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The Fog of War

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Perspective amid a volatile year as the Fed battles inflation.

Fog often envelopes the Bay Area. At times, it is very dense, limiting visibility and raising uncertainty for travelers. Fog horns blare. Cars crawl. Flights get delayed. Financial markets have dealt with elevated uncertainty this year as the Federal Reserve declared war on inflation and growth slowed, limiting economic visibility. The historically weak returns across asset classes that have resulted can leave observers disoriented. Just as it is grounding to slow down and reorient oneself when traveling and confronting intense fog, so it is prudent to take a step back and get some perspective about where the key drivers of financial markets sit and what it could mean for future returns.

Risk-Free Reset

Asset pricing may seem obscure and at times even random. But across asset types, it is influenced by growth expectations, risk premiums, and a risk-free rate. The risk-free rate reflects what a person is paid to hold an asset where there is essentially no risk of losing the principal invested if held to maturity. In the US, the 10-Year US Treasury is often used as a proxy for the risk-free rate. One way to think about the 10-Year Treasury is it reflects the yield on cash and a premium for having to tie up their money versus enjoying the flexibility of holding cash. The 3-Month Treasury Bill is a proxy for cash and is heavily influenced by the Federal Funds Rate.

As the Fed increased the Fed Funds Rate this year, the 3-Month Treasury Bill (i.e., the return on cash) rose from 0.06% at the start of the year to 3.33% at the end of September. Throw on the time premium, and the risk-free rate (10-Year Treasury) was at 3.83% at the end of September – more than double from where it started the year. This higher risk-free rate got baked into the required rates of return for other assets since those assets must offer higher returns to incentivize investors to tie up their capital versus just holding cash. Higher required rates of return mean lower asset valuations. Assets with higher starting valuations, like growth equities, momentum equities, and global real estate, were hurt the most by the higher risk-free rate.

After this risk-free reset, valuations for many risk assets are now at or close to 10-year lows.

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The Risk-Free Reset and Changes in Valuations

	Risk-Free Rate		**Asset Class Valuations**					
	3-Month Treasury Bill Yield	10-Year Treasury Yield	Domestic Growth Equities P/E	Domestic Momentum Equities P/S	Domestic Value Equities P/E	Foreign Equities P/E	Global Real Estate P/E	Natural Resource Equities P/E
Proxy			IWF	ARKK	IWD	ACWX	RWO	GUNR
12/31/2021	0.06%	1.52%	30.6	9.2	16.2	14.3	20.6	10.0
9/30/2022	3.33%	3.83%	20.4	4.1	12.1	10.8	14.0	7.4
Change in Valuation			-33%	-55%	-25%	-25%	-32%	-26%

P/E = Forward price-to-earnings   P/S = Forward price-to-sales

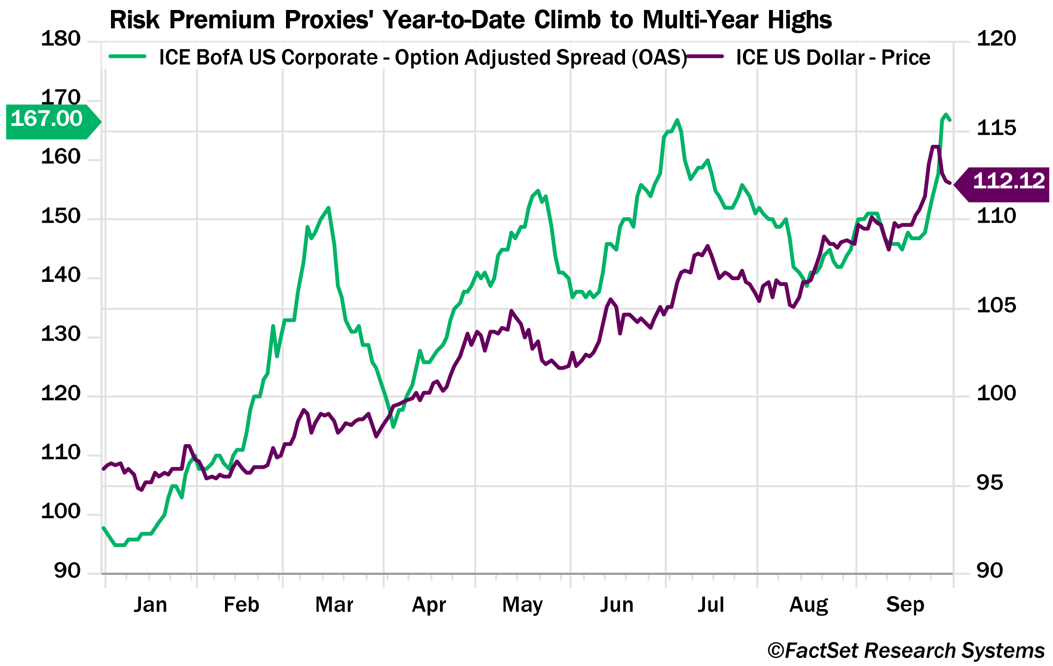
Sources: FactSet, FRED, Osborne Partners

