Dear Friends,

Welcome to our latest 5x5 write-up. The 5x5 was created soon after launching our firm, almost 5 years ago. We created this write-up to highlight 5 events that caught our attention and 5 things that our investment team is focusing on. The ultimate goal was to bring our investors closer to our investment process and to highlight the areas of focus that may garner more detailed discussion. The receptivity to this piece has been fantastic, but with that in mind, we are always looking for feedback to help us improve how we are communicating. Please do not hesitate to reach out.

Our attention has been strongly centered around the yield curve, the Dollar, the Fed, earnings, and the new myopic focus on financial conditions by the Fed. As it relates to focus areas, we would be hard-pressed to not be focused on the massive repricing of risk assets over the last 9 months. Additionally, the transition from a negative to a positive real rate world, inflation, the threats of Quantitative Tightening (QT), and the volatility and illiquidity associated with these changes have our focus. Lastly, and probably the most important element of this cycle, the repricing of the cost of capital.

We all know that heightened levels of volatility and significant repricing of risk assets frequently bring out the worst on Wall Street. With this in mind, increased attention to the intercorrelations of markets is critical these days. We debated making this the 5x7 this round but felt it important to stick with the 5x5 format and save the two additional topics, China and the Government, for the next write-up. China, as the second largest economy in the world, demands great focus as it relates to global growth as well as how it plays in the stressful world of geopolitics. As for Government, it is easy to see the dysfunction and leadership void over the last decade. We find the increased focus on polarization over collaboration to be shameful and not in the country's best interest but find ourselves more concerned about the lack of focus on the long-term health of our country and economy to be of even greater concern. Poor decisions today become bigger problems in the future. We save these for future writing and discussions.

As it relates to markets, my views have not changed significantly over the last several months – defensiveness is needed, and incrementalism on risk and heightened levels of liquidity in portfolios seem to be the right approach today. *Smart* and *Aggressive* continue to be my mantra and one I stress with the team. Some things seem so obvious that we find ourselves frequently questioning the consensus. The recent volatility in the MBS

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market that triggered duration extensions (1.5 years to 6.0 years) and wider spreads (+10 to +85) are great examples. One could argue that in a world where correlations are high and there are limited places to hide from negative returns that the consensus is destined to be wrong. But when we look at the dispersion of performance across different categories in the fixed income space, it becomes very clear that there may be less consistency in positioning around the consensus.

There is clearly a lot of fear in the marketplace today that is amplified by the three failed rallies in risk assets over the last 10 months. Most did not want to believe that higher rates would be achieved as quickly as they have. I was in that camp. The Fed is on a mission and will not step back until they see inflation stabilizing and turning over – take them at their word, they have zero incentive to deceive investors here.

There is also a lot of hope in the marketplace. The obsession with a Fed pivot being a signal of 'all clear' tells me that the historical conditioning by the Fed's actions is far stronger than I thought. We work in a marketplace that believes in bailouts, likes to buy the dips, and believes the Fed is their friend. We have been in a marketplace where aggressive risk-taking has been historically rewarded by central banks around the globe - large drawdowns are ultimately relieved by reversals in monetary policy and new rounds of liquidity. Greater geopolitical risk, the deglobalization theme, and heightened levels of inflation make it very difficult for the prior central bank analog to repeat itself. I see our philosophical belief that portfolios should change and evolve as we move through cycles being reinforced in this environment. There will be a time in the future when an opportunistic position will be appropriate and ultimately rewarded, but I think this sits further out on the horizon.

The markets feel oversold and too bearish to me, but I find it also hard to express significant risk positioning in a world of high volatility and horrible liquidity. So, the risk of a violent and quick rally seems more probable today, but I question the sustainability if this were to happen – note that good news results in buying which quickly closes the liquidity gaps. With liquidity in mind, the market is terrible. Stories of poor U.S. Treasury liquidity are very in vogue these days. Even Treasury Secretary Janet Yellen took the opportunity to comment last week. If it is bad in U.S. Treasuries, how bad is it in high yield or bank loans?

While I find myself in a defensive mindset, I know that the math behind the market holds the key to success. Today the market looks more attractive, even considering the uncertainty on the horizon, than at many points over the last 5 years. I have shared with many clients that I have never seen a period of such great hatred toward the bond market. This hatred has resulted in significant underweights and short duration positioning (the right positioning for what we have just gone through). I have started questioning what will happen if the hatred in the bond market returns to a general dislike and portfolio

positioning normalizes. This would mean a lot of money in motion and a very supportive technical for the market. Something to keep in mind as we progress into year-end.

I close with a note of great gratitude and appreciation. As we approach our 5-year anniversary of the firm, I find myself incredibly grateful to so many. I have a great appreciation for my teammates for believing in me and the vision, committing their lives to build this business, and serving our investors. Our investors, for believing in the team, the process, and our longstanding philosophy around managing fixed income. You are the foundation for why Smith Capital Investors exists. And for all those that have engaged with us in making our dream a reality. We talked about building the firm that we always wanted to work for and working for people whom we respected and cared about. Speaking for the team, we feel an amazing amount of gratitude for being given the opportunity to serve. Thank you!

Enjoy the 5x5 and remember, Let's Talk! We are happy to get on the phone and dig deeper into any of the topics or discuss markets.

Warmly,

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Events that Caught Our Attention in 3Q 2022

1. Treasury Yields – The Cracks Are in the Curve
2. Return of the Greenback
3. We All Move Together….When the Biggest Mover Is the Fed
4. Accelerating Downward Earnings Revisions Has Us Leaning on the Fundamentals
5. Financial Conditions – The New Leading Indicator

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Events We Are Watching in 4Q 2022

1. The Repricing of Risk: Only When the Tide Goes Out…..
2. Negative Real Rates Show Restrictive Fed Policy is *Not* an Absolute Level
3. High Inflation – Governments Fighting Fire with Gasoline
4. The Reversal of QE – Elevated Vol and the Hunt for Bad Risk Taking
5. Increasing Cost of Capital and Its Possible Impact on Investment

Welcome to the Smith Capital Investors 5X5. We explore topics from the third quarter of the year and issues facing us in the fourth quarter of 2022. (Use the links above to jump to a section.)

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5 Events that Caught Our Attention in 3Q 2022

1. Treasury Yields – The Cracks Are in the Curve

The Treasury yield curve reflects the current interest rates, or yields, received by U.S. Treasury securities of increasing duration. Typically, the yield curve slopes upwards to reflect higher compensation for taking on longer-duration risk. **When a yield curve inverts, long-term interest rates fall below short-term rates, indicating investor expectations of a weakening economic outlook.**

- The difference between the yield of the 10-year U.S. Treasury and the 2-year U.S. Treasury is a commonly used metric to signal yield curve inversions when this relationship turns negative. The spread between the 10-year and 2-year U.S. Treasury yield has inverted prior to every recession in the U.S. since 1980 (though this relationship did not foreshadow the COVID-19-induced recession). **In the past, when the yield curve inverted, the recession which followed took on average 20 months to materialize.** Yield curve inversion occurred for the first time in 2022 briefly in April but quickly reversed. The relationship between 10s and 2s turned negative again in early July and has remained in negative territory since then; as of this writing, it remains near -40 bps. The current level of inversion is deeper than that of 2006 and on par with the inversions which occurred in 1999 and 1989.

