Titan Advisors, LLC

What Gives?

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Financial markets in 2023 have been a bit perplexing. As I write this in early-December, the Nasdaq 100 (QQQ) is up 37% year to date and the S&P 500 has gained 19%. The yield on the 10-year Treasury bond ended 2022 at 3.8%. That yield seems to move higher each day and has approached 5%. The Federal Reserve's balance sheet ended 2022 at $8.55 trillion; today, it is $7.84 trillion. Inflation, as measured by CPI, has fallen swiftly from a mid-June 2022 high of 9.1% to today's stubborn level of 3.2%.

Most of the gains in equity indices this year have come from the so-called "magnificent seven" mega cap tech names. The Russell 2000 small cap index, on the other hand, is flat for the year. We think what has been driving the "magnificent seven" is a widespread belief that they will be the disproportionate beneficiaries of the dawn of Artificial Intelligence (AI). While it is a near certainty that AI will have a big impact on our lives, it is difficult to know for certain what the economic benefits ultimately will be and to whom they will accrue. Back to the title of this paper, one thing we do know is that the level of risk-free rates should have a meaningful impact on the prices of financial assets. For fun, I asked Chat GPT what the effect of Quantitative Easing is on the stock market. Here is its answer:

Quantitative easing (QE) can benefit stocks for several reasons:

Increased Liquidity: QE involves central banks purchasing government securities or other financial assets, injecting a large amount of money into the financial system. This increased liquidity can find its way into the stock market as investors seek higher returns on their capital. The influx of liquidity can drive up demand for stocks, leading to higher prices.

Lower Interest Rates: One of the primary goals of QE is to lower long-term interest rates. When interest rates are low, fixed-income investments like bonds and savings accounts become less attractive to investors seeking higher returns. This encourages investors to allocate more of their capital into riskier assets like stocks, which can push stock prices higher.

Portfolio Rebalancing: QE can lead to a phenomenon called "portfolio rebalancing." As central banks buy government bonds and other fixed-income securities, it reduces the supply of these assets in the market. This can push investors to rebalance their portfolios by shifting into stocks and other higher-yielding assets, driving up stock prices.

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Well! We think that seems to make total sense, but we now find ourselves in an environment of quantitative tightening, which consists of conditions opposite to those described above. Liquidity is being withdrawn from the system, rates are meaningfully higher, and that "portfolio rebalancing" effect one would think should be working the other way. Markets followed that QT script to some degree in 2022, but 2023 has been a good year for stock market indices. In addition, the treasury market has yet to find a level that attracts buyers back into the market. So, what gives?

Over the last year or so, there have been a few drivers that we believe kept liquidity conditions supportive of risk assets. The first event, was the regional bank crisis in March that resulted in the failure of Silicon Valley bank and several other entities. In response, the Federal Reserve launched several new programs to inject liquidity into the banking system. Specifically, the Bank Term Lending Program was introduced on March 12, 2023 and served to undo a lot of the reduction in the Fed's balance sheet that had been accrued in the post-QE era. Second, the running down of the Treasury General Account (TGA) ahead of the debt ceiling talks added further liquidity into the system.

Those factors are now reversing, so why haven't higher interest rates attracted more capital away from equities? We believe one potential reason is long duration bonds have lost their appeal as a safe-haven asset. The trailing 12-month volatility of the TLT ETF is 22.7% vs 17.1% for the QQQ Nasdaq 100 ETF.

(1.) TLT US Equity Hist Vol (60)
(2.) QQQ US Equity Hist Vol (60)

Source: Bloomberg Charts
December 2023

The last time interest rates were at these levels alongside a narrow, technology-led market was in 1999-2000. The subsequent several years were an excellent time for actively managed, hedge fund strategies. We believe, increased dispersion and the end of the "free money era" sets up an environment well suited for active management.

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Where are cracks appearing and what breaks?

The long period of low interest rates created many excesses in debt markets. Corporations issued debt (through both bonds and loans) with relatively narrow spreads to those issued by governments. Just as cheap debt doesn't encourage fiscal discipline with governments, neither does it encourage discipline with corporations. A large proportion of global corporate debt will mature in 2025, and it will need to be refinanced at much higher coupons. (Even assuming the same spread to government debt, the risk-free rate has moved higher by more than 5%.) Assuming a company issued debt at 3% above the risk-free rate, they will now be faced with an increase in debt servicing costs of over 165% (using a risk- free rate of 5% versus 0%).

How many companies have seen their earnings grow at 165% over the last five years? Likely not many. As a result we believe these companies will now see significant earnings erosion, before even considering any wage increases that may also cut into profitability. It appears the markets have begun reacting to this likelihood, as high-quality companies (less levered) have outperformed low-quality (highly levered) companies.

Many investors hope that generative AI will be a deflationary force, bringing down payrolls at companies. If this is true, then wouldn't this deflationary force likely be a major driver of unemployment, thus bringing a fresh set of challenges to central bankers? Both AI and rising rates will cause winners and losers, with much higher idiosyncratic risk priced into securities.

Whether you fall in the inflation or deflation camp, volatility seems to be the release valve. We believe active management thrives in periods of higher market volatility, effectively offering managers more "at-bats" from which to generate alpha. We expect to see more volatility and much more idiosyncratic risk between securities over the next few years as the forces of inflation and rapid rate increases filter through the market. It is our premise that idiosyncratic risk rewards skill, while volatility amplifies the trading opportunity. Hedge fund strategies are designed to capitalize on both.

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