It Makes Sense to Remain Cautious

"Don't ever take a fence down until you know why it was put up." — Robert Frost

" I've moved from being ***cautiously optimistic*** to being ***optimistically cautious***. "

The Fed Funds futures market is pricing in somewhere between six and seven 25 basis point rate hikes for 2022. Judging by the recent flattening in the treasury bond yield curve along with the inversion in the forward rates curve, the bond market believes a policy mistake by the Federal Reserve Board is becoming more likely. One implication of a flat or inverted yield curve is the Federal Reserve Board could be forced to either halt or reverse interest rate hikes sooner than expected.

In retrospect, the Fed should have begun to dial back monetary stimulus months ago, but instead decided to take a cautious approach. In my view this was more of a political

decision, as many things of consequence appear to be nowadays. Therefore, the future trajectory of the financial markets is more uncertain today as easy money over-stayed its welcome.

Taking these points into consideration have prompted me to shift to a more cautious approach regarding equity allocations. For the time being, a flatter or even inverted yield curve means greater risk premium should be priced into riskier assets. In plain language, this means higher stock prices will likely be challenged until the interest rate narrative shifts.

With that said, the recent high inflation numbers which have many commentators (both political and non-political) totally freaking out are **lagging economic indicators**. **Lagging economic indicators** tell you what has happened in the past, not what is currently happening today or what may happen in the future. Judging by the out of the ordinary increases in both growth and inflation statistics during this time last year, large changes in period over period comparisons will prove difficult to sustain. Therefore, holding all else equal, both the incoming inflation and growth data are likely to start decelerating, just as the Fed is tightening monetary policy – financial markets will not like this.

To me, this means we will likely need to get past the first interest rate hike for markets and the Fed to gain a little more clarity. In the meantime, I think it makes sense to remain cautious.
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As many of my clients and readers are aware, I am constructive on the bond market. Ultimately, I believe interest rates, particularly at the long end of the yield curve are headed lower, not higher. Barron's recently put out a piece titled, Forget About Inflation. Contrarians Expect a Recession and a Drop in Bond Yields." I agree with this point of view.

Forget About Inflation. Contrarians Expect a Recession and a Drop in Bond Yields.
By Randall W. Forsyth
Barron's
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"Something that everyone knows isn't worth knowing," as the famed financier Bernard Baruch once observed.

And so, I was reminded by a long discourse in the New York Times this past week on why bond yields remain low, despite rising inflation and large budget deficits. Central banks around the globe have pinned rates at zero or below while buying trillions of

dollars' worth of bonds to lower their yields. Aging demographics and ongoing demand for safe, liquid investments, along with a global savings surfeit, have further lowered risk-free government-bond yields. Fit to print, but hardly news.

But, as everybody also knows, the Federal Reserve is about to begin raising its short-term policy rates, with a one-quarter-of-a-percentage-point increase a near lock and a half-point hike an outside, but growing, possibility. As many as five one-quarter-point raises by December are being priced in by the fed-funds futures market, according to the CME FedWatch site.

So, to find out what everybody doesn't already know, I turned to two contrarians who have challenged the consensus (and me) over many years. Spoiler alert: They think bond yields will turn lower, not higher—if not immediately, then in the not-too-distant future.

"I've never been afraid of going against the consensus or the Fed," says Lacy Hunt, chief economist of Hoisington Management, in Austin, Texas, which was getting pelted by an ice storm as we chatted by phone. Notwithstanding the most recent gross-domestic- product data showing annualized growth of 6.9% in the fourth quarter, he sees the U.S. economy as frail because of its debt burden.

Gary Shilling, who runs the long-established economic advisory service bearing his name, also departs from the crowd in looking for "an economy that is going to be soft" and "inflation that is going to fade." A recession has followed 11 of the past 12 Fed policy tightenings, he points out, in a phone conversation from his northern New Jersey perch, which was being hit by near-freezing rain from the same storm.

Beyond the weather, what these two veteran market economists share is the conviction that the rise in bond yields over the past year, to a recent peak of 1.83% on the benchmark 10-year Treasury note, will reverse.

