What We Are Hearing And Seeing

Envestnet offers one of the largest asset manager networks in the industry. Given the current environment, we want to share what we are seeing and hearing – perspectives from our trading & operations and Envestnet | PMC teams.

Michael Pajak, CAIA

Tactical Fixed Income in Uncertain Times

Investors experienced challenging equity and fixed income markets during the first half of 2022, resulting in one of the worst starts since 1950. For multi-asset class portfolios, the typical fixed income hedge was non-existent as bonds experienced double-digit losses. The Bloomberg U.S. Aggregate Bond Index returned -10.35%, while the S&P 500 returned -19.96% year-to-date (as of June 30, 2022). We're noticing that tactical fixed income strategies can help dampen the risk in these uncertain times.

One of the most popular and effective risk management methods uses tactical high-yield strategies with relative-strength-based quantitative models. Mathematical trading rules help position the portfolios defensively during periods of duress, helping remove emotions from the decision-making process. These tactical portfolios typically invest in high-yield bond funds when the trend is positive or defensively in Treasury bond funds (if they are in an uptrend) or in cash equivalents if neither bond market shows positive signals. Tactical high-yield strategies aim to provide investors with the upside of high-yield bonds while limiting the impact of the significant drawdowns that high-yield bonds can experience. For example, the Bloomberg U.S. Corporate High Yield Index fell 14.19% through the first half of 2022, while one of our Approved-Qualitative tactical high-yield strategies was down only 4.53% for the same period. This tactical high-yield strategy's ability to limit whipsaw and protect assets more precisely was an advantage through the end of the second quarter.

Understanding the nuances of tactical high-yield strategies is critical, as they are not created equally. One unique method uses trailing stop losses based on volatility for each underlying holding while also including an element of manager selection. This approach helped to limit the drawdowns more effectively in 2022. While all momentum-based systems are prone to whipsaw, trailing stop losses at the security level can help manage choppy periods while also capturing alpha through manager selection.

The most common way to execute this strategy uses a quantitative model that dictates when the entire portfolio is invested in the high-yield bond asset class (or not) and doesn't believe that manager selection adds alpha. These managers generally believe that returns within the high-yield bond mutual fund universe are homogeneous. Additionally, some managers have incorporated derivatives like credit default swaps (CDS) and total return swaps to improve efficiency and increase capacity. Strategies that used derivatives tended to have more significant drawdowns during market dislocations in 2020 and 2022, though. High-yield trends quickly changed in these periods, creating the whipsaw environment detrimental to relative-strength-based systems. Still, tactical high-yield bond strategies can provide compelling risk-adjusted performance, particularly in volatile markets, due to their systematic investment processes and ability to mitigate behavioral biases.

Michael Wedekind, CFA

TIPS Haven’t Perform as Advertised, But the Tide May Be Turning

After a harrowing first half of 2022, regardless of the fixed income foxhole one chose to hide out in, those holding Treasury Inflation-Protected Securities (TIPS) have learned the painful lesson that these bonds are not a surefire hedge against inflation. Although the Bloomberg US Treasury TIPS Index, which fell 8.92% in the first half of 2022, outperformed the Bloomberg US Aggregate Bond Index’s -10.35% return and the Bloomberg US Treasury Index’s -9.14%, these returns were likely not what TIPS investors had in mind when they allocated seeking an inflation hedge.

Why, then, are TIPS posting negative results while inflation is running hot? As it turns out, sensitivity to changes in interest rates (i.e., duration), isn’t just something that nominal bond investors have to worry about. Changes in real yields affect inflation-adjusted instruments like TIPS the same way that nominal yield fluctuations affect plain vanilla Treasurys. While the yield on the nominal 10-Year US Treasury Note doubled from 1.51% at the end of 2021 to 3.02% at mid-year 2022, the US 10-year real yield rocketed from -1.04% to a peak of 89 basis points (bps) in mid-June before ending that month at 65 bps. This increase in real yields hit TIPS prices hard enough to outweigh the positive impact of the inflation adjustment to their principal, with longer-duration TIPS portfolios taking the biggest hits. Illustrating this point, the popular iShares TIPS Bond ETF (TIP) entered 2022 with an average effective duration of 7.5 years, contrasting with the 2.5-year duration of the similarly popular Vanguard Short-Term Inflation-Protected Securities ETF (VTIP), according to Morningstar data. TIP fell 10.24% in 2022 through June, while VTIP gave up a comparatively mild 2.81%.

