LNWM Quarterly Commentary – Q4 2023

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BACK TO THE FUTURE

> "Don't stop thinking about tomorrow… Yesterday's gone, yesterday's gone."
>
> — Fleetwood Mac

A mentor in wealth management who is now a friend once counseled me: "Stop hoping for a better past." This can also mean don't get anchored to the recent past.

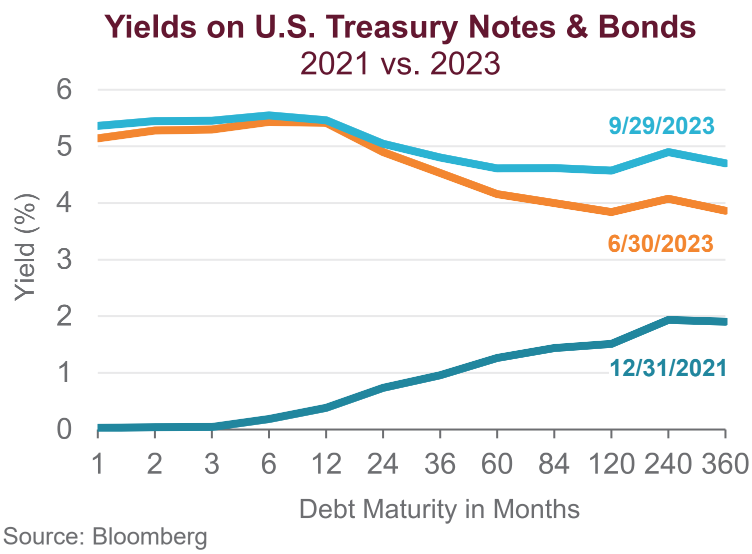
Until the 3rd quarter of this year, investors appeared anchored to the decade before COVID – benign inflation and low, even negative, interest rates. This "Goldilocks" world was a happy place for borrowers of all stripes. And it provided incentive to invest in anything likely to appreciate above the ridiculously low cost of capital.

Sorry to say, the pre-pandemic economy is likely not coming back. Since the start of 2022, we have posited that a change in market regime appears to be underway. The Peace Dividend from the collapse of the Soviet Union gave us 30 years of globalization, supporting low interest rates and inflation. But in 2020, the music stopped. We had a global pandemic followed by geopolitical conflict -- Russia's invasion of Ukraine, China's saber-rattling, and most recently the invasion of Israel by Hamas.

We are now living in a more fragmented world, leading to geopolitical instability and a shift toward reshoring. Add to this the energy transition toward renewables plus political and social polarization in the U.S. and elsewhere. The implications will take years to play out, but a higher steady state of inflation and higher interest rates seem likely to be byproducts.

The Not-So-New Normal

The higher-for-longer premise on interest rates is not necessarily a bad thing. Lenders/savers are getting 5% on U.S. government money market funds, as borrowers pay a premium over the rate of inflation and lenders pocket a real rate of return. That is the way the markets have historically operated, with the recent past seemingly the aberration.



Source: Bloomberg

Another positive: U.S. interest rates could be closer to a peak than not, as the shift up along the yield curve is doing some of the Fed's work to slow the economy. And inflation has come down dramatically from the 9% peak last year to less than 4% recently. All the while, the economic "tug-of-war" we described in July between the forces of stimulus and contraction is continuing to play out, most recently favoring contraction.

In this Commentary, we look at recent developments likely to keep interest rates and inflation higher for longer, and the implications for client portfolios in context of a long-term framework. But first, let's take a look at what happened in the third quarter.

Third Quarter Wrap-Up

U.S. Equities: Seven of the 11 sectors in the S&P 500 are up so far this year (through Sept.). Virtually all the gains were from giant companies in communication services (+40%), technology (+37%) and consumer discretionary (+27%). Contrast those heady numbers with the nearly flat return on the equally weighted S&P 500, which is more representative of how most equities fared. Utilities (-14%) and REITs (-5%) have been hurt by competition from higher bond yields, and small stocks have continued to struggle.

