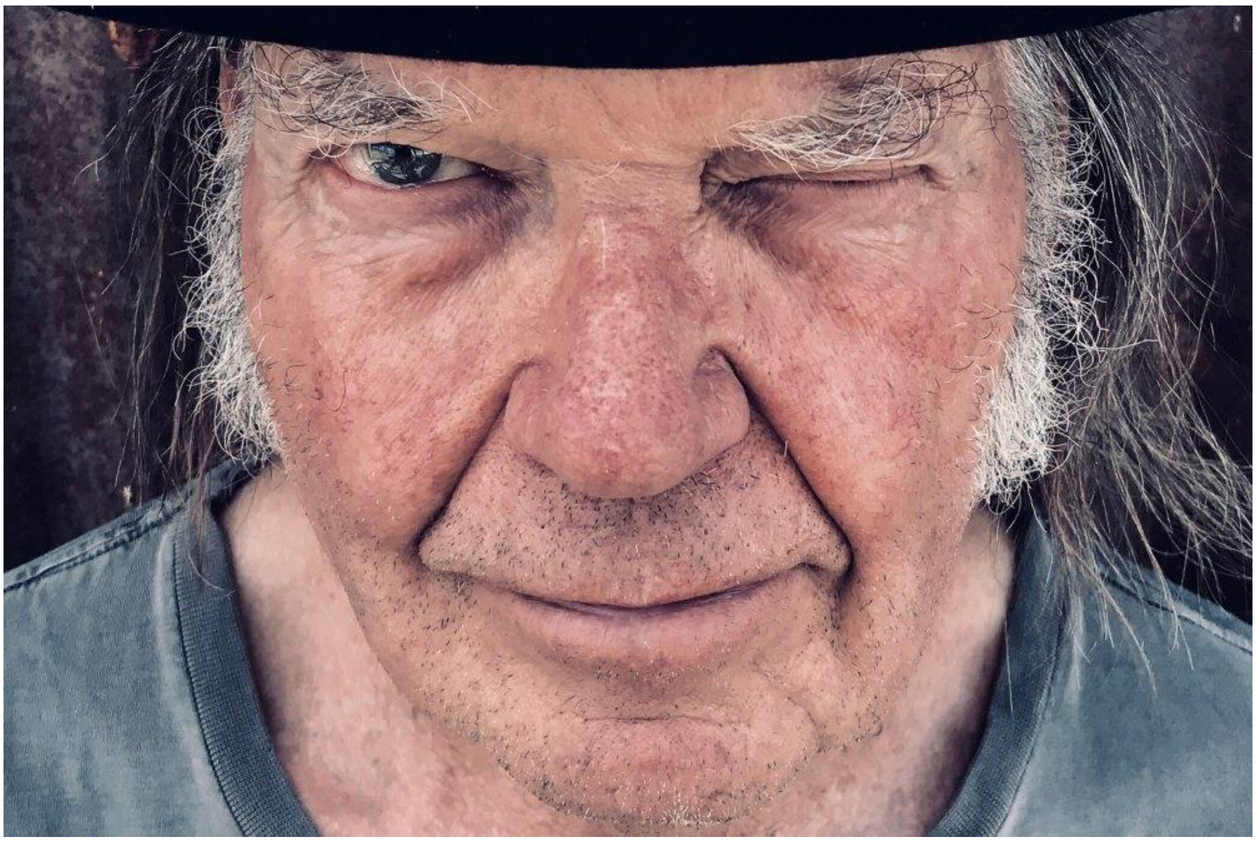
LANSING STREET ADVISORS — FAMILY OFFICE

Q1 2022 Letter – Fed Ends Sugar Mountain

The Fed Ends Sugar Mountain

Oh, to live on sugar mountain
With the barkers and the colored balloons
You cannot be twenty on sugar mountain
Though you are thinking that you are leaving there too soon
You're leaving there too soon
Sugar Mountain by Neil Young



Introduction

The Fed has created a sugar mountain of liquidity in markets that will be hard to unravel.

Friends, you will not see many 40-year bull markets in a lifetime so witnessing one ending is a historical investment and economic event. Interest rates have been trending downward for 40 years driving a bond favorable market that ended abruptly during the first quarter of 2022 leaving the aggregate bond indexes down more than the stock market. Most bond investors opened quarterly statements showing losses for the first time in 40 years, including Muni-bonds experiencing worst quarter since 1980. We have the lowest inflation adjusted (real) yields in 60 years.

https://www.bloomberg.com/news/articles/2022-03-22/treasuries-threaten-to-breach-a-decades-long-bullish-trend-line?sref=GGda9y2L

Higher interest rates will not only effect bond returns going forward but every investing class available. The below chart illustrates a vivid picture on the financial sugar mountain.

U.S. Private Sector Financial Assets as a Percentage of GDP During Bond Bull Market

What are US financial assets? **Cash, stocks, bonds, mutual funds, and bank deposits** are all examples of financial assets. Unlike land, property, commodities, or other tangible physical assets, financial assets do not necessarily have inherent physical worth or even a physical form.