- The current yield curve inversion is a result of the aggressive monetary policy implemented by the Federal Reserve, with the Fed Funds Rate increasing by 3 percent over the course of the past 5 months to combat inflation. **Short-term interest rates are signaling an ongoing aggressive stance by the Fed over the short-term, but long-term rates indicate a shift in monetary policy to lower rates in the future, leading to the current yield curve inversion.** In the past, inverted yield curves have typically signaled heightened economic uncertainty and brought upon increased volatility - neither of which typically bring out the best on Wall Street. Does this current yield curve inversion forebode cracks emerging in the economy? History points in that direction. Then again, past performance is not always indicative of future results.

BOTTOM LINE

Yield curve inversions have historically been a consistent and widely used indicator of economic contraction, but they by no means *cause* recessions on their own. Each recession in U.S. history has been unique in its underlying causes,

length, and overall severity. The current inversion does, however, signal that markets are anticipating further economic weakness in the short term - a potential catalyst that may force the Fed to change its stance on monetary policy further down the road. Current yields are relatively attractive at the front end of the curve, with more compensation for less duration risk. **If the Fed does find it necessary to pivot and lower rates in the near future, we believe there may be more opportunities in longer-duration assets.**

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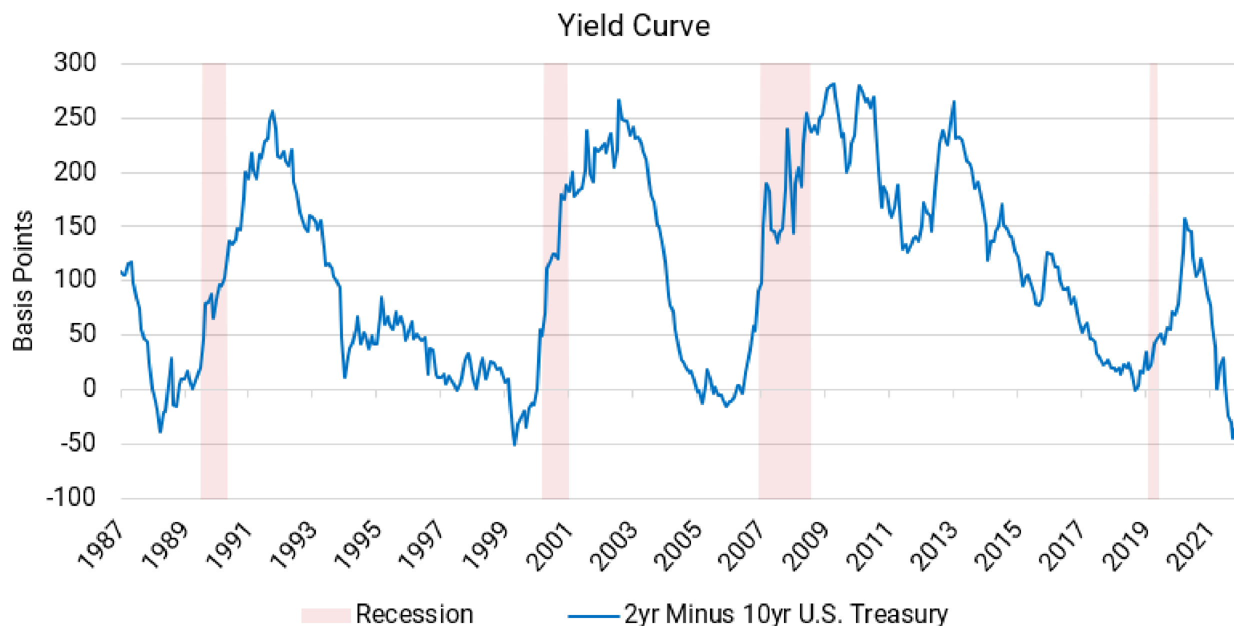

Source: Smith Capital Investors, Bloomberg, 10/11/2022

2. Return of the Greenback

Equity and fixed income volatility have garnered plenty of attention this year. FX volatility (JPM Global FX Volatility Index) has slowly inserted itself into the mix as we sit at levels not seen in over 10 years, excluding the brief spike at the onset of COVID in 2020. Many significant pivot points for markets start with FX volatility. **We believe the strength of the U.S. Dollar and its impact on developed and EM economies will be an important dynamic to monitor in the coming months.**

- **The greenback finds itself at levels not seen in over 20 years and is among the top-performing asset classes of 2022 with a year-to-date return of 18%** (10.12.2022). Dollar strength is a double-edged sword when it comes to inflation. Domestically, it insulates the United States from importing additional

inflation as foreign goods are cheaper to purchase. Abroad, it adds to global inflationary pressures as the cost of dollar-denominated goods increases.

- Recently, the United Kingdom has taken much of the focus as the GBP/USD cross rate currently sits at its lowest level since 1985 following announcements of fiscal stimulus measures from the United Kingdom. This comes at a time when the BOE is fighting inflation with higher rates. Across the pond, the Euro trades below parity with the Dollar. Weakness in European, UK, and EM currencies brings to light the increasing costs to service dollar-denominated debt. **This adds to the burden companies face operating in these environments (and, therefore, their countries face) when combined with already high inflationary pressures and tightening global financial conditions.**

- In China, we have seen the Yuan break the 'psychologically important' 7-handle with the USD/CNY cross rate at the highest level since the pre-GFC (Great Financial Crises) era. To get the Yuan back under the level noted above, the PBOC could sell dollar-denominated assets (U.S. Treasuries) to receive Dollars and buy back their currency, **adding to the potential of another negative technical to the U.S. rates market.**

- Currency signals out of Japan are also concerning as we have seen the USD/JPY cross rate jump from the 115 level in March to 146.87 today. The BOJ has been unrelenting in its easy monetary policy stance, even in the face of rising inflation. Governor Kuroda's term ends in April 2023, which may be the turning point in the BOJ's policy and will be worth monitoring. A lifting of the caps on long-term Japanese government bond yields, which would relieve pressure on their currency, could lead to sizable repatriation flows into Japan. In effect, **we could see a sizable reduction in Japan's holdings of U.S. Dollar fixed income assets.**

BOTTOM LINE

With the dollar sitting at levels not seen in over 20 years, sustained strength will continue to pressure foreign economies' ability to deal with inflation and service dollar-denominated debt. On the corporate side, companies reporting in U.S. Dollars with large exposure to foreign markets will continue seeing a negative hit to earnings. Rising volatility in the FX arena brings to light the interconnectedness of global financial markets. **Keeping an eye on FX volatility and USD cross rates should be high on investors' radars – in tandem with rate and equity volatility as cross-asset correlations push higher.**

