

Episode 29

Market Madness roundtable

The Investment Research team leaves it all on the court as they share their top picks for the most impactful market event of Q2.

Kara O'Halloran (00:02):

We're very excited to bring you this special edition of The Fireside Podcast. It is our Market Madness tournament. If you want to follow along with our brackets, which were all based on a survey of FS employees, you can find them all on the Fireside tab of fsinvestments.com. I hope you enjoy. Welcome back to Fireside, a podcast from FS Investments. My name's Kara O'Halloran, and I am here with my whole team for our inaugural Market Madness tournament. So in the room with me is Rob Hoffman, the head of our research team. We have Andrew Korz, another director on the team, and Lara Rhame, our chief U.S. economist. Hi, everyone. [crosstalk 00:00:43]

Kara O'Halloran (00:43):

All right. So I want to just set the stage about how this is going to work. So I have created a bracket with 16 things that could impact markets over the next three months. This is going to work exactly like a basketball bracket. We're going to start in the Sweet 16 round, though. There are four regions, there are four seeds in each region, and we're going to go through head-to-head matchups in a bracket style competition, until we narrow it down to the one thing that we think is going to impact markets the most over the next three months.

Lara Rhame (01:10):

Kara, I just want to say that I am so happy that your love and passion for college basketball was able to intersect with your incredible podcasting skills, and your passion for the markets. This is a perfect storm for you.

Kara O'Halloran (01:24):

It's a dream come true.

Lara Rhame (01:25):

This is your dream come true.

Kara O'Halloran (01:25):

I've had a lot of fun with this. And I know a podcast is an audio medium, but I need to let everybody know that Andrew and I are sitting here in the room in Villanova jerseys, so those are where our true loyalties lie. All right. So the winner of each round that we'll go through, and therefore, the factor that is moving on to the next round, was determined by a survey that we took of FS employees. So once we've walked through it, all the full survey results will determine what our correct or official bracket is.

Kara O'Halloran (01:55):

Obviously, we don't know at this point what's really going to impact markets for the next three months, so we're just going to use our survey results for the purposes of today. But maybe people check back in three months. That could be kind of fun. And I should say this upfront,

none of this is investment advice or should be considered artificial forecasts. And to make it a little more fun, my team has not seen the bracket results yet and has filled in their own brackets, and they're going to compete by competing real time on this podcast to see who has the most correct bracket.

Lara Rhame (02:25):

Bragging rights. That's what we get. Bragging rights.

Kara O'Halloran (02:26):

We're only winning bragging rights, that is all.

Lara Rhame (02:29):

I mean, that's good enough for me.

Kara O'Halloran (02:30):

I know this team. Bragging rights will do.

Andrew Korz (02:32):

Given my experience and my previous history of filling out brackets, I probably didn't do very well, but we will see.

Kara O'Halloran (02:39):

I've seen the results, and I don't want to give any spoilers, but-

Andrew Korz (02:43):

You got to take some flyers in there. You never know.

Rob Hoffman (02:47):

Yeah. Always got to pick the upset. [crosstalk 00:02:47]

Kara O'Halloran (02:47):

Yeah, yeah, yeah. Oh, and one thing I want to make clear as well is that we're having fun with this. I like to think we always have fun on the podcast. A lot of these things are very, very serious issues with very human tolls associated with them, so while we are just having fun today, we acknowledge that, and not trying to make light of that situation. All right. Everyone ready?

Lara Rhame (03:08):

Yeah.

Andrew Korz (03:09):

I'm ready.

Rob Hoffman (03:10):

Do it.

Kara O'Halloran (03:10):

Let the games begin. So I'm going to walk through some of our early matchups, just because they were pretty much blowouts in our survey results. So running down the left side of our bracket, the number one seed in the East was Russia/Ukraine, which handily beat Elon Musk tweet, and I think we all know Russia/Ukraine has been the topic of conversation lately. And even though Elon Musk tweet didn't get many votes, I think it's a good time to remind people that the U.S. has become a very tech-dominated market, and we actually have seen things like

that move the whole market. So maybe in another season with less competition, but this year, Russia/Ukraine is moving on to the Elite Eight round out of that bracket, out of that game.

Rob Hoffman (03:54):

Not without Musk trying to maybe tilt the scales, I think, yesterday.

Kara O'Halloran (03:58):

That is true. There was a late night tweet, but as of now, Russia/Ukraine's moving on. Moving down, we have quantitative tightening versus an antitrust ruling against I guess we're calling them Magma stocks now. Again, quantitative tightening handily won out, but these small tech things could move markets, like we just talked about. Going to keep going. Interest rates beat natural disaster. And then Andrew, I think you want to talk a little bit about this one. So we have energy market angst versus crypto-related contagion. We actually had some people vote for crypto contagion. We've seen a lot of headlines about Bitcoin this year. What did you see in that matchup?

