

## PRACTICE AND CLIENT MANAGEMENT

### **Voices Risk-on or risk-off? How to play the summer market rally**

By [Tim Urbanowicz](#) August 14, 2023, 6:00 a.m. EDT4 Min Read

Between recession fears, bank collapses and record inflation, it's no wonder the first half of 2023 has investors feeling skittish and seeking refuge in traditional safe havens like cash and fixed income.

But it's been a summer of surprises. With GDP up, jobless claims down and stocks rallying nearly 20%, the data suggests things might not be as bad as they had seemed — at least not yet.



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A recession may still be coming; it's just more likely to hit next year. The market continues to underestimate how long the Fed will have to keep interest rates elevated to combat inflation. The reality is, the longer rates stay elevated, the higher the odds are of a recession. With history as our guide, we know there is a lag between when a rate hike occurs and when the resulting pain is felt in the economy.

While we don't know if and when that moment will arrive, historically, on average, equities have delivered positive returns in the three to six months leading up to a recession. That's a long time to miss out on market upside while waiting for an event that may or may not come.

#### **Fed push-pull**

Despite the recent spate of positive economic news, the reality is a lot more nuanced. For one thing, we are seeing a striking push-pull: While the Fed is taking rates to the highest level in 22 years — tightening conditions and making a recession more likely — fiscal policy is working in opposition. About a fifth of GDP growth in the first quarter can be explained by fiscal spending, and the deficit of 7% of GDP on a 12-month basis is keeping growth higher than it would have been otherwise.

Consumer spending may also be a red herring. It's great to see the economic boost from concertgoers, but we need to consider that this pattern of spending from savings is starting to slow as Americans draw down the last of their pandemic stimulus reserves.

### **The cost of cash**

At the same time that the average American is drawing down cash, higher net worth individuals are hoarding it. According to research from Capgemini, high net worth investors stored 34% of their wealth in cash and cash equivalents in 2022, up 10% from the prior year, and 20% higher than in 2006.

Especially after the SVB incident, wealth poured into high-yield savings accounts, some of which are paying upwards of 5%.

That kind of yield for virtually no risk seems like a good deal, but we know the real risks of cash: opportunity cost, taxes and inflation. When factoring in inflation, those yields are largely diminished — and over time, an overallocation to cash at the expense of equity exposure can make a meaningful difference in performance.

In fact, over the last 30 years, a 20% cash allocation on a \$1 million portfolio would leave an investor with \$7 million less than a portfolio that was fully invested.

### **The challenge for fixed income**

Treasury bills have been another beneficiary of investor anxiety, also paying around 5% while carrying little risk. But while nominal rates may be higher, these and other fixed income investments are barely eking out a positive real return when accounting for inflation.

Additionally, the uncertainty around continued inflation, or even a second wave, makes increasing duration risky and calls into question how valuable fixed income would be in the event of a market correction. The benefits of owning fixed income kick in when interest rates drop; however, the Fed won't be able to do so while core inflation is still hovering close to 5%.

In the past, the higher core CPI has been, the higher the correlation between equities and bonds. In other words, higher core inflation means less value from a bond allocation.

### **Unpacking the equity rally**

The stock market is up nearly 20% year to date, driven entirely by a move in valuations, and is back to the highest level since early 2022.

While AI euphoria has been a boon to tech stocks, there are other signs of life across the S&P 500. As such, those who have exited the equity market because they can't stomach the volatility may regret playing it too safe.

But we know this rally, like all others before it, will eventually bottom out. We have a market that is pricing in no economic pain but is also pricing in rate cuts early next year — two things that don't add up.

### **How to play it**

What all this means is that investors and those who shepherd their money must learn how to invest in a world where interest rates are structurally higher for longer. A looming recession does not necessarily mean that equities will perform negatively in the near future.

My guidance? Stay risk-aware, not risk-off — as going risk-off prematurely could be a costly mistake. It already has been for many investors who have been lured in by higher cash yields. If inflation comes down, higher cash yields will not be sustained, and equities will likely benefit.

Investors with an overweight to cash will be looking to put money that has already had a good run to work. Seek out strategies that can help your clients maintain equity exposure with some form of built-in risk mitigation. Diversify income sources to hedge additional rate hikes.

We are in a new era, and the old 60/40 playbook may no longer provide the same benefits. With all the recent innovations in the investment industry, such as buffered, hedged equity, and option income strategies, including in ETFs, I believe investors have the tools necessary to succeed in this new regime.

This is really a case of "timing is everything," but the perils of trying to time the market are well understood. Positioning a portfolio to capture the peak while also planning for the inevitable valley is the way forward.

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