

Market Commentary

Faith, Trust and Pixie Dust

January 2023

Summary

- It's been a great start to the year for markets; both stocks and bonds ended January with decidedly positive returns. The NASDAQ Composite enjoyed its best January since 2001, ending the month up 10.7%.
- Most central banks have continued to raise interest rates, and tighter monetary policy has helped bring inflation down from multi-decade highs.
- One exception is the Bank of Japan, which has been compelled to maintain its ultra-easy monetary policy—injecting significant liquidity into the global financial system—despite the country experiencing its highest inflation in over four decades.
- The market's response to Japan's continued quantitative easing suggests that investors may be losing patience with central banks that use a heavy hand to carve an extreme path.

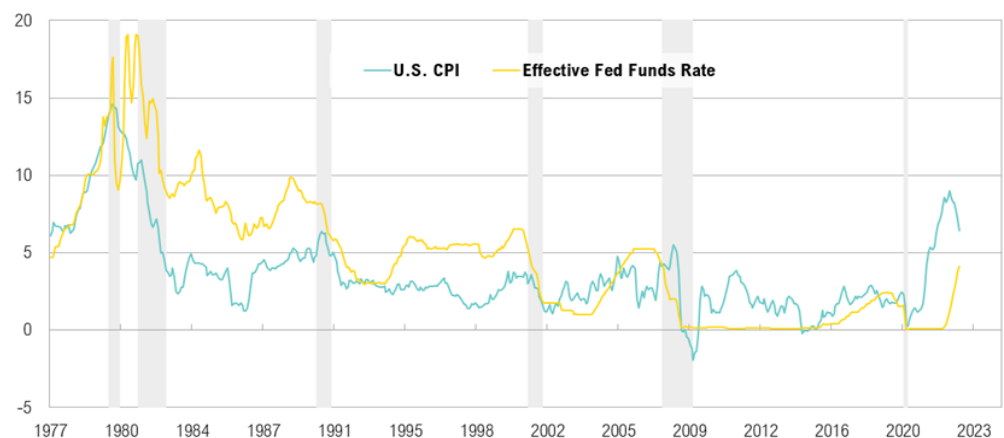
Overview

It's been a great start to the year for markets. In January, both stocks and bonds produced decidedly positive returns. The S&P 500 was up 6.3%, and the Bloomberg U.S. Aggregate Bond Index ended the month up 3.1%. The NASDAQ composite posted its best January since 2001, returning 10.7% for the month.

Earnings season kicked off in January, and 50% of S&P 500 companies have currently reported fourth-quarter 2022 earnings.¹ Due to ongoing concerns about a possible economic slowdown or recession, analysts lowered earnings per share (EPS) estimates more than normal for the first quarter.¹ Full-year estimates have also been lowered, and expectations now sit at 3.0% growth in 2023 relative to last year, down from 4.8% expected at the end of December.¹ Given the decline in earnings expectations and the recent rise in stock prices, the forward 12-month price-earnings ratio of the S&P 500 Index has increased to 18.4x from 16.7x at the end of December—back above its long-term average of 17x.

The Last Decade Has Been an Outlier for Monetary Policy in the U.S.

U.S. Consumer Price Index & Federal Funds Effective Rate, as of 12/31/2022
Year-over-Year, %



Source: FRED

Since mid-2022, central banks around the world have been hiking interest rates to bring inflation back under control, and these tighter monetary policy efforts have started to work. Following record-high levels in many countries in the latter half of 2022, global inflation levels have reversed. In the U.S., inflation hit a four-decade high of 9.1% in June 2022, but it has since dropped to a still-high 6.5% as of the end of December. Inflation in the Eurozone has dropped to 8.5% in December from its record-high of 10.6% in October 2022.²

A notable exception to both tighter monetary policy and improving inflation has been Japan. The Bank of Japan (BoJ) was a pioneer in adopting ultra-easy monetary policy decades ago in order to battle the persistently sluggish economic growth and deflation that had plagued the country since the 1990s. Despite Japan experiencing its highest inflation levels in over three decades in January, the BoJ not only maintained its ultra-easy monetary policy, but it has recently expanded the program at an alarming rate.³ This comes on the heels of last year's attempt to raise interest rates in response to rising inflation and a precipitous decline in the yen.⁴

Japan's unusual case illustrates a new risk that capital markets may need to deal with in the coming years. By overdoing its interventions, the BoJ has distorted markets for so long and by so much that it has created an impossible predicament—one with potentially enormous implications for global capital markets.

