The Conservative Strategist

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The Fed is behind the curve. Hopelessly far behind.

This season brought the not-unexpected news that Teslas can't drive themselves. Documents reveal hundreds of crashes from malfunctions of the so-called driver-assist technology.

Our economy, too, has fallen out of self-driving mode. Years of low inflation, low interest rates, and steadily rising stock prices have been interrupted by a pandemic, a global shutdown, a war in eastern Europe and accompanying supply chain shortages.

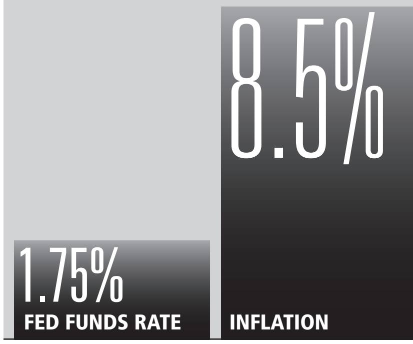
Our leaders, who simply chose to hold the wheel for years as the economy seemed to drive itself, have since found themselves navigating ever-tougher terrain, pop-up obstacles, and now sudden acceleration (in prices).

The strain seems to be showing. On Sunday, June 19, Treasury Secretary Janet Yellen said a recession was "not at all inevitable". Two days later, Fed Chairman Jerome Powell told a Senate Finance Committee that recession is "certainly a possibility". Then he said it again.

This lack of consistent messaging is certainly not doing much to give business leaders and investors a sense that the Fed is in control.

Unless all the problems in the second paragraph above fix themselves quickly and comprehensively, the Fed is going to have to continue to apply the brakes. June's 0.75 point raise in the short-term lending rate is constructive, but as the accompanying graphic shows, the Fed is far behind the curve this time.

Rates need to rise further



"When inflation exceeds 5%, there has never been an instance of inflation coming back down without the Fed Funds Rate being raised above the inflation rate… If you're predicting a soft landing, it's going against decades of history.

— Stanley Druckenmiller, June 9, 2022

Inflation may moderate somewhat as business slows down — and it's already slowing. Consumer sentiment has plummeted to an all-time low (yes, lower than during the early pandemic (2020), or even the Great Financial Crisis (2007-2009)). Much depends on what level it moderates to.

But it's likely that if inflation doesn't fall to 5% or lower by early next year, interest rates will have to be hiked much further to get it under control. We may be in for a series of three-quarter or even one-percent rate hikes. Hitting the brakes that hard always raises accident risk.

None of this bodes well for US stock and bond markets that already have suffered their worst first-half on record, yet still register well above historical averages.

It's likely there is more pain to come. We continue to maintain below-benchmark risk in our portfolios. ■

The Markets June 30, 2022	Price/Yield	Gain, Qtr	Gain, YTD
US Stocks (S&P 500/Vanguard Index)	3785.38	-16.13%	-20.02%
International Stocks (Vanguard Index)	16.52	-12.85%	-18.19%
Emerging Markets Stocks (Vanguard Index)	26.33	-9.24%	-14.94%
Real Estate Stocks (Vanguard REIT Index)	30.26	-15.48%	-20.56%
Bonds (30 year US Treasury/Vanguard Index)	3.14%	-12.25%	-21.20%
Dollar (US Dollar Index)	104.69	6.49%	9.09%
Gold (London Afternoon Fix)	$1817.75	-6.41%	0.66%
Money Market Funds (Vanguard Federal - VMFXX)	1.39%	0.12%	0.17%*

*change in yield

Portfolio Planning

Private credit a safe haven and effective diversifier

We wrote about the opportunity in private markets in the summer of 2021, and identified our then recent acquisitions of *Versus Real Assets* (VCRRX; private infrastructure, real estate, farmland and tim-berland) and *Variant Alternative Income* (NICHX; private credit) as excellent lower-risk diversifiers.

This evaluation seems to be vindicated by the action of the past 18 months that we've held these funds. Look at the stock market. From January 1, 2021 to June 16, 2022, the S&P total return is precisely flat and has exhibited huge volatility. Bonds have fared even worse. *Vanguard Total Bond Market* is down at a 9.25% annual rate as rates have risen.

Bigtime outperformance

Meanwhile, VCRRX is up at a 6.83% annual rate as its inflation-sensitive assets have benefited. And NICHX has risen at an 11.06% annual rate as it has found much demand for its loans amidst corporate supply chain issues.

Just as importantly, these returns were achieved with lower risk than either the stock or bond markets. VCRRX exhibited a standard deviation roughly one-fifth that of the S&P. NICHX did not suffer even a down month over the period.

