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The CIO Monthly Perspective

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POLICY RISKS GALORE

No more financial sedatives; bye-bye, TINA

September 2022 unfolded like an old film featuring long-forgotten characters – bond vigilantes, central bankers with stiff backbones, currency speculators who took on the British government – and human foibles such as hubris, fear, and greed. Unfortunately, there was no happy ending as stocks, bonds, and commodities all declined precipitously in the face of continued macro uncertainties and still elevated inflation.

The month had an auspicious start on investors' delusion that nothing could out-hawk Chair Powell's Jackson Hole speech. However, that optimism was soon crushed by stickier-than-expected inflation data, which drove the FOMC (Federal Open Market Committee) to spew more hawkish warnings at its September 21st meeting. The 2-year U.S. Treasury note went on a 13-day losing streak with the yield hitting a 15-year high of 4.34%. Despite rising odds of recession, the 10-year Treasury yield surged to an intraday high above 4% - 82 bps above the August closing level. The hawkish Fed further lifted the U.S. Dollar Index to new two-decade highs. Across the pond, the U.K.'s new Prime Minister Liz Truss introduced unfunded tax cuts - the biggest in five decades - in the face of double-digit inflation. Bond vigilantes and currency speculators reacted in unison by pounding the U.K. gilts and British sterling to dangerously depressed levels, prompting market participants to call on the Bank of England (BOE) to raise interest rates aggressively to stabilize the currency. However, the BOE surprised the world by announcing unlimited purchases of long-dated gilts in an attempt to drive their yields lower. It turned out that rapidly plunging gilt prices have triggered margin calls on U.K. pension funds, which would have started a doom loop by forcing them to liquidate more gilts to raise cash. While the BOE's intervention has provide a temporary reprieve, it nevertheless contravenes the bank's tightening moves to tame inflation and support its currency.

The U.K.'s emerging market-like crisis demonstrated the fragility of the global financial system in the face of surging yields and tightening liquidity. What happened in the U.K. may be a precursor to other financial accidents lurking in the wings. History has shown that to short circuit these problems effectively and stop financial

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contagion, the Fed – the world's de facto central bank – will have to turn on its liquidity spigot. However, in the face of still elevated inflation, the Fed may opt to watch Rome burn until the crisis spills over to our markets.

GLOW-WORMS

It was a chaotic time, and one of the most physically, emotionally, and politically debilitating periods for a proud and ambitious man. Just a month earlier, in September 1922, Winston Churchill, the then British Secretary of State for the Colonies, was busy juggling several balls in the air. The balding and chubby 47-year-old was negotiating to purchase the Chartwell estate in Kent while his wife Clementine gave birth to their fifth child, Mary. Back in the office, he was dealing with the Chanak Crisis that had brought Great Britain to the brink of war with Turkey. Churchill and Liberal Prime Minister Lloyd George favored going to war, but the British public and Conservative Party in the coalition government wanted to negotiate a settlement. The latter prevailed, and Lloyd George's handling of the situation led Conservative Members of Parliament (MPs) to call for a meeting on October 19th to decide whether to pull out of the Liberal-Conservative coalition government.

Churchill, a Liberal MP at the time but an influential voice with the Conservatives, tried to persuade them from turning against the coalition. However, he had to suspend all activities on October 17th, when a pain in his abdomen turned severe. The following evening, he was lying on the surgical table undergoing an appendectomy. While he was recuperating in the hospital on October 19th, the Conservative Party voted to leave the coalition government, forcing Lloyd George to tender his resignation to the King that afternoon.

A week later, parliament was dissolved, and elections were scheduled for November 15, 1922. Churchill announced that he would once again stand for his seat in Dundee, but he was not in shape to campaign against two formidable opponents from the rising Labor Party. He got into a wheelchair for the first time in early November and was too frail to appear in public. Clementine had to take the seven-week-old Mary on the road to campaign on behalf of her husband. Churchill finally made two feeble campaign appearances on wheelchair a few days before election day. He wound up losing his seat by a wide margin. Churchill later quipped that the 1922 election had left him a man "without an office, without a seat, without a party, and without an appendix."

