INVESTMENT STRATEGY INSIGHTS

Sizing the De-Risk

September 19th, 2022

The Fed "Keeping At It"

- Rapidly rising interest rates are likely to surpass neutral soon, which should restrict the economy

The Economic Impact

- The odds of recession in the U.S. are pronounced, which may put corporate earnings at risk

Sizing the De-Risk

- Methodical tactical tilts can enhance returns and reduce risk, but should be sized appropriately to a goals-based plan

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Sizing the De-Risk

The Fed "Keeping At It"

- **FOMC Meeting.** Ending weeks of speculation, the FOMC followed through on its third straight .75% rate hike last week, consistent with recently realigned consensus expectations. Notably, with only two more meetings left this year, the median respondent in the Fed's Summary of Economic Projections is now calling for a cumulative 125 bps of tightening by year-end. Realizing it's still behind the curve, the Fed is likely to remain hyper-focused on its price stability mandate until they see clear and persistent signs that inflation is on a sustainable course to return to its 2% target.
- **Fed's New Projections.** The newly revised Summary of Economic Projections shows the median respondent now expecting slower economic growth and a larger increase in the unemployment rate. This is an admission that economic pain will likely be tolerated as an incidental effect from rising interest rates meant to combat inflation. The median respondent also expects cuts in 2024 and 2025, which highlight that the Fed expects its rate hike campaign to ultimately restrict the economy and reduce inflation by the end of 2023.
- **One Step Closer to Neutral.** Investors should not underestimate the Fed's resolve to keep rates in restrictive territory for some time, even if it raises the risk of recession. While estimates for the level of the "neutral" policy rate vary, Glenmede estimates that the fed funds rate now sits quite close to neutral and will eclipse neutral with any subsequent rate hikes. Given the stubborn inertia of inflation and the Fed's will to fight it, prevailing premium valuations on equities do not appear justified given the material risks facing the economy and corporate profits, which further warrant an underweight to equity/market risk.

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The Economic Impact

- **GDP Trouble Brewing.** As the Fed has become increasingly more aggressive in its fight against inflation, the path for an economic soft landing that avoids a recession has become increasingly narrow. For example, the Atlanta Fed's GDPNow model is forecasting 0.3% real GDP growth for Q3, driven by expected contractions in residential investment and inventories. This tepid growth projection comes after two straight quarters of negative GDP growth to begin the year, highlighting the pronounced stakes for recession in the near-term.
- **A Tale of Two Housing Markets.** The housing market continues to soften as single-family housing starts were down approximately 30% in August from late-2020 levels when prime 30yr fixed mortgage rates were below 3%. However, mortgage rates have since spiked to 6.3%, which has been a contributing factor to the 23% increase in listing times for homes on the market. In contrast, multifamily housing starts came in at the highest level since 1986 last month, jumping a total of 28% in August as they tend to be less sensitive to prevailing mortgage rates. Residential investment represents about 5% of U.S. GDP, so the health of the housing market may influence the likelihood of recession.
- **Earnings at Risk.** Despite the deteriorating economic fundamentals, earnings estimates have remained relatively resilient. Consensus earnings per share for the S&P 500 for 2023 have only declined a modest $10 from their late-April high of $252. However, Glenmede's Leading Economic Indicator, which intends to directionally inform on the path of corporate profits on a forward 6-month basis, currently sits in negative territory, suggesting there may be downside risk to earnings as the odds of recession rise.

The odds of recession in the U.S. are pronounced, which may put corporate earnings at risk

Sizing the De-Risk

How Large a De-Risk?

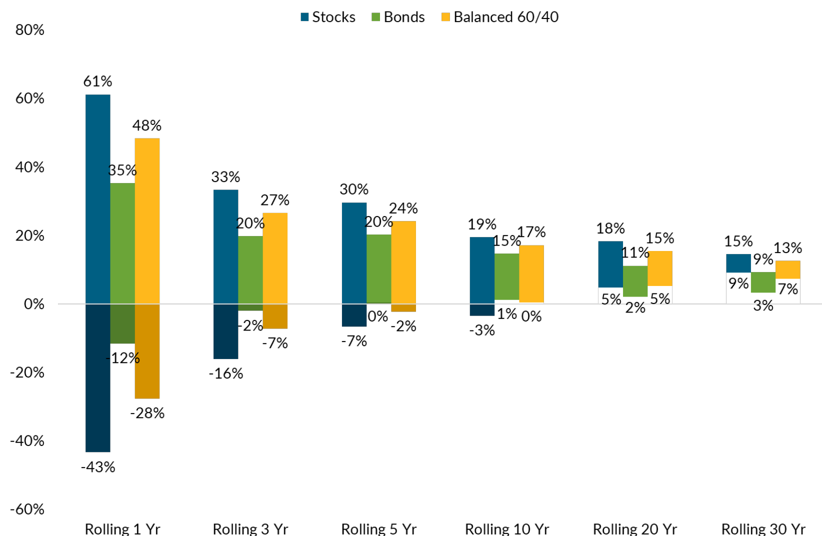
- **Lower Risk Needed.** The cumulative weight of the evidence favors a more difficult time ahead. Inflation remains quite high, the Federal Reserve is hiking quickly and about to take rates above neutral, recession risks continue to build and current market valuations do not seem to properly reflect the likelihood of a recession. Until markets properly reflect these circumstances and risks, investors should maintain a reduced risk position in their portfolios by holding less equity relative to their longer-term goals-based investment plans.
- **Less Risk Longer Term.** Investors need to take into account more than just near-term circumstances to properly make this decision regarding how much to reduce risk. The longer an investor can wait to use their investment dollars for spending, the less likely they are to be disappointed by their investments. The lowest historical one-year returns for stocks and bonds are quite large negatives, but the lowest experienced annualized returns are notably higher for longer time frames. Time allows markets to recover and gains to compound. For these reasons, investors should be wary and careful not to stray too far from their long-term goals-based investment plan.
- **Sizing Tactical Tilts.** Reduced risk is warranted given the weight of the information, but tactical tilts must be sized appropriately. A good investment process should center around a framework for making such decisions. This framework should place reasonable limits on the tilts so as not to deviate too far from the goals-based investment plan and not overwhelm the impact of other coincident investment theses. Additionally, tactical decisions should be sized relative to the confidence in a favorable outcome from such positioning.

> *Methodical tactical tilts can enhance returns and reduce risk, but should be sized appropriately to a goals-based plan*

Chart of the Week:

Long-term investors have time on their side in managing risk

Highest and Lowest Returns on Stock, Bonds and Balanced Portfolio Returns



Source: Glenmede, FactSet Data through 9/15/2022

Returns shown are based on historical monthly total returns from 1950 through the as of date and reflect the historical range of annualized returns from stocks, bonds and a balanced 60% equity/40% bonds portfolio for different length rolling periods: 1yr, 3yr, 5yr, 10yr, 20yr and 30yr. For example, the highest 5yr return for stocks was 30% and the lowest 5yr return for stocks was -7%. Stocks are represented by the S&P 500 Index. Bonds are represented by the Bloomberg Barclays U.S. Aggregate Bond Index. Past performance may not be indicative of future results. One cannot invest directly in an index.

Sizing the De-Risk

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