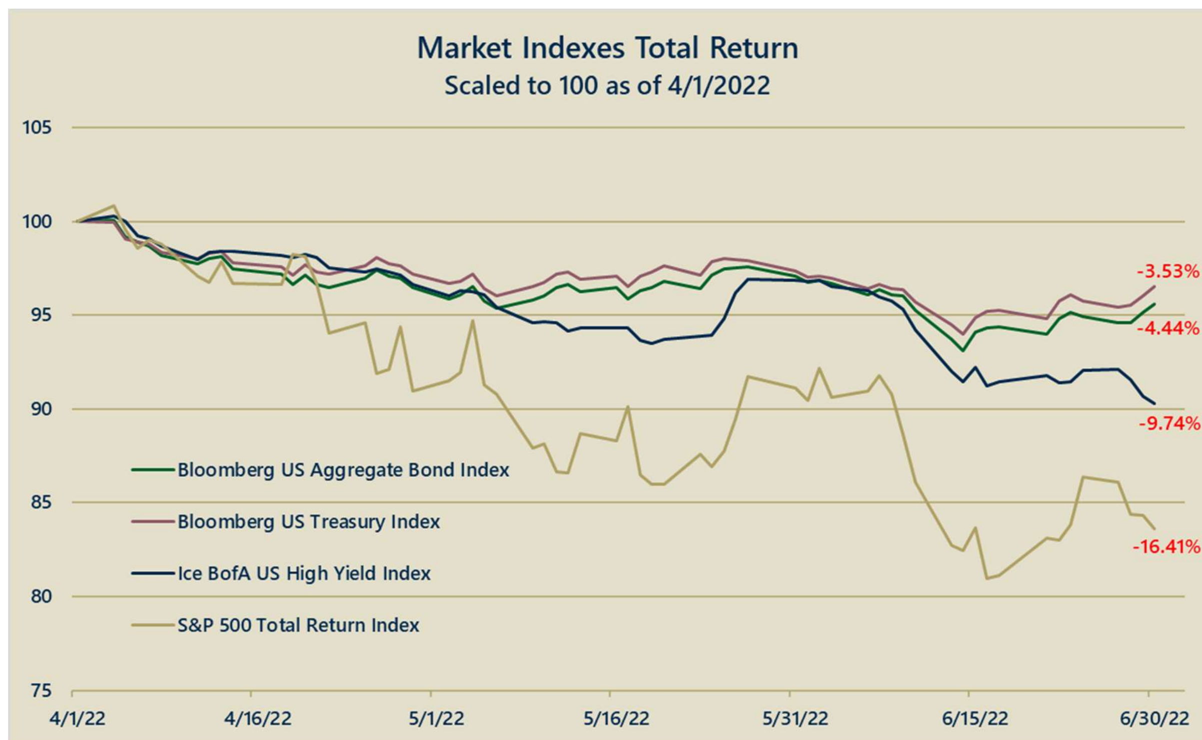
Portfolio Managers' Quarterly

Q2 2022: "Soft Landing" Might be the New "Transitory Inflation"

Dear Fellow Investor:

The 2nd quarter of 2022 appeared even more unsettled than the 1st, with the S&P losing 16.41% in the quarter and ending June with its worst first half performance in over half a century. The Bloomberg Aggregate Bond Index declined 4.44% in the quarter, while the ICE BofA US High Yield Index fell 9.74% and the Bloomberg US Treasury Index fell 3.53%. The chart below shows the performance of these indexes over the quarter, all scaled to a value of 100 on 4/1/22.



Source: Bloomberg

Headline Inflation, a gauge of total inflation that includes commodities such as food and energy prices, tends to be volatile and prone to inflationary spikes. As measured by the Consumer Price Index (CPI), headline inflation unexpectedly increased to a year-over-year change of 9.1% in June, up from 8.6% in May and 8.3% in April. Although Core CPI has continued to decrease from its high in March 2022, it has remained above expectations and the May report was enough to shift the Federal Reserve's course of action to increase interest rates by .75% at the June Federal Open Market Committee meeting. They had

previously communicated a rate hike of .50% before the media blackout period. Markets discounted the risk of a .75% hike going into the meeting and asset returns suffered as a result. After the June CPI print, markets now indicate that traders expect a 1 in 3 chance of the next hike being 1%.

With more rate hikes communicated, we believe the market has now shifted to a 'wait and see' mode as to whether the Fed can control inflation while preventing a recession. With our proprietary models continuing to discount more risk ahead due to our "sell" signal in high yield, we anticipate Q3 to be just as volatile as the previous quarter, which will continue to affect both equities and bonds.

