2022 First Quarter Commentary: Don't Fight The Fed

There was no shortage of uncertainty for investors to digest during the first quarter of 2022. Taking center stage was the war on the European continent - which is a shock that has yet to be fully understood in terms of its longer term political, economic and market impacts. However, the latest developments suggest that a new geopolitical landscape is in the making – one that divides the world into spheres of nationalism vs. globalism. Forecasting the war's end is anyone's guess, but a more deglobalized world certainly points to a higher inflationary regime. And while Russian and Ukrainian share of GDP may be small on relative terms, we are already seeing the short-term inflationary impacts given the war's disruption of supply chains and global commodities supply.

After a shock event such as a war, it is useful to reflect on one's past views and re-examine if this earlier thesis remains intact. Our fourth quarter 2021 commentary noted four primary risks to our cautiously optimistic view of a strong global economic recovery. Those listed then were as follows:

1. Continued supply side stress would continue to push inflation higher
2. A policy error by the Fed
3. Falling consumption in China given an inevitable fall from COVID due to its zero-tolerance policy
4. Escalation of geopolitical tensions on the European and Asia regions

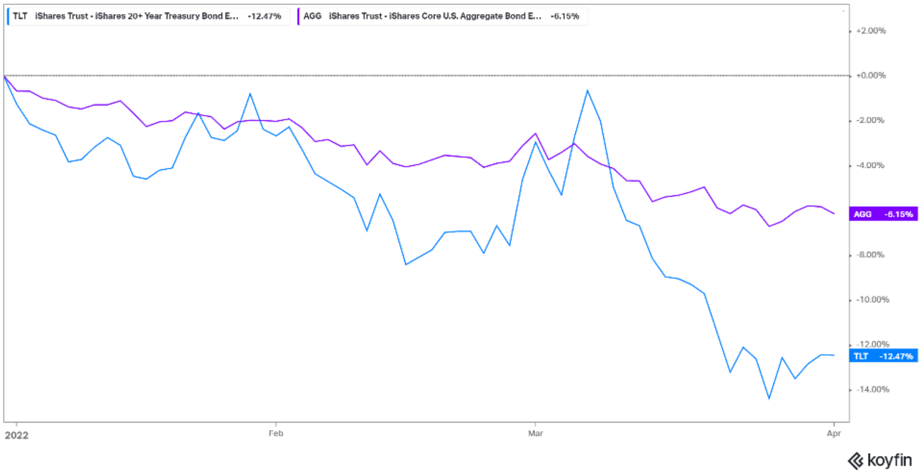
Exhibit 1: YTD 2022 Market Index Returns:

Total Returns	1Q 2022
Bloomberg Commodity TR USD	25.55
ICE BofA US High Yield TR USD	-4.51
S&P 500 TR USD	-4.60
Bloomberg US Treasury 3-10 Yr TR USD	-5.38
Bloomberg US Agg Bond TR USD	-5.93
MSCI EM NR USD	-6.97
Russell 2000 TR USD	-7.53
NASDAQ Composite TR USD	-8.95
Source: Morningstar, as of 3/31/2022	

Unfortunately, each of these risks became more apparent and caused turmoil in both stock and bond markets during the quarter. Despite the various narratives being offered by the street in making sense of these new developments, it is our opinion that inflation is the true driver of underlying market pricing. Chart 2 may help illustrate our perspective which highlights the 2022 YTD returns of both the Bloomberg Aggregate Bond Index, and TLT[1] (a proxy for long dated US Treasury bonds). During most risk off episodes, bonds would usually catch a strong bid in a flight to quality from investors. However, the -5.93%, and -12.54% YTD 2022 returns reveal how the diversification benefits of duration are rendered ineffective during periods of rapidly rising inflation.

[1] Please note AlphaCore does not actively invest in the ETF, TLT, and this is used for illustrative market returns only.

