Portfolio Positioning as Credit Conditions Tighten

Summary

Central banks and governments around the world dramatically eased credit conditions during the Covid pandemic. Monetary policymakers slashed interest rates to near 0% and ramped up their monthly bond purchases, while fiscal authorities passed multiple rounds of fiscal stimulus that sent checks to individuals, paid payroll at businesses, and expanded unemployment benefits. Their combined quick actions kept credit flowing and prevented the global economy's collapse. Now that inflation pressures are building and Covid trends are improving, the tightening phase is on the horizon. Multiple central banks are preparing to taper their monthly bond purchases and raise interest rates, while some emerging market central banks have already raised rates.

Global tightening is one of our big 2022 investment themes. This *Strategy Snapshot* looks back at prior periods when the Federal Reserve and China both tightened credit conditions at the same time — 2013 and 2018. History shows risk-off equity and credit classes outperformed during the two tightening cycles. In our view, now is not the time to increase portfolio beta and layer on additional risk. The risk/reward setup is becoming less compelling, with strong 2021 returns pointing to single digit returns during 2022 (**9/10/21 Strategy Snapshot**). While we expect the market to trade higher over the next 12 months, we favor a more cautious and opportunistic approach. Our preferred positioning continues to be pockets of relative value and market segments with the potential to grow earnings in the current environment.

Main Points

- Multiple central banks and China are tightening at the same time (**Figure 1**).
- The current tightening cycle points to lower commodity prices and weaker global equity returns (**Figures 2-3**).
- Tighter credit conditions broadly favor U.S. equities, defensive and growth factors, and defensive sectors (**Figures 4-6**).
- Long duration and corp IG outperformed during the prior two tightening cycles, but we do not view either cycle as an appropriate comparison for today. We will be watching spreads and yields closely, but we remain OW short duration and HY (**Figure 7**).
- Can this time be different? We are monitoring two themes — bigger U.S. fiscal deficits and corporate operating leverage. Both suggest this tightening cycle's landing may be softer (**Figures 8-9**).

Report Summary

Listen to Audio ▶

Table of Contents

1 Summary & Main Points
2 Credit Impulse
3 Asset Allocation Positioning
4 Is This Time Different?
5 Disclosures

Research Portal →

The information herein was obtained from sources which MarketDesk Research LLC (MDR) believes to be reliable, but we do not guarantee its accuracy. Neither the information, nor any opinions expressed, constitute a solicitation of the purchase or sale of any securities or related instruments. MDR is not responsible for any losses incurred from any use of this information.

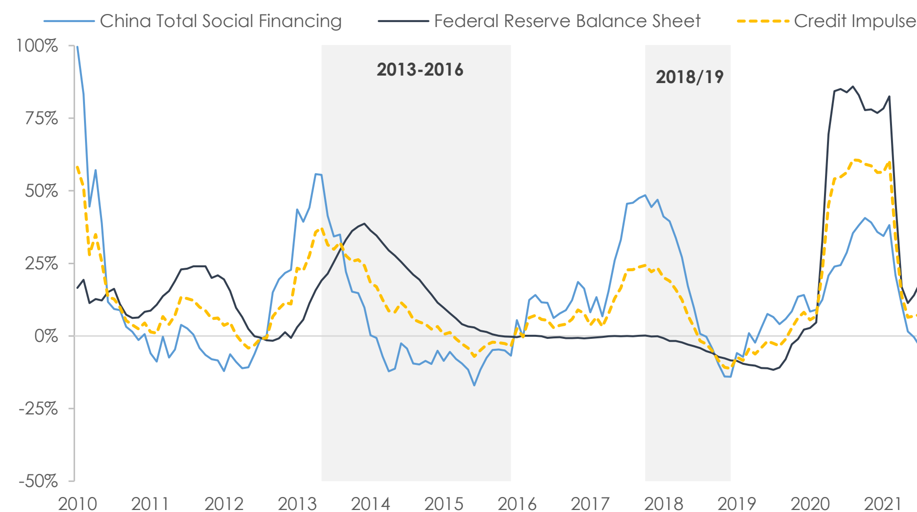
Key Takeaways

● Multiple central banks and the Chinese government are tightening at the same time. The Fed is preparing to taper later this year and raise interest rates in late 2022. Chinese officials started tightening credit conditions in late 2020. The ECB is "recalibrating" its monthly bond purchases at "a moderately lower pace". The Bank of England warned investors to expect "significantly earlier" interest rate hikes as inflation pressures build. Global tightening is one of our big 2022 investment themes.