Finally, both funds showed very low correlation to mainstream stocks and bonds. For instance, with 1.00 representing perfect correlation and 0.00 perfect non-correlation, NICHX exhibited a correlation of just 0.06 with the S&P 500 and 0.24 with the *Bloomberg Barclays Aggregate Bond Index.*

A newer addition and two more on their way

Given the above advantages in a bear market, we are adding to our position in private assets with a focus on private credit funds. In the last two quarters, we added *First Eagle Credit Opportunities* (FECRX), a private credit interval fund with somewhat more mainstream holdings than NICHX.

Direct lending beats high yield and leveraged loans

CDLI *vs.* Bloomberg High Yield Index and S&P/LSTA Leveraged Loan Index
By calendar year, 2005-2021

Calendar Year	CDLI	Bloomberg High Yield Bond Index	S&P/LSTA Leveraged Loan Index
2005	10.10%	2.74%	5.06%
2006	13.70%	11.87%	6.74%
2007	10.23%	1.88%	2.08%
2008	-6.50%	-26.15%	-29.10%%
2009	13.18%	58.21%	51.62%
2010	15.79%	15.11%	10.13%
2011	9.75%	4.98%	1.51%
2112	14.03%	15.81%	9.67%
2013	12.68%	7.46%	5.29%
2014	9.57%	2.46%	1.59%
2015	5.54%	-4.46%	-0.70%
2016	11.24%	17.14%	10.11%
2017	8.62%	7.50%	4.14%
2018	8.07%	-2.08%	0.46%
2019	9.00%	14.20%	8.65%
2020	5.45%	7.11%	3.12%
2021	12.78%	5.28%	5.20%

The CDLI index of private credit has beaten its counterparts in 12 of 17 years, with much lower risk. CDLI has suffered only one down year in that period, 2008. Its 6.50% decline that year was less than one-quarter that of the other asset classes. *Source: Cliffwater*

We have also done our due diligence on the Cliffwater organization and we're impressed with their team, experience and track record. We intend to add the *Cliffwater Corporate Lending Fund* (CCLFX) and the *Cliffwater Enhanced Lending Fund* (CELFX) in coming weeks and months. CCLFX is the more mainstream of the two, similar to FECRX, while CELFX allocates to alternative credit vehicles, similar to NICHX.

Interval funds a better mousetrap

All of the above funds are interval funds. These are structured like most mutual funds with daily NAVs reported, but one difference: They limit aggregate quarterly withdrawals to 5%-25% of the total amount of fund assets. This way, they can stay invested in relatively illiquid loans without fear that sudden major redemptions from the fund will force them to sell into a sagging market.

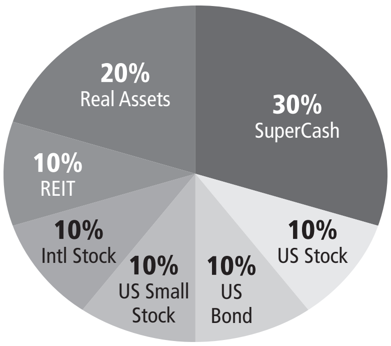
We think this structure benefits all holders, and allows them to own assets that provide a so-called *illiquidity premium* that's been well-documented by both academic literature and performance tracking.

Given that we expect rough investment seas for some time, we intend to boost our allocation to private assets in the form of interval funds from the current average 10% of our client portfolio to closer to 25%. This remains well below the level of many top-performing endowment funds. According to *Blackrock*, the average endowment now holds 30% of its portfolio in private assets, and some are as high as 40% to 50%. ■

SuperDiversified Portfolios (SDPs)

Worst first half ever for classic 60/40 mix

SDP1 ***Conservative***

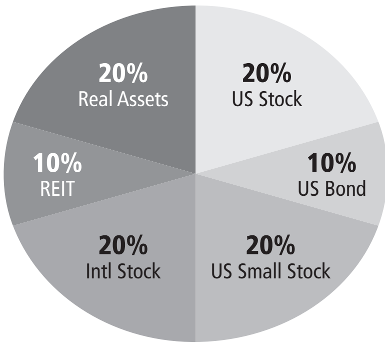


2nd Quarter **-9.04%**

*Year-to-Date** **9.99%**

The traditional asset allocation of 60% US stocks/40% US bonds is enduring a record bad first half, down 17% as of mid-June. You don't usually see stocks and bonds dropping sharply at the same time, but that's what sudden inflation has wrought.

