FAIRCOURT
Asset Management Inc.

3rd Quarter Commentary – 2022

Key Take-aways:

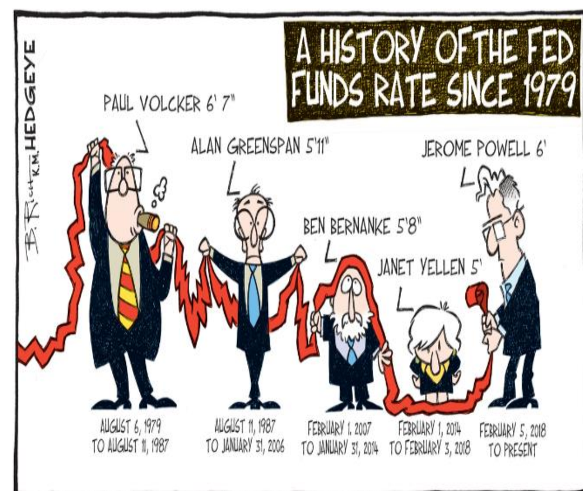
- The S&P 500 has posted an uncomfortable -24.7% year to date with a weak September printing -9.3%
- The Federal Reserve is tightening into slowdown, leading to a very high probability of recession
- Cross asset volatility is taking place in a world where there was pre-existing fragility in the system, imbalances and a lot of hidden risks (leverage and lack of transparency)
- Recent inflation prints and forward expectations suggest the Federal Reserve is unlikely to pivot
- Equity markets have yet to fully price in the structural change in rates (higher for longer)
- The probability of a soft landing (raising rates to counter elevated inflation into an economic slowdown without triggering a recession) appears to be nearing zero

Positioning:

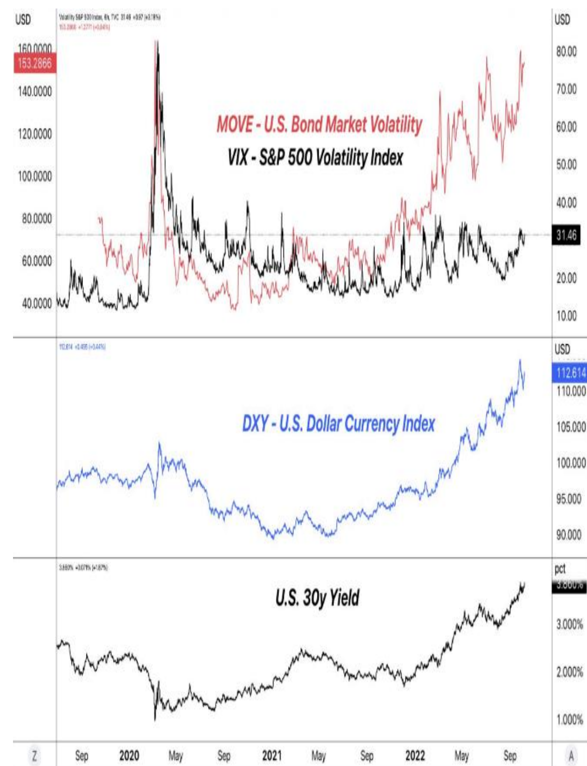
- Maintain defensive posture, reducing net market exposure
- Maintain overweight USD dollar
- Execute on selective shorts on vulnerable sectors/indexes and high yield bonds
- Beware bear-market bounces and position for weaker earnings
- Continue to be macro aware, showing discipline, and focusing on investible volatility.
- Patience remains our core allocation

3rd Quarter Commentary – 2022

There were few meaningful disinflationary signals to celebrate in the September inflation print. On the morning of October 13th, the September reading of the Consumer Price Index (ex food and energy) printed +40bps acceleration from August to +8.2% year over year and showed that inflation continues to be a problem for the FED, an unquestionably strong inflation read concentrated in housing/shelter. The FED will have no choice but to move forward with its mandate, +75bps expected in November and more or less another identical raise in December. No relief, no pivot is coming, this latest report basically confirms this. After being criticized for being slow to recognize inflation, the FED has embarked on its most aggressive series of rate hikes since the 1980s. In the 1980s, Fed Chair Volcker tried to tame inflation by raising the Fed funds rate up two-fold from 10% to 20%. Fed Chair Powell in 2022 has so far increased it 13- fold from 0.25% to 3.25%. Under Chair Volcker, the increase in long term Treasury yields was 1.6X—from 10% to 16%—compared to 8.1X— from 0.5% to 4.02% under Chair Powell. As can be seen, the 2022 version of rate hikes, on a rate of change basis, is far more aggressive. We believe this rate of change distinction is under-appreciated by the market. Under Chairman Volker inflation peaked at 14.6% in April 1980, Fed Funds rate went to 19.1% by June 1981, unemployment rose to 10.8% by December 1982 and the S&P500 fell as much as 33% between two induced recessions (January to July 1980). We are currently living through the efforts of Chaiman Powell but safe to say we are witnessing a regime change, going from falling rates and easy money to rising rates, tightening policy and desperate to get inflation prints lower quicker. Monetary policy has a delayed effect and will have to remain tighter for longer as Central Banks looking in the rear view mirror to fight elevated inflation.