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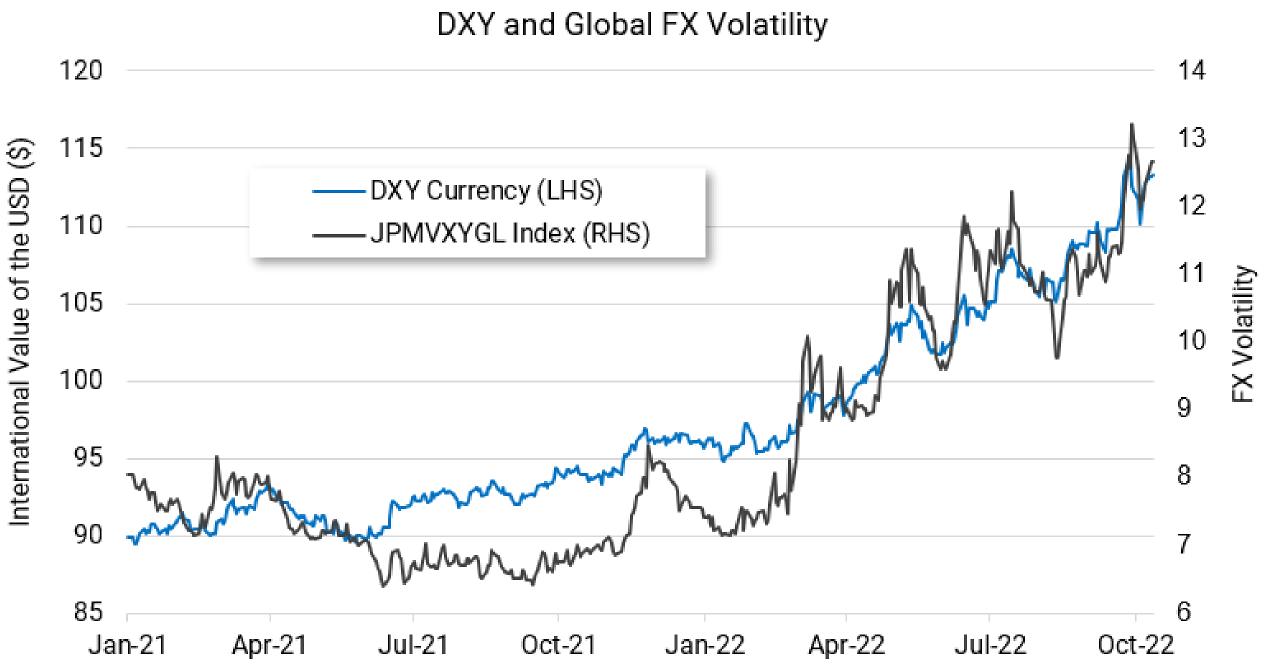

Source: Smith Capital Investors, Bloomberg, 10/12/2022

3. We All Move Together…. When the Biggest Mover Is the Fed

It's hard not to notice the converging of correlations, particularly between stocks and bonds. Reviewing the YTD statement of a 60/40 portfolio will tell you the same story. **The inverse relationship that much of the market has been conditioned to expect has not been as evident in 2022.**

- The Fed giveth and the Fed taketh. We believe the impact of the Fed, intended and unintended, as well as other central banks' actions around the world have had a great deal to do with this increasing correlation, as the biggest influencers of liquidity creation and cost of money.

- As students of risk, we take note of this dynamic and respect the current forces at play but also look to the future for any signs of change. On this front, we **wouldn't be surprised that when the biggest economic risk swings from inflation damage to growth damage, the flight-to-quality nature of Treasuries will again serve investors well.**

- Even if correlations stay high in the near term, the math behind the fixed income market will help cushion forward returns for bond investors and could serve to drive divergent outcomes over time. **In corporate credit, for instance, historically elevated yields and low dollar prices provide a tailwind for investors with which to absorb incremental downside as well as dampen volatility over the longer term.**

BOTTOM LINE

Pick your analogy, but right now the Fed is pulling liquidity out of the market. The liquidity that it had previously provided subsequently found its way into just about every aspect of the marketplace. These actions pushed the cost of capital down, spurred risk-taking (not always a bad thing), and caused capital to flood into bonds, stocks, private credit, housing, you name it, etc. The reverse is now in effect. While the old adage "don't fight the Fed" still applies, **we believe that recently observed high correlations between stocks and bonds will not remain in place forever.**

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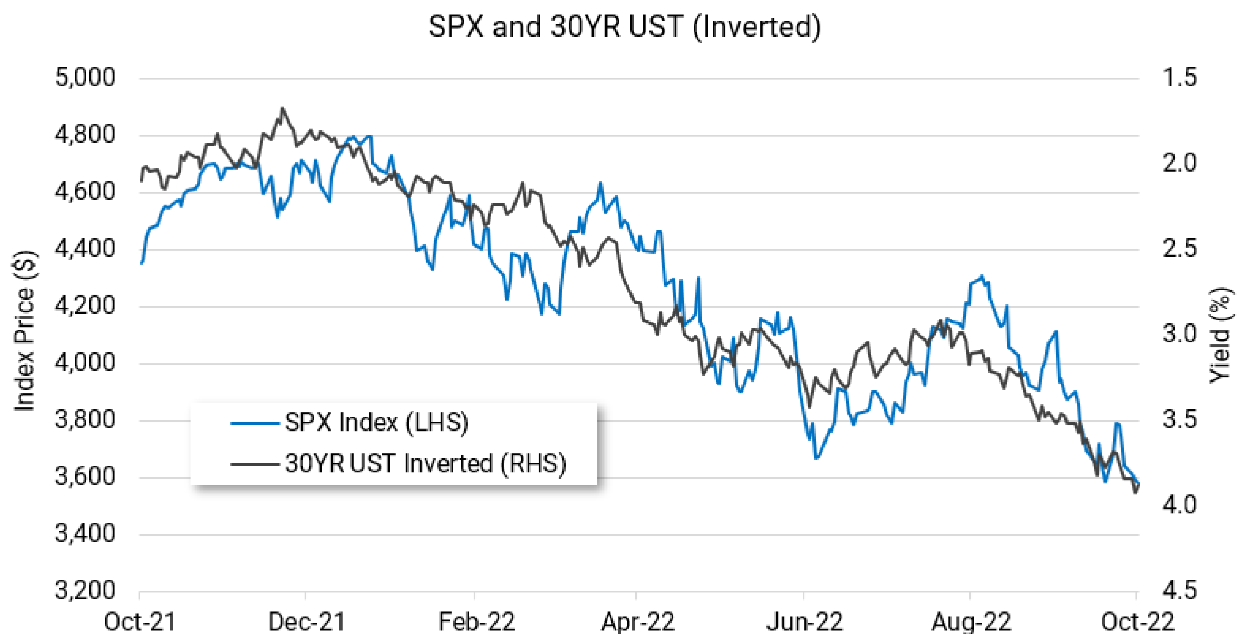

Source: Smith Capital Investors, Bloomberg, 10/12/2022

4. Accelerating Downward Earnings Revisions Has Us Leaning on the Fundamentals

Over the last several weeks, the occurrence of management teams cutting, lowering, or removing guidance has accelerated. We take note of this as both near- and medium-term outlooks widen on diverging macro, sector, and company-specific indicators. As we enter the 3Q22 earnings reporting season, revisions YTD have left many investors massaging their necks, as volatility remains high in this dynamic environment. **Through periods of high volatility, we have found returning to the**

basics of fundamental analysis through a sound process to be of utmost importance. Away from the widening array of near- to medium-term outlooks, there are many things that we take comfort in.

