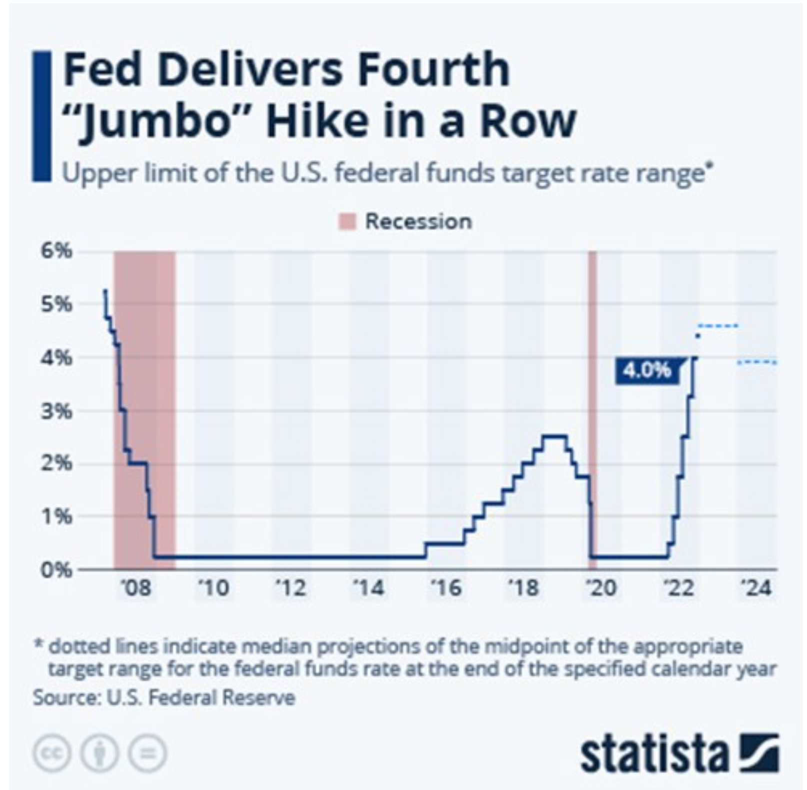
Covered Call Commentary

November | 2022

The Fed: Between a Hawk and a Hard Place

All eyes are on the Fed. Central bank policy has become so pivotal to the markets that reactions to economic news have become perverse at times, with slowing GDP and job losses leading to market rallies. The market is hungry for a pivot. Why? The infamous Fed pivot in late 2018 unleashed a massive 45% rally over the next 15 months. And just two years later, the Fed's "QE Infinity" program in the spring of 2020 led to another huge rally, this time 120%, over the subsequent 21 months. These rallies were based on easy monetary policies, not economic news. There is no question that policy shifts like these can unleash the bulls.

