LNWM Quarterly Commentary – Q3 2023

THIS TUG OF WAR IS FAR FROM OVER

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> "The surprise is half the battle. Let's think about what's the whole battle."
>
> — David Mamet, playwright

It's been a surprising year, proving yet again that it's never wise to predict the markets. Coming into 2023, a great many economists expected a recession; instead, U.S. economic growth accelerated. Wall Street strategists expected another down year for stocks; instead, the equity markets took off like a rocket.

The U.S. economy and corporate earnings have demonstrated a significant amount of resilience in the face of three of the largest bank failures in history, a historically steep and accelerated 5-point increase in interest rates, the war in Ukraine and continued tensions between world powers. In a recent press conference, Fed Chairman Jerome Powell noted that "reducing inflation is likely to require a period of below-trend growth." This does not seem to be happening.

So where do we go from here? In our view, the recent stock rally and the economy's resilience seem to have reset the clock on the recession call, but we are not out of the woods yet. With the U.S. economy slowing by many measures and interest rates likely to remain relatively high, the risk of recession or at least below-trend growth continues to increase.

The view from 30,000 feet: We are in the midst of a prolonged tug-of-war between powerful economic forces: massive multi-year fiscal stimulus; and countervailing monetary contraction, with no resolution in sight (see box below).

This tug-of-war, the resulting volatility, and what looks like a market regime change will continue to unfold, favoring patient and skilled investors. In this Commentary, we delve into what are likely to be the deciding factors in the tug-of-war, both positive and negative, and the implications for portfolios.

Economic Tug-of-War

Fiscal Stimulus – Ongoing U.S. government spending, including: the American Rescue Plan, the Inflation Reduction Act, the Infrastructure Act, and the CHIPS and Science Acts, have infused tens of billions into the U.S. economy (and will continue to do so for years to come), coupled with a big, inflation-driven increase in Social Security benefits for millions of retirees, which as a group have amassed more than $74 trillion in wealth.

Monetary Contraction – 10 interest rate increases in the past 16 months, taking the Fed funds rate to 5% from zero, with the long-term impact of this yet to be seen. So far, this has resulted in the three of the largest U.S. bank failures in history and tighter credit conditions.

First Half Summary: Major Rebound

U.S. Equities: Halfway into 2023, nearly 20% of the S&P 500 stocks were up at least 20%[1] and more than half had gains, a far cry from last year when 80% of the S&P 500 was in the red around this time. Multi-year returns were compressed into six months as the Nasdaq gained a whopping 32%, while the S&P 500 generated an impressive 17% gain.