Equity Market Indices[1]	8/31/22 Price	9/30/22 Price	MTD Change	YTD Change
MSCI All Country World	613	553	-9.7%	-26.7%
S&P 500	3955	3586	-9.3%	-24.8%
MSCI EAFE	1841	1661	-9.7%	-28.9%
Russell 2000®[2]	1844	1665	-9.7%	-25.9%
NASDAQ	11816	10576	-10.5%	-32.4%
TOPIX	1963	1836	-6.5%	-7.8%
KOSPI	2472	2155	-12.8%	-27.6%
Emerging Markets	994	876	-11.9%	-28.9%
Fixed Income				
2-Year US Treasury Note	3.50%	4.28%	79	355
10-Year US Treasury Note	3.20%	3.83%	64	232
BBG US Agg Corp Spread	1.40%	1.59%	19	67
BBG U.S. HY Corp Spread	4.84%	5.52%	68	269
Currencies				
Chinese Renminbi (CNY/$)	6.89	7.12	3.3%	12.0%
Brazilian Real (Real)	5.18	5.42	4.5%	-2.9%
British Pound ($/GBP)	1.16	1.12	4.1%	21.1%
Euro ($/Euro)	1.01	0.98	2.6%	16.0%
Japanese Yen (Yen/$)	138.96	144.74	4.2%	25.8%
Korean Won (KRW/$)	1338.10	1431.15	7.0%	20.4%
U.S. Dollar Index (DXY)	108.70	112.12	3.1%	17.2%
Commodities				
Gold	1711	1661	-2.9%	-9.2%
Oil	89.6	79.5	-11.2%	3.2%
Natural Gas, Henry Hub	9.13	6.77	-25.9%	81.4%
Copper (cents/lb)	352	341	-3.0%	-23.5%
CRB Index	290	268	-7.6%	15.5%
Baltic Dry Index	965	1760	82.4%	-20.6%

Source: Bloomberg

Across the pond on the shore of the Atlantic Ocean exactly a century ago, another ambitious politician was confronting an even greater crisis. Franklin D. Roosevelt (FDR) was a young rising star in the Democratic Party. He was elected to the New York State Senate in 1910 and had backed Woodrow Wilson's successful 1912 presidential campaign against Republican President William Howard Taft and Teddy Roosevelt, his famous uncle who ran as a third-party candidate. FDR was rewarded with a position in the Wilson Administration as the Assistant Secretary of the Navy. In 1920, FDR became the Democratic Party's vice-presidential candidate at age 38, although his ticket went on to lose to the Harding/Coolidge dream team. Less than a year later, however, his meteoric rise was derailed by a polio infection that left him permanently paralyzed from the waist down.

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In the spring of 1922, FDR moved back to his upstate New York childhood home, the Springwood estate, which he had renovated seven years earlier. The mansion sat on a bluff overlooking the Hudson River and was an ideal place to start his arduous physical rehabilitation. He built up his upper body strength and fitted his legs with metal braces so that he could swing his legs forward while on crutches. As a man of supreme confidence and optimism, he began planning his political comeback with the help of his wife Eleanor and advisor Louis Howe. He won the 1928 New York gubernatorial race by a slim 0.6% margin, but that was enough to keep his presidential dream alive. By the time of the 1932 presidential election, the country was in the throes of the Great Depression and ready for a new political realignment – FDR's New Deal coalition won not only the White House, but also both chambers of Congress by a landslide.

Churchill's rise to the top of British government was circuitous and took much longer. After his 1922 electoral loss, he retreated to the French Riviera to focus on painting and writing – the gifted wordsmith and orator would be awarded the Nobel Prize in Literature thirty years later. In October 1924, he rejoined the Conservative Party and won a seat at Epping. Despite having no background in economics or finance, Churchill was appointed the Chancellor of the Exchequer by Prime Minister Stanley Baldwin. However, his political star dimmed after the Conservative Party's defeat in 1929. For the next ten years – dubbed his wilderness years – Churchill held his parliamentary seat but was relegated to the backbench for being out of sync with the mainstream consensus of the period. He opposed granting more independence to India, warned of Hitler's menace repeatedly and railed against the British government's policy of appeasement and disarmament. It was a difficult period for a man who had once crowed to an admiring female friend, "We are all worms, but I do believe that I am a glow-worm." He felt his talent was being wasted, suffered several bouts of depression, drank heavily, but remained a prolific writer and public speaker.