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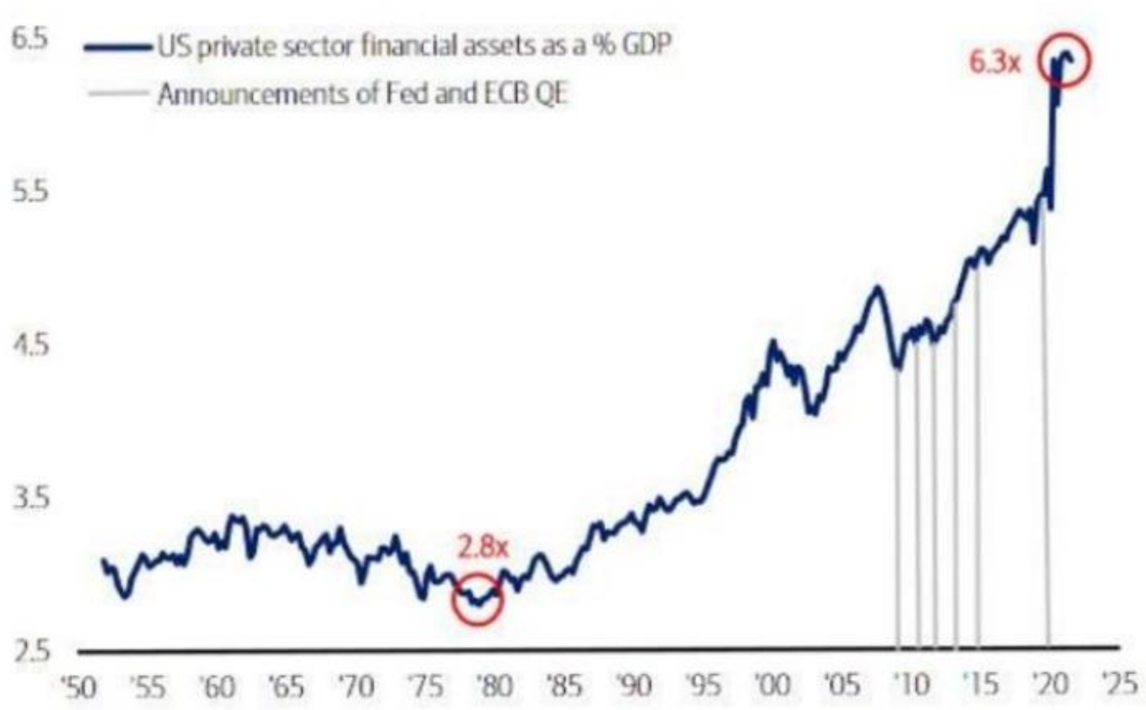
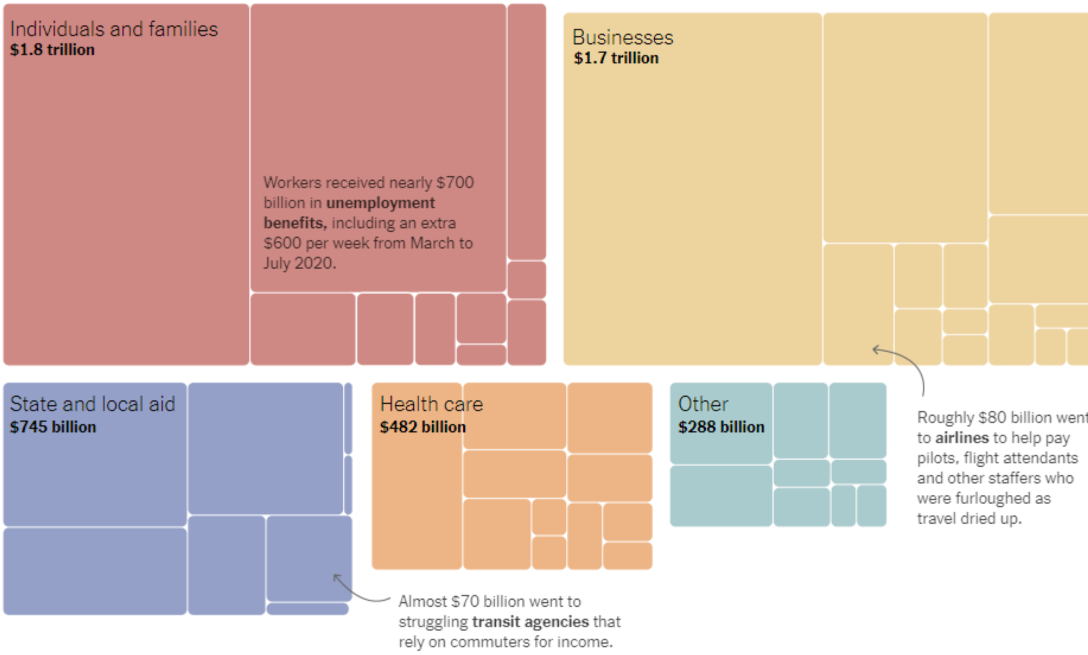


https://twitter.com/MacroAlf

The 10-year treasury rate hit .56 basis points during Covid plus the government provided six times the stimulus as 2008 housing crisis. Here is the simple equation we are left to ponder…. $5 trillion in stimulus + Zero interest rates=Financial Sugar Mountain i.e., inflation. The FED faces unraveling a 40-year sugar mountain and now we added in a war, supply chain issues and sanctions.
It is fair to say that 2008 bail out went to Wall Street versus Covid rescue going to Main Street. Families and small businesses got the majority of pandemic stimulus, but this enhanced our current climb to 40 years high in inflation.

