

# Investment Update



## Q1: BETTER THAN ANTICIPATED?!

Had we told you that we would see two of the largest banking failures in US history in the first quarter, few would have expected the outcome we garnered. Yet another tumultuous ride concluded far from how many would have projected it to play out...at least so far.

Let's begin with Q1 performance and then work backwards a bit:

- S&P 500: +7.5%
- Russell 2000: +2.7%
- Russell 1000 Growth: +13.9%
- Bloomberg Agg Bond Index: +3.0%
- TIPS (Treasury Inflation Protected Sec): +3.3%
- MSCI EAFE (non-US): +8.5%

The US Federal Funds rate now reads 4.75-5.0%, the highest level since the Global Financial Crisis of 2008. The failures of Silicon Valley Bank and Signature Bank in March threatened to unravel confidence of the corporate depositor base and consumers alike. For now, the Treasury Department and Federal Reserve's actions to provide enhanced liquidity and protection to the banking system seems to have stemmed the tide.

As we reflect on Q1, we believe it's fair to evaluate what propelled markets higher and whether it is sustainable. To do this, we believe one must evaluate fixed income and equity markets separately (despite their correlation with one another).

For the first time in modern history, bonds wrapped up 2022 by posting a second consecutive losing year. The Fed's move from a zero-rate policy to current levels meant a huge repricing across the entirety of the fixed income

landscape. *Unlike the 2008 crisis, the past 24-months' selloff was not driven by credit!* In contrast, credit remains at one of its healthiest levels in the last half century. High Yield and Bank Loans were among the best performers within fixed income over the past two years.

The High Yield bond index (often looked at to ascertain credit stress in the marketplace) posted historically low defaults in 2021/22 and has the highest average credit rating since the index's inception. The US Mortgage market remains healthy, with low unemployment rates and nearly all consumers having locked in historically low rates in recent years.

We are not suggesting there will not be economic slowdowns (or even a recession) both in the US and abroad, but rather that it will likely have different repercussions than the last 2 recessions. Accordingly, the impact on fixed income assets is likely also much different. Investors now have YIELD as a mechanism of resilience/protection in the current environment. After the 2022 losses in fixed income, investors now stand to benefit as the Fed slows and eventually pauses (and at some future point cuts) rates.

For fixed income investors, patience and discipline, a focus on quality, and duration management provides an attractive risk/reward as we move forward from here.

### What about equities?

Equities pushed higher in Q1, driven heavily by "off-side" investors reengaging with many of 2022's most beaten-up names. Tesla, Meta, and Nvidia were among mega-cap names up more than 50% for the quarter! What changed? Positioning had become too bearish as 2022 wrapped up and the tax-loss selling had run its course. In some

instances, great brands had been discounted too deeply and, in others, investors simply owned too small of an allocation to stocks. The 2022 leaders (Value and Energy to name a couple) were laggards in the first quarter.

It's a difficult argument to position many names as "cheap" in today's market, but the earnings forecast remains among the most uncertain in recent years. The most recent earnings cycle wasn't spectacular but was "less bad" than many had feared. That may happen again! Several major tech companies have announced cost-cutting measures (including layoffs and property sales) in recent months but the ultimate earnings impact of those remains to be quantified.

For equity investors, we maintain a cautious bias while staying appropriately allocated to equities. Rather than WHEN, we are focused on HOW we maintain equity exposure in this environment. Had an investor tried to time the 2008 bottom, they likely missed a meaningful portion of the March-Dec 70% rally. Had Covid's 37% plunge sparked a move to cash, the 63% rally in ~6

months could have been missed. Had we been on the sidelines in Q1, we would have missed its gains.

At ~18x projected 2023 earnings, the broad market isn't historically cheap. That also doesn't mean there aren't many opportunities for the disciplined and skilled manager. Current overweight recommendations in equities include allocations to quality as a factor, income-focused strategies, buffered equity investments, and non-US equities.

The last on the list, non-US equities, may seem counterintuitive to some. ***While it's largely true that non-US equities have been out of favor relative to US stocks since the GFC, we are tasked with deploying capital on a forward-looking basis.*** The reality is that many companies outside the US trade at a meaningful discount to US peers. These same companies often have less debt, higher dividend yields, and stand to benefit from a weaker US Dollar and more meaningfully from China's reopening.

## EYES WIDE OPEN AS WE MOVE FORWARD...

As referenced earlier, we do NOT believe we are entering a "Goldilocks" environment for risk assets. We believe risk management is imperative and so too is actively pursuing attractive risk/reward opportunities.

