

CIO Quarterly Commentary

Q2 2022

The times are getting tougher

Pretty much the whole world has been wrong about how high inflation would go – including us. As investors' views have changed, they have sold fixed income securities, pushing prices down and driving the Bloomberg Barclays US Aggregate to its worst quarter in 40 years at -5.93% in Q1 2022, followed by -4.69% in Q2. This -10.35% year-to-date loss is the worst first half of the year ever for the index. Results this poor don't tend to occur when investors anticipate and are properly positioned for what lies ahead.

We believe the single most important investment question today is whether the Fed will – or won't – get ahead of inflation. Typically, the Fed must balance the dual mandate of full employment and low inflation. Because inflation has been low for most of the past 40 years, the Fed has historically been able to respond quickly to economic or market events by easing rates. With inflation today above 8.5%, that calculus has changed: We expect that until inflation comes under control, the Fed will be talking tough and raising short rates, even if stock and bond prices are falling and even if the economy appears to be slowing. Until the Fed proves their mettle in taming inflation, they have lost the option of easing rates. We believe that only once the Fed has shown they can get inflation under control will they regain the ability to provide liquidity when markets require. This suggests a more difficult and volatile market backdrop in the short term, with the end of this term dictated by the path of inflation.

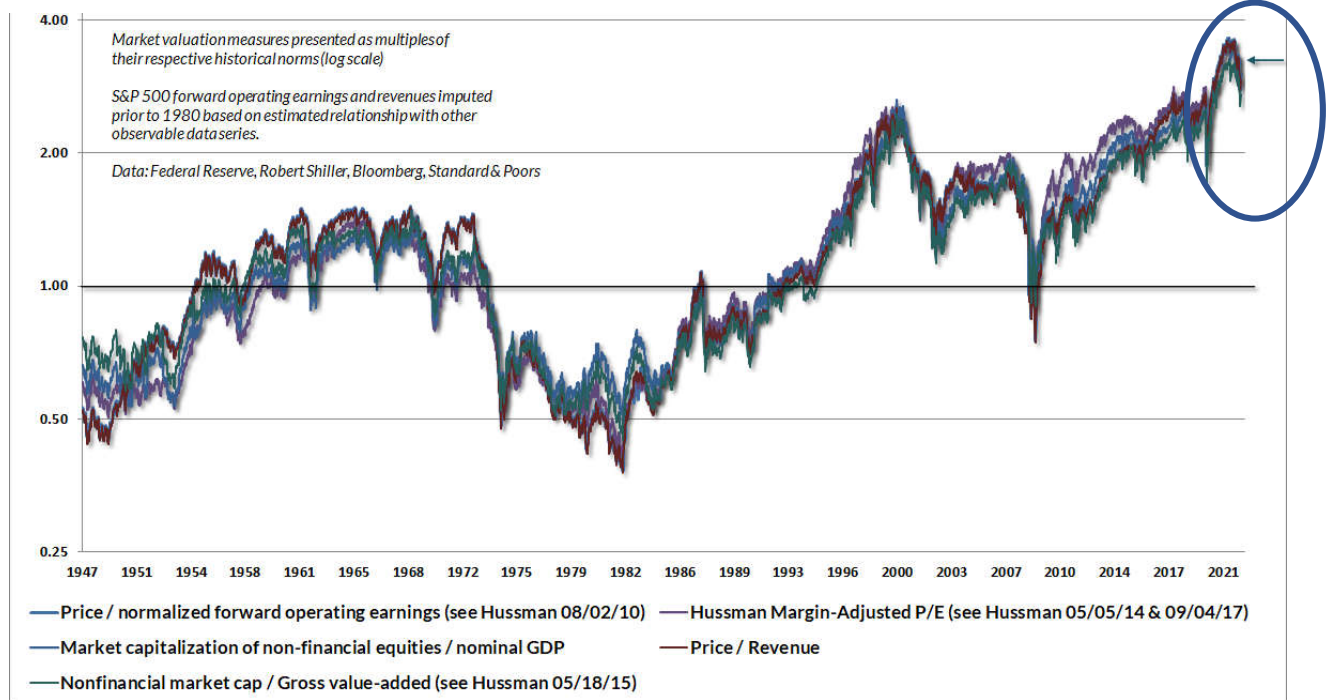
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In the interim, we don't expect a gut-wrenching recession, but we do expect a recession simply because soft landings are extremely difficult to achieve. Our belief is based on fewer excesses and stronger balance sheets than is typical at this stage of the economic cycle (for example, banks, corporations generally, and consumers in total are much stronger than when we entered the 2008 to 2009 recession). If we are right, this can create opportunities for investors who are looking for them. Once the market sees inflation coming down and the prospect of a hard landing decreases or becomes discounted – which will be right about the time that current market reports are near their worst – we believe the market can improve.