● Figure 1 charts the y/y change in the Fed's balance sheet and China's total social financing (TSF). The dashed line averages the two y/y changes to produce a 'Credit Impulse', and the shaded areas highlight the two most recent tightening cycles — 2013 and 2018. While we view tighter credit conditions as a mean reversion trend after stimulus surged during the pandemic, the simultaneous global tightening removes liquidity and will significantly impact financial markets.

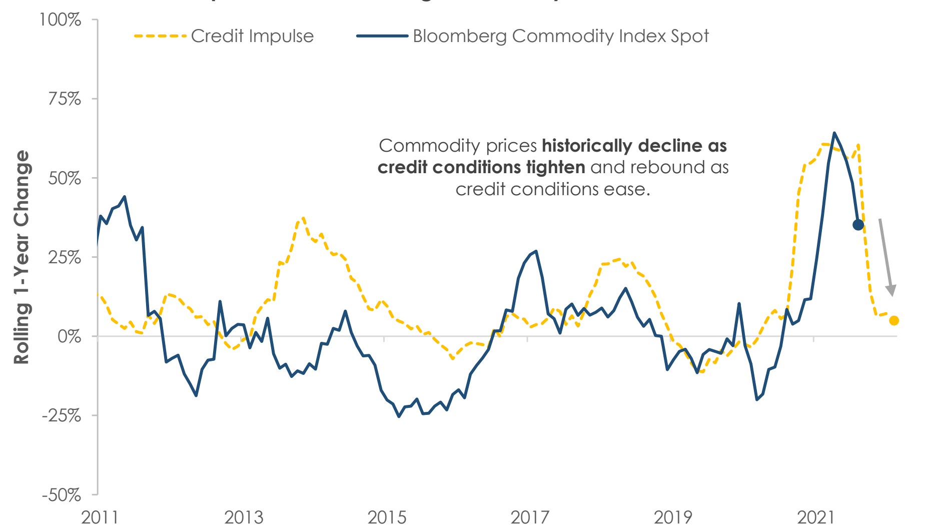
● Figures 2 and 3 chart the forward 12-month performance of the Bloomberg Commodity Index Spot and MSCI AC World equity index against the Figure 1 Credit Impulse (dashed line). The Credit Impulse is shifted forward 6 months to highlight its ~ 6-month lead time relative to the global cycle. The current tightening cycle points to lower commodity prices and weaker global equity returns.

FIGURE 1: Y/Y Change in China Social Financing and U.S. Federal Reserve Balance Sheet



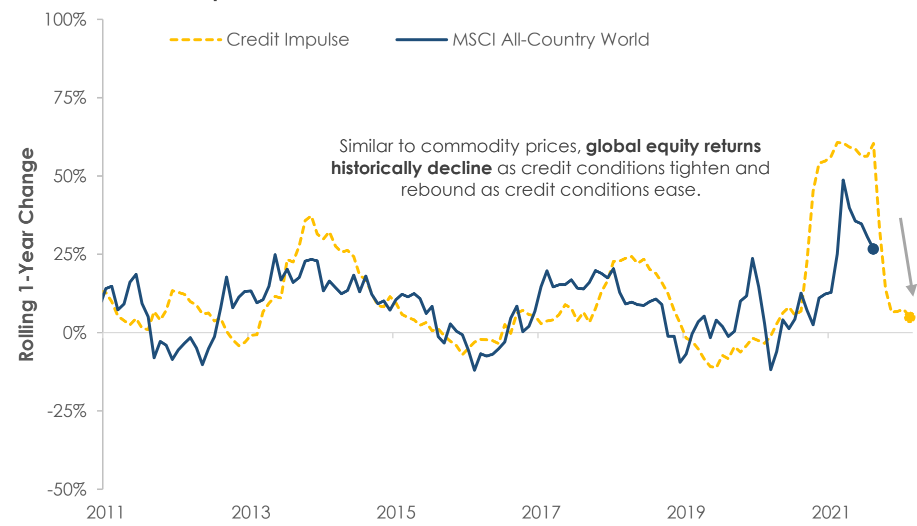
Source: MarketDesk, People's Bank of China, Federal Reserve. ***Note*** *: Tightening cycle dates: 11/30/2013-6/30/2016 (2013); 4/30/2018-6/30/2019 (2018).*