### What does that mean?

There always have and likely always will be reasons NOT to invest. In our lifetimes we've witnessed a President assassinated, multiple wars, a President resign, two others impeached, natural disasters, acts of terror and much more. DESPITE all of it, markets continue to press higher. There's no assurance the road ahead will be a smooth ride, but history has consistently rewarded the patient and disciplined participant for more than a century.

### Challenges ahead...

There's little denying that the headlines for the foreseeable future could wreak negativity. Below are a

few of the headwinds facing the markets in the coming months:

- Tight Fed Policy
- Sticky Inflation
- Banking stresses
- China fears
- Russia/Ukraine
- Earnings slowdown
- US Debt Ceiling
- 2024 US Election

The news cycle will almost certainly cause some investors to make poor, ill-timed, emotional decisions. It is those mistakes we are trying relentlessly to avoid.

The following is a quick snapshot of our viewpoint on several key headwinds and how (if at all) that impacts our current positioning.

**The Fed:** While there's no denying that the Fed has been the primary driver or behavior over the last 18 months, we believe the remaining action of the Fed will conclude in the coming quarter. Whether 25 or 50 basis points

more, the May or June meeting will likely usher in the Fed Pause. The market already has this “priced-in.” What remains to be seen is whether the economic slowdowns surfacing in the data are indicative of the lagging impact of Fed policy or something more damaging.

The probability of the Fed getting rates “just right” is nearly 0%...what remains to be seen is how far off they are and how quickly they recognize and respond. The bond market is currently pricing in an anticipation that the Fed must cut at least once in Q4. Our base case is that they don't begin rate cuts until 2024, but a late '23 cut cannot be ruled out.

The investment implication of the Fed carries across all asset classes but has created a specific opportunity in quality fixed income. “Quality” doesn't just mean Treasuries, but we believe encompasses mortgages, IG Corporates, and select segments outside IG. We are positioned relatively low duration currently, but would anticipate extending duration a bit (not a big duration bet) when the Fed Pause is clearly in-hand.

### **Inflation, the Banks, and the slow growth economy:**

Debate continues about whether inflation from current levels will eventually come down on its own or whether further policy action is warranted. What is less debatable is that recent stresses in the banking arena will lead to tighter credit, decreased lending, and more government regulation...all a recipe for slower economic growth.

Weakness in the mortgage markets and announced layoffs in recent months suggest there's a strong deflationary element on the horizon. What remains to be seen is whether the Fed will acknowledge these factors and soften their tone this summer. Lower CPI and PCE prints will make that case easier to accept by members of the Fed Board of Governors.

Data coming out of China shows that the reopening is real but is materializing a bit slower than some had projected. Ultimately, a more elongated reopening cycle could be a help for inflation readings (steady demand vs. a rush to travel, consume, etc.). The supply chain in many industries remains sub-optimal and worker shortages still plague many businesses. We question whether the Fed

can fix this phenomenon without material economic casualties. Is the effort worth the risk? What price are we willing to pay to bring inflation down faster? While not a prediction, we believe there's a high probability the Fed will soften its tone mid-year and acknowledge these risks.

### **Geopolitics:**

One can never dismiss the role of turmoil overseas on the US investment landscape. The surprise OPEC+ cut on 4/1 is yet another example of such unexpected events. We believe China and the war in Ukraine will remain risks for the balance of 2023 and beyond (but not reasons to avoid investing in any specific asset class outside of those geographies themselves). While defense companies intuitively benefit from increased spending globally, they also trade at expensive multiples. Often geopolitics just adds volatility to the already complex landscape for investors.

### **Politics & the US Debt Ceiling:**

Did we mention volatility? Another year, another debate in Congress that has the potential to cause considerable angst for investors. In 2011 the Debt Ceiling debates led to the US having its debt rating lowered for the first time in history. The 2023 iteration has the makings of another fiery season.

In the second half of 2011, US Equity markets sold off double-digits. This coincides both with the debt ceiling debates and the PIIGS fiasco (fear that Portugal, Italy, Ireland, Greece, and Spain could default on their debt). During the market's selloff, investors flocked INTO US Treasuries, suggesting their concern was more about Europe than the possible default on US Debt.

It's undeniable that these debates will cause anxiety and scary headlines. Ultimately, as we see things currently, we believe the result will mirror the last dozen...a raising of the debt ceiling and a “kicking of the can.”

Inherent in each of the above is VOLATILITY. The investment implications are that we are squarely focused on strategies that can help us dampen that volatility, capture cash flow along the way, and make it through to the “other side.”

# WHY TO NOT HOARD CASH & WHY DOLLAR COST AVERAGE

U.S. Investors currently sit on Trillions in money markets and deposit accounts. Is that a bad thing?

While holding cash certainly felt like a win in 2022, cash lost more than 5% relative to inflation. Today's money markets yielding 3-4% still lag inflation by more than 2%. What is an investor to do with cash?