Peter Pan Monetary Policy

In an attempt to fight deflation and spur economic growth, the BoJ adopted a zero-interest rate policy in 1991, and in 2001 it introduced the world's first quantitative easing (QE) program. In short, QE is a monetary policy strategy in which a central bank makes large-scale purchases of financial assets, such as government bonds and other financial assets, to stimulate economic growth.⁵ In the words of former Chairman of the Federal Reserve, Ben Bernanke, the process is akin to electronically “printing money” and using that money to buy assets.⁶ These policies were adopted more broadly by other central banks to deal with the Global Financial Crisis in 2008 and then again during the COVID-19 crisis of 2020.

“I trust that many of you are familiar with the story of Peter Pan, in which it says, ‘The moment you doubt whether you can fly, you cease forever to be able to do it.’ — Bank of Japan Governor Haruhiko Kuroda, June 4, 2015.”⁷

In 2015, after struggling with a chronically sluggish economy, Japanese policymakers felt they needed to try something dramatic. The statement above is an excerpt from a speech that BoJ Governor Kuroda made a few months before the BoJ expanded its QE policy and introduced ‘yield curve control’—a new approach that took the country's already ultra-easy monetary policy one step further, capping the yields on Japanese government bonds. Kuroda's view was that for this extreme policy to succeed, the Bank of Japan, the Japanese government, and the world *would have to believe that it would work*, perhaps creating the world's first macro-economic Tinkerbelle Effect. The goal of the strategy was to get inflation, which had remained near zero for most of the past decade, above the BoJ's target of 2%, which would hopefully spur growth.⁸

To implement this yield curve control strategy, the BoJ offered to buy an unlimited amount of bonds at or above a target cap rate, which was set at “around zero percent”.⁸ This policy, implemented after several years of massive amounts of QE, resulted in the BoJ

gradually replacing other market participants as the buyer of Japanese government bonds. As is the case with QE, the purchases were made with electronically ‘printed’ money. As of the end of 2022, the BoJ had accumulated more than 51% of the roughly \$8 trillion Japanese government bond market—one of the largest in the world.⁹ So heavy-handed is the BoJ in the Japanese government bond market that sometimes days go by without any trading occurring. For example, Japanese 10-year government bonds did not trade for five consecutive days between October 7 and October 13 last year—the longest streak since March 1999.¹⁰ For context, the average daily trading volume for U.S. Treasuries is well over \$600 billion, representing hundreds of thousands of trades.¹¹

As if that were not enough, the BoJ has also been purchasing equity exchange-traded funds (ETFs) since 2010 as a part of its QE program.¹² More than a decade later, the BoJ now owns 63% of all locally owned ETFs.¹³ During the COVID-19 crisis in 2020, the U.S. Federal Reserve (Fed) resorted to a similar program whereby it purchased \$13.7 billion in corporate bond ETFs through a program called Secondary Market Corporate Credit Facility (SMCCF).¹⁴ The Fed started buying bonds for this program on May 12, 2020 and stopped purchasing for this program on December 31, 2020.¹⁴ Unlike the Fed, the Bank of Japan has continued to purchase ETFs.