Bulls Versus Bears

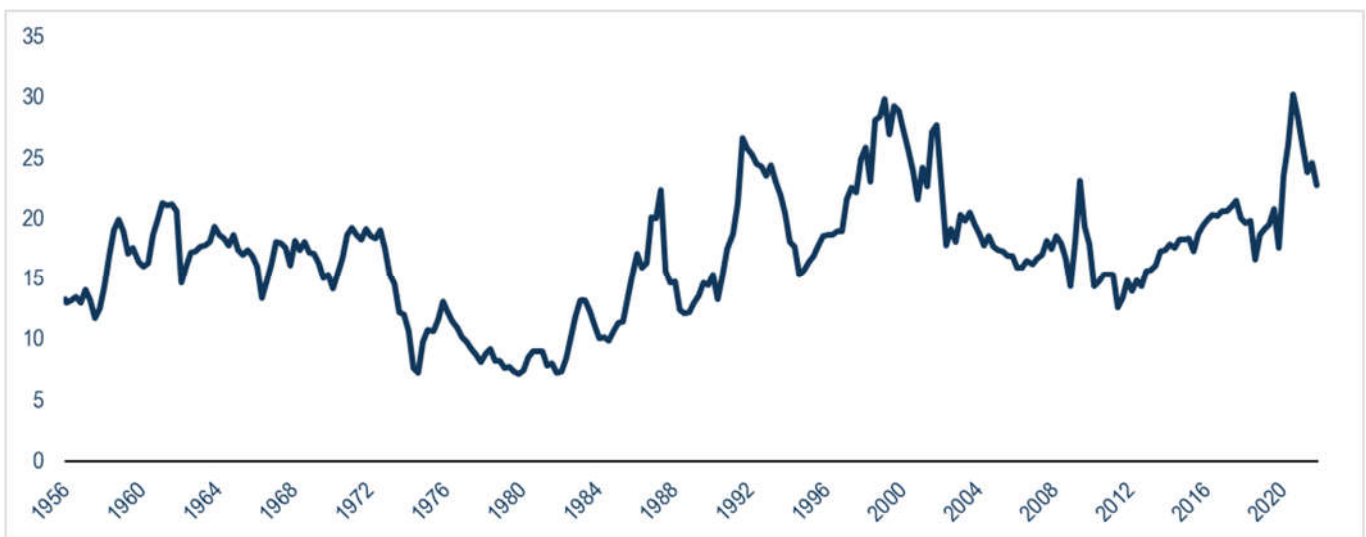
With stock and bond markets pulling back, we find our inboxes filled with more negative market commentary than normal. Sifting through all the supposed reasons for the market's behavior is always a laborious – but necessary – chore. Most of what you read is Monday morning quarterbacking. But occasionally you read something that makes you think. A recent paper by John Hussman made us think. His is a complicated, math-heavy argument that concludes with the idea that investors in stocks won't make any money investing in the S&P 500 over the next decade. We'd note that Mr. Hussman seems to have a reputation as a bear.

Market Valuations Measures Presented as Multiples of Their Respective Historical Norms (Log Scale)¹



A more familiar framework to most investors (which we’ve written about before) is the Jeremy Siegel view. His model suggests a more normal 6+% real return over the next decade. For the record, Mr. Siegel has a reputation of being bullish. “Siegel vs. Shiller: Is the Stock Market Overvalued?” provides a good short recap of his thinking. The main difference between the two is that Hussman uses sales as the correct denominator, and Siegel uses operating earnings. Essentially, Hussman’s model assumes above-average margins will revert, compressing future multiples, whereas Siegel’s model does not.