Andrew Korz (04:43):

I think that's an interesting one. I know we have some people at the company who are hardcore crypto enthusiasts. I would say you and I are a little bit more passers by, or visitors to the space. But I think that just to think about the scale of the crypto market, it's roughly a \$1.7 trillion market right now. Both Bitcoin and Ethereum are already off almost 50% from their highs from a few months ago, so that wiped about \$1.2 trillion of market cap of wealth out of the market. Which is a significant number, but if you look at the S&P, that's down almost \$6 trillion just this year. So number one, the scale compared to say the equity market is just not really comparable.

Andrew Korz (05:32):

And you also have to think of who holds the wealth in crypto. It's a very small, concentrated group of people. So when we think about the crypto market, I just don't think it's, number one, well enough ingrained into the financial market. Bitcoin's not being used as collateral across a huge number of broad financial transactions, and it's also just not big enough of a market right now to really impact consumers through say the wealth channel. So I think it's a valiant effort from crypto here, but I think you look at what's happening in energy, and I know we'll talk about this more coming up, I just don't know if it's a contest.

Kara O'Halloran (06:14):

Yeah. I think energy moves on here. Crypto got a headlines, but couldn't show up in a big spot. Let's move on to the right side of our bracket. The number one seed there was inflation, our most talked about topic this year. It really easily won out against it's lowly competitor, cargo ship-related incident.

Rob Hoffman (06:39):

Not without, however, a challenge, with a cargo ship from the same company, the Ever Forward currently stuck in the Chesapeake bay.

Lara Rhame (06:49):

But is it blocking traffic?

Rob Hoffman (06:50):

Not moving forward currently.

Andrew Korz (06:53):

They need to come up with some more humble names for these ships, I think.

Lara Rhame (06:57):

The Ever Stuck.

Kara O'Halloran (06:59):

So we had a late game rally from the cargo ship, but inflation, once again, took this one. Next, we had a really contentious one. This was a tough battle. Corporate earnings versus household sentiment. And Andrew and Lara, I want you guys to talk about what you're seeing here. You had different results for this one. Andrew-

Lara Rhame (07:24):

Did Andrew pick corporate earnings?

Andrew Korz (07:25):

I did.

Kara O'Halloran (07:26):

He sure did. Yeah. He doubled out on them too. So Lara, let's start with you. Walk us through why you chose household sentiment over corporate earnings.

Lara Rhame (07:36):

Sure. Well, household, largest sector driving the economy. Household sentiment to me is really the canary in the coal mine for the overall economy. And because household sentiment and household consumption drives 70% of our consumption, it really accounts for an enormous amount of corporate earnings. We've seen inflation have this slow erosion in household expectations, and by one measure, the household sentiment indicator is already at recession lows. So I think over the next three months, it's going to be a more important driver, because that impacts fed rate expectations, it impacts long-term yields. It impacts growth expectations. Earnings are probably going to be solid, but they're not going to be a blowout, and I think it doesn't really serve as a catalyst for a move.

Andrew Korz (08:29):

So you make some good points there, Lara. I have to disagree. I have corporate earnings winning this game, and full disclosure, I actually had them going to the championship game, so this is a tough loss. It's a tough loss for me. That's probably going to knock me out of the running, but I will make my case here. So, the first point I would make is that in 2021, we saw S&P 500 earnings climb almost 50%. Now it's up from a much lower number in 2020, but significant growth, despite what we saw in significant declines in both of the major consumer sentiment gauges, the University of Michigan and conference board gauges, mostly due to inflation.

Andrew Korz (09:11):

As you've pointed out, Lara, time and time again, consumers have not seen these levels of inflation in decades, and that has really weighed on sentiment, but we haven't really seen it weigh on consumer spending in a meaningful way yet. So I think my point here would be as long as consumers, they may not like the things that are going on with prices, they're still spending right now. And until I think we see that lower sentiment flow through to companies, and really hit their pricing power, as long as earnings can stay afloat, like we've seen already, I think we could really see markets recover from this current bout of volatility.

Andrew Korz (09:59):

Now, the counter to that would be the 2018 episode, where as the fed started to raise rates, we saw a little bit of volatility. But markets really stabilized because they thought, "Hey, you know what? Fundamentals are going to be okay." And then in Q4 '18, obviously, we had the massive bear market in the S&P part of that was due to the fed continuing to tighten, but I think a lot of it was due to the trade war and GDP estimates being revised downward. And you saw, if you just look at a simple series of earnings expectations, they kind of fell off a cliff, and that's really when the market lost confidence. So I think what we're really looking for now is the fed's going to hike. Okay. That's fine. As long as earnings are okay, I think markets can do okay.

