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# 2022 2nd Half Outlook

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**Economy:** Hollencrest now sees a meaningful risk of moderate recession in the second half of 2022 with persistent but abating inflationary pressure and has taken action to position our clients accordingly.

- Don't Fight the Fed. This is a primary mantra to which Hollencrest subscribes in forming our macroeconomic outlook, and it is exceedingly relevant in today's economic environment. The unprecedented actions taken by the Fed to support demand during pandemic lockdowns and subsequent variant outbreaks stimulated demand, driving consumption and the formation of speculative asset bubbles that approached "ponzi finance." Hollencrest, so far with success, has navigated these waters and avoided allocations to things likes SPACs and crypto while also significantly pulling back on late-stage venture investing as valuations and underwriting methodologies lost touch with reality. Fed policy must now be reversed to contain inflation that decades of supply-side efficiency and productivity growth worked to contain in the past. Economists predicting truly transitory inflation, on the argument that dovish policies coming out of the 2008 crisis didn't lead to inflation back then so they shouldn't this time either, have been proven wrong. Time will tell how sticky this bout of inflation will be, but one thing is clear: the Fed's ability to contain inflation relies solely on their ability to reduce aggregate demand within the economy through reduction of liquidity and higher rates. This is inherently contractionary and means a recession in real economic growth is likely.

- The timing and depth of this now likely recession, and the associated pain, are still unclear. Q1 of 2022 saw a negative GDP print, although many see it as a technicality driven by prior inventory builds and timing of the recordation of international trade accounts. Based on the Atlanta Fed's GDPNow predictive model, it now looks like Q1 will be joined by Q2 with another negative print. Recessions are identified by the National Bureau of Economic Research's Business Cycle Dating Committee and are subjective by definition. So, it is possible history will say a recession is already underway. If GDP declines are moderate there may not be as much pain associated with this recession as is typically felt. A more severe recession that goes beyond a moderate dip in growth would include financial distress at both the personal and corporate levels resulting in defaults, bankruptcy, and a meaningful increase in unemployment. We have not yet seen evidence of this distress. In fact, one of the characteristics of the current economy is employment strength. Recent jobs data still show about 1.8 job openings for each unemployed person, which is a dynamic that continues to fuel inflation and nominal wage growth. With higher rates, financial conditions have tightened significantly, however they have not crossed over to a level indicative of distress. We are monitoring closely for changes in this data.

- Inflation became more problematic during Q2 of 2022. Over the past 18 months, as inflation became a more popular concern, much of the surge in prices were in durable goods that were not necessarily part of everyday consumption like cars, furniture, appliances, etc. A lot of this was due to supply chain inefficiencies and the unavailability of these goods. As price increases in these big ticket items have leveled off, continued stimulus and liquidity have caused inflation to move into other categories, and in recent months everyday items like

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groceries, gas and shelter (rent) have taken over as the categories driving inflation. These purchases are far less discretionary in nature and are much more impactful on the U.S. consumer, leading to declines in real purchasing power and standards of living, particularly at low and middle income levels. These categories also impact the average consumer's ability to spend on other items, leading to further drops in overall consumption and further recessionary pressure.

- The war in Ukraine and subsequent impacts on energy markets exacerbated an already tenuous supply/demand imbalance. We regularly discuss the challenges of moving the U.S. to entirely renewable energy sources with many of our political leaders viewing this as a move that must occur immediately and at any cost. We are not convinced that the true costs associated with a quick move to renewable energy, and the related policies that force energy prices steadily higher, are costs that those same leaders and politicians can truly stomach. We expect that, eventually, market forces will overcome posturing and more production will come online to reduce price pressures and reign in this driver of inflation. Energy executives will overcome their fear of future price instability (i.e. a drop in commodity prices that would once again leave them unprofitable), likely correlated with a government shift in policy to incentivize such production as a necessity to help protect low and middle income earners. A common saying that has been thrown around a lot lately, and makes a lot of sense, is that the best solution for high commodity prices is high commodity prices. We agree.

- Although we view at least a moderate recession as likely, there is still a meaningful chance that supply side pressures could correct and long-term deflationary forces can overcome recent trends, allowing the Fed to back away from their hawkish stance and achieve their improbable escape, returning to neutral policy without triggering a recession.

**Stocks:** The downside risks Hollencrest saw at the end of Q1 began to illuminate themselves in Q2, resulting in a break below 4,000 on the S&P 500 as it closed out the quarter at 3,785 (down 20% for the year) after falling as low as 3,667 in June (down 23% for the year at the low). If the moderate recession base case unfolds, we expect new lows to be made before a new long-term uptrend begins.