- While macroeconomic variables will likely pressure margin and FCF generation across high yield (HY) issuers, many credits are set up to remain resilient to stress. High yield leverage ended the 2nd quarter at the lowest levels since 2012-2013. High yield interest coverage ratios and LTM EBITDA margins recently set new all-time highs. **While directionally these metrics will deteriorate, broadly, HY companies are entering this period from a position of strength.**

- We are at the tail-end of a multi-year rating agency upgrade cycle. **While leveraged loans have seen more downgrades than upgrades year-to-date (YTD), high yield bonds continue to see net upgrades, with more issuers upgraded than downgraded in September rounding out a YTD upgrade/downgrade ratio of 1.9.** Again, this dynamic is likely to reverse, but following the upgrade cycle in 2021 and 2022 the quality of the high yield market from a rating perspective is near the highs.

- Defaults are likely to remain low in a historical context, mainly due to a lack of refinancing risk over the near-term. Away from running out of liquidity, a primary catalyst for default is an inability to repay or refinance an upcoming maturity**. After elevated refinancing volumes in 2020 and 2021 there is a dearth of near-term maturities outstanding, with only 6.2% of the leveraged credit base coming due in the next two years.**

BOTTOM LINE

While earnings and overall credit quality are expected to be pressured through the end of the year and into FY23, we find that corporates are well-equipped to handle near-term market volatility. **During times of uncertainty, we believe that focusing on credits with high balance sheet and fundamental resiliency and management teams that emphasize downside protection can help investors weather the storm.**

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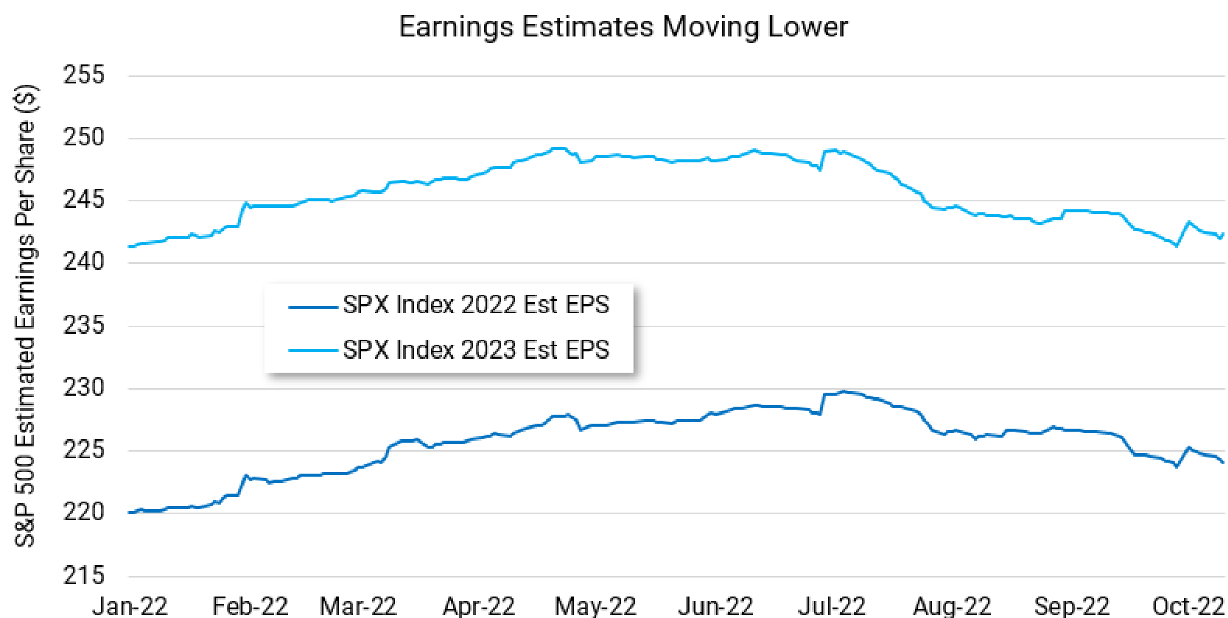

Source: Smith Capital Investors, Bloomberg, 10/11/2022

5. Financial Conditions – The New Leading Indicator

After the most recent monetary policy experiment resulted in inflation, the Fed clearly stated that they "are taking forceful and rapid steps to moderate demand." To moderate demand, the Fed is removing liquidity from the system, essentially repricing financial markets with the "hope" of slowing inflation. In this environment, **the Fed is laser-focused on tightening financial conditions, therefore we will also be laser-focused on financial conditions.**

- The Goldman Sachs Financial Conditions Index is a composition of the Fed Funds Rate, 10-yr U.S. Treasury yield, the USD exchange rate, equity valuations, and credit spreads, measuring how financial conditions impact the economy. The tightening or loosening of financial conditions has been a leading indicator of the impact that monetary policy *may* have on the broader economy.

- Pandemic-induced monetary policy actions created the most relaxed (looser) financial conditions going back to the 1980s and generated more liquidity in the system, which spurred increased risk-taking and inevitably inflation. **The Fed is now attempting to tame inflation via tightening financial conditions.** The more restrictive financial conditions become (tighter), the demand mechanism in theory should slow, and the Fed's hope is that less demand will bring inflation back to its mandate.

- The recent narrative from the market has been around the hawkish Fed tightening financial conditions too much and having to pause rate hiking and pivot (cut rates). The push/pull between the market's view and the Fed's

desires have been a consistent theme for many years. **It is important to remember that the market is traditionally early to a theme while the Fed is historically late to act.**

BOTTOM LINE

Digging into the components of the Financial Conditions Index tells the story of what the Fed is watching and desires. In a world where we want to get in front of the Fed and second guess their commentary and actions, the truth is we need to take them at their word. That being said, waiting on the Fed to give us the all-clear signal may result in regret and revisionist history. Thus, **incrementalism and great flexibility are needed here.**

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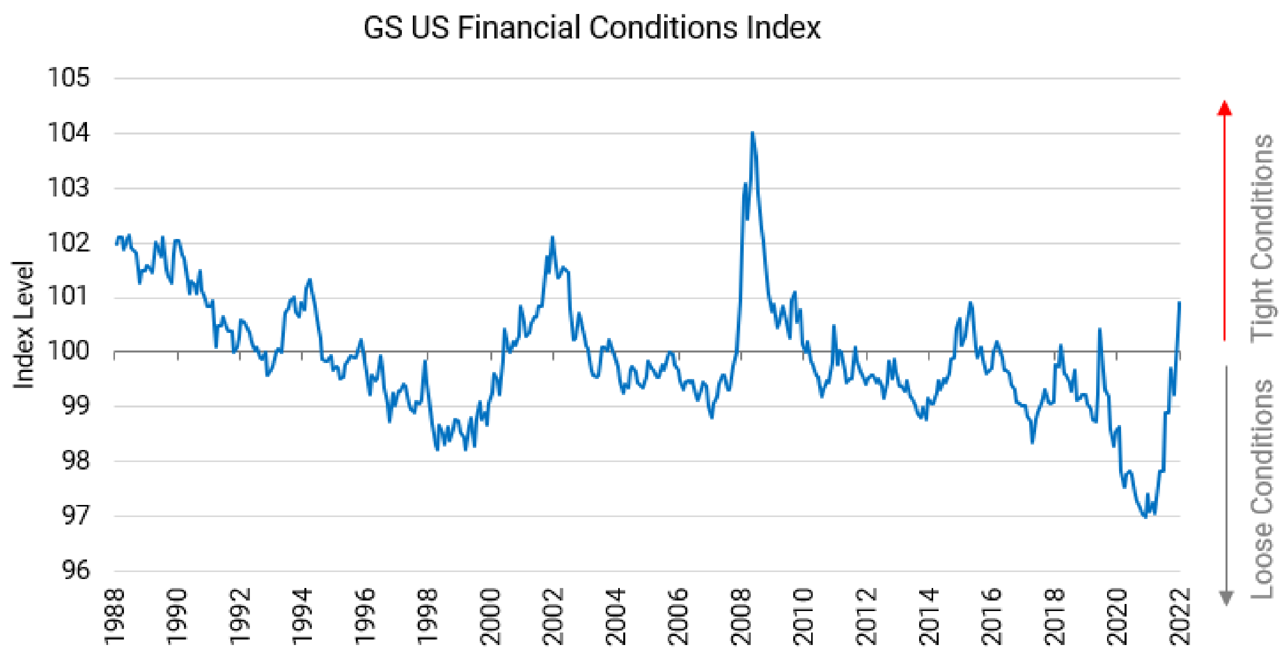