Brief rallies in the markets are based on hopes that any economic slowdown will force the FED to pivot away from aggressive liquidity withdrawal measures. The FED is attempting to contain inflation and maintain financial stability at the same time. This is a tricky situation. We acknowledge the FED may not be able to continue to hike rates at this aggressive speed and maintain financial stability. This is why we think the FED will eventually have to come to the conclusion and cave into the notion that inflation is now structurally higher for longer and focus back to financial stability. While equity markets are important we first look at credit and treasuries to really understand the fragility. Credit markets have been under stress for some time now and the worry is they could become disorderly. Yields have been rising and stressing the plumbing of the system. This is likely where the FED will need to intervene to avoid turbulence and forced liquidations. But in the meantime, they have choreographed their path and we must recognize this. The FED is doing quantitative tightening, meaning they are raising rates and they are net sellers of Treasuries as they let bonds mature off their balance sheet and choose not to reinvest the proceeds. Commercial banks are also not buying U.S. Treasuries. The foreign sector in aggregate has been reducing their US Treasury holdings as well.



Generally speaking, we've seen the bond market lead the stock market in 2022. If this is to continue to hold true, we would likely see further weakness in the major equity indexes. The losses being experienced in the bond markets have been sobering. An index that measures bond implied volatility,

MOVE Index, stands at its highest levels since the 2020 COVID-19 scare and the 2008- 2009 housing crisis, suggesting stress in US Treasury Bonds and the broader market. The UST Yield Curve, as measured by the 2-year Treasury yield relative to the 10-year Treasury yield, has inverted by 48 basis points, the 10-year yield at 4.02% compared to the two-year at 4.50%, currently at its lowest level since 1982 and is one of the biggest signals we have a weak economy and a recession is inevitable. The Bond market is pricing lower long-term rates than short-term rates and a much more reliable indicator of recessions than equity markets. The Bond market is telling a very clear message via the inversion of the yield curve. The divergence between the elevated MOVE index (treasury bond vol) and equity vol is uncomfortably wide. The MOVE index is currently around 150+ whereas equity vol is 31+. Normally the gap is tighter, even a 2-1 gap some might consider acceptable, but this is 5x so not healthy under any scenario. To us it suggests hidden risks/imbalances exists. Either treasuries settle down or equity volatility ramps up. Given the FED's aggressive path and bond market typically being a leading indicator the worry is it's the latter. The longer equity markets go without capitulating the bigger the problem becomes as the FED continues to aggressively tighten monetary conditions. Forced liquidations and deleveraging is something market participants should be worried about. As long as the financial system is still functioning, as long as liquidity is still present and we are not seeing systemic measures present nor the system buckling under pressure, rate hikes will continue regardless of what happens to asset prices. Outright recession may not stop rate hikes but broken credit markets or disfunctional treasury markets are the sort of things that could force the FED to pause or pivot. As always, the ultimate referee will be the data and global markets.

Data suggests to us both growth and inflation will decelerate meaningfully into 2023 which historically has not been the best environment for taking risk. As the FED continues to raise rates into a slowdown, the U.S. economy will slow faster. This is a developing recession. Corporate revenues, profitability, cash flows are deteriorating at an accelerating rate.

There seems to be a growing amount of data suggesting a real slowdown and rising probability of recession and a healthy amount of data to suggest that historically, market troughs have tended to lag rate peaks significantly. The FED is raising rates at the fastest pace in decades while the banking system is tightening financial conditions at the fastest pace since the Great Financial Crisis (GFC) of 2008. The treasury market seems to agree on slowing growth. By mid October the yield curve was inverted by -48 basis points, which is the most since 2000. The FED Fund Futures spread has now fully priced out pivot prospects and have moved from expecting rate cuts in 1H23 to beginning to price further hikes. In other words, it doesn't matter if the next rate hike is 75bps or 50bps, there doesn't appear to be any meaningful policy pivot in the cards in the intermediate term. What matters is that the FED is compounding a mistake they made in 2021 and are raising rates into an economic slowdown. Further rate hikes will only continue to weaken the consumer. Data is proving to us that the US consumer is not well positioned for this downturn and deteriorating at an accelerating rate. Consumer confidence and household sentiment are as low as was seen in 2008, expectations of the future is not promising. The worries range from not having adequate cash to pay monthly bills, paying rent, making minimum payments on credit card debt to having enough money for retirement. Americans are responding to these pricing pressures by putting more and more of their expenses on credit cards setting themselves up for credit default issues down the road. We are also seeing that the savings rate is falling in recent months indicating consumers are feeling the pressure of higher prices, forcing them to dip into savings to keep up.