- The drawdown in stocks to date is largely attributable to a reset in valuation. As the 10-year yield moved from 0.50% to 3.50% and short-term rate expectations went from 0% to 3%+, there was, suddenly, a much more attractive alternative to the stock market's volatility and low projected returns (assuming one could overcome inflation concerns long-term), and market discount rates had to adjust accordingly. Combined with reduced liquidity, this meant that valuation multiples had to come down to more reasonable levels across the entire stock market, with unprofitable companies that looked to become profitable well into the future the most intensely impacted. The fall from roughly 4,800 on the S&P to the 3,700-4,000 range can be almost entirely attributable to this reset in valuations. Some small element of this drawdown inherently includes some increase in recession risk, but we do not feel even a moderate recession is fully priced in.

- In Hollencrest's base case of moderate recession risk, the broad markets would likely return to their pre-covid levels, meaning 3,300-3,400 would be the target level for the S&P. If the market begins to price in the more painful recession scenario discussed above, the S&P would likely fall below 3,000. In these recessionary environments markets tend to overshoot, meaning a fall significantly below that 3,000 level could occur for a brief period. This would set up as an incredibly attractive oversold level that could create a long-term buying opportunity of which we must be prepared to take advantage. If the economy finds a way to avoid a moderate recession, there is a possibility lows have been set for this bear market and the S&P could return to a range of 4,200 to 4,500 by the end of 2022 with new highs possible in 2023 or 2024.

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- Given this outlook, Hollencrest has taken action to preserve client account values. Client portfolios have been positioned to take advantage of a further drop in the market scenario by reducing exposure to stocks. Small reductions in equity exposure occurred in 2021, but when the market began to roll over in January and February of 2022 our indicator deterioration caused us to raise significant cash, with target equity allocations being dropped to 75% of what would be typical, fully invested exposure to stocks and 25% of target equity exposure in cash. More cash was raised opportunistically in March, moving target equity allocations to 32.5% cash. Finally, in June, when inflation data and Fed communication began to further increase downside risk, another significant tranche of cash was raised, increasing cash to 46.5% and dropping equity exposure to 53.5% of targets. It is possible a small amount of additional cash could be raised, or additional hedges put on, in an opportunistic manner during a short-term overbought bounce, but we feel our client portfolios are positioned for the current negative environment in a way that will reduce volatility and give Hollencrest the ability to deploy meaningful dry powder as opportunities typical of a recessionary market arise.

**Bonds and Rates:** Longer-term rates may have already seen their peak after the 10-year Treasury's yield bounced off 3.50% and fell back below 3%. The Fed will continue to raise short-term target rates until inflation is contained, likely approaching 3% before being able to cut once again.

- The Fed has already moved to tighten financial conditions and the Treasury yield curve responded accordingly with rates moving higher for all maturities. As the bond market began to see the risk of slower growth with contained inflation over the long term, the upward move in yields lost momentum. If a moderate recession plays out, the long end of the yield curve may not be able to move higher than the levels seen in mid-June. It is likely the 10-year Treasury could bounce around the 3% level for a prolonged period. The Fed will have to move their short-term target rates close to parity with the long end of the curve to contain inflation.

- Credit instruments, including mortgages and corporate bonds, have seen drastic increases in yield relative to yields seen in 2021 with the move higher in risk free rates and some moderate spread widening. We expect corporate spreads to move higher in a moderate or severe recession, although to date they have not moved as high as we would have expected given macro conditions and the decline in stocks. Higher spreads would constrain corporate borrowing and produce adverse financing conditions for poor credits. The move higher in residential mortgage rates may be limited as those rates correlate to Treasuries and have already increased to levels that are reducing demand and restricting the housing market.

- The proliferation of private credit is a new dynamic in debt markets to which Hollencrest is paying close attention. Borrowers that used to rely on liquid credit markets (corporate bonds, bank loan syndications, etc.) are increasingly able to turn to private credit mega-funds with $10s of billions in dry powder as an alternative source for their debt. Private credit funds generally hold these loans on their balance sheet and market transparency into pricing and spreads is often lost. We are seeing signs that liquid market spreads may be distorted or artificially compressed by the wide availability of this alternative source of debt financing. Additionally, these private credit funds do not appear to be adequately adjusting pricing and spreads on their new originations to reflect the increased risk being posed by general economic conditions. We suspect this market may reach a tipping point, if a painful recession unfolds, where defaults increase and these lenders pull back on originations. If this does happen, the lack of visibility and transparency into these portfolios and their pricing will make it harder for the market to understand the depth of the market's deterioration.

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