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ALLOCATOR'S ANGLE

A Quarterly Newsletter from ***IOR**isk Aware*

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SUMMARY IN BRIEF

- Amid a uniquely fraught geopolitical backdrop, we continue to see signs that US Economic growth is slowing. In light of this observation, investors might look to favor defensive themes such as low-Beta strategies and counter-cyclicals.
- Additionally, cross-asset correlations appear to be breaking down, suggesting that diversification may no longer afford the same benefits. Often correlations move toward '1' during periods of downside volatility suggesting that allocators might want to consider a more defensive portfolio structure, including holding cash in the upper range of policy targets. Allocators accepting the low or even no return from holding cash in the short-term, may benefit from decreased portfolio volatility and might have the chance to deploy capital at a more opportune time.

CIO OUTLOOK:

SUMMARY

Allocators that have been overweight risk assets have been rewarded since the March 2020 lows, but now may be time to crystalize these excess returns by rebalancing risk assets back towards policy targets.

After a blockbuster year for risk assets in 2021, many institutional allocators are contemplating the decision to trim or reduce their risk asset exposure, which has likely risen above policy targets. Rebalancing a portfolio, or adjusting portfolio weights, is one of the most impactful decisions that CIOs make; however, most of us make these moves absent specific data to support our choices.

IOR's data-driven framework aims to reduce subjectivity and provide CIO's the situational awareness needed make appropriate and effective rebalancing decisions. Specifically, we draw upon a robust data set and trend lines to help us observe statistical outliers that often precede market inflections.

In this edition of ***Allocator's Angle***, we share observations of five indicators with statistical relevance, including four that are flashing warning signs for an economic slowdown or deceleration (Beta factor, Credit Spreads, Consumer Confidence, and a significant dislocation in Commodities vs. Financial Conditions). We also share an observation of our proprietary 'Turbulence Indicator', which appears to be cautioning investors to expect higher portfolio volatility.

As we explain below, these data points taken collectively suggest that allocators may want to consider the rebalancing decision with a close eye towards downside risks.

If you're an allocator facing a problem that may benefit from a data-driven approach, we'd love to hear from you. Please drop us a line at info@investmentofficeresources.com and we may discuss it in a future edition of ***Allocator's Angle***.

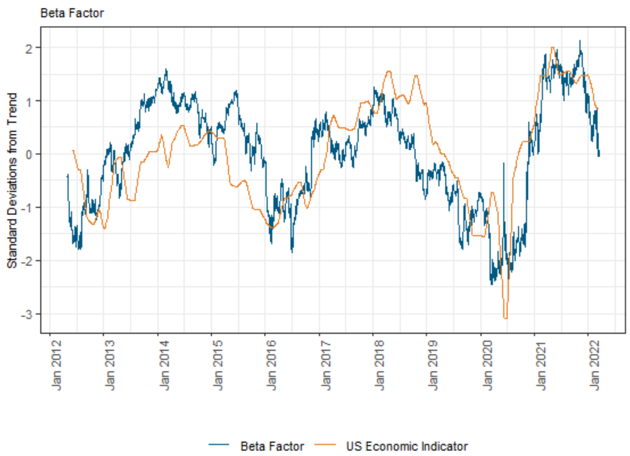
ONGOING ECONOMIC SLOWDOWN:

In our prior report we discussed mounting evidence that economic momentum had peaked, and we were entering a period of slower, but positive, growth. In the months since then we've seen leading economic indicators, including the ISM Manufacturing PMI, continue their decline from multi-year highs.

As growth continues to decelerate, the question becomes, how long can this slowdown persist, and when might we expect a rebound?

