Q3 2022 Outlook

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05 Jul 2022

The Volcker Playbook

The second quarter provided clarifying insight into Federal Reserve Chairman Jerome Powell's mind-set for combating inflation. Federal Open Market Committee (FOMC) members had previously been vague in specifying whether they would accept a recession, if necessary, to reduce inflation. It is now clear to us that Powell has embraced the Paul Volcker playbook from 1979 to 1982. We believe the FOMC will remain hawkish, even in the face of a recession, until inflation is under control.

Recession, Repression, Resolution

Paul Volcker was the tough-talking 12th chair of the Federal Reserve between 1979 and 1987. He's widely credited with ending the inflation of the 1970s while creating the groundwork for the high-growth, low-inflation environment of the 1980s, 1990s, and 2000s. How did he do it?

The early and mid-1970s were characterized by the Fed's oscillating focus on inflation and unemployment. Inflation accelerated from less than 2% in 1965 to 10% in 1974. Efforts to reduce inflation started in 1973, but a recession and rising unemployment led the Fed to loosen monetary policy before inflation had been contained. These indecisive, confused policy decisions led to the worst outcome of all, stagflation (i.e., low economic growth and high inflation), which characterized the period between 1976 and 1979.

When Volcker took office on August 6, 1979, inflation ran above 7% and increased monthly (Fig. 1). Due to the Iranian Revolution, oil prices had jumped 80% since the beginning of the year. He decided drastic measures were necessary. On October 6, Volcker shocked markets by announcing a significant tightening of monetary policy during an unscheduled Saturday evening press conference. The press called it "Volcker's Saturday Night Special." The US economy almost immediately fell into recession and unemployment jumped, but the approach eventually worked. Inflation peaked in March 1980.

Repression followed the initial recession, as Volcker didn't adhere to his predecessors' playbooks by immediately loosening policy to help the economy out of the recession. Inflation remained stubbornly above 10% until early 1981. Despite widespread criticism from Republicans, Democrats, the Treasury Department, and many trade groups, the Fed maintained tight, repressive policy that led to another deep recession.

Finally, resolution. Inflation fell below 6% in early 1982 and Volcker announced that the Fed would be able to back off tight monetary policy. Economic activity accelerated during the second half of 1982 and Volcker had won — the inflation rate declined for the next 30 years.

Market Reaction: 1979–1982

The 1979–1982 period was volatile and challenging for markets (Fig. 2). Interest rates rose rapidly (the 10-year Treasury rose from 9% to over 13% in just six months) after the Saturday Night Special, leading to negative stock and bond returns. Commodities, bolstered by rapidly rising energy prices despite a recession, did well during this initial period.

Once it became clear that the Fed would accept a sustained recession to fight inflation, equities, bonds, and commodities all declined. The S&P 500 fell an inflation-adjusted 26% between December 1980 and July 1982. It was only after Volcker signaled the all-clear in July 1982 that a new bull market started in earnest. US and international equities rallied 30% and 13%, respectively, during the second half of 1982.

> A hawkish Fed will be challenging in the near term for stock and bond markets, but we're investors, not day traders, and we see plenty of emerging opportunities in the market right now.

History Rhymes

Mark Twain is credited with saying, "History doesn't repeat itself, but it often rhymes." Our current environment is not a repeat of 1979–1982, but some aspects rhyme quite well. Inflation is too high, oil prices have surged, interest rates have increased, the economy is slowing down, and a tough-talking Fed has said they will fight inflation.

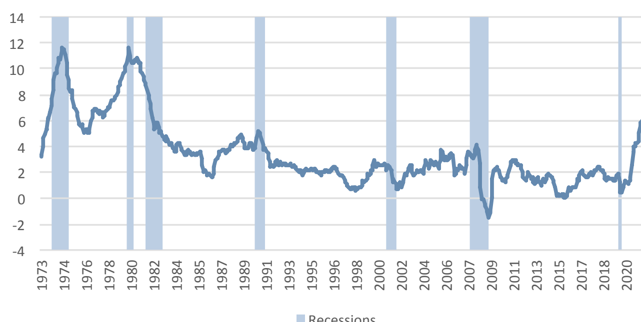
It's the rhetoric that we believe matters the most. Powell has frequently mentioned Volcker's legacy at the Fed in recent interviews and speeches, and, in our view, has studied that legacy quite closely. Powell has also adopted Volcker's language in explaining that lower inflation is necessary for long-term prosperity and that the process of reducing inflation could be painful.

