BRIEF INVESTMENT COMMENTARY
March 31, 2023

Given the news flow over the past few weeks, accompanied by financial market volatility, we are reaching out with a brief commentary piece to share our perspective. We summarize below our assessment of the macroeconomic backdrop and current portfolio strategy.

Macro Backdrop

- A near-term (next 12 months) US recession is widely anticipated by most economists at this point. Indeed, it's our base case assumption—but not a certainty. The labor market remains strong (despite high-profile layoff announcements in technology and finance) enabling consumer income and spending growth.
- Global central banks have aggressively raised interest rates over past 12 months to combat inflation. The US Fed's policy objective is to cool demand in order to tame inflation. In our view, it's really a matter of just how successful they are going to be in cooling demand—meaning how severe is the economic slowdown going to be.
- Fortunately, the inflation data has improved. The pace of inflation has decelerated, helped by easing manufacturing supply-related pressures. Falling housing prices and lower prices on new rental leases also indicate that the sticky "shelter and owners' equivalent rent" component of inflation will also decline. But core services inflation remains elevated, driven largely by the tight labor market, suggesting overall inflation may settle at levels higher than experienced in recent decades.
- We think it's important to acknowledge that monetary policy affects the economy with "long and variable" lags. It's anyone's guess when monetary policy becomes "sufficiently restrictive." This is why the adage exists that the Fed normally tightens "until something breaks." With a couple of recent bank failures and stress among some regional banks, it certainly feels like something is breaking. Based on fed funds futures, market participants now expect the Fed will be cutting rates by year end.
- To be fair, Silicon Valley Bank (SVB) and Signature Bank were somewhat unique cases. For example, SVB had significant concentration of its customer base in technology start-ups and venture capital firms, while also being acutely exposed to rising interest rates. But the banking industry at large is faced with competing for deposits while tightening lending standards, meaning profits will be squeezed—which would contribute to a softer economy.
- At this point, we'd agree with what seems to be the consensus view that, while short-term fears may roil some other regional banks, the SVB failure is not a harbinger of another 2008-type Global Financial Crisis (GFC). Most major banks are in generally healthy financial condition, in large part due to post-GFC regulations. But we also acknowledge that fear can be a powerful catalyst and difficult to predict.

Market Outlook & Portfolio Strategy

- The uncertain macroeconomic environment—persistent inflation, tightening monetary policy, and recession risk—suggests that volatility across asset classes will remain elevated. We believe proper portfolio diversification remains important as ever.
- Some of these challenging dynamics have been priced into markets in the form of more attractive valuations, particularly in fixed income and international equities. The onset of recession typically implies a challenging

time for riskier assets and outperformance of more-defensive categories—but that's not always the case. Market reactions to macro events can be unpredictable. Still, recessions can also sow the seeds of greater investment opportunities once they are underway.

- Even in long-term, growth-oriented portfolios we tend to include allocations to traditionally defensive assets such as cash and high-quality bonds that can serve as a source of "dry powder." Unlike 2022, core fixed income investments have acted like defensive positions over the past few weeks as yields have fallen.
- In terms of tactical portfolio positioning, we've maintained an underweight position to public equites (US large cap stocks in particular) versus long-term strategic allocation target weights. In our view, despite improved valuations, US stocks perhaps still reflect an overly optimistic outlook for near-term corporate earnings growth. Therefore, we've also maintained a tilt towards high quality. We remain fully invested in non-US stocks that we think stand to benefit from lower valuations, as a lot of bad news and negative sentiment is already priced into these markets. We've been adding to investment grade fixed income positions over the last several months—in addition to better forward-looking return prospects, higher starting yields also improve the potential diversification benefits of investment grade bonds in risk-off scenarios. Finally, we trimmed commodities positions throughout the second half of 2022 but maintain a modest overweight to public real assets (including energy and natural resources stocks).
- We'll continue to assess the changing environment and communicate any changes to our recommended tactical positioning.

Please feel free to get in touch with any questions. As always, we are happy to discuss.

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