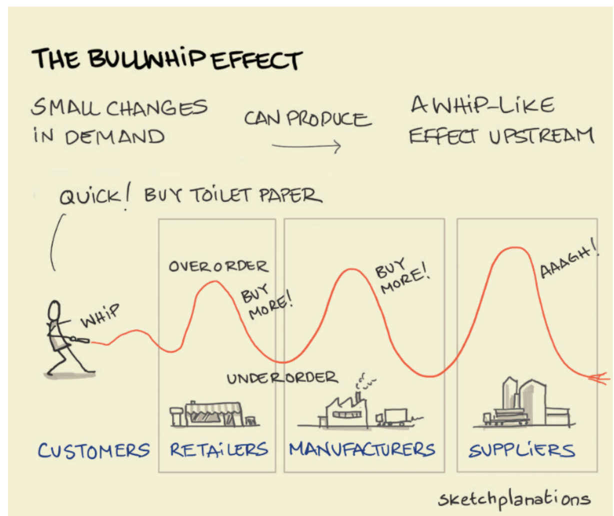
Eurodollars are basically U.S. dollars held outside the regulatory purview of the Fed. They are dollar denominated deposits held outside of the U.S. We do not have the space in this newsletter to cover the Eurodollar market in complete detail but to serve our purposes it is important to know this market is used for funding and collateral by global banks and participants. The key takeaway which makes this analysis relevant is that the Fed has no control over the Eurodollar market through quantitative easing. Therefore, we can look to this particular yield curve to get a read on how real economy global agents are positioning in light of the economic conditions and inflation prospects they see. You may have guessed – this curve is inverted, too.

And then there were three.
We have one last stop on this yield curve journey – the overnight index swap (OIS). The OIS curve is arguably the cleanest signal when it comes to market implied expectations for the Fed Funds rate because it reflects a contract by which a counterparty agrees to receive a fixed rate in exchange for paying the overnight Fed rate, the purest risk-free rate there is. As with the Eurodollar, comprehensive detail about the OIS market is not necessary for our purposes here other than knowing this curve, too, has flattened while slipping in and out of inversion which implies access to credit and borrowing is getting more expensive (from the rise in the short-end yields) while markets are pricing in less growth expectations over the long-term.

So, what is the message coming from bond markets?
We have looked at U.S. Treasuries, Eurodollar futures and overnight index swaps. Each of these respective curves are severely compressed, if not inverted, representing a healthy dose of skepticism towards sustained red-hot growth and inflation. Additionally, credit is becoming more expensive and restrictive and forward global economic conditions appear cloudy. We recognize bond markets are not always right; time and data will once again be the judge. However, we do acknowledge fixed income markets have an exemplary track record as a leading indicator in reflecting global economic conditions and they began presenting a different view about inflation, monetary policy and economic prospects many months ago. Bond markets are very complex and there are likely a number of reasons behind the yield curve inversions but we want to highlight two, in particular, that stand out as examples.

The disconnect in global monetary policy.
In the U.S. the Fed is signaling aggressive rate hikes and balance sheet runoff if not outright selling securities. The Bank of England has begun tightening as has Canada. Japan is on the opposite side of this with plans to remain accommodative as they have been for decades. China is cutting rates as GDP slows and the European Central Bank, although having stopped their asset buying program, is stuck in the middle slow playing any rate hikes until the second half of the year. That is clear as mud, is it not? Under the presumption each central bank is digesting not only its own economic data, but global information as well, it should not come as a surprise both equity and fixed income markets are all over the place trying to account for the extreme disconnect in policies.

Supply chains.
The bullwhip effect describes how the lag of information and data flowing up the supply chain can cause massive disruption. Not all price distortions are created equal. Covid shutdowns exposed the inelasticity of supply chains. Government stimulus boosted demand (not money printing by the Fed; they do not print money into the real economy) and prices have soared. Nobody, including bond markets, is debating that. The debate lives in determining if this equates to an inflationary regime change that warrants ultra-aggressive policy intervention to kill it; or does this more closely reflect severe price distortions from supply/demand imbalance during a global shutdown and subsequent reopening?



In conclusion.
We are in a guilty until proven innocent market. The conflicting global macroeconomic environment has hijacked orderly price discovery and valuation. In these times, we continue to focus on and assess the underlying businesses – not just the stock price. We also look to history as a guide and find many examples of when market fear, uncertainty and doubt led to great opportunity. We believe the future will not be one of regret for the patient and disciplined investor.

To our clients, thank you for the opportunity to serve your investment needs and please do not hesitate to contact us if you experience any material changes in your personal situation or would like to discuss any specific matters.

To our other readers, if you would like a complimentary review of your investment accounts or any other financial matters, please do not hesitate to contact us. As fiduciaries, we will happily provide you with an unbiased opinion based on our specific situation.

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