Morningstar data shows net outflows from mutual funds and ETFs in the inflation-protected bond category (synonymous with TIPS funds) totaled $3.9 billion in the first six months of the year after investors plowed over $75 billion into the asset class in 2021, indicating recently poor returns likely led many investors to reconsider their TIPS allocation. However, the selloff has taken a lot of the air out of TIPS valuations at a time of elevated inflation and when much of the price erosion due to rising yields may be in the rearview. Investors may benefit from giving TIPS a second chance.

Daniel Homan, CFA

US Dollars in the Wind

The US dollar has set a torrid pace of appreciation during the first half of 2022. Against a basket of currencies, it has gained nearly 10% so far this year. That meteoric rise has only been matched twice in a half year period since the global financial crisis (2007–09). The dollar even hit parity against the Euro for the first time since the early 2000s. This rise has been fueled by a Federal Reserve that has shifted from an accommodative stance to aggressive rate-raising that combats stubbornly high inflation. The novel aspect of this dollar run is that elevated inflation typically weakens currencies relative to peers. However, when the world is awash in inflation, monetary policy drives capital flows. In this instance, global investors are piling into relatively high-yielding dollar-denominated assets, driving the currency higher. The situation leads us to ask what the implications of a strong dollar are for US investors, and is this rise sustainable?

One big beneficiary of a strong dollar is the US consumer, who can buy goods from abroad more cheaply. This is a strong tailwind for non-US companies with substantial exports to the US, such as Toyota. On the flip side, US-domiciled multinational companies, who generate substantial portions of their revenue from abroad and in foreign currencies (such as Apple and Microsoft), will see net revenues drop because of dollar strength. This implies that companies with local currency costs and US dollar revenues will benefit the most, bolstering the case for increasing exposure to international companies.

While the greenback has been king through the first half of 2022, it may be vulnerable to a correction. According to London-based Mondrian Investment Partners, a PMC Select List manager who performs currency analysis as part of their process, the US dollar is now overvalued by nearly three standard deviations (according to purchasing power parity). That level not been seen in over 40 years. The combination of other major central banks (like the ECB) now embarking on monetary tightening, and the Fed potentially taking its foot off the gas, could cause the dollar to begin to slide. (The US technical recession that began in Q1 may downshift the Fed.) If the US dollar does back up, it could offer an excellent tailwind to US investors in international companies. As the dollar depreciates, the foreign company stock that was bought in local currency is worth more simply by the local currency appreciating. Further, international valuations remain very compelling versus their US counterparts (MSCI ACWI ex US Index NTM P/E: 11.5; MSCI USA NTM P/E: 16.2).

Whether the dollar remains in favor or begins to slide, we see an opportunity for international equity managers to generate excess returns by allocating to non-US companies positioned to benefit in either scenario. Additionally, with domestic recessionary fears on the rise and the momentum trade fizzling out, it could be time for US investors to top up their international exposure.

Akhil Gopalakrishnan

Should Investors Consider an Equal-Weighted Index?

Equally weighted indices (as opposed to traditional market cap weighted indices), and the passive funds that track them, are becoming more popular among investors who want to better diversify single stock risk. These indices capture a size-agnostic view of the underlying investment universe. However, controlling concentration risk isn't always favorable, and tactically doing so can be extremely difficult. For example, the S&P 500 Equal Weight Index has significantly underperformed the S&P 500 over the previous five years. The primary catalyst for this is the equal-weighted index's underweight to Information Technology and giant cap stocks, which have ballooned in market cap weighted indices. However, the tables turned in 2021, when the equally weighted approach marginally outperformed. Similarly, a number of active managers who exercised discipline by not chasing momentum and paying excess valuations for high-flying Technology stocks have benefited in this regime change.

This trend has continued so far in 2022. It is in stark contrast to previous years when Information Technology led the pack, and the equally weighted index's underweight to IT acted as a significant detractor. The recent bloodbath in the tech space contributed the most to the equal weighted index's relative outperformance because of its underweight to IT. Also, the rotation to defensive sectors such as Consumer Staples and Utilities has aided performance this year along with its underweight to Communication Services. Over the past year, Healthcare posted the worst relative performance for the S&P 500 Equal Weight Index, and Energy was the leader in both equal and cap weighted versions of the S&P 500. Many managers acknowledge that the multiple contraction experienced in the tech space has presented opportunities to own high cash flow-generating companies which can act as a natural hedge in uncertain periods. It seems clear this year that a more balanced approached to investing, not biased toward specific stocks or sectors, has been beneficial and may continue to be as this challenging market environment evolves.

