Driving with the rearview mirror

- After a CPI (Consumer Price Index) surprise, central bankers want their inflation-fighting efforts to be taken seriously.
- The real interest rate has only recently turned positive, making policy its most restrictive since 2007.
- Wide-ranging opinions on the state of the economy and business cycle point to a possible market inflection.

There are periods of time in the investing world when contradictions and disagreement among “experts” run rampant. Often, those periods tend to coincide with inflection points in cycles, although you only really know that with the benefit of hindsight, in my opinion. My two decades of experience managing multi-asset portfolios reinforced the following first principles in times of stress.

- The way to compound wealth and give investors the best chance of success has remained unchanged:
  ▶ Be a little bit more right than wrong.
  ▶ Try and structure positions so the magnitude of wins is larger than the magnitude of losses.
  ▶ Ruthlessly exploit diversification wherever you can find it.
- And while we know that valuation is a poor timing tool, over a long enough horizon, it is undefeated.

We chafe when we hear pundits say things like “you can’t time the market.” Surely, if one is measuring success over days or weeks, that is probably true. But for those who are long-term investors, and not traders, valuation remains a compelling tool.
Valuations provide helpful signals of long-term stock returns

Average S&P 500 5-year forward total return, 1926–2017, in quintiles based on rankings by Shiller P/E at the start of the period

Sources: Ibbotson, Barclays, Bloomberg. Note that Shiller P/E is a cyclically adjusted P/E measure where earnings are smoothed over 10 years. Past performance is not a guarantee of future results.

Valuations provide helpful signals of long-term bond returns

U.S. long-term government bond 5-year forward total return versus long-term government bond yield at the start of the period

Sources: Ibbotson, Barclays, Bloomberg. Past performance is not a guarantee of future results.
Caution has been rewarded

In writing the Capital Markets Outlook over the past decade, I have primarily sought to be a pragmatic realist, as opposed to a perma-bull or perma-bear, neither of which is particularly helpful to anyone. It is true we have leaned toward recommending a relatively risk-averse posture over most of the previous couple of years. But, in fairness, the S&P 500 has provided a price return of pretty close to zero since the summer of 2021 with quite a bit of volatility (which makes for a pretty lousy Sharpe ratio. The Sharpe ratio is a measure of historical risk-adjusted performance calculated by dividing the index’s return by its standard deviation, a measure of risk). And when it comes to recession forecasting, it is certainly unhelpful to investors to be the boy who cried wolf. But if you care at all about capital preservation, then a healthy dose of skepticism and paranoia can be helpful.¹

Central banks seek inflation inflection

The Federal Reserve and the European Central Bank (ECB) certainly continue to have a healthy amount of paranoia about whether inflation will quickly return to target, and it was reinforced by the slight upside surprise in the month-on-month change in core CPI for August² released on September 13. In an interview on the sidelines of the Kansas City Fed’s annual Jackson Hole Symposium, Chicago Fed President Austan Goolsbee said, “All this discussion about, ‘Oh maybe we should change the (inflation) target and declare victory,’ … you can’t do that until you’ve hit the target.” And so it seems likely that predictions by economists like Olivier Blanchard and others that the Fed will, de facto, increase its target from (a mostly arbitrary) 2% to (an arbitrarily somewhat higher) 3%, have fallen on deaf ears. What’s more likely is that central bankers have actually heard these prognostications and are stubbornly pushing back against them.

Rates are tightening for real

Regardless of whether the Fed and the ECB choose to increase the policy rate again or are, in fact, finished with this tightening cycle, “it’s a real rate that will matter,” as Powell pointed out in his September press conference. Given that the real rate is a nominal rate less inflation, it can change as inflation moves, without any change in the nominal level. Therefore, if inflation continues to decline into 2024, monetary policy will continue passively tightening if central banks choose to do nothing.

We have written before about the so-called natural (or neutral) rate of interest — what policymakers sometimes refer to as “r*.” It is an unknowable, theoretical interest rate that is neither expansionary nor contractionary to economic growth. There is an entire body of academic literature dedicated to figuring out how to best measure r*. Perhaps one of the best-known estimates is produced by the New York Fed based on the research of Kathryn Holston, Thomas Laubach, and John Williams. Interestingly, the current real federal funds policy rate (the federal funds target less the core personal consumption expenditures [PCE]) has only just moved into “restrictive” territory over the past few months. This metric now reflects the most restrictive monetary policy setting the U.S. economy has had since mid–2007.³
The policy rate in real (inflation-adjusted) terms has only recently become restrictive

The real federal funds rate and the New York Fed estimate of the real interest rate ($r^*$), 1996–2023

![Graph showing the real federal funds rate and the New York Fed estimate of the real interest rate ($r^*$), 1996–2023.]


**Government bonds compete with stocks again**

And with central bankers coming out of the Jackson Hole Symposium seemingly optimistic about the prospects for an economic soft landing, 10-year Treasury yields are now back above levels not seen since the 2008 global financial crisis (GFC). Higher nominal government bond yields are a compelling investment alternative in rapidly aging developed market economies, providing safe income in a world that had been starved of it for so long. Also, for the first time in almost two decades, Treasury yields are actually higher than the combined dividend-plus-buyback yield available in the equity market. The Fed continues to have the luxury of behaving as though only one part of its mandate matters, but we may not be far from the first negative payroll print, which will again force the Fed to choose its priorities. In that environment, we believe that duration will once again act as a good hedge against economic slowdown, producing compelling yield and the possibility of price appreciation. We continue to advocate for lower exposure to risky assets in favor of the renewed diversification benefit of bonds.

1. After all, “Just because you’re paranoid doesn’t mean they aren’t after you.” Written by Joseph Heller in Catch-22, sung by Nirvana on “Nevermind.”

2. Of which Harvard economist Jason Furman (@jasonfurman) noted, “One month is noisy so would not read too much into it. BUT a lot of the previous reassurance was based on just two months of data. Which is also noisy.” Twitter, September 13, 2023.

3. And nobody reading this needs a reminder about what came afterward.

4. Core European bond yields are also now at the highest levels since the European sovereign credit crisis, culminating with Mario Draghi’s 2012 “whatever it takes” speech.