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The Arrival of Long and Variable Lags: How We're Investing

- We expect the release of new economic data to be wide, varied and somewhat asynchronous.

- Said differently, the arrival of long and variable lags from the rapid pace of policy tightening will now have an effect on market data releases.

- This may lead to higher volatility as the market is apt to change its mind frequently on which tail-risks it want to latch onto. This happens when tail-risks are fat, as they are in 2023.

- Beyond this, a key Fed mouthpiece signaled a 25 basis point Fed hike at the Feb 1 meeting, and maybe one more in March, pushing everyone toward the left-tail. No wonder volatility is high!

- This combination of fat-tail risks and sizeable amounts of money on the sidelines will make managing risks particularly difficult in 2023.

- Adding to the difficulties is that *return correlations* between fixed income and equities are still very high, which makes it mathematically challenging for traditional portfolio management techniques (e.g. 60 Equity/40 Fixed Income) to reduce risk.

- The key to managing this type of volatility, the distribution of market risks, is to construct a portfolio of offsetting risks and achieve diversification, or risk reduction, through this balance.

Jim Caron: Hello, everyone. This is Jim Caron Co-CIO of the Global Balanced strategies. Well, very interesting times in the markets and we do expect the release of economic data to be wide and varied and somewhat asynchronous. Said differently, we're now seeing the arrival of long and variable lags from the rapid pace of Fed and central bank policy tightening take effect in market data releases. Notably, we're seeing that the volatility of the data may lead to higher volatility and market prices as people in the market are apt to change their minds frequently, depending on which tail risks they want to latch onto. This is what happens when tail risks are fat as they are in 2023, which is a thematic topic for us.

And just when everyone was ready to get bearish again and move towards the right tail, enter the Fed's mouthpiece, Nick Timiraos, who in Sunday's Wall Street Journal (WSJ) signaled a 25 basis point hike at the next Fed meeting on February 1st. Now, maybe that's it, or there's one more in March pushing everyone now towards the left tail of the distribution of risk. No wonder volatility is high! If the market was expecting that the Fed hike 50 basis points in February and now we're learning from the WSJ it might only go 25 and that may be the last one, meaning the Fed may end their rate policy hiking cycle at 4.75%. Or if they go one more time in March, they maybe it's 5%. The markets were expecting somewhere between 5 and 5.25% and the key quote from Timiraos was that Fed officials are preparing to slow interest rate increases for a second straight meeting and debate how much higher to raise them after gaining more confidence inflation will ease further this year. So a combination of fat tail risks and sizable amounts of money on the sidelines in money market accounts that may be rapidly deployed to chase returns, makes managing risk since 2023 very difficult. Adding to those difficulties is the high return correlations between fixed income and equities which are still as very high as they were last year, which makes it mathematically challenging for traditional portfolio management techniques, say in a

60/40 Equity/Fixed Income style portfolio to reduce risk through that simple type of diversification. As we've discussed before, the key to managing this type of volatility, or distribution of risks in the market, is through a portfolio construction of offsetting risks and achieving diversification or risk reduction through this balance. But as always context matters, so let's get into it.

The long and variable lags wreak havoc on forecasting the economic cycle. Let's talk about the base effects and in terms of inflation the key point here is that base effects cut both ways. Once again context is important. As I said before and the context I'd like to discuss is that of those base effects and data releases particularly in Europe. If we if we then start to look at measures such as growth, inflation, labor, wages and earnings, all of these were largely stronger last year due to the fallout and lagged effects of pandemic stimulus activities. Despite the fact that the Fed and other central banks were tightening policy, and that same policy tightening will cool growth, labor, wages and earnings to amongst others in 2023. But it will likely be asynchronous. As we recall the surprise strengthening and data that really start to occur last year around late 1Q 2022 before cooling in mid-4Q last year, those same variables for 2023 will look weaker and/or slower when compared against their growth rates from 2022. In other words, the growth rates of 2023-2022 year-over-year (YoY) comparisons will be slower than last year's comparisons of 2022-2021. That's the base effects that I'm talking about is that it's really a slowing of these measures, namely of growth, inflation, wages and earnings. But all happening asynchronously and that's the variable part of long and variable lags. That asynchronous data measures add to the complexity, meaning that the slowing in growth inflation, labor, wages and earnings aren't going to happen all at the same time. It's not going to be very linear. While many understand the impact of base effects, we're not sure the asynchronous nature that these long and variable lags of the data releases are fully appreciated by the market.