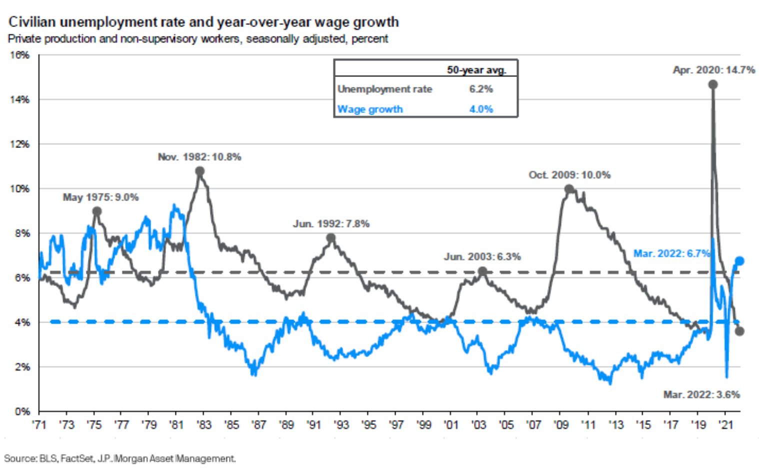
Exhibit 2: YTD Bond and Long Dated Treasury Returns :



Source: Koyfin, YTD as of 3/31/2022

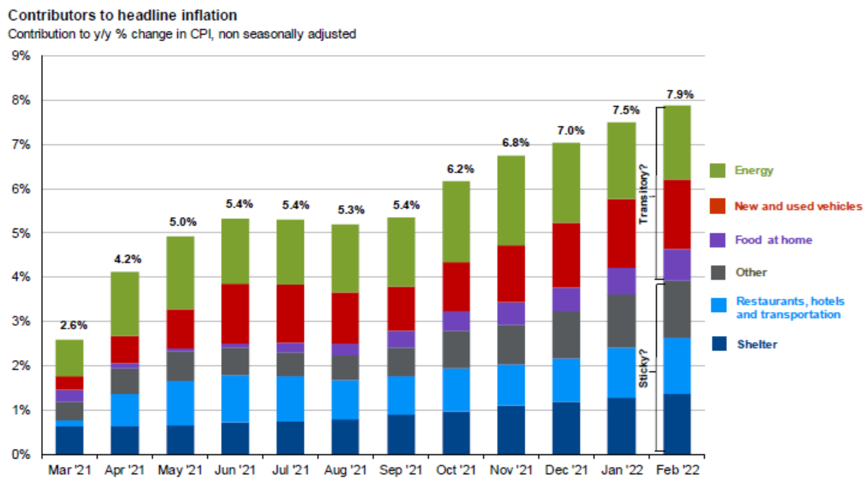
The moderation of inflation will be key to keeping consumption and growth drivers in place. Unfortunately, at this point, that appears to be too tall an order to fill. The past data did paint a picture of what has been domestically, a swift economic recovery. As expected, consumption of goods fell, while we saw a rebound in US household services. We also saw a boost in mobility behavior as it relates to travel and leisure. Hotel occupancy rates rose above their prior 2019 levels, while retail and dining activity also trended above 2019 levels. Furthermore, we saw a very strong labor market that continues to tighten having added another approximately 525,000 on average over the last three months as of March 2022, and an unemployment rate having fallen to just 3.6% (see Exhibit 3 for latest labor data). Wage growth is also climbing at a pace not seen in over two decades.

Exhibit 3: Labor Market Data:



Not all the data suggests a smooth transition from here. Consumer prices continue to rise given the sustained demand and supply pressures. The Consumer Price Index rose another 2% over a three-month period as of February 2022 and posted a 7.9% year-over-year change (see Exhibit 4). Meanwhile, the University of Michigan consumer sentiment index continued its fall in late March and now stands at its lowest level in over a decade. Similarly, on the manufacturing side, the ISM PMI index report for March highlighted that new orders fell sharply, while inventories are beginning to build. **Growing inventories and slowing production may be signaling the early signs of demand destruction from the elevated price pressures.** The economic outlook remains incredibly difficult to forecast given so many risk factors that are currently in play. Coming into the year, our base case scenario assumed a continuation of the strong economic recovery in the US supported by the post-pandemic economic reopening driven by strong consumer demand given relatively strong household balance sheets. The geopolitical conflict and its sanctions places growth at risk today by further contributing to commodities driven inflation -which ultimately brings about demand destruction. It is important to remain grounded and realistic in our expectations. Our outlook is more negative today. Price pressures are broadening, and in our opinion, may continue to surprise markets.