FIGURE 2: Credit Impulse Points to Falling Commodity Prices Over Next 12 Months



Source: MarketDesk, Bloomberg. ***Note*** *: Credit impulse shifted forward 6 months. Commodity returns represented by Bloomberg Commodity Spot Index.*

FIGURE 3: Credit Impulse Points to Weaker Global Returns Over Next 12 Months



Source: MarketDesk. ***Note*** *: Credit impulse shifted forward 6 months.*

Risk-Off Assets Historically Outperform as Credit Conditions Tighten

Strategy Snapshot

Key Takeaways

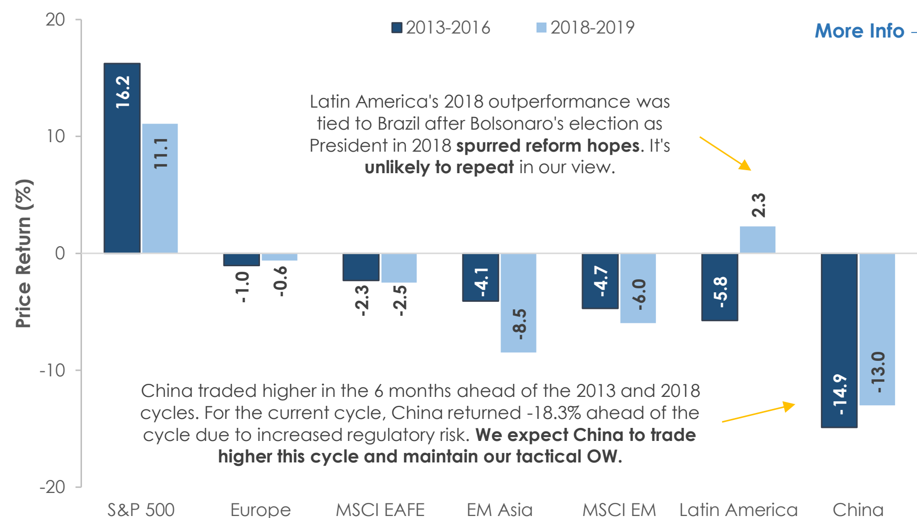
• The figures on this page graph global equity and U.S. sector and factor price returns during Figure 1's shaded tightening cycles. Tighter credit conditions broadly favor U.S. equities (**Fig 4**), defensive and growth factors (**Fig 5**), and defensive sectors (**Fig 6**). (Note: Click 'More Info' in Figures 4-5 to see return paths during the prior two cycles.)

• The S&P 500 significantly outperformed during both tightening cycles, while Europe and MSCI EAFE both traded down slightly. MSCI EM underperformed, with China accounting for most of the losses. Due to prior MSCI EM and Latin America losses, we remain UW rated EM. Within DM, we view Europe as overbought after its relative outperformance during 2Q21. We maintain our tactical DM Asia and China positions.

• Low Volatility was the top performing factor during the 2013 and 2018 cycles. Growth outperformed Value by ~10% during both cycles, while Large outperformed Small by +10%. Momentum was the third-best performing factor, although we caution it is tied to Value today and could underperform (***4Q21 AA Guide Figure 17***).

