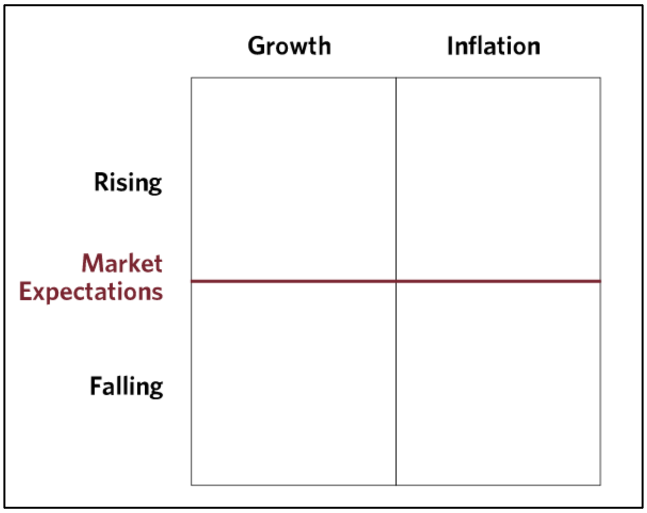
Asset Class Performance & Investing Through Economic Regimes

2022 has been a difficult year for investors as stocks and bonds were caught off-guard by the abrupt shift in monetary policy in response to increasingly accelerating inflation. While there is much uncertainty surrounding the future path of asset returns, growth, inflation, and monetary policy, it is useful to keep in mind that cross-asset correlations rarely move to and remain at 1. Furthermore, and consistent with our views that asset allocation, not security selection, drives the bulk of portfolio returns, Wellspring believes that keeping an innovative approach to traditional risk budgets (i.e., the 60/40 portfolio) can keep investors on the right track from an absolute and relative return standpoint.

Economic Regimes & Asset Class Returns

While 2022 has been a disorienting year for many given the substantial shift higher across the curve in interest rates, it is important to keep a close watch not on the level, but on the rate of change in both growth and inflation. For example, Headline CPI today is 8.2%. If the print over the next six months goes to 6%, then we would have decelerated by 2%. While the level is important, studies have found that it's the rate of change that causes shifts in asset class returns.

Ray Dalio of Bridgewater Associates, one of the largest hedge funds in the world, found that the rate of change in both growth and inflation drive and explain moves that happen in every asset class. It is a simple, yet timeless framework that can be sketched on the back of a napkin. The picture below is directly from Bridgewater's website:



Source: Bridgewater Associates

Taking this a step further, we can observe each of the four regimes to guide us about expectations for asset class performance. The table on the following page shows average annual returns under different regimes from 1973 to 2010.

	Average Annual Return, from Q4 1973 to Q4 2010			
	Regime 1	Regime 2	Regime 3	Regime 4
	Growth: Rising Inflation: Rising	Growth: Rising Inflation: Falling	Growth: Falling Inflation: Rising	Growth: Falling Inflation: Falling
	32 periods	*34 periods*	*36 periods*	*47 periods*
Commodities	9.1%	1.5%	11.7%	-6.3%
Treasuries	3.9%	8.7%	5.5%	11.5%
US Equities	4.5%	14.7%	1.0%	5.5%