For instance, if we look today, inflation is falling. There's no question about that. But the decline is mainly coming from the goods sector, particularly as supply chains and inventories were corrected. The Fed has now turned its focus to the service sector which still has troubling high levels of inflation. So inflation is falling, but maybe not quickly enough, nor in the right areas. This keeps policy tightening in the game. If we look the headline PPI data released last week, it fell more than expected at -0.5% month-over-month (MoM), but most of that was from final demand goods prices falling -1.6% and most of THAT came from a - 7.9% fall in the demand for energy and most of the THAT came from the decline of about -13.4% in gasoline prices. Essentially we're getting a large part of the decline in inflation from the same sector and that's not what the Fed wants to see. The Fed wants to see this broad decline in inflation, not just from a goods and/or energy perspective which we know is already happening. Sure, labor and wages are softening but still remain too strong for the Fed's comfort at this point in the cycle. We would argue this time that the labor market has the most lagged effect based on policy, where unemployment rate jobless claims are low, and wages are falling but still remain high. Remember that YoY wages are growing at about 4.6%. Now, that's a decline from where they were, but it's way above the 2.5% the Fed is requiring inflation to anchor around target levels. So even the wage growth is falling, it's probably still too high. The lag in fallen earnings is linked to the previous two points, so stronger for longer labor markets kept wages high and companies able to pass on price increases to consumers. This kept profit margins and earnings afloat and frustrated consensus forecasters who have been calling for a collapse in earnings really since mid-2022. Yes, valuations fell but earnings surprised forecasters so all of these things will add to the variability of what we expect to be a correction in the growth inflation in earnings data. We do think that data is softening, but it's going to be very variable. Again, long and variable lags.

Now let's talk about the lags. Interest rate sensitive sectors of the economy are showing signs of stress and the consumer is growing worried despite the robust jobs market. Let's look at some of the data we got last week. Retail sales came in weak from December and they were downward revisions to November as well. It came in at -1.1% MoM, but this really follows a YoY trend decline in retail sales: in October it was 7.8%; November, 6.2%; December, 5.3%. So retail sales data YoY is declining pretty rapidly and you're even seeing MoM declines. The housing sector is another area that we can look for some of these lags to exist. In December 2022, existing home sales fell to its slowest pace since October of 2010. Again, we're starting to see the impact of all of these rate hikes really starting to be felt in the markets as the median price decline for houses fell 1.5% MoM. On a YoY basis home price appreciation came in at about 2.3%, which is the lowest since May of 2020. To add additional context to this, this measure peaked at plus 25.2% home price increases in May of 2021. This is a significant correction in the housing markets, due to the slowing economy to a degree, but really because of higher interest rates. So while the year over year, pace is still positive, this is the 6th straight month over month decline in housing. Housing inventory is falling and interest rates have declined and we may see housing bottom over the next few quarters, depending of course on the recession and its depth. Now, if we add the Philly Fed manufacturing number, which was weak last week, and see that the auto sector could be added to the pile of soft data as well. Perhaps even PMIs, where the softness there has been running ahead of all of this. Essentially the lagged effect of these rising rates is still yet to be fully felt, but we're starting to feel it right now. And remember ,the variability component of this means that the data correction or the slowing of the data is not going to happen in the uniform matter. In the end, these long and variable lags really add to a lot of volatility in the market.

How do we think about investing in this type of market? Constructing a portfolio to manage the risks associated with a cycle of long and variable lags? Well, the asynchronous nature of long and variable lags means that managers need to construct a portfolio that creates a balance by attempting to offset the risks in the portfolio. So one position risk may offset another. In other words, play the variation in the cycle against each other in order to reduce correlation risk. Let me say that again: play the variations in the cycle against each other in order to reduce correlation risks. This is really what we're trying to achieve. We find this is particularly useful when correlation risks across broad asset classes, like stocks and bonds are running high as they are today, as they were in 2022. The key for us is to think about constructing a portfolio with offsetting risk positions.

Here are some ideas on how to do this. First, add equity-like bond exposure to portfolios, but offset that risk by adding high quality fixed income and value equity and even add some commodity exposure too. The reason I like to set up this format is I think that bond yields are still reasonably high particularly in credit sectors like emerging markets and high yield, given that interest rates are likely to be in a range, especially now that the Fed may be ending its cycle. These sectors actually fit the bill as equity-like bond exposure, a riskier bond exposure that gives you additional yield. These positions have their own merits, certainly based on value and higher real yields for different reasons, but they also have risk associated with them as well. That risk would be a hard landing. To offset that risk, what you may want to do is buy short-duration or money market assets in combination with also holding some index level core fixed income, that's traditional core plus style fixed income that has about six years of duration. When we add the balances, you may come in around 3.5 to 4 year duration mark, which I think is reasonably good at this point in the cycle. Owning higher quality and value oriented equity and some growth is probably a good idea as well, but we would overweight value just because we think that might fit the economic cycle better, has less risk and there's better value in value these days in our opinion. I would also recommend commodities, mainly energy-related, some metals perhaps, but there is potential for China reopening which may not be fully priced. Additionally the risk that inflation falls but is unanchored can be offset by having some exposure to commodities. In effect we propose a barbell strategy where we have exposure both to the left tail and right tail risks and we try to manage those risks or balance them to the middle.

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