STRATEGAS

insight

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The Great Margin Call

In their 1977 hit , "Torn Between Two Lovers," U.S. folk trio Peter, Paul and Mary sing, "loving both of you is breaking all the rules." While it was unlikely songwriter Peter Yarrow's muse, this sentiment would seem to hold as much for monetary policy as it does for affairs of the heart. Our decade long affair with easy money has been exposed and it turns out there exists no modern theory to spin monetary vice into virtue. We have felt for some time that sorting this all out is very likely to be messy. We believe two related though increasingly distinct areas of focus deserve investors' attention.

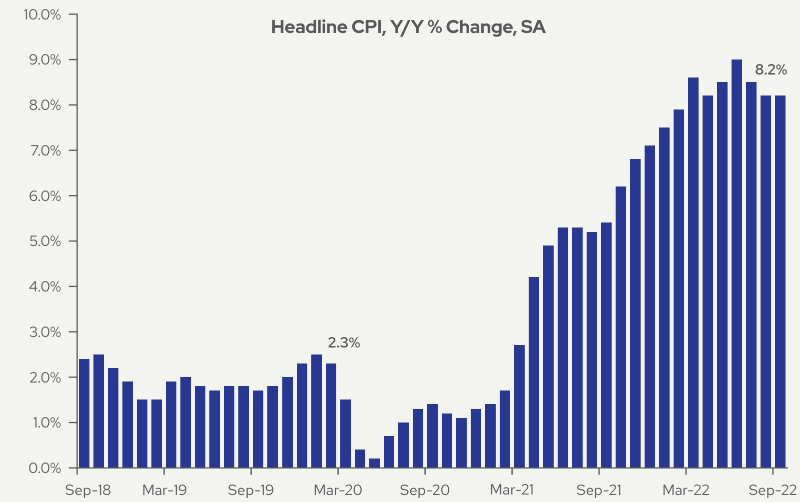
The remit and current preoccupation of the Federal Reserve – and therefore the primary focus of most investors – is the gnawing tension between the regressive scrooge of inflation and the recession-inducing policy prescription necessary to wrestle it back to an acceptable level. The degree of emphasis the Fed puts on anchoring inflation versus any attempt to engineer a soft-landing, or otherwise prolong the business cycle, would appear to directly impact investors' handicapping of (and hope for) a Fed "pivot," an increasingly desired salve for the second order effects of inflation fighting.

To this end, we took away two interesting observations from our annual Investment Forum at Tucker's Point in Bermuda earlier this month. Aware that many of the Fed's previous tightening campaigns were halted when they led to something abruptly "breaking," we were surprised to learn from one guest – a former regional Fed bank president – that the Fed is often "as surprised as the market" when and where these fractures occur. Hardly reassuring. Moreover, there was consensus among our clients, even those who shade toward more optimistic outcomes, that for the bullish (or less bearish) thesis to take root, global central banks and the Fed in particular, would need to slow the pace of policy rate hikes if not begin to reverse them entirely.

What would induce the Fed to do so? Is 'institutional pressure' (e.g., the IMF, the UN, etc.) enough? Perhaps 'pressure plus some softer data' or 'pressure, softer data, and the warnings or insistence of another central bank'? How firm is Chair Powell's resolve? His Jackson Hole speech was less than two months ago… The September CPI print came in higher than the Street's expectations at 8.2%. Thus far no offshore epicenter of dislocation has been enough. That the intensity of focus appears fixed more on what the Fed can do for investors than the conditions necessary for the Fed to be successful at its stated objective would seem to support Strategas Chief Strategist Jason Trennert's observation that investors have become conditioned to anticipate policy-supported "v-shaped" bottoms.

What's more, that may not do the trick this time; it may not even be an offer. As we wrote earlier this summer, we view the "anchoring" of inflation expectations as a pre-condition for the market to stop going down, first, and second for the level-setting of prices and fundamentals (i.e., valuations) in combination with the emergence of discernible organic drivers of growth to be present before the market can start going up. There is work to be done.

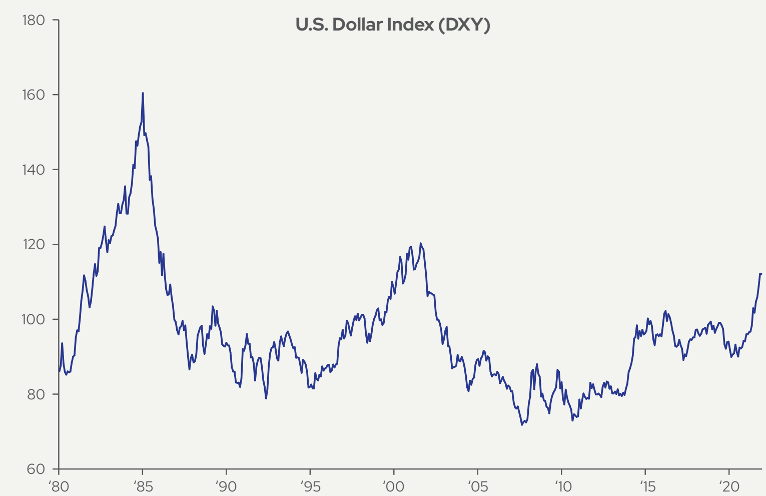
Without being flippant, it has almost become a parlor game to try to handicap how much external pressure it will take or the degree of collateral damage necessary to induce the Fed to pivot. This was never more obvious to us than at a recent dinner party.



