Key Points

- Financial markets have already priced in a lot of bad news, having registered declines of 18% to 29% for stocks – depending on the index used to measure them – and an astounding 10% drawdown for investment-grade bonds.[1]
- Since asset markets discount the future, there is a silver lining to these declines in that a lot of bad things can happen now without *necessarily* triggering substantial further downside in financial markets.
- We suspect this dynamic may be particularly supportive for the bond market, where current prices already discount an aggressive path for monetary policy toward a Fed Funds Rate over 3% by early 2023, up from zero at the start of this year.[2]
- The stock market is much more uncertain, of course, but declines in the 20% to 30% range have been sufficient in the past to reflect a "normal" recession, where normal is defined as a mild backslide in economic growth and corporate profits that is not overlaid with a concurrent trauma like a credit contraction (1929-39 and 2008-09), or the bursting of an asset bubble (2000-02 and 2008-09).
- Unfortunately, there are multiple risk factors today with the potential to serve as a "concurrent trauma" to an otherwise standard contraction, most notably inflation.
- Despite the very real possibility that stocks might have further to fall, we believe it is important to recognize the magnitude of disruption that has already occurred beneath the surface of the market averages.
- This disruption has created opportunities for active investment strategies: With that in mind, we offer the following observations:
    I. **On De-Risking:** Regardless of one's current level of anxiety, we caution against dramatic action like selling out of the stock market completely. While we appreciate that de-risking may be appropriate for some investors (and we welcome these conversations with anxious clients), we encourage only incremental change – perhaps a 10% reduction in the equity allocation – rather than a complete overhaul of a well-designed portfolio.
    II. **On Un-invested Cash:** For investors fortunate enough to have cash reserves available for investment into equities, we believe the process of putting this money to work into stocks should begin and/or continue. This view is informed by our belief that there are attractive opportunities today at the individual security level, rather than any expectation that the overall market has found its floor.
    III. **On Fixed Income:** We believe investors should not be alarmed by media headlines about the Fed raising interest rates. Fixed income markets have already priced in a 3%+ Fed Funds rate, so the Fed needs to hike interest rates aggressively just to catch up to where bonds are already trading.

[1] Source: Bloomberg; Data represents the peak-to-trough decline as of the low point in 2022 thus far for the S&P 500 Index, NASDAQ Composite Index, and Bloomberg U.S. Aggregate Bond Index
[2] Source: Bloomberg

Recent Conditions in the Financial Markets

In recent weeks, the consensus view seems to have converged around the idea that an economic recession may be unavoidable in the U.S. and elsewhere. The Bank of England was forthright on this topic last week, saying a recession may be inevitable for the British economy.[3] This cheery outlook comes on top of rampant inflation, a war in Europe, and self-imposed lockdowns throughout the world's second largest economy in China.

If there is a silver-lining for investors, it is that financial markets already incorporate a lot of bad news. This is reflected in steep declines for stocks *and* bonds this year, including a roughly 29% drawdown for the *NASDAQ* market index, 18% for the *S&P 500*, and 10% for the *Bloomberg U.S. Aggregate Bond Index*, the bellwether benchmark for the domestic bond market.[4]

With multiple risk factors in plain view capable of pressuring markets further, we believe investors should brace for the possibility that things might get worse before they get better, particularly for the equity markets. Even so, we believe it is important to recognize the magnitude of disruption that has already occurred beneath the surface of the market averages, creating opportunities at the individual security level, in our opinion.

We encourage clients to participate in these opportunities by remaining committed to their long-term objectives in the equity markets. For those fortunate enough to hold material cash reserves, we believe it is wise to begin the process of buying into the equity markets using incremental purchases in staggered stages over the next several months.

We plan to pursue a similar approach with the cash reserves we have accumulated in our *Managed Equity Growth* strategy, in addition to ongoing security selection and position sizing across both of our Managed Equity strategies.

