Eagle Strategies LLC

The Eagle Edge

Quarterly

MARKET & ECONOMIC OUTLOOK

MARCH | 2022

On the Radar Screen

1. **Inflation remains the clearest threat at present to our economic vitality.** As the Q1 earnings season dawns, we will get some granularity on where inflation is biting vis-à-vis corporate input costs and consumer behavior. Readings on wages, rent and energy prices will also be of particular importance in the months ahead.
2. **The Fed's response to these unrelenting inflationary pressures is of profound importance to capital markets.** Anticipate a steeper rate hike trajectory and the beginning of quantitative tightening (aka balance sheet runoff) in the near future.
3. **While default rates remain exceptionally low, credit spreads have widened in recent months.** Further widening would likely signal some degree of trouble for the economy on the horizon.
4. **Likewise, the spread between 2-year and 10-year Treasury bonds has historically proven a useful,** if early and sometimes over-stated, indicator of a coming recession. It remains positive but has narrowed considerably this year.

Insights from Multi-Asset Solutions' Portfolio Managers

"Brains and substitutions have always beat major economic problems and shortages, and probably always will." *— Gary Shilling*

Human ingenuity will see us through. For much of the past two years, our inboxes have been inundated with stories of supply chain disruptions and shortages of materials and components. Blame has consistently been laid at the feet of the pandemic: lockdowns, worker absenteeism, and excess demand for physical goods that has led to clogged ports and transportation hubs. Climate change has played a part, too, both in the form of droughts, floods, and wildfires that have curtailed production of some goods as well as in the form of preventative measures that have had a similar effect (curbing extraction of fossil fuels and slowing deforestation comes at a cost). We can now add to that list the effects of geopolitical conflict. War in Ukraine and sanctions on Russia will significantly impair global stocks of everything from crude oil and wheat to neon gas (critical for semiconductor fabrication) and palladium.

At the same time, governments have been fueling voracious demand with massive fiscal stimulus in the form of COVID relief legislation and via extraordinary monetary policy that was considered unconventional not long ago but that today seems almost de rigueur (zero interest rate policy and quantitative easing). As taught in Econ 101, shifting supply and demand curves results in price change: a scarcity of goods desired and/or an increase in the willingness and ability to spend will result in higher prices. Sure enough, we're seeing higher prices. Much higher.

While supply/demand dynamics generally shift quite slowly, they do shift and do so in both directions. Many of the challenges that came with the pandemic have already abated to considerable degree, and some

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ESG-linked restrictions are being actively reconsidered in the context of a renewed East v West schism. Meanwhile, governments and private industry are working feverishly to reengineer energy, industrial, and agricultural policies to adapt to these new circumstances. An old adage holds true: the cure for high prices is high prices. Additional sources of supply or sources of alternative supply will soon be found and brought online.

Likewise, demand is being tempered. High prices discourage households from incremental purchases; the expiry of COVID relief programs and the failure of the administration's Build Back Better bill means there's less money to spend; and the Fed has embarked on a rate hike campaign that will lift the cost of debt capital to businesses and consumers alike. Inflation will come back down; it's just not going to happen overnight.

Until such time as we find evidence that inflation has been well and truly contained, we are inclined to favor short duration assets within our portfolios. Doing so is fairly straightforward for a fixed income investor: lean into instruments with shorter maturity and higher yields. The concept of duration works less well with equities, but we generally think of lower volatility, higher dividend yielding stocks as having a shorter duration, and so we tilt in that direction. That's been our posture for some time now, and it is likely to remain so until we find ourselves in a different environment (higher bond yields, lower equity valuations.

In terms of overall risk posture, we're less enthusiastic than was the case a month or two ago, yet we nevertheless tilt ever so slightly into equities. It's difficult to be risk averse when the labor market is so strong and consumers are sitting on bloated household savings. That said, the runup in inflation, rising mortgage rates, and a slump in consumer confidence give us pause. Our conviction is very low, particularly following the strong run observed during the back half of March, hence the modest degree to which we are overweight. We're a little more comfortable with our value bent and a moderate emphasis on smaller and mid cap stocks, which we see as attractively valued on a relative basis; somewhat shielded from overseas turmoil and the international sanctions regime; and a likely beneficiary of a growing re-shoring/deglobalization theme.

"There go my people. I must follow them, for I am their leader." - Alexandre Ledru-Rollin. The Fed has been woefully slow in adjusting policy in response to accumulating inflation pressures. Time and again, it has been rates traders and Wall Street strategists that seem to be dragging the Fed into a more appropriate policy stance. The harm in this dynamic is that inflation has been allowed to develop into a genuine threat to the economic expansion. The delayed response in policy is likely to require that it be more aggressive than would otherwise have been necessary and may tip the economy into recession within the next 24 months.

The less consequential implication of laggard Fed policy is that it diminishes the utility of forward guidance. The rapidity with which their economic projections as reflected in the much ballyhooed "dot plot" become obsolete render this exercise to be of little value, entertaining though it may be. Fed Funds futures contracts have proven to be both timelier and a better determinant of coming Fed policy than have been the forecasts of the Fed itself. The market always knows best!

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SMRU 1935644 (Exp. 10/31/2022)