Where the $5 Trillion in Stimulus Went-NYT



https://www.nytimes.com/interactive/2022/03/11/us/how-covid-stimulus-money-was-spent.html

Part I - Where do we stand?

In my last letter, I discussed the top in excess speculation with Ben Affleck and Matt Damon leading the charge by advertising for gambling and crypto investing. The Nasdaq promptly corrected -22% and the S&P -15% but more speculative parts of market such as IPOs, Disruptor Stocks (Cathie Wood ARKK), SPACs, ect. got walloped for -40-70%. More importantly we are witnessing a huge rotation of sector leadership away from technology and toward inflation friendly sectors. At the same time, an asset class rotation into commodity stocks and value stocks in underway.

I want to be clear on the difference between a stock market correction and an economic recession. Ten to fifteen percent stock corrections are commonplace and, in most cases, they are buying opportunities, while recessions are -35% corrections that last 18-24 months with multiple head fakes that suck in investors before the market makes new lows. At the end of a recession, investors become exhausted and mass selling happens on the bottom.

2010-2020 was the first decade without a recession since 1850. The Covid crisis was a 30-day bear market so a true American recession in on the horizon but like always in markets, the timing is complicated.

At this moment, the U.S. is not facing an imminent recession but more on that in part II of today's letter. See below history of 10-15% corrections from LPL research. Outside of the 2000 internet bubble, they all posted positive returns one-year later.

Stock Market History Post 10-15% Correction

S&P 500 Index Corrections Between 10% - 15% (1980 - Current)

					S&P 500 Index Returns	
High Date	S&P 500 High Price	Low Date	S&P 500 Low Price	Correction Return	1-Year Return After Lows	2-Year Return After Lows
5/7/1982	119.47	8/12/1982	102.42	-14.3%	57.7%	57.9%
10/10/1983	172.65	7/24/1984	147.82	-14.4%	30.3%	61.5%
10/21/1987	258.38	10/26/1987	227.67	-11.9%	24.0%	51.5%
11/2/1987	255.75	12/4/1987	223.92	-12.5%	21.4%	56.6%
10/9/1989	359.80	1/30/1990	322.98	-10.2%	3.7%	28.5%
10/7/1997	983.12	10/27/1997	876.99	-10.8%	21.5%	47.9%
9/23/1998	1066.09	10/8/1998	959.44	-10.0%	39.2%	46.9%
7/16/1999	1418.78	10/15/1999	1247.41	-12.1%	10.2%	-13.9%
3/24/2000	1527.46	4/14/2000	1356.56	-11.2%	-12.1%	-18.8%
11/27/2002	938.87	3/11/2003	800.73	-14.7%	40.4%	51.0%
5/21/2015	2130.82	8/25/2015	1867.61	-12.4%	16.5%	30.6%
11/3/2015	2109.79	2/11/2016	1829.08	-13.3%	26.6%	45.2%
1/26/2018	2872.87	2/8/2018	2581	-10.2%	5.0%	30.1%
1/3/2022	4796.56	2/22/2022*	4304.76	-10.3%	?	?
		Average		-12.1%	21.9%	36.5%
		Median		-12.1%	21.5%	46.9%
		% Higher			92.3%	84.6%

Source: LPL Research, Ned Davis Research, FactSet 02/22/2022 * The current correction may not be over yet.

The invasion of Ukraine will change the geopolitical landscape for a generation. A new world order is forming that will set the international stage for decades to come, but the markets have no soul. The stock market is higher since the day of invasion and the U.S. dollar has gone straight up. Since the day I entered finance over 25 years ago, endless amounts of market predictors have warned on the end of the U.S. dollar as the world currency. This time its Bitcoin's turn but color me skeptical again. Where do you want to park your liquidity - China, Russia, Latin America, Europe? I thought so. The strongest currency is held by the most powerful military and the deepest most liquid markets.
The markets have no soul – remember we recovered to new highs withing days of 9/11

Geopolitical Events and Stock Market Reactions.

