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OPINION

Markets Insight

It's not all about a Fed pivot

Investors should resist a knee-jerk move to speculative assets based solely on the central bank potentially reversing course

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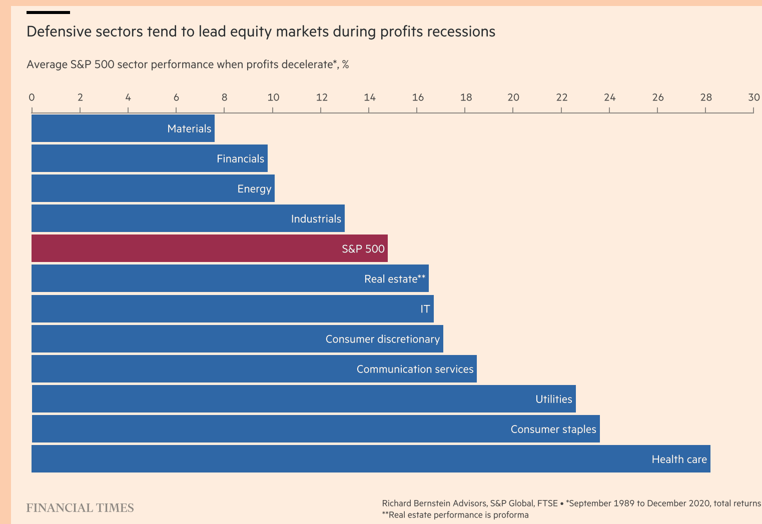
So many recent market moves have been driven by the intense examination of the public statements of US Federal Reserve board members for clues regarding the possibility of a "pivot" by the central bank.

This relentless parsing has caused short-term volatility spikes as investors rush to buy or sell speculative assets like technology stocks and cryptocurrencies at even the remotest suggestion from the Fed that they might curtail or maintain tight monetary policies.

Such speculative fervour seems very premature. First, the benchmark fed funds rate, after taking into account inflation, remains near historically negative levels. With inflation near 40-year highs and the Fed's credentials to fight such rising prices at risk, the central bank is unlikely to ease monetary conditions soon because today's real rates would, in most cycles, be considered very stimulative.

Second, it's not all about the Fed. There are two inputs to any classic valuation formula: interest rates and earnings. And investors seem to have forgotten the importance of earnings.

The likelihood of a full-blown profits recession — at least two quarters of negative year-on-year earnings growth — seems high during early 2023. Whereas there were numerous fillips to corporate profits growth as the US economy exited the worst parts of the pandemic, many of those forces are now reversing. Corporations are facing the troublesome combination of weakening demand, rising labour costs, a very strong dollar, and the simple maths of difficult comparisons with 2021-22's strong earnings growth.



The combination of the Fed tightening monetary policy and profits decelerating means both primary inputs to valuation are worsening. Yet, overall market valuation remains expensive.

Consensus equity portfolios do not reflect this undesirable combination of rising rates and decelerating earnings. A popular debate centres on the relative attractiveness of cyclicals versus growth — stocks more exposed to the economy compared with companies that have superior secular profits growth. Unfortunately history suggests neither of those two groups lead performance when profits decelerate.

Rather, defensive sectors tend to lead equity markets during profits recessions. Consumer staples, healthcare, and utilities have historically been the three best performing sectors during such periods. One needs to remember that no matter what goes on in the economy, people still eat. They might switch from steak to bologna, however, so necessities rather than dreams and desires usually dominate successful investment themes during profits recessions.

Relative earnings growth is a primary driver of stock returns. Earnings growth in stocks that are more defensive in downturn look very boring and too stable when the economy revs up, and investors shift portfolios to more cyclical investments when economic and profits growth accelerate. However, boring and stable becomes quite attractive during profits recessions when broad earnings growth turns negative.

Credit has been very popular among fixed-income investors, but lower quality bonds tend to underperform higher quality ones during profits recessions. Lower quality bonds underperform during profits recessions because the cash flows of the companies that issue them deteriorates, making it hard to pay debt obligations.

Many have suggested the current strength in corporate balance sheets implies "this time is different" for corporate credit investing and that lower quality bonds will perform unusually well. However, similar claims have been made at the peak of nearly every profits cycle when balance sheets always look strongest.

It seems unrealistic to assume that lower quality credits will go untouched by tighter monetary conditions. After all, isn't that the whole point to tightening? Indeed, credit spreads have already begun to widen as the Fed has raised rates, and a profits recession in 2023 will certainly cause credit spreads to widen further.

There comes a point in every cycle during which investors believe the markets will "look beyond the recession". This provides comfort to those holding more cyclical assets, but the markets have never ignored a profits or economic recession. One must remember the cycle, by definition, is determined by cyclicals.

Investors should resist the knee-jerk reaction of rushing to speculative assets based solely on the Fed potentially reversing course. Their portfolios also need to reflect the realities of an approaching profits recession.

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