While the common perception is that American consumers are being prevented from buying what they want because of supply-chain kinks, Shilling thinks they are tapped out. Inventory building, the main reason for the robust fourth-quarter GDP report, will likely turn out to have been overdone. In particular, he notes a rise in inventories at big retailers Walmart and Target in the quarter, while overall retail sales reported by the Commerce Department fell a sharp 1.9% in December.

With unwanted inventories continuing to pile up, Shilling looks for cuts in orders and production. At the same time, he thinks the surge in housing prices is about to burst. Supplies of new homes will catch up with demand. "I get the feeling the rush to the 'burbs and rural areas is about over," he adds. He also doubts that people moving to

lower-cost regions will continue to get the same pay from big-city employers for remote work.

Hunt, meanwhile, sees the economy continuing to be beset by debt and demographics. Contrary to the common belief that higher debt pushes up interest rates, he argues that debt-imposed drag slows growth and, in turn, lowers long-term rates.

Looking at very long-term trends, he says that real per-capita growth has been halved to 1.1% since the late 1990s, from 2.2% from 1870 until then, which he attributes to the build-up in U.S. debt. As for demographics, he sees the nation's slowest population growth since the 18th century restraining investment, which will constrain the economy's output.

In the meantime, Hunt sees inflation hurting most households, especially those with more modest incomes, as prices invariably outpace wages. As the cost of necessities, such as food and fuel, take a bigger chunk of budgets, consumers effectively get a tax increase.

Shilling expects the tightening on which the Federal Reserve is about to embark having the same impact that tighter policy has had in almost every other previous instance. Only in the 1990s was the Fed able to achieve the proverbial soft landing by tightening and then easing in time to avoid a recession. During 1994-95, the central bank roughly doubled the fed-funds rate in short order, albeit leading to major financial repercussions in the mortgage-backed securities market, the bankruptcy of Orange County, Calif., and the Mexican peso crisis that led to a U.S. bailout.

Once the Fed's rate hikes hit a slowing economy, Shilling sees a resumption of the "bond rally of a lifetime," which he called when it was starting four decades ago and now declares isn't over. He thinks long-term Treasury yields have already priced in more than a one-percentage-point hike in the Fed's short-term rate target.

If the tighter monetary policy leads to a recession, he looks for the 10-year Treasury's yield to return to its early 2020 pandemic low of 0.54%, from 1.8% this past week, and the 30-year bond's to fall back to 1% from 2.1%. Since bond prices rise as rates fall, that would produce a total return of 30.7% for a 30-year Treasury and 38% for a 30-year zero-coupon bond.

Shilling emphasizes that he has always recommended Treasury bonds for capital gains, not income. But he's not buying yet. He's waiting for the economic weakness from the inventory overhang to develop and for worries about the Fed overdoing it before pulling the trigger.

Hunt thinks economic conditions in Western Europe and Japan have made for even lower yields there. So, global investors are apt to continue to be attracted by higher U.S. Treasury yields, which he sees becoming increasingly alluring to domestic investors, too, as the American economy disappoints and inflation recedes.

Will these veteran bond bulls prevail? I must admit that over the years when I've disagreed with them, they have ended up being right more often than not. If nothing else, contrary opinions force you to reexamine your assumptions.

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ASSET CLASS & SECTOR OPINIONS		
OVERWEIGHT	**NEUTRAL**	**UNDERWEIGHT**
U.S. Real Estate & Related Equities	**International Developed Market Equities**	**Small Capitalization Stocks**
Large Capitalization Technology	**Emerging Markets Equities**	**Financial Services Sector**
Consumer Discretionary Sector	**Gold & Gold Miners**	**Leisure & Hospitality**
Healthcare Biotech & Pharmaceuticals	**Energy Related Equities**	**Materials Sector**
Aerospace & Defense	**Consumer Staples**	**Leverage Loans (Floating Rate Debt)**
U.S. Treasury Notes & Bonds	**Communication Services Sector**	**Treasury Inflation Protection Securities**
Investment Grade Corporate Bonds	**Mortgage-Backed Securities**	**High Yield Corporate Bonds**
	Local Currency EMG Bonds	

Sincerely,
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