To answer these questions, we look to the internals of the stock market, which Stan Druckenmiller termed "the best economist I know and which I've used every cycle when I've invested"[1]. **Exhibit 1** below plots the Beta factor vs our US Economic Indicator – both lines are de-trended and z-scored to enable apples to apples comparisons. Right now, the Beta factor appears to be discounting a more pronounced economic slowdown. In fact, the current pricing is consistent with the US Manufacturing PMI falling to 55 in the coming months. This is hardly alarming, but it suggests we are unlikely to see growth sustainably re-accelerate soon.

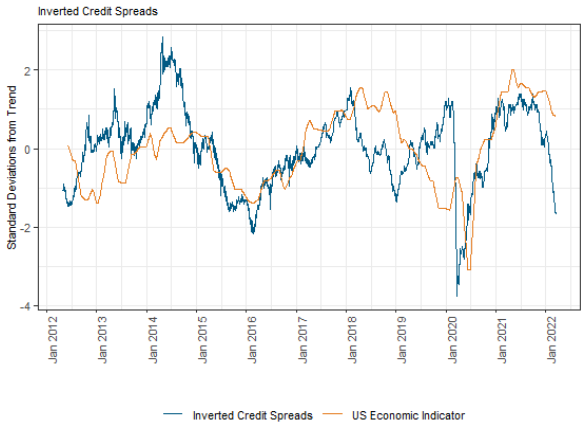
Exhibit 1*: Stocks Discounting Continued Economic Slowdown



*Source: Bloomberg, Investment Office Resources calculations as of 15 March 2022
1 "Druckenmiller warns that the stock market is one big 'mirage' right now" www.marketwatch.com 12/18/18

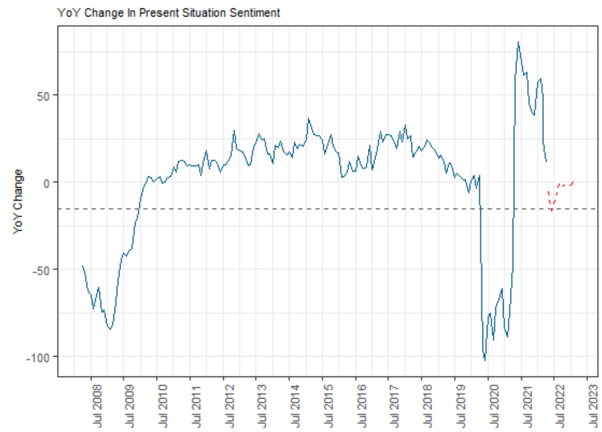
Credit Markets appear to be discounting a more pronounced economic slowdown. **Exhibit 2** plots Credit Spreads (inverted) vs our US Economic Indicator. The two lines are more than 2 standard-deviations apart – this is a statistically significant dislocation that suggests credit investors are turning more pessimistic on economic growth prospects. In fact, we'd estimate that credit markets are discounting an ISM Manufacturing PMI near 50, the level that separates economic expansion from economic contraction.

Exhibit 2*: Credit Markets Imply a More Pronounced Slowdown



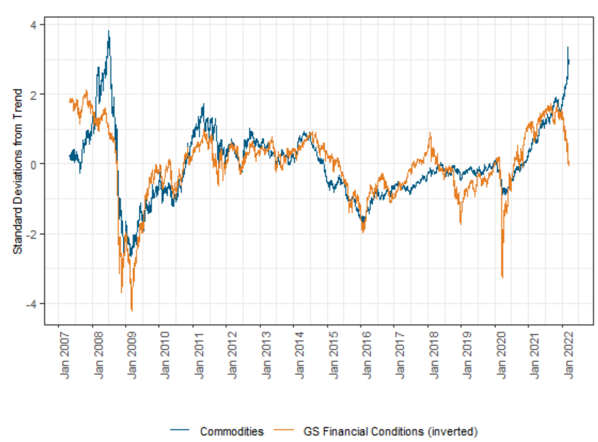
Several macroeconomic indicators are also pointing to signs of trouble. Among them is the YoY Change in the Conference Board Consumer Confidence Present Situation Index. Historically, when a decline of -15 points has happened year over year, it has preceded a recession by 2-3 months. **Exhibit 3** plots the historical YoY Change in the Present Situation Index, and the projected YoY Change if the Present Situation Index remains unchanged from the February reading. This chart suggests that if consumer confidence does not meaningfully improve, the YoY change will be dangerously close to the recession threshold by June 2022.