Market Shock Events	Event Date	One-Day	Total Drawdown	Bottom	Recovery
Iranian General Killed In Airstrike	1/3/2020	-0.7%	?	?	?
Saudi Aramco Drone Strike	9/14/2019	-0.3%	-4.0%	19	41
North Korea Missile Crisis	7/28/2017	-0.1%	-1.5%	14	36
Bombing of Syria	4/7/2017	-0.1%	-1.2%	7	18
Boston Marathon Bombing	4/15/2013	-2.3%	-3.0%	4	15
London Subway Bombing	7/5/2005	0.9%	0.0%	1	4
Madrid Bombing	3/11/2004	-1.5%	-2.9%	14	20
U.S. Terrorist Attacks	9/11/2001	-4.9%	-11.6%	11	31
Iraq's Invasion of Kuwait	8/2/1990	-1.1%	-16.9%	71	189
Reagan Shooting	3/30/1981	-0.3%	-0.3%	1	2
Yom Kippur War	10/6/1973	0.3%	-0.6%	5	6
Munich Olympics	9/5/1972	-0.3%	-4.3%	42	57
Tet Offensive	1/30/1968	-0.5%	-6.0%	36	65
Six-Day War	6/5/1967	-1.5%	-1.5%	1	2
Gulf of Tonkin Incident	8/2/1964	-0.2%	-2.2%	25	41
Kennedy Assassination	11/22/1963	-2.8%	-2.8%	1	1
Cuban Missile Crisis	10/16/1962	-0.3%	-6.6%	8	18
Suez Crisis	10/29/1956	0.3%	-1.5%	3	4
Hungarian Uprising	10/23/1956	-0.2%	-0.8%	3	4
N. Korean Invades S. Korea	6/25/1950	-5.4%	-12.9%	23	82
Pearl Harbor Attack	12/7/1941	-3.8%	-19.8%	143	307
Average		-1.2%	-5.0%	22	47

Source: LPL Research, S&P Dow Jones Indices, CFRA, 01/06/20

U.S. Military Spending vs Other Top Countries=Strong Currency

[Visual Capitalist](#) From Barry Ritholtz Blog https://ritholtz.com/2022/04/weekend-reads-510/

Part II - Interest Rates are Rising so the Market will Crash? Not Exactly.

Rising interest rates mean the economy is doing well and considering we have 5m more jobs than people willing to fill them, it is safe to say business in America is healthy. Contrary to media commentary, rising interest rates do not mean an immediate end to a favorable market. The below grid tells us that probabilities are in favor of equities following Fed rate hikes.

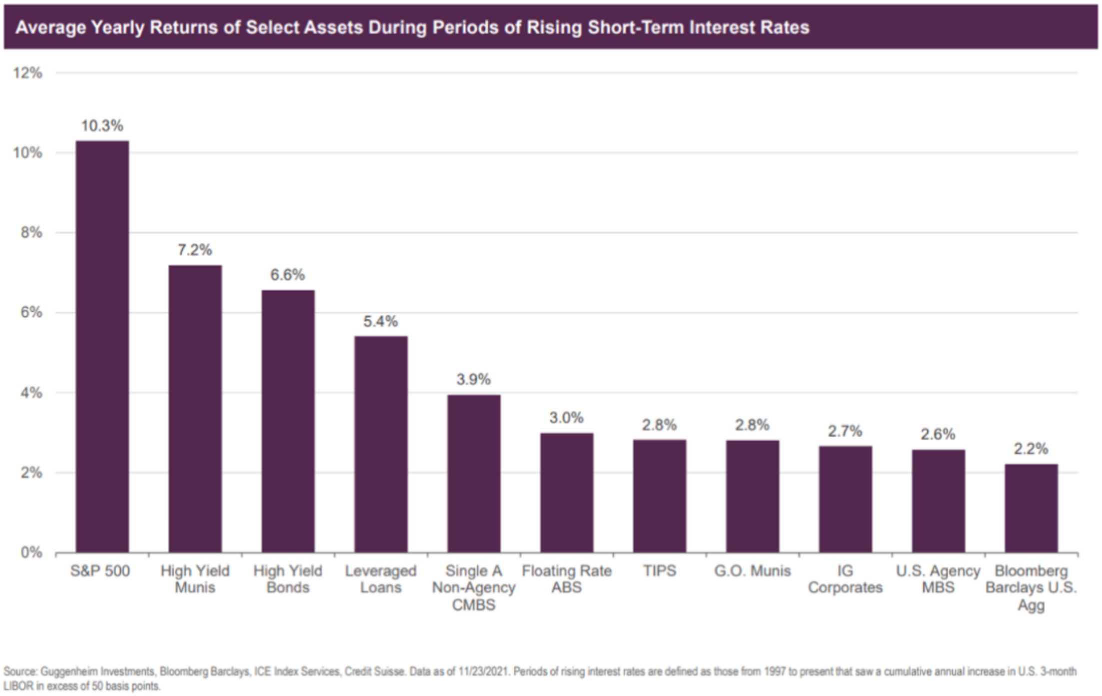
Forward S&P 500 Index Returns Following Fed Rate Hikes

	1mo	3mo	6mo	9mo	12mo
Average	0.40%	2.01%	4.77%	7.80%	11.18%
Pct. Pos.	*59%*	*73%*	*77%*	*80%*	*82%*
Max	11.49%	19.12%	22.43%	30.51%	39.66%
Min	-22.36%	-29.67%	-20.80%	-23.53%	-24.89%

