Tug of War

Introduction

Since the beginning of last year, markets have engaged in a giant tug of war as it relates to the direction of the economy, inflation and the subsequent level of interest rates. For the overall period from Jan 4, 2022 through the end of Q1, every major asset class except for inflation-sensitive assets are negative. This is after a bounce in almost all assets in the first quarter of 2023.

There are shifting narratives based on the belief that the Federal Reserve might be nearing the end of its interest rate hiking cycle supported by solid evidence that inflation pressures are easing and economic growth remains positive. Still, the belief in a "goldilocks" scenario that would allow the Fed, the markets and employees to all win, ebbs and flows.

Returns from Peak (2022 – Q1 2023)

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In February, strong economic data drove a "higher (interest rates) for longer" narrative in the market that caused stocks to falter. In March, that sentiment reversed when some mismanaged banks (including Silicon Valley and Signature Bank) put pressure on the entire regional banking system. An even larger failure was the near giveaway of Credit Suisse to UBS. The subsequent uncertainty and panic were enough to renew expectations that the Fed would back away from raising rates for fear of breaking the banking system and the economy. This reignited a rally in most assets that carried into the final days of March.

For the quarter, Avalon client portfolios were positive as gains from most asset classes including gold and gold stocks, US and International equities, and fixed income (including money market funds yielding over 4% per annum) were more than enough to offset small losses in market hedges. Given the current economic situation and the Fed's stated willingness to battle inflation, we expect to continue to hedge general market risk for the foreseeable future.

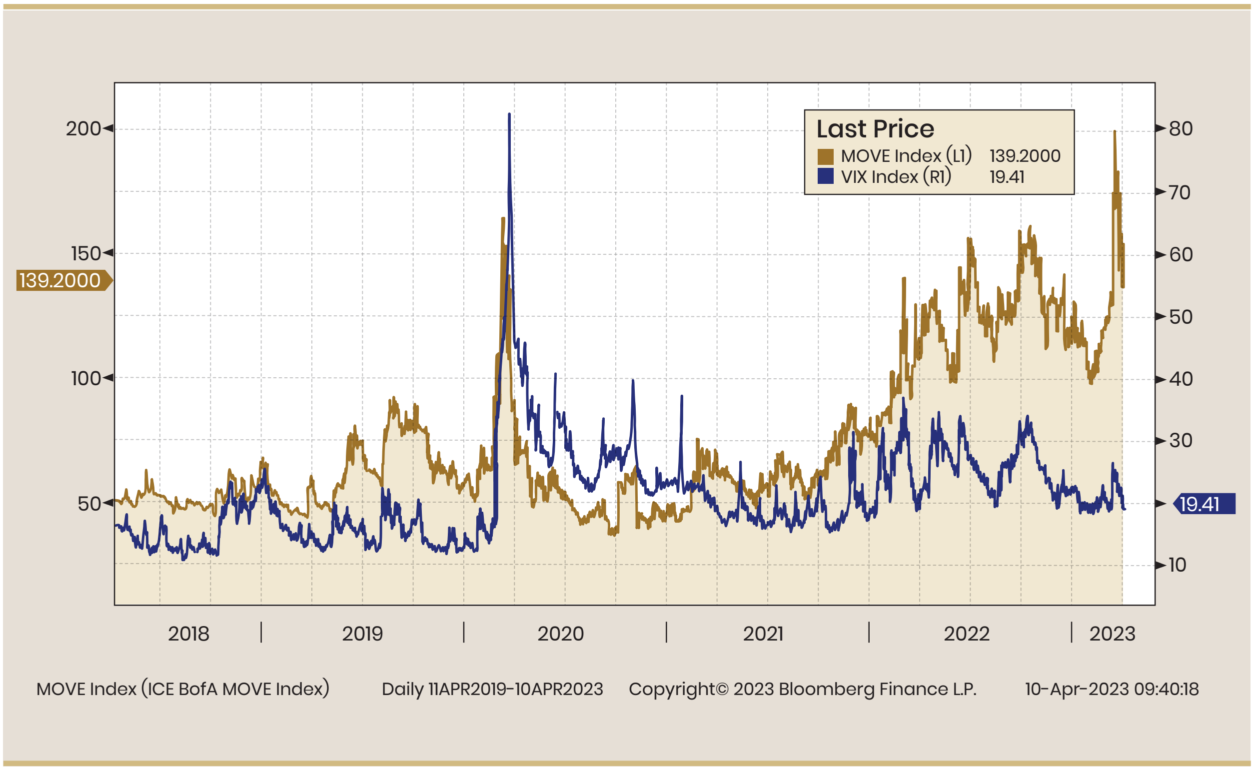
Of note for Q1 is that some of the worst performing asset classes of 2022 were among the best performing asset classes to start the new year. For the quarter, The Nasdaq Composite rose 19.6% while the S&P 500 finished up 7.1%. Similarly, the asset classes that performed best in 2022 (Natural Resources and US Value stocks) were laggards this quarter.