For example, in July 1979, Volcker told the Senate Banking Committee that he believed the Fed should take "a tough stand" and "proceed as quickly and effectively as we can…" to rein in inflation. At the FOMC May press conference, Powell similarly said, "Inflation is much too high, and we understand the hardship it is causing, and we're moving expeditiously to bring it back down."

After the Saturday Night Special, Volcker said, "Some difficult adjustments may lie ahead." On May 12, as the Fed embarked on an aggressive hiking cycle, Powell said, "The process of getting inflation down to 2 percent will also include some pain."

Fig. 1: Inflation has jumped to its highest level since the early 1980s

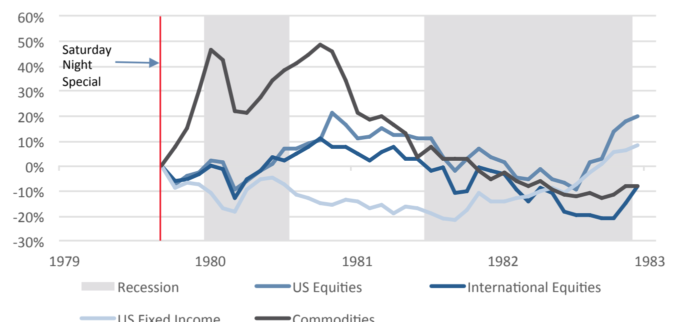
Personal Consumptions Expenditures Price Index (percent change)



Source: Bloomberg, Mill Creek.

Fig. 2: Markets sold off in 1981 once Volcker's playbook became clear

Inflation-adjusted market performance



Source: Bloomberg, Mill Creek.

Volcker's policy tool was different in 1981, but he continuously reiterated that the Fed's objective was to restrain money supply until inflation had sustainably declined. At the June 15 FOMC meeting, Powell said the committee wanted to see a "series of declining inflation readings" before signaling that monetary policy is sufficiently tight.

Finally, in 1982, Volcker announced that inflation had subsided to the point that the Fed could back off previously communicated policy actions. He jawboned hawkishly up until the point of the reversal. We expect the Fed to do the same this time around. Powell will need to maintain hawkish forward guidance until inflation is resolved to his satisfaction — anything less risks a replay of the 1970s.

To reuse an old refrain: Don't fight the Fed. Paul Volcker created the playbook in 1979. Powell is executing it again today.

Invest like it's 1981?

We should reiterate: History rhymes, but it doesn't repeat. The differences between today and 1980 are at least as important as the similarities. Inflation is lower today; Powell is starting this hiking cycle with better growth dynamics than Volcker (Fig. 3); and household balance sheets continue to hold $2.5 trillion in excess savings — money that can be used to mitigate the effects of a slowdown. Even so, it's more likely than not that the US economy will fall into recession. The Fed's own projections indicate that they cannot accomplish their objectives without resolving current labor market tightness and unemployment rising at least 0.5% — a shift historically commensurate with a recession.

A hawkish Fed will be challenging for stock and bond markets in the near term, but we're investors, not day traders, and we see plenty of emerging opportunities in the market right now.

For example, we expressed quite a bit of concern about bond markets in our 2022 Outlook, but the recent rise in interest rates has resolved some of those worries. We remain cautious but see 3.5–3.75% on the 10-year Treasury as a cap on longer-term rates through the end of the year. As we lay out in our Spotlight article, our current focus within fixed income is finding an attractive entry point for high yield corporate bonds.

Equity valuations have also declined to reasonable levels (Fig. 4). US large-cap value, small-cap equities, and emerging markets are trading below intrinsic value based on forward earnings. We remain overweight US equities versus international equities, US large-cap value versus US large-cap growth, and global small-cap equities. Despite attractive valuations, we are underweight emerging markets due to ongoing concerns about China's zero-COVID policy and US dollar strength.