Investors Losing Faith and Trust in the Magic of QE

In 2021, as inflation levels started to creep past the BoJ’s target of 2%, it attempted to raise rates.¹⁵ First, the BoJ raised its cap on government bond yields from 0% to 0.25% in March 2021, and then it raised them again from 0.25% to 0.5% in December 2022.¹⁶ However, investors didn’t bite. At the risk of oversimplifying, it is unsurprising that they were reluctant to buy bonds that locked in a yield of 0.5% in a country targeting inflation of 2%. As a result, the BoJ was forced to return to its ultra-easy monetary policy or risk letting bond prices be fully subjected to market forces—something it was not willing to do. Since then, the BoJ has been frantically buying bonds to maintain control of yields, but this may be further fueling inflation.¹⁷

In January, Japan’s inflation hit a 30-year high of 4%. The magic of buying bonds with ‘printed’ money could be losing its captivating spell. For the first time, Japan is implementing QE in an inflationary environment, and the ramifications of this strategy are not yet clear. Japan is the largest foreign holder of U.S. Treasuries, totaling more than \$1.08 trillion as of November 2022.¹⁸ Japanese investors have also played a crucial role in global markets, funneling the equivalent of hundreds of billions, even trillions, of dollars around the world in search of higher yields.¹⁹ Historically, due to the BoJ’s artificial suppression of Japanese government bond yields, Japanese investors could generate more meaningful returns by simply investing cash outside of Japan via U.S. Treasuries. However, now that the BoJ may be compelled to let interest rates increase, the relative attractiveness of U.S. and other international assets for Japanese investors has changed.

Like the BoJ, the U.S. Federal Reserve also believes in QE’s magical properties. When the Fed announced another QE program in November 2010, then-Chairman Ben Bernanke wrote an op-ed in the *Washington Post* to convey his faith and trust in QE’s ability to drive economic growth—

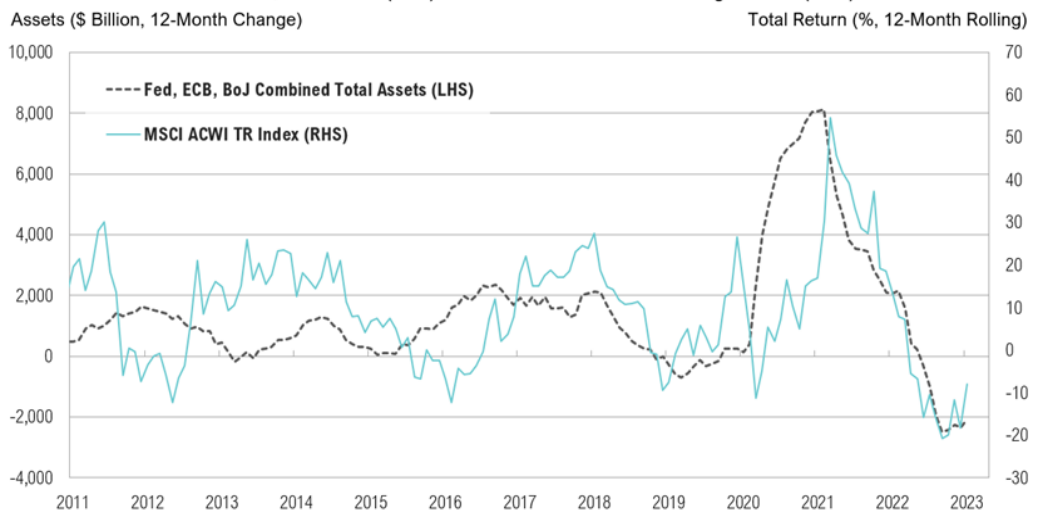
“[Quantitative easing] eased financial conditions in the past and, so far, looks to be effective again. Stock prices rose and long-term interest rates fell when investors began to anticipate this additional action. Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing

more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion.” — Ben Bernanke, Opinion Letter published in the Washington Post, November 4, 2010.²⁰

While QE works in the short term, history suggests its impact on asset prices (and growth) is fleeting. This dynamic was evident during the COVID-19 pandemic, when global QE efforts by central banks supported stock market gains. Since June 2022, most central banks have not only stopped expanding balance sheets, but they have also shifted focus to tightening policy to fight inflation. For example, between the third and fourth quarter of 2022, the Fed and the European Central Bank (ECB) began to reverse QE, and both banks together reduced their balance sheets by \$537 billion. However, in comparison, the BoJ’s balance sheet expanded by \$640 billion over the same period.