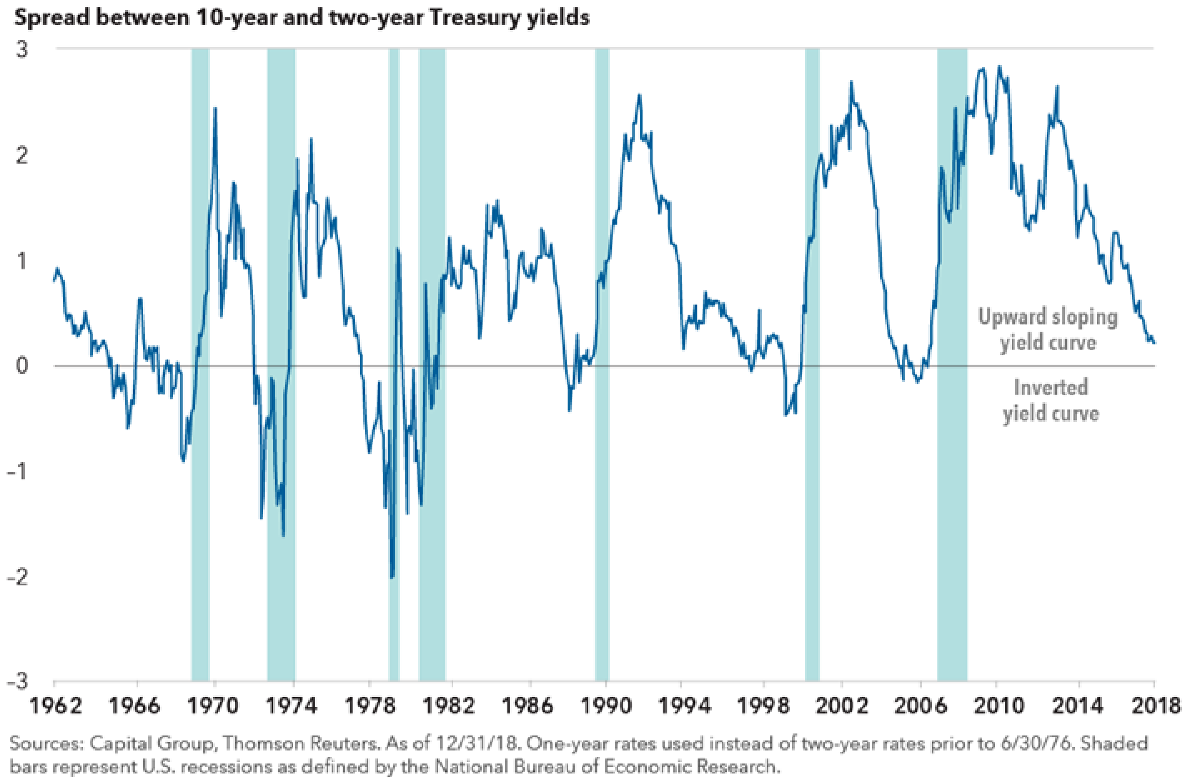


The Fed has been incredibly hawkish this year, hiking rates aggressively to 4%, with more increases likely in the coming months. Pretty good Volcker impersonation so far.

The problem is these actions have pushed short term rates well above long term rates, resulting in an "inverted" yield curve. In fact, the yield curve is currently more inverted than it has been in more than 40 years. See chart below.

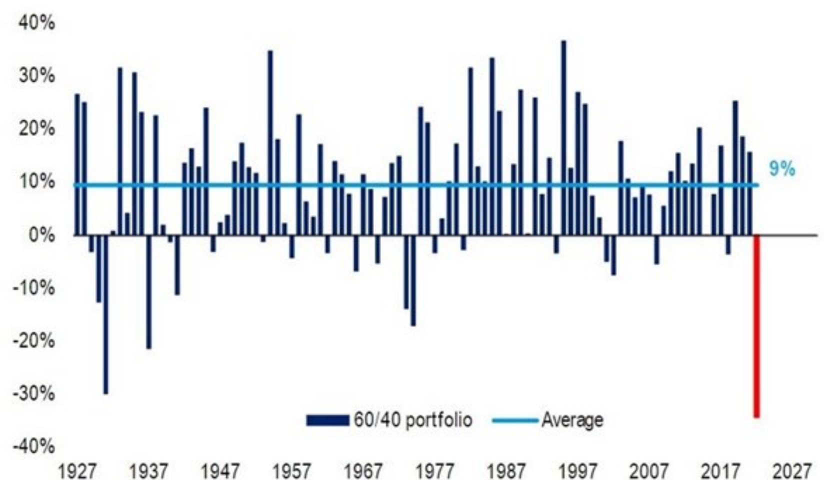
Recession Looming?

Inverted yield curves are ominous. Recession has followed ***every*** inverted yield curve in recent history. See chart below. The zero line represents a flat yield curve, and the shaded areas represent US recessions. Some economists believe we are already in recession. Others are forecasting a recession in the coming year. Either way, pundits are calling this the most anticipated recession of all time.