Parina Sharma

High Yield Credit: A Tale of Fundamentals and Technicals

High yield credit had a resilient first quarter and held up relatively well amidst the sharp sell-off across fixed income markets. However, the tide turned in mid-April as credit spreads widened significantly, with investors seeking higher risk premiums amid increased recessionary fears and the rise in defaults and elevated volatility that could ensue. As a result, the ICE BofA US High Yield Index's effective yield peaked at 8.8 % in July, 2022, its highest level since the initial COVID-19 drawdown.

However, fund managers we've spoken with harbor cautious optimism as the strength of high yield issuers' underlying fundamentals, at least relative to previous recessions, is evident in improved leverage and coverage ratios, margins, and cash flows generation. This is a result of these issuers' conservative balance sheet management during the post-COVID recovery period. Given that many of the weakest companies defaulted in 2020, the average credit quality of the high yield market is now the highest it's been in the past decade, with BB-rated bonds currently comprising 52% of the universe.

The high yield market also appears to be on sound footing from a technical perspective, powered by a strong secondary market ($1.4 trillion) that experienced a flood of new issuance in 2020 and 2021. Most maturities now fall between 2026 and 2029, which contributed to below-average default projections for 2022. However, according to a forecast by Strategas, a macro research firm, US high yield default rates could rise toward the long-run average of 4.5% in 2023. Slowing growth has already hit primary issuance, which bottomed out in July as net supply dropped by $80 billion.

While the bulk of this decline in issuance can be attributed to rating upgrades, our managers expect net issuance to spiral down further as inflation and higher financing costs continue to pressure companies with speculative credit ratings. Though credit fundamentals, at the moment, seem to be favorable across the high yield market, it is yet to be seen how these corporate issuers will weather the likely challenging times ahead. However, at current yields and spread levels, this should create opportunities for discerning active managers who may be able to generate excess risk-adjusted returns through diligent credit selection.

https://www.wsj.com/articles/borrowing-among-junk-rated-firms-slows-to-a-trickle-11658746980

Beau Noeske, CFA, CAIA

Dividends Resuming Their Defensive Role

In February–March 2020, amidst one of the most dramatic market drawdowns in U.S. history, dividend stocks largely failed to protect investors. Lockdowns caused investors to flee traditionally high dividend-paying segments of the market: REITs, threatened by missed rent payments; Energy, facing an economy without commuters; and Consumer Staples, with stores abandoned by customers wary of a yet-unpreventable virus. Instead, growth stocks rallied as the workforce went virtual and the Federal Reserve ran the quantitative easing (QE) playbook it had previously used to rescue the collapsing American economy during the Financial Crisis of 2007–2009. Low borrowing costs and easy access to capital boosted future growth prospects and lengthened the runway for companies which were not necessarily turning profits. As the rising tide of accommodative monetary policy lifted all boats, correlations between stocks rose. This environment made things challenging for active equity managers attempting to outperform the market through security selection. As QE has unwound in 2022, the more speculative areas of the market have crashed, while a flight to shorter duration assets, like dividend-paying stocks, has ensued.

Several asset managers we have spoken to noted how revenue growth, a success marker for long-duration growth companies, is taking a back seat to profitability during this bear market. We began to see this as early as late 2021. When looking at the software industry – a poster child for revenue growth darlings during the QE regime – profitability overtook revenue growth as the primary driver of positive stock returns for the first time in four years.*

Unlike in March 2020, the 2022 bear market is one contending with more familiar macroeconomic factors, such as inflation and geopolitical uncertainty. As the Fed continues to increase interest rates and shrink the money supply to curb inflation, equities which are shorter duration in nature and pay attractive dividends have led the market as investors have demanded safety. Through the end of the second quarter of 2022, the Dow Jones Select Dividend Index returned -2.56%, easily beating the Russell 1000 Value
(-12.86%), S&P 500 (-19.96%), and Russell 1000 Growth (-28.07%) indexes. As dividend-payers and short duration assets have resumed their traditionally defensive role in portfolios during this more traditional bear market of 2022, it appears that the pandemic-induced lockdown in 2020 was the anomaly in which growth served as the best defense.

*https://techcrunch.com/2022/01/24/for-the-first-time-in-4-years-profitability-beats-growth/