MARKET INSIGHTS

from Ziegler Capital Management

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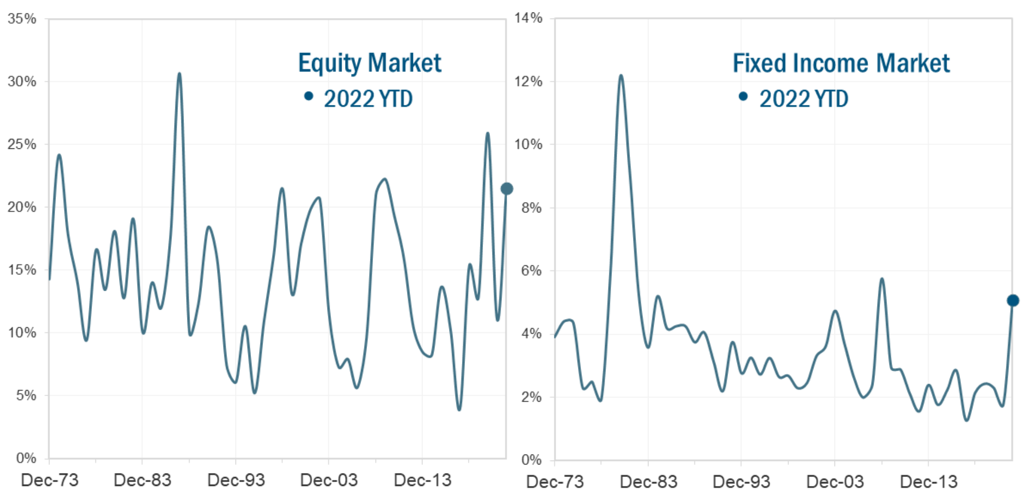
The Fed – Friend or Foe

We recently offered insight into the impact of inflation on market returns in our piece *2022 Has Been a Rare Beast*. But what about the other side of the Markowitz wild world of risk-return, RISK?

Starting in 1973, we looked at the last 50 years of risk, as defined by the standard deviation of monthly returns for a calendar year. Our focus was with the two largest asset classes as represented by the S&P 500 for the equity market and Bloomberg Intermediate Government/Corporate for fixed income.

Fixed Income and Equity Market Risk Data since 1973



Last Observation 11/31/2022. Data Source: Morningstar. Average annual standard deviation calculated monthly. 2022 is a partial period.

A Deeper Look At The Equity Market

Starting with the equity market and looking prior to 2022, we see the expected annual volatility in risk scores, ranging from a high of 31% in 1987, a low of 4% in 2017 and an average of 14%. The 14% in itself, says that the historic 10% average return for stocks will be expected to normally range from a high of 24% and to a low of -6% with a 68% probability. (At 95% probability the range would be 38% and -20%.)

Looking a little deeper using a 10-year rolling average we can see a steady drop in risk, with a sharp and brief drop in 1997 to 11%. This low was a result of a drop-off of the all-time high of 31% in 1987 and 3 years (1992, 1993, and 1995) of mid-single digit risk.

KEY TAKEAWAYS

- The Fed's dual mandate of stable, low inflation and maximum unemployment has met its natural conflict.
- Fed policy created imbalance as opposed to efficiency resulting in risk trending downward.
- As they take their finger off the scale risk scores should normalize.

ABOUT ZCM MARKET INSIGHTS

A series that provides a glimpse of our internal thought process through current topics affecting our clients and colleagues.

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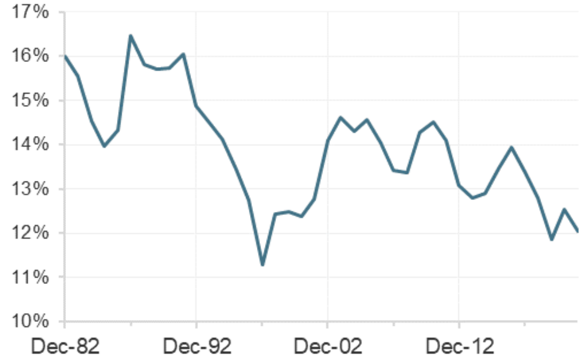
This of course was set up by a more accommodative Fed policy... and a fiscal budget moving toward balance. Through most of the late 90's and through the Great Financial Crisis, risk levels returned to more normal. Starting in 2011, the 10-year rolling average began to drift lower, recording a bottom in 2019 of 11.86%, and marked the most consistent and lowest decade for risk in the past 50 years.

