Finding resilience in the Fed’s bear market

Stubborn inflation and the Fed’s resulting aggressive policy approach have narrowed the opportunity for a “softened economic landing” in the U.S.

Against this backdrop, investors seek to position their portfolios both defensively amid volatility and with resilience to inflation. Given elevated inflation, the defensive strategies used during the last economic cycle may now also be deemed suitable.

A global allocation opportunity may present itself as economies across the globe adjust to the varied phases within their own economic and policy cycles.
2022 has been a year of heightened yield volatility and disappointing price action in stocks. By the end of Q2, U.S. equities had tumbled more than 20% off their peak and entered a bear market. We ascribe this volatility to two major factors: a more aggressive Fed policy response to inflation and related concerns about recession. While each comes with its own asset allocation implications, positioning is complicated by two factors. First, peak hawkishness and recession are not singular events; they are likely to have both immediate and gradual impacts on the real economy, markets, and sentiment. Second, both are only identifiable in hindsight.

In the meantime, it may feel like there is no place to hide in capital markets—yet maintaining a diversified asset allocation remains critical for long-term wealth preservation for the majority of investors. In this piece, we explore how best to allocate amid economic uncertainty and market volatility in the coming months and quarters.
**Peak hawkishness: Still room to run**

Until the May consumer price inflation (CPI) report was released, the market appeared hopeful that inflation had peaked, as rate-hike expectations had leveled out for the better part of two months. Investors were hoping that “peak hawkishness,” or the point at which future rate expectations are at their most elevated, was moving behind us. But when May’s CPI delivered 8.6% year-on-year, Fed hawkishness struck the market yet again. Within just three market sessions, the year-end implied Federal Funds rate increased to over 3.5%, the U.S. 10-year yield spiked to nearly 3.5%, volatility spiked by over 25%, equities fell by 7%, and bonds lost 3%.

**Hawkish changes in market expectations for Fed policy...**

...have been major drivers of volatility in both stocks and bonds

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Sources: New York Life Investments’ Multi-Asset Solutions team, Bloomberg Finance LP, July 2022. The End-2022 Fed Funds Rate is implied by Federal Funds Futures. Past performance is not a guarantee of future results. It is not possible to invest directly in an index. Index definitions can be found at the end of this report.

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Why do changes in interest-rate expectations jostle the market so pervasively? Higher expected interest rates impact bond market pricing; they result in a higher discount rate for equities, creating a drag on stock prices; and, over time, they contribute to slower economic growth, impacting earnings for both stock and bond issuers alike. This is why the narrative around “peak hawkishness” matters so much: as long as interest-rate uncertainty prevails, so too will market volatility.

We still believe inflation, and therefore interest-rate expectations, will peak this year, both because economic capacity is improving and because the Fed is highly focused on making it so. But timing is everything when it comes to the economy and markets. If the next months’ data do not show signs of stabilization—and in our view food, energy, and shelter prices are at real risk of staying elevated—investors should expect more volatility across asset classes.

How to identify peak hawkishness

How to Allocate

What it means for allocation

Much of the upward move in interest rates is likely behind us, but that doesn’t mean the market pain is over. It could be a couple of months before interest-rate expectations truly stabilize. Until then, the biggest risk we see to portfolios is an attempt to time this market by making wholesale rotations away from risk assets as fear takes hold. Therefore, we encourage clients to stay invested in well-diversified portfolios.
Recession: Not yet driving asset allocation

As inflation marches stubbornly higher, the opportunity for the Fed to achieve a “soft landing”—slowing the economy to contain inflation without causing recession—has narrowed considerably. Bearish price action in stocks has only compounded fears of recession, and various surveys suggest Americans are worried about a recession, even in 2022.

Our models, which use a large number of economic indicators to identify patterns from historical recessions, suggest the risk of recession is material in the coming 12 months. However, that risk is considerably greater for the coming 24-month period; the probability of recession rises for the second half of 2023 and first half of 2024.

Too early to position for recession

Per our team’s model, recession risk is 40% for the 12 months ahead, rising to 70% on a 24-month time horizon.