Exhibit 4: Monthly Look at CPI Components:



Source: JP Asset Management, Bureau of Labor Statistics

At last, the Federal Reserve has communicated to the market it is shifting gears with its policy to fight off inflation and raised the overnight borrowing rate by 0.25%. The yield curve has meaningfully repriced on the front end to reflect what may be the new path upwards over the next year for short-term interest rates. The market anxiously awaits until Fed officials share notes regarding how they plan on reducing the balance sheet (effectively the unwinding of their massive purchases of Treasury bonds and mortgage-backed securities), which has been a tremendous source of market liquidity for capital markets. How this void gets filled remains to be seen. The saying "don't fight the Fed" certainly worked for investors this last cycle. We think the inverse is also true. As money becomes scarcer, and expensive, price discovery will take center stage.

Rather than obsess over the next policy move, more than anything, we are emphasizing what we believe to be very common-sense steps within a portfolio to make it more durable and all weather in this time of uncertainty. Our long-standing themes remain intact which we will cover in the subsections below.

EQUITY

Equities were down during the period -4.60% as represented by the S&P 500 Index. In particular, the worst performing sectors were communication services, consumer discretionary and technology. Large cap stocks outperformed small cap stocks, and value outperformed growth. The standout performance from a sector standpoint came from the energy sector.

In terms of equity positioning within our portfolios, we remain globally diversified, with a strong preference for factors like quality and profitability, which translates into heavier exposures to those companies with strong balance sheets and meaningful cash flow generation.

- What does it mean today to focus on cash flow? On first impression, one might quickly conclude that this means cyclicals exposures given the recent upswing, but a free cash flow yield-focused portfolio today provides meaningful sector exposures to healthcare, materials, information technology and consumer discretionary. We like this blend of both defensive and more reflationary sectors.

- Inflation has shifted investor sentiment to prioritize profits. We think this not only makes sense given the new paradigm of real return, but also from a valuation multiple perspective, many of these types of companies have long been forgotten by Wall Street in the last several years and often trade below current market multiples.

Exhibit 5: S&P 500 Index Top 10 Stocks Valuations:

Exhibit 6: S&P 500 Index Top 10 Stock Index Weighting and Earnings Contribution:

Source: JP Asset Management, FactSet

- We are still proponents of growth investing but recognize the current macro environment suggests a more balanced equity portfolio. We therefore advocate active management.

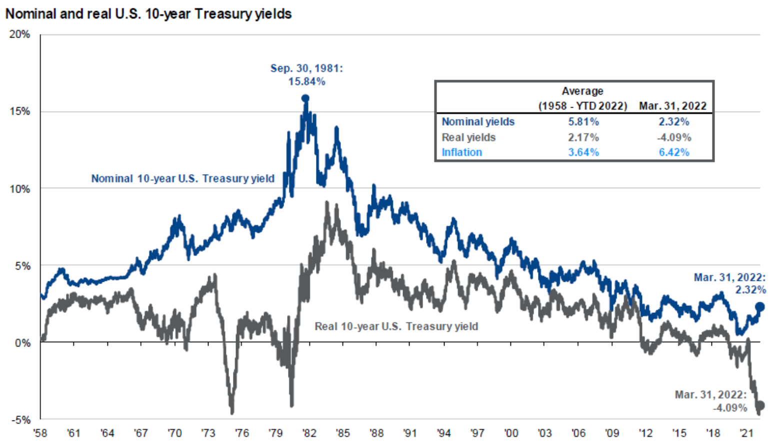
Equity investors are looking at a consensus earnings growth forecast of 9% for 2022, which is far lower than the 50% earnings growth we saw from the market in 2021. This is all happening at a time when corporate profit margins appear to have already peaked late last year, inflationary pressures continue to trend higher (labor and materials), and Uncles Sam's pandemic stimulus checks have been exhausted.

