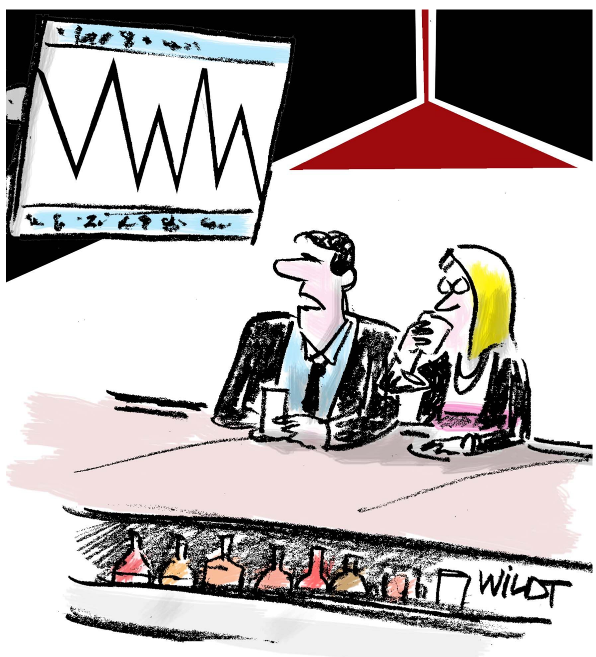
Fear is a Powerful Emotion

"Fear is the path to the Dark Side. Fear leads to anger, anger leads to hate, hate leads to suffering." – Yoda



"Sometimes I'd like to smack the stock market across the face and tell it to just chill."

CartoonStock.com

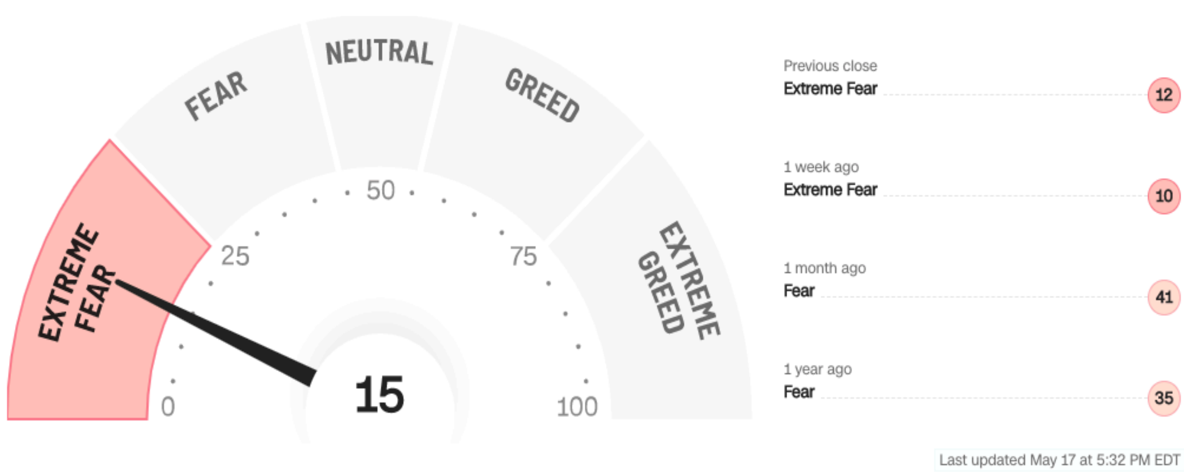
Financial markets are trading on extreme levels of fear. This has been going on for weeks and can be exhausting for both novice and professional investors alike. Both stocks and bonds are having their worst start to a year in decades as the Fed embarks on an aggressive monetary tightening schedule, which they believe will slow both GDP growth and employment. In turn, the Fed is simultaneously betting a slowing economy will also slow inflation. Barring any unforeseen supply-side shocks, this is the most likely outcome.

The Fed would also like to see financial conditions tighten. They are behind the spike in market volatility and the lack of liquidity across all asset classes. This is making both buy and sell decisions increasingly difficult.

On the other hand, searching for safety by parking a large chunk of one's assets in cash does have a downside. Namely, the corrosive effect of inflation, which makes the real return on cash negative. In pursuit of safety, investors who are out of the market sitting on the sidelines earning a negative real return, give up the option of capital appreciation once things turn around. And when things turn, they can turn quickly.

In its quest to slay inflation, the Fed has taken the air out of almost all tradeable financial assets leaving investors, including the most sophisticated professional investors with losses year to date. A recent article from the Financial Times illustrates this point below and how difficult the year has been for just about everyone.

With that said, sitting tight and managing one's emotions during periods of drawdowns and volatility is the inescapable reality of growing wealth over the long term. Markets cannot continuously go up in a straight line, as that would be too easy. Using history as our guide, this period of market dislocation shall pass and will ultimately reward disciplined, steady hands.