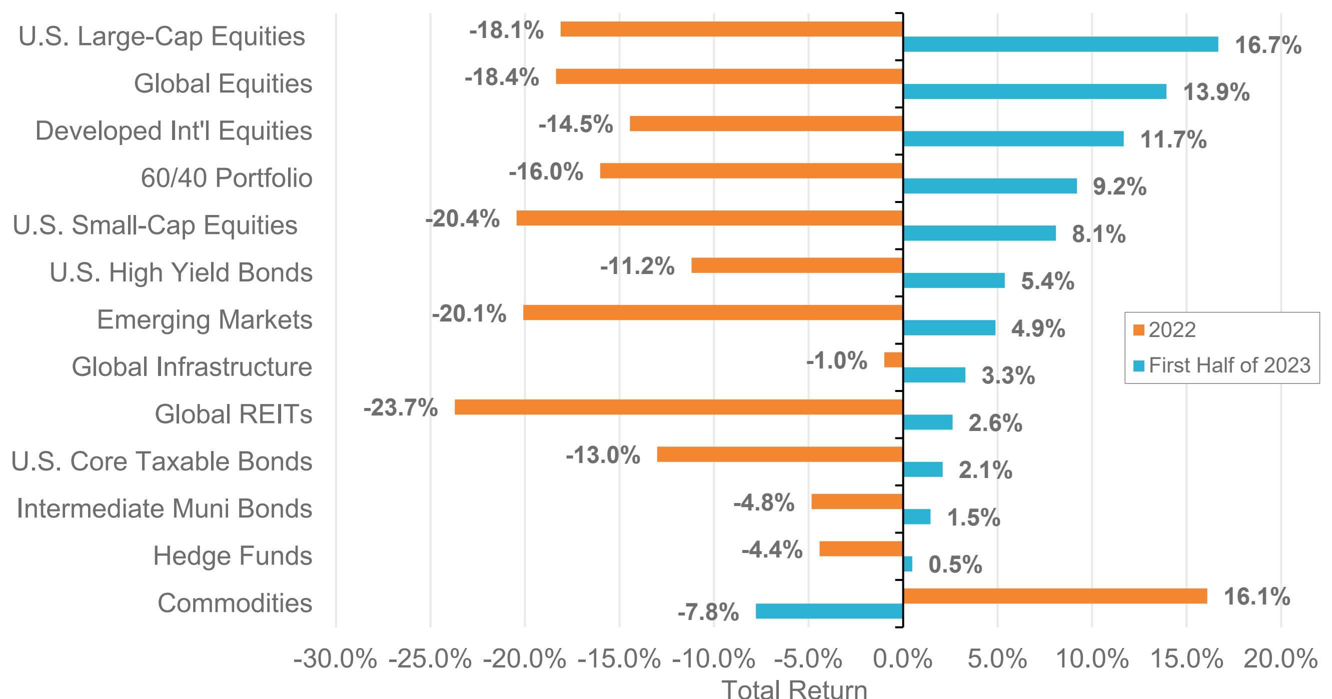
Stock market leadership started to expand beyond Big Tech; by the end of June, 71% of stocks were priced above their 50-day moving average, up from 26% at the end of the 1st quarter. And "Big Mo Tape" (an indicator from Ned Davis Research that shows the percentage of sub-industries in uptrends) hit a 19-month high of 71%.

Foreign Equities: International developed equities fared relatively well on better-than-expected earnings in Europe and economic reforms in Japan, despite headwinds from a stronger dollar as the U.S. debt ceiling issue was resolved amid better-than-expected economic growth. In emerging markets, China's (- 5.4%) sluggish post-Covid recovery pulled down returns.

Fixed income: Bonds lagged as longer-term interest rates rose. The yield on 10-year Treasuries finished June roughly at 0.4%, higher than where it was in March, as investors realized rate cuts where not on the horizon after the pause in June.

Real Assets: With U.S. headline inflation trending down to around 3% (still high vs Fed's stated 2% target), the asset class that benefits most from inflation continued to struggle. Real assets are the worst performers so far this year, with the deteriorating economic backdrop an additional headwind for energy (-20%) and industrial metals (- 12.4%) in particular.

[1]Bespoke Premium.



Source: LNWM, Morningstar, Bloomberg, Hedge Fund Research, ICE Data Services. Global.

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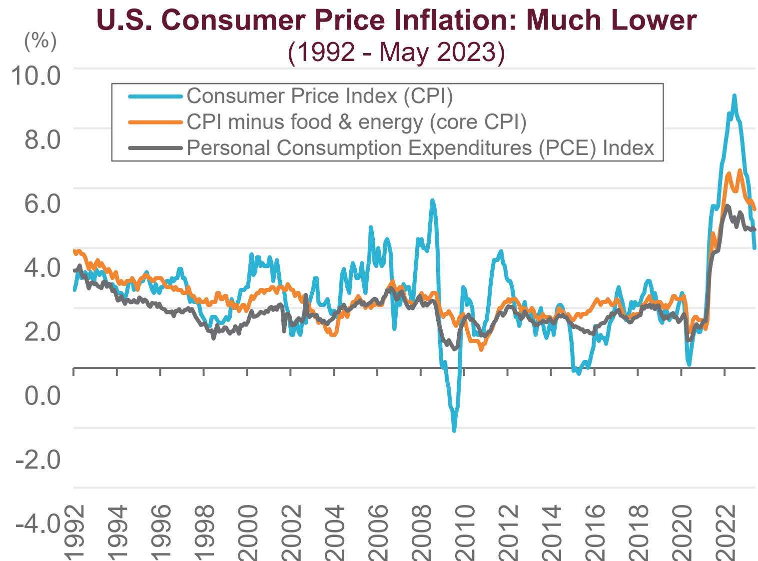
POSITIVE PUSH

Let’s start with the positive factors supporting the economy and markets.



