Portfolio Managers' Quarterly

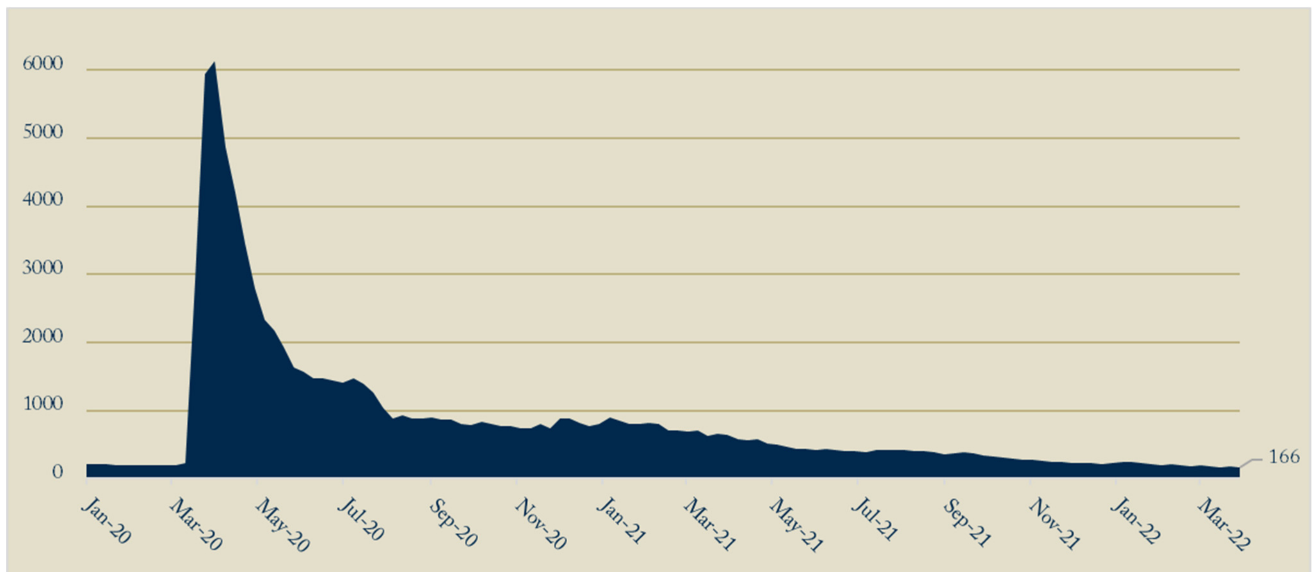
Q1 2022: Geopolitical and Fed Risks in a Robust Economy

by Vilis Pasts, Matthew Pasts, CMT, Isaac Braley, Co-Portfolio Managers

Dear Fellow Investors:

After a turbulent Q1 2022, which saw heightened geopolitical risk and the return of many hawkish monetary policies, our outlook going forward remains cautious yet optimistic due to the strength of the U.S. economy. Economic growth is still widely projected to remain positive and the labor market remains strong with weekly initial jobless claims for unemployment nearing all-time lows. Additionally, the forward projected default rate of High Yield Corporate bonds remains low with High Yield outperforming the Bloomberg Barclay's Aggregate bond index since the beginning of the year.

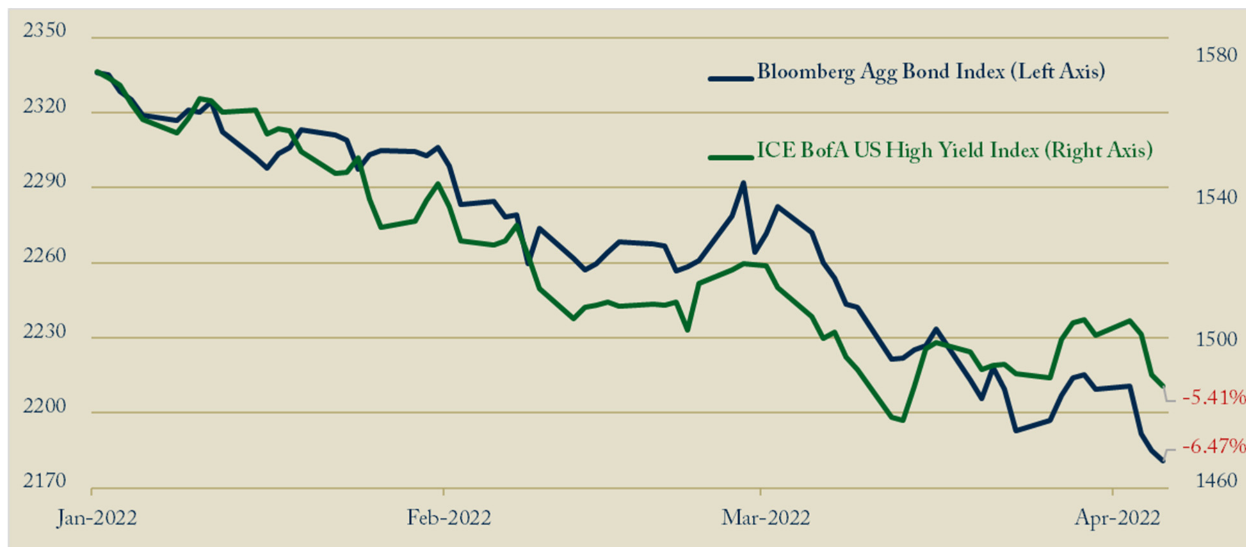
Initial Jobless Claims (01/02/2020 – 04/01/2022)



