Investment Update

HEAD INVESTMENT PARTNERS

Q3: THE PAUSE OR THE INFLECTION POINT?

Investors seeking calm heading into the back-half of 2023 found little during Q3. Equities largely sold off around the globe while bond yields rose. Global Central banks (including the US Federal Reserve) continue to remain center-stage, despite efforts to push them aside for other news stories.

While Q3 data gave small glimpses of a weakening US consumer, the labor force (accompanied by recent strikes at UPS and by the UAW) remains tight. Commodity prices (oil specifically) saw a large increase in Q3, further supports the plausibility of a Fed needing to keep rates higher for longer to tame inflation.

Let's begin with performance for Q3 and YTD then work backwards a bit:

- S&P 500: -3.3% & +13.1% YTD
- Russell 2000: -5.1% & +2.5% YTD
- Bloomberg Agg Bond Index: -3.2% & -1.2% YTD
- TIPS (TSY Infl Prot Sec): -2.6% & -0.8% YTD
- MSCI EAFA (non-US): -4.1% & +7.1% YTD

The US Federal Funds rate now reads 5.5%, its highest level since the Global Financial Crisis of 2008. Meanwhile, the 10-year US Treasury yield spiked more than 70bp during the quarter, to 4.57%. While the Fed may have ushered in a slightly more patient posture on monetary policy from here, the move in bond markets further challenges the wallets of the American consumer.

The amount of negativity present today can easily weigh on the psyche of even the most patient investors. ***HOWEVER, timing this market will again likely prove perilous.*** Companies with pricing power and large "moats" historically benefit from a strong consumer and an inflationary environment. These same companies today are not cheaply priced, nor are they immune from the tight labor dynamics. There are, however, pockets of the market that are attractively valued…more on this later.

During past episodes of economic weakness/recessions, owning high yield bonds proved challenging. This year high yield has outpaced the AGG by over 7% (and by 7% a year over the last 3 years!). High yield is just one example of a category whose risk we view differently today. With stimuli in the markets and better balance sheet management, this isn't the same "junk bond" market we've seen during past episodes of stress.

We are not suggesting that historical references are to be disregarded and that everything is "different this time." ***Instead we assert that we must continually evaluate the nuances to today's environment to make the best calculated decisions involving risk and reward.***

Over long periods of time, equities have outpaced bonds. Over many stretches of time, bonds and stocks move in opposite directions. While both are true statements, we believe there are **generational** opportunities in fixed income right now and more selective pockets of opportunity in equities.

Does Q3 signal a continuation of the recent trends or an inflection point? Anticipating a Fed pause and inflection point is about as worthwhile as trying to diagnose whether economic weakening is good or bad for markets. ***In a weird way, it's both!*** A slowing consumer can slow inflation (which is generally good for equities) but also hurts sales. Less wage pressure helps business, but slower spending impairs their ability to grow. In the end, there's a very good reason there's a modest correlation between economics and stock market performance. ***We again reinforce the core belief that patience will be rewarded!***

BARGAINS, RISKS, HEADWINDS & OPPORTUNITIES…

It is only appropriate to begin our look ahead with an expression of our deepest sympathy for those embroiled in and impacted by the conflict in and around Israel. Our thoughts and prayers to all of those in the area and with loved ones in the region.

This tragedy serves as a humbling reminder that there are elements of risk one can never fully calculate nor account for in his/her portfolio. A single event can trigger an inflection point or exacerbate an already troubling trend. In the example of the Israeli tragedy, the conflict further challenges of global Central banks as they battle inflation, as energy prices rise, and as consumers face weakening balance sheets and tighter access to credit.

As this section is titled, below we will look at where our team believes the markets are offering the greatest opportunities (and the most visible) and what areas of the markets we believe merit and underweight or avoidance.

Bargains?

A bargain can be defined as a thing bought or offered for sale more cheaply than is usual or expected. In the world of investing, bargains often also carry the moniker "buyer beware." Sometimes stocks are cheap for a good reason.

As we survey the investment landscape for bargains entering Q4, we have identified the following candidates:

- Energy Stocks (both US & non-US)
- US Industrials (think defense, Deere, Caterpiller)
- Non-US high cash flowing dividend growers
- Emerging Market Equities (including China)
- US healthcare sector
- BB/BB rated consumer-backed bonds, mortgages and municipal bonds with moderate duration

The scale of discount and risk of each of these varies. Our greatest confidence among those listed lies within the fixed income space. Mathematically, there is a real possibility of total returns in parts of fixed income that rivals equities over the coming 1-2 years. Not only do many bonds offer an appealing return potential, but they do so with a risk profile far lower than equities.

Among equities, energy and non-US dividend growers each make a lot of sense. Both generate robust dividends and trade at multiples well below their historical averages and the broad markets. Historically, stocks entering a period of economic slowdown at below-market multiples fare better than higher P/E peers. Couple their attractive valuations with the resilient demand for their products and we believe you have a recipe for gains ahead.

Risks…

There has never been, nor will there be a riskless marketplace for investors. Some risks can be avoided, others muted, and many others managed. ***We believe a successful investor is one who does not attempt to mute/avoid every possible negative outcome.*** He maintains an appropriate level of risk and stays nimble.