SDP2 ***Moderate***



2nd Quarter **-8.13%**

*Year-to-Date** **-8.70%**

Inflation forces interest rates higher as lenders scramble to earn a real return. Meanwhile, higher prices make consumers pull back, which tanks earnings forecasts, hitting stock prices. Our models have fared substantially better than the 60/40 standard.

The above model portfolios are not intended to indicate the performance of any real account, but reflect the composite performance, before fees, of the percentage allocations in the asset classes and funds listed in the table below. Seasonal Strategy's actual allocations vary from these models, and among portfolios. **Reflects revision of Q1 data.*

How the Sectors Performed

Real Assets, SuperCash cushion the blow

Asset Class	Mutual Fund	Performance 2nd Quarter '22	Performance Year-to-Date	
SuperCash	PIMCO Instl Low Duration	-1.56%	-4.44%	Best
	Merger	-1.78%	-1.61%	Worst
	Calamos Market Neutral	-5.77%	-7.05%	
US Stock	Vanguard Index Trust 500	-16.13%	-20.02%	
US Bond	Vanguard Long-Treasury	-12.25%	-21.20%	
US Small Stock	Vanguard Small-Cap Index	-16.90%	-21.70%	
Intl Stock	Vanguard Intl Index	-12.85%	-18.19%	
REIT	Vanguard REIT Index	-15.48%	-20.56%	
Real Assets	PIMCO Commodity Real Return	-7.65%	14.70%	

A major part of our outperformance this year has come from the lower volatility of the SuperCash allocation (as well as Cash reserves), and the contra-trend strength in Real Assets, buoyed by rising inflation. However, in the last half of June, we saw weakness even in these areas.

Our real assets benchmark *PIMCO Commodity Total Return*, for instance, up more than 30% in Q1, rose another 10% into mid-June. But as preoccupation with inflation gave way to fears from Fed tightening, the fund lost 13% in a hurry and is finishing down for the quarter.

Why private credit?

Private credit generally refers to non-bank lending to smaller and mid-size companies. Since the Great Financial Crisis and the resulting regulation, banks have retreated from private credit, replaced by private lenders such as Business Development Companies (BDCs), both public and private. For investors, it offers several advantages.

Bespoke nature

In private debt, we align with the *manufacturers of custom credit.* The *manufacture* part is good because the creator of debt can dictate terms that govern the security of repayment. That means stricter covenants. The custom part is good because by tailoring the credit to borrowers, the manufacturer of credit can garner a higher rate, earn an origination fee, even participate in an equity kicker on occasion.

Short, senior and floating

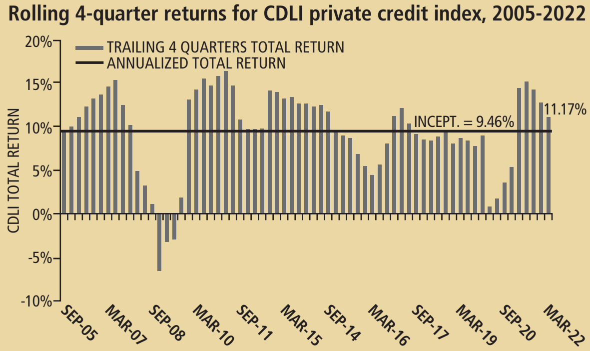
In the funds in which we invest, the majority of private loans are 3 to 5 years in duration and constantly rolling over. Most are senior in the capital structure and so have preference over public debt including high-yield bonds, resulting in low default rates and high recovery rates in the unlikely instance of default. Finally, the great majority of private loans are floating rate, and so rise in yield with rising interest rates.

Protection from sentiment swings

Finally, because the debt is not publicly listed, it is not subject to the swings of fear and greed that accompany bonds in times of rising rates (inflation) or deteriorating credit (recession). This lower volatility improves risk-adjusted return.

Held for even one year, private credit returns have been consistently solid

Rolling 4-quarter returns for CDLI private credit index, 2005-2022



In the 70 rolling four quarter periods since 2005, private credit as measured by the CDLI has been negative in only three quarters, while returning an average 9.46%. The three down quarters all occurred during the Great Financial Crisis (2008) and were quickly followed by some of the highest returns in the span. Note, too, that returns did not go negative during the 2020 business shutdown. These were the two great credit stressors of the past 20 years.

Source: Cliffwater

SEASONAL STRATEGY

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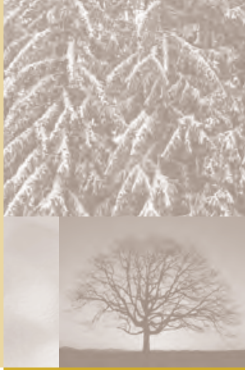


A view on the Fed's resolve

Yes, the Fed is finally getting serious about tightening. Its three-quarter point June increase in its target short-term lending rate, Fed Funds, was the sharpest hike in nearly 30 years. The chart on this page puts that hike into perspective. With apologies to the late Karen Carpenter, the Fed may have only just begun.