In September 1939, Great Britain was forced to declare war on Germany following Hitler's invasion of Poland, and Churchill was reappointed First Lord of the Admiralty and joined Prime Minister Chamberlain's war cabinet. On May 10, 1940, Churchill finally became Prime Minister at age 65 after the Labor Party pressured Chamberlain to step down. Churchill later wrote that he felt a profound sense of relief upon taking premiership as he believed that his life up to that point had been "a preparation for this hour and for this trial."

In August 1941, onboard USS Augusta off the coast of Newfoundland, Churchill and FDR met for the first time during the war – they had crossed paths at a dinner in London in July 1918, but neither had made an impression on the other. The two men were no paragons of old-fashioned images of outward strength – one was overweight and the other was wheelchair bound. However, their inner strengths and the special relationship they forged would overcome great adversity and liberate much of the world from tyranny and atrocity. This meeting led to the joint declaration of the Atlantic Charter, which envisioned a post-war world order based on principles that we now take for granted, e.g., the right of self-determination, and territorial adjustments must be in accord with the wishes of the peoples concerned (take note of it, Putin).

All told, Churchill and FDR had met eleven times and exchanged nearly two thousand cables and letters during the war. Their unique bond and partnership were critical to the Allied victory. Unfortunately, FDR did not live to see the victory – he passed away suddenly, 18 days before Hitler's suicide in April 1945. On May 8th, in front of a jubilant, spontaneously gathered crowd, Churchill gave his Victory in Europe Day speech from the balcony of the Ministry of Health building. He then waved his arms to conduct the singing of "Land of Hope and Glory" with an adoring crowd (this is the tune played at many high school graduation processions). However, to Churchill's utter surprise, he was swept out of power merely two months later as the war-weary electorate gave the Labor Party a landslide electoral victory under their promise of a nanny state. Perhaps Churchill had a point when he said that people are worms.

LONG LIVE THE QUEEN

Last month, Queen Elizabeth II, the last political vestige of the Greatest Generation, bowed down off the stage of life after seven decades on the throne. During WWII, at age 19, then Princess Elizabeth, had served in the Auxiliary Territorial Service, the women's branch of the British Army, as a driver and mechanic. She had a close relationship with Winston Churchill, who returned to 10 Downing Street in late 1951 after avenging his 1945 electoral loss to the Labor Party. Since becoming Queen in February 1952, she had met with her prime ministers for weekly off-the-record catchups that normally lasted

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30 minutes. However, the young queen would sometimes stretch her meetings with old man Churchill to two hours. Sir Winston reciprocated with near idolatry of the Queen and was a great defender of the monarchy. However, Elizabeth did not always heed Churchill's advice as she worked on modernizing the monarchy. For her coronation ceremony in June 1953, there was much debate over whether the BBC's cameras would be allowed inside Westminster Abbey, which Churchill was opposed to for the sake of tradition. The young Queen overruled Sir Winston and had her coronation televised in full to the world. When Churchill died in 1965, she broke the protocol that required the Queen to be the last person to arrive at any function by showing up at his funeral before his family to express her deep respect.

Ironically, FDR had complicated Queen Elizabeth II's job by insisting, much to the chagrin of Churchill, that the right of self-determination be included in the Atlantic Charter. FDR laid the groundwork of decolonization to ensure that the British Empire would never be able to rival the U.S. as a superpower after WWII. As the British Empire devolved into a Commonwealth of numerous independent nations, Queen Elizabeth II, as their nominal head of state, had to work tirelessly and travel extensively to maintain goodwill with these nations across six continents. She exemplified devotion to public service and always acted with grace and an unwavering sense of duty.

THE POT CALLING THE KETTLE BLACK

As we approach the midterm elections on November 8th, some might wonder where we can find political leaders like Churchill, FDR, or the Queen, who possessed the now-rare qualities such as vision, courage, civility, and selflessness. Americans are suffering a crisis of confidence in the country's major institutions. According to Gallup's Confidence in U.S. Institutions poll conducted in June, our confidence in major U.S. institutions has dropped to a record low in the poll's 50-year history. Confidence in 11 of the 16 institutions included in the survey suffered significant declines from a year ago, and none had improved. Confidence in all three branches of the federal government hit new lows. Congress was at the bottom with just 7% of Americans having confidence in it.