Risk Premiums Elevated

Two other key elements of asset pricing are growth expectations and risk premiums. These are intertwined. The more uncertain the growth outlook, the higher the risk premiums. As economies deal with higher inflation and the impact of higher interest rates, global growth has decelerated. A proxy for growth is the JP Morgan Global PMI Composite Output Index. Anything above 50 indicates economic expansion, while anything below 50 indicates contraction. This index hit a post-COVID high of 58 in May 2021 before ending 2021 at 54. As of August, it had slipped to 49. Concerns about growth trends have driven risk premiums higher, negatively impacting asset prices.

Credit spreads are a proxy for risk premiums. Wider spreads mean more elevated fears about defaults. Another risk premium proxy is the US Dollar, since demand for it rises in periods of uncertainty as it is viewed as a safe-haven asset. As the following chart shows, corporate credit spreads have widened from less than 1.00% to 1.67%, a multi-year high, while the US Dollar has strengthened from 96 to 112, a multi-decade high. This amidst a backdrop where implied volatility or “Fear Indices” for bonds and equities ended September near multi-year highs.

Risk premium normalization from elevated levels could prove supportive of asset prices.



Setup for Return Improvement

Discounted valuations at the end of the third quarter resulting from the risk-free rate reset and elevated risk premiums are an encouraging setup for future returns. Growth expectations are crucial to lower risk premiums, stop the risk-free reset cycle, and drive returns.

Regarding the risk-free reset, the Federal Reserve at its September 2022 meeting released its economic projections for 2023. Its median Federal Funds Rate projection for 2023 is 4.60% vs the current range of 3.00% - 3.25%. This would suggest the risk-free reset process is only around 67% of the way done.

But the history of Fed projections shows they too can get lost in the fog of economic uncertainty and face the need to course correct. The following table shows how the Fed's economic projections made at its September meeting for the following year compares to the actual economy. Even when excluding 2020, their forecasts have proven unreliable. Take 2019, for example. In September 2018 they projected the Fed Funds Rate in 2019 would hit 3.10%, but the economy and inflation missed expectations, and the Federal Funds Rate ended up being only 1.75%. The lagged impact of 2018 tightening policy was felt then, and in similar fashion, numerous leading indicators today also suggest the lagged impact of this year's tightening could get felt next year, necessitating less tightening than expected as growth and inflation could disappoint their 2023 projections. This would mean the risk-free reset cycle is close to finished, and that the Fed may have already turned the tide on inflation. As this becomes clearer, assuming the growth slowdown is moderate, risk premiums could normalize, and asset prices could improve.

Forecasting is Hard

Estimates at September Federal Reserve Policy Meeting for Year Ahead vs Actual Results

		2016	2017	2018	2019	2021	2022	2023
Core PCE Inflation	Actual	1.60%	1.70%	2.00%	1.70%	3.50%	5.0% Q1, 5.3% Q2	?
	FOMC Est	1.70%	1.80%	1.90%	2.10%	1.70%	2.20%	3.10%
Real GDP Growth	Actual	1.70%	2.20%	2.90%	2.30%	5.90%	-1.6% Q1, -0.6% Q2	?
	FOMC Est	2.30%	2.00%	2.10%	2.50%	4.00%	3.80%	1.20%
Fed Funds Rate*	Actual	0.75%	1.50%	2.50%	1.75%	0.25%	3.25%	?
	FOMC Est	1.40%	1.10%	2.10%	3.10%	0.10%	0.30%	4.60%

*Fed Funds Rate: 2022 is the high end of the policy rate range at the September meeting

Sources: FactSet, Federal Reserve, Osborne Partners

Foggy Bottoms

While economic visibility is foggy as the Fed's war on inflation continues, and some economic indicators suggest growth could disappoint Fed projections in 2023, it is important to remember that asset prices often bottom before growth does. This is because market participants incorporate growth expectations into asset pricing. When risk premiums are high, growth expectations are often too low. That is why at Osborne Partners there is an intense focus on valuations, the implied growth expectations included in asset prices, and a disciplined approach to weighing upside vs downside. This applies to all asset classes. This multi-asset class approach helps clients navigate these periods of limited visibility to reach their intended financial destinations.

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