Equities too hot and Inflationary risks persistent; Case for Commodity strategies

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The economy is booming. The reopening trade has led to economic growth levels that we have not seen in recent history. With the boom, the S&P 500 valuations are hitting historical levels. Currently, the estimated S&P 500 P/E ratio (trailing) sits at 45, which is in the 99th percentile based on historical ratios going back to 1871. As the pandemic hit, “stay-at-home” companies boomed with the lockdown, and reopening companies rallied during the recovery phase. All of this is fueled, in part, by the high levels of liquidity provided by the Fed’s dovish monetary policy and the loose fiscal policy to fight the pandemic. Even with plenty of evidence pointing to outlandish evaluations, investors have continued to increase allocations to the equity market.

Corporate bond markets are also telling a similar story but with a twist; The US AAA corporate bond yields are at a 9th percentile based on data going back to 1919. However, the yields are off the record lows seen during mid-2020 and trending higher as the market prices in higher risk premiums for lending to US companies. This recent divergence between the equity and bond market should be a warning for investors.

The diverging nature of the two markets can partially be attributed to the increasing market risks linked to inflation and the Fed’s attempt (or lack thereof) to control it. US CPI for May 2021 printed at 5% increase year on year, which is well above the Fed’s 2% target, and above the 3.4% inflation forecast for 2021 from the Fed. In March, the Fed’s stance on inflation was that the effects we are seeing now are “transitory,” and a rate hike wouldn’t occur until at least 2024. As of the June meeting, the Fed is now projecting two rate hikes in 2023. Should inflation remain high for the balance of the year, we are likely to see the rate hike projections brought further forward with tapering of asset purchases in the horizon as well. The K-shaped recovery that we have seen coming out of the pandemic is certainly unlike anything we have seen before, and the uncertainty around the Fed’s actions is likely to increase as more data trickles in. A misstep by the Fed, a major political event, or a failed infrastructure bill could all trigger a significant correction in the equity market given the historically rich valuations.

Even if a correction does not materialize, these record-high valuations imply compressed returns to investments for the foreseeable future. As such, investors should look to diversify their holdings into alternative investments that are not correlated to their portfolio and offer attractive risk adjusted returns. Such preemptive measures will not only increase the expected return on their portfolio, but more importantly, give the room to buy the dips during the next correction.

Commodity markets in particular have been exhibiting higher alpha generation opportunities with the rise in inflation and the increase in capital flows from the investment community. Given the idiosyncratic nature of commodities, the best way to capture the said opportunity would be to deploy strategies that are tailored to the individual markets but also diversified across all commodities. Our NWOne diversified strategy program achieves this all within a disciplined systematic framework that was tested and developed at Morgan Stanley, Ellington Management and Tudor. Please do not hesitate to contact us with comments, thoughts, and inquiry into our program.