Source: Smith Capital Investors, Bloomberg, 10/11/2022

5 Potentially Market-Moving Events We Are Watching in 4Q 2022

1. The Repricing of Risk: Only When the Tide Goes Out….

One of the key themes we have been focused on at Smith Capital Investors has been the repricing of the cost of capital as risk-free rates move higher and risk premiums expand in the face of heightened uncertainty. **From a discounted cash flow perspective, this increase in the discount rate will impact valuations across all risk assets, but the mechanism and timing of repricing will vary.** Looking ahead we are particularly focused on the direct and indirect impacts of this repricing across different markets.

- One area where the repricing of the cost of capital may be most acutely felt is the leveraged loan market and by extension the CLO market. The leveraged loan market has been the primary financing avenue for private equity leveraged buyout activity and has expanded greatly in the years since the GFC. **Currently, the average loan issuer has higher leverage and in general lower credit quality than issuers in the high yield bond market.** On top of lower relative fundamental resiliency to credit stress, leveraged loans are primarily floating-rate in nature, meaning that a higher cost of capital will negatively impact fundamentals more directly than in markets where issuers have primarily fixed-rate liabilities. Downward pressure on loan issuer fundamentals could create a ratings downgrade cycle, which could be a problem for CLOs as both a ratings-sensitive strategy and as the primary buyer of leveraged loans. **The significant widening of the AAA segment of the CLO market may be telling us more than just highlighting the illiquidity of the market.**

- From a transmission perspective, it makes sense that the repricing of the cost of capital will be felt in the most liquid markets before working its way through more illiquid assets. One area where repricing may still be in the early innings is private credit. Using the CCC-rated portion of the high yield market as a proxy, the yield-to-worst (YTW) of the Bloomberg Caa U.S. High Yield Index has more than doubled on a year-to-date basis and currently sits at 15.02%, up 275bps over the past two months alone. In general, one would assume that investors would command a fundamental discount to lend to private credit issuers that tend to be smaller in size and less diversified than publicly traded peers as well as a liquidity discount given the lack of a secondary market in the asset class. **Recent performance in BDC debt and equity securities would seem to indicate that the market is expecting markdowns in private credit portfolios and maybe more difficult times ahead for the private markets.** Given the rapid expansion

of the private credit asset class, large markdowns could have far-reaching capital market implications.

- We have seen time and again that financial leverage amplifies outcomes and reduces resiliency. **The repricing of the cost of capital and the volatility associated with the repricing will have amplified outcomes for investors reliant on leverage.** One area where this dynamic has already played out is in the UK, where pension funds using derivatives were unable to face margin calls associated with the rapid spike in Gilt yields. We have no doubt that additional headlines associated with debt-driven blowups will surface during this cycle. Another area reliant on leverage is the private equity industry. **With bank capital markets groups facing big losses on committed LBO financing, we expect underwriting standards to tighten which could impact future LBO activity.** Furthermore, investors may demand more conservative capital structures on future LBO transactions, which could impact private equity IRRs.

BOTTOM LINE

The repricing of the cost of capital will have broad implications across risk assets, with the potential to shift relative valuations as some areas are more acutely impacted than others. **In this environment, we are reminded that, for both corporates and investors, prioritizing resiliency and optionality during the good times, while it may come at a cost, can prove invaluable during times of uncertainty and volatility.**

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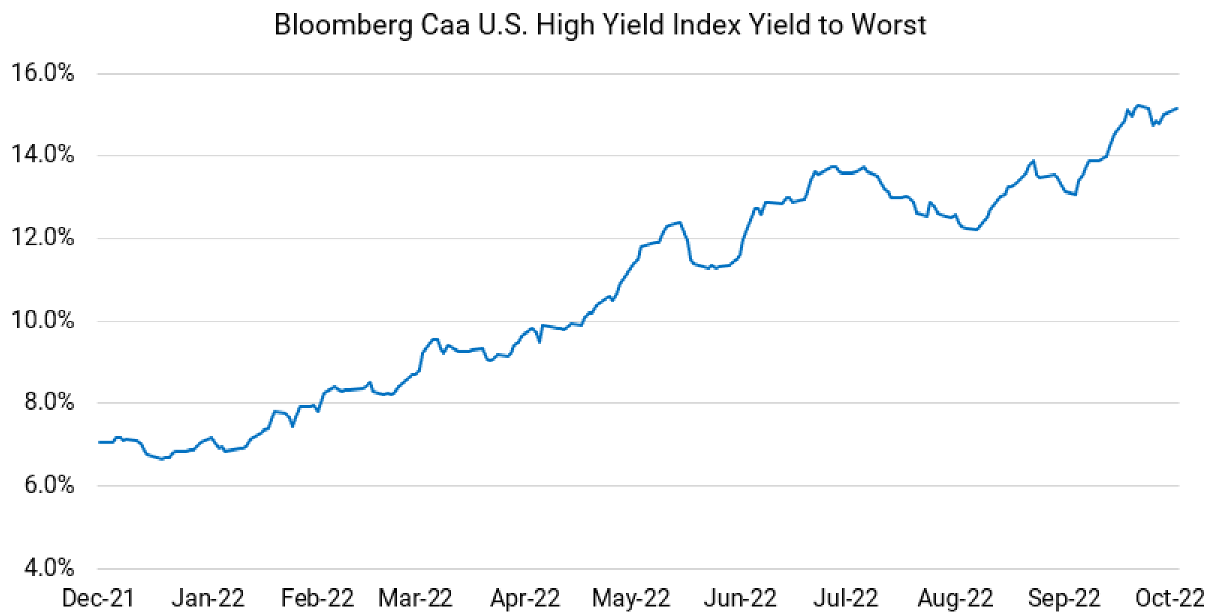

Source: Smith Capital Investors, Bloomberg, 10/11/2022

2. Negative Real Rates Show Restrictive Fed Policy is *Not* an Absolute Level

When thinking about financial conditions – the magnitude to which fiscal and monetary policy stimulate or stifle economic activity – it is important to consider real rates. These 'real' measures of yield adjust for inflation, for example, to calculate the 'real' 10yr U.S. Treasury yield…

$$Real\ 10Yr\ US\ Treasury = Nominal\ 10Yr\ US\ Treasury\ Yield - CPI\ \%\ chg\ y/y$$

… where CPI (Consumer Price Index) is used as a common measure of inflation.