Exhibit 3*: Early Signs of Trouble Ahead



While the preponderance of evidence points to continued economic deceleration, there is one asset class that appears to be discounting vastly different economic conditions. **Exhibit 4** plots the Bloomberg Commodity Index vs the Goldman Sachs Financial Conditions Index (inverted) – again, both series are de-trended and z-scored to enable apples to apples comparisons. As of March 15, the difference between these two lines is 2.8 standard deviations. A dislocation of this magnitude is not without precedent; in fact, the dislocation between these two lines peaked at 3.0 standard deviations on July 2, 2008. While we are not anticipating another Financial Crisis, the current investment landscape appears uniquely fraught. As stewards of capital our objective is to protect assets when we spot headwinds. Given the current headwinds, we continue to favor defensive themes including low-Beta and counter-cyclicals.

Exhibit 4*: A Historic Dislocation



*Source: Bloomberg, Investment Office Resources calculations as of 15 March 2022

NO FREE LUNCH:

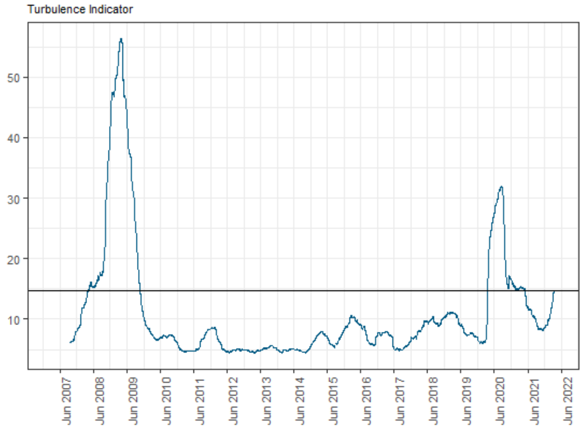
It is often said that diversification is the only free lunch in investing.[2] This saying, attributed to Harry Markowitz, is a useful rule of thumb for institutional allocators, but like any rule of thumb, this isn't strictly applicable to all situations. Asset class correlations tend to be unstable, and portfolios that rely on historical volatility and correlation assumptions may be vulnerable to episodic shocks whereby diversification does not afford the same benefits.

To help address the common (and justified) concern that asset class correlations are unstable and tend to break down in periods of market stress, we introduce our proprietary 'Turbulence Indicator', which measures the extent to which asset price movements violate the prevailing correlation structure (the convergence of uncorrelated assets). Elevated financial turbulence often coincides with bouts of market volatility when diversification may fail to provide adequate levels of portfolio protection. While anticipating periods of financial turbulence may be challenging, turbulence is persistent – once correlations break down, they take some time to normalize.

Exhibit 5 plots our proprietary measure of financial turbulence. As of March 15, the Turbulence Indicator is at a level that has preceded or coincided with major financial shocks. In fact, the current reading is equal to what we saw in March 2008, prior to the Great Financial Crisis, and March 2020 during the COVID crisis.

This observation has us concerned that we may be entering a period whereby diversification no longer affords the same benefits. In light of this, asset allocators may reconsider their cash sleeve, which can help dampen portfolio volatility when other assets behave erratically. By moving cash exposure to the upper range of policy targets, allocators may not only decrease portfolio volatility but may also have the chance to deploy capital at a more opportune time.

Exhibit 5*: Choppy Waters Ahead



*Source: Bloomberg, Investment Office Resources calculations as of 15 March 2022
2 "Diversification is the only 'free lunch' in investing" www.netwealth.com 11/25/21

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