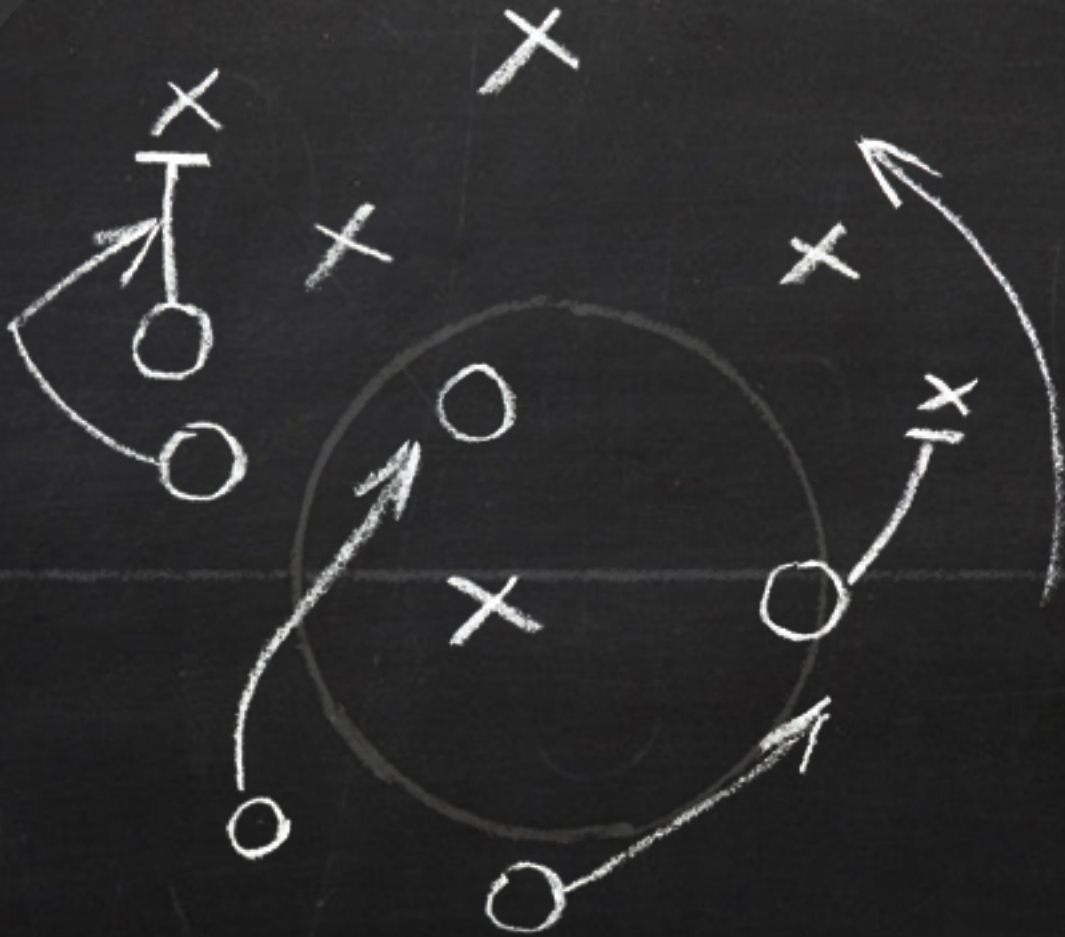




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English Version



NOTE FROM THE CIO

Navigating Market Volatility

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“The most important quality for an investor is temperament, not intellect”