- For most current market participants and their investing track records, real rates (let alone inflation) have not been top-of-mind – these investors have instead found it more natural to focus on nominal yields as discount rates, an approach that can be defended with inflation having averaged 2.8% from 1981 to 2021.

- Only when inflation prints begin to run high, as they have in 2022, does the broader investment community pay attention to real rates (and rightly so). The real 10yr and real 30yr U.S. Treasury yields are just off their most negative levels going back to 1962, while the Federal Funds rate is further in negative territory, **which points out a very important disconnect between the risk-free rate and the level of inflation.**

- **Another way to look at the current dilemma that the Federal Reserve sits in is to look at CPI vs. the Fed Funds Rate – by this measure, never has the Fed been so far behind in the hiking cycle.** The gap between CPI and the Fed Funds Rate highlights the recent time period when the "transitory inflation" narrative dominated the marketplace (and was perceived to be the most important factor in the Fed's decision-making). Clearly, the pandemic was an unprecedented and incomparable event in the way it shocked financial markets, but one must wonder if history will look back at this chart as a perfect painting of the Federal Reserve's true policy mistake.

BOTTOM LINE

Real rates – whether real Federal Funds Rate or real U.S. Treasury yields – are close to or at their most negative levels in history. Whether one believes the Federal Reserve has taken the appropriate steps to fight inflation thus far in a post-COVID world (all things considered), the data shown by real rates makes one thing clear: they are behind the ball. While we are encouraged by nominals minus inflation expectations metrics turning positive, we may be just beginning to feel the pain from the fallout of a zero-lower-bound Fed Policy gone wrong. **As we navigate the landing from inflation-fueled highs in valuations across financial assets in a QE (Quantitative Easing)-riddled economy, we acknowledge that a positive real Fed Funds Rate is truly a restrictive policy.**

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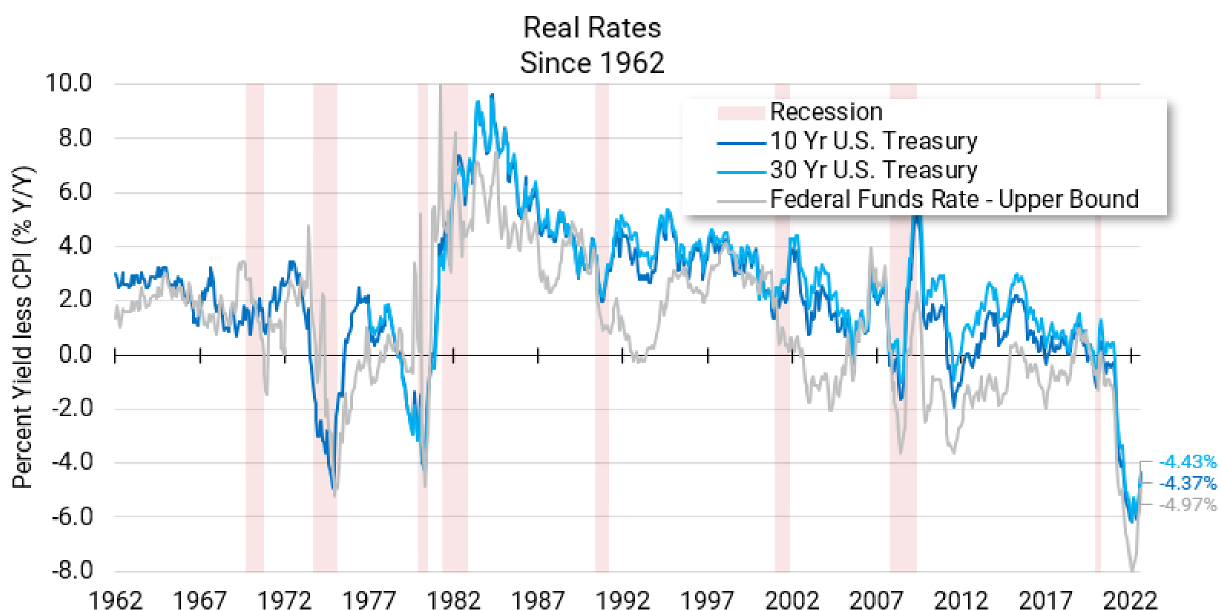

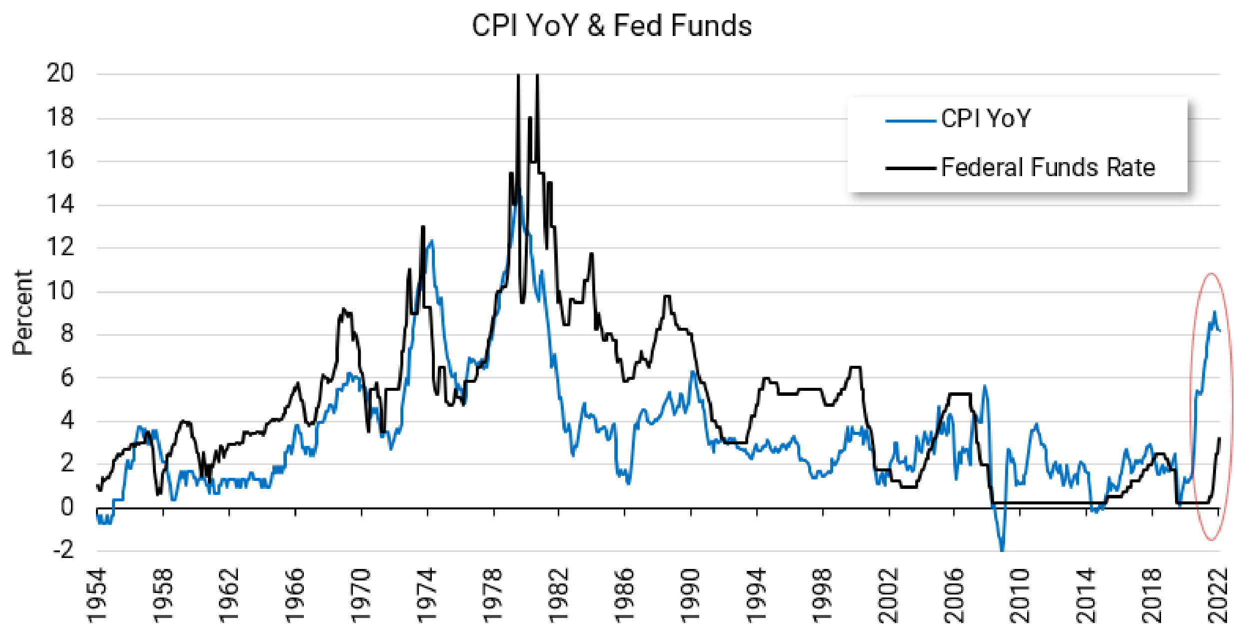

Source: Smith Capital Investors, Bloomberg 9/30/2022

3. High Inflation – Governments Fighting Fire with Gasoline

Despite central banks' efforts to fend off inflation globally via monetary policy, many federal and state governments are ramping up fiscal stimulus and perhaps exacerbating the rise and resiliency in prices.