Lara Rhame (10:47):

And I think that's where we get the difference, because I see earnings as really the ballast, not the catalyst. And I think as I see an erosion in household confidence, I think that could really swing federated expectations, which is probably for another round.

Kara O'Halloran (11:03):

It's coming. All right. Well, that was-

Lara Rhame (11:04):

That was a tight game.

Kara O'Halloran (11:05):

We had a buzzer beater. That was a 2016 Villanova championship style matchup.

Andrew Korz (11:10):

Those two should not have been seeded together, I don't think. I think that was a mistake by the committee.

Kara O'Halloran (11:14):

No problems with the selection committee. The selection committee stands by their decision. All right, moving on to our next number on seed as fed rate hikes. Easily beat mem stock short squeeze, which really was a big contender in the 2021 season, not something that we talked about much in 2022. Maybe if commodity short squeeze was in there, that's been a topic lately, but fed rate hikes won out this round. So moving onto our last matchup in the Sweet 16 round, we have COVID versus China policy. And this one, Rob, I want to bring you into the conversation. Walk us through what you saw in this matchup, and who you picked.

Rob Hoffman (11:53):

Yeah. So, I went with COVID. I think that it's a tough one. It's a tough seed for a first round battle. I think look, China policy in terms of thinking about what that represents, whether it's the U.S.'s policy towards China, or the Chinese policy toward the us. I think that from a large, big picture perspective, what do these countries want right now? China wants growth. They've come through a zero COVID policy, or they still have a zero COVID policy. It's clearly had a negative impact on GDP for the country over the past couple years. They've come out and said they're trying to target 5.5% GDP growth, I think they really want that.

Rob Hoffman (12:38):

Similarly, what does the U.S. want? The U.S. wants lower inflation. In addition to full employment, and growth, and everything else, I think the U.S. politicians certainly feel the pressure of higher inflation and what that represents for individuals. So, what is the propensity, then, for the U.S. to, say, go for new tariffs or something like that against China? That would not be beneficial for inflation. What does China want in terms of some of the geopolitical conflict? I think they would try to avoid entering into anything that can impair all their ability to hit their

growth targets, and try to really emerge from the pandemic, from a growth perspective. So to that end, I pivoted to COVID. I think that-

Kara O'Halloran (13:22):

Well, I think it's interesting. We just saw this weekend that China has locked down another territory, so how does that factor in?

Rob Hoffman (13:29):

Yeah, I think that what COVID has shown, and I get in the U.S., over Delta and then Omicron, the impact to the U.S. has seemed to be less and less from an economic standpoint. Certainly, the human toll is still very large, but I think that what we saw, Omicron came out of nowhere, and it was, 'Hey, here's this variant. We're seeing it in some places. It seems to be growing," and then boom, within a couple of months, it was the number one thing. Cases were skyrocketing, people were reacting to it.

Rob Hoffman (14:05):

So I think COVID has shown the ability to grow very quickly, and to the context of a bracket looking over the next three months, that strikes me as something that could there be a COVID surprise, it's not just a U.S. reaction. There's still a lot of countries that will very quickly go to lockdown, whereas we may not do that here. That has the propensity, I think, to spiral into more supply chain problems, more inflation, everything else. Global concern, maybe the fed can't raise rates. Those could all have major market implications, and so for those reasons, I went with COVID over China.

Andrew Korz (14:42):

Yeah. And just to quickly add onto what Rob said, I think COVID transcends. Obviously, COVID is the chicken or the egg with China's zero COVID policy, but COVID is right now raging across Asia. You're seeing it in Vietnam, in South Korea, a lot of really important countries to the global supply chain. So I also had COVID here. You're seeing in Germany, yesterday they had the highest that they've had, as the Omicron BA.2 variant spreads there, so we really don't know. There's a lot of uncertainty around that as well. So while, like you said, the economic toll in the U.S. might be diminishing with each wave, I think the impacts to the supply chain and what that means for sort of forward inflation expectations could be pretty significant.

Lara Rhame (15:31):

China won though, right?

Kara O'Halloran (15:33):

China did win. China did win, and Lara, you, I believe, had China.

Lara Rhame (15:40):

Yes. I'm really liking the way this first round is going for me.

Kara O'Halloran (15:45):

Are you eight for eight?

Lara Rhame (15:47):

I don't know.

Kara O'Halloran (15:47):

I think you did.

Lara Rhame (15:48):

I don't know. I think I am.

