Q2 2022 | Capital Markets Outlook

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Perspective on the global economy and asset classes with insight on market history.

The end of the Great Moderation

Given the speed at which this pandemic-driven cycle has played out, two years ago seems like a distant memory. The buzzword in the spring of 2020 was "unprecedented," a term to describe a whole host of things, like the misses of consensus economic forecasts and the price of oil in the futures market (negative $37 — remember that?). We propose that the official buzzword of 2022 should be "inconvenient."

While our thoughts are with Ukrainians fighting for their freedom or living abroad as war refugees, we turn to address the timing of Russia's invasion and how it presents a whole host of inconveniences for the global economy. It is inconvenient that Europe in general, and Germany in particular, rely so heavily on Russian oil and gas, and that in turn, Russia invests the proceeds of those sales back into European government bonds. It is inconvenient that the time it takes to transition from fossil fuel-centric infrastructure for electricity generation, heating, and manufacturing output toward less carbon intensity is best measured in years, not weeks or months. It is inconvenient for Europe, Africa, and Asia that Russia and Ukraine together supply almost a quarter of the world's wheat output. It is inconvenient for central banks that monetary policy is generally ineffective at dealing with supply-side-driven inflation without crushing demand. It is inconvenient for the corporate sector that supply chain constraints and wages are not easing. It is inconvenient for asset markets that central banks are beginning a new tightening cycle when financial assets are richly valued and households have their highest exposure

Asset allocations

Shading in the table indicates the change from the previous quarter

	Underweight	Neutral	Overweight
EQUITY		●	
U.S. large cap		●	
U.S. small cap		●	
U.S. value		●	
U.S. growth		●	
Europe		●	
Japan		●	
Emerging markets		●	
FIXED INCOME		●	
U.S. government	○	●	
U.S. investment-grade corporates		●	○
U.S. mortgage-backed			●
U.S. floating-rate bank loans	●	○	
U.S. high yield	●		○
Non-U.S. developed country	●		
Emerging markets	●		
COMMODITIES		○	●
CASH		●	

Currency strategy

U.S. dollar versus	Favor other	Neutral	Favor dollar
€ Euro		●	○
£ Pound		○	●
¥ Yen		●	

Asset allocation and currency strategy views of the author at time of publication.

to equities in history.[1] If the Covid-19 pandemic has not ended the Great Moderation — the decline in volatility of macroeconomic data and the longer, more moderate business cycles the world experienced since 1982 — these combined inconveniences will end it, we believe.

Big stakes in stocks

The high average equity allocation of U.S. households makes it a bad time for a policy error

Source: Federal Reserve Economic Data, St. Louis Federal Reserve.

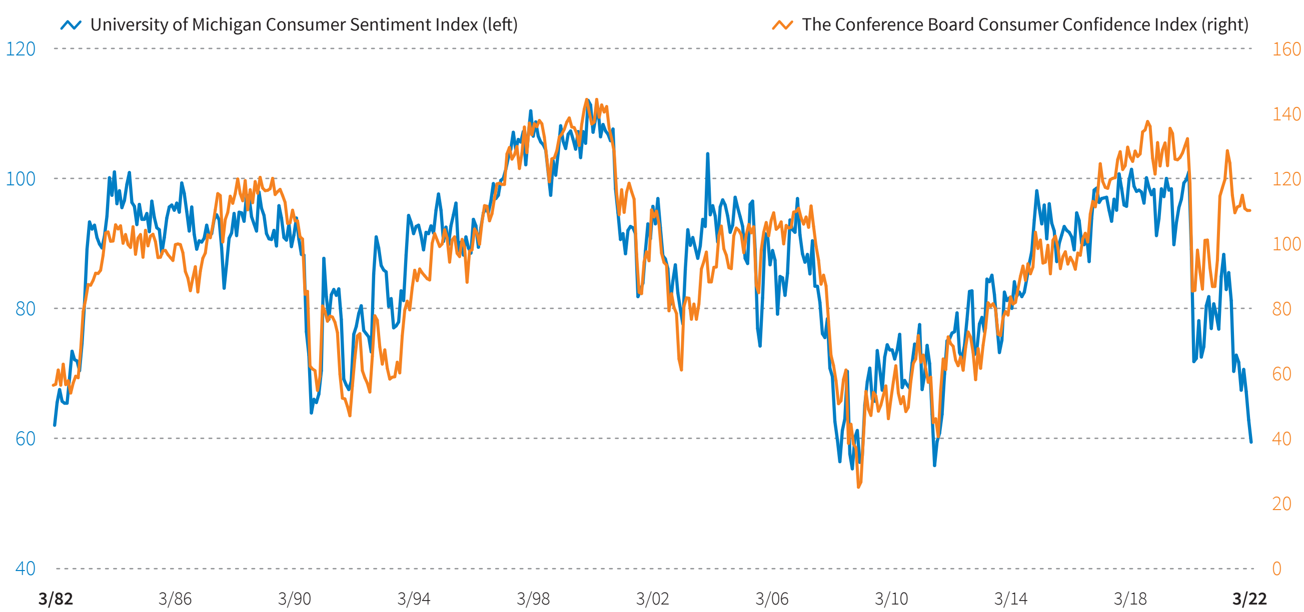
Perhaps most important for financial markets is the fact that it is extremely inconvenient for policymakers that this cycle and macroeconomic data are progressing at such high velocity, making decision-making even more difficult than usual. There is no better illustration of the resulting confusion than the current popular views expressed regarding the state of household wealth and consumer behavior. The narrative goes something like this: "Thanks to all the direct pandemic stimulus and the robust labor market, U.S. households are in fantastic shape as evidenced by high aggregate savings levels relative to the previous trend."