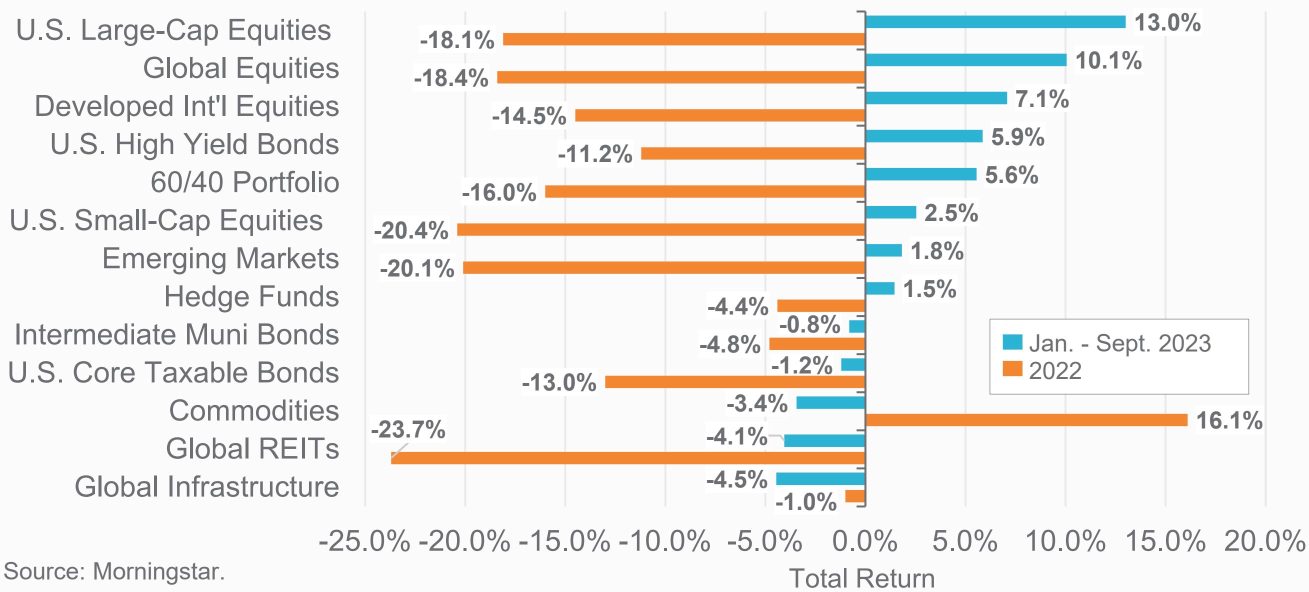
Foreign Equities: A stronger U.S. dollar hurt returns on foreign stocks, which continue to lag the U.S. this year due to slower growth, especially in Europe and China. Notably, China (-7.3%) is experiencing a negative mix of capital outflows, weaker growth, high debt levels and youth unemployment.

Fixed income: U.S. bond returns are back in the red so far in 2023, as longer-term interest rates rose sharply in Q3. Investors have begun to question whether the Fed will lower interest rates significantly, even if the U.S. enters recession. Moreover, long-term concerns over U.S. creditworthiness have emerged due to ongoing congressional budget battles and the spike in annual deficits.

Real Assets: Commodities, real estate and infrastructure are among the weakest performers so far in 2023, on declining inflation and expectations for modest economic growth. The exception is energy, which has relatively outperformed on surging oil prices. That said, the renewable energy corner of the energy market has suffered from higher costs and supply agreements that were locked in at lower rates.

Diversifiers and Private Equity: Private equity strategies have generally been positive but have not kept up with the recovery in U.S. public equities. Meanwhile, hedge funds and private credit are continuing to benefit from higher market volatility and interest rates.