Andrew Korz (15:48):

Collusion.

Lara Rhame (15:52):

And I just think at the end of the day, when we think about that global flywheel of growth, COVID is a factor, but China, as the second largest economy in the world, really remains a driver both of growth, and a way where we could really just continue to it slow down. So that's why I picked China.

Kara O'Halloran (16:15):

All right. Well, we'll see how China does in the next round. All right. So we are done with the Sweet 16 round. We're moving onto the Elite Eight. I'll run through what the bracket looks like right now, just to catch everyone up. Moving on, we have Russia versus quantitative tightening, and then we have interest rates versus energy inflation versus household sentiment, and fed rate hikes versus China. Let's start back in the East, with Russia versus quantitative tightening. And QT is not something that we've really talked about. Not a team we've talked about since the 2018 season, the last time the fed did QT, or the only time the fed has talked about QT-

Lara Rhame (16:52):

Yeah. The only time.

Kara O'Halloran (16:53):

So really, this is a dark horse candidate. We don't really know much about this team. So Rob, what do you like in this round?

Rob Hoffman (17:00):

Well, I went with Russia/Ukraine. I think that the common saying is that markets hate uncertainty, and when you think about this geopolitical conflict and the level of uncertainty that it potentially wreaks upon markets, it could spiral in all different ways, and that is something that is extraordinarily difficult to quantify. It could happen very quickly. The propensity for that to cause market madness over the course of the near term is quite significant. Quantitative tightening, it's not happened a lot historically, because quantitative-

Kara O'Halloran (17:40):

Once. It's happened once.

Rob Hoffman (17:40):

... hasn't happened a lot historically. It's a new thing. That being said, the fed hasn't even signaled that they are actually going to do it. The market expects it to start happening perhaps in June. June would put us right at the three month deadline, so it's another way that I think I could-

Kara O'Halloran (18:02):

T him up. Technical foul.

Kara O'Halloran (18:03):

Tempting

Rob Hoffman (18:04):

... pick the current conflict. But look, these types of things, I think what the fed has shown is that they want to telegraph their actions to the market, whether it's in terms of what they're saying about rate hikes. And I think that as we get closer and closer to the point in time where quantitative tightening will actually happen, I would expect that the fed will say a lot about it. They'll let us know that it's coming, they'll tell us how it's going to happen. It'll give the market a lot of time to absorb it and react to it, and so for all of those reasons, I went with Russia/Ukraine over quantitative tightening.

Kara O'Halloran (18:36):

All right. I think you all did, and I actually have a question now for the group. Do you think any of the things that are happening in Russia/Ukraine, as you said, Rob, the fed, we think they're going to start quantity of tightening likely in June. That's what markets are pricing in. We're not sure about that yet, but do you think any of the events in Russia/Ukraine could delay that, or postpone it?

Lara Rhame (19:00):

Yeah, I do. I think at the end of the day, the fed is very clear that raising interest rates or changing interest rates is their primary policy lever, and not manipulating the balance sheet. So I think it goes without saying that they want to unwind some of the really acute emergency measures related to the pandemic that they've put in place, but I think it's a lower priority than raising interest rates. And to the extent that it injects volatility, it's pretty easy for them to back off of that.

Lara Rhame (19:33):

And to Rob's point, I think that'll come out as they communicate more clearly what they want to do, versus when they actually do it. This is something that they want to be priced in. We didn't have a great experience with QT in 2018. It arguably added to that bad market volatility that we saw. But I think the point there is that it happened later, after they had been engaged in shrinking the balance sheet. It's something that is not, I think, going to be the primary source of market volatility in the next few months.

Kara O'Halloran (20:09):

All right. And it does. We've talked about on this podcast before, you and I, Lara, about just the lack of flexibility with the fed right now, since we are facing near 8% inflation-

Lara Rhame (20:20):

They're behind the curve.

Kara O'Halloran (20:21):

... and you have to hike. Yeah, exactly. So they don't have much flexibility in terms of the hikes, at least at this point, so it just adds. It's an option for them down the line. All right. Let's move. So Russia is moving on out of that game, so let's move on to interest rates versus energy. Andrew, I want to talk to you about this one. Oil has historically been a big driver of inflation expectations, and we're definitely seeing that in real time right now, and oil has been extremely volatile. It's off its highs now, but if we were to see sustained very high oil prices, theoretically, we could see that feed into interest rates, but then there's also the flip side of that, where it weighs on growth. So walk me through what you were thinking in this round.

Andrew Korz (21:08):

Yeah. I think this is a really interesting one, because first of all, you can go anywhere you want with interest rates, that's fairly broad.

Kara O'Halloran (21:15):

Long-term. We're doing long-term.