Source: New York Life Investments’ Multi-Asset Solutions team proprietary model-based estimations, July 2022. These recession risk estimates are generated from the team’s machine-learning model, based on recognizing patterns in a large number of economic indicators around historical recessions. These include the labor market, business/manufacturing activity, oil prices, and corporate earnings, among others. For illustrative purposes only. Past performance is not a guarantee of future results.
How to identify a recession

What it means for allocation

Though it may be tempting to make allocation shifts well in advance of a recession, we believe it is far too early to do so. In our Q2 Outlook, we shared why growth should hold up this year, and we believe this thesis still holds: post-pandemic reopening is still underway as services spending picks up, and the strong labor market continues to support consumers.

That said, this environment is increasingly likely to challenge the real economy, consumers, and investors. Nominal growth may very well be high, but high inflation will feel burdensome to household and business spending decisions. In other words, a “stagflation-like” backdrop is likely. This creates a fine needle to thread with positioning, which must be sufficiently risk-on to achieve returns that can match inflation, but also be sufficiently resilient to growth pressures (see “Resilient multi-asset approaches” section).

In the coming months, we will be monitoring economic activity and recession risk not just in the U.S., but globally, to help us determine a critical component of recession-era allocation: U.S. vs global. In a global recession, investors have tended to flock to the safety of the U.S., with dollar-denominated assets benefiting. However, if the Fed fails to achieve a soft landing, and the U.S. enters a recession, other regions may be less affected, pointing us to a more global allocation.
A global perspective

During the pandemic and recovery in 2020 and 2021, driving economic forces were primarily global in nature. Most major regions faced synchronized economic contraction in 2020—met with meaningful fiscal and monetary policy stimulus—and a less synchronized, though directionally harmonious recovery period in 2021. The major exception to this has been China, which was first-in and first-out of the early COVID-19 waves, did not experience an economic contraction in 2020, and is now quite countercyclical to the U.S.

As the post-pandemic recovery matures, we see organic economic cycles and monetary policy adjustments taking hold, resulting in disparate asset-allocation takeaways by region. Investing with a global, multi-asset approach to investing may overexpose or underexpose the portfolio to certain geographies and currencies relative to peers or benchmarks. To manage this risk, investors can consider approaches that include top-down allocation.

The global economic cycle: Major countries and regions face disharmonious economic growth dynamics and policy approaches

Source: New York Life Investments’ Multi-Asset Solutions team, July 2022. For illustrative purposes only.

Our Global Asset Allocation Views

Source: New York Life Investments’ Multi-Asset Solutions team, July 2022. For illustrative purposes only.
Resilient multi-asset approaches for a more volatile, high-inflation environment

In periods of market stress, investors may feel inclined to seek shelter in traditionally “safe-haven” asset classes such as cash, high-grade bonds, or Treasuries. However, these defensive positions are inappropriate for most investors when inflation is high, as they may cause investors to miss out on dividends and yield. Today’s economic backdrop of strong but slowing growth, paired with a meaningful pullback in policy support, do merit some level of defensive positioning. But defensiveness looks different in today’s environment. Investors need to defend against volatility in equities and yields, while also seeking resilience to high inflation.

Defensiveness Amid Volatility
Approach #1: Value equity overweight

Growth equity, despite falling 30% year-to-date, remains relatively expensive compared to value equities. What’s more, growth equities face two sources of ongoing pressure. First, rising interest rates are likely to continue to weigh on valuations. Second, during COVID-19, years’ worth of earnings and corporate growth expectations were pulled forward under the assumption that stay-at-home trends were permanent (see below). Growth equities may face a reckoning regarding these earnings expectations in the months ahead.

We remain overweight value within U.S. equities. Defensive sectors such as real estate, utilities, consumer staples, and health care have become expensive, but should offer the most resilient earnings.

Growth equities had earnings expectations pulled forward in the COVID-19 recovery...

...but value equities now see stronger earnings growth and earnings momentum on a go-forward basis

Sources: New York Life Investments’ Multi-Asset Solutions team, Bloomberg Finance LP, July 2022. Past performance is not a guarantee of future results. It is not possible to invest directly in an index. Index definitions can be found at the end of this report.
**Approach #2: Quality across asset classes**

A quality lens can be applied to a variety of equity and fixed-income positions. In equities, higher profitability, lower earnings variability, and lower leverage are key markers of relatively high quality, with lower leverage particularly beneficial with borrowing costs rising. As an example, the S&P 600 Small Cap Index displays all of these characteristics versus the Russell 2000 Small Cap Index, and has outperformed since the start of 2021 (below). Earnings stability can point to a high and stable dividend-payout ratio, providing income potential to offset inflation even when market price action is bearish.