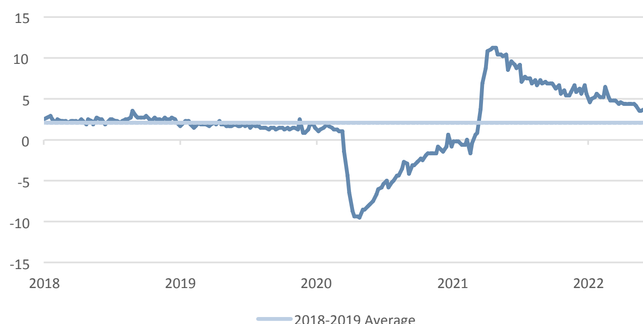
Our preferred areas of private debt have held up well this year and continue to offer value for investors willing to accept some illiquidity.

Well-established managers are enjoying enhanced deal flow as traditional lending markets become increasingly disjointed. The pickup in rates has also lowered competitive pressures and provides an edge to those with experience and the ability to execute quickly. Strategies with floating rate debt will see an immediate uptick in the gross yield of their portfolio, while those with a fixed structure will need more time for higher rates to flow through.

We're also starting to see more attractive valuations within private equity markets and a slowdown in fundraising, improving the likelihood that 2022 will be a better-than-average vintage year.

Fig. 3: Economic growth continues above trend

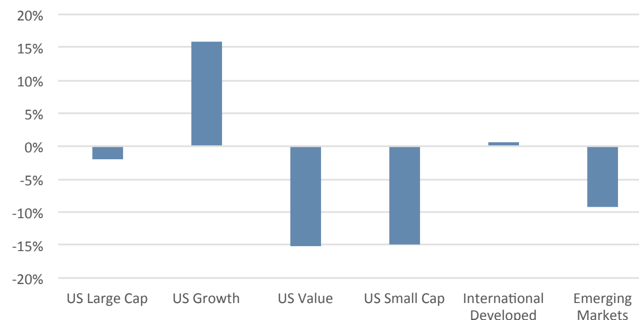
US Federal Reserve Bank of New York Weekly Economic Index



Source: Bloomberg, Mill Creek.

Fig. 4: Equity valuations have declined to reasonable levels

Percent over or under intrinsic value



Source: Bloomberg, Mill Creek.

House View Summary

Global economy

- Global real GDP growth peaked in 2021 at around 6% and we believe it will gradually decline to 3–5% for 2022–2024.
- Most major central banks have begun tightening cycles to combat inflation, but we expect inflation to remain elevated through at least 2023.
- US economic growth remains above trend but is slowing quickly. The Fed has communicated a policy path that will push growth below potential and raise unemployment. We expect the Fed to continue hiking aggressively, and an eventual recession, potentially shallow, is more probable than not.
- International developed markets face a range of challenges, including energy shortages due to the Russia-Ukraine war. Inflation and central banks will be forced to follow the Fed in tightening policy.

Market perspective

- We believe Powell is following the 1979–1982 Volcker playbook. The Fed won't ease, regardless of economic growth concerns, until inflation has suitably declined over a sustained period.
- Stocks and bonds face headwinds, but market repricing has begun to create some opportunities.
- Bond valuations are no longer as concerning as they were at the end of 2021, but despite higher yields, bonds are not yet cheap. We continue to see opportunities in certain private debt strategies as a bond complement.
- High yield corporate debt spreads are not yet wide enough for us to add a tactical position, but we anticipate finding an attractive entry point for high yield corporate debt as economic growth slows.
- US large-cap and international developed markets are fairly valued based on forward earnings expectations. US growth remains somewhat overvalued, whereas US value, small-cap, and emerging markets are undervalued.