Asset Class Performance: 2023 (through 9/30) **& 2022**



Source: Morningstar.

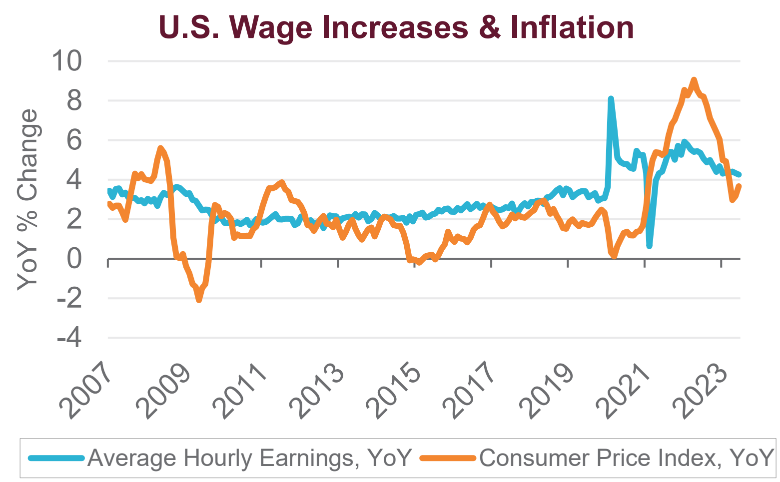
The Rise of U.S. Organized Labor – Inflation-Neutral (Long Term)

Approximately 362,000 U.S. workers have hit the picket line this year, a tenfold increase over the first nine and a half months of 2021.[1] A wide variety of unions are striking -- actors, auto workers, nurses, package delivery drivers, etc. But generally, these are workers who cannot do their jobs from home and are negotiating for higher pay (to make up for years of falling behind) as well job security and safety.

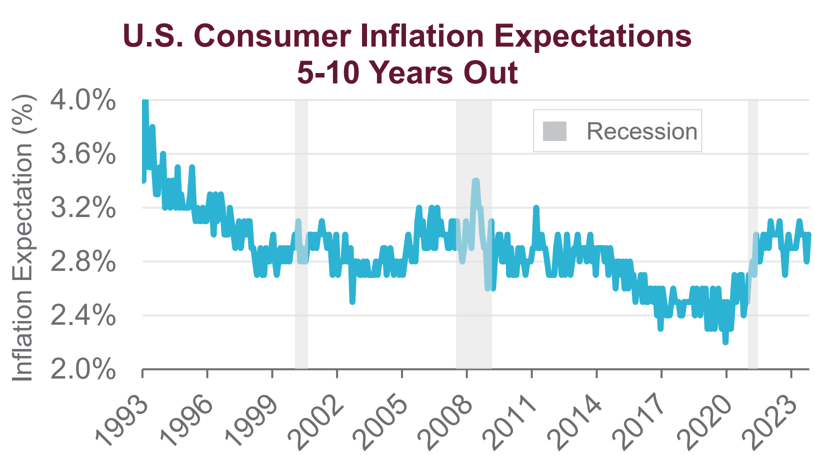
Many recent research papers have delved into the relationship between wages and inflation. They are in agreement that wages actually lag inflation – prices increase and then workers demand higher wages, not the other way around (see chart at right).

Could this time be different? Probably not. Long-term inflation expectations are a key leading indicator for the future path of inflation. Recent surveys show consumers expect inflation to be muted in the next 5 to 10 years (in the 2%-3% range). As long as this is the case, workers are not likely to ask for pay raises that protect them from *future* increases in the cost of living.

*Jan. 1 through Sept. 15 of each year.
Source: Cornell University School of Industrial and Labor Relations.



Source: Bloomberg and FRED as of 8/31/2023.