Andrew Korz (21:16):

So I think, as you laid out, we are seeing what we call breakeven inflation expectations, which is basically just the market's pricing of what they expect inflation to be going forward, have come up fairly significantly since Russia's invasion, and a lot of that has been due to the higher oil prices and the volatility in oil prices, which I think WTI was up over \$130 a barrel a few days ago, and now it's below \$100. So in that case, higher inflation expectations lead directly into higher long-term interest rates, because investors are requiring an added yield premium to compensate for that inflation.

Andrew Korz (22:02):

On the other hand, we know that energy price spikes have historically not been good for global GDP growth. They tend to dampen consumer demand for everything else, other goods and services, which ultimately tamps down global GDP growth. We know that lower GDP growth leads to lower long-term interest rates, so it's a question of how long do you think this really acute energy crisis lasts? And I think that comes back to what we were just talking about, the Russia/Ukraine issue, and what the ultimate outcome is there. I went with energy because I think there, the dog that's wagging the tail of interest rates right now.

Andrew Korz (22:50):

We're seeing a lot of volatility in interest rates. We were down to the 160s on the 10-year treasury. Now we're up in the 2.1, 2.2% range. There's a ton of volatility, and I think we can clearly say that a lot of that is driven by Russia/Ukraine, and a lot of that is driven by the energy market. So I think that's one thing, and the second thing would be that markets are trying to understand all the things that are going on in the energy market, in the Russian gas market, in Europe, and the massive, seismic impacts that's going to have for what energy looks like over the next 10, 20, 30 years. Now, that's a bit longer than our three month purview, but-

Kara O'Halloran (23:31):

We'll come back in 20 years.

Andrew Korz (23:33):

But I think, as markets do, they're a discounting mechanism. They're looking to see who the winners from this are going to be, and I think over the next few months, we're going to see some interesting market moves as investors try to suss out where does that lead us in the energy market going forward?

Lara Rhame (23:49):

By interesting, you mean wildly volatile. I think last week we had oil moving in \$15, and today, it was really crazy.

Andrew Korz (23:56):

Yeah. And of course, there's still the thread of the NATO countries sanctioning Russian energy payments, which they haven't done yet. So if this thing escalates, that could absolutely happen, and that would have a massive impact on energy prices.

Lara Rhame (24:12):

A lot of uncertainty.

Andrew Korz (24:13):

Yeah.

Kara O'Halloran (24:14):

All right. Let's move on. So inflation versus household sentiment is our matchup, but Andrew, you were so passionate about corporate earnings that I do want to give you the chance to walk us through, because I do think this is just an interesting conversation, inflation versus corporate earnings. So if that were the matchup, it's not, you were wrong, but if that were the matchup, what would you walk us through? What you would be watching there?

Andrew Korz (24:38):

Yeah. I didn't know we turned this into a double elimination tournament here. No, so I think it's pretty simple. I think my point here would be that even if inflation is high, even if consumer sentiment is uncertain based on that higher inflation, we've seen throughout history that as long as growth remains strong, companies can retain their pricing power. Companies can retain their margins, and we've seen it. The old adage of one company's cost is another company's revenue is absolutely true.

Andrew Korz (25:11):

We've seen massive margin expansion in areas like energy, like transportation, like commodities, like semiconductors, and we've seen margin compression, especially in consumer staples, especially in healthcare. So we are seeing this big dispersion between sectors, in terms of who can defend their margins and who can't. But for the market as a whole, as long as growth remains good, some companies can pass those costs onto those customers, and I think that ultimately can carry the day for earnings, which will obviously feed through to market moves.

Kara O'Halloran (25:51):

Yeah. And just to make you feel a little bit better, because I think I was a little harsh, most people in our survey, if they chose corporate earnings in this round, had it beating inflation, so you were not alone.

Andrew Korz (26:02):

Who cares about fundamentals, right?

Rob Hoffman (26:05):

Well, I will say, if you look at how this year started in terms of markets, whether it was interest rates related or inflation related, which fed into interest rates, but for the first six weeks or so, you saw a fairly large sell off in equities, a huge rotation in equity markets, a fairly significant sell off in fixed income markets. And I think a lot of that was just a reaction to the higher interest rate environment being induced by inflation, so that even though if your fundamental outlook for corporate earnings was still relatively strong, and I think for us, it was, the market was still seeing quite a bit of volatility, just adopting to this new regime of what it meant to have higher inflation, and the potential impact that could have had on rates.

Kara O'Halloran (26:49):

And I think case in point there is something we've talked about in credit markets, Rob, where the ratings that we saw sell off the most were those highest rated, so the strongest fundamentals, as we saw those interest rates rise.