1981: Volcker's tough medicine

The last time inflation was at current levels (8.6%) was December 1981. That year, the Fed Funds rate traded as high as 22.36% and the prime lending rate 21%, all-time highs. Paul Volcker was the Fed chair, and he was deliberately keeping short-term rates high to induce a brief, sharp recession and "wring inflation out of the system."

Volcker took a lot of flack for his action. "Wanted" posters blamed him for murdering small business. Farmers dumped tons of unsold product outside his office. There were dozens of calls for his firing.

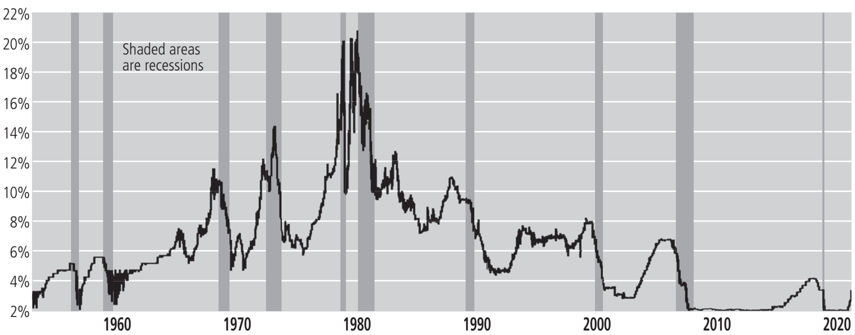
Volcker's hikes led to two rolling recessions. But months after the end of the second one, in August 1982, the greatest bull market ever was born. Volcker succeeded through tough medicine that ignored public opinion and the short-term thinking of investors and businesspeople.

In short, Volcker was a leader and made tough, unpopular decisions that led our economy back to longer-term vitality.

2022: Powell's tepid response

That contrarianism seems to be missing today. Powell and the other Fed members have acted less like leaders than followers — following the data, following consumer sentiment, following the markets. The lack of pre-emptive tightening leaves them with fewer choices as the twin influences of the pandemic and the war in Ukraine create a perfect inflationary storm. Recall that as recently as 2020, the Fed maintained that they were not even *"thinking about thinking about raising rates"* — a complacency we noted as dangerous at the time. Remember the word *'transitory'* the Fed used to describe inflation as recently as 2021? Inflation rose to the high sixes before the Fed *'retired'* the word.

Fed Funds rate, the very long-term picture (1954-2022)



A 40-year secular decline in the Fed Funds rate ended just a matter of months ago at the zero bound. In June, the Fed raised its Fed Funds target rate from 1.00% to 1.75%. But note that Fed Funds reached nearly 5½ percent in 2006 (when inflation averaged 3.23%), nearly 8% in 1996 (2.93% inflation), and briefly (not shown on chart), 14% and change in 1987 (3.66% inflation).

Source: Federal Reserve

It was not until March of 2022, with inflation in the eights, that the Fed raised interest rates — a quarter-point to 1.00%. Now the Fed wants to raise rates to an arbitrarily-determined "neutral level" of roughly 3% — with inflation at 8.5%! Hedge fund manager David Einhorn refers to the move as "like trying to clear your snow-covered driveway with an ice-cream scooper."

It's difficult to gauge just how high rates must now rise, since as they do, they should begin to have a quelling effect on business activity and inflation. The interaction of the two is dynamic and somewhat unpredictable.

But Einhorn, speaking at the Ira Sohn investment conference on June 9, offers a candid historical take:

It is Monetary Policy 101 that to defeat inflation you need positive real interest rates. In 1980, Volcker raised rates to 19% to combat 14% inflation. In 1990, Greenspan raised rates to 8 ½% to fight 6% inflation. Even (Arthur) Burns raised Federal Funds to 13% in 1974 to fight 11½% inflation, but retreated too quickly to get the job done. Today we have the most negative real interest rates in the last 70 years. The idea that tightening a percent or two from here will beat inflation is hardly credible.

The Fed says they have powerful tools to combat inflation, while their counterparts at the Bank of England maintains that 80% of the inflationary problem is out of their control.

In short, Einhorn thinks the Fed is bluffing. And we agree.

Einhorn's favorite asset class amidst the Fed's dilemma is also one of ours: Gold. ■