Apparent Correlation Between Global Central Bank Balance Sheets & Stock Returns

Combined Total Assets of Fed, ECB & BoJ (LHS) vs. the MSCI ACWI Index Rolling Returns (RHS)



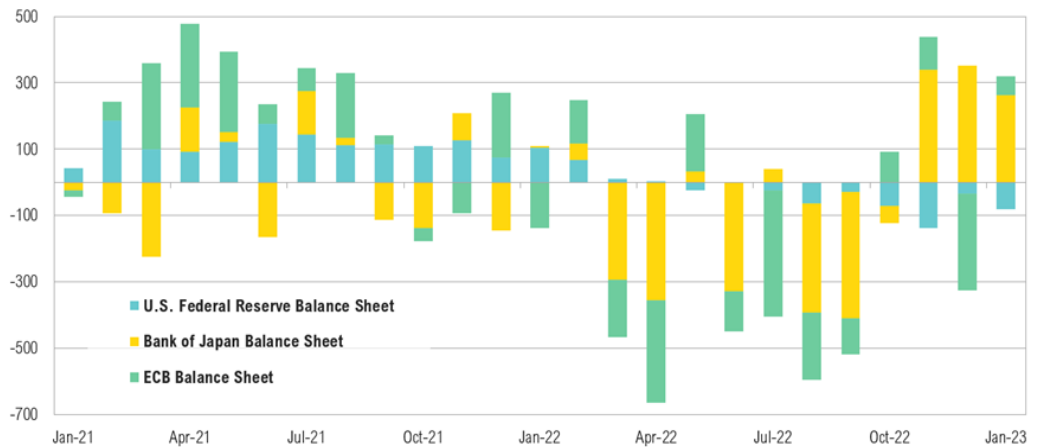
Source: Bloomberg

In the past few months, the BoJ has been rapidly expanding its balance sheet, adding more than \$953 billion between November 2022 and January 2023, in what appears to be a desperate effort to maintain control of its bond market.²¹ As one example, the BoJ spent more than \$39 billion in its fixed rate operations on Friday, January 13 alone—breaking a record for its largest one-day operation. Despite that, the 10-year Japanese government bond yield ended the day above target, at 0.51%. The BoJ’s aggressive purchasing has now dwarfed the Fed’s quantitative tightening efforts, meaning that global quantitative easing is rising at its fastest pace since the COVID-19 crisis. These efforts can be compared to the Fed’s ‘panic buying’ during the early stages of the COVID-19 pandemic in 2020²² when it expanded its QE program by more than \$1.4 trillion between March 18, 2020, and April 16, 2020.²³

Leading up to its January 18 Policy Board meeting, there was widespread speculation that the BoJ would increase its inflation target to 3%.²⁴ However, the BoJ remained steadfastly committed to its ultra-easy monetary policy. To justify the decision, Governor Haruhiko Kuroda cited the fragility and uncertainty in the country’s economy:

Bank of Japan Has Expanded Its Balance Sheet By \$950bn Over The Past Three Months

Balance Sheet (\$ Billion, Monthly Change), 1/31/2022 - 1/31/2023



Source: Bloomberg

“Uncertainty regarding Japan’s economy is very high. It’s necessary to support the economy with our stimulus policy, to ensure companies can raise wages. By maintaining ultra-easy policy, we will strive to achieve our price target stably and sustainably accompanied by wage hikes.” — Bank of Japan Governor Kuroda, Policy Board Meeting, January 18, 2023.²⁵

