BRIEF INVESTMENT COMMENTARY
October 2, 2023

Market Review

The combination of continued global economic expansion with moderating inflation provided a favorable backdrop for financial markets in the first half of 2023. Corporate earnings results were generally better than expected, which improved investor sentiment toward equities. The US market rally was led by mega-cap technology stocks and fueled by excitement around artificial intelligence. Yet, September has been a tough month for risk assets and equities in particular. The recent weakness in stocks coincides with a move higher in bond yields and the price of oil, along with a strengthening US dollar. As a reference, the 10-year Treasury bond yield currently stands at almost 4.6% after starting 2022 at only 1.5%. Financial markets are perhaps also reacting to a shift in expectations about future US Federal Reserve (Fed) policy.

In March 2022, the Fed decided that inflation was not transitory and pivoted from its decade-long accommodative stance into one of the fastest rate hiking cycles on record. Last week the Fed voted to keep its benchmark fed funds rate unchanged at a range between 5.25% and 5.5%, which aligned with market expectations. However, Chairman Powell signaled again that rates could wind up being "higher for longer" and there was some acknowledgment that Fed officials believed the so-called neutral rate—which keeps inflation and employment stable over time—has risen.[1] With the economy resilient thus far to tighter policy, Fed officials are clearly starting to think about the neutral rate differently now. This has reset expectations for where interest rates could go from here, particularly as inflation trends lower but remains above the Fed's 2% target.[2] The fed funds futures market currently shows a possibility for one more rate increase and no chance of a decrease until mid-2024.

Asset Category Performance (As of September 26, 2023)	MTD September	YTD 2023	Last 5 Years*	Last 10 Years*
Fixed Income				
Municipal Bonds (Bloomberg 1-10 Year Municipal)	-1.4%	-0.4%	+1.3%	+1.7%
Taxable Bonds (Bloomberg Aggregate Bond)	-2.4%	-1.0%	+0.2%	+1.2%
High Yield Corporate Bonds (Bloomberg High Yield)	-1.3%	+5.8%	+3.0%	+4.2%
Equities				
Global Stocks (MSCI All Country World)	-4.5%	+9.6%	+6.3%	+7.4%
US Large Cap Stocks (S&P 500)	-5.1%	+12.7%	+9.9%	+11.8%
US Small Cap Stocks (Russell 2000)	-7.2%	+1.1%	+2.2%	+6.5%
Non-US Developed Markets Stocks (MSCI EAFE)	-3.6%	+6.9%	+3.0%	+3.7%
Emerging Markets Stocks (MSCI Emerging Markets)	-3.2%	+1.2%	+0.5%	+1.9%
Real Assets				
Commodities (Bloomberg Commodity)	-0.2%	-3.0%	+6.4%	-0.8%
Natural Resources (S&P Global Natural Resources)	-1.3%	-0.5%	+6.1%	+5.0%
Energy MLPs (Alerian MLP)	+1.7%	+18.7%	+6.8%	+1.8%
Global REITs (S&P Global REITs)	-6.8%	-4.1%	+1.2%	+4.1%

*Note: Data provided by Addepar. *Indicates annualized return. Past performance is not indicative of future results.*