Portfolio positioning

- We are neutral duration in our taxable and tax-exempt fixed income portfolios.
- We are overweight high yield municipal bonds in our tax-exempt FI portfolios.
- Within equities, we are overweight US versus international, large-cap value versus growth, and global small-cap equities.
- We are overweight private debt and absolute return hedge funds versus fixed income.
- We recommend allocating a portion of equity exposure to private equity.

Risks we're watching

- Sustained oil prices above $150 per barrel
- A sharp rise in inflation expectations that would force the Fed to hike into a deep, 1981-style recession
- Exacerbated geopolitical tensions spilling out of the Russia-Ukraine war or China

Please click any link to access additional information and insights.

Does an Allocation to High Yield Bonds Make Sense Today?

Our long-standing approach to managing fixed income portfolios reflects a defensive bias and emphasizes capital preservation to dampen overall investment volatility, while providing a steady stream of periodic income. High grade bonds are one of the few liquid asset classes that serve these objectives well and, as such, play a starring role in our model portfolios. However, we have executed tactical allocations to non-investment grade bonds in the past when markets dislocate and offer the potential for outsized returns. We only use high yield bonds episodically in portfolios because of the greater volatility, equity beta, and credit risk they exhibit versus higher-quality securities.

When considering an allocation to the space, three key factors play into our analysis:

- The absolute level of credit spreads;
- Expected default rate over the next 12–24 months; and,
- Stage of the economic cycle.

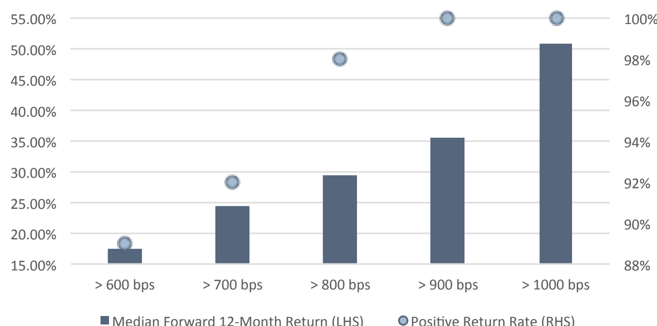
Credit Spreads

Our recent weekly commentary discussed credit spreads and their importance in signifying risk and value in the high yield market. Macro and micro factors shape the market's overall view of risk, pushing spreads wider during times of uncertainty and tighter when conditions are steady.

Over the past 20 years, high yield credit spreads have traded between 200–500 basis points 60% of the time.

Fig. 1: Higher starting credit spreads provide margin of safety for US high yield investors

Median forward 12-month US high yield bond total returns vs periods of positive returns across increasing credit spread levels



Source: Bloomberg, Mill Creek.

We consider this a normalized range that reflects a constructive view of fundamentals and economic conditions by the market. However, shock events such as the Great Financial Crisis and COVID spark a flight to quality, causing high yield bond prices to drop and spreads to widen as investors exit the space. While nerve-wracking, these events may also provide attractive investment opportunities as market prices dislocate from underlying fundamentals.

And like a stock's price-earnings (P/E) ratio, investors significantly improve their odds of achieving positive future returns when credit spreads climb to historically cheap levels. For instance, once spreads trade above 600 basis points, or the 75th percentile (i.e., spreads are higher just 25% of the time), forward 12-month returns average 17% and are in positive territory 89% of the time. This compares with the long-term average of 7.2% annualized returns and a positive rate of 84%. The statistical odds of achieving above-average returns continue to improve as spreads move to more extreme levels (Fig. 1). For this reason, we generally wait to initiate a high yield position until credit spreads exceed at least the 50th percentile (440 basis points) but preferably above the 75th percentile mark (> 600 basis points).