Andrew Korz (27:02):

Yeah. I would say while the market moves have been pretty concerning over the past few months, it could have been a lot worse. If you look at since October 1st, the market has gone

from pricing in one hike in 2022 to seven hikes now, and over that time period, the S&P is down 1%. And why is that? Because earnings are still really strong.

Kara O'Halloran (27:24):

All right. Well, we're not on the fed hikes game yet. Lara, we needed to do the actual matchup here, inflation versus household sentiment. Give us a couple of quick thoughts.

Lara Rhame (27:36):

So, I had inflation, because I still see a lot of positives for the household that will just, I think, keep household momentum solid. And we've seen from the various disruptions from the Delta wave, the Omicron wave, household spend can be really resilient. I think inflation is the big driver here, and really stands to upend markets, should it get worse before it gets better, which I think it will.

Kara O'Halloran (28:02):

All right. All right. Moving onto our last game in this round, it is fed rate hikes versus China. So we are recording this on March 15th. The fed is meeting as we speak, and markets all expect them to announce a 25 basis point rate hike tomorrow. We've talked a lot on our podcast before about just the volatility in fed rate hike expectations, so there's a lot to talk about in this matchup. So Lara, I'm going to turn it over to you, fed rate hikes versus China. What'd you go with?

Lara Rhame (28:32):

Tomorrow, the fed's likely to raise rates for the first time. I just second what Andrew talked about, in terms of what has been a truly remarkable hawkish pivot by the fed, going from virtually no rate hikes, or just one rate hike as of August of last year, to now seven priced in. That's one rate hike at every meeting that we have, now until the end of the year. So this has been a big move that has caused, I think, a lot of the volatility we've seen in equities, despite earnings and, and really is going to mean that the fed is really going to continue to be a big driver for overall market sentiment going forward. So that's why I think even though China is on the radar, it's important for global growth when it comes to U.S. equities, U.S. fed expectations is really, I think to me, the primary influence.

Kara O'Halloran (29:37):

And we never said whether things were impacting markets positively or negatively, and so-

Lara Rhame (29:42):

Well, and this is, I think, something that to your point, Kara, when I look ahead at the coming year, I firmly believe, given how far the fed is behind the curve in fighting inflation, they're going to go in March, and I think a rate hike in May, a rate hike in June, those are fully priced in and make sense. But to the extent that we start to get higher energy prices or broader uncertainty influence the economy, all of that may hit us towards the end of the year. It's just important for everyone to remember that just because the future's curve has rate hikes priced in, does not put the fed on autopilot to do those. And those are subject to changing, moving even more hawkish, or coming down.

Kara O'Halloran (30:30):

Right. We get into almost that if rate hikes start getting priced out, into bad news is good news for markets conundrum that we've seen before.

Lara Rhame (30:40):

Yeah.

Kara O'Halloran (30:40):

All right. Let's move on. Oh, we're at the Final Four. So in the Final Four, we have Russia, energy, inflation and rate hikes-

Andrew Korz (30:50):

Us Villanova fans are very comfortable here.

Kara O'Halloran (30:52):

We are. We hope to be there in a few short weeks.

Lara Rhame (30:56):

We've gone 10 minutes not mentioning Villanova, so I'm glad that you guys brought it back.

Kara O'Halloran (31:00):

Thank you, Andrew. I appreciate that. So I would actually check in with you guys. Who do you guys have in your Final Four in your brackets? These brackets, not your actual ones, because I know what Andrew would pick there. Rob?

Rob Hoffman (31:12):

So I had Russia/Ukraine, energy markets, inflation, and COVID.

Kara O'Halloran (31:18):

All right. Three for four.

Lara Rhame (31:19):

All right. I had Russia/Ukraine, energy, inflation, and fed hikes.

Kara O'Halloran (31:24):

Oh, a perfect four out of four.

Andrew Korz (31:25):

I had Russia/Ukraine, energy, corporate earnings, and COVID.

Kara O'Halloran (31:29):

Yikes.

Andrew Korz (31:31):

Yep.

Kara O'Halloran (31:32):

All right. Let's get into it. Oh, okay. Let's start with inflation versus the fed. This is a great matchup. Inflation is high and rising. The fed has done nothing until now, as we said. By the time this podcast comes out, we expect they will have hiked 25 basis points, as we just talked about. Many people think the fed is late to the game, behind the curve, as you just mentioned, Lara, so I'll turn it over to Rob first. Who do you have in this game?

Rob Hoffman (32:04):

Well, I took inflation, and it's difficult because mentally, I was inflation versus COVID, but the actual bracket is inflation versus fed rate hike.

