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Q3 2022 Update and Outlook

Executive Summary

- Markets fell broadly in Q3 experiencing a rare third consecutive quarter of losses. Broad risk off sentiment was driven by global policy makers urgently attempting to cool inflation during a period of heightened geopolitical risk. After unprecedented money printing and fiscal stimulus during the pandemic and post-pandemic periods, global policy makers are now reversing course, draining the world of liquidity, and making cash more valuable.
- Predicting geopolitical events and their impact on markets is always difficult. We therefore focus on valuations and use that as a backdrop to convey our thoughts on asset allocation.
- The higher yield on cash, particularly in the form of US dollars, is attracting more attention especially in a world rife with uncertainty. We expect to remain overweight cash but will slowly step into various pockets of opportunity where we see more attractive valuations.

Cash and Bonds

Cash in the form of US dollars is typically where we like to start evaluating opportunities. Lending money for three months to the US government is generally seen as one of the safest investments in the world. This "risk-free" rate is where most investors start when they look to value all other assets. The three-month Treasury bill yield has risen this year from 0.1% to 3.9% as the Federal Reserve has embarked on what of its fastest rate hiking cycles in history. At the same time, the Federal Reserve is shrinking the supply of US dollars after its unprecedented money expansion that began during the depths of the pandemic and continued until earlier this year. In short, US dollars are becoming scarcer and more valuable in a world rife with uncertainty.

We remain overweight cash in US dollars but expect to move toward neutral slowly. We say slowly because even though the Federal Reserve has increased rates at a historic pace and plans to continue to do so, they may still need to go further than either they or the markets expect. Inflation has continued to surprise to the upside, north of 8%, through October. To move into truly inflation fighting restrictive territory the Fed may have to hike rates beyond their currently expected 4.5% terminal rate. Even if the 4.5% rate is enough, the Fed has repeatedly stated they expect to stay at 4.5% for some time to avoid a repeat of the stop-and-go inflation of the 1970s. The market however still sees rate cuts beginning in early 2023. While holding excess cash in US dollars feels comfortable now, we must remember that cash long-term has not preserved its value. Even at today's 3.9% interest rate, investors are losing purchasing power after 8% inflation and taxes. We must therefore seek other assets with higher potential yields.

The next "safest" place most investors seek excess yield is by lending money to the US for longer time periods. This is a space we remain underweight. 10- and 30-year loans to the government yield just 4.2% and 4.3% respectively, while 2-year debt yields 4.5%. Generally, investors demand more yield for lending money to the US for longer time periods to compensate for the risk of future inflation. This is surprisingly not the case today despite near-record inflation. The US fiscal deficit will shrink in 2022 by one of its greatest amounts in history, but we are still running a $1 trillion deficit. The Federal Reserve is also moving from purchasing billions of dollars of this debt to selling $95 billion of debt per month for the foreseeable future. We remain concerned about where the demand for these bonds at these yields comes from, and we would prefer to remain underweight and keep our loans shorter in duration.

We are however turning a bit more optimistic in some other areas of fixed income. Municipal finances are in much better shape as municipal revenues from sales, property and income taxes have all benefited from inflation. Corporate balance sheets also remain strong, and we think shorter duration high yield bonds yielding north of 8% are relatively attractive.

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US and International Equities

US equities struggled in Q3 and while we remain underweight, we are beginning again to see some pockets of opportunities. Equities rallied quite strongly in Q3 through mid-August, but buckled following Jerome Powell's hawkish Jackson Hole speech, two hotter than expected inflation prints, and the start of the Fed's quantitative tightening program in September. Despite the broad declines in equities, US stocks broadly, and large cap stocks especially, are not historically cheap. Valuations on the large cap S&P 500 are approaching fair value, but earnings expectations may need to fall further, and interest rates used to discount future earnings could certainly continue to move higher. The S&P trades at roughly 15 times next year's expected earnings for a 6.7% earnings yield. If inflation cools and the Fed can stop hiking cash rates much beyond 5%, this may be a fair yield, but we'd prefer to see even cheaper valuations before adding significantly now. US mid and small caps however are trading at historically cheap valuations with yields in the 8-9% range. Many of these companies are more isolated from both geopolitical risk and the stronger US dollar. We began slowly adding to this space via inexpensive, liquid exchange traded funds at the very end of Q3.