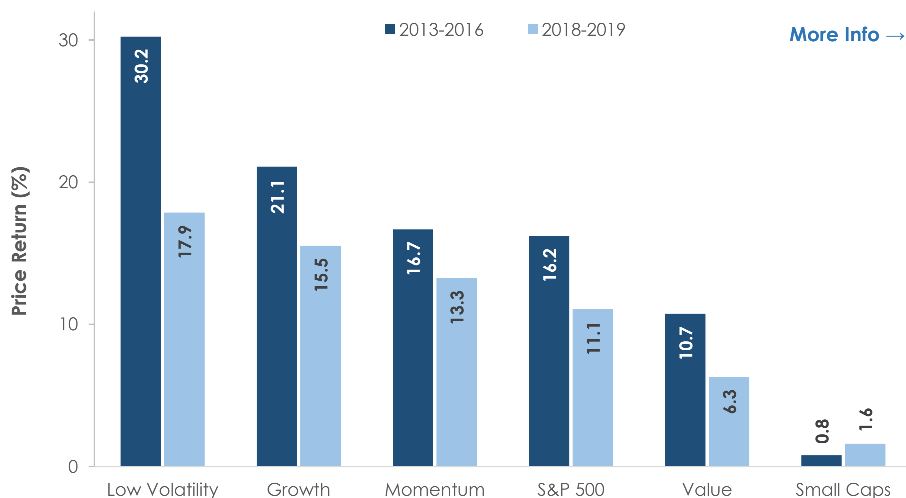
• Defensive and 'Growth'-sectors outperformed during the 2013 and 2018 tightening cycles. Tighter credit conditions historically lead to slower economic growth and increased market volatility, which sends investors to less economically sensitive sectors.

FIGURE 4: Tighter Credit Impulse Favors S&P 500 Over International Equities



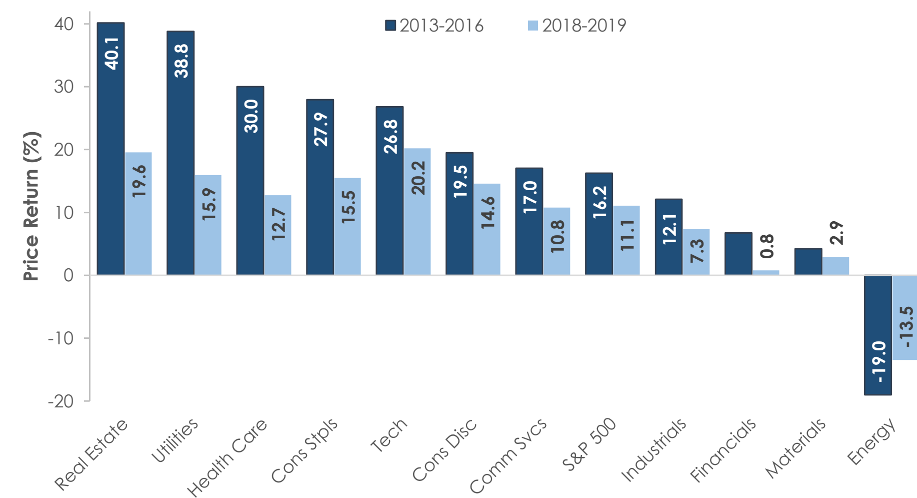
Source: MarketDesk. ***Note*** *: Performance represents price returns.*