- In response to a pandemic-induced shutting of the global economy, governments instituted the one-two punch of both monetary and fiscal stimulus. **Fast-forward to 2022, where YoY CPI has notched readings between 7.5% and 9.1% each month.** To combat this, the Fed is in the process of moving towards restrictive monetary policy. However, what about the fiscal side of the equation?

- **Amidst interest rate hikes by the Fed, President Biden announced an executive action to forgive $10,000-20,000 of student loans that the CBO estimates could cost $400 billion.**[1] This after the $1.9 trillion American Rescue Plan Act of 2021, sending $1,400 checks into the pockets of many Americans, and the $2.2 trillion CARES Act of 2020.

- Perhaps the starkest example of fiscal stimulus that is perhaps countering the Fed's objectives are at the state level. **California governor Gavin Newsom recently proposed a windfall tax on petroleum companies with collected revenues to be returned to consumers' pockets.**[2] **This is on top of 'inflation relief' checks of up to $1,050.** Maine residents could receive up to $850 in direct relief payments. The Virginia General Assembly passed a law sending

$250 checks. The list goes on and includes Pennsylvania, South Carolina, New York, New Jersey, and more.[3]

- The Fed is seeking to reduce aggregate demand through the transmission of higher interest rates. **Fiscal policy at both the state and federal levels, however, could be stimulating demand via transfer payments**. While a phenomenon globally, it is acute in the U.S., and studies by the Fed have noted the inflationary effect of fiscal stimulus is outsized compared to other economies.[4]

BOTTOM LINE

Stimulative fiscal policy may be aggravating the goals of monetary policy by juicing consumer demand. **Continued over time, this could lead to stickiness in inflation and force monetary policy into even more restrictive territory than if left alone to reduce demand on its own.**

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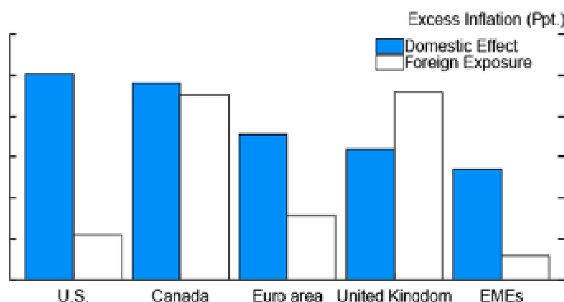
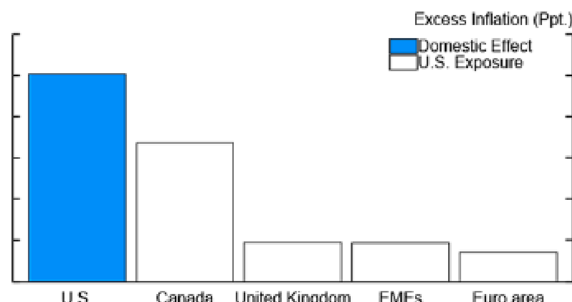
Figure 5. Fiscal Stimulus and Excess Inflation

5.1. Impact of Domestic and Foreign fiscal stimulus on inflation in selected countries



5.2. Impact of U.S. Fiscal stimulus on inflation in the U.S. and abroad



Aggregates are constructed using real GDP weights. The Euro area comprise of France, Germany, italy and Spain. EMEs comprise of 32 countries using Federal Reserve Board country classifications.

Source: Staff calculations.

Accessible version

Source: Federal Reserve, FEDS notes, July 15, 2022

[1] https://www.cbo.gov/publication/58494

[2] https://blinks.bloomberg.com/news/stories/RJ1JT4T1UM0W

[3] https://www.cnet.com/personal-finance/taxes/state-stimulus-checks-2022-states-mailing-payments-this-week/

[4] https://www.federalreserve.gov/econres/notes/feds-notes/fiscal-policy-and-excess-inflation-during-covid-19-a-cross-country-view-20220715.html

4. The Reversal of QE - Elevated Vol and the Hunt for Bad Risk Taking

Low-interest rates, a plethora of market liquidity, and the crowding out or TINA "There is no alternative (but to buy stocks)" effect were all results of the Federal Reserve's Quantitative Easing program. **As the Fed begins to unwind its accommodative monetary policy and QE turns into Quantitative Tightening, the market is faced with the combination of much lower market liquidity, higher volatility, and significant losses on positions where investors were forced to stretch for return potential.**

- As the Fed started draining liquidity from the system and tightening financial conditions, we have seen an exaggeration of valuation moves in the market highlighting the poor liquidity function through the end of Q3 2022. We have witnessed numerous large intraday moves in Treasury yields. Intraday volatility for major U.S. stock market indices is at levels not seen since 2008 amid the Great Financial Crises. **30yr U.S. Treasury TIPs have lost almost 50% despite continued high inflation reports.** The ICE BofA MOVE Index (measuring U.S. Treasury volatility) has almost doubled and is at levels not seen since 2008. **30yr U.K. Government bond yields have round-tripped over 350 bps between 9/22/22 and 10/12/22 on the back of the new government's budget and tax plan and the Bank of England bond market intervention announcements.**

  - Exaggerated volatility has only been one part of the impact of the Fed's shift from accommodative to restrictive monetary policy. There have also been major losses in asset classes where investors pushed to reach for returns. High-flying technology stocks have struggled in the face of increasing interest rates which dramatically impact valuations, especially on companies with negative earnings. The ARK Innovation ETF is down 75% from its peak in Feb 2021 and over 50% this year. **Some of the most hyped "new economy" IPOs from 2020/2021 are down substantially from their offering prices, including Rivian Motors, RobinHood, Coinbase, Poshmark, Bumble, Warby Parker, and SoFI.** Meanwhile, Bitcoin (and other crypto assets) have fallen over 50% YTD and almost 70% from its highs.

BOTTOM LINE

As we look forward, the Fed's shift from QE to QT will have dramatic impacts on valuations and market volatility. We are very interested to see some of the year-end valuations and returns on less transparent, "alternative", asset classes and investment vehicles like private credit, direct real estate, and private equity. Given the losses we have registered in public markets, we think there is a chance for these private investment categories to surprise on the downside. **Beyond that, while the change from the Fed and the associated readjustments in trading liquidity, asset valuations, and investor psychology are long-term positives; they underscore a necessity that money managers be committed and disciplined with their investment process and that an active management approach is extremely valuable in markets like these.**