The problem with looking at aggregate numbers is that, by mathematical definition, it becomes solely an assessment of the upper tier of the wealth and income distribution. And while, yes, that cohort drives an outsized share of total consumption, markets care about what happens at the margin, and the second derivative matters. To highlight these issues, we have recently been intrigued by the unusual dispersion between the University of Michigan Consumer Sentiment Index and The Conference Board Consumer Confidence Index. Historically, they have been very highly correlated, but

[1] The Fed's flow of funds equity allocation measure is our preferred long-term valuation tool.

Hand in hand no more

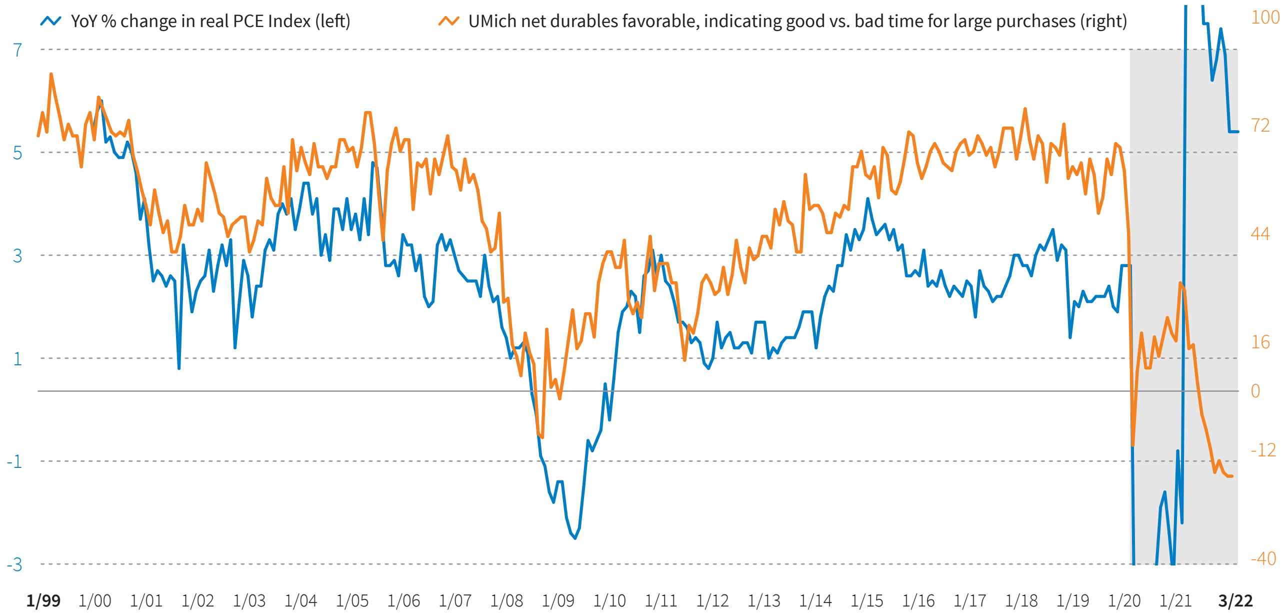
Consumer confidence and consumer sentiment surveys have diverged by an historic amount in the past year



Sources: University of Michigan; The Conference Board.

What they say and what they do

After the Covid pandemic recovery caused an historic spike in spending, consumers may cut back in coming months



Sources: Bureau of Economic Analysis; University of Michigan.

since the summer of 2021, that relationship has broken down. One explanation is that The Conference Board's measure is more focused on labor market developments, and so is merely reflecting the happy state of affairs for the average worker enjoying an abundance of job openings and rising wages, whereas the more wide-ranging University of Michigan survey is being tarnished by the spike in inflation, which is proving to be quite un-transitory.

Normally, this kind of consumer survey data (what some refer to as "soft" data) tends to have less impact on markets, which care more about what people do rather than what they say. As such, we were somewhat surprised at the results of our recent research focused on finding good leading indicators of actual consumption. The single best measure we found to predict real personal consumption expenditures 6 and 12 months in the future was the portion of respondents from the University of Michigan survey saying that now is a bad time to purchase large household durable items. Changes in this measure explain 60% and 36% of the 6-month and 12-month forward changes in real personal consumption expenditures (PCE), respectively. The February reading of this measure was the worst in this survey's history going back to 1978, with almost 60% of respondents saying that now was a bad time for large durable purchases. It seems likely that some combination of the pull-forward in spending that occurred with pandemic-related stimulus and the substantial uptick in inflation will combine to sap the spending power of U.S. households in 2022.

This is all happening at a time when the Fed has now revealed a reaction function that prioritizes price stability over economic growth (at least for the moment) when these two pillars of the mandate are in conflict. Recent post-Fed-meeting speeches have cleared the way for beginning to move the policy rate in half-point increments, in hopes of getting to "neutral" quickly, and then to begin the process of quantitative tightening shortly thereafter. This path suggests the strike price of the "Fed put," which has historically put a floor under risk asset prices, is uncomfortably far away. While an actual recession in the U.S. is not currently a base-case scenario, the risks of that outcome have risen substantially in the first quarter. An S&P 500 Index that is barely 5% off all-time highs does not properly reflect that risk. We advocate caution over the next few months while these inconvenient dynamics play out.

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