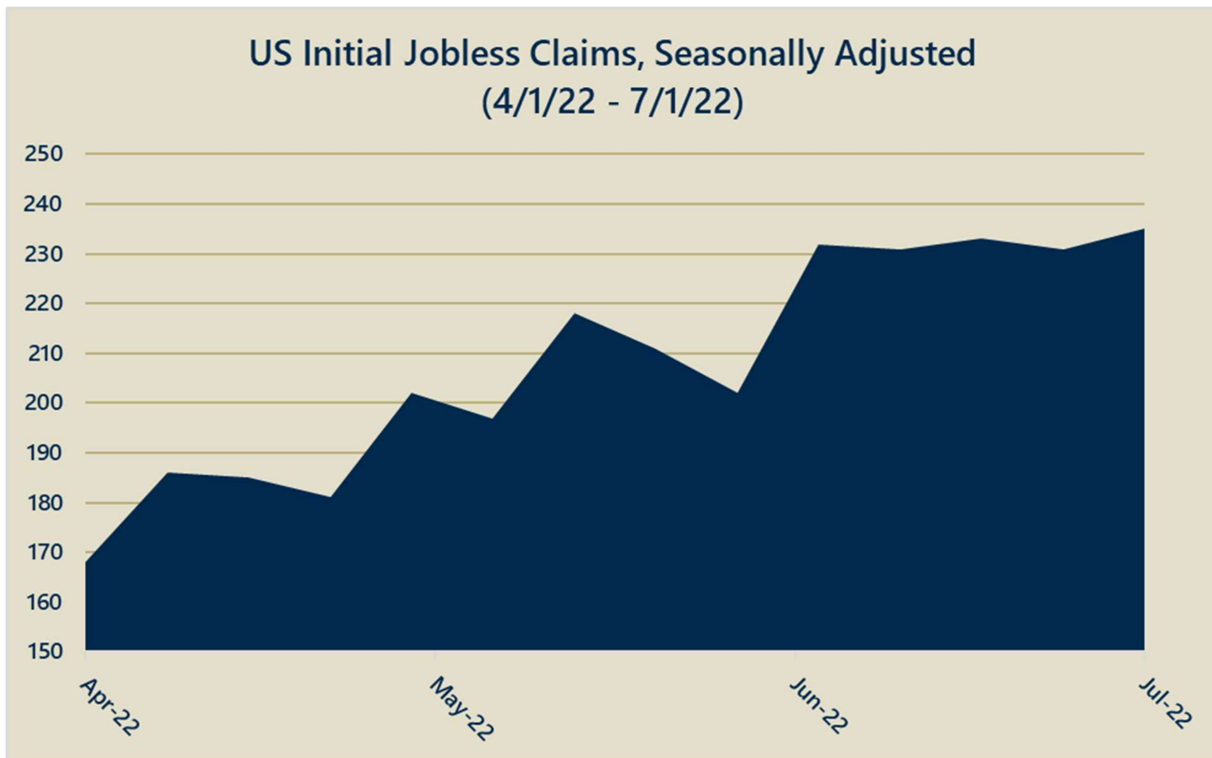
Outlook for Q3

While overstimulation from the Fed allowed markets to quickly recover from their 2020 lows, the artificial and simultaneous propping up of equity, bond, and housing markets was likely to have longer-term unintended consequences. We are now starting to see the fallout from these policies with selloffs in all three markets. The Fed's pandemic response also bolstered aggregate demand at a time when supply chains were already reeling from pandemic shutdowns, thus stoking the flames of inflation that is now reaching levels that we have not seen in over 40 years.

While Fed officials spent much of 2021 insisting that inflation was merely transitory, their new buzz-phrase has become "soft landing", or the idea that they can implement policy that will both tame inflation and avoid a severe or prolonged recession. At this point, as markets have fallen and economic data has become increasingly alarming, it seems that the idea of a soft landing is highly questionable in much the same way that we predicted transitory inflation would be incorrect back in 2021.

Thus, we are now at a point where the Fed is backed into a corner regarding inflation. Core CPI, which strips out the more-volatile food and energy prices and is often more predictive of future trends, has not been quite as alarming as Headline CPI, but it is Headline CPI that Americans see and feel at the gas pump and in the grocery store. Fed Chairman Jerome Powell has indicated his awareness of how important it will be to alleviate headline inflation moving forward. While their overly accommodative response to Covid-19 presented great challenges to technical models such as ours, we believe the current inflation environment will lead to a normalization of Fed policy response going forward that should present opportunities for technical managers, similar to the 2008-2009 period.

The greatest risk we see related to the Fed's precarious position is that they are being forced to hike rates in the face of increasing economic weakness. In our last quarterly update, we pointed towards the downward trend of Initial Jobless Claims as a promising sign for the economy. Today, while the job market remains strong in many respects, cracks seem to be emerging, including a reversal of the trend in Initial Jobless Claims. They have increased by nearly 40% since our last quarterly writing.



Source: Bloomberg

Additionally, more forward-looking predictors such as the Leading Economic Index (LEI) and the Treasury yield curve also point towards impending weakness. The LEI comes from the U.S. Conference Board and is composed of 10 economic components connected to data such as consumer spending and business investment whose changes tend to precede changes in the overall economy. As of May, it had fallen for three consecutive months and there is a high likelihood that it will fall again in June given the trends we have seen in its components. Historically, four straight months of a declining LEI have always led to a recession. Meanwhile, the closely watched 2-10 year section of the yield curve has just inverted for a second time this year, with this inversion being steeper than any seen since February 2007. Every recession has been preceded by an inversion on this part of the curve.

