



PACIFICUS
CAPITAL MANAGEMENT

INVESTMENT OUTLOOK – JULY 2022

When Markets Are Tricky, Play Defense

“Notice that the stiffest tree is most easily cracked, while the bamboo or willow survives by bending with the wind.” — Bruce Lee



“What did I tell you about practicing on the cat?”

Managing balanced portfolio risk over the past six months has been among the trickiest of my career. According to Schwab’s Liz Ann Sonders, the average U.S. stock is down approximately 30% year to date, while bonds haven’t encountered such large half-year drawdowns ever in modern market history. Commodities, including energy were the one bright spot for a while, but recently cracked lower, as markets began to discount both slower global growth and economic recession. Cash has been the only place to hide in this illiquid topsy turvy environment, which is why on a tactical basis I recently increased cash allocations by about 10% beyond the upper bound in client portfolios. For the time being, we are playing defense until the uncertainty surrounding either higher inflation or lower growth becomes the more apparent driver in financial markets.

The Fed does not like to surprise markets. Years ago, it was The Wall Street Journal economics reporter Greg Ip, who appeared to receive privileged leaks. Today, it is The Wall Street Journal's, Nick Timiraos who has taken the baton. Some readers may recall it was Nick Timiraos who reported a couple days after last month's dismal CPI release the Fed was now more likely to hike rates by 75bps rather than 50bps. Mr. Timiraos job is not to predict where the economy is going, but to explain to readers what the Fed is thinking. It is with this in mind, I felt it made sense to pass along his recent piece below.

For the Fed, Easing Too Soon Risks Repeat of Stop-and-Go 1970s

By Nick Timiraos

The Wall Street Journal

July 10, 2022

Federal Reserve Chairman Jerome Powell is raising interest rates at the fastest pace since the 1980s. That has been easy so far because rates are low and the economy has been strong.

The hardest part lies ahead. Just as it proved difficult for the Fed last year to tell when to start raising rates, it is tough to know when to stop. What happens, for example, if the economy begins slowing sharply but inflation stays too high?

Because the Fed hasn't confronted a situation like this one in decades, it will be tricky for most investors and even Fed policy makers to have much confidence over how the central bank would respond.

Since the Fed raised its interest-rate target by 0.75 percentage point in June, the largest increase in 28 years, investors have responded in ways that reflect growing worries about recession. Oil and commodity prices have tumbled. Market-based measures of future inflation and bond yields have dropped. Futures markets now see the Fed pushing its benchmark rate, currently between 1.5% to 1.75%, to around 3.5% by next March. Markets expect the Fed to cut rates later next year.

Those expectations depend on inflation falling quickly. Were the Fed to ease because of growth fears before inflation has been vanquished, it would risk repeating its stop-and-go tightening of the 1970s, which economists now see as a costly policy error. To avoid that mistake, "the Fed may not be able to pivot and cut rates quickly or at all" if a recession begins later this year, said Krishna Guha, vice chairman of Evercore ISI, in a recent report.

"Stop-and-go" refers to how the Fed oscillated between raising rates to tame inflation and then backing off to shore up growth—succeeding at neither. It began in the late 1960s, when Chairman William McChesney Martin Jr. paused rate rises during a recession scare. It worsened under Fed Chairman Arthur Burns, who raised rates

significantly between 1972 and 1974 but cut them the following year in the midst of a sharp recession. Inflation fell but settled at still-elevated levels.

“The problem in the 1970s was you tightened. You hit the labor market. And you eased up, and you never took care of the problem,” said Peter Hooper, global head of economic research at Deutsche Bank. Ultimately, it took a change in tactics by the Fed in 1981 under Chairman Paul Volcker to raise rates to far higher levels for inflation to come down and stay down.

Mr. Hooper, who began his career at the Fed in 1973, thinks Mr. Powell won’t repeat those mistakes because the central bank has exhaustively studied them. Instead, he sees the U.S. economy falling into a recession next year that sends the unemployment rate to at least 5.5%, up from 3.6% in June. “Having seen this play before, if you don’t deal with it now, then you’re looking at a repeat of the 1980-82 episode, where unemployment topped 10%,” he said.

Fed officials are eager to see inflation pressures diminish soon so that they won’t have to raise interest rates above 4% or 5%. But they are also using terms such as “fortitude,” “resolute” and “bumpy road” to show they are alert to the risks of stubborn inflation.

“This kind of worry that there’s going to be a stop-and-go policy by the committee like what happened in the ’70s—that’s just not going to happen in my view,” Fed governor Christopher Waller said during a webinar with private-sector economists last week.