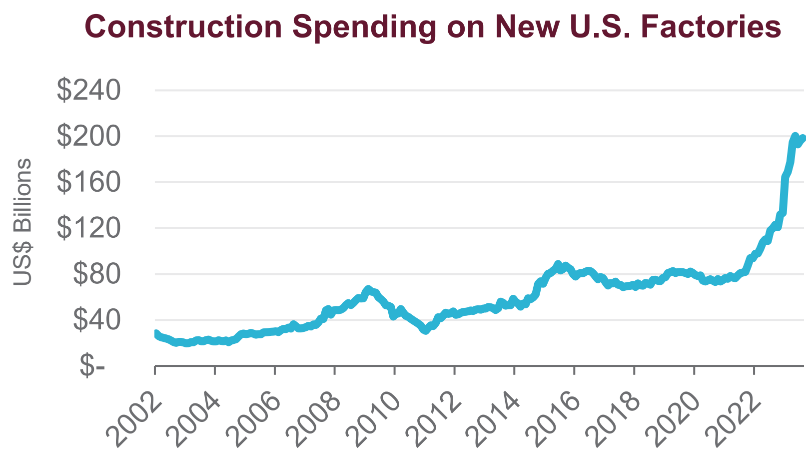
Source: Bloomberg, University of Mich Survey of Consumers as of 9/30/2023.

More Production in U.S. & Americas – Supportive of Growth and Inflation

Three separate U.S. Acts, signed into law in 2021 and 2022, provide more than $1 trillion in U.S. federal funding, tax breaks, and other incentives for new infrastructure projects, green energy initiatives and the domestic production of strategic goods such as semiconductors to reduce reliance on

[1] Source: CNBC, "UAW strikes could make 2023 the biggest year for labor activity in nearly four decades," Sept. 22, 2023.

imports, mostly from China.[2] Between the start of 2022 and April 2023, spending on the construction of new factories in the U.S. more than doubled, to $189 billion. You would have to go back to 2002 to see a bigger increase. In April 2023, factory construction accounted for about 10% of all U.S. construction, the highest percentage since 1993 (in 2010-2022, factories averaged just 5.7% of total construction spending). Long term, the opening of more factories in the U.S. is expected to create millions of quality jobs and boost economic growth.[3]

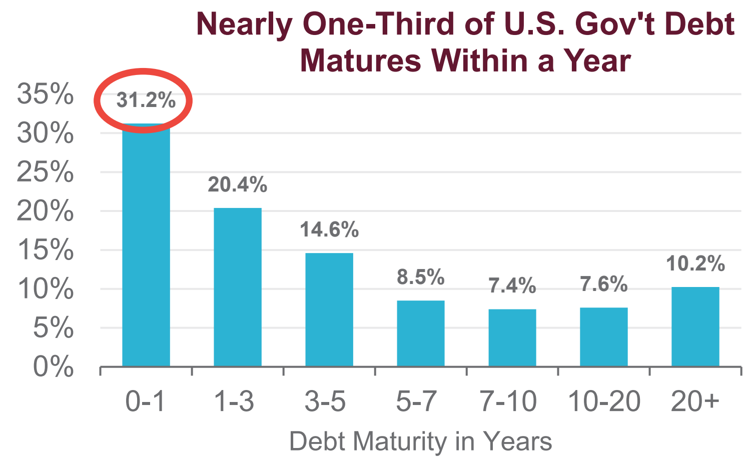


From Jan. 2002 through Aug. 2023. Seasonally adjusted annual rates.
Source: U.S. Census Bureau via FRED.

With that said, moving production away from countries with lower-cost labor puts pressure on corporate margins and makes price increases more likely.

Higher U.S. Federal Deficit – Higher Rates/Inflationary

Escalating U.S. government deficits have compelled the U.S Treasury to flood the market with short-term debt issuance, which has become more costly as interest rates rise, thus increasing deficits and creating its own vicious cycle.



Source: Strategas Securities, LLC. As of September 2023.