**In small-cap U.S. equities, quality has benefited performance**

![Graph](image)

Sources: New York Life Investments’ Multi-Asset Solutions team, MacKay Shields, Bloomberg Finance LP, S&P Ratings, Fitch Ratings, July 2022. Past performance is not a guarantee of future results. It is not possible to invest directly in an index. Index definitions can be found at the end of this report.

In fixed income, we have focused a lot on interest rates because interest-rate sensitivity, or duration, drives valuations to a considerable degree as rate expectations fluctuate. But as the economy slows, considering credit quality becomes just as important to ensure cash flows are not imperiled by default risk. So far in this economic cycle, credit quality has been very strong. The combination of low default rates—just 1% for high yield, per Fitch Ratings—and the shorter-than-average duration of the asset class have driven our overweight to high yield bonds. Looking ahead, we expect defaults to remain moderate despite a slowdown in growth. This is in part because recent high yield issuance has been concentrated in the BB-rated segment, implying lower credit risk. We welcome this relatively higher-quality bent within high yield for the sake of portfolio resilience; such positioning delivers short-duration exposure without worrying default risk. Consider strategies with a lower allocation to more vulnerable CCC-rated issuances.

**High yield, though sub-investment grade as a whole, tends toward the highest-quality issuance in its asset class (BB credit ratings); the credit risk outlook for high yield remains healthy**

*ICE BofA U.S. High Yield Index composition, by credit rating*

**Approach #3: Mindful rebalancing**

Market volatility can prompt investor fears, which can also prompt asset sales when the markets are low. However, this human instinct stands in stark contrast to investment best practice: due to the difficulty of timing the market, it is necessary to stay invested to fully benefit from recoveries when they occur. When risk asset prices have suffered, we encourage the use of dollar-cost averaging or a similar mindful rebalancing approach for those whose investment time horizon allows.
Building portfolio resiliency does not mean avoiding inflation sensitivity entirely, particularly when it comes to a major driver of today’s inflation: energy. The increase in economic activity and resource demand in the post-pandemic recovery, paired with the supply-side shock from Russia’s war on Ukraine and resulting sanctions, provide near-term support for commodity and energy prices. The structural story in favor of energy investment is also crystallizing, as decades of underinvestment in both traditional and renewable energy capacity may contribute to setting a “floor” under prices in the coming years. Diversified upstream and downstream resource-equity strategies, both in the U.S. and globally—with overweights to energy and materials sectors, which include oil, metals, and agriculture—could benefit.

Commodities are more likely to offer shelter from stock volatility in times of inflation

During the episodes of 10%+ total return drawdowns in the S&P 500 below, commodities have provided more of a “hedge” against stock market volatility in higher-inflation environments, such as the 1970s and 2000-2007. In the period of sustained low inflation after the Global Financial Crisis, commodities offered no respite when the stock market suffered.

Source: New York Life Investments’ Multi-Asset Solutions team, July 2022. The team has identified periods of 10% or larger drawdown in the total return of the S&P 500 Index, including the reinvestment of dividends. Commodity returns match to the period of each drawdown. Past performance is not a guarantee of future results. It is not possible to invest directly in an index. Index definitions can be found at the end of this report.
**Approach #2: Floating Rate Bonds**

By their nature, floating rate bonds (bank loans) benefit from rising interest rates. In our view, these bonds may offer the best of both worlds: their floating rate capacity makes them less sensitive to interest-rate risk, and, because bank loans are typically secured with collateral, they tend to have less credit risk as well.

Floating rate bonds have delivered positive returns in all but two of the past 30 years (2008 and 2015), amounting to an annualized return of 5.5%

*Annual return of the Credit Suisse Leveraged Loan Total Return Index, %*

Sources: New York Life Investments’ Multi-Asset Solutions team, MacKay Shields, Bloomberg Finance LP, July 2022. Past performance is not a guarantee of future results. It is not possible to invest directly in an index. Index definitions can be found at the end of this report.

