GRAHAM CAPITAL MANAGEMENT

CIO Outlook

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The Path of Inflation and Portfolio Construction

Currently, a key question in the mind of most investors is how to position their portfolio for high inflation. This is a natural question given the multi-decade shock to inflation, but it assumes that the shock is permanent and that we will settle in a high inflation paradigm. If that were the case, the answer is quite straight-forward as investors can position their portfolios for higher yields, steeper curves, higher commodities, and (potentially) modestly lower equity returns.

However, I do not believe that we will settle at a permanently high inflation. We will either have a gradual, orderly transition to lower levels of inflation and lower growth or, if inflation stays persistently high, we will have a Fed-induced disorderly adjustment to lower inflation and recession.

To me, the key question is instead: What is the path to normalized inflation? The answer then involves a very complex, dynamical analysis of the interaction between realized inflation and inflation expectations as well as expectations of the Fed's response. Then, in turn, one must consider the impact of that on growth and risk assets and the feedback loop between all these factors.

These very complex questions highlight why these kinds of markets are typically very fertile for most macro trading styles and, in particular, more tactical approaches. Let me detour for a minute so I can fully articulate this thought.

A Bayesian Approach

The way that I best understand macro analysis is through the lens of a Bayesian approach. In Bayesian analysis, the parameters of a given model are seen as random and the data, after an observation, is fixed. This approach contrasts with established and traditional statistical inference that thinks of models and parameters as unknown but fixed and data as random. Within a Bayesian framework, one first develops a hypothesis of how things should evolve, then one observes how the data (markets in our case) are behaving and adapts one's view to a mix of the hypothesis (called your "prior") and the data. This process is dynamic and helps to continuously update both views and data into a combined and hopefully robust predictor.

Why do I bring this up? It is because I strongly reject the idea that we can forecast with certainty where we will be in the distant future. We can take very dissimilar yet likely paths that will drive us to very different portfolio implications.

This does not mean at all that one cannot have a very well-informed forecast of what will happen, but rather, when faced with extremely uncertain scenarios, we have to constantly evolve our forecasts in a dynamic way, mixing a priori views with a posteriori data.

Core Views

Within this context, let me spell out my core views:

At a high level, given the increase in nominal and real rates, the sell-off in risk assets, and the broad dollar rally, we are seeing a significant tightening of financial conditions. At the same time, the fiscal deficit has drastically improved. The improved deficit will help to cool off inflation but also to significantly reduce the size of Treasury auctions, almost completely offsetting the impact of QT. Given all these factors, I think it is very likely that we have passed peak inflation and that we will see inflation moving down gradually and steadily. By “steadily” I do not mean the actual month-to-month path of inflation, but rather that the market will see inflation as having peaked and will gradually reduce inflation expectations.

To say it in a different way, the repricing of rates and risk assets have gone as far as they can go without triggering a recession. From this point on, a significant further widening of financial conditions will almost surely bring a deep recession which will cause yields to move significantly down.

A list of “top of mind” subjects that I believe should be on any investor’s radar are:

- **Rates:** We said in previous write-ups that the sell-off in bonds was inevitable as otherwise, how was the Fed supposed to cool off the economy if real rates continued to be strongly negative all along the yield curve? Now, with real yields having tightened significantly (140bps YTD increase in 10y real yields) the yield curve looks a lot closer to being balanced.
- **Equities:** Higher real rates, slowing growth, a distressed international environment and a crypto collapse are certainly not tailwinds for equities. However, earnings have proven to be very resilient, most likely the result of nominal GDP growth close to 10%. If the case for peak rates is correct, then I think equities will likely find some stability and trade in a range for a while.
- **FX: T**he U.S. dollar has appreciated tremendously. There are several reasons behind the move, most notably the hawkish Fed, the war weighing on European currencies, and the yield curve control for the Japanese yen. There are two points to make here. First, it is hard to see how the yen can stay at current levels for long, especially if the risk-off sentiment continues and global rates move down. I think this makes the yen a great hedge to a global recession (think out of the money USD-JPY puts). My second point is about emerging markets. In a Bank for International Settlements (“BIS”) study, it was calculated that per every 1% that the appreciates, the median emerging market GDP decreases by 0.3%. If this sensitivity holds, emerging market countries will see a sharp correction in the coming months.
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I find two main challengers to my main outlook. One relates to internal market dynamics of forced liquidations given the large moves we have seen. In markets with leverage, a 10 sigma move like we are seeing is disproportionately worse and much more painful than 10 times 1 sigma. The other scenario is that inflation stays persistently high and forces the Fed to a Volker type of adjustment, a terrible scenario for risk assets.

DISCLOSURE