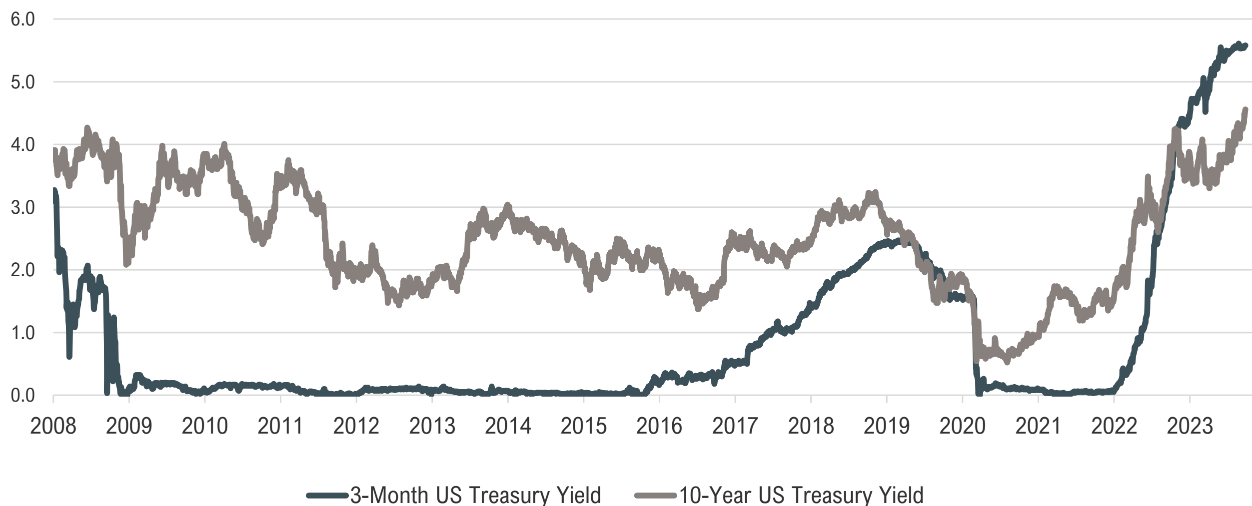
Macro Backdrop

The US economy and corporate profits have been more resilient than most expected, defying predictions of a recession. Despite higher interest rates and tighter lending standards, robust consumer spending and historically low unemployment have supported solid economic growth. For example, the Atlanta Fed's GDPNow model estimate for real GDP growth in the third quarter is almost 5%. At the same time, initial jobless claims for the week of September 16th fell to slightly below 200,000, hitting the lowest level since January 2023. Debate exists among economists about how much of the pandemic-related "excess savings" remains, but this could also continue to support household spending.

It's important to acknowledge, however, that monetary policy affects the economy with "long and variable" lags. And the US Fed's policy objective is to cool demand in order to tame inflation. Chair Powell has indicated that tolerating a recession may be the necessary trade-off for regaining control of inflation, but policymakers remain hopeful for a "soft landing." However, the historical track record of achieving such an outcome is spotty. Prior to the 1990, 2001, and 2007 recessions, many economists believed that the Fed had managed to engineer a soft landing, effectively stemming inflation without leading to an economic downturn. Yet, the economy entered a recession each time. The most recent example of a successful economic soft landing was in 1995 when Fed officials quickly doubled the fed funds rate from 3% to 6%, but soon realized that they were too aggressive and cut interest rates three times.[3]

Forward-looking recession indicators continue to flash warning signs. The Conference Board's set of leading economic indicators has fallen for nearly a year and a half straight, reaching levels that have historically preceded recessions. In addition, the Treasury yield curve remains inverted, meaning short-term yields are above long-term yields. Historically, yield curve inversions have been a fairly reliable predictor of economic recessions, though the timing from inversion to onset of recession has been highly variable. In fact, every recession since 1957 has been preceded by an inverted curve. Yet, there have been instances where the curve has inverted without a recession.

While the US economy still has some momentum, there seems to be no shortage of potential near-term challenges, including the autoworkers' strike, recent run-up in oil prices, and resumption of student debt payments. The initial impact of the United Auto Workers strike is expected to be modest, but a broader work stoppage could curb production and drive up vehicle prices. Workers at auto-parts suppliers could also lose their jobs. Goldman Sachs estimates that a broad strike could shave off as much as 0.1% from annualized economic growth for every week it lasts.[4] Elevated energy costs and the resumption of federal student loan payments on October 1st could also threaten consumer spending.



Source: Federal Reserve Bank of St. Louis, Economic Research Division as of September 26, 2023.

Market Outlook and Portfolio Strategy

The uncertain macroeconomic environment—persistent inflation, tighter monetary policy, and recession risk—suggests that volatility across asset classes will remain elevated. We also worry that equity markets may be overly sanguine about the lagged impact of monetary tightening. US stock valuations in particular may not be adequately discounting the risk of a decline in corporate earnings, which typically occurs at the end of rate hiking cycles. The forward price/earnings (P/E) multiple for the S&P 500 Index is now 17.9x, which is below the 5-year average of 18.7x, but above the 10-year average of 17.5x.[5] By comparison, various international developed and emerging markets appear more attractively valued, either trading near or below their 10-year averages. As a result, the valuation disparity between US and international equities is much wider than usual, indicating a favorable long-term backdrop for non-US stocks.