Source: BLS, BEA, LNWM.

Declining Inflation. Headline inflation as measured by the Consumer Price Index (CPI) is down more than 6 percentage points in the past 12 months -- from over 9% down to 3% recently, a 27-month low. June was the 12th straight month of decelerating CPI. Looking beyond CPI, virtually every survey of inflation expectations indicates inflationary pressures are easing.

Commodity prices are also on a steady downtrend, helping to keep a lid on food and energy prices. Consumers can then continue to spend on non-essential discretionary items, potentially mitigating the risk of an economic downturn.

A potential long-term contributor to lower inflation is artificial intelligence (“AI”) applications, which are starting to be used in many sectors to boost productivity. The net impact of AI on the economy is uncertain: To what degree will AI be a net benefit via enhancements and new industries being created vs. jobs being lost?

Jobs & Savings Plentiful. According to the U.S. Dept. of Labor, there were recently 1.7 job openings per unemployed worker, which means most people who lose their jobs are likely to find new ones. Keep in mind, however, that unemployment tends to be low at the beginning of recessions and can spike rather quickly as aggregate demand falls and companies pivot from hiring to layoffs. Additionally, the unemployment data may be a bit understated as much of the recent layoffs have been in the higher-paying, white collar jobs, a cohort less inclined to file for unemployment.

Half of the extra $2.4 trillion in U.S. household savings accumulated during the pandemic have been spent, leaving an estimated $1.2 trillion, which might take consumers another 12-18 months to burn through.[2]

Houses Are Selling. Demand for housing continues to outstrip supply, incentivizing builders and keeping prices fairly steady, despite much higher mortgage rates (6% to 7%). U.S. housing starts surged 22% in May vs. April, the largest monthly increase since 2016. And since housing and ancillary industries (appliances, furniture, etc.) have historically accounted for approximately 20% of U.S. GDP, this is helping to keep the wind in the housing market’s sails.

Housing inventory is low because more homeowners are opting to stay put, having locked in mortgage rates of 2% to 5% (80% of U.S. mortgages outstanding are below 5%). And homebuilders for the past 15 years (since the 2008 Financial Crisis) had not been producing as many homes.

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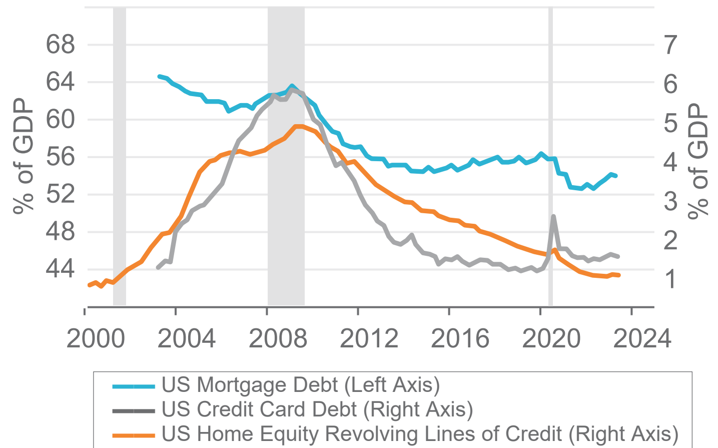
[2]BCA Research.

With that said, housing affordability is near its lowest level since 1986 and this could weigh on home sales in the coming months.

