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Q&A-U.S. stocks could see worst performance since 2018; opportunities in long-dated bonds, Japanese yen, utilities: Arnim Holzer, EAB Investment Group

The years of U.S. equity investors raking in double-digit returns may be over, at least for the time being, **Arnim Holzer, global macro strategist at EAB Investment Group**, told the Reuters Global Markets Forum on Thursday, June 23.

"We think the SPX could still end the year down 5% to 7%, potentially a bit worse than 2018… we see a low single-digit equity returns for the next few years until the Fed and structural issues are addressed," Holzer said.

He sees opportunities for funds tracking longer-dated U.S. Treasuries, the Japanese yen and utility stocks.

Following are edited excerpts from the conversation:

Q: As we face an uncertain macro environment, what are the biggest risks right now?

A: I think there is a very big risk that market participants see the process of "normalization" as cyclical and not secular. Market expectations of a short and understandable correction are driving positioning that seems very optimistic and potentially understates the type of adjustments that would need to be made if in fact the forces elevating inflation are at least as much secular as cyclical.

Q: What are the secular forces potentially being underestimated?

A: Even before the pandemic, we saw deglobalization of trade, high forecast energy transition costs and insecurity risks, geopolitical stress points, and changes to consumer patterns that increase competition for resources and higher end goods and services. Add to that, a pandemic related supply chain and infrastructure crisis and the situation becomes secular, not simply cyclical. The impact of these issues is to increase costs for individuals and the cost of production for firms.

Q: U.S. Federal Reserve (Fed) Chair Jerome Powell pointed out that Congress needs to decide if the tools at the Fed's disposal/Fed mandate needs to be changed. Should Congress consider it for the future, given current inflation, rate hikes?

A: Yes, we would agree that the Fed is responsible for monetary factors that impact the cyclical status of growth, labor performance, investment liquidity, and the soundness of the financial system. We agree that Congress should fiscally address national security and longer-term planning that impacts economic development and industrial investment. When Chair (Janet) Yellen was at the Fed, she highlighted that the U.S. government needed to address the gridlock that was constraining the U.S. response to the recession. Now, she is the Treasury secretary and can address the fiscally dependent measures. The supply chain issues are better addressed through fiscal policy.

Q: Can you tell us about the use of hedged equity strategies to manage risk?

A: Along with higher inflation and a higher degree of Fed hawkishness, equity volatility has been elevated. Hedged equity as an approach allows investors to reduce the damaging risks of extreme downside to participate in equity gains without as much overall risk. The approach allows investors to diversify their market volatility risk because the approach reduces the correlation to the S&P 500 index when the market is declining while benefitting from rises in volatility. That benefit is not present in the S&P alone. We believe that the current environment favors hedged equity strategies and helps investors stay invested more consistently through difficult times because of the way it reduces extreme downside.

Q: Where are you looking for those hedges?

A: The approach is an over defended put spread collar in SPX (S&P 500 index?) and SPY (SPDR S&P 500 ETF) options. Basically we sell out of the money calls to buy an excessive amount of downside put spreads in the four to six week expiry. The approach is managed in such a way that the revenue we receive from selling the calls, nets out against our defense. That means we give up some of the upside of the market but don't lose money from the cost of the puts. We also advise clients on hedges in multi-assets such as TLT (iShares 20 Plus Year Treasury Bond ETF), HYG (iShares iBoxx High Yield Corporate Bond ETF), FXY (Invesco CurrencyShares Japanese Yen Trust), XLU (Utilities Select Sector SPDR Fund) options where we see opportunity to long or short at the moment.

Q: Could you expand on what opportunities you're seeing for those ETFs?

A: We have been discussing heightened recession risks for about a month now and as a result see power in a long TLT short HYG (long quality safety long bonds vs short credit) play. We think 10-year rates could reapproach 2.5% by year end as the recession becomes clearer but that the recession risk is not fully incorporated into HY Option Adjusted spreads yet. We also see the likelihood that the Bank Of Japan will need to address the increasing event horizon qualities of the Yen and start allowing JGBs (Japanese government bonds) to float. That would significantly benefit FXY. regarding XLU, we believe the secular forces in power generation and electrification make the recently weakened ETF a solid play for the future. The correlations in almost all of these assets has underperformed where they should be in a crisis environment and we think a return of correlation forces would benefit these positions significantly.

Q: You mentioned how capital markets need to adjust forecasts for equity RoR - what might that look like for stocks? Is it possible for stocks to get back to 2020/2021 levels of growth?

A: Regretfully, I think the adjustment will take a few years and we think the SPX could still end the year down 5% to 7%, potentially a bit worse than 2018. We think the increased interest rate and volatility environment hinders a large high PE stock recovery and places the burden on index performance on smaller cap and more value/ Growth at the right price stocks. Given that view we see a low single-digit equity returns for the next few years until the Fed and structural issues are addressed.

Q: Any views on commodities being sharply down recently? When do you see global growth come back on track?

A: The beneficiaries of the pandemic are also being reverted and some of the expectations around inflation and the coming recession are likely to become clearer. We watch copper, gold, oil, and silver carefully. If the Copper and Silver relationships to gold don't rise that is a growth concern and we do expect some weakness there until we see a bottoming of the cycle. The Chinese stimulus process is very important though and there is some hope that they can stabilize some demand. But while that demand may help growth it comes with an inflationary cost as competition for goods is also a part of that equation.

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