The outlook for fixed income investments is certainly different than it has been over the last decade. The era of unconventional monetary policy following the 2008 Global Financial Crisis pushed bond yields to extremely low levels, which made stocks highly attractive by comparison. The acronym TINA became a popular way to describe the environment where "there is no alternative" to equities. Given the sharp rise in interest rates, today's environment is different. For example, across the US Treasury bond yield curve, investors can earn a "risk-free" yield of 4.5% or more. Investment grade corporate bond yields are higher, though they carry some credit risk. This increase in yields across fixed income investments has created more attractive alternatives for equities. On a comparison of earnings yields to bond yields, stocks no longer look *relatively* cheap.

Our tactical portfolio positioning themes are summarized below.

- **Increase exposure to core/investment grade fixed income given more compelling yields.** While rising interest rates still pose a risk to high quality bonds, yields are at the highest levels in over a decade. The likelihood of policy rates staying tight also bolsters the appeal of income and the investment case for short-term bonds. In our view, short-term Treasuries and investment grade corporate bonds offer attractive yields with relatively low volatility risk.

- **Target an underweight position in US large cap equities while emphasizing high-quality stocks and more reasonably priced small cap and emerging markets stocks.** US large cap stocks perhaps still reflect an overly optimistic outlook for near-term corporate earnings growth. Thus, we recommend an underweight position, along with a tilt towards higher quality companies (those with strong balance sheets, stable earnings, and high margins). While non-US stocks are also at-risk from a potential recession, we believe a lot of bad news and negative sentiment is already priced into these markets. And the headwind of a strong US dollar should reverse itself over the next few years, given the large US federal budget and current account deficits and a shrinking interest rate gap versus the rest of the world.

- **Continue to target an overweight position in real assets.** While traditional asset classes can be vulnerable to unexpected increases in inflation, commodities and commodity-producer stocks can offer a potent hedge. We also share PIMCO's view that, over the long-term, a prolonged period of limited supply-side investment along with the secular transition toward renewable energy sources could further support commodities prices, and energy in particular.[6]

- **Where appropriate, continue to develop private equity and private real estate investment programs.** Because of the associated illiquidity and inherent inefficiencies, private assets typically compensate investors with a premium return. We recommend maintaining the planned pace of commitments as new capital deployed during periods of economic disruption often generate significant upside. In our view, secondary opportunities are attractive as General Partners seek liquidity for maturing funds in a poor exit environment, while the increasing level of distressed debt should also drive an expanding opportunity set.

The table below illustrates our current tactical asset category views.

Asset Category Tactical Views	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight
Cash					
Cash and Short-Term Bonds				✓	
Fixed Income					
Investment Grade Municipal Bonds			✓		
Investment Grade Taxable Bonds			✓		
Bank Loans and High Yield Credit				✓	
Equities					
US Large Cap Stocks		✓			
US Small Cap Stocks			✓		
Non-US Developed Markets Stocks		✓			
Emerging Markets Stocks			✓		
Real Assets					
Commodities and Natural Resources				✓	
Public Real Estate	✓				
Flexible/Alternative Strategies					
Diversifying Hedge			✓		

Note: Based on research and opinion provided by Greycourt & Co. Tactical views reflect a three-year investment horizon. Suggested asset class weights are used as a starting point in assessing client portfolio weights against strategic targets which typically reflect a ten-year investment horizon.

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[1] *Greg Ip, Wall Street Journal, "Higher Interest Rates Not Just for Longer, but Maybe Forever," September 21, 2023.*
[2] *Mitch Zacks, Zacks Investment Management, "Weekly Market Update," September 22, 2023.*
[3] *Ibid.*
[4] *David Harrison, Wall Street Journal, "U.S. Economy Could Withstand One Shock, but Four at Once?" September 24, 2023.*
[5] *John Butters, FactSet, "FactSet Earnings Insight," September 29, 2023.*
[6] *Greg Sharenow, Lewis Hagedorn, and Jennifer Ziehe, PIMCO, "Growing Demand, Tight Supply Support Commodities in 2023."*