Stealth Bear Market?
Individual Stock Prices Have Already Been Stirred Up a Lot
May 3, 2021 to May 3, 2022

% Change From 52-Week High	S&P 500	Nasdaq 100	Nasdaq Composite	Russell 2000	Russell 2000 Value	Russell 2000 Growth
% Of Members With At Least 50% Correction	3%	12%	45%	34%	28%	45%
% Of Members With At Least 25% Correction	35%	50%	68%	68%	61%	79%
% Of Members With At Least 20% Correction	49%	63%	74%	78%	73%	86%
Average % Price Decline	-22%	-29%	-45%	-42%	-38%	-49%
Overall Index % Change From 52-Week High To Current Price	**-14%**	**-22%**	**-23%**	**-23%**	**-16%**	**-31%**

Source: Alpine Macro; Bloomberg

[3] Source: Bank of England press release, May 10, 2022
[4] Source: Bloomberg; Measured as the percent decline from the 12-month high as of the close on May 11, 2022

The Future Path of Inflation is Important

We suspect financial markets may remain hostage to inflation until there are clearer signs of moderation in the national pricing data. Beyond monthly updates for indicators like the Consumer Price Index (CPI) and Producer Price Index (PPI), we are watching market-based signals for long-term inflation *expectations* derived from the yield differential between standard U.S. Treasury securities and inflation-protected bonds, or "TIPs."

As the chart below reflects, inflation expectations began to climb above their longer-term range in the spring of 2021, before spiking higher following Russia's invasion of Ukraine. This chart shows that the "market price" of the two-year average inflation expectation approached 5% in late April, before retreating more recently (note: 5-year inflation expectations show a similar pattern but with lower average inflation in the outer years).

Source: Bloomberg

We believe this data is important because it can help to frame the outlook for the asset markets. Regarding fixed income, the pain investors have already suffered in their bond portfolios was triggered by a rapid re-pricing of bonds to reflect surging inflation and an aggressive reversal of monetary policy. We believe these factors have now been largely incorporated into bond prices. Therefore, substantial further downside for high-quality bonds would likely require a renewed uptrend in longer-term inflation expectations. We are watching forward interest rate differentials like the index above to track this possibility.

Likewise for equities, the recent surge higher for interest rates has been putting downward pressure on the price-to-earnings multiple (P/E) investors are willing to pay for stocks. We believe it is important for longer-term inflation expectations to remain well-anchored to allow the recent contraction of P/E multiples in the stock market to run its course.