Investors continue to heavily favor the mega cap stocks as reflected by the weighting concentration of the top 10 stocks of the S&P 500 Index still hovering near the all-time high at 32%. Yet, over the last year, their contribution to earnings has fallen by nearly -30%. Investors are paying a hefty premium for these earnings at nearly 2 times the forward price-to-earnings ratio vs. the other stock constituents outside the top 10 -- the equity "safety" trade. Going forward, we question the reliability of earnings growth of even the largest corporates at these types of valuation premiums. The way forward is breadth and active stock selection in our opinion.

FIXED INCOME

The yield curve saw a meaningful rise across all maturities during the period which led to a flattening of term premium on the longer end of the curve. Such a shape rarely forms in this manner and is often a prelude to a slowing economic growth environment. Investment grade credit and high yield spreads also widened out during the period, which caused another pain point for traditional fixed income investors.

Exhibit 7: Nominal and Real Yields of the 10-year Treasury Bond:



Source: BLS, FactSet, Federal Reserve, J.P. Morgan Asset Management.

AlphaCore's strategic underweight positioning to core bonds and corporate credit led to relative outperformance for our portfolios. While bonds have historically served as a reliable form of yield and ballast to equity beta, we find that the poor asymmetry embedded in their return profiles at such low absolute yields supports our call for positioning away from the asset class and into fixed income alternatives. The drawdown observed in bond markets during the quarter illustrates this long-held view. In the span of one quarter, investors who held a Bloomberg Aggregate Bond Index-like basket of bonds gave up about two years' worth of total return. While higher yields may entice investors to jump back into bonds on what appears to be more attractive relative valuations, we remind readers that inflation remains elevated. Forward looking real returns from the asset class are still deeply negative. We maintain our heavy underweight positioning to core bonds.

ALTERNATIVES

Alternatives were a bit of a mixed bag, but on balance, the allocation beat both stocks and bonds during a critical time when correlations of traditional asset classes broke down. January and February proved to be another difficult period for our growth biased long-short equity managers. Growth stocks sold off hard again, and short portfolio profits did little to provide meaningful offsets to losses incurred on their long books. Our low net, value aware manager performed incredibly well in this environment, and built on the strong 2021 performance. On balance, our long-short equity platform outperformed the broad equity indices for the period. We remain excited about this component of our portfolio for the remainder of the year. We believe stock dispersion remains at attractive levels for our managers to create value in the portfolio and like the idea of having a short book present for what could be a very turbulent path forward for risk assets. Given the inflation picture, we would rather short stock than own large exposures to core bonds and duration as a source of risk management of our equity risk.

Yield-generating assets like real estate and private credit continue to perform offering a high and consistent level of yield for our portfolios. Corporate default rates remain relatively low, but active credit selection and lending remain critical as economic headwinds from inflation put cost pressures on corporate margins and consumer spending. Overall, we remain constructive on the asset class. Other strategies and assets had more muted levels of contribution, but in general, helped preserve capital and helped provide ballast against the drawdowns in equity and bond exposures.

Regarding new alternative exposures, we wish to share some notable developments as it relates to new strategies onboarded at the firm (beyond just our views, we think it is always important to share with our clients the actual implementation of our views). We've reintroduced managed futures/trend following strategies in our portfolios during the first quarter having taken a more bullish stance on macro trading. Given the un-anchoring of interest rates, in our opinion, the increase in the cost of capital will reprice asset prices across the board. Developed market central banks are embarking on a hiking cycle globally, given inflation pressures having reached levels not seen in 40 years. We believe an investment strategy that seeks to deliver absolute returns by implementing a variety of trend-following models that can go both long and short will perform well in this type of environment. Furthermore, trend-following serves as a true diversifier to equity and duration factors- the trend factor exhibits a unique correlation profile that offers near-zero long term historical correlation to both factors.