At his recent speech in front of Independence Hall, President Biden rightly pointed out that "too much of what is happening in our country today is not normal." However, he failed to acknowledge that both sides – the far right and left – are to blame. In his attempt to turn the midterm elections into a referendum on Trump rather than his own record, Biden might have gone too far in continuing the practice of denigrating the opposition with inflammatory generalizations. In 2008, candidate Barack Obama characterized people in small towns as "bitter" and "cling[ing] to guns or religion." Republican presidential candidate Mitt Romney was called out by the media in 2012 for saying 47% of Americans vote for Democrats because they were "dependent upon government." In 2016, Hillary Clinton unwittingly energized the MAGA movement by saying half of Trump's supporters could be put in "the basket of deplorables." These were things said privately to donors at campaign events. President Biden, however, upped the ante by using a prime-time presidential speech to label MAGA Republicans as "extremists" who are "a threat to our personal rights, to the pursuit of justice, to the rule of law, to the very soul of this country." Real card-carrying extremists must be upset that the President has cheapened their self-worth by liberally calling many Republicans extremists.

The President's harsh characterization of MAGA Republicans and his claim that it's "our duty and conscience" to confront them may just be political theatrics. However, history has repeatedly shown that a government's incendiary remarks and calls to arms against its opponents can devolve into ostracization or even persecution. Do we really want to see our neighbors or acquaintances fired or have their bank accounts frozen for supporting and donating to the "wrong" political cause? If you don't think that can happen in a Western Democracy, look no further than to the north of our border where those exact measures were taken against some Canadians for supporting the Freedom Convoy protest in February 2022. For years, tech companies have not only muzzled many conservative voices on social media, but also de-platformed some from payment networks and e-commerce sites. Big tech's censorship overlords need to be reminded that the freedom of speech is designed for content that we would vehemently disagree with, and, as Albert Einstein said, "Blind obedience to authority is the greatest enemy of truth."

As for our "duty" to confront these extremists, the White House did not clarify where the demarcation is between MAGA "extremists" and the rest of the 74 million people who had voted for Trump in 2020. The fact is that Trump supporters are not a homogeneous crowd. Most of them

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are well aware of former President Trump's many faults – from his narcissism to pettiness – and some hope that he will not run again in 2024. However, they support many of Trump's ideas – fair trade, a secure border, strong defense, deregulation, and anti-wokeness. Some may opt to vote for Trump-endorsed candidates in protest of what they perceive to be hypocrisy and unfairness in the system, especially with selective prosecution. Some are driven to the MAGA movement by social issues such as gender identity in public schools and even in our armed forces. To wit, a division of the U.S. Pacific Air Forces (PACAF) has reportedly ordered its senior leaders to stop using gender pronouns in written format. Most of us don't have the educational and professional pedigree to assess if banning gender pronouns will indeed improve our service members' "interoperability, efficiency, creativity, and lethality." However, the brave Ukrainian soldiers fighting for their country's survival are probably not concerned with gender pronouns or toxic masculinity.

Unfortunately, our politics have become so polarizing that an increasing share of Democrats and Republicans seem to despise each other. An August 2022 poll by the Pew Research Center showed that majorities in both parties view their opposing partisans as more closed-minded, immoral, and dishonest than average. Six in ten Republicans think of Democrats as more lazy than other Americans. It's also no secret that liberal elites often question the intelligence of rural Republican voters. A September 2022 poll by the New York Times and Siena College confirmed the wide ideological gulf between members of the two parties. With Democrats in control of the executive and legislative branches, 50% of Democrats surveyed think that the U.S. is on the right track, but 92% of Republicans believe the country is on the wrong track. A majority of Republicans have a favorable or somewhat favorable impression of capitalism (66%) and the Blue Lives Matter movement (74%), while more than half of Democrats are more favorably disposed to socialism (53%) and the Black Lives Matter movement (84%). 83% of Democrats believe abortion should be always or mostly legal, and only 36% of Republicans hold that view. There is a big gap regarding building a wall along the U.S.-Mexico border with 87% of Republicans and just 20% of Democrats in support of it. As for how we view America's place in the world, 69% of Republicans believe America is the greatest country in the world, while only 37% of Democrats do so.