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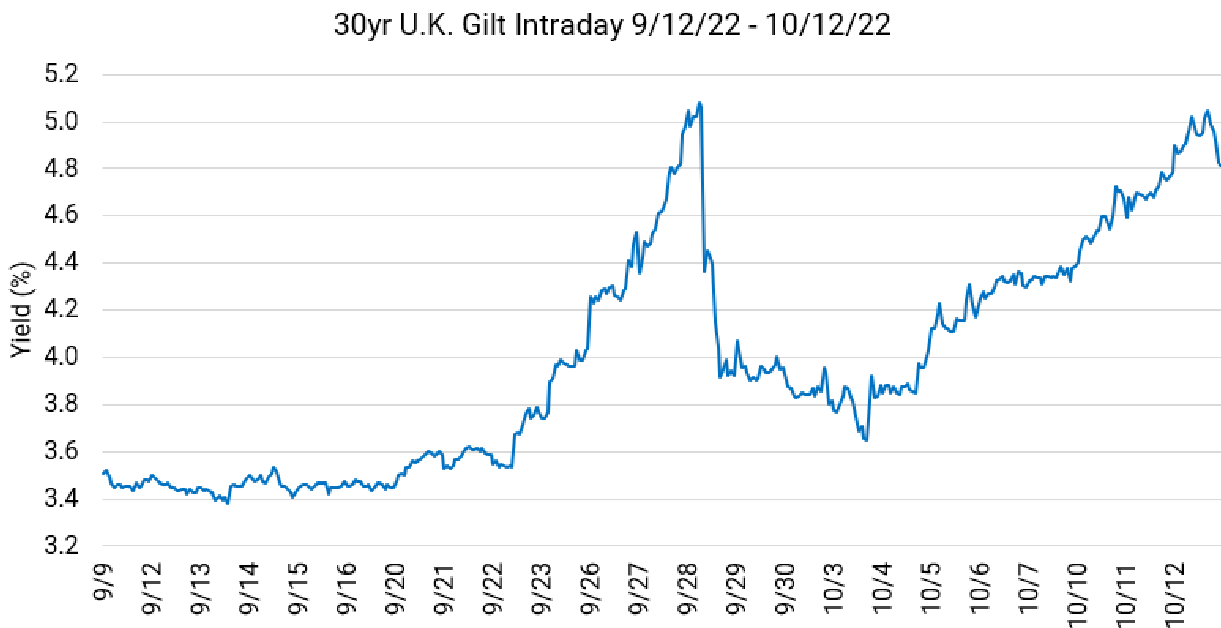

Source: Smith Capital Investors, Bloomberg, 10/12/2022

5. Increasing Cost of Capital and its Possible Impact on Investment

High inflation, higher interest rates, increased volatility, and increasing risk premia demanded by investors have increased the cost of capital in the system. **This can have ripple effects on companies, consumers, and the overall economic system around the globe.** We believe the increased cost of capital will have ongoing impacts. We highlight a few of the considerations that come to mind.

- **We find that short-term Capex cycles are closely tied to confidence, or lack thereof, along with adjustments in the cost of capital.** A higher cost of capital, by definition, raises the hurdle rate on projects. While at the same time it raises the cost of debt financing. Simply stated, we would suspect company and consumer behavior closely follows.

- When we think about the increased cost of capital and our investment process, companies that are resiliently positioned have a higher propensity to find confidence in uncertain times. They can put capital to work at advantageous returns, and over the long term, create/capture significantly more value than companies that are "optimized" for stasis. **A recent study, according to the consulting firm Gartner, found that the companies that invested during the Great Financial Crisis doubled their earnings. This compared favorably to companies that did not invest/were optimized for stasis.**

- The consumer "Capex" cycle is often overlooked in these periods of uncertainty. We also see the higher costs of capital impacting purchase behavior, particularly in areas that have been heavily influenced by interest rate-driven purchasing power coming to a head. We remind investors that homes are benchmarked off longer rates and consumer durables and autos tend to be much more front-rate sensitive. **It is hard to argue that a higher cost of capital is not going to have an impact on consumer demand.**

- We would be surprised if the current higher costs of capital permanently damage strategic plans to onshore or bring production closer to home as companies prioritize supply chain fidelity and continuity but must acknowledge that the higher cost of capital brings with it a higher hurdle rate. **We will see if companies have the fortitude to make the much-needed investments domestically to avoid future dependency on foreign producers.** This likely brings more focus back to the FX markets as well.

- We will hold the discussion around the Government incentivizing behaviors around greater domestic resiliency for a future 5x5, but it is hard not to criticize programs that focus on transfer payments and a misallocation of capital over skill training and job placement programs, along with longer-term production capabilities. We are constantly reminded that incentives drive behaviors and behaviors drive outcomes.

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BOTTOM LINE

Overall, we find that higher costs of money will work its way through the system and garner outcomes that have long-term implications. The repricing of risk assets highlights the jeopardizing nature of a higher cost of capital on the most infant of companies. **After a long period of very cheap and abundant capital, we find the process of an economy adjusting to higher costs of capital likely one fraught with volatility and uncertainty.** We also question the impacts of cheap capital on creative technology funding and implementation.

In the end, there will be great opportunities presented as we work through this change and a healthier long-term outlook, particularly for those companies and leadership teams that have resiliently positioned themselves to invest in these times. Finally, Reid Hoffman, one of the co-founders of LinkedIn was recently quoted saying, "One of the difficult things about making decisions is it reduces opportunity in the short-term, but that's the only thing that really creates *great* opportunity in the long-term." **We find this particularly pertinent to consider as we analyze not only the decisions and actions of companies in the current environment but also our own.**

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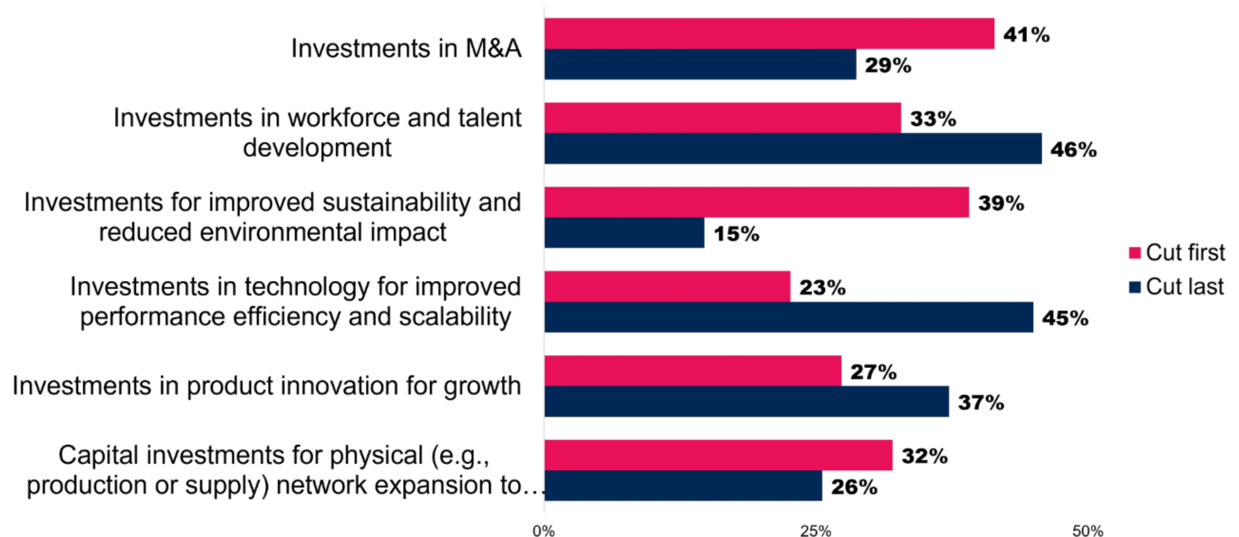

Source: CNBC The Bottom Line: Where Walmart, Amazon and Target are spending billions in a slowing economy 9/13/22

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