INVESTMENT STRATEGY INSIGHTS

What's in Store for May, Jay?

May 2nd, 2022

Volatile Markets

- The recent significant and synchronous decline in stocks and bonds mostly reflects a repricing of interest rate expectations

Investing in the Late Stage

- Investors should target a neutral risk position relative to a well-established goals-based wealth management plan

The Fed Unleashed

- Hikes in the first half of '22 shouldn't be disruptive, but the Fed needs to be careful not to overtighten later in the year

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Volatile Markets

- **Rebound Fades.** Equity markets experienced a particularly difficult April, with the S&P 500 down 9% for the month and 13% year-to-date. The decline reversed a rebound at the end of the first quarter from the market's prior correction. With markets back in correction, investors appear to be questioning if stocks are incapable of reestablishing the prior upward trajectory that had been in place since the lows of 2020..
- **A Synchronous Decline.** So far in 2022, various equity and fixed income markets have largely fell in tandem with returns ranging from high single-digit to low double-digit declines, leaving investors with few options for protection. Notable exceptions were cash and short-term bonds, value equities and most real assets and associated equities (e.g., commodities, resource equities and real estate) all of which have managed to outperform bonds. This market performance mostly reflects the significant rise in interest rate expectations and their impact on how various long-term assets are priced, as investors prepare for the Federal Reserve's coming rate-hike campaign.
- **Fairer Valuations.** Significant market declines can be painful and quite unsettling, but corrections serve a purpose in reducing excess valuations to more reasonable levels. Heading into 2022, Glenmede's Global Expected Returns model estimated that global equities sat at the 83rd percentile of longer-term valuations, but now sit closer to the 65th percentile. Likewise, U.S. large cap equities are down to the 80th percentile vs. 93rd to start the year. Further, market sentiment has weakened and has begun to provide a modest near-term oversold signal, the first such reading since the start of April.

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Investing in the Late Stage

- **Late Cycle Shift.** The U.S. economy appears to be transitioning to the late stage of the current cycle. As is typical of this late stage, the overall economy has grown enough to near its potential level, unemployment is near its lows, wages are rising and inflation is forcing the Fed to embark upon a tightening campaign.
- **Investing in the Late Stage.** Glenmede estimates that the U.S. economy has historically sat in late cycle for roughly a quarter of the time since the early 1960s, so it's important for investors to develop a late-cycle investing playbook. Importantly, entering the late stage of an expansion does not guarantee a near-term recession, but growth does typically slow and the odds of recession do rise to around 30-40%, higher than the below-10% likelihood of earlier in the cycle. As of now, Glenmede's Recession Model still projects a modest 6% probability of recession within the next twelve months, but this probability will likely rise as the economy transitions further toward late stage.
- **Tactical Changes.** In particular, the gap in realized returns between stocks and bonds, while still positive, typically shrinks during late cycle. Equities, at still above-average valuations, face lower growth and the risk of recession while fixed income has become incrementally more appealing given the move higher in yields year-to-date. As a result, investors should rebalance to a neutral risk allocation, paring back equity allocations, particularly international equities where economies are the weakest, in favor of short-duration, investment-grade bonds which capture the majority of the recent higher yields without the extra interest-rate risk inherent from longer-maturity fixed income.

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The Fed Unleashed

- **FOMC Meeting This Week.** The Federal Open Market Committee will likely take the next step in its policy shift this week with a half percentage point rate hike, the first such move since 2000. Investors in futures markets are already pricing in a near certainty that the FOMC delivers a 0.5% increase at each of the next three subsequent meetings in June, July and September. The FOMC is also expected to formally share its plans to begin shrinking its $9 trillion asset portfolio.
- **Full Year Rate Path.** While the Fed has historically undershot market tightening expectations, it is more likely this time around that they will exercise a heavier-than-normal hand. Looking at full year expectations, fed funds futures have priced in ten rate hikes for 2022. If the FOMC follows through on this path, they may find themselves bumping up against estimates of neutral fed funds in the back half of the year.
- **The Driving Force: Inflation.** Historically, markets for risk assets have performed relatively favorably during periods of easy-and-tightening monetary policy, an environment in which the Fed is operating today. However, returns typically become more challenging once policy turns outright tight relative to neutral. The Fed appears to have some room to maneuver rates before nearing neutral (and beyond). As a result, rate hikes in the first half of 2022 shouldn't be disruptive, but the Fed will need to be careful to avoid overtightening later in the year. Since inflation is the driving factor behind this tightening cycle, developments on that front will be key to gauging whether the Fed will need to take rates that far.

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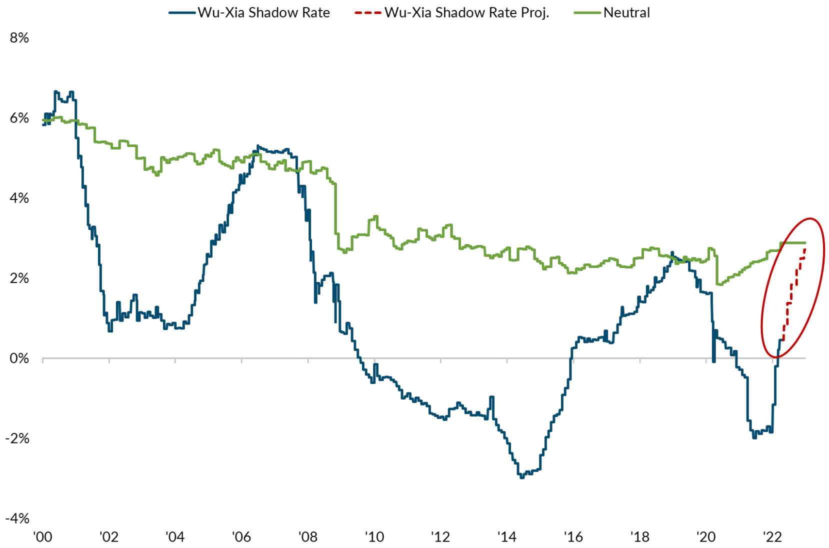
Chart of the Week:

The market is expecting markedly higher rates by year-end



Source: Glenmede, FactSet Data through 5/2/2022

Data shown in blue is the Wu-Xia Shadow Federal Funds Rate which is a measure of the stance of monetary policy that captures the impacts of the federal funds rate and other, unconventional monetary policy tools such as quantitative easing. Data in green is Glenmede's estimate of the neutral federal funds rate over time (i.e., the level of rates that is neither economically stimulative nor restrictive) based on expectations for real interest rates via the Holston-Laubach-Williams model and Glenmede's 10yr inflation expectations. Past performance may not be indicative of future results.

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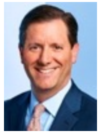

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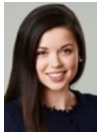

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GLENMEDE CORPORATE FACTS

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