CION INVESTMENTS

2021 Q4 Economic Summary and Market Performance

Black Swans and Grey Rhinos

Early on a bitter cold Monday in 2008, Richard "Dick" Fuld, the CEO of Lehman Brothers, slid bleary-eyed into a Mercedes idling in the driveway of his 12-acre Greenwich estate. Fuld was whisked south on the Merritt Parkway, down the West Side Highway, to Lehman's Midtown Manhattan headquarters. Arriving just after 6am he took the elevator to 31, Lehman's daunting executive floor. Usually a buzzy cauldron of deal-making, infighting, and chest-beating, it was now hushed as a criminal sentencing. As he sat scowling at two Bloomberg monitors, his personal net worth plummeted by $90 million—and the market had yet to open. The Global Financial Crisis was about to hit a fever pitch.

The ensuing tidal wave of chaos changed everything. Lehman, old enough to survive the Civil War, was wiped out in the largest bankruptcy in history. Fuld's stock holdings would drop from $1 billion to less than $70k. Following the crisis, Nassim Taleb's 2007 book The Black Swan became required Wall Street reading. The Global Financial Crisis is the archetypical Black Swan—unpredictable in origin, severe in consequence, and scary as a murderer's nightmare.

What scares the market these days, however, are the Grey Rhinos—obvious problems, gigantic in scope, and utterly ignored by everyone with the ability to solve them. Black Swans are fun to talk about, however it's the Grey Rhinos that are most likely to impact financial markets. And being more predictable, they are amenable to investment solutions.

The largest Grey Rhinos are inflation and shortages, high valuations, and interest rate changes. Big, hairy, polycausal problems, resistant to painless resolutions. The Fed wants inflation to go away. Investors want higher valuations. Savers want higher interest rates. The Grey Rhinos are sure to disappoint at least two of them.

After an update on Q3's market activity, we discuss Grey Rhino risks and what investors should consider.

2021 Q3 Economic Summary and Market Performance

Q3 was a mixed bag: GDP is higher, but growth is slowing. Stocks climbed, then pulled back in September. Credit issuance is robust, but real yields are negative. Unemployment rates declined even as labor shortages appeared. Overall the economy is strong and improving.

Economic Performance: GDP Now Above Pre-Covid Levels

Q3 saw the US economy finally exceed pre-Covid GDP levels, bouncing back from the 30% annualized drop last year. However, full-year growth estimates are dialed back from last quarter to 5.9%, down from 7% in June, on Covid

resurgence concerns.

The US job market continues to recover, even as unemployment rates remain above pre-Covid levels. In August, the unemployment rate dropped to 5.2% from 5.8% one quarter prior, much improved from the 15% rate at the pandemic's peak. Labor shortages continue. From fast food giants, to hospitals, and trucking companies, all are feeling the squeeze.

The US Housing market is still scalding hot, despite a slight August decline in existing-home sales. With kids back in school and workers back in offices, the mad scramble to move has slowed. Prices remain near record highs, as low mortgage rates encourage buying.

Monetary Policy Overview: Rate Increases Coming Sooner Than We Thought

The key takeaways from the Fed's September meeting: (1) bond buying may end in 2022, and (2) rates may go up sooner than expected, as early as 2022. Both are signs of increasing Fed hawkishness. Further, the Fed expects inflation to hit 4.2% this year, more than double the Fed's 2% target. Despite higher inflation estimates, the Fed continues to keep rates pegged near zero. The Fed's balance sheet keeps expanding, adding $500 million to hit nearly $8.5 trillion during the quarter. By contrast, immediately following the 2008 crisis, the Fed's balance sheet was just $2 trillion.

US and Global Equity Market Summary: Equity Markets Up, With a September Stumble

In September, autumn started and equity markets spiraled down, changing returns from green to red in an absurdly seasonal fashion. All the same, Q3 saw new equity market highs with the S&P 500 and Nasdaq 100 both up over 14% YTD[1].

The collapse of Evergrande has shaken investor confidence in China. The formerly high flying Chinese real estate (RE) firm has crashed down to earth, or at least its stock has—it's down 80% YTD. Although Evergrande's troubles have a lot to do with the price of RE in China, US investors have broader concerns. A regulatory crackdown has hit Chinese tech stocks hard. Investors are now more concerned with the return of their money than the return on their money.

Global equity markets are still up YTD but gave back some of H1s gains. Leading the YTD return table are India (+24) and Russia (+26%).

Credit Markets: IG Bonds are Down, HY and Leveraged Loans are Up, Defaults Remain Low

Investment Grade[2] bonds (IG) were flat during the quarter and remain down slightly for the year, at -1.3% YTD. High Yield[3] was up in Q3, at 4.6% YTD. The Leveraged Loan[4] market returned 4.4% YTD through Q3. BBB yields, now at 2.4%, have increased slightly YTD, and are currently 50% below long-term averages. Deal volume remains high even though inflation adjusted (real) yields on IG are negative.

Loan defaults will likely remain low through the end of 2022, according to Fitch Ratings. Fitch lowered its YE 2022 loan default forecast rate to 1.5%, from a previous range of 2.5-3.5%. Twelve-month trailing loan defaults are tracking to 1.2% at September month end.

> A Grey Rhino is a two-ton problem. It's not the elephant in the room, a problem people don't talk about. Instead, a Grey Rhino is the problem people won't stop talking about. Three Grey Rhinos are glowering at investors: shortages and inflation, high valuations, and interest rates. Only the Fed's balance sheet has them on a short leash, for now.