Historical PE Ratios S&P Index (1955 to Present)²



¹“Making Friends with Bears Through Math,” John Hussman, Hussman Strategic Advisors, June 2022.

²Bloomberg.

Who's Right (Right Now)?

First off, it is important to note that both authors would admit that forecasting a one-year return is exceedingly difficult. Regardless of what either of their “formulas” say, some new event could occur which causes the market to go up or down in the next 12 months. If corporate taxes were raised sharply, for example, then the market would likely decline; if someone conquered fusion, giving the world access to low-cost carbon-free energy in perpetuity, then markets would likely rise. The goal of each model is to try and provide a long-term direction that is more plausible than not.

Second, it is also important to remember that the stock market is a discounting machine: It does not look back – nor at the

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present – to determine prices. The stock market’s job is to discount what *future* earnings will be and price them appropriately *today*. If interest rates are expected to rise, then the economy could slow and cause earnings growth to be lower than what was expected yesterday. Higher interest rates could also increase the discount rate used to value a future cash flow stream. These are two ways that rising rates can impact stocks. Declining rates work the opposite, benefiting stocks.

Of course, *anything* that impacts the economy will impact stocks, including interest rates, consumer health, corporate capital spending, the value of the US dollar, competition, inflation, the cost of labor, and pricing power. Any company earnings report will give reasons for earnings that are better or worse than expected. The market can go up and down in the short term as it tries to figure out the correct way to price these various dynamics. This is especially true in times of higher uncertainty.

Today’s expectations are generally already embedded in stock prices. The important question is what will investors be focused on in 12 to 18 months? Will inflation still be a problem? Will energy prices continue to march higher, or will some resolution to today’s supply/demand imbalance cause prices to peak? Will the economy grow faster or slower than today’s expectations? How will this impact corporate earnings? How will this impact the discount rate used on future earnings to arrive at a fair price today?

Because we expect elevated uncertainty until the Fed gets ahead of inflation, at the end of Q1, we trimmed our equity holdings to our 65% benchmark target and have not increased them since. Similarly, we trimmed our fixed income duration to 1.7 years (60% of our benchmark, or 25% of the Bloomberg Barclays US Aggregate) and have not increased it since. We also continue to hold our diversified hedge fund exposures versus our simple benchmark, which includes the Bloomberg Barclays US Aggregate. This positioning is as conservative as we’ve been since 2015 or maybe longer. After the Russian invasion of Ukraine made commodity prices more difficult to forecast and increased the unpredictability of global growth forecasts, we also entered into hedges where we benefit if: 1) the Fed tightens financial conditions; or 2) if metal and agricultural commodity prices rise. To date, these hedges have been additive.

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Looking Forward

The Russian invasion of Ukraine will keep upward pressure on energy, metals, and agricultural prices: Commodity supply side is being crimped. If the world can’t bring on additional supply to balance higher demand, prices could move higher still. All the Fed can do is try to reduce demand – by raising rates until the economy slows and demand falls.

The need to transition to green energy is also boosting inflation today. Last quarter, we talked about the prospect of greenflation if we were unable to replace hydrocarbons with green alternatives in a timely way. Timing is and will likely continue to be a problem going forward. The silver lining is that higher energy prices will spur investment in clean energy sources. However, this won’t help us today.

In regard to geopolitics, we hope to see a less concerning outlook 12 to 18 months from now. Global supply chains may shift back closer to America into, say, Mexico or Canada – if not directly into America. Some in each those places is most likely. The jobs will be created wherever the new factories are. This could improve our economy in the long run, but possibly keep upward pressure on wages and inflation in the short term. And moving away from the lowest-cost source of production is probably inflationary, at least initially.

On the positive side, the massive government spending policies enacted during COVID are winding down. Less money printing usually leads to lower future inflation. We are also encouraged to see a move away from Modern Monetary Theory – where excess money creation has no theoretical limit – toward historic monetary theory. As Milton Friedman said, “Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output.” At least one economic forecaster believes that the pending decline in year-over-year money-supply increases will help reduce inflation toward the Fed’s long-term target *without* further interest rate hikes. Although this might be overly optimistic, it is directionally correct. Quantitative tightening (QT) has also begun; rolling off \$95 billion per month from the Fed balance sheet will further drain cash from the system.