Source: Strategas, FRED

Despite refreshingly few investors in attendance, and high hopes of talking about anything but, the discussion still turned toward inflation, politics, the economy and, ultimately, the expected Fed pivot. After some clarification on what "pivot" entails technically, the supposed merits and costs were debated at some length. (All followed by a wonderful chocolate soufflé for dessert.) The discussion provides entrée, however, to a second – perhaps more worrisome – area worthy of investors' focus. An important point Strategas' Fixed Income Strategist Tom Tzitzouris has made in recent months resonates in this moment: whether the stress appears in the sovereign, with state, provincial, canton or municipal credit, or in their pension systems, the "leverage" is in government. Recessions, however severe, are manageable, but when fixing the problem risks killing the patient – and the doctor, perhaps the measure of policymakers' actions on long-held global economic operating conventions should be more thoroughly considered.

We have already seen acute pockets of dislocation which hint at the systemic risk posed by such fault lines and the market pressure which results when counterparties and capital markets disagree on the appropriate marks for increasingly impaired collateral (e.g., U.K. pensions). At the center of the storm is the ultimate form of off balance sheet liabilities, trillions of debt that would seem to stretch the limits of Westphalian monetary orthodoxy. Much of this debt is U.S. Dollar-denominated though most of it was neither originated by U.S. banks for U.S. borrowers, invested in the U.S., or collateralized by anything remotely associated with U.S.; the only association the debt has with the U.S. are repayment covenants linked the value of, or requiring, Greenbacks. That's the problem. As the Fed continues to pursue tighter monetary policy under the cover of improved 3Q GDP data and a relatively strong labor market, the value of the U.S. Dollar increases and with it the cost of Dollar-denominated debt service. With the knowledge that non-Dollar borrowers are under increased pressure, spreads widen and volatility spikes, the classic liquidity trap opens in the form of a global margin call.



Source: Strategas, FactSet

With this as the backdrop, it is likely that risk assets will remain under pressure in general, and in some cases may even gap lower from current levels. The best we can do is continue to offer some framework with which to consider intrinsic value. To this end, we have been surprised by the modest downward revision of the Street's bottom-up earnings estimates. While it is fair, given the prevailing rate of inflation to argue that the "money illusion" may prop up nominal levels of revenue and profits from the percentage declines historically associated with recession, inside the numbers we have already evidenced a good degree of margin contraction. Though the preliminary read on 3Q'22 suggests broad economic data are modestly stronger than 1H'22 (the Atlanta Fed GDPNow tracker is running at 2.8%) we anticipate the forward guidance accompanying 3Q'22 earnings reports to be uninspiring. The market tends not to do well when the outlook is being revised lower. The percentage of S&P sub-industries estimated to post positive earnings growth over the next twelve months has fallen -15 pct. points to ~79% and the downtrend is accelerating suggesting weakness in broadening.

As it stands the market appears to be comfortable trading roughly 15.0-15.5x S&P NTM and CY'23 consensus EPS. This is consistent with the prevailing market multiple during historical inflation regimes of 4-6% Y/Y. Is this too optimistic? At a minimum we should consider that resolving the laundry list of global uncertainties may not occur quickly, without repercussion to corporate operators, or both. The average TTM S&P multiple at both previous bear market bottoms and in historical inflation regimes of 6-8% Y/Y is 11.6x. The symmetry is a coincidence, but can the Fed wrestle the regressive scrouge of inflation below 6% sooner than later? Will something break before they're successful requiring an accommodative (i.e., inflationary) policy response? Should they proceed apace, in the absence of monetary or fiscal incentives? Do substantive organic drivers of growth exist to call private capital to the economy? Too many questions. Too few good answers. Tread carefully.

About Strategas

Strategas is a global institutional brokerage and advisory firm. The Firm provides macro research, capital market and corporate advisory services, and investment management solutions to institutional investors and corporate executives in more than twenty countries around the world.

Founded in 2006 by Jason DeSena Trennert, Nicholas Bohnsack, and Don Rissmiller, the Firm was acquired by Baird Financial Group in 2018. Strategas operates independently as a wholly-owned subsidiary of Baird and offers institutional securities services through Strategas Securities, LLC, a broker-dealer, and investment management solutions, including this commentary, through Strategas Asset Management, LLC, a registered investment advisor.

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Index Overview & Key Definitions

Fed, The Fed or FED refers to the Federal Reserve System, the central bank of the United States. Fed Funds Rate, the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The Gross Domestic Product (GDP) rate is a measurement of the output of goods and services produced by labor and property located in the United States. Real Gross Domestic Product (GDP) is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year. Nominal Gross Domestic Product is gross domestic product (GDP) evaluated at current market prices. The S&P 500 Index is an unmanaged index comprised of 500 widely held securities considered to be representative of the stock market in general. The Russell 1000 Index is a market capitalization weighted benchmark index made up of the 1000 largest U.S. companies in the Russell 3000 Index. The Russell 2000 Index is an unmanaged index considered representative of small-cap stocks. The PCE (Personal Consumption Expenditure) Index of Prices is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures; essentially a measure of goods and services targeted towards individuals and consumed by individuals. The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services. FAANG is an acronym for the five of the market's most popular tech stocks, namely Facebook, Apple, Amazon, Netflix and Alphabet's Google. The North American Free Trade Agreement (NAFTA) is an agreement signed by Canada, Mexico, and the United States, creating a trilateral trade bloc in North America. The Seasonally Adjusted Annual Rate (SAAR) is a rate that is adjusted to take into account typical seasonal fluctuations in data and is expressed as an annual total. SAARs are used for data affected by seasonality, when it could be misleading to directly compare different times of the year. The Atlanta Fed GDPNow forecasting model provides a "nowcast" of the official estimate prior to its release by estimating GDP growth using a methodology similar to the one used by the U.S. Bureau of Economic Analysis. GDPNow is not an official forecast of the Atlanta Fed. Rather, it is best viewed as a running estimate of real GDP growth based on available data for the current measured quarter.

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