FIGURE 5: S&P 500 Factor Performance During 2013 & 2018 Tightening Cycles



Source: MarketDesk. ***Note*** *: Price returns based on S&P 500 factors.*

FIGURE 6: S&P 500 Sector Performance During 2013 & 2018 Tightening Cycles



Source: MarketDesk. ***Note*** *: Price returns based on S&P 500 sectors.*

Why We Expect The Landing to Be Softer This Time

Strategy Snapshot

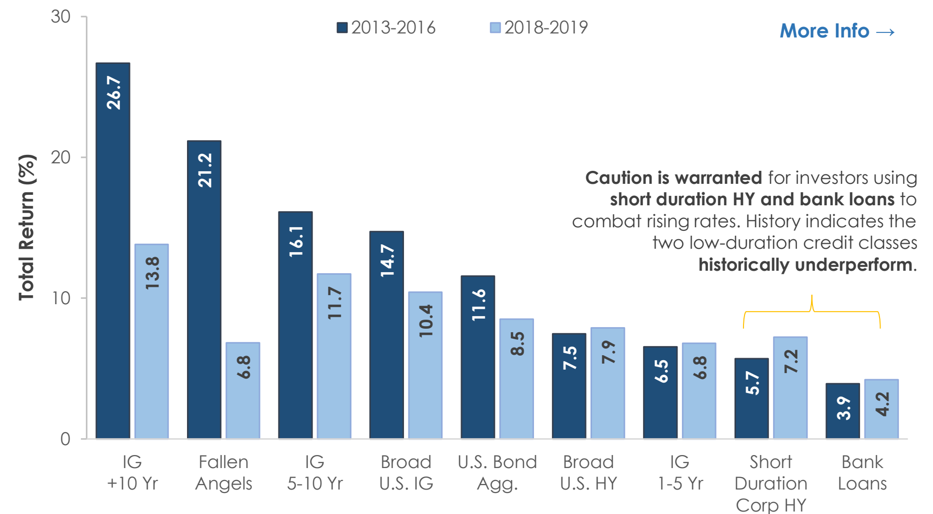
Key Takeaways

- Long duration bonds and corp IG outperformed during the 2013 and 2018 cycles. We attribute long duration and corp IG outperformance to a falling 10Y Treasury yield, which offset credit spread widening. Corp IG also benefitted as corp HY spreads widened during the two cycles. Click 'More Info' in Figure 7 to see credit return paths, as well as spread and rate movements, during the two cycles.

- In our view, neither 2013 nor 2018 are perfect comparisons for today. The 2013 cycle started immediately after the 2013 taper tantrum and included the 2015-2016 industrial recession, while the 2018 cycle started near the end of the 2016 rate hike cycle and included the U.S.-China trade war. In contrast, the Fed is widely expected to raise rates in late 2022 and economic growth is robust today. We will be watching spreads and yields closely, but we remain OW short duration and corp HY for now.

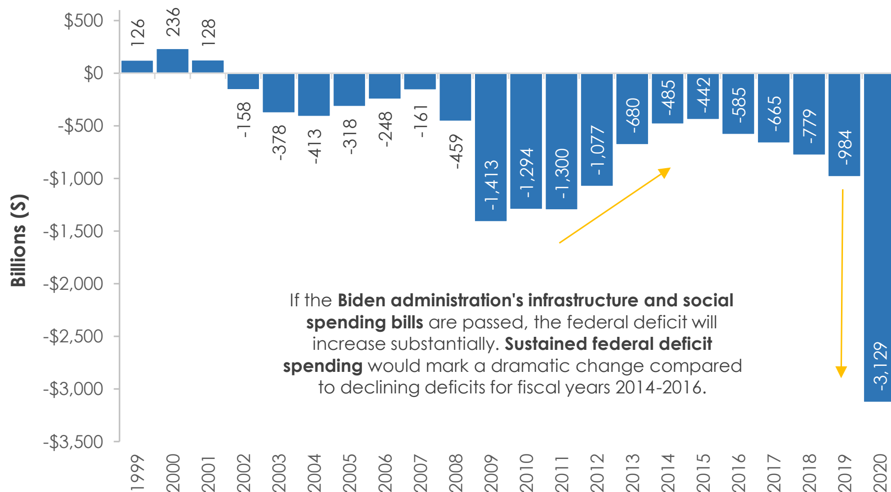
- Can this time be different? We are monitoring two themes — bigger U.S. fiscal deficits and corporate operating leverage. Sustained federal deficit spending over the coming years (i.e., Biden stimulus) could partially offset tighter credit conditions (**Fig 8**). In addition, corporate margins sit at a two-decade high due to pandemic cost cuts and increased operating leverage (**Fig 9**). The two themes suggest this tightening cycle's landing may be softer, which could lead to tighter performance trends.

FIGURE 7: Yields Fell & Credit Spreads Tightened During 2013 & 2018 Tightening Cycles



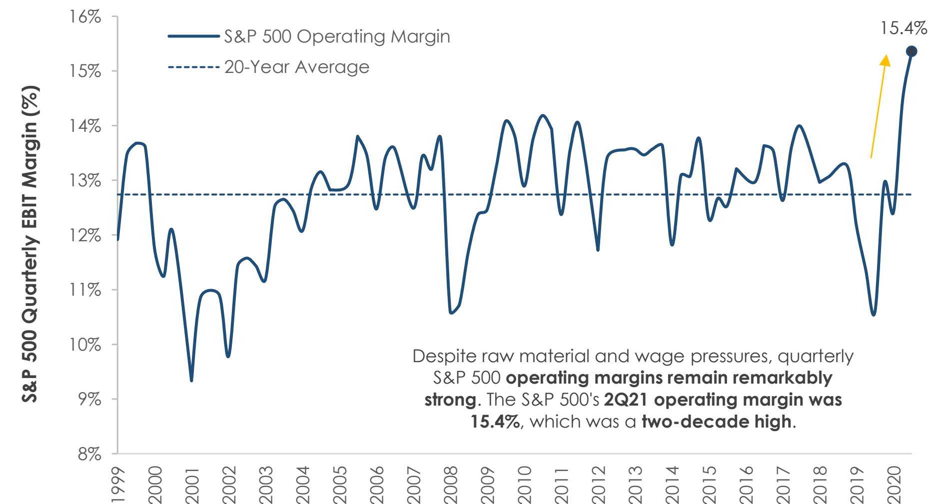
Source: MarketDesk, U.S. Treasury, Bloomberg. ***Note*** *: Performance represents total returns.*