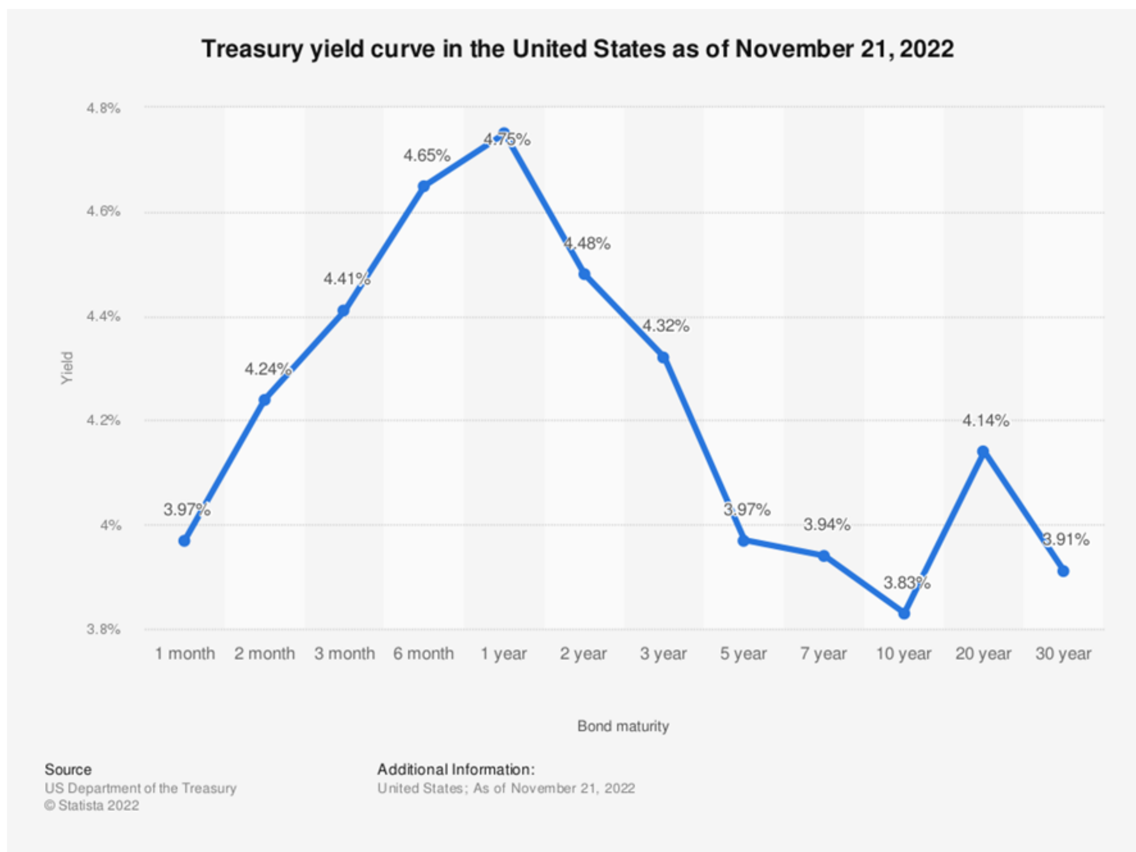
Market Impact Thus Far

Thus far, these rate hikes have hit markets hard. Stock and bonds are ***both*** down double digits, which rarely ever occurs as these asset classes are traditionally uncorrelated. A recent BofA analysis (below) shows that 2022 is the worst year for an index 60/40 portfolio in 100 years. The BofA analysis annualizes the first 9 months to get their figure 2022 figure. But even without annualizing, we haven't seen conditions this bad since the mid-1970s.



Current Yield Curve

Here's a closer look at the current yield curve. As you can see, long term rates (10-30yr Treasury yields of 3.8%-4.1%) are significantly lower than short rates (3mo-2yr Treasury yields of 4.4%-4.8%). Yield curves are upward sloping in "normal" markets, which is what makes today's curve unusual.



Looking Forward

The prevailing wisdom is that higher rates will weigh on stock returns, as they did in the 1970s. But we had runaway (double digit) inflation in the 1970s, whereas inflation appears to be slowing and rolling over today. We found a T. Rowe Price study that shows that when Treasuries are below **5%** (as they are now, barely), rising rates have actually been associated with rising stock prices. It's when rates rise above this 5% threshold that additional increases start to negatively impact the stock market. See below.

Interest Rates and Equities

As of September 30, 2016

CORRELATIONS BETWEEN WEEKLY STOCK RETURNS AND INTEREST RATE MOVEMENTS

Weekly S&P 500 returns, 10-year Treasury yield, rolling 2-year correlation, May 1963–September 2016

The Hard Place: 5%

So the Fed has been the Hawk. What's the hard place? We believe it's around **5%**. Not only do financial markets not like rates above this level (see above), it also happens to be the 200 year average for long term treasuries (see Credit Suisse chart below). Once rates rise above 5%, things can start falling apart quicky. The Fed wants to avoid going much higher than 5% if it can. And we're getting close.