As we sit today, we believe the most important risks to manage are as listed below:

- Balanced exposure to spread and duration among bond holdings
- Maintaining valuation exposure among equity holdings well below that of the market
- Avoid the risk of NOT diversifying meaningfully outside the US markets
- Limit concentration risk among Large Cap US equity positions (and avoid the temptation to overweight the Magnificent Seven" and familiarity)

Headwinds & Opportunities…

These two items are coupled because we believe the single biggest opportunity today is standing steady in the face of the obvious list of headwinds we face. For most investors, their appropriate asset allocation hasn't meaningfully changed in the last 2 years, but the lay of the land has. Generally, the 60/40 investor is still a 60/40 investor…but how we maintain that exposure to each "bucket" presents us with opportunity.

Areas of the market we believe merit avoidance:

- Leveraged Loans (aka Bank Loans)
- Private Credit (despite all the TV adds)
- Less liquid strategies (private REITS, interval funds, etc.)

- High P/E companies without earnings
- "Theme" stocks (including AI) trading at incalculable multiples
- Leverage-based solutions (cost prohibitive in most instances)

Areas where we believe caution is warranted:

- Large Cap Growth
- Bank stocks (especially regional banks)
- China (although a strong case can be made to begin adding here)
- Areas that seem too obvious (defense, consumer staples) because many trade at elevated multiples

As mentioned earlier, bond strategies offer a very appealing risk/reward today. Selectivity in equities offers a similar logical opportunity. The conviction of these opportunities must be rooted in **patience**. It is that key element that will dictate success or failure in the coming quarters. ***The markets' timing will not always align with logic, reason, and even common sense.***

With an election less than 15 months away, geopolitical risks among the highest in 2 decades, and the Federal Reserve still at center stage we are paid to be patient. We believe that patience will be rewarded. As President Kennedy remarked over half a century ago, "the time to repair a roof is when the sun is shining."

Moving up in quality is among the most obvious positioning decisions and we believe will be rewarded between now and the 2024 election. Over the last few months we've extensively de-risked and repositioned across our book of business to help our clients be prepared for the risks and rewards we see ahead. This work continues daily!

ALTERNATIVE ≠ ILIQUID

We often write about non-traditional strategies in this newsletter. In this update we want to emphasize the importance of maintaining liquidity during episodes of market uncertainty and volatility. Liquidity is of no real value…until it's needed.

With over 75 years in the industry, our team has seen firsthand the consequences of illiquidity. In that line of thought, may "alternative" investments also come with liquidity constraints.

We've seen Apartment REITs with a 7-8% annual payout that end up having no way for you to exit. Hedge Funds and Private Equity strategies offering great historical performance until a down year…and you can only access a portion of your money. The industry's largest publicly traded REIT product only met a portion of redemption requests in the past quarter.

Limited liquidity should garner improved potential return…but is that a trade you should make? Can you survive illiquidity?

Most investors buying alternative strategies are simply seeking a return differentiated from more traditional strategies. A better yield, better downside performance, or tax efficiencies have led many down the path toward alternatives.

Don't mistake our words…we are PRO ALTERNATIVES, however we are also PRO LIQUIDITY.

For clarification, there's an immense array of strategies that offer daily liquidity through an ETF or mutual fund that can accomplish what most investors seek in an alternative. While some of these instruments may be new and have short track-records, the underlying concepts are not. Belowe is a short list of alternative strategies we employ that have daily liquidity:

- Covered Calls
- Buffered ETFs
- Managed Futures
- Market Neutral
- Other options solutions

Think about when your less-disciplined neighbor might want out of a strategy. Chances are that may coincide with when you too might seek an exit. If you want to avoid various potential unintended consequences, consider liquid alternative strategies for your needs.

Table 1: The greatest Treasury bear market of all time.. 2020-today

History of US Treasury bond bear markets

Date of Market Peak	Date of Market Trough	Peak to Trough Performance	Recovery One Year from Trough	Duration of Bear Market (mos)
7/31/2020	10/31/2022	-24.7%	0.0%	28
06/30/1860	05/31/1861	-18.7%	32.4%	12
05/31/1835	12/31/1839	-16.1%	19.0%	56
06/30/1979	02/29/1980	-15.8%	8.2%	9
05/31/1931	01/31/1932	-15.4%	18.5%	9
06/30/1980	09/30/1981	-14.6%	43.1%	16
09/30/1833	03/31/1834	-13.7%	16.5%	7
05/31/1811	03/31/1813	-11.3%	6.8%	23
02/28/1987	09/30/1987	-10.5%	14.7%	8
10/31/1993	11/30/1994	-10.2%	25.1%	14
7/31/2012	12/31/2013	-10.1%	10.8%	18

Source: BofA Global Investment Strategy, Global Financial Data; "bond bear market" = total return decline of 10% or more

As you see to the left, the pain in bonds is truly historic. We've navigated this rather well in the last 12 months and feel excited by what could lie on the other side…

IMPORTANT ANNOUNCEMENTS…

2023 Holiday Event
Tuesday, December 19th
Chesapeake's on Parkside Drive
6:00 – 9:00 PM (Drop by)

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