Consumer Debt is Reasonable. Mortgage debt has declined from 64% of GDP to 45% over the past decade, with home equity lines of credit at just over 1% of GDP down from 5%. While credit card debt is rebounding, it is doing so from very low levels. There is little doubt that higher interest rates will weigh on discretionary spending but keep in mind that 70% of consumer debt is mortgages, with most of these now at very low rates.



Source: Federal Reserve Bank of New York.

Corporate Profits Are Rising. Companies have been navigating the new economic landscape far better than expected. In the first quarter, nearly 80% of the companies in the S&P 500 beat earnings expectations (albeit reduced expectations). What is more encouraging, corporate earnings are now expected to increase by 6.4% in 2023, up from 1.4% at the start of the year.

Capital Spending Poised to Increase: For the past 20 years, U.S. companies have been investing a lot less in new plant and equipment. In inflation-adjusted terms, capital spending is down 25% since 2000. But this is changing. The supply shocks created by the pandemic and the war in Ukraine have caused executives to pivot from Just-In-Time Inventory (which Japanese companies pioneered in the 1980s) to a Just-In-Case approach. We have been highlighting the theme of manufacturing and production moving closer to home (in the U.S., border countries or friendly economies), and the data is indicating this is beginning to play out. U.S.-based construction of manufacturing facilities is up. While this is a long-term trend, this could provide the catalyst for exiting either an economic slowdown or recession.

The China Factor. China's economy continues to struggle despite the lifting of Covid lockdown restrictions (see chart showing the contraction in manufacturing activity in 2023). In response, the Chinese government and central bank have been applying a variety of fiscal and monetary measures to stimulate the economy. As a result, forecasts by the World Bank and others envision China's economy rebounding to 5% GDP growth in 2023, still below its historical rate but a meaningful contribution in absolute terms to world economic growth.

Source: National Bureau of Statistics, China (NBS).

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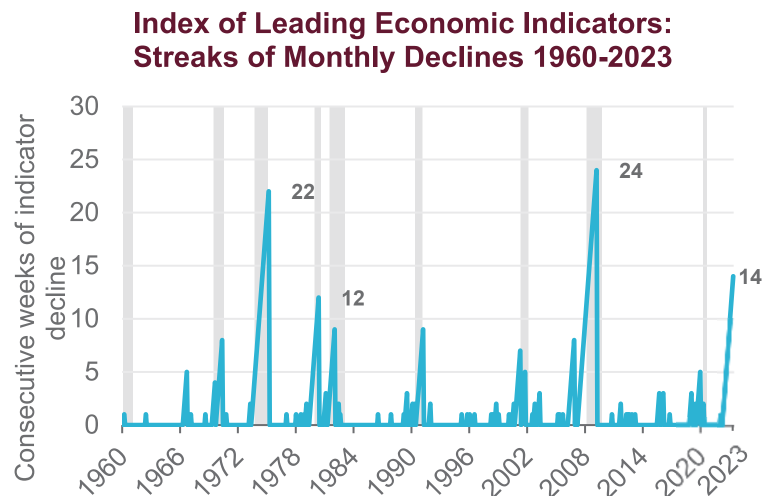
NEGATIVE PULL

While investors may certainly be right to lean into the positives, negative factors continue to exert pressure on the economy and markets.