Data spanning 82 rate hikes from 3/31/1982 - 12/20/2018

Image Source: **NASDAQ DORSEY WRIGHT**

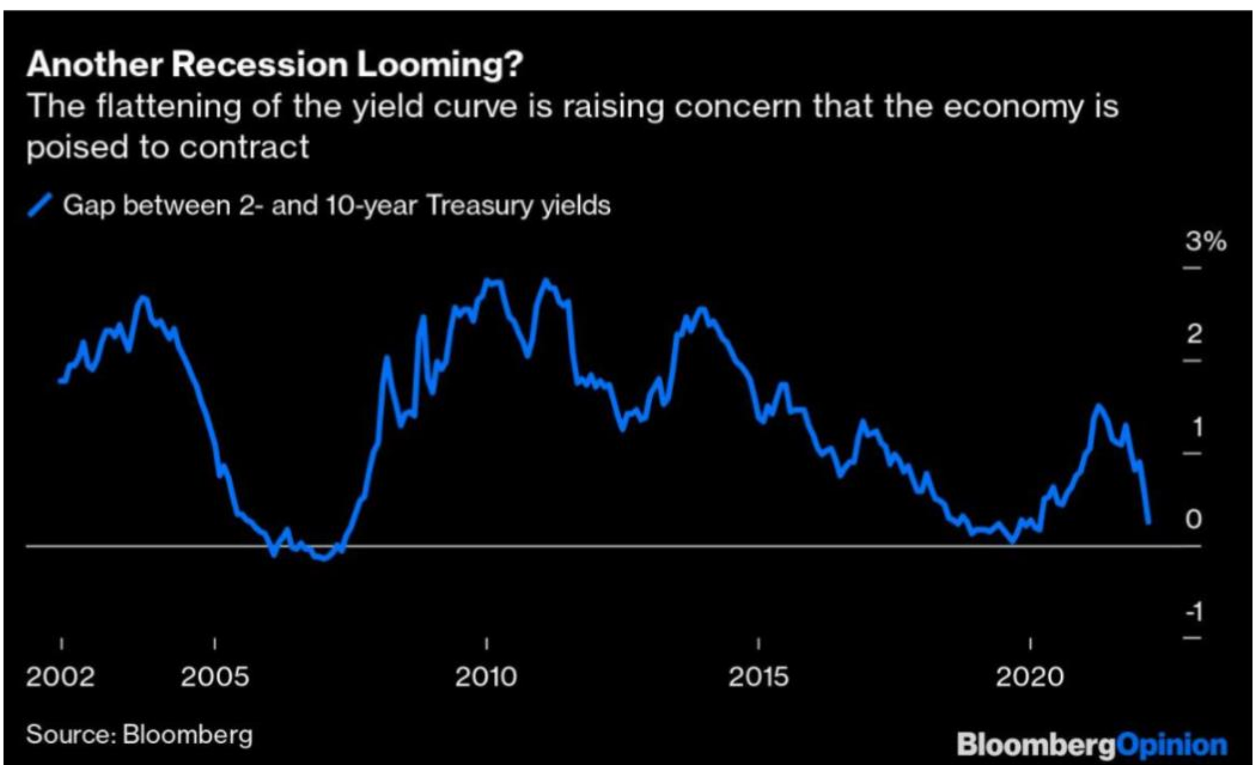
Also, during periods of rising short-term interest rates, stocks have the best history of returns versus bonds. I would expect the market to be volatile straight through the Summer as inflation, geopolitical events, and still high valuations converge to leave investors short-term emotional. But, rising interest rates are not a historical death sentence for stocks.



Guggenheim https://www.guggenheimpartners.com/perspectives

Part III - The Yield Curve is Inverting so the Market will Crash? Not Exactly.

Here is every pundit's recent favorite chart and this is not without reason because the yield curve has preceded most U.S. recessions. However, like everything else related to investing, its complicated or no one would need to work. For example, the yield curve inverted in 2019 and the S&P is up 63% since the event.



Yes, the yield curve is an excellent indicator of a recession but like most fundamental market indicators, it is not a timing mechanism. Since 1980 the average lead time between inversion and a recession is 18 months and the stock market on average posts positive returns in the run up to a recession.

Inverted Yield Curve (10-Yr minus 2-Yr) and Recessions (1976 - 2022)

Recession Start	Recession End	Inverted Yield Curve Before Recession?	First Yield Curve Inversion	Lead vs. Recession Start (Months)
Feb-80	Jul-80	Yes	Aug-78	18
Aug-81	Nov-82	Yes	Sep-80	11
Aug-90	Mar-91	Yes	Dec-88	20
Apr-01	Nov-01	Yes	May-98	35
Jan-08	Jun-09	Yes	Dec-05	25
Mar-20	Apr-20	Yes	Aug-19	7
?	?	?	Apr-22	?
Average Lead Time				**19**
COMPOUND			@CharlieBilello	

https://compoundadvisors.com/about

As mentioned in my last quarterly letter, Ben Carlson explains topics much better than me. He says it makes sense to look at the returns between the yield curve inversion and the start of these stock downturns:

Start of Inverted Yield Curve	Start of Market Correction	S&P 500 Total Returns
Aug. 1978	Feb. 1980	123.3%
Sept. 1980	Nov. 1980	16.2%
Dec. 1988	July 1990	37.6%
Feb. 2000	March 2000	7.7%
Dec. 2005	Oct. 2007	28.4%

Data: Returns 2.0 (monthly total returns)

Ben Carlson-*Even if the yield curve does predict a recession yet again you cannot predict:*

- *When the recession will happen.*
- *If/when the stock market will begin to fall.*
- *The magnitude of the recession and stock market correction.*
- *What the Fed will do in the meantime.*

[Full read at A Wealth of Common Sense]

Part IV - Where does this data leave investor?

As mentioned in my 2021 year-end letter, there is no need to panic but it is going to be harder to make money in the stock market going forward. I showed Vanguard's projected 10 year returns in my last few quarterly notes that project bonds losing money after inflation and stocks returning reasonable but much lower returns than the last 10 years.

Asset-class return outlooks

The greatest change in our outlooks from the June 30 running of the Vanguard Capital Markets Model® (VCMM) was in emerging markets equities. Large price declines in the intervening months lowered valuations, which are reflected in a 10-year forecast range that is 60 basis points higher in the September 30 running. In fixed income, yields increased marginally in the third quarter, allowing for a marginal rise in forecasts for many fixed income sub-asset classes.

Our 10-year, annualized, nominal return projections, as of September 30, 2021, are shown below. Please note that the figures are based on a 1.0-point range around the rounded 50th percentile of the distribution of return outcomes for equities and a 0.5-point range around the rounded 50th percentile for fixed income.

Equities	Return projection	Median volatility
U.S. equities	2.3%–4.3%	16.7%
U.S. value	3.1%–5.1%	19.2%
U.S. growth	–0.9%–1.1%	17.5%
U.S. large-cap	2.2%–4.2%	16.3%
U.S. small-cap	2.2%–4.2%	22.5%
U.S. real estate investment trusts	1.9%–3.9%	19.1%
Global equities ex-U.S. (unhedged)	5.2%–7.2%	18.4%
Global ex-U.S. developed markets equities (unhedged)	5.3%–7.3%	16.4%
Emerging markets equities (unhedged)	4.2%–6.2%	26.8%

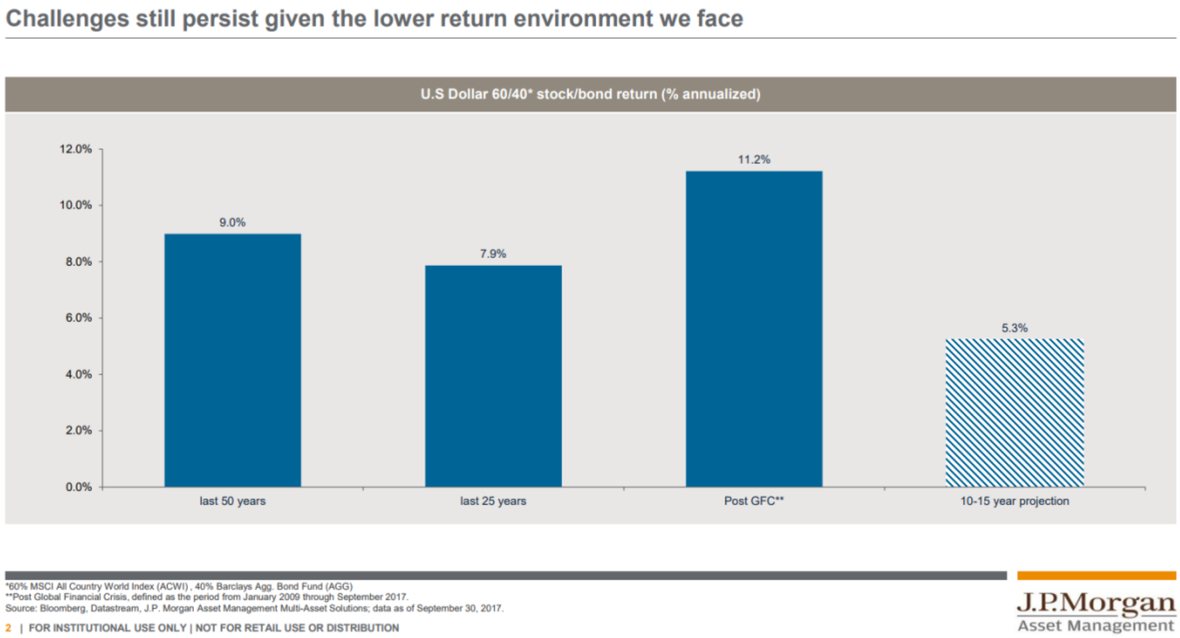
These probabilistic return assumptions depend on current market conditions and, as such, may change over time.