FIGURE 8: U.S. Federal Budget Deficit — Biden's Fiscal Spending Splurge



Source: MarketDesk, U.S. Treasury

FIGURE 9: S&P 500 Quarterly Operating Margins Sit at a Two Decade High



Source: MarketDesk, FactSet

MarketDesk

Website

www.MarketDeskResearch.com

Sales Team

+1 (646) 787-0394

Sales@MarketDeskResearch.com

Client Support

+1 (646) 787-0394

Support@MarketDeskResearch.com

Important Notices & Disclaimer

MarketDesk is wholly-owned by MarketDesk Research, LLC ("MarketDesk Research" or "MDR"). The information and opinions expressed herein are solely those of MDR, are provided for informational purposes only and are not intended as recommendations to buy or sell a security, nor as an offer to buy or sell a security. Recipients of the information provided herein should consult with a financial advisor before purchasing or selling a security. MDR is not an investment advisor and is not registered with the U.S. Securities and Exchange Commission or the Financial Industry Regulatory Authority, and, further, the owners, employees, agents or representatives of MDR are not acting as investment advisors and might not be registered with the U.S. Securities and Exchange Commission. The information and opinions provided herein are provided as general market commentary only, and do not consider the specific investment objectives, financial situation or particular needs of any one client. The information in this report is not intended to be used as the primary basis of investment decisions, and because of individual client objectives, should not be construed as advice designed to meet the particular investment needs of any investor. The comments may not be relied upon as recommendations, investment advice or an indication of trading intent. MDR is not soliciting any action based on this document. Investors should consult with their own financial adviser before making any investment decisions. There is no guarantee that any future event discussed herein will come to pass. The data used in this publication may have been obtained from a variety of sources including U.S. Federal Reserve, FactSet, Bloomberg, Bank of America Merrill Lynch, iShares, Vanguard and State Street, which we believe to be reliable, but MDR cannot be held responsible for the accuracy of data used herein. Any use of graphs, text or other material from this report by the recipient must acknowledge MarketDesk Research as the source. Past performance does not guarantee or indicate future results. Investing involves risk, including the possible loss of principal and fluctuation of value. MDR disclaims responsibility for updating information. In addition, MDR disclaims responsibility for third-party content, including information accessed through hyperlinks.

MDR is not a registered investment adviser. No mention of a particular security, index, derivative or other instrument in the report constitutes a recommendation to buy, sell, or hold that or any other security, nor does it constitute an opinion on the suitability of any security, index, or derivative. The report is strictly an information publication and has been prepared without regard to the particular investments and circumstances of the recipient. SUBSCRIBERS SHOULD VERIFY ALL CLAIMS AND COMPLETE THEIR OWN RESEARCH AND CONSULT A REGISTERED FINANCIAL PROFESSIONAL BEFORE INVESTING IN ANY INVESTMENTS MENTIONED IN THE PUBLICATION. INVESTING IN SECURITIES AND DERIVATIVES IS SPECULATIVE AND CARRIES A HIGH DEGREE OF RISK, AND SUBSCRIBERS MAY LOSE MONEY TRADING AND INVESTING IN SUCH INVESTMENTS.

Principals of MDR may or may not hold or be short any of the securities, options, or futures discussed in the report, or any other securities, at any time.

Please refer to www.MarketDeskResearch.com/terms for the complete list of terms and disclaimers.

© 2021 MarketDesk Research LLC. All Rights Reserved.