Source: Credit Suisse

Key Takeaways

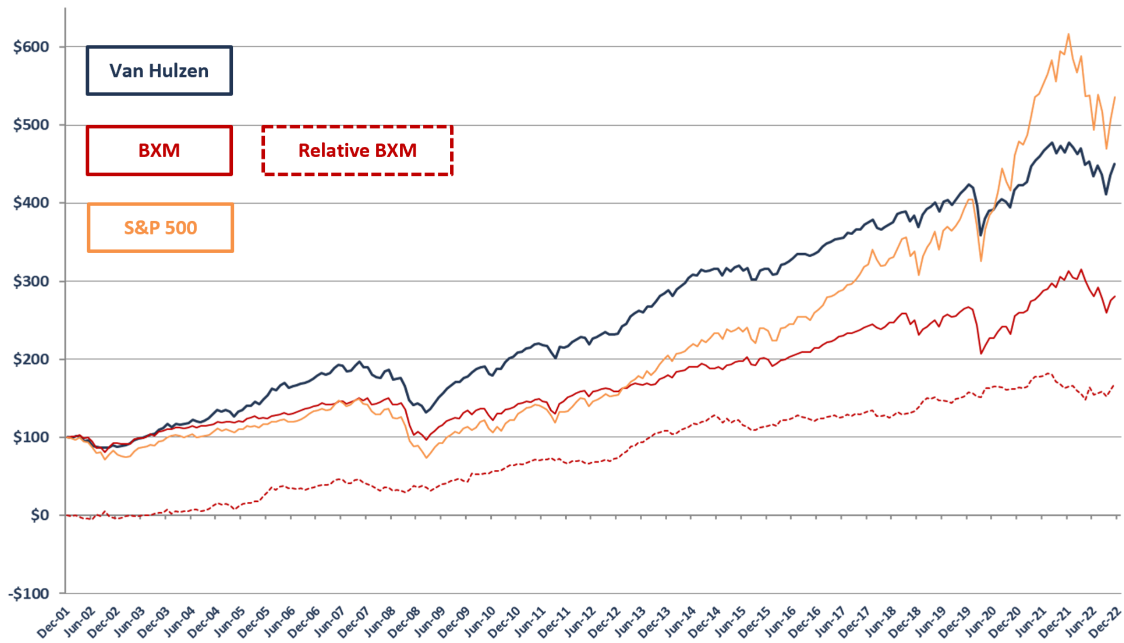
This is interesting food for thought. But does this mean you should be buying the current market weakness? That's a difficult call when market valuations are still lofty. And rates could still spike above this critical 5% level. We are not market timers, but we are invested in this market. One thing we do feel very confident about is that the speculative frenzy of the past decade has finally come to an end. Stock selection matters again. And quality matters more than ever. This is our wheelhouse. Most economists expect mid-single digit returns for stocks over the coming decade, as markets continue to consolidate. This is what happened in the decades following the blow off tops of the 1960s and the 1990s as well.

Our covered call strategy is perfectly suited for today's market, which is likely to remain volatile for some time. Our strategy has the same standard deviation as high yield bonds (40% lower than the S&P), but a higher targeted yield (7-8%) and a (weighted) investment grade rating of A.

Van Hulzen Covered Call Strategy

The Van Hulzen Covered Call strategy invests in US companies that we consider to have high shareholder yield (dividends and share repurchases) and uses call options with the goal of reducing portfolio volatility and creating incremental income. The goal is a portfolio that has equity exposure while seeking higher than average annual income (target of 6-8% annual), although there is no guarantee that the strategy will achieve its objective, generate profits or avoid losses. Below you will find the graph of the Van Hulzen Covered Call Strategy and the Covered Call Index BXM.

Covered Call Strategy Performance (gross as of 11/30/2022)



Returns (annualized)*	Nov 2022	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	3.3%	3.2%	-0.6%	-5.7%	-3.0%	2.6%	3.9%	5.2%	6.9%	7.5%
Van Hulzen (Net)	3.3%	3.1%	-0.9%	-6.2%	-3.6%	2.0%	3.3%	4.6%	6.2%	6.6%
BXM	1.9%	1.1%	-2.9%	-10.2%	-6.8%	2.0%	3.1%	4.8%	5.9%	5.1%
Difference (Gross-BXM)	1.4%	2.1%	2.3%	4.5%	3.8%	0.6%	0.8%	0.4%	1.0%	2.4%

*Inception date : 12/31/2001. Figures greater than one year are annualized. Van Hulzen returns represent actual returns from composite of accounts

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