For Illustrative Purposes Only.

Source: Bloomberg

ICE BofA High Yield Index vs Bloomberg Aggregate Bond Index (01/03/2022 – 04/06/2022)



For Illustrative Purposes Only. Percent Change Indicates Total Index Returns From 1/3/22 to 4/6/22.

Source: Bloomberg

Although the U.S. economy seems to remain robust, there are still two factors we see that may affect returns going forward, namely geopolitical risk and Federal Reserve monetary policy decisions. Wars and other geopolitical events have tended to be short-lived, thus we believe the former risk will not weigh as heavily on financial markets than the latter risk of Fed policy going forward. With the labor market currently strong, the Fed will likely continue to use its policy tools to fulfill its mandate of price stability by raising the Fed Funds rate and reducing the size of its balance sheet. We feel this policy is appropriate given the inflationary environment, but the most important question is whether the Fed can execute a 'soft landing' and prevent causing a recession from its hawkish policy.

If the Fed can raise interest rates and unwind its balance sheet in a gradual manner without inadvertently causing a recession or economic slowdown, forward returns for High Yield bonds and other risk assets may be strong. However, in the event that a recession or economic slowdown does occur, BTS' proprietary models will look to preserve capital through tactical allocations.

What if the Landing Isn't Soft?

While we remain optimistic for risk-assets in the short-term, the unique confluence of economic events we are currently experiencing could lead to a particularly damaging recession if the Fed doesn't achieve its goal of a soft landing. Over the past year or so, we've written repeatedly about the persistent nature of many of the factors that were driving inflation, despite the transitory message that the Fed clung to before abandoning it in December. Many of these factors remain today, with the war in Ukraine providing an additional catalyst to the mix. While the Fed is likely to empty their toolbox in an effort to curb inflation, it's possible that their rate

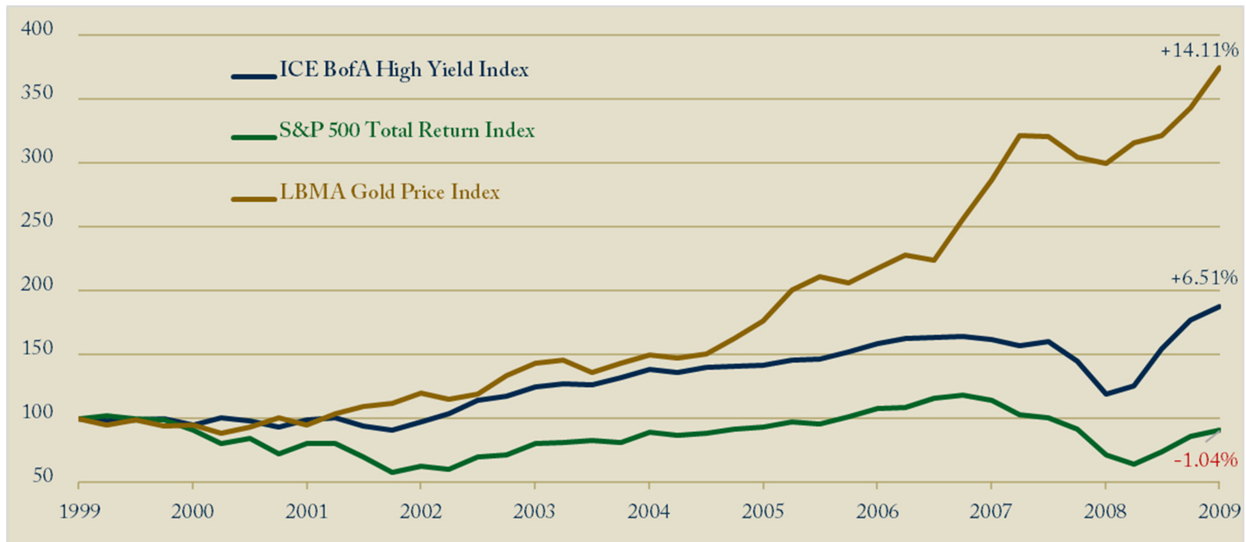
hikes and balance sheet unwinding will be too strong to avoid a recession, yet too weak to curtail inflation.