The good news is that independent voters are becoming a larger cohort, and they offer a glimmer of hope for centrism and compromise. The White House should be worried that 57% of independents think the country is on the wrong track, and just 27% believe we are on the right track. 74% of them are okay with capitalism, and only 28% like socialism. Nearly 60% of independents are supportive of both the Black Lives Matter (58%) and Blue Lives Matter (57%) movements, showing that one can support both causes without being conflicted. Regarding the support for abortion and the border wall, independents are somewhere between the two parties – 65% and 46%, respectively. Lastly, only 48% of independents agree with the statement that America is the greatest country in the world. It is puzzling that nearly half of Americans do not believe that the U.S. is the greatest country in the world. I wonder what countries are the greatest in these folks' minds.

For the upcoming midterm elections, various polls are indicating that the abortion issue will energize many female voters to tip the balance of the Senate to Democrats and narrow the GOP's margin of potential victory in the House. However, the White House's attacks on MAGA Republicans may have complicated polling as many "submerged voters" – those who plan to vote for MAGA candidates but are reluctant to admit it to pollsters – could once again surprise political pundits. In short, America's political polarization will unfortunately linger on while both political parties pander to the more extreme elements of their bases. The loss of a political center makes it hard to craft sensible policies sorely needed for sectors such as Big Tech and energy. The former appears to have incurred the wrath of lawmakers on both sides of the political aisle, but they cannot reach a compromise – Republicans want to check Big Tech's power of censorship while Democrats seem to prefer more of it. As for the critically important energy sector, Republicans want more exploration and production while many Democratic lawmakers are still hostile to fossil fuels even though some of them would not turn down offers to fly on private jets. Ironically, there is one issue that the majority of all political stripes can agree on: there should be a maximum age limit for elected officials, with 70 being the most preferred cap. According to a CBS News/YouGov poll conducted in late August, those favoring a maximum age limit among Democrats, Republicans, and independents amounted to 71%, 75%, and 75%, respectively. An age limit of 70 would disqualify Trump from making a political comeback and help Biden with his so-called "battle for the soul of the

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nation." However, Speaker Pelosi, Leaders Schumer and McConnell, and the President himself would also have to give up their cushy jobs and retire into highly profitable corporate speaking tours. Who says life is fair?

POLICY ASYMMETRY

To some observers, years of partisan political dysfunction and paralysis have left the supposedly independent Federal Reserve as the last governing institution with adult supervision and common sense. To the Fed's credit, despite some policy errors, it has successfully shepherded the U.S. economy through various crises: the dot-com bubble implosion, the 9/11 attacks, the Great Financial Crisis (GFC), and COVID-19.

Prior to the dot-com implosion and 9/11, the U.S. federal government's finance was in tip-top shape: we had a budget surplus from 1998 through 2001, and our gross federal debt-to-GDP was only 55% in 2001. To pull the economy out of the recession of 2001, Fed Chairman Greenspan lowered the Fed funds rate from 6.5% to 1%, which ignited an epic housing boom. It was in essence a strategy of levering up banks' balance sheets – increased lending – for growth. However, the housing boom got carried away and morphed into a subprime crisis, which wound up damaging the banking system and bringing the global financial market to the brink of the abyss.

Having failed in conducting proper oversight over the banking system, Fed Chairman Bernanke then rode to the rescue by kicking off the era of ZIRP and QE – he cut the Fed funds rate to zero (zero interest rate policy) and initiated quantitative easing, which effectively levered up the Fed's balance as a shock absorber. Bernanke wound up doing three rounds of QE which expanded the Fed's balance sheet from below $1 trillion pre-GFC to an interim peak of $4.5 trillion by early 2015. President Obama and Congressional Democrats also seized the crisis to roll out fiscal rescue and new programs (e.g., Obamacare). All told, during President Obama's first presidential term (years 2009-2012), the gross federal debt-to-GDP soared from 68% to 100%.

When President Trump moved into the White House, the Fed was belatedly trying to normalize its monetary policy with timid rate hikes and a very gradual balance sheet runoff. Trump implemented the largest tax cuts in U.S. history at the expense of fiscal probity, but still griped repeatedly that it was unfair of the Fed to restrain economic growth with monetary tightening. By the time Jerome Powell become Fed Chair in February 2018, the Fed had raised the Fed funds rate by merely 1.25% cumulatively, and quantitative tightening (QT) had just been initiated a few months earlier.