Warren Buffet



Ahmed Riesgo
Chief Investment Officer
Insigneo Financial Group

This year, so far, has been a trying time for investors with virtually nowhere to hide from tumultuous markets. Most financial assets have been roiled by three simultaneous sources of uncertainty: Chinese Covid-related lockdowns, the ongoing Russian invasion of Ukraine, and hawkish surprises to the path of monetary policy around the world. The MSCI All Country World Index and the S&P 500 have fallen sharply and flirted with bear market territory. On the last day of trading in April, the US index broke below a level that served as soft support for the trading range established since the Russian invasion back in February. Consequently, the market has suffered some technical damage that could take some time to unwind. Not surprisingly, investor sentiment has turned extremely negative as exemplified by the American Association of Individual Investors' bearish inclination level approaching its worst reading in 30 years, a period that encompasses the Covid-19 pandemic and the Global Financial Crisis. But volatility in equity markets is commonplace. It has been the precipitous fall in bond prices around the world that have most unnerved investors with their so-called safe-havens or ballasts in blended portfolios not delivering the promised cushion in times of stress. Because of the nascent inflationary environment that is likely to persist over the next few years, we declared during our April quarterly call that the 40-year bond bull market in US Treasuries that

began in 1981 ended in March of 2020 when rates hit historic lows during the Covid-19 pandemic. The sudden reopening of the global economy in the midst of still-disrupted supply chains and the Ukrainian conflict have turbocharged the selloff to dizzying levels. Since that date, a constant duration 30-year US Treasury Bond has delivered an astonishing -50% total return (as an aside, we have now turned tactically neutral on long duration assets like the long bond given the magnitude of the sell-off and the unfolding inflationary landscape and expect at least a pause in the structural bear market). Unsurprisingly, people are becoming despondent and fearful.

One final point before we delve into the fundamentals that should tell us whether we should be following the recent trend or fading it. It is worth pointing out the distinction between risk and volatility, as they are not the same. Risk is the permanent loss of capital. Unfortunately for investors, this relates to events in the future and are not measurable. This unknown is most pertinent with respect to individual securities where the potential permanent loss of capital is possible and unknowable. On the other hand, volatility is a temporary fluctuation in price, and it is measurable. Investments can be volatile without being risky, and high volatility does not mean high risk. For investors with a short-term horizon or a poor under-

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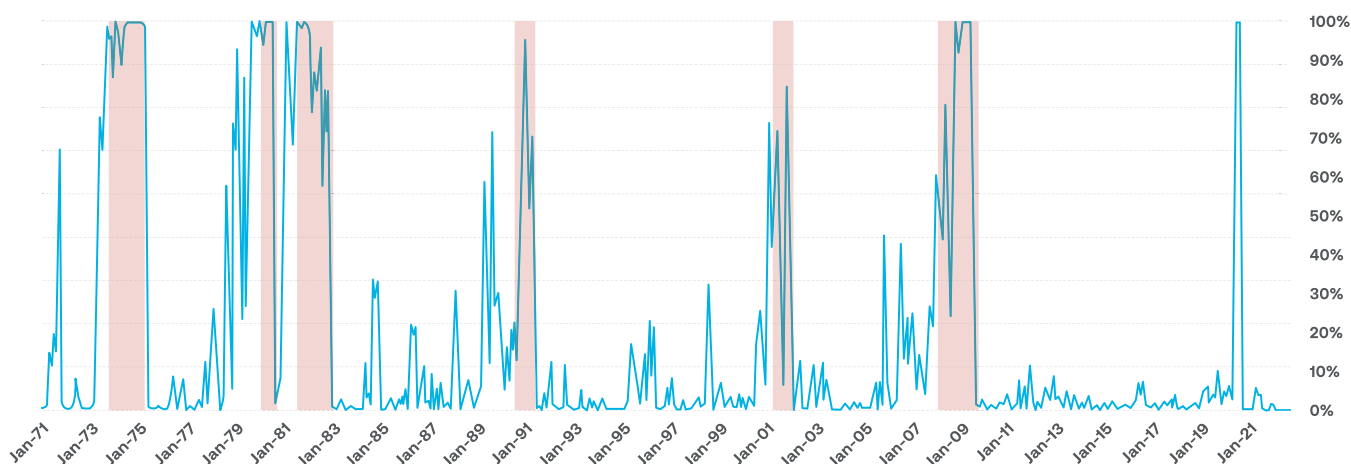
To comprehend why this heightened level of fear (or its opposite, greed) is so frequently a powerful contrarian signal requires some understanding of human psychological and cognitive biases. **Those same evolutionary adaptations that made us especially pro-social primates work against us when it comes to market behavior.** We seek validation from others, follow crowds, and watch what others are watching. These traits work well in the natural world and, thus, selection pressures reinforce them among human beings. But they also make us less successful investors. The more a market goes up, the more people want to buy it. A successful investor would be buying less or outright selling. Conversely, the more a market falls, people want to sell it even more. A successful investor would be selling less or net buying.