International stocks are also trading at both historically cheap valuations and with historically cheap currencies, but current geopolitical risk has kept us underweight and less excited about the space for now. While Europe may have stored enough gas for this winter, next winter remains a question. The United Kingdom briefly floated cutting taxes in this difficult environment, but the bond market vigilantes revolted with UK bonds and the British Pound registering historic one-day losses. While the UK has quickly reversed course, politicians subject to reelection often favor quick populist fixes that can stoke inflation further over more painful medicine. The rest of Europe faces similar difficult choices, and this may further stress the European Union itself with various members moving in opposing directions.

Meanwhile authoritarianism often in violent fashion is on the rise. Although Russia has faced numerous setbacks in its war against Ukraine, a cornered Vladimir Putin may turn to even more ruthless measures. Recent drone kamikaze attacks on Ukrainian civilians are just one example. These drones were purportedly supplied by Iran, a country ruthlessly suppressing its own citizens recently. Despite President Biden's pleas, OPEC+ cut oil production during a period of desperate need for energy supplies. Finally in China, Xi Jinping is wrapping up his third-party congress with no signs of pivoting away from his recently more authoritarian and communist policies. US-China tensions have only increased around Taiwan, semiconductors and artificial intelligence. As noted, these tensions and the move toward deglobalization may certainly stoke inflation higher. While we are maintaining our current international exposure as some of the best returns for markets - especially foreign markets - come after such tensions ebb, we remain underweight and unlikely to add.

Alternative Assets

Hedge funds as a complex have done little to hedge risk meaningfully in this environment. We continue to believe that only a handful of funds in this space are truly worth the associated fees, illiquidity, and limited transparency. We have worked hard over the past several years to concentrate our portfolios with these select partners and have been relatively pleased with the results. Our partners are finding opportunities amidst the wreckage. Biotechnology stocks are trading at historically cheap valuations, but the space is still riddled with poor quality 2021 IPOs burning cash. The SPAC and IPO frenzy of 2021 has also left the market with many young unprofitable companies. Many of these will fail, but many other have a path to profitability and positive cash flow. Our select partners who can go both long and short these firms see a rich opportunity set ahead.

Turning to private markets, the liquidity-fueled IPO and SPAC frenzy of 2021 has turned quickly to a deep freeze. Private valuations have fallen back to earth and may certainly fall further, but we think the current market is a good one for long-

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term investors. Most Fortune 500 firms today were built during either a bear market or a recession. Talent is becoming easier to find as many workers' stock and option based compensation from large corporations has fallen significantly. Large private funds that drove valuations higher and often closed deals with limited due diligence have stepped back leaving a great opportunity for long-term, patient providers of capital to step in. We plan to do so here.

Finally turning to commodities and real assets, results have been mixed. Gold continues to struggle against rising rates and a strong US dollar, but we continue to believe a small allocation makes sense in a world of growing unrest and distrust. Cryptocurrencies have plummeted further. We believe they were beneficiaries of the excess liquidity created during the pandemic days and conversely that they will continue to struggle in a world of declining liquidity. While energy is higher on the year, fears of a global recession have pulled down prices recently. We still believe that demand for traditional energy will grow long-term while supply from authoritarian regimes is shrinking. Both political parties in the US seem to be warming to the idea that the US has both the will and ability to produce more oil and gas for our security and the security of our allies. While public companies are still faced with shareholders preferring cash flows over capex, private US companies can step in and provide the capital needed to meet the world's growing energy needs responsibly. We are optimistic and adding capital here.

Real estate, often seen as a beneficiary of inflation, has not behaved as expected in 2022 to date. Through the end of Q3, publicly trade real estate stocks are down over 30%. The Fed's rate hike and inflation fears have driven mortgage rates to nearly 7% recently from below 3% last year. This has effectively doubled the cost of home ownership in the US. While housing prices have fallen moderately in two consecutive months and may fall further, we do not expect a repeat of 2008 given the chronic undersupply of housing stock. We are concerned with office real estate, especially older and lower quality buildings, but again are finding pockets of opportunities elsewhere. The fundamentals and cash flows in industrial, multi-family and medical real estate remain strong and many firms locked in historically low long-term interest rates. A large pool of dry private capital may well find its ways into the depressed public markets, and our active managers can capitalize on this opportunity.

CONCLUSION

In conclusion, the first three quarters of 2022 have been extremely difficult. While the Federal Reserve and its global peers have come a long way in reducing liquidity to cool inflation, they may still have a way to go especially if geopolitical risk ignites further. Given unpredictable and heightened inflation and geopolitical risk, we expect to remain relatively conservatively positioned against our long-term strategic targets, but we are seeing pockets of opportunity and expect to buy into them slowly over time.

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