By the start of fourth quarter 2018, the Fed funds rate was raised to just 2.25% and the Fed's balance sheet was only down $300 billion from the early 2015 peak. However, investors started to push back against the tightening cycle. On December 19, 2018, after Chair Powell raised the Fed funds rate to 2.5% and stated that QT was on autopilot, investors dumped risk assets in droves and bought Treasuries. The sell-off culminated on Christmas Eve 2018 with the S&P 500 Index having suffered a 19.8% drawdown on a closing basis. Chair Powell got the message and quickly signaled a policy pivot that calmed the market. He wound up ceasing QT at the end of July 2019 and cutting the Fed funds rate three times in the third and fourth quarter. When the repo market seized up in September 2019, Chair Powell quickly expanded the Fed's balance sheet by nearly $400 billion but insisted that it was not to be called QE.

COVID-19's sudden arrival in the spring of 2020 led to unprecedented lockdowns and cratered the economy and financial markets. With markets seizing up on rapidly disappearing liquidity, the Fed sprang into action by purchasing nearly $3 trillion of securities, including non-investment grade corporate bonds, from mid-March to early June. Congress also appropriated several trillion dollars to stimulate the economy and forestall bankruptcies. This combination of unprecedented liquidity injection and fiscal stimulus not only steadied the economy, but also jumpstarted a powerful bull market. By the end of 2020, Uncle Sam's gross debt-to-GDP had soared to a record 128%, and the Fed's balance sheet stood at $7.36 trillion. Interestingly, Chair Powell kept the Fed's balance sheet largely unchanged from early June to Election Day 2020. It was perhaps a subtle payback to Trump for his relentless tormenting.

Inflation probably would not be as rampant today had Chair Powell refrained from his last round of QE. A few days after Election Day 2020, Pfizer announced success in its mRNA vaccine trials, which would pave the way for normalization. However, in the name of maximizing employment and stoking higher inflation for "price stability," the Fed announced a massive, open-ended QE program of $120 billion per month in December 2020. This would ultimately expand the Fed's balance sheet by another $1.6 trillion to a whopping $9 trillion. One can't help but wonder if it was politically motivated – with Trump out of the way, it was time to turn on the liquidity

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spigot again to fund President Biden's green agenda. The program also conveniently funded Congress' massive stimulus of $2,000 for every qualified man, woman, and child – a largess bigger than the first round of financial aid during the depths of the COVID-19 crisis in the spring of 2020. With the benefit of hindsight, one can argue that this big QE program and the $2,000 stimulus checks were unnecessary, and that they helped to stoke the runaway inflation we are suffering today. The Fed further compounded its policy errors by insisting that the rising inflation which began in spring of 2021 was transitory until Chair Powell got nominated for his second term last November.

The lesson from the last few decades is that the Fed had consistently operated with a policy asymmetry: it was overly responsive to market setbacks but consistently late in curbing bubbles that would eventually cause financial instability. The former tendency has created a moral hazard as speculators could always assume that they would be bailed out by the so-called "Fed puts." Seasoned investors can recount the numerous occasions when the Fed used a variety of tools – verbal interventions ("open mouth operations"), rate cuts, and asset purchases – as monetary morphine to dampen volatility and keep the wealth effect going (Note: Former Dallas Fed President Richard Fisher had warned of "monetary morphine" in as early as 2012.). On the other hand, the Fed was repeatedly asleep at the switch in policing bubbles – the dot-com bubble, the housing bubble, the negative real interest rate bubble, meme stocks, crypto bubbles, and today's inflation bubble. Its easy money policy also enabled politicians to spend recklessly with impunity.