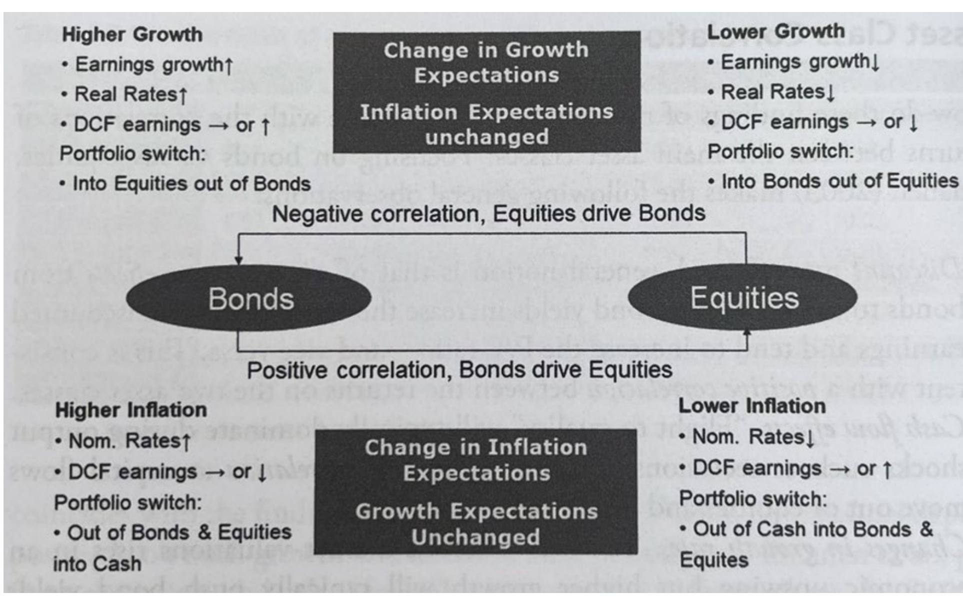
Source: Shiekh and Sun (2012)

Taking a closer look at this data, we can look backward and reasonably conclude that post-Covid we experienced two distinct, but similar environments. From the trough of Covid we experienced "Regime 1" where both growth and inflation were accelerating. As we entered 2022, the regime shifted to "Regime 3" where inflation continued to accelerate, and growth slowed. Both periods exhibit the two best regimes for commodity returns and the two worst regimes for equities and bonds. Wellspring took steps throughout 2020 and 2021 to increase the allocation to commodities.

On a forward-looking basis, there are two ways to use this framework to think about asset allocation:

1. Utilize consensus and in-house forecasts to determine the most likely regime(s) for the next 12-24 months
2. Probabilistically determine the regimes that are *least likely* to occur over the next 12-24 months

While we use a combination of the two methods, we place more weight on the latter. Given we just experienced the fastest pace of accelerating inflation in recent history, we believe it to be a low probability event to continue to expect "Regime 1" or "Regime 3" with the latest inflation prints slowing and market expectations staying anchored. That leaves us with "Regime 2" or "Regime 4", with a greater emphasis on "Regime 4" due to the Federal Reserve's continued harsh rhetoric on fighting inflation and historically high starting equity valuations. Note that the return profile for Treasuries improves, commodities become less attractive, and the range of outcomes in equities widens substantially.



Source: Shiekh and Sun (2012)

The figure on the prior page utilizes a similar framework but excludes commodities and includes cash as an asset class. While the conclusion from the prior regime data does not change, this model adds a correlation aspect with changes in growth *or* inflation as the driving factor. 2022 can be easily explained by looking at the bottom portion of the above figure – while many (including Wellspring) would argue that growth expectations fell, inflation expectations rising drove the bus throughout the year. This led to a positive correlation between bonds and equities where higher yields (lower prices) on bonds were the main factor in driving equity multiples lower. The preferred allocation in this scenario is cash, which we started allocating to in late Q1/early Q2. If the inflation story takes a back seat to growth (i.e., a recession in 2023), it will be important to focus on the top part of the figure above to help us think about asset classes that will perform best if growth expectations continue to slow – this points to an environment that is consistent with "Regime 4" where cash and bonds are the preferred asset classes.

Current Positioning & Future Considerations

Throughout the post-Covid period, Wellspring took incremental steps to innovate and protect portfolios for the economic environment that was to come. In addition to decreasing portfolio sensitivity to broad market moves, Satellite assets, which include commodities, real estate, and infrastructure, were added to traditional risk budgets to withstand a higher inflation environment. Cash was also added with the substantial increase in yield on short duration Treasuries and credit. This will continue to be a focus as we head into 2023, though we are preparing for what the world will look like coming out of a "Regime 4" where there is a favorable environment for risk assets.

We appreciate the confidence you have placed in Wellspring to be your trusted advisor. Please feel free to contact us at any time to discuss changes to your financial situation or to review your portfolio.

Author: Kevin Bruss, Portfolio Manager, Wellspring Financial Advisors, LLC
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Investing involves risks, including the possible loss of principal and fluctuation of value. Past performance is no guarantee of future results.