Default Rate

Non-investment grade bonds yield more than investment grade bonds because of the additional risk borne by investors. We layer our default rate expectations onto credit spreads to assess whether the market is providing adequate compensation for assuming high yield risk. To illustrate, assume the following:

High Yield Bond Yield: 7.7%

Credit Spread: 4.4%

Forecast Default Rate: 3.0%

Recovery Rate: 40%

Expected Return = 7.7% - 3.0% * (1–40%)

Expected Return = 5.9%

The inputs used in this calculation align with long-term historical averages and translate to high yield investors requiring roughly 2.6% (5.9% - 3.3%) of excess return above risk-free Treasuries through a cycle. Substituting today's data into the equation and sensitizing forward 12-month default and credit spreads, we arrive at the output illustrated in Fig 2. For example, if we allocate to high yield today and experience a default rate of 3%, we would expect a one year total return of 5.61%. If the default rate is 4% and credit spread increased by 200 basis points, we would expect a total return of -0.11%. If credit spreads narrow by -100 basis points over the next 12 months, then we would expect a one year total return of 7% to 10% assuming the default rate stays below 6%.

The sensitivity table provides a range of performance outcomes over the next 12 months which helps us evaluate risk-reward and the sizing of a potential allocation to the space.

Economic Cycle

The final piece of our analysis zooms out to consider the prevailing stage of the business cycle. High yield is generally more attractive from a risk-reward perspective in the early to mid-phase of a cycle as growing output, modest leverage, and improving lending conditions provide a favorable backdrop for issuers. We turn more cautious on the space as the cycle ages and heightened risks start to emerge. Timing each phase is inherently difficult, but having a general sense of economic conditions adds an important perspective to the equation.

Triangulating between credit spreads, default rates, and the economic cycle shapes our thesis and conviction behind a high yield allocation for MCCA portfolios. Today, with spreads hovering close to long-term averages and the increasing likelihood of a recession in 2023–24, we are not ready to initiate an allocation to high yield bonds because compensation for the assumed risk remains underwhelming. But we continue to monitor the space closely and have preapproved an experienced, highly skilled active high yield manager whom we are prepared to utilize should market conditions change.

Fig. 2: Default rates play a large role in forecast return assumptions

High yield credit spreads vs forecast default rates

		Credit Spread Delta				
		-200 bps	-100 bps	Current	+200 bps	+400 bps
Default Rate	1%	13.3%	9.97%	6.81%	1.09%	-3.93%
	2%	12.7%	9.37%	6.21%	0.49%	-4.53%
	3%	12.1%	8.77%	5.61%	-0.11%	-5.13%
	4%	11.5%	8.17%	5.01%	-0.71%	-5.73%
	5%	10.9%	7.57%	4.41%	-1.31%	-6.33%
	6%	10.3%	6.97%	3.81%	-1.91%	-6.93%

Source: Bloomberg, Mill Creek.

Around Mill Creek

Firm highlights, milestones, events, and resources

Chief Investment Officer Michael Crook Provides Outlook on Volatility in Equity Markets

On May 19, we published a market update view in which our CIO **Michael Crook** provided perspective on the current market correction, including historical context, a comparison to the 1979–1982 Volcker period, and insight on the path ahead for markets as the Fed attempts to bring inflation under control.

Watch the replay.

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Navigating Interest Rate Volatility in Bond Portfolios

On May 10, we were joined by panelists **Leah Traub**, Global Head of Rates at Lord Abbett, and **Nora Pickens**, Managing Director of Investments at Mill Creek Capital Advisors. We discussed the outlook for interest rates and the likely impact on bond portfolios.

Watch the replay.

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A Conversation on Inflation

Inflation has been top of mind. On March 1, we hosted a Livestream where we discussed the outlook on inflation and the likely impact on investment portfolios. We were joined by panelists **Elga Bartsch**, Head of Macro Research at the BlackRock Investment Institute, and **Michael Crook**, Chief Investment Officer at Mill Creek Capital Advisors.

Watch the replay.

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New Hires

We are excited to continue to grow our team. Please welcome our newest additions:

Meaghan Buly, Client Service Analyst

Colleen Glenn, Controller

Zachary Fisher, Client Service Analyst

AJ Misiti, Client Service Analyst

More on back page...

Volunteer Day with Philadelphia Orchard Project

We had the pleasure of volunteering with the Philadelphia Orchard Project (POP) at their Learning Orchard in the Woodlands this spring. We are so grateful for the opportunity to contribute to their mission and support our community. To learn more about Philadelphia Orchard Project, click here.

PUBLICATION DETAILS

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