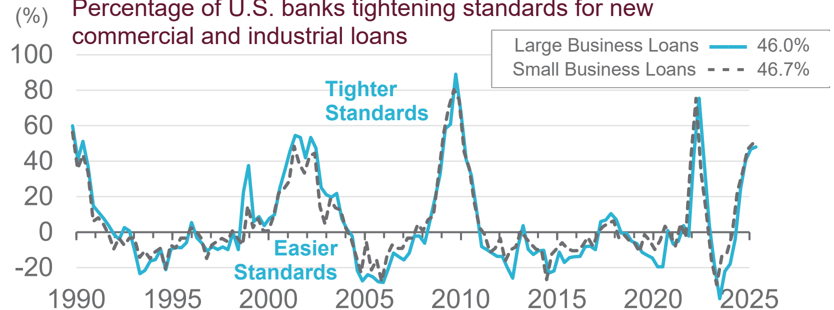


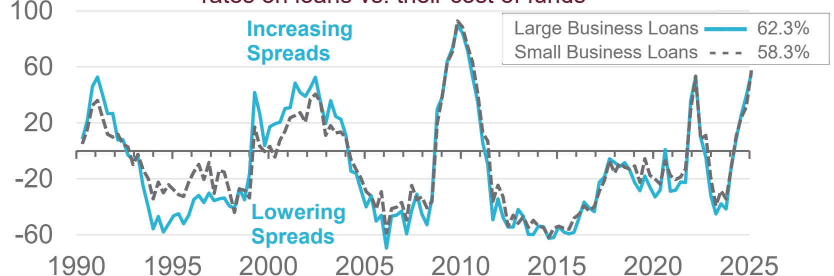
Source: Federal Reserve Bank of New York.

U.S. Economy Is Wobbly, by many measures. The Conference Board's Index of Leading Economic Indicators continues to forecast recession, as May's print was the 14th month in a row of declines. Over the past 73 years (see chart), we have seen comparable streaks only three other times – all occurred within 12 months of a recession.[3]

The Purchasing Managers Indexes (PMIs), which gauge business spending plans, are also flashing orange. June PMIs for manufacturing showed contraction across the world's major economies, except for Australia. In the U.S., the manufacturing PMI dropped to 46.0, right around its post-Covid low. Activity in the services sector remains mostly in expansion territory; however, based on readings from the last couple of months, the rebound in services appears to be slowing.

Near-Term Interest Rate Cuts Are Unlikely. The Fed did pause interest rates hikes in June, but signaled more increases may be forthcoming. Futures markets now expect the Fed funds rate to be 5% by January 2024, about where it is now. This is a big change from expectations in May that we would see four rate cuts this year. Where does that leave us in terms of the yield curve? We generally have inversion (longer-term bonds yielding less than shorter-term ones) across 82% of the maturity spectrum. For example, 3-month and 2-year Treasury debt are both yielding more than 10-year Treasury bonds. The high prevalence of inversions has historically presaged an upcoming recession[4].





Source: Ned Davis Research.

Tighter Credit Conditions. As we have pointed out in previous Commentaries, each Fed rate hike typically takes 12-18 months to manifest in the economy and that seems to be holding true this time. The percentage of U.S. banks tightening

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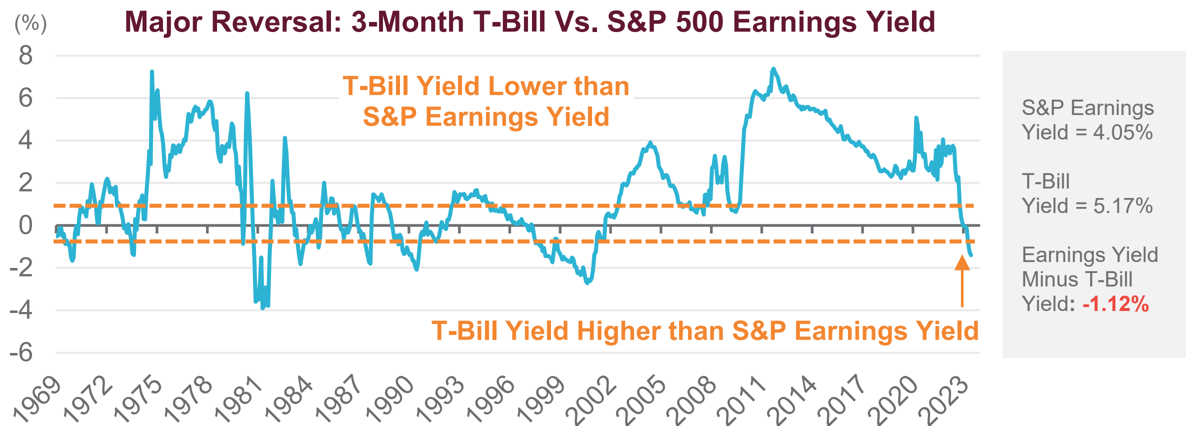
[3] *The Bespoke Report*, June 23, 2023.
[4] Ditto.

their lending standards is the highest it has been since the 2008 financial crisis and the very early days of the pandemic. The spread between what banks charge on loans vs. their cost of funds is also at the highest level since 2008[5]. Tighter credit conditions tend to lead to lower consumer and business spending in the quarters ahead.