It's too early to sound the "all clear" based on one quarter's returns even as stock and bond markets probe for a bottom. We note that this quarter's returns for the Nasdaq and S&P 500 were driven largely by the FAANG stocks which feature companies with pristine balance sheets and sustainable franchises that are likely to benefit most from AI technologies such as ChatGPT. And while FAANG stocks such as META returned over 76% this quarter (we note the stock is still trading 45% below its peak from mid-2021), market strength was not supported with breadth beyond mega-cap tech. For example, the equal-weighted S&P 500 index was up only 2.3% as the S&P Energy, Health Care, Utilities, and Financials sectors all finished the quarter with losses. Another broad market benchmark, the Dow Jones Industrial Average rose just 0.93%.

During the quarter, we maintained overweight allocations to gold and gold stocks as well as allocations to international equities. We also maintained modest exposure to US stocks throughout client portfolios. Our analysis indicates that this quarter's rally in US equities is not yet confirmed. While history never repeats, we note that the only quarter in which the Nasdaq performed better was in Q2 2001 when it returned 20.7%. That year, which came amidst a 78% multi-year drawdown for the index, saw the Nasdaq finish the full year down over 21%.

Stock and Bond Markets are Sending Mixed Messages

2022 marked the first year in decades where US stocks and bonds jointly suffered negative returns. Largely, last year's stock market drop could be explained by the rise in interest rates (which negatively impacted bonds). And while this year's decline in interest rates (and modest rise in bond prices) has been the tailwind for the rally in US growth equities, there are key divergences



between stock and bond volatility measures this year that don't support the stock market rally. We note that the MOVE Index (a measure of implied volatility in the US Treasury Bond market) remains elevated while the more well-known VIX Index (the corresponding volatility measure for US stocks) trades at relatively low levels. Given that the historical relationship between these two indices is slightly less than 1, this spread warrants caution as it relates to (highly levered to interest rates) growth stocks.

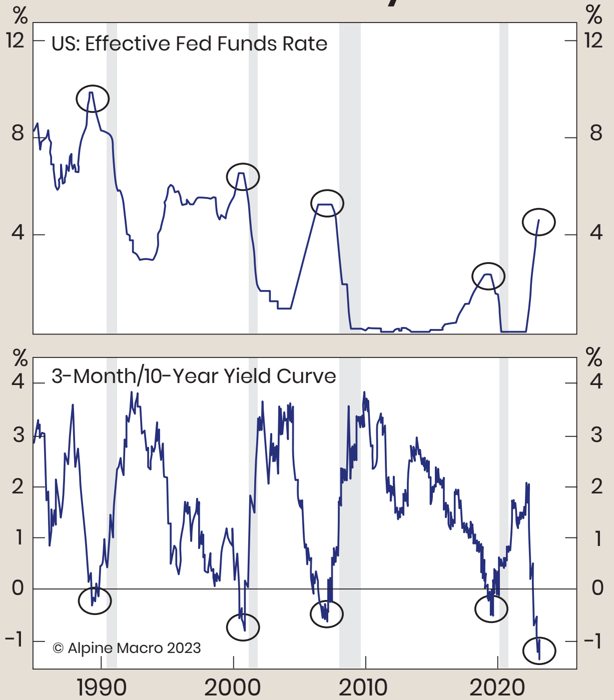
Our analysis indicates that sequencing matters as it relates to the start of another equity bull market. And that it is hard to envision a scenario where the stock market continues to rally unless short rates, which are controlled by the Fed, peak. The historical evidence is heavily against the ability of stocks to sustain a multi-year rally from here without a corresponding economic slowdown, implying the yield curve would need to re-steepen before we have confirmation of a market turn. And while the Fed is indirectly supporting the stock market through its efforts to stabilize the banking system (Quantitative Tightening has stopped, for example), the Fed continues to unflinchingly raise short-term interest rates in its fight against inflation.