standing of their own volatility tolerance, this important distinction is less meaningful because volatility can cause permanent capital loss if it makes an investor sell an investment following a temporary drop in price. This is precisely why one should never invest in highly volatile assets or markets if one has either a) intolerance for volatility or b) high liquidity needs.

It is important to remember that markets are forward-looking so we must always ask ourselves what the global economy will look like in the future and not what it looks like today. As you know, as long-term investors, we construct our asset allocation firmly rooted on macroeconomic and market fundamentals. For that, we rely heavily on our proprietary Insigneo-Forefront recessionary indicator that gives us the probability of a US recession over the next six months.

Forecasted Recession Probability for 2-Quarter Forward Period using All Macro Leading Indicators

Source: Insigneo, Forefront Analytics (shaded areas indicate US NBER recessions)



So, what is our recessionary indicator signaling today? As this graph demonstrates, it is telling us that **the probability of a recession in the US in the next six months is still incredibly low hovering below 10%**. US growth is slowing and showing signs of late-stage dynamics of the economic cycle which means that recessionary probabilities should become a significant risk in 2023. But currently, the US consumer remains buoyant thanks to incredibly robust private balance sheets that are offsetting the squeeze in real income caused by higher inflation. On the corporate side, capex should be buttressed by elevated levels of cash and a still generous spread between the real return on invested capital and the real weighted average cost of capital. However, the sector of the US economy that looks particularly vulnerable right now is the housing sector where skyrocketing mortgage rates have made the average monthly cost of the median US home 50% more expensive than it was just a year ago. It is worth noting though that our recessionary indicator incorporates over 50 input series that capture all facets of the US economy. Finally, the statistical confidence of our model 2-quarters out based on past data is 81%. This means that it has successfully captured upcoming US recessions roughly 80% of the time going back to 1971.

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Is it perfect? No model is, but the correlation is high enough that it would not make sense for us to claim that the next recession, whenever it arrives, will be in the 20% distribution not captured by the indicator.

So, why is the market down so much? Another way to phrase it is “why is the market forecasting such a high probability of a US recession?” As of the end of April, S&P 500 returns (which were down over -13% at the time) were forecasting a 35% chance of a US recession in six months. But guess what is the degree of statistical confidence (i.e., its explanatory power) for only the stock market signal? It is only 2%, which basically amounts to statistical noise. The power of the

