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Portfolio Strategy
Investors Should Not Expect Much Relief from Volatility

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2022 was such a white-knuckle year for interest rates and market valuations. Investors should be forgiven for hoping that 2023 will be different. It will be different, but they should not expect much relief from volatility.

The strong U.S. jobs figures for January demonstrate that real-time economic releases still have the power to surprise. But the more meaningful long-term matter for investors to keep in mind is that we have transitioned from a world of quantitative easing (QE) to one of tightening.

We believe that no one should be betting on the Federal Reserve (Fed) pivoting from that in a quarter or two just because the United States is close to a recession. The days of making easy money during QE are over. The year-over-year growth rate of the M2 measure of money supply in the United States neared 30 percent post-COVID because of the massive monetary and fiscal policy response to the pandemic. But it did not drive goods and services inflation or real economic activity to the degree that Milton Friedman would have predicted.

Due to the big gap between economic and money supply growth, this excess liquidity showed up in inflated asset prices. Prices went up for everything, both for quality assets and for speculative ones that did not deserve capital. We believe that contraction in the Fed's balance sheet and M2 should have the opposite effect.

The Fed may be closer to the end of its hiking cycle than the beginning, but quantitative tightening (QT) will continue with the central bank's run-off strategy of reducing its balance sheet by not reinvesting the proceeds from maturing Treasurys and mortgage-backed securities. Its balance sheet reduction has barely started. In April 2022 the Fed balance sheet peaked at about $9 trillion in assets, and today it stands at $8.5 trillion.

The nominal cap amount of runoff is $95 billion per month and it will be continuing on autopilot for the foreseeable future (although partly offset recently by slower prepayments on some MBS held by the Fed). We do not expect a repeat of September 2019, when money markets were spooked by the decline in the aggregate size of the Fed's balance sheet from $4.4 trillion at the beginning of 2018 to $3.7 trillion and the central bank had to begin purchasing Treasurys again. The Fed has since put programs in place that should help ease a similar dislocation in money markets.

We are now in a consolidation period that marks the end of a secular bond bull market that lasted more than 35 years. This period will be characterized by reduced market liquidity, capital rationing, and persistent volatility in asset prices. The silver lining for bond investors is that consolidation periods can endure for years before the next bond bear market begins.

During this kind of consolidation period, market participants have to be thoughtful and nimble about where to invest. A recession could come as early as the middle of the year, but corporate credit fundamentals are strong heading into the downturn. Guggenheim research shows that the debt of all domestic non-financial corporate businesses is around 5x pre-tax profit, a leverage ratio that is much lower than typical heading into a recession. Among the same companies, the current coverage of interest expenses by earnings before interest and tax is the highest for 50 years at 16x.

The consumer balance sheet is also strong, with savings still higher than before the pandemic, low levels of debt and significant homeowner net equity. These factors should help keep the recession relatively mild.

But the transition from QE to QT spells trouble for risk assets, while a looming turn in the business cycle means the rates market should be a tailwind for fixed-income investors as 10-year Treasury yields head back down towards 3 percent from current levels around 3.7 percent. Equity markets should decline as we move through an economic slowdown, and finish meaningfully lower than they are today.

Based on analysis conducted by our research team of price-to-earnings multiples during times of slowing economic activity, the S&P 500 could trough as low as 3,000–3,200 during the forecast recessionary period, down from the current level of around 4,130. Our view is that along with the fall in equities prices, the lowest rated credit end of the markets, like CCC-rated bonds, will also come under price pressure, likely selling off as defaults rise and downgrade activity increases.

With equities likely set to fall, and investment-grade corporate credit and structured credit yields at attractive levels, our view is that now is a good time for active managers to start allocating defensively and move up in credit quality. We may have started a new year, but investors should still be prepared for a bumpy ride. The good news of higher bond yields is that they are getting paid to prepare.

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