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FROM THE DESK OF DARRELL L. CRONK

State of the Markets

June 21, 2022

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Cruel to be kind

“You’ve got to be cruel to be kind — in the right measure” — Nick Lowe

It is fitting that Nick Lowe released his Top 40 single “Cruel To Be Kind,” which plucks its chorus line from Act 3 of Shakespeare’s “Hamlet,” in 1979. Historians of the U.S. economy may very well point to 1979 as the year the playbook for combatting inflation was written. It was the year of the Iranian revolution, and the disruption of oil supply helped create the second big oil crisis of the 1970s. Inflation was running at 11%, higher than today, and unemployment was pulsing at just under 6%.

On August 6, 1979, 11 days before “Cruel to Be Kind’ was released in the U.K., Paul Volcker became Chair of the Federal Reserve (Fed). Lowe’s hit song would be an appropriate sound track for the era. Volcker quickly came to the realization that to combat inflation, economic growth would need to be sacrificed and unemployment would inevitably move higher. In other words, the Fed would need to be cruel to be kind by aggressively tightening monetary policy in an effort to break the back of inflation. Sure enough, Volcker rewarded then-President Jimmy Carter for his new appointment to the Fed Chair with a modest recession beginning in January 1980, as unemployment spiked to 7.5% by May of 1980, and by July 1981, the U.S. had joined other developed countries — Germany, the U.K., Japan — in the worst global recession since World War II. Volcker took harsh action. He led the Fed to slow the rate of money supply, with multiple rate hikes of 100 basis points (100 basis points equals 1%) or more, and he raised the federal funds rate all the way to 20% by June 1981. By 1983, inflation was down to 3.21%.

Why cruel to be kind may be a very good sign

That's not to say that 1979 is a perfect parallel for today. For one, today we have the benefit of Volcker's playbook for inflation, and while it may have taken too long to put its lessons to work, Chair Powell and the Fed have embraced Volcker's "cruel-to-be-kind" strategy. Secondly, unemployment is far lower today than it was in 1979, and consumers and business came out of the pandemic-driven recession with more cash and capital. We do not expect a federal funds rate anywhere close to 1981 levels; the Federal Open Market Committee's (FOMC's) latest dot plot, released after last week's meeting, puts its terminal rate at 3.8%. We believe the Fed will ultimately need to go higher than that. Our target for 2023 is a fed funds rate range of 4.00% to 4.25%.

The Fed showed last week that it is singularly focused on inflation, even if it means economic growth has to be a casualty along the way — at least in the short term. The Fed raised the fed funds rate by 75 basis points, its largest rate hike since 1994, and Powell was clear that another hike of 50 to 75 basis points is likely in the cards when the FOMC meets again July 26-27. By the end of 2022, we expect a fed funds rate of 3.50%-3.75% — with the U.S. 10-year Treasury yielding 3.25%-3.75%. We were an outlier earlier this year when we said that we expected a recession late in 2022, but that has now become the consensus Wall Street view.

Just as the Fed needs to be cruel to be kind, we find ourselves needing to be cruel to be kind to investors. The unvarnished truth is that the U.S. economy is deteriorating faster than most realize, causing risk premia within capital markets to be reset as they adjust to this data. The Conference Board Leading Economic Index for the U.S. declined in May for the third month in a row, and the misery index — the sum of the rate of inflation and the rate of unemployment — is now at its highest level since 2010 (excluding the pandemic). This trend hasn't helped risk assets, which have been under assault for weeks now. Current data indicate falling mortgage applications, declining auto sales, surging credit card borrowing, and even early cracks in employment in key areas such as the technology sector.

While all things are possible, not all things are equally probable. Unfortunately, the Fed has not had a good history of "soft landing" the economy — in other words, avoiding a recession while tightening monetary policy. The Fed has only successfully averted a recession in 3 of its last 11 tightening cycles (1965, 1984, and 1994). In all three, inflation was lower than it is today and the federal funds rate was higher at the tightening onset than where we are today. The preponderance of hard landings is not a function of the committee not having enough smart people, but rather that it is using blunt force tools of interest rate hikes, which have a lag effect of typically 9 to 12 months. This delayed response has made it difficult for the Fed to avoid overtightening, and historically it has often tightened until it breaks something.

In fact, what we are watching now is whether the economy already may be in a technical recession. The Atlanta Fed's GDPNow tracker, typically tilted toward optimistic readings, is signaling that U.S. gross domestic product (GDP) for the second quarter of 2022 is now tracking at 0%. Following a 1.5% contraction in the second estimate of first-quarter U.S. GDP, we are dangerously close to lacing together two consecutive quarters of GDP contraction, which translates into a technical recession, according the National Bureau of Economic Research.

We expect the pendulum to swing — but we're not there yet

We have been clear-eyed since our recession call earlier this year that playing defense in portfolios remains the order of the day. As economic growth deteriorates, unemployment is likely to rise and risk assets are likely to continue to struggle in the near term. We know from history that there will be a bottom for the stock market at some point — but we are not there yet. Markets simply have not been able to sustain the meek rallies they have attempted, so it would be far crueler for us to tell you that we believe the current market downtrend has reached its ultimate end.

If history is any guide, a durable market bottom, often marked by some form of capitulation, has still been elusive. That capitulation is often a process, not a single-day event. Selling has proven indiscriminate recently, with New York Stock Exchange breadth recording some outstandingly awful levels. The CBOE Volatility Index (VIX) has not pierced a level over 40, and put/call ratios still have not registered readings in the historical 95%/99% range, often required to mark near-term bottoms.

We also would caution against selling into this downturn. Selling now would be the equivalent of locking in losses, and given the equity market's worst start to a year in history, along with fixed income markets posting their worst losses since the 1970's, a lot of negativity has already been priced into assets. We also know from history that when stocks recover, sometime after all hope has been wrung out of the last optimistic investor, the rebound can be just as sudden and just as difficult to bring into focus until it is too late.

We believe this is Jay Powell and this Fed's Volcker moment. It fell way behind the curve last year, hanging on to easy policy too long, and is now playing a dangerous game of catch up in a mad scramble to arrest inflation. Just as the initiation of tough — or as many would have said at the time, "cruel" — measures in 1979 eventually led to a roaring economic recovery and bull market in the 1980s, I am convinced that despite the dark clouds gathering, there is sunshine on the other end of this.

Recessions are normal parts of any economic cycle, and while tough to withstand, they often create favorable entry points when the pendulum swings too far and asset prices decline to a level that investors should not pass up. We expect to see this scenario play out again, and while it may not yet be time to run toward the sunshine, investors should ready their investment plans to take advantage of what may prove to be a generational buying opportunity. It is important to remember that historic bear markets and recessions have historically begotten historic recoveries.

Risk Considerations

Forecasts are based on certain assumptions and on views of market and economic conditions which are subject to change.

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate.

Definitions

Chicago Board Options Exchange Volatility Index (VIX) reflects a market estimate of future volatility, based on the weighted average of the implied volatilities for a wide range of strikes.

Misery index is meant to measure the degree of economic distress felt by everyday people, due to the risk of (or actual) joblessness combined with an increasing cost of living. The misery index is calculated by adding the unemployment rate to the inflation rate.

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