CONCLUSION

At present, we are of the view that the economy is on a less-optimistic growth trajectory than previously forecasted. Lower economic growth, higher inflation and rising borrowing costs will likely create more volatility across risk assets. We are reliant on alternative strategies more than ever to help us navigate the road ahead.

Our industry in the last several years has been floating around the acronym "TINA," which stands for "there is no alternative" which has often been cited in justifying the heavy purchasing of stocks given the low level of yields in bond markets. We try to keep our investment approach grounded in fundamentals. It's our view that overreaching and chasing both stocks and bonds at irrational valuations will lead to unfavorable outcomes for investors. We believe the problem with "TINA" is that it often incites exuberance and blind faith. The solution to investing in a market environment with stretched valuations and irrational behavior is through alternative investments. The first quarter highlighted the dangers and vulnerabilities that inflation poses on stocks and bonds, and when long-held correlations break down, there is nowhere to hide. This should be a loud wake up call for traditional asset allocators. Our Investment Committee is closely monitoring the geopolitical situation and will update clients accordingly on any portfolio updates. As always, we appreciate your confidence and trust in our team, and encourage you to reach out if you have any questions.

Best,

Johann Lee
Director of Research

DISCLOSURES

- Bloomberg Barclays Capital US Aggregate Bond Index: The index consists of approximately 17,000 bonds. The index represents a wide range of securities, from investment grade and public to fixed income.
- ICE BoAML HY Index: The index is a commonly used benchmark index for high-yield corporate bonds. It tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market.
- Russell 3000 Index: The Russell 3000 Index is a market-capitalization-weighted equity index maintained by the FTSE Russell that provides exposure to the entire U.S. stock market. The index tracks the performance of the 3,000 largest U.S.-traded stocks which represent about 98% of all U.S incorporated equity securities.
- Russell 2000 Index: The Russell 2000 Index is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.
- MSCI ACWI (All Country World) Index: The MSCI ACWI is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI Index is comprised of stocks from both developed and emerging markets.
- MSCI Emerging Markets Index: The MSCI Emerging Markets Index is used to measure the financial performance of companies in fast-growing economies around the world. The index tracks mid-cap and large-cap stocks in 27 countries, dominated by Chinese, Taiwanese, and South Korean companies.
- S&P 500 Index: S&P 500 index is a float-adjusted market-cap weighted index, largely reflecting the large-cap US equities. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.
- NASDAQ 100 Index: The Nasdaq 100 Index is a basket of the 100 largest, most actively traded U.S companies listed on the Nasdaq stock exchange. The index includes companies from various industries except for the financial industry, like commercial and investment banks.
- Purchasing Managers' Index (PMI): PMI Index is an indicator of economic health for manufacturing and service sectors. The purpose of the PMI is to provide information about current business conditions to company decision makers, analysts and purchasing managers.
- ISM Manufacturing Index: The ISM Manufacturing Index is a widely-watched indicator of recent U.S. economic activity. The index is often referred to as the Purchasing Manager's Index (PMI).
- The Bloomberg Commodity Total Return Index: The BCOM TR Index is composed of futures contracts and reflects the returns on a fully collateralized investment in the BCOM. This combines the returns of the BCOM with the returns on cash collateral invested in 13-week (3 Month) U.S. Treasury Bills.
- CBOE Volatility Index (VIX Index): The VIX Index is a real-time market index used to measure the market's expectation of future volatility. Being a forward-looking index, it is constructed using the implied volatilities on S&P 500 index options (SPX) and represents the market's expectation of 30-day future volatility of the S&P 500 index which is considered the leading indicator of the broad U.S. stock market.

This commentary represents the current market views of the author, and AlphaCore Capital in general and there is no guarantee that any forecasts made will come to pass. Due to various risks and uncertainties, actual events, results or performance may differ materially from those reflected or contemplated in any forward-looking statements. The opinions are based on market conditions as of the date of publication and are subject to change. No obligation is undertaken to update any information, data or material contained herein.

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