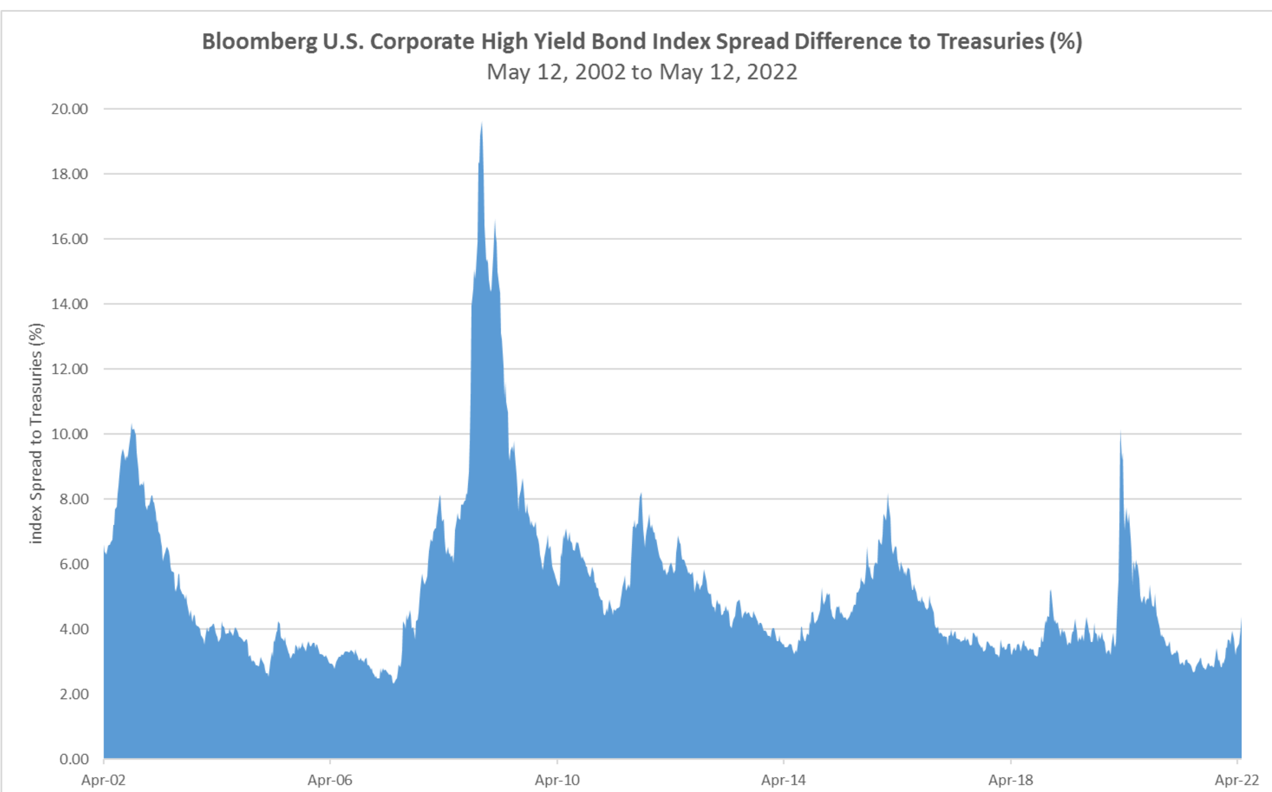
Measuring Systemic Risk

Another market signal we watch closely is the behavior of credit spreads in the fixed income markets. The "spread" refers to the interest rate differential between a given credit instrument, like a corporate bond or a bank loan, relative to a risk-free U.S. Treasury security of similar duration. When the incremental risk of a particular security is perceived to be low, the interest rate differential is narrow, and vice versa whenever credit risk is perceived to be higher.

We use credit spreads to measure the health of the financial system and the overall economy. The relevant signal comes from *changes* in the spread over time. One of the most economically sensitive indicators we track is the spread between sub-investment grade corporate bonds and U.S. Treasuries.

The universe of sub-investment grade bonds includes companies that operate in economically cyclical industries and/or maintain aggressive debt ratios in their capital structure. These securities, known as "high-yield" or "junk" bonds, are usually early to sniff out pending trouble in the economy, and/or frictions within the plumbing of the financial system.

The graph below shows the 20-year history of this indicator through May 12th of this year, the low point (so far?) for the major stock market averages. We take comfort in the fact that high-yield spreads remain well within the range of "normal" for this metric. However, the direction of change has turned decidedly higher, so this signal bears watching for potential further deterioration.



Source: Bloomberg

The War in Ukraine

We want to close this commentary with a brief comment about the investment implications of the war in Ukraine. It is an exercise in the obvious to suggest the range of potential outcomes is very wide, with regime change in Russia at the most favorable end of the spectrum (at least in the near-term), and deployment of a tactical nuclear weapon on the unspeakable end of the range.

It is impossible to design an investment portfolio for every scenario because the optimum design for each end of the spectrum is a near total opposite. Investors in any of our risk market strategies should know that we are concentrating our risk management around the visible ramifications of the conflict in areas like commodity prices, supply chain disruptions, inflationary pressures, and geopolitical risk premiums. These strategies are not optimized for either of the extremes.

Disclosures

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The **S&P 500 Index** seeks to track the performance of 500 large companies listed on stock exchanges in the United States. It is one of the most commonly followed equity indices.

The **Nasdaq-100 Index** is a stock market index made up of equity securities issued by 100 of the largest non-financial companies listed on the Nasdaq stock market. It is a modified capitalization-weighted index.

The **Russell 2000 Index** is a small-cap stock market index that makes up the smallest 2,000 stocks in the Russell 3000 Index.

The **Bloomberg US Corporate High Yield Bond Index** measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

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Items of Note Regarding ETFs — An ETF is an investment company that typically has an investment objective of striving to achieve a similar return as a particular market index. The ETF will invest in either all, or a representative sample of the securities included in the index it is seeking to imitate. Like closed-end funds, ETFs can be traded on a secondary market and thus have a market price that may be higher or lower that its net asset value (NAV). If these shares trade at a price above their NAV, they are said to be trading at a premium. Conversely, if they are trading at a price below their NAV, they are said to be trading at a discount.

Strategy Risks - The strategy invests in ETFs, which are subject to additional risks that do not apply to conventional securities, including the risks that the market price of an ETF's shares may trade at a discount to its net asset value ("NAV"), an active secondary trading market may not develop or be maintained, or trading may be halted by the exchange in which they trade, which may impact a strategy's ability to sell its shares. Sector-specific ETFs may entail greater volatility than ETFs diversified across sectors since sector-specific ETFs are more susceptible to economic, political, regulatory, and other occurrences influencing such sector. Investments in debt securities typically decrease in value when interest rates rise. The risk is usually greater for longer-term debt securities.

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