The Yield Curve is Tremendously Inverted

The Federal Reserve has traditionally managed the economy by setting short-term interest rates. Just as short-term rates matter in a vacuum (for money market rates, etc), the relative levels of short-term rates vs long-term rates (the yield curve) matter as a predictor of where the economy might be headed. While yield curves are not often inverted, recessions historically follow periods where the yield curve is inverted. As the chart below documents, the Fed has moved the yield curve to record levels of inversion.

The rally in US stocks is a sign that the market either does not believe that the Fed can sustain this yield curve inversion or that the inversion is driven by factors (such as Quantitative Easing) that would not cause a recession. Though with the labor market starting to show cracks, purchasing data decelerating and the S&P 500 trading at a historically elevated 18x PE, we think caution is still warranted.

The Fed's Monetary Overkill



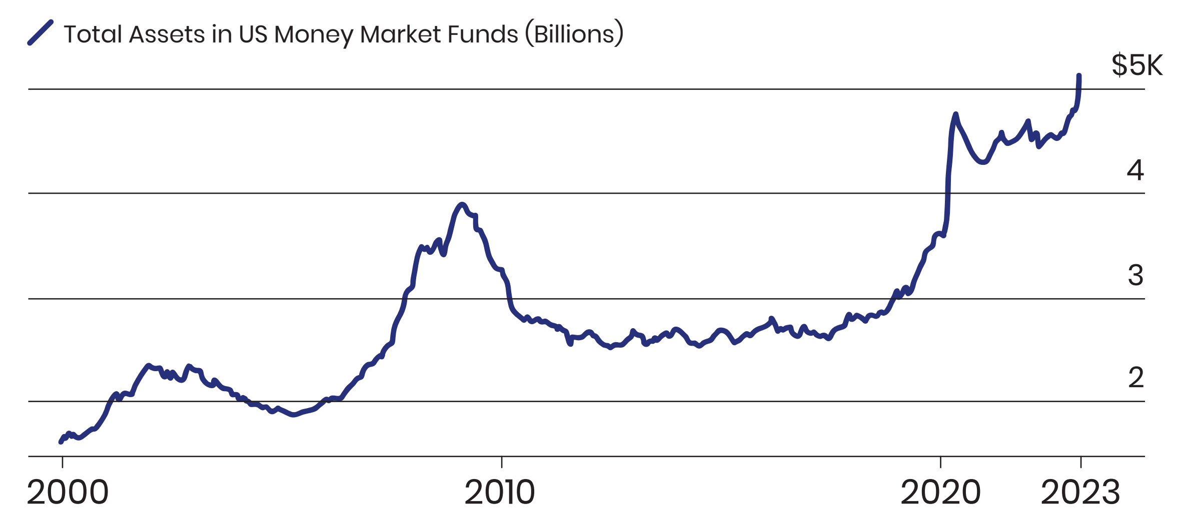
Note: Shading denotes U.S. recessions

The Case for Long Bonds

As the Federal Reserve raised short-term rates last year, higher yielding purchased money market instruments became (for the first time in a decade) much more attractive than cash. As a result, we moved client cash positions into purchased money market funds (investing in short-term US Treasuries) which are currently yielding over 4%. We note that part of what is pressuring banks is that many investors are becoming aware of this yield discrepancy and moving their 0.15% yielding bank deposits into these money market instruments at brokerage firms. If you became familiar with the banking concept of "cash sorting" in March, the below chart documents it well.