*As of June 9, 2023. Source: Ned Davis Research.

Cash is King Again. The increasing attractiveness of cash versus equities is a byproduct of money markets and short-term bond funds yielding 4%-5%. As you can see in the above chart, the yield on U.S. Treasury bills now exceeds the S&P 500 earnings yield (corporate earnings divided by share price). You need to go back to 2001 for the last time investors had more incentive to hold cash instead of investing in equities[6].

PORTFOLIO IMPLICATIONS

The S&P 500 tends to peak about six months before a recession begins. If current forecasts calling for recession in the first half of 2024 prove correct, equity market performance during the 2nd half of 2023 may be quite different. The equity-centric financial media would lead you to believe the stock market is the only game in town. As clients of ours well know, we build portfolios populated with a broad range of asset classes, each with a distinct purpose in portfolios, as well as underlying strategies that can take advantage of different sources of return and risk, beyond just relative price volatility.

Attempting to call market peaks and troughs is a fool's game. Instead, we rely on pulling the levers we can exert some degree of control over, such as portfolio asset allocation, which is driven by each client's unique situation. With high-quality, intermediate-term fixed income now yielding 3% to 5% (vs. 1%-2% a year ago), some portfolios may not need to take as much risk to generate the returns needed to meet their objectives. Similarly, this could be an opportune time for some to trim public equity risk in favor of private equity, private credit, and hedge funds, currently among our strongest conviction for long-term goal attainment.

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[5] "Waning economic strength in 2H 2023," June 7, 2023, Ned Davis Research.
[6] "Second Half U.S. Equity Outlook," June 14, 2023, Ned Davis Research.

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UNIQUE OPPORTUNITIES

Along those lines, we believe there will be a variety of opportunities to add value through credit-oriented investments in the face of declining bank lending. Across a variety of industries, companies are seeking alternative sources of funding. This is especially true in the venture capital space, where the failure of Silicon Valley Bank (SVB) has created a funding vacuum.

The startups most likely to attract funding now are those with the highest potential to keep growing and which are known to the VC community through previous funding rounds. Private funds can thus double down on funding high-conviction companies at potentially better terms. As we have said throughout 2022 and 2023, if you are a long-term investor and can be a liquidity provider when liquidity is scarce, the opportunity set in the private markets now and for the foreseeable future has become increasingly more attractive.

Commercial real estate (CRE) could be another credit opportunity, as owners are having to refinance loans at much higher rates and in a market that has weakened significantly as banks pull back on lending. Private market investors may be able to step in and command attractive yields and debt terms from promising CRE firms.

Infrastructure equities remain a strong and ongoing focus. The trillions required to upgrade electrical grids, transportation systems and other infrastructure in the U.S and abroad will require investment from the private sector, as governments are debt heavy. There are compelling public and private market vehicles for investing in this space, which also offer environmental and societal benefits.

Lastly, as mentioned above, artificial intelligence is in its early days. For now, the mega-cap tech stocks are uniquely positioned to benefit given their significant investment, but new opportunities are bound to arise as AI becomes more widely used.

IN CLOSING

With equity markets levitating in the first half of 2023 and account balances looking more robust, you might be lulled into thinking that the risks to the global economy and markets have faded. As we have pointed out in previous Commentaries, investors are hoping to return to the pre-pandemic era of low interest rates, low inflation and an abundance of liquidity. Don't be fooled. The only certainty in investing is uncertainty.