Dollar strength is one of the most important variables in how risk assets perform. As macro conditions shift, it

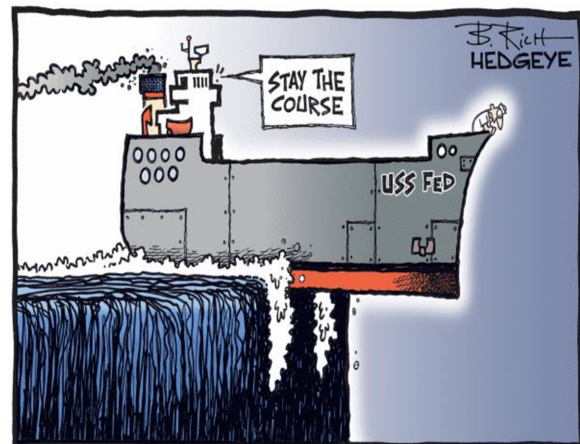
is imperative to think of the implications that a stronger dollar will have on risk assets. The equity market is directly correlated to the inverse of the U.S. dollar, because people are going to cash, and equities are risk off. The U.S. dollar has strengthened considerably against nearly every major currency this year, and its rally from the May 2021 low is one of the strongest on record. The strength of the US dollar is helping to destabilize overseas economies because it increases inflationary pressures outside the U.S. That currency effect forces other central banks to take hawkish action themselves, putting additional downward pressure on global economies. And that will continue until we hit the flashpoint that causes central banks to reverse course. The Dollar accounts for 96% of trade invoices in the Americas, 74% in Asia-Pacific, 23% in Europe, and 79% in the Rest of the World. After such a strong run-up, we may see some consolidation here (though we caution that doesn't mean the dollar bull run is over). As the Fed continues on the current hawkish path, do not rule out another period of prolonged dollar strength. The US dollar strengthened because they had the most aggressive Central Bank early, highest interest rates in addition to its reserve currency status. As the dollar strengthens, it will continue to serve as a headwind for risk assets. If the dollar begins to stabilize, or better yet weaken, it could serve as a much-needed tailwind.

We are witnessing falling retail sales, weakening industrial production and fixed investment and consumer confidence all showing signs of deteriorating. Markets may not be fully appreciating the complexities of the upcoming earnings season and weak forward looking management guidance. Company valuations face a dangerous mix of high or rising interest rates, elevated inflation, slowing economic growth, and a strong dollar. Of the four, interest rates should be the most enduring headwind because higher rates in place for the long term reduces the multiple of earnings investors are willing to pay for shares. Also, analysts' projections remain far to optimistic in our opinion. Double digit EPS growth is not attainable if the private sector is being faced with the sharp tightening in financial conditions and now setting up for

tighter for longer. Corporate P&L's are decelerating and we continue to expect cross asset volatility to misbehave. If in fact inflation does end up being sticky high, then the FED has quite a bit of work to go and in a liquidity driven capital market that could be problematic. We are into a period where you need to have strong data interpretation skills on growth and inflation to properly position for the likely monetary policy outcome. For now though, patience is needed.

The largest central bank in the world is actively draining liquidity from the financial system while most economic indicators are pointing towards significant economic deceleration. Important signals for our process remains cross asset volatility, USD dollar strength, and the activity coming out of fixed income markets. Being macro aware and data driven, we had pivoted to a more defensive portfolio, adding macro hedges such as being overweight the USD dollar and shorting select indexes and high yield bonds while monitoring trending cross asset volatility. Market participants are still not bearish enough nor grasping the scale of the treasury market volatility. Our non-consensus view remains, the longer equity markets go without capitulating further and re-evaluating fair value the bigger the problem becomes as the FED continues to aggressively tighten monetary conditions. Our goal in our portfolios is to be directionally accurate and get allocations correct on a rate of change basis. Yield curves flatten and invert while headed into a recession and steepen while in a recession. For economic growth there needs to be capital available and that currently does not appear to be the case with inflation outpacing wages, cost of mortgage funding spiking, and significant wealth destruction in stocks and bonds. For now the market risk is to the downside. The big headwinds still prevail, the tightening of financial conditions and global liquidity among the most prominent. The FED is hiking into an economic slowdown, real income growth for households is negative, inflation is at generational highs, real spending growth is decelerating, excess savings is negative, households are still getting squeezed by ongoing contraction in real (inflation adjusted) purchasing power and financial asset value destruction is set to reverse

wealth effect spending. Houses are the key component of most consumer's balance sheet. As demand slows, inventory builds, and home prices begin to decelerate, the consumer feels poorer and is likely to spend less on the margin. This is a developing recession. History of bear markets is that there are observable deterioration points across various macro economic variables before we achieve a bottom. The bottoming of the market is a process and not a point. We continue to recommend caution and believe defensive strategies and selective shorting of equities (benefit when stock prices fall) may help protect capital during these choppy markets. For market direction to change, we will need to see a macro trend reversal, usually driven by a catalyst event like a drastic change in Federal Reserve rhetoric that causes the market to reposition for a different policy regime and which brings renewed enthusiasm and capital into risk assets. For now, the Central Banks around the world are expected to continue the tightening path ahead despite the weak economic data. We need to see lower levels of trending volatility and accelerating volume signalling to us a healthier investing environment. We will continue to be macro aware, showing discipline, and focusing on investible volatility. Patience remains our core allocation.



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Sincerely,

Christopher Panagopoulos, CPA, CA, CFA

The Portfolio Management Team

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