Goods Shortages are Becoming Widespread

Lately, US shoppers are finding an item rarely seen in the modern stores—empty shelves. Over optimized global supply chains are breaking down amid surging demand and labor constraints, leaving shortages everywhere.

Shipping and trucking are a mess. Seventy container ships—the same size fleet as the entire Royal Navy, and twice the ships Nelson had at Trafalgar—currently sit outside LA/

Long Beach ports waiting to be unloaded. Global container freight rates have risen over 400% from last year and sit at record highs. Anecdotal reports suggest there are over 40 customers waiting for each available flatbed truck. The transportation bottleneck has caused supply chaos. Even large companies, like Taco Bell and Starbucks, are having trouble sourcing ingredients. And if you haven't started your Christmas shopping yet, you're already behind—the Wall Street Journal predicts that supply issues will last into 2022. There is an Everything Shortage happening.

Labor Shortages are Exacerbating the Problem

It's not just goods that are scarce. Firms can't find workers. In August, 50% of small businesses reported open jobs that they cannot fill, the highest ever surveyed.

While big businesses like Costco, Amazon, and Target have increased wages, smaller firms have cut hours, reduced service, and struggle to hold onto current employees. New employees are impossible to find, especially in the service sector. For example, in Virginia Beach, a job fair for the hotel and restaurant industry hosted 27 employers, but not a single applicant showed up.

The Solution: Wait

Labor markets will eventually normalize, but supply chains will always lag expectations. Additional capacity may be slow to come online as companies try to avoid the bullwhip effect, in which retail demand gets distorted as it travels back up the supply chain, resulting in oversupply. Thanks to Amazon turning two-day shipping from a miracle of logistics to an entitlement, Americans are not used to shipping delays or service declines. There are no limits to the number of times consumers can click the Buy button, but there are limits to the amount of shipping containers, trucking capacity, warehouse space, overtime hours, etc. that can be profitably deployed. Back-end constraints can always be improved but, as Jeff Bezos noted, customers will always be "beautifully, wonderfully dissatisfied"

Supply constraints will eventually fix themselves; investors should be concerned with the Grey Rhino of inflation.

Inflation is Real and Growing

In September, Dollar Tree, the 15,000-store discount chain, finally broke the buck. It capitulated to inflation, announcing that prices would rise to $1.50 or more for certain items. Dollar Tree was one of the last holdouts in the discount space; it had maintained a $1 price since its founding in 1986, even as inflation eroded 40% of the value of a dollar. Food, cars, gas, and clothing are all getting more expensive. And it's not just the US seeing higher prices. Inflation in Europe hit a 13-year high last month. In the EU's largest economy, the schnitzel has hit the pan as Germany had its highest inflation in three decades. Inflation is everywhere, confounding central banks who are hesitant to raise rates.

The Federal Reserve is in a Tight Spot as Inflation Rises

If inflation continues to climb, the Fed will be stuck between the devil and the deep blue sea. Equity valuations are at all-time highs, fueled by low rates and Fed liquidity. For example, the "Buffet Ratio" (a ratio of stock market capitalization to GDP) just exceeded its tech bubble high. Ending low rates or Fed market support could trigger asset price declines. (Investors already got a taste of that during 2013's "taper-tantrum.") With debt and low rates powering so much of the economy, the Fed is playing 4D Jenga with every rate change, potentially sending the Grey Rhinos charging. The Fed's low rates may yet prove to be a White Elephant. Investors are now hanging onto every Fed utterance with bated breath.

Equity Investors are Vulnerable to Inflation

Equity investors are harmed by high inflation, which stifles equity returns. By contrast, when CPI is under 1%, the S&P's gain is about 17% annualized. Inflation brings higher discount rates, lowering valuations. Credit or cash will begin to look comparatively more attractive when rates are higher. Tech stocks appear particularity sensitive to increased rates.

Investors expecting higher inflation should carefully examine how sensitive their equity holdings are to rising rates.

Debt Investors Focus on Floating Rate Instruments

Inflation is painful for fixed income investors, especially when interest rates are near record lows. With yields low, investors have struggled to find income, especially in fixed rate investments. Investment grade bonds are hardly compensating investors at all. Real yields are negative, and bond principals will be torpedoed if rates rise.

Floating rate instruments can help tame the Grey Rhino of inflation. First, because the principal value would be far less volatile during interest rate fluctuations. Second, because yields automatically adjust to higher or lower rates. Investors have been focusing on leveraged loans and direct lending as a result. .

How to Avoid a Crash of Grey Rhinos

Black Swans upend the world. Bedrock institutions wink out of existence; new ideas and companies take root in the scoured terrain. Black Swans, being both rare and unpredictable, are not amenable to investment solutions. Grey Rhinos, by contrast, can be observed, prepared for, dealt with, and even profited from.

The correct collective name for a group of rhinos is, ironically, a crash. Investors today have more options than ever to hedge against a crash of Grey Rhinos. By watching the Fed and the economic data, inflation and higher interest rates can be managed, but not always with traditional investments. Investors are increasingly going outside stale 60/40 allocations. Alternative investments, real estate, and more esoteric instruments, like cryptocurrencies and NFTs, are receiving larger allocations. When a Grey Rhino finally charges, investors can not only avoid being trampled but may even be able to come out ahead as a result.

1. All YTD figures as of 9/30/21
2. As represented by the Barclays Capital US Investment Grade Bond Index.
3. As represented by the Bloomberg Barclays US Corporate High Yield Total Return Index Value Unhedged USD
4. As represented by S&P/LSTA Leveraged Loan Total Return Index

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