On top of the Fed risk and geopolitical risks, we've also recently seen one of the most reliable predictors, but not always a harbinger, of an impending recession: yield curve inversion. Various points along the curve have briefly flashed this warning sign since October 2021, but the type of inversion seen recently, between 2-year and 10-year yields, has historically been the most reliably predictive. In fact, there has never been a recession that wasn't preceded by an inversion on this part of the curve. The good news is that yield curve inversion is only an early warning sign of a downturn, sometimes taking 2 years to materialize, so it's likely not yet time to run for the hills.

In our view, this leaves the economy at its highest risk of stagflation in decades. Stagflation occurs when inflation and unemployment are high, while growth is low. The strong jobs market should ease some fears, but the risk remains. The last period of prolonged stagflation was the 1970s, a particularly difficult decade for buy-and-hold investors. That environment was spurred in part by a global shock to oil markets, not unlike the shocks seen this year as a result of the war in Ukraine. While price pressures on global oil markets appear to be abating, further shocks are still a risk as the conflict continues.

Another troubling scenario that arises from the Fed failing to achieve a soft landing is that of a possible "lost decade," when equity market returns are negative over a period of ten years or more. Historically, 20-year returns in the stock market have always been positive but there have been several periods of negative 10-year returns[1], often occurring in tandem with stagflation as was the case in the '70s. Other potential drivers of lost decades include supply-chain disruptions, geopolitical turmoil, indebted governments, and regulatory pressures, all of which exist today. The most recent example of a lost decade occurred in the 2000's, when equities returned -1.04% annually as measured by the S&P 500, and the classic 60/40 portfolio returned just 2.3%[1] a year. As shown in the chart below, there were, however, certain asset classes that offered relief over this period, namely high-yield bonds which returned 6.51% a year, and gold which appreciated by 14.11% annually. Another lost decade could wreak havoc for buy-and-hold investors and those who only look to traditional asset classes.

ICE BofA High Yield Index vs S&P 500 Index vs. LBMA Gold Price Index, All scaled to beginning value of 100 (12/31/1999 – 12/31/2009)



For Illustrative Purposes Only. Percent Change Indicates Annualized Total Index Returns From 12/31/99 to 12/31/09.

Source: Bloomberg

As a tactical manager, we remain ready to adapt to all future market conditions as they unfold, and we believe that opportunities exist in expansions, recessions, and everything in between. We appreciate the opportunity to manage your assets.

Sincerely,

Vilis Pasts
Matthew Pasts, CMT
Isaac Braley

Co-Portfolio Managers

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[1] https://fortune.com/2022/03/21/stock-market-lost-decade-stifel-barry-bannister/

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IMPORTANT RISK INFORMATION

Investing, including investing in mutual funds involve risk, including possible loss of principal.

There is no assurance that any strategy will achieve its investment objective. The value of fixed income securities will fluctuate with changes in interest rates. Defaults by fixed income issuers could also harm performance. Lower quality bonds known as “high yield” or “junk” bonds, present greater risk than bonds of higher quality, including an increased risk of default. An economic downturn or period of rising interest rates could adversely affect the market for these bonds and reduce the Portfolio Manager's ability to sell its bonds. The use of leverage within a strategy will indirectly cause additional expenses and could potentially magnify the gains or losses.

The S&P 500 includes 500 leading companies in leading industries of the US economy and is a proxy for the total stock market.

Bloomberg Aggregate Bond Index - An index used by bond funds as a benchmark to measure their relative performance. The index includes government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturities of the bonds in the index are more than one year.

ICE BofAML US High Yield tracks the performance of US dollar-denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody’s, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one-year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $100 million. Also, qualifying securities must have risk exposure to countries that are members of the FX-G10, Western Europe, or territories of the US and Western Europe. The FX-G10 includes all Euro members, the US, Japan, the UK, Canada, Australia, New Zealand, Switzerland, Norway, and Sweden.

LBMA is the London Bullion Market Association (LBMA), a London-based international trade association that represents the wholesale over-the-counter gold and silver market in London. The LBMA Gold Price PM is set in the London gold market at 15:00 GMT, in U.S. dollars, serving as a benchmark for pricing gold. It is widely used by producers, consumers, investors and central banks.

Initial Jobless Claims track the number of people who have filed jobless claims for the first time during the specified period with the appropriate government labor office. This number represents an inflow of people receiving unemployment benefits.

*Index returns are for illustrative purposes only and should not be construed as BTS model performance or performance achieved by any BTS client. More specifically, any reference to index returns during isolated or defined periods in time is for reference only and is not meant to imply index returns are indicative of actual returns achieved in client portfolios. Investors cannot invest directly in an index, and index returns do not reflect management fees, custodial fees or brokerage commissions, which vary depending upon the custodian chosen.

Source: Bloomberg (for index returns)

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PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS.

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