This is a Test. This is Only a Test.

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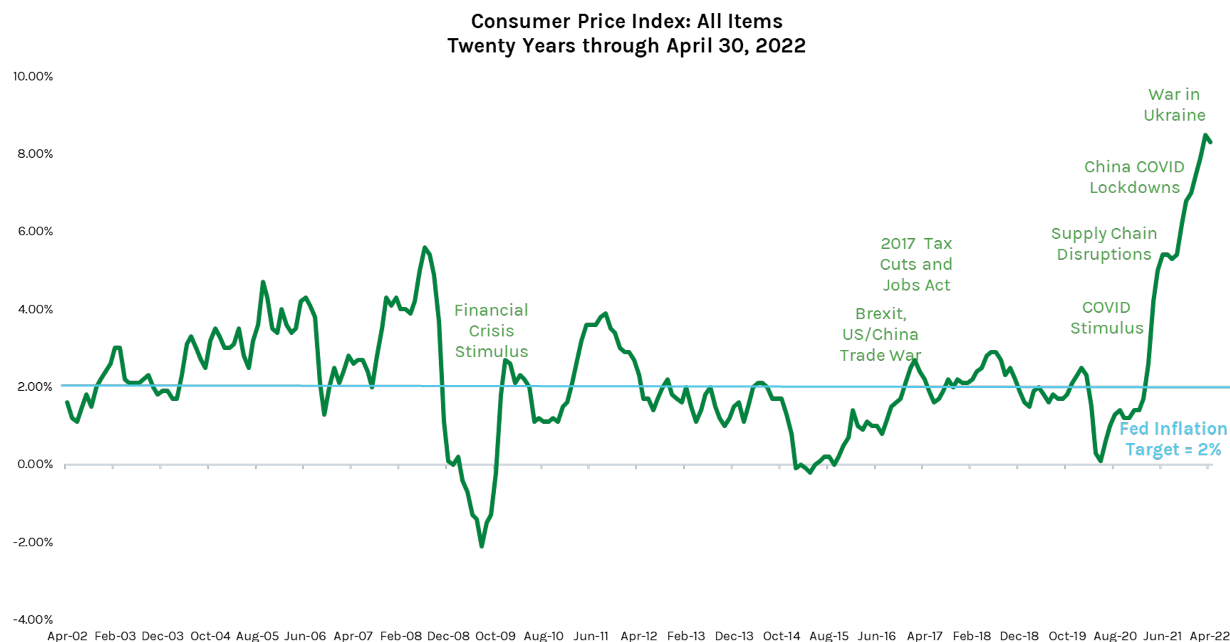
Ben Valore-Caplan
CEO, Syntrinsic

It has been a while since we have been tested like this. While we have experienced a few downturns in the past decade, there has been nothing like the current market environment.

With the spread of COVID-19 in February 2020 into a global phenomenon, risk assets fell for six weeks before rallying into a 21-month surge that enriched asset owners immeasurably. In December 2018, equity markets plunged for a bizarre three weeks, turned on a dime at Christmas and broke even a few weeks later, presaging 12 straight months of positive S&P 500 gains. January 2015 to October 2016 was a long slog with the S&P 500 barely moving, but few investors were losing money; thus, it was more annoying than painful. When S&P downgraded the United States to AA+ from AAA in August 2011, risk assets sold off for eight weeks, gold spiked to $1,900, and many prognosticators declared the era of US dollar dominance over. A few months later, things were back to normal.

And now this. A different beast altogether. Almost 4½ months of equity and real estate declines and interest rate increases. A market buffeted by record high inflation, war in Europe, geopolitical realignments, Federal Reserve tightening and rising interest rates, a recession likely by 2023 in the US, supply chain disruptions, a reimagining of how we work and use real estate, and China's COVID lockdowns and crushing regulatory interventions.

Exhibit 1: 13 Years of Inflationary Stimulus



Source: Bureau of Labor Statistics

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And exhausted investors. Exhausted investors who entered 2022 flush with five (unexpected) years of phenomenal wealth creation driven by fiscal and monetary largess (see Exhibit 1). Exhausted investors who might be out of practice investing without a central bank "put" in place to mitigate risk. Exhausted investors who might also have become complacent when making money became so easy for so long—even in a global pandemic!

In this fatigued and fatiguing time, we at Syntrinsic are finding clarity in a few important places.

Not Time to Sell Low

If one's objective is to outperform inflation, and if one thinks as we do that inflation will stay in the mid to high single digits over at least the next two years, then this is not the right time to sell stakes in high quality companies to move to cash. Doing so would require exiting companies that are at the most attractive valuations in years to lock in inflation adjusted losses. While it might help some investors feel that they are "doing something," such a move would most likely destroy capital.