The need to hike rates in the face of these economic weaknesses could create a stagflation environment similar to the 1970's if inflation continues to climb despite the Fed's best efforts, or the Fed may succeed in taming inflation, but the Fed's efforts to do so could prevent it from reversing an economic downturn for some time, which could lead to a recession of considerable depth and duration. Either scenario could cause major headaches for buy-and-hold investors who may not have sufficient time horizons to weather such a storm.

The Utility of Alternative Investment Strategies Going into Recession

With such uncertainty and volatility negatively affecting risk asset returns, alternative investment strategies, including tactical asset allocation strategies, may position themselves to offer uncorrelated return streams that could hedge a portfolio going into and coming out of the next recession. These strategies may be especially valuable in recessionary environments, such as those seen in 2008 and 2020, where most risk assets correlated with each other on the downside.

For Illustrative Purposes Only

Daily Risk Asset Correlations (01/02/2007 - 01/02/2009)

Security	S&P 500	NASDAQ	DOW JONES	RUSSELL 2000
S&P 500	1	0.965	0.989	0.927
NASDAQ		1	0.947	0.942
DOW JONES			1	0.904
RUSSELL 2000				1

Daily Risk Asset Correlations (01/02/2020 - 03/23/2020)

Security	S&P 500	NASDAQ	DOW JONES	RUSSELL 2000
S&P 500	1	0.988	0.996	0.937
NASDAQ		1	0.983	0.946
DOW JONES			1	0.945
RUSSELL 2000				1

Risk Asset Returns (01/02/2007 - 01/02/2009)

Security	Return
S&P 500	-31.37%
NASDAQ	-31.26%
DOW JONES	-23.67%
RUSSELL 2000	-34.03%

Risk Asset Returns (01/02/2020 - 03/23/2020)

Security	Return
S&P 500	-31.02%
NASDAQ	-24.33%
DOW JONES	-35.22%
RUSSELL 2000	-39.68%

Index Comparison: The indices shown are for informational purposes only and are not reflective of any investment. As it is not possible to invest in the indices, the data shown does not reflect or compare features of an actual investment, such as its objectives, costs and expenses, liquidity, safety, guarantees or insurance, fluctuation of principal or return, or tax features. Past performance is no guarantee of future results

Source: Bloomberg

Adding alternative strategies has the potential to hedge part of one's portfolio to the risk of a multi-year bear market in risk assets that may result from a prolonged recession where the Fed cannot use dovish monetary policy to jumpstart demand. With the Fed possibly unable to intervene, given the backdrop of inflation caused by an extended cycle of easy credit and prolonged global supply chain shocks, the fate of risk asset returns most likely falls on economic growth.

Thus, Q2 GDP released at the end of July will likely be important for market sentiment, as well as the CPI reports over the 3rd quarter, which should serve as a gauge of how well inflation is responding to the current Fed policy and what adjustments may need to be made. Corporate earnings will also play an important role in dictating Q3 market returns. In general, BTS expects economic growth to soften in line with decreasing GDP Now estimates by the Atlanta Fed, which fell to -1.2% for Q2 as of July 8th. Continued negative shocks in GDP or CPI numbers could send risk assets lower, which we feel calls for an emphasis on alternative strategies and risk management techniques, such as capital preservation. Current portfolios are positioned to navigate the next period of volatility by staying disciplined to this approach.

At BTS, we remain ready to adapt to ever-changing market conditions. Thank you for the opportunity to manage your assets.

Sincerely,

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

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IMPORTANT RISK INFORMATION

Investing, including investing in mutual funds, involves 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.

The Bloomberg US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index. STRIPS are excluded from the index because their inclusion would result in double-counting. (Future Ticker: I00054US)

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.

The NASDAQ Composite Index is a broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market. The index was developed with a base level of 100 as of February 5, 1971.

The Dow Jones Industrial Average is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

The Russell 2000 Index is comprised of the smallest 2000 companies in the Russell 3000 Index, representing approximately 8% of the Russell 3000 total market capitalization. The real-time value is calculated with a base value of 135.00 as of December 31, 1986. The end-of-day value is calculated with a base value of 100.00 as of December 29, 1978.

Consumer Price Index is a measure of the average change over time in the prices paid by urban consumers for a market of consumer goods and services.

Headline inflation is the raw inflation figure reported through the Consumer Price Index (CPI) that is released monthly by the Bureau of Labor Statistics (BLS).

Core inflation is the change in the costs of goods and services, but it does not include those from the food and energy sectors.

The Composite Index of Leading Indicators, otherwise known as the Leading Economic Index (LEI), is an index published monthly by The Conference Board. It is used to predict the direction of global economic movements in future months. The index is composed of 10 economic components whose changes tend to precede changes in the overall economy. Businesses and investors can use the index to help plan their activities around the expected performance of the economy and protect themselves from economic downturns.

GDPNow is a forecasting model from the Atlanta Fed that estimates GDP growth using a methodology similar to the one used by the U.S. Bureau of Economic Analysis. It 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 economic data for the current measured quarter. There are no subjective adjustments made to GDPNow—the estimate is based solely on the mathematical results of the model.

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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