Fixed income	Return projection	Median volatility
U.S. aggregate bonds	1.4%–2.4%	4.6%
U.S. Treasury bonds	1.2%–2.2%	4.7%
U.S. credit bonds	1.6%–2.6%	4.7%
U.S. high-yield corporate bonds	2.2%–3.2%	10.4%
U.S. Treasury Inflation- Protected Securities	1.0%–2.0%	7.0%
U.S. cash	1.2%–2.2%	1.2%
Global bonds ex-U.S. (hedged)	1.3%–2.3%	3.8%
Emerging markets sovereign bonds	2.3%–3.3%	10.1%
U.S. Inflation	1.5%–2.5%	2.3%

IMPORTANT: The projections or other information generated by the Vanguard Capital Markets Model® regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results.
Distribution of return outcomes from the VCMM are derived from 10,000 simulations for each modeled asset class. Simulations are as of September 30, 2021. Results from the model may vary with each use and over time. For more information, see Important information page.

Source: Vanguard Investment Strategy Group.

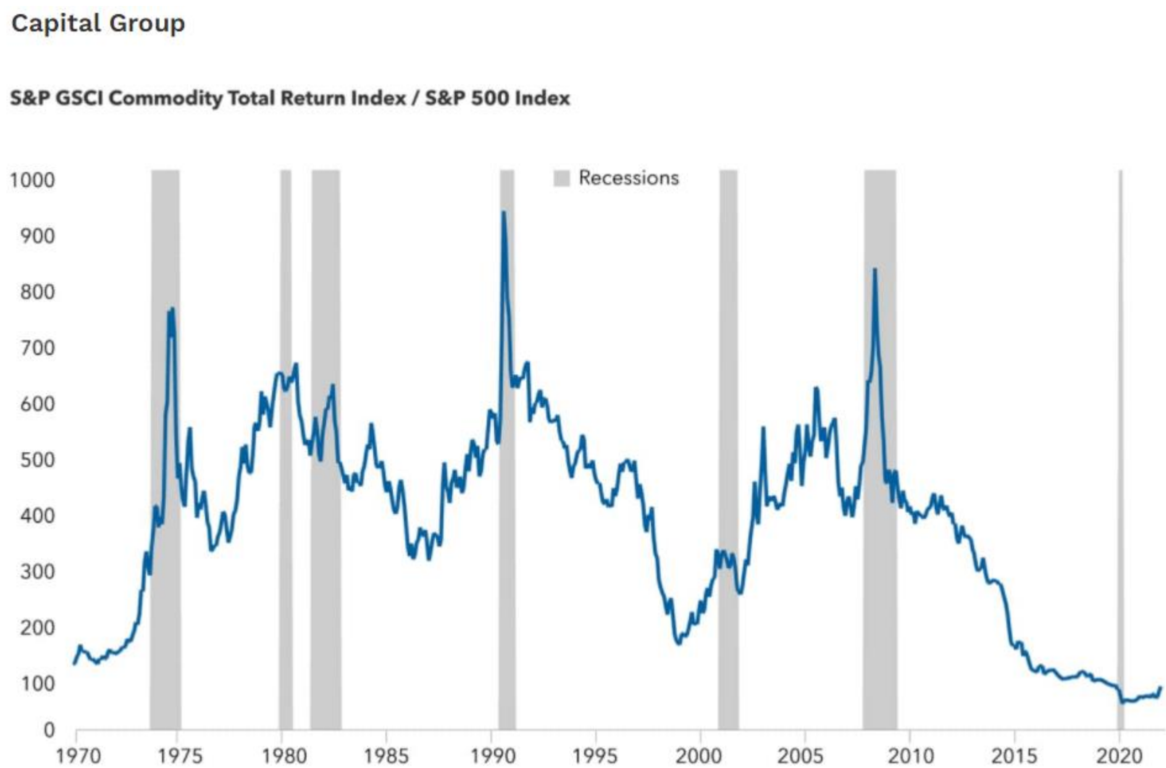
Below chart from JP Morgan shows expected returns based on math for a 60/40 portfolio versus the last 10, 20, and 30 years. Will it be exact? Of course not, but it could also be worse.



First, the basics. These projected returns make it even more paramount to dollar cost average and get aggressive buying on corrections. Second, it will be prudent to do your due diligence on asset classes that are not expensively based on fundamentals. It will also be important to not let recency bias dominate your investment thought process, i.e., growth stocks will continue to dominate like the last 10 years.

When interest rates go up and inflation goes up, price to earnings multiples come down. There are asset classes that are worth your time to research. Commodities had their best quarter in 32 years, but they are not yet expensive versus history. The following chart from the Capital Group (American Funds) tells us that commodities are still quite cheap versus the S&P 500. For this chart, high means expensive commodities vs. low means cheap commodities. Warning: please discuss any investing in commodities with a professional as this is a trading play, not a long-term buy and hold asset. It is a highly volatile asset class.