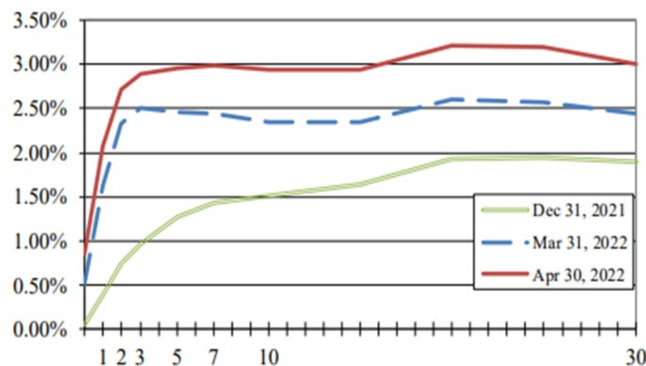
Not Time to Chase Energy

Some might be tempted to sell the quality growth stocks that have been hit the hardest these first months of 2022 to buy energy stocks that already have advanced over 30% since the beginning of the year. While energy stocks have profited from increased oil and gas prices, stocks tend to price in roughly six months in advance; as such, those stock gains for ExxonMobil, Shell, and others already have priced in higher energy prices. To keep advancing from here, oil and gas prices would need to keep marching upward at a steady clip even as those same high energy prices would dent demand and ultimately serve as a brake on global economic growth. While it is a relief for some investors to see energy stocks perform well after a dismal five years, we do not see recent moves as predictive of long-term forward trends. (See Syntrinsic Insights: Does Russia's Invasion of the Ukraine Change Our Investment View?)

Not Time to Extend Bond Duration

Now that the 10-year US Treasury Bond yield has been bouncing around 3% for the first time since late 2018, at least some investors are adding to their intermediate to long-term investment grade fixed income. We are concerned, however, that the ten-year Treasury could be on its way to 4% for at least a short period. If so, investors buying intermediate to long-term bonds in this environment could be in for another tough chapter. The Bloomberg Gov/Cred 5–10-year index was down 10% Year-to-Date

Exhibit 2: 2022 US Treasury Yield Curve



Source: Baird

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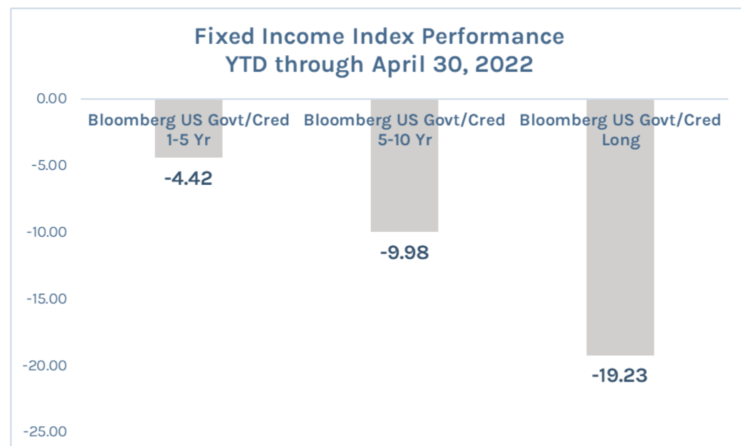
through April 30, while the Bloomberg Gov/Cred Long index was down 19% (see Exhibit 3). Nobody buys bonds to be down double-digits. Another 1% rise across the yield curve would be a brutal sequel to an already difficult 2022.

Act as if "Stagflation" is a Possibility

For the first time in decades, there is broad based concern about the possibility that we are entering a period of slow growth and high inflation—what in the 1970s was known as "stagflation." While macroeconomic conditions are quite different in the 2020s, it remains important for investors to consider our options in a stagflationary environment. Even with stagflation, investors would need to deploy their capital. The corrosive effects of inflation would make cash less and less desirable. Fixed income could be interesting if yields are high enough, but demand for higher yielding bonds would pressure yields down and make outpacing inflation difficult at best. Companies with risky balance sheets or high commodity sensitivity are hard enough to invest in during good times. Who would want them in a time of low growth and higher interest rates? If stagflation is to be our next nemesis, we would want to invest in high quality companies with healthy balance sheets and resilient earnings. We might not earn the 26% per year that the S&P500 returned 2019 – 2021, but we might just keep our heads above water. And that is better than the alternative.

Exhibit 3: Fixed Income Performance YTD



Source: Morningstar

Consider Investing, Rebalancing, Repositioning

With asset prices down 15-20% or more today, with valuations back to a more reasonable level in equities and real estate, and with the Fed activating policy levers to mitigate excessive inflation, it is a compelling time to deploy cash, rebalance, tax-loss harvest, reposition, and otherwise take advantage of this rare investment opportunity. A portfolio of over-levered companies can be trimmed to make room for healthier balance sheets. Duration can be shortened. Cash can be deployed.

Some might prefer to wait until prices have declined 25%. Perhaps 35%. But greed is just as dangerous when markets are raging as when markets are struggling. One can cause investors to buy an asset when it is too expensive; the other to not buy an asset when it is being sold at a discount.

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How Did I Handle this Test?

Extended downturns are difficult by any measure. They test our patience, resolve, and experience. After the fact, it is easy to reflect on the opportunities taken and those missed. In the midst of the downturn, it can be hard to remember that the crisis will end one day. But it will.

And as investor fatigue and frustration deepen, it is a perfect time for each of us to imagine that post-crisis reflection for ourselves. What decisions did I make? How did I manage my fear? What opportunities did I seize? What mistakes did I avoid? How did I handle this test?

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