Q2 2022 OUTLOOK: RATES, RUSSIA, AND RECESSION

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On July 1, 1914, just three days after Archduke Franz Ferdinand was assassinated in Sarajevo, a *New York Tribune* front page discussed the "critical situation" and an "abandoned peace conference." It was talking of course about the Mexican Revolution, giving that conflict multiple headlines on page 1. The Archduke's death had already been relegated to page 3, with a short article about his will. The archduke's life was insured for $12,000,000 and his estates in Bohemia and Salzburg would be inherited by his children, the *Tribune* noted.

To the average citizen, a dust-up in the Balkans seemed like an ordinary 'cabinet war.' Elsewhere, Ireland was on the verge of civil war. Issues in Haiti and Santo Domingo had the U.S. ready to send in the Marines. *The North Dakota Daily Herald* summed up world opinion at the time: "To the world, or to a nation, an archduke more or less makes little difference."

Then, a month later, the guns of August fired, and world plunged into war.

War, like economics, is hard to predict — trends in place for decades can collapse in days. Extreme events, those epochal Black Swans, now seem more frequent. Witness a world locking down as markets hit new highs, or meme stocks and cryptocurrency.

With Covid concerns fading, investors are fighting for yield and now dealing with new risks: inflation, curve inversion, rising rates, and conflict. Will those risks be soon forgotten or persist for years? To investors, to the world, or to a nation, it makes a great deal of difference.

After a summary of Q1 market activity we discuss how portfolios are evolving to address new risks.

2022 Q1 ECONOMIC SUMMARY AND MARKET PERFORMANCE

2022 stumbled out of the blocks. Inflation soared, Russia invaded, and the Fed raised rates. Equity markets had their worst quarter in two years and bonds languished. A yield curve inversion hinted at troubles ahead. A looming recession overshadowed positive employment news.

Economic Performance: Inflation Surged and GDP Growth Slowed

The U.S. inflation rate hit a 40-year high of 7.9% in Q1, and prices turned painful:

Food Prices

Beef	Pork	Chicken
+26%	+19%	+15%

Energy Prices

Nat Gas	Oil	Gasoline
+81%	+66%	+36%

GDP growth hit an annualized 1.7% for the quarter and is trending to 3.0% for the full year, according to Conference Board estimates. At the same time, the Conference Board lowered its 2022 and 2023 GDP growth estimates due to inflation and invasion uncertainties.

The unemployment rate continues to decline, hitting 3.6% in March, slowly trending toward pre-pandemic levels (3.5% back in February 2020).

Monetary Policy Overview: Fed Raises Rates, More and Bigger Rate Increases Are Coming

The Fed raised rates for the first time since 2018. The market expects six more increases this year to combat inflation. Even the Fed's proposed increases won't bring rates high enough to pace with inflation. Chairman Powell has turned hawkish and has messaged a 50-basis point rate hike, even as the yield curve has inverted for the first time since 2006.

The Fed has tricky shoals to navigate: it has to increase interest rates while keeping the country out of recession. That will take both art and luck. Investors will need both, plus yield, to keep pace with inflation.

U.S. and Global Equity Market Summary: Equity Markets Retrace

Following a stellar 2021, equities retraced on bad news, higher rates, and general uncertainty. Big Tech was hit hard. Many large cap tech names are now down more than 50% from their peak. The tech-heavy NASDAQ was down (-9%) YTD. Energy was a bright spot, up +38%[1] through Q1. Global equity markets ended the quarter down. Big decliners include Russia[2] (-79%) and China[3] (-15%).

Credit Markets: IG and HY Bonds Decline, Leveraged Loans Steady, Defaults Remain Low

Investment Grade[4]	High Yield[5]	Leveraged Loans[6]
-7.7%	-4.8%	-0.1%

Fitch estimates leveraged loan default rates will be at 1.5% for FY 2022, even after factoring in invasion uncertainty.

As we enter Q2, rising rates, Russia, and recession are driving markets. Despite rates rising, yields are still far below inflation. Below we explore these risks and where the smart money might be going.

1. Rates Are Rising, Bringing Pain to Fixed Income Investors

Yield is absent from public markets. Government bonds don't have it. Neither do inflation protected instruments or corporate bonds. Expect bond prices to drop more, as rates are going up globally. The amount of outstanding negative-yielding sovereign bonds has already declined by 90%.

For investors, rising rates bring the worst of all worlds: rates will still be less than inflation, and capital losses will show on their fixed income investments (we discuss the impact of rising rates below). Some of the credit carnage we cover includes an AA-rated bond that declined 50%, losses in safe U.S. government bonds, and the inflation hedge that didn't work.

The AA-Bond with a 50% decline

If God created war to teach Americans about geography, as Mark Twain quipped, then surely bankers created 100-year bonds to teach Austrians about duration risk. In Q1, Austria's AA-rated government bonds declined by 50%, a staggering drop for a non-defaulting sovereign bond. Yet, it's just math; a long maturity and minuscule yield makes this bond particularly sensitive to rate changes.

U.S. Treasuries with a 10% Decline; Inflation Linked Instruments Haven't Kept Pace

Less extreme, but still unexpected for some investors, is the decline in TLT, the long-dated treasury fund ETF, which had a double-digit drop in Q1 (-10.9%). Fixed income investors are experiencing the downside of higher rates from a low base.