Officials are concerned that inflation psychology is shifting in a way that will lead businesses and consumers to continue to accept higher prices. To prevent those expectations from becoming self-fulfilling, the Fed is using words and actions now that it hopes will shock the public out of believing inflation will stay high.

The Fed is willing to risk a recession because it sees sustained inflation as a potentially greater menace—one that distorts decision-making and leads to more booms and busts. “Inflation messes up the price signals in the economy, makes it harder to tell where to invest. It is harder to tell which job to take,” St. Louis Fed President James Bullard said recently.

After last month’s 0.75 percentage point increase, Fed officials have indicated they are likely to approve another in about two weeks and eventually raise rates to at least 3% this year.

Still, elevating inflation so far above other priorities carries its own risks. For example, the day after Lehman Brothers collapsed in 2008, with the financial crisis spiraling out of control, Fed officials declined to cut rates out of concern about inflation, which oil prices had pushed up.

Another worry is that inflation data lags behind economic activity. By raising rates in such large chunks while using inflation to know when to slow or stop, the Fed might weaken the economy more than needed. “They’re doing the right thing right now...but if that kind of reaction function is maintained, it practically guarantees overshooting,” especially if the economy faces new supply shocks such as oil-price jumps, said Donald Kohn, a former Fed vice chair who began his career as an economist at the central bank in 1970.

On a panel last month with Mr. Waller, Mr. Kohn urged the Fed to consider a “second Volcker moment” that doesn’t rate as much attention as Mr. Volcker’s famous declaration of war on inflation. That was when Mr. Volcker decided in the summer of 1982 to abandon his policy-setting framework, which called for continued rate increases that fall.

Inflation was falling to around 5%, “so it was still pretty high. But he said, ‘Enough. We’ve accomplished a lot. The cost of continuing this process outweighs the gains,’” recalled Mr. Kohn.

By then, rate increases were touching off a fierce debt crisis in Latin America that threatened several large U.S. banks. The Fed would resume rate increases in May 1983, and the economy expanded for the rest of the decade without a reacceleration of inflation.

Mr. Kohn is less concerned about a rerun of the stop-and-go policies of the 1970s and instead worries that the Fed will commit the same type of error it made last year, when it played down rising inflation to deliver on its promises to boost employment. “What if the script flips?” said Mr. Kohn. “And there’s so much attention on inflation that you don’t see the economy is weakening, and that will itself help contain inflation.”

Looking forward six months out, I think it is more likely the economy will be dealing with a shallow recession rather than an inflationary problem. This means the Fed could shift its hawkish language down the road, which in turn would be positive for stocks. However, we are not at that moment yet, as recent high inflation data keeps the Fed hawkish and on an aggressive path to higher short-term rates. This makes the current short-term outlook for stocks cloudy at best.

Historically, it has been uncommon for the Fed to engineer a soft landing, which is partially why intermediate and long-term U.S. Treasury bonds have rallied a little lately, and segments of the yield curve inverted. Additionally, Core PCE Inflation (the Fed’s preferred measure of inflation) although high, appears close to peaking. Couple this with the recent large declines in commodity markets and this would increase the likelihood consumer inflation could be in the process of topping out this cycle. Time will tell.

With all the uncertainty above, we continue to focus on playing defense. For the time being, this translates into a higher than usual cash position throughout client portfolios. Although just about all financial instruments have incurred declines this year, market relationships will eventually begin to normalize, and diversified portfolios should do what they have done historically – minimize risk and maximize risk-adjusted returns. Intermediate and long-term government bonds will likely turn the corner first before the rest of the market eventually follows. Time in the market is how growth compounds, while near term volatility and drawdowns are the price we all pay to participate.

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|--|---|--|
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| Cash | International Developed Market Equities | Small Capitalization Stocks |
| U.S. Treasury Notes & Bonds | Emerging Markets Equities | Financial Services Sector |
| Investment Grade Corporate Bonds | Consumer Discretionary Sector | Leisure & Hospitality |
| U.S. Real Estate & Related Equities | Consumer Staples | Materials Sector |
| Large Capitalization Technology | Communication Services Sector | Energy Related Equities |
| Healthcare | Mortgage-Backed Securities | Leverage Loans (Floating Rate Debt) |
| Aerospace & Defense | Local Currency EMG Bonds | Treasury Inflation Protection Securities |
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Founder, Portfolio Manager & Adviser
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