Source: CNN Fear & Greed Index
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Hedge Funds Scale Back Bets on US Stocks as Losses Surge
By Eric Platt, Ortenca Aliaj and Nicholas Megaw
The Financial Times - May 16, 2022

Hedge funds focused on US equities are pulling back sharply on their bets after the longest stretch of sustained selling in more than a decade left many managers nursing stiff losses.

The S&P 500 index has fallen for six weeks in a row in a tumultuous stretch that on Thursday left Wall Street's benchmark share barometer down by almost a fifth from the peak it reached at the start of 2022, before a dramatic swing higher on Friday.

Long-short equity funds, which pitch themselves on the ability to protect client money in down markets, have lost 18.3 per cent for the year up to and including Wednesday, according to Goldman Sachs estimates.

The declines have been staggering for funds invested heavily in riskier corners of the market, including lossmaking technology companies, with traders warning that there could be a spate of large redemptions that prompt fund closures.

The sharp pullback has prompted funds that trade with Goldman, Morgan Stanley and JPMorgan Chase, three of the largest prime brokers on Wall Street, to dial back their positions over the past week, according to client reports seen by the Financial Times.

"When you're seeing daily moves of 2.5 or 3.5 per cent in indexes, those are not just everyday moves being driven by trading volatility," said Peter Giacchi, who leads Citadel Securities' floor trading team at the New York Stock Exchange. "There's obviously deleveraging going on — it's not just noise, there are clearly people taking risk off."

Goldman on Thursday reported five consecutive days of declines in gross leverage — a measure of a fund's overall exposure to stock-price moves — among its US long-short equity hedge fund clients, the largest reduction since it began tracking the figures in 2016.

At Morgan Stanley, the gross leverage of its US long-short hedge fund clients — which attempt to profit on stocks rising or falling — this week fell to its lowest level since April 2020 and was just 15 per cent above a low hit in March of that year, when the pandemic pushed the US into recession. It noted that those hedge funds were again selling stocks but had also added to their short trades, bets that could pay off if a stock or index falls in value.

Executives working in JPMorgan's prime brokerage unit, which reported similar findings, said there were signs that the US stock market could be close to finding a bottom, but they warned that funds still had room to cut their exposure to the market.

"The market continues to teeter between complete apathy and bewilderment," Ron Adler, who works on JPMorgan's trading desk, wrote to clients. "While flows haven't quite been ‘capitulatory’ yet, we have begun to see some of the more prominent growth players on the long-only and hedge fund side start to finally unwind some of these positions.”

Meanwhile, mutual funds and exchange traded funds that buy US equities have registered nearly $37bn of outflows over the past five weeks, according to data provider EPFR.

Charlie McElligott, an equities derivatives strategist at Nomura, said the outflows had appeared to be driving some of the recent leg lower in stocks, as big fund managers sold stocks to raise cash.

US stocks have tumbled this year as the Federal Reserve has tightened monetary policy in an attempt to rein in inflation that has shot far above policymakers’ forecasts. The central bank has embarked on a path of aggressive interest rate rises that are meant to cool economic growth and in turn suppress rapid price increases.

But coupled with Russia’s invasion of Ukraine and an economic slowdown in China, the move has weighed heavily on investor sentiment and driven a sharp uptick in volatility.

“Hard-landing recession risk fears are again trending as central banks again look behind the curve on what looks set to be sticky inflation,” McElligott said.
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In an effort to get market psychology on its side, the Fed has been talking tough on inflation. From their perspective, this has been working given both the sharp pop higher in yields over the past few weeks and the drop in risk-based assets.

It does appear to me the bulk of the move to higher yields along the intermediate and long end of the yield curve is now behind us. Over the past few trading sessions, the hedging properties of owning government bonds against an equity-oriented portfolio is beginning to have a stabilizing effect again. This is a good thing as most investors and investment managers struggle when everything goes lower together.

Going forward, if either the stock market declines, or short-term interest rate markets price in a considerably greater terminal Fed Funds rate, the reaction should be met through higher bond prices, as the market begins to understand tighter financial conditions and higher short-term rates could lead to lower growth and ultimately lower long-term yields. Inflation may have peaked, but it will take more data point readings over the next couple of months until anyone can say this with confidence.

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**
Gold & Gold Miners	**Consumer Discretionary Sector**	**Leisure & Hospitality**
Healthcare	**Consumer Staples**	**Materials Sector**
Aerospace & Defense	**Communication Services Sector**	**Energy Related Equities**
Utilities	**Mortgage-Backed Securities**	**Leverage Loans (Floating Rate Debt)**
U.S. Treasury Notes & Bonds	**Local Currency EMG Bonds**	**Treasury Inflation Protection Securities**
Investment Grade Corporate Bonds		**High Yield Corporate Bonds**

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Justin Kobe, CFA
Founder, Portfolio Manager & Adviser
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