Andrew Korz (32:15):

So you could bounce back.

Rob Hoffman (32:18):

Look, I think that fed rate hikes, while not solely determined based on what's going on with inflation, inflation is clearly the driving factor, I think, with what is forcing the fed's hand right now. The fed is not in a position of cutting rates to try to stimulate growth, or cutting rates to try to stimulate a job market. We're in a position of relatively full unemployment. The main headline is inflation, and it's really the driver of many things. Fed policy, interest rates, what's going on in equity markets, what's going on in fixed income markets. All of these things, I think, are major drivers to the market. For those reasons, I put inflation over what I had coming out of our Midwest bracket, whether it be COVID or fed rate hikes.

Lara Rhame (33:10):

Yeah. And this is what is so... Inflation has skipped a generation, right? So over the next three months, there's still room for inflation to get worse. We have seen, even though we've written about this a lot, that when you add up inflation from the bottom up, it's going to get worse before it gets better. Markets continue to be caught wrong footed by high monthly inflation prints, even when they are expected by the consensus. And I think it is just going to take more pain from here for markets to really internalize what that means for returns, for future discounting, for yields, for inflation expectations. All of it is just something that we really have not had to contend with for a long time.

Rob Hoffman (34:01):

What I will say is we think about stuff like supply chain issues, which is clearly a major theme in markets right now. One of the ways that clearly expresses itself is higher inflation. Inflation is almost a catchall for a lot of these underlying issues that we're seeing globally. For that reason, I think it makes it a very strong contender on this side of the bracket.

Lara Rhame (34:23):

Yeah. And one final point, keep in mind that fed rate hikes can't resolve several of the key drivers of inflation. Fed rate hikes don't solve supply chain issues, and they don't bring energy prices down, so for this reason, I think inflation just remains the dominant for the markets had to contend with.

Kara O'Halloran (34:44):

All right. Inflation's moving on to the championship. Other side of the bracket, we have Russia/Ukraine versus energy. Another really interesting matchup. Who wants to talk about this one? It's a jump ball.

Andrew Korz (34:55):

Oh, okay. I'm happy to start off. I think Russia is certainly the key drive of the energy crunch, but I will say that European natural gas prices were surging even before Russia invaded Ukraine. I picked Russia here, just because I think if you just game through the potential outcomes, if there was a ceasefire right now, what do you think markets would do? I think they would surge, and if there was an escalation, I think markets would plummet. There's just such a wide array of outcomes here and over the next three months that it's crazy when you think about it, but this war has only really been going on for three weeks.

Andrew Korz (35:40):

It's still really young, and we still really don't know all of the potential impacts of the global economy and to global markets, despite all of the carnage we've seen so far. So I think there's a lot to think about in energy, especially, as I mentioned before, going forward, what does this mean for how Europe gets their energy? Are they going to completely wean themselves off of

Russia? I think that's their hope. We'll see. But for the next three months, I think this what happens on the ground in Ukraine is going to continue to really drive markets, as we figure out all of the potential effects of what's going on.

Lara Rhame (36:22):

I think Russia really encapsulates the potential energy impact and so much more. Widespread commodity price inflation now, in the wake of this. We see it in the grains market. We see outside of the military destabilization, which is just we're going to be reading about in history books for a generation, it fast forwards the regionalization trends that we were seeing, the onshoring trends. The implications of Russia/Ukraine just keep going, so that's why I also picked it over energy in this bracket.

Andrew Korz (36:55):

Yeah. And I would also add, while the energy crunch, again, is really bad and really volatile it makes it really hard for consumers to plan, for businesses to plan on costs for new project, how are you going to plan what their costs are for a new project, if you have no idea what the input costs are going to be from commodities? But as we've seen... sorry, let me start that over. If you look at the data U.S. consumers spend half as much on gasoline and half as much on energy in general than they did say 20 or 30 years ago, so in terms of the direct impact on consumers, it's significant, but it's less significant than it might have been in say the 1990s.

Rob Hoffman (37:39):

I know Lara, you and I were talking about that earlier today. Energy prices are high, gasoline prices at the pump are high, but they have been at this level before, and they've been at this level in periods of time when the U.S. has had exceptionally strong growth. So I think the transition to a high commodity price environment can induce volatility, can feel very painful once you get there, but the economy historically has been able to adjust to that environment yeah, and has been able to power through it.

Lara Rhame (38:11):

Yeah. Russia/Ukraine.

Kara O'Halloran (38:13):

Yeah. I think that was common consensus. All right. We made it, guys. We're at the championship. It Russia/Ukraine versus inflation. So I want to go around, I want everyone to tell me who you had, who you took to win at all. We're not going to use the word win. What do you think is going to impact markets the most over the next three months?