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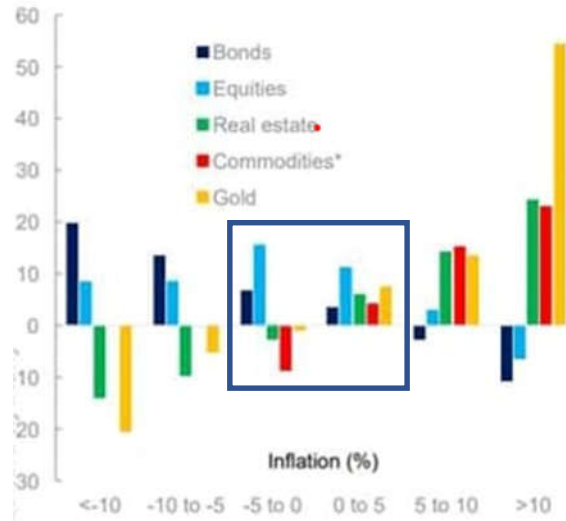
Finally, improving supply chains should help reduce price pressures. Now that the pandemic has evolved into an endemic, a shift in consumer preference back toward services should further reduce demand for goods, helping to moderate goods cost pressures. Hopefully, prices on airfares, hotels, and restaurants will also moderate as increased demand for services is met with increased supply of services.

Conclusions

One thing we learned early in our careers is that there are a lot of smart people who are almost all working to make the world a better place. This is why over time stocks move up and to the right. Keeping this in mind enables us to look to add equities at opportune times, which over the long run is what helps generate higher returns. In trickier times, as we have been in this year, we try to stick pretty close to the portfolio construction targets that we and our board agree give us the best chance to achieve our long-term goals. When we see an opportunity to add to our equity exposure, as we did in March of 2020, we will take it.

Whose “formula” is correct? The market will decide that, of course. We would say that it is good to be reminded after one of the best three-year stretches ever for stocks to make sure you are not becoming complacent. Similarly, history has shown time and time again that the best way for even the most bearish investors to make money is by owning equities. The next two charts show that while real assets outperform during high inflation periods, over the long run, equities will generate the highest long-term rates of return. And except for (what have historically been) brief periods of high inflation, equities are also an excellent inflation hedge as capable managements work hard to maintain/grow pricing power in all market environments. Bonds and hedge funds can be excellent ways to control risk in the portfolio, but are very unlikely to produce returns competitive with equities over time.

US Average Annual Real Returns by Inflation Level (1871 to 2021)³



Trailing 12-Month Equity Returns and Batting Average Segmented by Contemporaneous Inflation Rate (1970 to 2021)⁴

	Trailing 12-Month Inflation Rate Segments			
	0% - 2%	2% - 4%	4% - 6%	>6%
Number of Trailing 12-Month Periods	122	273	112	102
Average Inflation Rate	1.6%	2.7%	4.7%	8.8%
MSCI World - (% of Periods With Positive Real Returns)	79%	71%	69%	50%
MSCI World - (Average Real Return)	8.9%	8.5%	9.4%	-2.8%

Times like today are what create (at some point) the best opportunities to establish new equity positions at prices that in a few years' time will look very attractive. We will remain cautious as we remain vigilant in our efforts to uncover the really good investment opportunities ahead.

As always, we want you to know we very much appreciate the opportunity to help manage your capital and to help you achieve your organization's financial goals. We are here to assist you in any way possible, so please reach out and let us know how we can help.

Your TIFF Investment Team

More Bulls Versus Bears	
<i>We encourage you to learn more about John Hussman and Jeremy Siegel on their respective websites and to read each of the papers referenced above. It will take about 30 minutes to read both papers.</i>	
Bull: Jeremy Siegel	Bear: John Hussman
"Siegel vs. Shiller: Is the Stock Market Overvalued?," summarized from the "Financial Markets, Volatility and Crises: A Decade Later" conference held at the Jacobs Levy Equity Management Center for Quantitative Financial Research, New York, NY, September 14, 2018.	"Making Friends with Bears Through Math," John Hussman, Hussman Strategic Advisors, June 2022.

³Citi Research.

⁴"The Inflation Outlook for Nonprofit Portfolios," Matt Hoehn, TIFF, October 2021.

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