Let us begin answering that question by first acknowledging that cash often has a designated purpose. If earmarked for a major purchase, rainy day fund, or specific anticipated outlay maintaining liquidity is entirely appropriate. The cash we are referring to is what we refer to as "excess cash." This cash is above and beyond designated purchases and often represents a meaningful allocation of one's total assets.

Who has excess cash? Why?

- Sold an investment property
- Sold a business
- Profit from downsizing a home
- Inheritance
- Divorce
- Reduced equity holdings in portfolio (or even fixed income %) tactically or out of fear
- Thriving business generating excess cash flow

## If you have excess cash, what should you do with it?

The answer is not as simple as INVEST IT! To fully ascertain what one should do, we must first understand how and why a cash position has been accumulated. If it's simply resultant from a recent transaction of a business or property, the answer typically involves exploring one's goals, objectives, and risk tolerance and make recommendations accordingly.

For someone who is relatively new to having "excess cash" (i.e. divorce or inheritance) the conversation will involve a greater level of focus on planning and education. There will be significant

similarities but also meaningful differences from client to client.

For the final group, those either hoarding excess cash over time or those who have tactically moved into a large cash position, the conversation is likely to focus on return opportunities. Not only may such an investor feel relief by missing out on potential losses sitting in cash, but also anxiety over the potential missing out on larger gains associated with other asset classes over time.

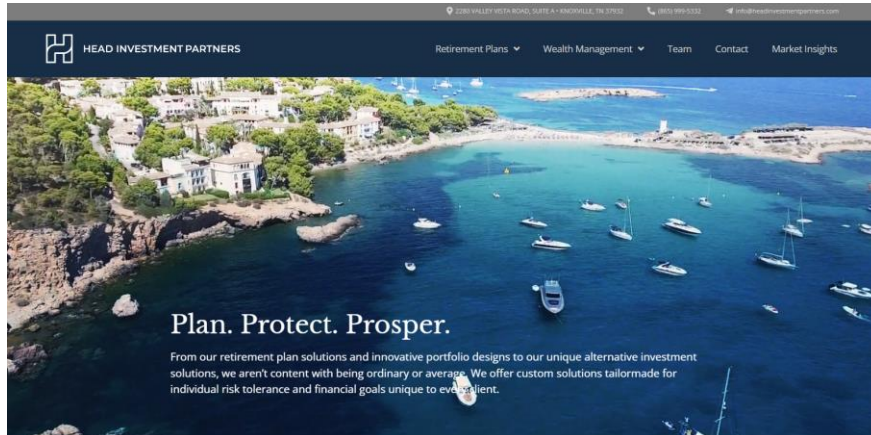
Dollar cost averaging involves the investment in any asset class over a period of weeks, months, or years. One of its greatest benefits is that its mechanical nature reduces the emotional element of the decision and increases the probability of success. The most common example of dollar cost averaging occurs in 401(k) plans where investors invest with each payroll cycle, most often without thought. A disciplined purchasing pattern reduces the impact of poor timing decisions.

The example below shows a security that ended the year flat, but the DCA investor garnered a return of over 6%. Not only can a DCA approach yield better results, it will also likely feel more comfortable for an investor sitting in cash. The DCA approach lines up well with a "live to fight another day" approach to the current market. Limit the potential impact timing can have on your cash.

	Investor A: 100% invested Day 1			Investor B: Allocated equally over 12 months		
	Value	Price /share	Shares	Value	Price /share	Shares
Jan	\$100,000	\$1,000	100	\$100,000	\$1,000	8.333
Feb	\$95,000	\$950		\$99,583	\$950	8.772
Mar	\$90,000	\$900		\$98,728	\$900	9.259
Apr	\$85,000	\$850		\$97,410	\$850	9.804
May	\$90,000	\$900		\$99,218	\$900	9.259
Jun	\$85,000	\$850		\$96,947	\$850	9.804
Jul	\$90,000	\$900		\$99,708	\$900	9.259
Aug	\$110,000	\$1,100		\$112,607	\$1,100	7.576
Sep	\$105,000	\$1,050		\$109,003	\$1,050	7.937
Oct	\$90,000	\$900		\$97,003	\$900	9.259
Nov	\$95,000	\$950		\$101,466	\$950	8.772
Dec	\$100,000	\$1,000		\$106,368	\$1,000	8.333
Year End	\$100,000		100	\$106,368		106.368

## GOOD NEWS...

- Head Investment Partners has a new revised website. Please check us out at [www.hip3.net](http://www.hip3.net)



- It's time to Tee it up at Top Golf: call us to learn how to schedule a time with our team at Knoxville's most exciting new attraction



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