Equity Market Risk: 10-Year Rolling Average

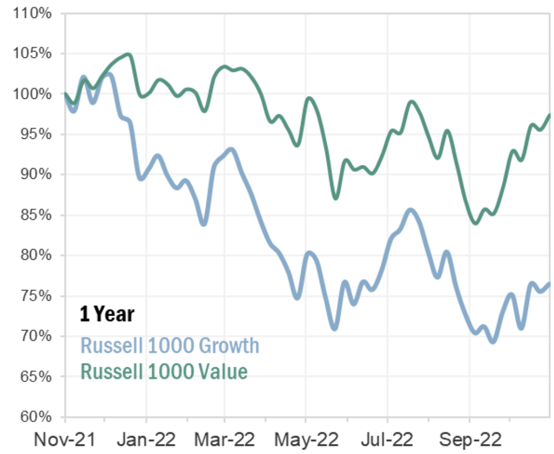


Last Observation 11/30/2022. Source: Morningstar. Annual standard deviation calculated using monthly average. 2022 is a partial period.

Why Did This Happen?

The most likely reason was a Fed that remained extremely accommodative with a near zero interest rate policy and Quantitative Easing, which extended the Fed's range. This "Fed Put" placed a great deal of influence on stock volatility, valuations, and the tenor of what succeeded in terms of stock type. This deliberate control of otherwise dynamic market forces created a situation where typical risky investments were given a leg up when normally they would be subject to the rigors of proving the business model. Our view is that it was as a direct result of Fed activities and the markets' willingness to assign hefty valuations to some of the most fundamentally risky investments. We believe, Fed activity was the single most important influence as to what propelled growth indices to sharply outpace value-based indices as illustrated in the charts below. This inappropriate "finger on the scale" led to a sense of complacency and potentially dysfunctional capital allocation.

Large Cap Growth vs Value Performance Comparison: Growth of $100 Dollars

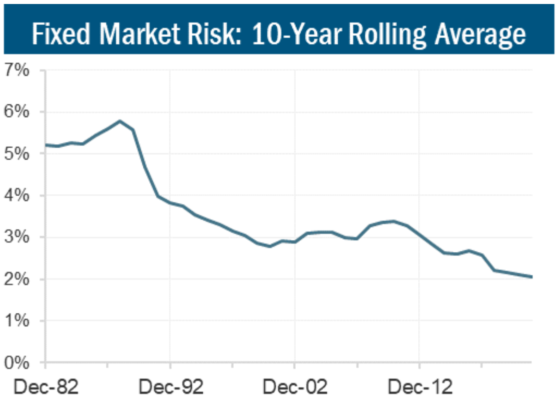


Last Observation 11/31/2022. Data Source: FactSet

Turning to the current experience, 2022 has seen a sharp spike in risk of 21.5%, or the fifth highest in 50 years. Once again, the Fed has raised its invisible hand to let the market know that it has reengaged with a principal focus of stable prices. Assuming the Fed remains vigilant and controls inflation, the outcome is expected to be positive from a return standpoint. However, risk scores will likely return to normalized levels and spike up and down based on non-Fed influences. This market-based outcome should be seen as a win for investors, but as the Fed removes its invisible hand, beware the return of higher volatility .

Fixed Income Shows A Similar Story

Looking prior to 2022, we see expected annual volatility risk scores, ranging from a high of 12% in 1980, a low of 1.26% in 2017 and an average of 3.45%. The 3.45% risk itself, says that the historic 6% average return for intermediate fixed income will be expected to normally range from a high of 9.5% and to a low of 2.5% with a 68% probability. Looking a little deeper using a 10-year rolling average we can see a steady drop in risk scores. This experience was similar for other categories within fixed income. As interest rates declined to all time low historic levels, volatility was also pushed down with the full weight of the Fed ready to defend.



Last Observation 11/30/2022. Source: Morningstar. Annual standard deviation calculated using monthly average. 2022 is a partial period.

Similar to stocks, 2022 has seen a fixed income risk scores spike to 5%, but not to any great extreme and ranks 7th in the 50-year history. Clearly the spike in interest rates caused by Fed action saw a swift and direct repricing of all interest rate sensitive assets. This reset, and with inflation expected to calm, should result in a more stable period of normalized fixed income volatility and a return to positive absolute returns. Both are a welcome change.

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