The probability of a return to the environment that characterized the last 30 years appears extremely low. As the world evolves into becoming multi-polar, both economically and politically, the investment landscape will likely change and make volatility a constant companion. The best strategy is to open up your aperture to the long-term horizon you have to achieve your goals, take comfort in the soundness of your financial and investment plans and tune out the rollercoaster ride of the equity markets.

ABOUT THE AUTHOR

Ronald G. Albahary, CFA® is Chief Investment Officer at Laird Norton Wealth Management and Wetherby Asset Management. As the head of the combined investment team (see below), Ron determines investment strategy, directs the investment selection process, and works in tandem with both firms' client services teams to deliver investment solutions structured to attain each client's unique goals. Prior to joining LNWM in 2021, Ron served as CIO or CEO at regional investment firms focused on ultra-high-net-worth families and foundations. Earlier in his career, he held leadership positions in the private client business of major global financial institutions, including Merrill Lynch and Northern Trust Private Bank. Ron has a degree in economics from the Wharton School at the University of Pennsylvania and currently serves as advisor to the Center for High Impact Philanthropy at the University of Pennsylvania.

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INDEX DEFINITIONS

CASH: Morningstar US 1-3M T-Bill - The index measures the performance of fixed-rate, investment-grade US Treasury Bills with 1-3 months remaining until maturity. It is market-capitalization weighted.

U.S. TAXABLE BONDS: Bloomberg US Aggregate Bond Index – Covers the US Dollar-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS, ABS, and CMBS sectors.

U.S. INTERMEDIATE MUNI BONDS: Bloomberg Muni 1-10 Year Index – Tracks the performance of US dollar denominated investment grade tax-exempt debt publicly issued by U.S. states and territories, and their political subdivisions, in the US domestic market with maturities between 1 and 12 years.

U.S. HIGH YIELD BONDS: ICE BofA US High Yield Index - Tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.

GLOBAL BONDS: Bloomberg Global Agg Index - A measure of global investment grade debt from a multitude local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

10-YEAR US TREASURY BONDS: BofAML US Treasury Current 10 Year Index – The market value weighted index of public obligations of the US Treasury with maturities of 10 years.

U.S. LARGE CAP EQUITIES: S&P 500 - The index includes 500 leading US companies and captures approximately 80% coverage of available market capitalization.

U.S. SMALL CAP EQUITIES: Russell 2000 Index - Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, representative of the US small-capitalization securities market.

INT'L DEVELOPED EQUITIES: MSCI EAFE Index - A free float-adjusted market-capitalization index that is designed to measure developed market equity performance, excluding the US and Canada. Consists of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

EMERGING MARKETS EQUITIES: MSCI Emerging Markets Index - A free float-adjusted market-capitalization index that is designed to measure equity market performance in the global emerging markets. Consists of the following 25 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

GLOBAL EQUITIES: MSCI ACWI Index - A free-float weighted equity index. It was developed with a base value of 100 as of December 31, 1987. MXWD includes both emerging and developed world markets.

GLOBAL REITs: FTSE EPRA/NAREIT Global REITs Index - A measure that tracks the performance of listed real estate companies and REITs worldwide.

GLOBAL INFRASTRUCTURE: S&P Global Infrastructure Index - Provides liquid and tradable exposure to 75 companies from around the world that represent the listed infrastructure universe. To create diversified exposure across the global listed infrastructure market, the index has balanced weights a cross three distinct infrastructure clusters: Utilities, Transportation, and Energy.

COMMODITIES: Bloomberg Commodity Index - A broadly diversified index of futures contracts intended to be representative of the commodities market. It currently includes 19 commodity futures in seven sectors.

LIQUID HEDGE FUNDS: HFRX Global Hedge Fund Index – A daily-valued index designed to be representative of the overall liquid hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry.

ILLIQUID HEDGE FUNDS: HFRI Fund Weighted Composite Index – A global, monthly-valued, equal-weighted index of over 2,000 single-manager funds that is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies. Constituent funds report monthly net of all fees performance in US dollar and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

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60/40 PORTFOLIO: 60% Global Equities, 40% U.S. Taxable Bonds

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