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**Approach #3: Infrastructure**

Though we favor short-duration exposure within fixed income until Fed hawkishness peaks, some amount of core bond exposure usually has a permanent place in portfolios. Infrastructure bonds can be a convenient diversifier of core bond exposure. For example, allocating 25% of core bond exposure to infrastructure would leave 25% each in Treasuries, mortgage-backed securities, and investment-grade corporate bonds. In a traditional 60/40 portfolio, this would appear as a 10% allocation to each of these four fixed-income strategies.

We also like infrastructure equities, which can provide cash flows linked to inflation. In contrast to the U.S. housing market, where higher mortgage rates are beginning to pressure new home sales, listed infrastructure can be more stable in the face of higher interest rates due to the long-term nature of infrastructure projects, and, in many cases, inflation protection built into contracts.
The Multi-Asset Solutions team is New York Life Investments’ specialist in multi-asset investing. The team leverages the depth and breadth of New York Life Investments’ platform to seek to deliver strong investment opportunities across multi-asset strategies, market intelligence and insights, and customized solutions to its strategic partners.
INDEX DEFINITIONS

The S&P 500 Index measures the performance of 500 U.S. listed large-cap companies. The total return of this index includes the reinvestment of dividends in addition to price performance.

The S&P 500 Growth Index measures the performance of companies from the S&P 500 that fit Growth style characteristics of valuation and earnings.

The S&P 500 Value Index measures the performance of companies from the S&P 500 that fit Value style characteristics of valuation and earnings.

Bloomberg Commodity Total Return Index is composed of futures contracts and reflects the returns on a fully collateralized investment in the Bloomberg Commodity Index, which broadly reflects futures price movements of major commodities in energy, materials, and agriculture.

The S&P 600 Small Cap Index measures 600 U.S. stocks with small market capitalization.

The Russell 2000 Small Cap Index is comprised of the smallest 2000 U.S. companies of the Russell 3000 index.

The Bloomberg U.S. Aggregate Bond Total Return Index measures the performance of publicly issued U.S. dollar-denominated investment-grade debt, including the reinvestment of coupons.

The Inter-Continental Exchange (ICE) Bank of America (BofA) U.S. High Yield Index tracks the performance of U.S.dollar-denominated, below-investment-grade-rated, corporate debt publicly issued in the U.S. domestic market.

The Credit Suisse Leveraged Loan Total Return Index tracks the investable market of the U.S. dollar-denominated leveraged loan market, including the reinvestment of coupon payments.

Treasury Inflation-Protected Securities (TIPS) are Treasury bonds indexed to an inflationary gauge to protect investors from the decline in the purchasing power of their money.

The Chicago Board Options Exchange (CBOE) Volatility Index (VIX) is a calculation designed to produce a measure of constant, 30-day expected volatility of the U.S. stock market, derived from real-time, mid-quote prices of S&P 500 Index call and put options.

The 10- and 30-year AAA Tax Exempt Muni Yields are based on Bloomberg’s baseline curve for tax-exempt municipal bonds, populated with U.S. municipals with an average rating of AAA from Moody’s and S&P.

The 30-year U.S. Treasury Yield is the average of yield paid on actively traded U.S. Treasury bonds with 30-year maturity.

The 10-year U.S. Treasury Yield is the average of yield paid on actively traded U.S. Treasury bonds with 10-year maturity.

The 10-year Real U.S. Treasury Yield subtracts the average expected inflation over the coming 10-year period.

The 5-year U.S. Treasury Yield is the average of yield paid on actively traded U.S. Treasury bonds with 5-year maturity.

The 5-year Real U.S. Treasury Yield subtracts the average expected inflation over the coming 5-year period.

The Federal Funds Rate is the rate banks charge each other for overnight unsecured loan of reserves on deposit with the U.S. Federal Reserve. It is the effective policy interest rate for the Federal Reserve.

Federal Funds Futures are financial futures contracts based on the federal funds rate and traded on the Chicago Mercantile Exchange.

The Purchasing Managers’ Index (PMI) is an economic sentiment indicator, from a survey-based index of the prevailing direction of economic trends in the manufacturing and service sectors.
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