Market Note

Market Scenarios and Risk Levels

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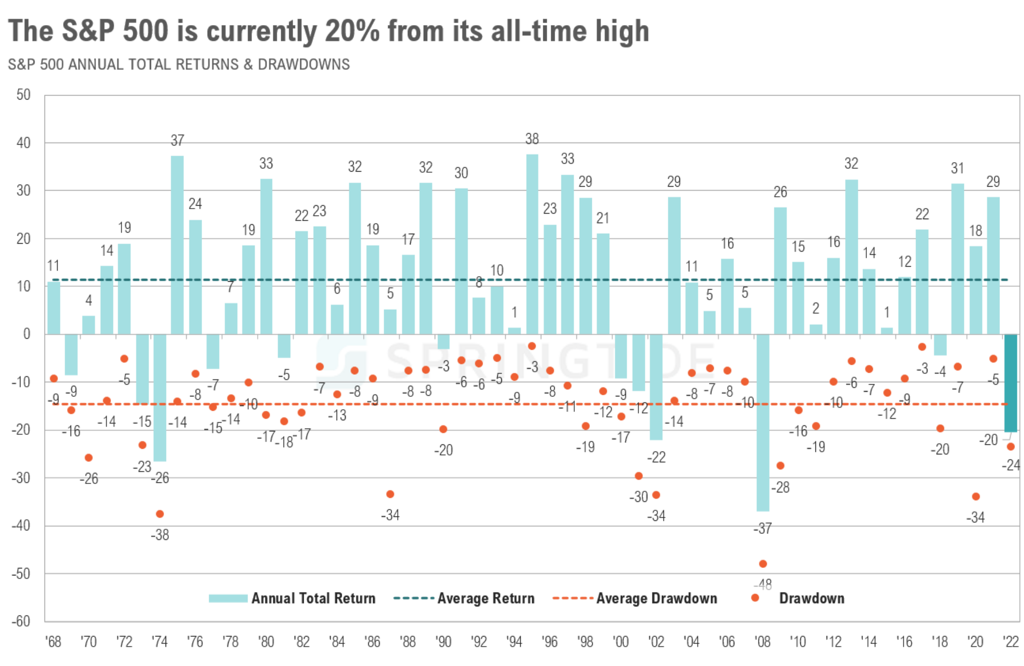
Summary

- Recent economic data suggesting real GDP growth contracted in the second quarter has materially increased the potential for a recession this year.
- While we are broadly comfortable with risk levels and positioning, we want portfolios to be able to weather a range of potential outcomes that include a short-term rally, but also an eventual resumption of the bear market and substantial new lows in risky assets.
- The average decline in post-War bear markets has been over 35%. With the current drawdown on the S&P 500 being a little worse than half of that, we want to make sure we are in a position to layer in risk, potentially aggressively, at lower prices rather than be forced to do the opposite.

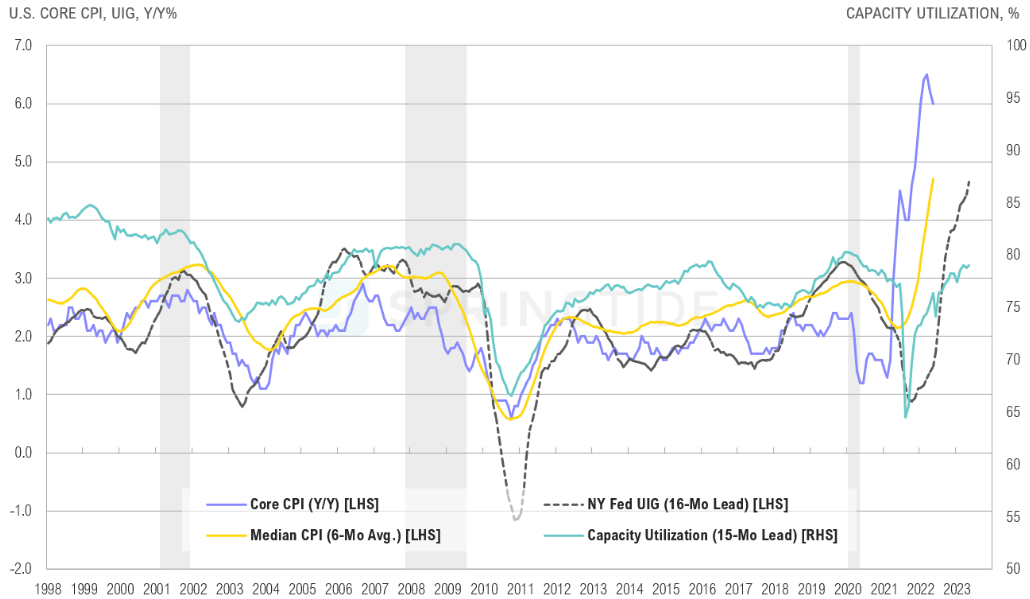
Market Scenarios

Considering recent economic data suggesting real GDP growth contracted in the second quarter (the second consecutive quarter of decline), we are making two small reallocations to model portfolios (a re-weighting of managers within Tactical Multi-Asset and removing the tactical overweight initiated earlier this year to Closed-End Funds). These changes represent more of a repositioning within existing asset categories rather than wholesale changes.