Investors expecting Treasury Inflation-Protected Securities (TIPS) to outperform in Q1 were also left with losses. TIPS actually *declined* during the quarter as inflation hit record highs. TIPS, like all bonds, still decline when rates rise. Investors looking for total return may have to look outside sovereign securities. But even corporate bond markets offer limited options.

Bond Investors Worldwide Have Suffered

In Q1, global bond markets had their worst drawdown on record. The Bloomberg Global Aggregate index, which includes government and corporate debt, is down 11% from its high. That's a greater decline than at the peak of the global financial crisis. Additional rate increases could further that decline.

In the hunt for yield, Moody's Investor Services, expects demand to shift to more alternative assets after the sector raised over $1 trillion in 2021. And the conflict in the Ukraine may hasten that shift.

2. Russia – A Conflict Transforming Supply Chains and Markets

Sanctions, war, and Covid are transforming supply chains, according to a recent *Wall Street Journal* article[7] . The last 50 years of globalization, which brought chains optimized for cost at the expense of resilience, may be reversing.

Companies are adding capacity closer to home to mitigate future supply chain disruptions. These changes can create investment opportunities, as re-shoring will require additional capital investment in the U.S. and Europe. Soon to be implemented emissions disclosure requirements, including Scope 3, will enhance supply chain scrutiny.

The supply chain shift will take time, especially in the energy sector. For example, currently Germany gets 30% of its oil, 55% of its natural gas, and 25% of its coal from Russia. To replace that supply—possibly with ESG friendly options—will take vast amounts of capital. Private markets could be the primary source of that capital, as PE funds currently sit on over $1.5 trillion of dry powder, according to Preqin. Alternative investment infrastructure has been gearing up to deploy that capital, with private markets being the primary beneficiaries.

Private Markets Could Benefit From the Shift

Expect fragmentation to bring new ideas and new markets. In a recent Bloomberg column[8], Mohamed El-Erian, former Pimco co-Chief Investment Officer listed some of the long-term ramifications of conflict. He expects more inflation, heightened US and China tension, and more self-sanctioning by companies due to ESG concerns. Crucial for assets managers, he expects these concerns will increase the shift from public to private markets. Private markets have flexibility unavailable to public markets participants. "Private equity, venture capital, private credit and real assets" will all benefit from the migration, he believes.

Large asset managers are already gearing up to deploy private market capital. Preqin notes that 45% of PE funds have increased their use of private credit investors to fund transactions. With expanding opportunities for retail investors to enter private markets, PE funds and alternative lending platforms may prove more appealing than traditional debt or equity investments.

3. Is a Recession Coming?

A recent yield curve inversion hinted the economy may soon stumble. Data from previous recessions suggests holding fast.

The Yield Curve is an Imperfect Guide to Future Recessions

Although inversion is a reliable recession indication — the SF Fed says inversion has preceded every recession for the last 60 years — not all indicators point to a recession. Low unemployment, for example, suggests underlying economic strength. Further, an inversion doesn't mean a recession is imminent. The yield curve inverted in 2005 and a recession didn't start until 2007. However, even a flat yield curve is not good, as it suggests lower future growth.

The Data on Recessions and Market Returns

Recessions are psychologically painful. Jobs are lost, markets decline, and the news is depressing. Taking all the recessions from 1945, the market has had an average max drawdown of 29%. The 2008 recession had the highest peak to trough move, with a 57% decline.

The data says that investors should sit tight and wait it out. Retail investors buy the most at the top and typically sell the most at the bottom.

However, the data also shows that one year after a recession, 85% of investors who held on would have recovered. And after 3 years 100% of investors would be back positive. In other words, time in the market beats timing the market.

SHELTER FROM THE STORM

Q1's simultaneous decline in stocks and bonds subverts the assumptions of the balancing effect of the classic 60/40 portfolio. In theory, risky stocks should be balanced out with stable bond yield. However, in Q1, both stocks and bonds experienced declines. Institutional investors aren't getting the yield and volatility management they need in traditional stock and bonds. In the face of rising rates, investors are more likely than ever to look to alternative investments to find total return over traditional assets and strategies.

Capital allocators expect to move fast to capitalize on fleeting opportunities. This played out during the initial stages of Covid when large asset managers had the bench of talent and availability of capital to help portfolio companies survive and manage shareholder returns. Managers with private market flexibility may be able to best capitalize on new opportunities and market fragmentation, turning flexibility into alpha, and experience into total returns. Investors have more access than ever to access markets formerly only available to large institutions. To an investor trying to find yield, that might make all the difference.

1. As represented by the Energy Select Sector SPDR Fund.
2. As represented by the VanEck Russia ETF
3. As represented by the Xtrackers Harvest CSI 300 China A-Shares ETF
4. As represented by the Barclays Capital US Investment Grade Bond Index.
5. As represented by the Bloomberg Barclays US Corporate High Yield Total Return Index Value Unhedged USD
6. As represented by S&P/LSTA Leveraged Loan Total Return Index
7. How Sanctions on Russia, War in Ukraine and Covid in China Are Transforming Global Supply Chains, *Wall Street Journal*, Mar. 26, 2022
8. Ukraine War Hastens Investor Migration to Private Markets, Bloomberg.com, March 31, 2022