Rob Hoffman (38:35):

I took inflation over Russia/Ukraine.

Lara Rhame (38:38):

I did too.

Kara O'Halloran (38:40):

Andrew?

Andrew Korz (38:41):

I took the Russia/Ukraine war.

Kara O'Halloran (38:43):

Okay. Let's put 25 seconds on the shot clock, give you a few seconds to walk me through why.

Rob Hoffman (38:52):

Yeah. Look, I spoke on inflation in the previous round, so I think a lot of that applies here. When you look at so many things going on in markets, in the underlying economy, supply chain issues, cost for consumers, impacts from rising COVID and economic reactions to it, all of that can roll up to inflation. And then inflation, depending on where it goes, a driver of fed policy, a driver of interest rates. What sectors are doing well or poorly in equity markets? going on in fixed income markets?

Rob Hoffman (39:30):

It just has such these broad, overwhelming impacts to many different sectors and markets globally, that for those reasons, I took inflation. It's not to say that there aren't huge uncertainties coming out of Russia/Ukraine. There are certainly, I think, views out there that it could spiral out of control in a whole variety of ways that it's not hard to paint a picture of how it generates a larger impact than inflation. But I guess maybe even though I'm a credit person by training, maybe more of an eternal optimist that there will be a path of resolution here, and it won't continue to spiral out of control, so for those reasons I picked inflation.

Kara O'Halloran (40:13):

We all certainly hope to see that. Andrew, you took Russia. You walked us through. Do you have any last closing thoughts there?

Andrew Korz (40:24):

I think I pretty much laid out my pitch. The distribution of outcomes is huge. We could see a massive source of uncertainty come out of the market, should we get some good news around some sort of cease fire, or we can get some really bad news that could, as Rob mentioned, lead this conflict to bloom into something much larger and more terrible. And I think the final point is that I think inflation is a bit more of a slow burn in terms of impacting growth and impacting economic activity. This war, if it were to get worse, I think could put us into a recession fairly quickly, and I think that specter alone is why I picked that.

Kara O'Halloran (41:15):

All right. Lara?

Lara Rhame (41:16):

I also picked inflation, because I look at the equity market inflation traditionally just is consistently undervalued by market participants as a real way to erode the present value of future earnings. I think we've already seen that impact on headline indices, as the fed has really swung into action. And here's where I'll disagree, Andrew, I don't think inflation's been a slow burn. I think inflation came on like a freight train at the end of last year, and has really necessitated the fed to make this very hawkish pivot that's been painful for markets.

Lara Rhame (41:55):

So we talk about fundamentals, which are solid, but inflation forces you to really dig in and pick inflation winners and inflation losers. And it really makes it more challenging to access those strong corporate earnings because you do have, and you do feel, that PE compression. And on the income side, 10 years at 2%, inflation's at almost 8%. I know we talk about 10 year inflation expectations and 10 year real interest rates, but right now, today, interest rates are deeply, deeply negative. So I think the impact to market continues to just be this giant, looming black cloud of inflation that's eating returns across the board.

Kara O'Halloran (42:40):

All right. Well, I think we all want to root for the Cinderella stories, that 10 seed Loyola Chicago, we made it to the Final Four a few years ago, but we did end up with a pretty marquee matchup at the end. Our survey results had Russia/Ukraine winning it all, so Andrew, congrats on having the correct champion, but Lara, I think you had the most correct bracket.

Lara Rhame (43:01):

All right.

Kara O'Halloran (43:02):

You were perfect until the end, I think.

Lara Rhame (43:04):

So who gets the bragging rights?

Kara O'Halloran (43:05):

I think Lara's getting bragging rights. Sorry, Andrew.

Lara Rhame (43:07):

Sweet.

Kara O'Halloran (43:08):

Andrew, hopefully we'll have some bragging rights for our team soon enough.

Andrew Korz (43:11):

Lara doesn't need any more bragging rights.

Kara O'Halloran (43:15):

All right. Well, thanks guys. I thought that was fun. Thanks for joining.

Lara Rhame (43:18):

Kara, I think we should come back in three months and go over who really-

Kara O'Halloran (43:23):

I'd love to do it.

Lara Rhame (43:23):

... got the right bracket.

Kara O'Halloran (43:24):

We'll have to do it. Andrew, you still have a chance for some writing.

Andrew Korz (43:26):

I was going to say, this isn't the winning bracket, it's just the most common bracket.

Kara O'Halloran (43:33):

Okay. Oh, he's fighting words over there. All right, guys. That was really fun. Thanks so much.

Lara Rhame (43:40):

Thanks, Kara. Great idea. (silence)