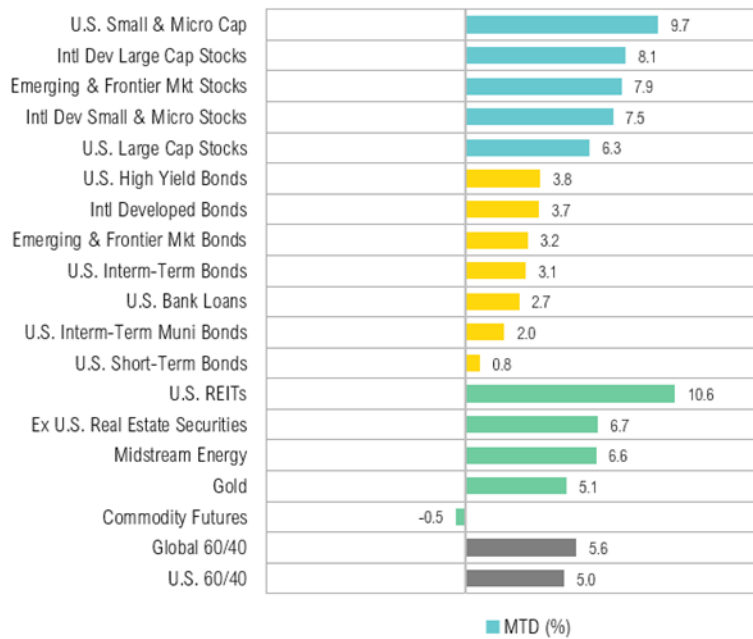
Governor Kuroda’s term ends on April 8. The next governor will be faced with the mammoth and simultaneously delicate task of unwinding decades of ultra-easy monetary policy, which has come under increased criticism for distorting markets.²⁶

Markets

Commodity futures were the only asset class that failed to produce positive returns in January, ending the month marginally down at -0.5%. U.S. REITs and U.S. small cap stocks were the top performers in January, returning 10.6% and 9.7%, respectively. International markets outperformed the U.S., and the MSCI EAFE Index ended up 8.1% while the S&P 500 closed January up 6.3%. Both U.S. and international fixed income markets ended January with positive returns. The Bloomberg U.S. Aggregate Bond Index gained 3.1% while international developed market bonds closed the month up 3.7%. The rally in January was focused on the most beaten-down names of the prior year. For example, the Goldman Sachs Liquid Most Short Index is an index of companies in the Russell 3000 with over \$1 billion in market cap that have the highest percentage of short interest, as measured by float. The index ended 2022 down 56.6% but increased 24.2% in January.

The Bank of England hiked interest rates by 50 basis points to 4% on February 2, with economic forecasts pointing to a shorter and shallower recession in the U.K. than previously anticipated.²⁷ This is welcome news for the U.K., where a rising inflation crisis has spurred widespread worker strikes since mid-2022. The ECB also hiked rates by 50 basis points to 2.5% and has already stated that the next rate hike would be another 50-basis point hike.²⁸

January 2023 Key Market Total Returns



Source: Bloomberg

Looking Forward

The longer-term implications of the BoJ's recent actions are unclear, but the longer they suppress yields, the more painful the adjustment will be if and when its interventions are stopped, whether voluntarily or if effectively compelled by global markets. If inflation does not subside in Japan, policymakers may be forced to choose between (1) allowing their currency to devalue further and prompt even higher inflation or (2) risking what could be a dramatic re-pricing of the Japanese government bond market.

Massive intervention by central banks when inflation is at a multi-decade high poses a new risk for markets. While the U.S. is not Japan, Japanese investors have been major participants in global capital markets, and we think dynamics around the BoJ, Japanese inflation, government bond markets, and the yen should be watched closely over the coming quarters for insight on investors' reaction to central banks' heavy-handed moves. For now, we are taking a wait-and-see approach, but it may well be that faith and trust in the extreme monetary policy of the last few decades are waning.

Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

Asset Class Definitions

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Interm-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Interm-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

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