Advisory Blog

Timely insights on the issues that matter most to advisors and their clients

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Alternative Investments | Fed | Inflation | Volatility

EV Forward: Managing Risk when Uncertainty Is High and the Range of Possible Outcomes Is Wide

By: EV Forward | June 30, 2022

New York - Each inflation data point takes center stage as markets focus on how inflation is trending relative to expectations, translate this to the path of monetary policy and evaluate the growth implications.

The basic shape of the inflation debate has been consistent throughout 2022, with expectations for inflation to peak in the first half of 2022 and then trend lower as pandemic stimulus fades into the rear view, demand trends normalize, supply constraints ease and base effects take hold. Market debate has focused on the balance of transient inflation versus more persistent inflation, and ultimately the degree of monetary policy response required to bring inflation to the Federal Reserve's target.

May CPI marks turning point

For a brief period prior to the May Consumer Price Index (CPI) report, markets started to reflect a view that inflation was decelerating in a manner consistent with expectations. The May CPI brought this view to a halt, with both headline and core CPI coming in above expectations, and measures of the underlying trend showing acceleration.

The market immediately priced the terminal policy rate higher, and equities started to fall again based on negative valuation and growth implications.

The June Federal Open Market Committee (FOMC) update that followed was unsurprising in that it showed an updated outlook consistent with where the market had moved — growth estimates revised down, inflation estimates revised up and the "dot plot" implied path of the policy rate revised higher.

The Fed has identified bringing labor supply and demand into balance as its primary focus — a goal that's within the scope of its tools. Ideally, policymakers could maintain that focus, and supply-side issues would resolve through post-pandemic normalization and market forces.

If supply-side challenges persist, the Fed might find itself having to risk inflation expectations moving higher —with potential self-reinforcing effect — or tightening financial conditions until a recession becomes inevitable; markets have now priced in a probability of this downside scenario.

Positioning for higher inflation and lower growth

We have approached portfolio positioning in 2022 recognizing the upside momentum in inflation surprise and rising risks to growth, with both suggesting greater potential for volatility. Positioning for both high inflation and decelerating growth is challenging — commodities have been the only source of positive return so far this year, while both equity and fixed income total returns have been negative.

Our approach to this environment has been to maintain an overweight in commodities, reduce equity exposure to neutral, take our fixed income underweight closer to neutral and upgrade quality within equities and fixed income. These steps took us in the right direction ahead of recent volatility, though hindsight can always highlight areas where we could have been either more or less aggressive.

Bottom line: While we continue to monitor the evolving macro situation and shifting valuation dynamics, we intend to manage risk with an understanding that uncertainty is high and the range of potential outcomes over the next 12 months remains wide.

Rui De Figueiredo
Co-Head and CIO of Solutions & Multi-Asset Group

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