The U.S. Treasury borrowed $1.01 trillion in the third quarter, as it had depleted its cash reserves prior to the debt limit being lifted in June. For the fourth quarter, borrowing is expected to be $852 million ($3.4 trillion annualized), considerably higher than the $2 trillion expected.[4]

Aside from higher Treasury bond issuance and rising federal debt as a percentage of GDP, we have had a breakdown in Congressional budget negotiations leading to the last-minute debt ceiling deal in June, followed by the government shutdown cliffhanger in September (which may play out again in November). All this unnecessary haggling could also be blamed for higher bond market volatility and investors demanding higher long-term bond yields.

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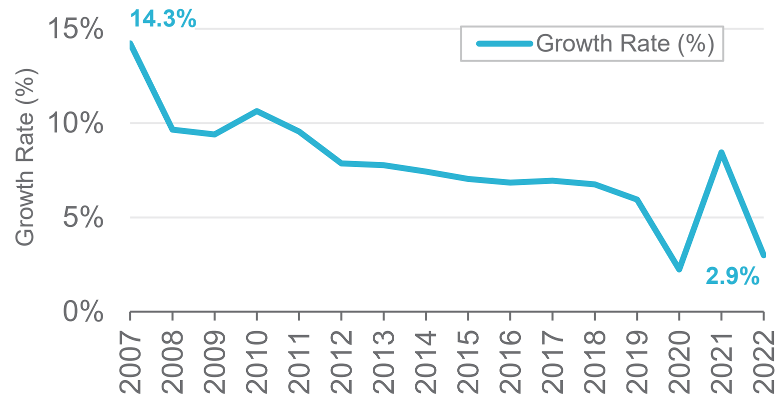
[2] Reuters, "Why a rout in government bonds is worrying," Oct. 3, 2023.
[3] Unpacking the Boom in U.S. Construction of Manufacturing Facilities | U.S. Department of the Treasury
[4] Treasury Announces Marketable Borrowing Estimates | U.S. Department of the Treasury

At the same time, the Federal Reserve continues to reduce its balance sheet by allowing approximately $95 billion in U.S. Treasuries and government-backed securities to roll off as they mature. With the Fed no longer sucking up a lot of demand as a buyer (as it was prior to March 2022), rates have risen to attract other buyers.

Slowing Growth in China – Possibly Deflationary

In September, I was interviewed by *Barron's* on the following question – "how big a deal is what's happening in China for the global economy and US markets?" China overinvested in infrastructure and real estate during the past 15 years, and as a result, the country's GDP growth has gone from 6%-7% to around 4%, after hitting a low of just under 3% in 2022 due to COVID lockdowns.

China's GDP Growth (2007-2022)



Source: Macrotrends.

A linear way of thinking would suggest slowing growth in the world's second-largest economy would lead to slower global growth. While that may be true, the global economy is complex and requires a multi-dimensional analysis. In that vein, we are examining the potential for both positive *and* negative impacts (when most of the narrative around a topic is negative, that is when we recalibrate to focus on what could break to the positive).

The positives are that lower demand from China for key commodities and other inputs could keep a lid on inflation, as can moving U.S. factories out of China to even lower-cost countries such as Vietnam and Thailand. The downside is slowing global economic growth and the potential for China to divert attention away from its troubled economy by increasing hostilities with Taiwan and the U.S., potentially leading to armed conflict.

Israel at War with Hamas – Known Unknown

In my more than three decades in investment management, commenting on the economy and the markets in the face of tragic events has always been difficult. Our thoughts are with all the innocent victims. Clearly, the horrific Hamas attack on Israel in early October further amplifies geopolitical risk.

So far, this tragic development has had little impact on the markets, but it is still too early to know where things will end up. Escalation into a broader regional conflict is still possible. There is also the potential for significantly higher oil prices, adding to inflationary pressures and slowing the global economy. This could result in what has been a lower probability scenario so far for the U.S. economy: stagflation. Also, emerging markets in the Middle East are likely to suffer negative pressure while those that can continue to do business within a multi-polar world could benefit.