Commodities Historical vs. S&P

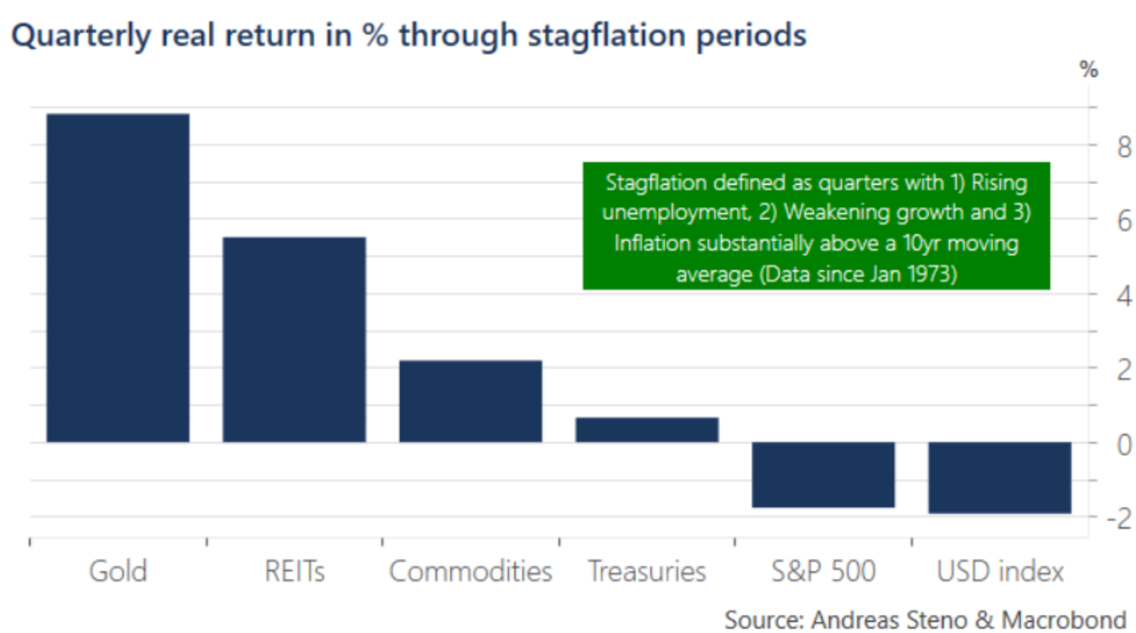


Keeping with the theme of inflation hedges and bond replacements, private real estate is another interesting space to spend research time. Yes, returns have been outstanding for the last 10 years in commercial real estate and it is true that the space is not cheap, but real estate is an excellent inflation hedge. Also, for those who can afford to have a portion of their portfolio illiquid, it is an attractive space versus bonds.

The key for private real estate is choosing the right manager because alpha is generated in this space over the long-term from a disciplined and experienced team. As you can see on the risk/reward chart below, private real estate offers attractive annualized returns with reasonable risk.

Risk – Reward of Private Real Estate

I am not a believer that 1970's style stagflation is imminent, but commodities and real estate have a positive historical history if stagflation occurs.



Source: @AndreasSteno

Full Disclosure-Lansing Street Advisors offers investing in private real estate, if you are a qualified investor, please contact us for information.

Another option is sectors trading at reasonable valuations and paying healthy dividends. One example is the healthcare sector that trades at a discount valuation, has inflation proof margins, and has a history of performing well in bear markets.

Especially important, none of the above are a recommendations for you to buy or sell any security. This is for information purposes only. Please talk with your advisor regarding any advice around the subject matter and your goals.

Conclusion

Jerome Powell as Neil Young sings “Ain’t it funny how you feel when you’re findin out it’s real” in this case inflation is what is real. Inflation is a monetary, fiscal, political, and social hot potato that no one wants to own so look for the Fed to aggressively act to the point of accepting a mild recession. The era of record cheap loans is ending as inflation has ripped the printing press out of the Fed’s hand. Input costs, wages and rents are rising. This adds up to pressure on current record high margins for the S&P.

Investment returns in the stock market will revert to the mean instead of high double digits during the past decade. The era of low inflation driven by technology and relocation of workers to low wage countries looks to be ending. There is still opportunity for investments focusing on safety of principal and reasonable rates of return.

The ultimate black swan event was Covid. Since the chances of a Black Swan are 3.6%, our probabilities are low that an out of the box incident will imminently crash the market. The stock and bond markets already experienced a traditional non-recessionary correction in the first quarter 2022 so where does that leave investors?

The next negative event will be a recession but predicting the timing is not easy. Right now, a promising idea is to diversify beyond the traditional 60/40 portfolio, dollar cost average aggressively due to increased volatility, hedge for inflation, and put any cash to work in equities during downturns.

The Fed has an incredible task, but we have been through these situations in history and the U.S. always comes out on top. The best investing days are always ahead.

Now you say you're leavin' home
'Cause you want to be alone.
Ain't it funny how you feel
When you're findin' out it's real?

Oh, to live on Sugar Mountain
With the barkers and the colored balloons,
You can't be twenty on Sugar Mountain
Though you're thinking that
you're leaving there too soon,
You're leaving there too soon.
Sugar Mountain by Neil Young

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