Where the Money Is Going

Money market funds' assets have hit a new record



Source: Investment Company Institute, Bloomberg

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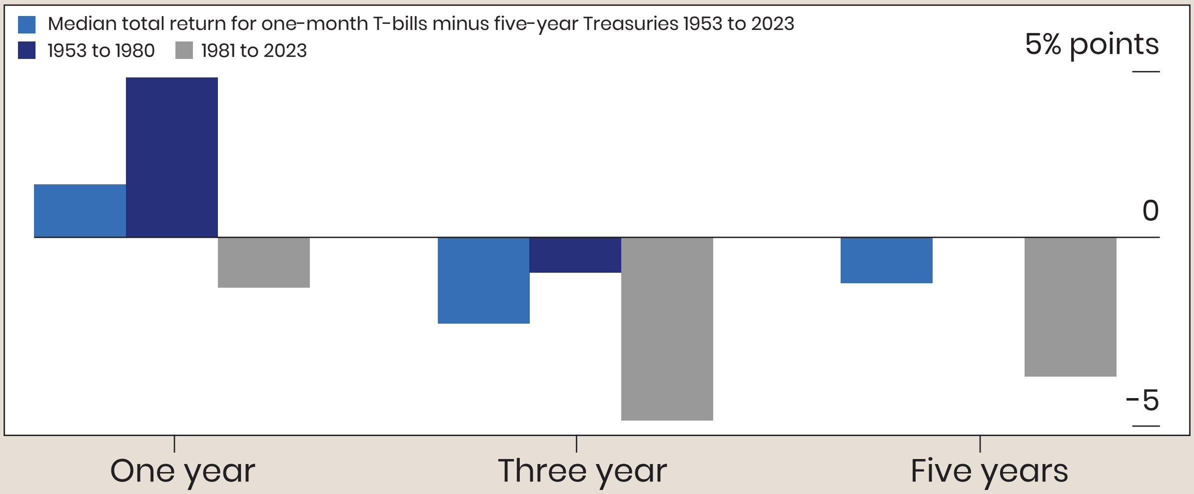
Cash Is Not King

Longer-term bonds have often been a better bet than cash in years after inversions despite starting with a lower yield



Sources: Bloomberg, Morningstar
Note: Through February 2023.

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And while short-term US Treasury Bills are currently yielding far more than their longer duration brethren, there is potential opportunity cost in staying in Treasury Bills once short rates peak. Historically, over 3–5-year periods following an inversion, investors would have been better off not in Treasury Bills but in longer duration US Treasuries. The reason for this is that changes in interest rates (and the larger price appreciation associated with these changes) have had a greater impact on the subsequent total return than did the starting yield. This is like the parable of the Tortoise and the Hare. When interest rates are set to drop, having more exposure to "locked-in" yields though not the highest cash flows (the Tortoise) has historically overcome the difference in the starting point yield (the Hare).

For these and for many technical and investor behavioral reasons, we continue to favor long duration US Treasuries in client portfolios in addition to the money market funds. Once the economy falls into recession, long bonds are one of the top performing asset classes. And while cash will act as a buffer, those relatively high yields will quickly melt away.

Cash Flow is King

While we are happy to make the case above that, with an inverted yield curve, cash is not necessarily king, we have a different perspective when thinking about many of our equity holdings. In the case of our most recent allocation to international stocks, we would argue that cash flow is king (or certainly an important component of stock returns). As it relates to our most recent allocation to Large Cap International equities, we are underwriting a set of stocks that offer a Free Cash Flow yield of 17.2% with a corresponding Dividend Yield of 6.3% and a PE of 4.6x. This valuation seems completely sensible to us and compares favorably with the S&P 500 which offers a Free Cash Flow yield of around 4%, a Dividend Yield below 2% and a PE of 18x.

A Better Start

We stated in our last three quarterly client letters, *"Our current view is that the bear market in equities is advanced, yet incomplete. In the short term, neither fundamentals, valuations, nor financial conditions are bullish."* Our analysis continues to support this view in the US though we remain excited about the opportunities in non-US Dollar assets based on the falling Dollar, the normalization of interest rates and historically attractive valuation spreads in many equity markets.

Indications are that long cycles for bond yields are topping and long cycles for stocks are starting to bottom, so we are patiently optimistic about the opportunity to be more aggressive, especially as it relates to growth assets. Nevertheless, we still believe that the backdrop for any multi-year equity rally requires short-term interest rates to peak and a resulting economic slowdown. We do not believe that stocks have yet discounted that probability or the risk to corporate earnings. Sequencing matters. Thus, we watch and wait for the bond market rally that is the likely precursor to stocks bottoming.

Please let us know if your financial situation has changed. We are looking forward to seeing you soon.

Clara Basile   David Rahn   Bill Oberman   Ross Revenaugh

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