PORTFOLIO POSITIONING

Equities. U.S. equity valuations may be pricing in a too-rosy economic outcome, given the run-up in prices during the first half of 2023 coupled with more pressure on corporate earnings. Meanwhile, fixed-income yields have risen well above the average levels of the past 10-15 years. Given the divergence in equity vs. fixed income performance, a rebalancing of portfolios to maintain long-term risk profiles may be in order.

Core fixed income. High-quality, intermediate-term bonds now yield 4%-6% and are again serving their traditional role as income generators. There is also the possibility of capital gains if interest rates are near a peak and an economic slowdown or recession drives yields down from current levels. As such, portfolios may not need to take as much equity risk to generate the total returns required to meet goals and objectives.

Diversifiers. Hedge funds and other diversifiers such as real assets should benefit from an environment of higher yields and market volatility amid tepid global economic growth. Pre-pandemic, hedge funds were competing with generally positive equity markets, falling interest rates and low volatility. That dynamic appears to have shifted in the opposite direction, increasing the hedge fund opportunity set. Separately, with banks pulling back from the less-liquid corners of business lending, private credit strategies have taken their place, finding they can make loans to solid businesses at yields reaching into the double digits in exchange for less liquidity and patience.

Real assets. Returns on real assets (commodities, infrastructure, real estate) have broadly lagged in 2023, with investors seemingly underestimating the duration of elevated inflation. That underperformance plus the potential benefit from the reshoring of production are distinct positives. Moreover, given a downturn in the office real estate market, we are exploring opportunities to invest as the sector works through difficulties.

IN CLOSING

The fog induced by COVID and the war in Ukraine has not totally lifted, and now we also have the uncertainty of a new war as Israel battles Hamas. Many new and at times countervailing forces impacting the world economy are at play (the tug of war we referenced in July), creating a wider dispersion of potential outcomes -- economically, geopolitically, financially and even socially.

Does the wider range of outcomes concern us? Not really. We aim to minimize the dispersion of portfolio outcomes over time, not by trying to time the market but by focusing on what we can control, including an asset allocation that supports each client's long-term goals, ongoing rebalancing, and minimizing fees and taxes.

I leave you with this: Yes, asset prices were challenged in the 3rd quarter as investors started pricing in higher-for-longer interest rates (hurting new borrowers), higher oil prices (hurting the marginal consumer) and a stronger dollar (making U.S. goods and services more expensive abroad and thereby hurting corporate earnings). A quarter (or even multiple quarters) of negative returns should have little bearing within the context of a long-term investment plan if we execute the plan with discipline. Additionally, markets that sell-off provide more opportunities to rebalance into exposures that might be underpriced based on long-term fundamental value. Remember, the flip side of risk is opportunity for those with both capital and patience.

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ABOUT THE AUTHOR

Ronald G. Albahary, CFA® is Chief Investment Officer at Laird Norton Wealth Management (LNWM) and Wetherby Asset Management (WAM). As the head of the investment team (see below), Ron determines the firm's 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 & WAM, 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.

The investment team resulting from the combination of Laird Norton Wealth Management and Wetherby Asset Management is comprised of 11 analysts and strategists working together to design and implement investment solutions for client portfolios. Six analysts at the firm hold the Chartered Financial Analyst® designation, with expertise spanning macroeconomics, public and private asset classes across the global capital markets, and impact investing. Collaborating with each other and with client advisors, the investment team's overarching goal is to help clients and their families preserve and grow their wealth over many generations.

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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.

DIVERSIFIED PORTFOLIO: 10% US Municipal Bonds; 10% US Core Bonds; 25% US Large Cap Equities; 5% US Small-Cap Equities; 22% Int'l Developed Equities; 9% Emerging Markets Equities;4% Global Infrastructure; 13% Illiquid Hedge Funds; 2% Commodities.

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

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