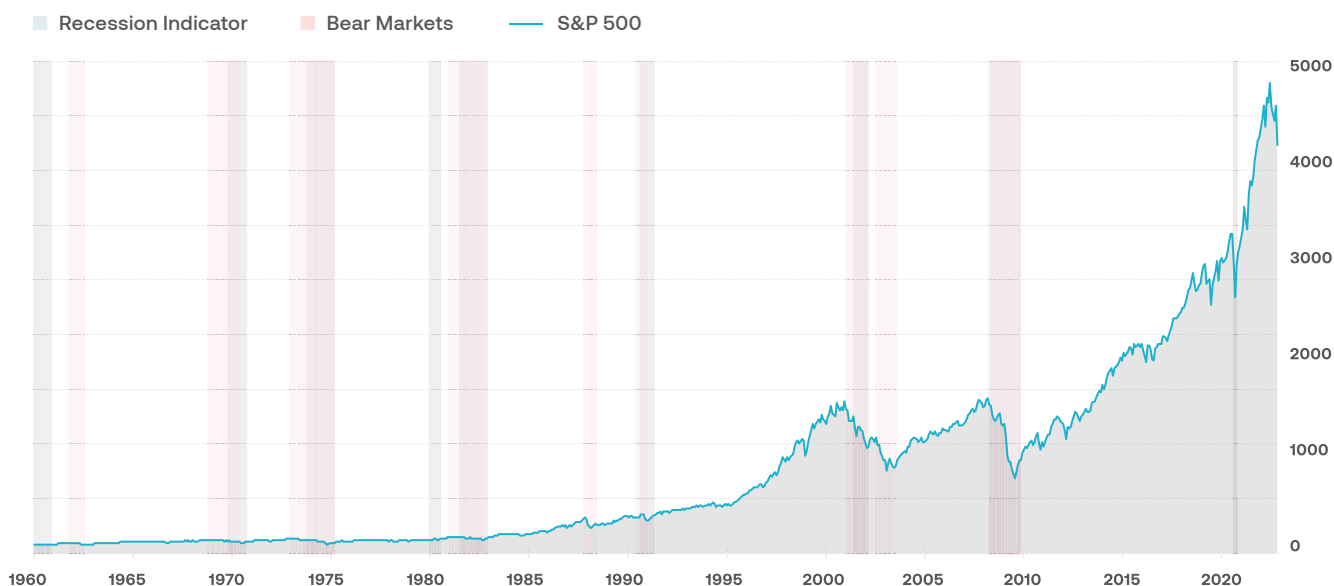
indicator lies in aggregating the fifty input variables, improving the degree of statistical confidence based on past data to 81% vs. solely relying in the stock market as a predictor of future recessions with only a 2% degree of confidence based on past data. The indicator allows us to block the noise and to generate a meaningful signal that is actionable. So, my answer to the original question would be that, **taken in isolation, equity market price movements tell you little about the probability of a US recession in six months' time.**

And as this next chart shows, **absent an imminent recession one should not reduce volatility in portfolios because bear markets and recessions tend to overlap.** Is this general rule of thumb perfect? Again, the answer is “no” as there was one instance in 1987 where US equity markets fell by 20% or more absent an economic recession. But we should not position ourselves bearishly given those odds. In other words, we would bet that the “next one” will overwhelmingly be more like the other ones rather than the 1987 Black Monday bear market exception.

No one knows the future for certain. All we can do is play the better odds.

Let me end this note with a consideration that pushes back against everything I just wrote. First, let us assume that we are right that the macroeconomic fundamentals are so solid in the US that a recession is not imminent. But we are wrong in our assessment that inflationary pressures will ease enough during the second half of the year as pandemic dislocations subside and services consumption normalizes. At least, ease enough that the Fed does not need to hike rates by more than what is currently expected by markets (i.e., a Fed Funds rate of 2.75% by December 2022). In other words, let us assume that the Fed has already decided or will decide as more data come in that the only way to bring inflation back under control is to induce a US recession. In fact, one could argue that sentiment is what has caused this most recent sell-off. Well, if that is the case, then it still does not make sense to reduce volatility (i.e., make losses permanent) now that the market has fallen so much already. During the twelve recessions in this country

Bear Markets & Recessions Tend to Overlap | Source: Bloomberg



since World War II, the S&P 500 experienced a median contraction of -24%. With the index down approximately -18% as I write this, the median downside would be limited as 75% of the median fall has already been absorbed. **The time to reduce volatility (i.e., to raise cash) was back in February**, as we advised our more conservative clients in that month's CIO Note. The time for that has passed. **Now, we would advise our conservative (i.e., lower volatility tolerance) investors to stay the course until the three sources of uncertainty we mentioned earlier get clarified. But for our more aggressive clients (i.e., those with higher volatility tolerance), now would be the time to start buying markets or assets one finds attractive.**

Corrections always feel “healthy, normal, and necessary” until you are actually in one. That is the moment when those aforementioned emotional and psychological responses kick in and people become fearful and make losses permanent. **As long as an economic contraction is not in the offing, corrections tend to end only when many investors think the bear market has already begun.** According to the latest investor surveys and my own meetings with clients, I would say that we are at or near that capitulation moment. And once the last investor has finally given up and sold, that is usually when markets start to rip higher.



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