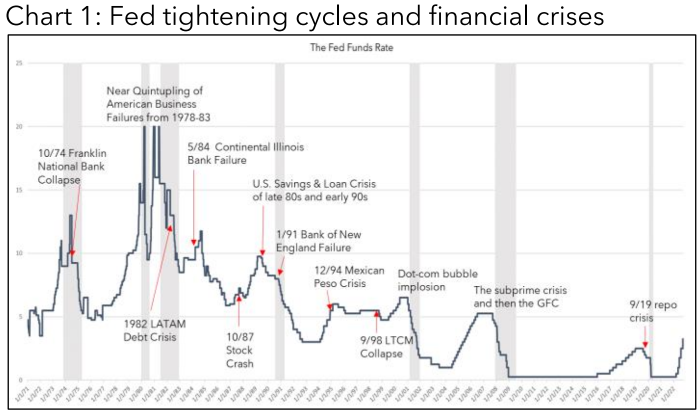
In short, the situation we find ourselves in has been two decades in the making. The Fed had first used the banking system's balance sheet to gin up growth. It then levered up its own balance sheet to bail out the banking system during the GFC. The COVID-19 crisis pushed the Fed to turbocharge its balance sheet with $4.7 trillion of QE to indirectly monetize much of Washington's $5.3 trillion "helicopter money." This final act induced four-decade high inflation, which will require much pain (i.e., a recession) to restore price stability. Elevated inflation means that the Fed can no longer come to the market's rescue with monetary easing. Investors, having grown addicted to monetary morphine from the Fed, were still deluding themselves with the dovish pivot narrative until Chair Powell made his concise but forceful Jackson Hole speech. For the first time in decades, investors are left to fend for themselves without the assurance of a Fed put. This is why sentiment has turned so bearish in a matter of weeks, even though economic growth and earnings estimates have yet to be cut materially.

AN ACCIDENT-PRONE WORLD

After several decades of policy asymmetry that put asset prices and the suppression of market volatility above longer-term financial stability and probity, the proverbial chicken is now coming home to roost. In the face of four-decade high inflation, the Fed has been forced to embark on the most aggressive tightening cycle in decades.

The months ahead will likely be fraught with risks and volatility as the global economy and financial system adjust to rapidly rising rates and declining liquidity. The stress is already reflected in the rapidly surging U.S. dollar, which amplifies the liquidity crunch in the offshore euro-dollar system. It can evolve into a vicious cycle as the stronger greenback forces foreign central banks to further raise their interest rates in order to defend their currencies. If history is any guide, the Fed's aggressive tightening will wind up triggering some financial accidents here or abroad, as is the pattern over the last five decades.

Chart 1: Fed tightening cycles and financial crises



Source: Bloomberg; RGFO

The silver lining on the horizon is that the Fed may be forced to pivot in the not-too-distant future, as we have just witnessed how the Bank of England blinked in the face of a potential financial crisis. Unfortunately, this pivot will likely come only after much pain is inflicted on the economy and the market. The eventual pivot will likely set the stage for the next bull market. In the meantime, however, our job is to minimize drawdowns while waiting for the cycle to turn.

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TINA'S RETIREMENT

For much of the last decade when central banks around the world kept interest rates artificially depressed, investors were forced to allocate more to equities under the "there is no alternative," or TINA thesis. Today, however, with bond yields surging and equities no longer being protected by Fed puts, TINA's glorious days are over, and select fixed income opportunities are starting to look interesting.

For investors who are not overly concerned with fixed income's mark-to-market risk, it may be time to nibble at longer-dated U.S. Treasuries. With the 10-year Treasury yield approaching 4%, I suspect there is room for capital appreciation as the coming recession will likely push U.S. Treasury yields lower. The risk in the near term, of course, is that yields could still overshoot. However, given our financial system's elevated leverage – total U.S. private and public debt hit 369% of GDP at the end of 2021, compared to roughly 160% in the early 1980s when Volcker was battling inflation – I suspect interest rates cannot stay elevated for an extended period without triggering economic and market problems. Similarly, select AAA-rated municipal bonds now offer 7%-plus tax-equivalent yields, which would be good for buy-and-hold. The one caveat is that, during periods of great financial stress, municipal bond yields can spike up substantially above Treasury yields. However, that would be a temporary phenomenon and an excellent buying opportunity. No one knows if the market will be hit with such stress in the near-to-intermediate term, so it's prudent to nibble with yields rising while keeping some dry powder.

In the final analysis, we continue to advise investors to be patient, selective, and defensive for now. It is starting to feel like the capitulation stage of the bear market is drawing near. During the capitulation stage of a bear market, the pace of market decline will be accelerated and even turn disorderly. However, that will likely be a good buying opportunity for those with dry powder to put to work.

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