Broadly speaking, we are comfortable with the levels of risk taken in the SpringTide models between equities, fixed income and credit, real assets, and opportunistic categories. We continue to lean to U.S., quality, and value within equities; shorter-duration, higher-quality bonds in fixed income; and various real asset classes that we believe are structurally supply-constrained and will provide a hedge when the Fed ultimately is forced to pivot away from further rate hikes. Further, we believe active managers should be emphasized in this environment. While we remain overweight areas that should outperform if inflation continues to be a concern, we have tried to reduce those overweights in recent months given exceptionally strong relative returns earlier in 2022, such as trimming midstream energy and adding to the Technology sector in May. This move came on the heels of completely exiting commodity futures in the first quarter.

Inflation appears to be peaking on a year-over-year, expected to moderate towards the end of the year



Source: Bloomberg

As markets continue to tilt away from an inflationary tone to more of a recessionary one, we want to make sure portfolios are not left flat-footed for multiple outcomes and timeframes. Below we want to lay out two of those scenarios for consideration.

SCENARIO 1: RETURN TO THE “GOLDILOCKS/LOWER RATES” TRADE

While this scenario may seem counter-intuitive given the U.S. economy may be on the brink of a recession, a resumption of the deflation trade could mean that longer duration bonds rally, technology stocks outperform, credit spreads contract (high yield bonds outperform), and inflation hedges including commodities lag. We fully acknowledge that technology stocks rallying into a slowing economy and potential recession may seem like a low probability event but given how much longer duration assets have lagged over the last six months, we do not want to underestimate the potential for this to play out. A catalyst for this could be the recent decline in commodity prices, which, if it continues, will result in a decline in inflation fears, providing some cover for the Federal Reserve to ease back from their hawkish stance. While we are not positioned for this per se, we want to make sure we consider that this may be short-term “pain trade” (the trade that seems least likely, that fewest market participants are positioned for, and that may play out as a result). Whether or not this scenario could play out for more than a few months would come down to whether or not inflation inputs (and headline inflation) roll over dramatically and stay low versus just pausing before rising again.

SCENARIO 2: A RECESSION WITH NEW LOWS IN RISKY ASSETS

By this we mean a classic recession scenario, but with the Federal Reserve still “stuck in a box” given inflation remaining stubbornly high relative to a level where the Fed could claim “victory”. Under this scenario, all risky assets would likely decline in concert with few areas to hide aside from cash and potentially longer-term bonds. The declines could be dramatic if we consider that by many measures, stocks are relatively close to long-term average valuations (modestly below on a forward-looking basis, although there is risk that earnings estimates would be cut in a recession; modestly above average in terms of trailing valuations; and not very attractive when compared to bond yields, which have risen dramatically). Another important reason we want to take this scenario so seriously is because despite exceptionally negative sentiment readings, we have not yet seen dramatic de-risking as it relates to real money flows or actual positioning. Surveys or indices that show where investors are currently allocated (i.e. BofA FMS, AAII Asset Allocation Survey, VIX) point to allocations to stocks modestly below all-time highs, but still above average and nowhere near anything that could be considered capitulation.

During the first half of the year, we openly discussed the potential for a lot more volatility later in the year if recession concerns escalated or if the Fed was forced to continue to “slam on the breaks”. Our reasoning for this view was that the backdrop for capital markets was hostile enough that valuations in equities and credit could move lower and through average—roughly where they are currently—and start to get truly cheap relative to history. Given recent economic data and the reaction across various markets but especially Treasury spreads, we believe the odds of this happening are increasing. Again, notwithstanding the potential for a short-term rally in risky assets given sentiment, especially if rates continue lower and lower commodity prices take some of the sting out of inflation concerns in the near term, we believe investors should actively think about how they will respond if we head materially lower.

The average decline in post-War bear markets has been over 35%. With the current drawdown on the S&P 500 being a little worse than half of that, we want to make sure end clients will be in a position to layer in risk, potentially aggressively, at lower prices rather than be forced to do the opposite – liquidate at the lows.

Sincerely,

The SpringTide Investment Team

Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

Citations

1. n/a

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Asset Class Definitions

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Interm-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Interm-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.