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Q1 2023 Review and Outlook

Executive Summary

- In his book Thriving on Chaos, Tom Peters noted "if you're not confused, you're not paying attention." This sums up Q1 of 2023 in our opinion.
- Chaotic macro events occurred throughout the quarter. The US saw the second and third largest bank failure in history, the steepest plunge in 2-year rates since the 1987 crash, and the first ex-president indicted on criminal charges. Outside of the US, inflation moved higher, Credit Suisse collapsed, the war in Ukraine continued, and US-China tensions simmered hotter.
- Despite this backdrop, most assets turned in strong positive Q1 returns. We remain defensively positioned with some excess cash but are sticking close to our long-term targets, which should always guide investors through such chaotic times.

A Chaotic Q1 and the difficulty in forecasting macroeconomic events

In his book Thriving on Chaos, Tom Peters noted "if you're not confused, you're not paying attention." This sums up Q1 of 2023. In the US, we saw the second and third largest bank failures in history. On this news, the 2-year US Treasury yield fell over 1% in three trading days, the largest decline since the stock market crash of 1987. The bank failures shook confidence broadly. US consumers, already experiencing rising delinquencies, are about as pessimistic as ever. Bank loan officers facing rising real estate vacancies and deposit outflows expect to tighten lending standards further. Investor sentiment and small business optimism fell below 2020 pandemic levels.

Also in the US, former President Trump became the first ex-president indicted on criminal charges. This intensified the already heightened political distrust in the US as we head toward yet another debt ceiling debate and the 2024 election. Despite all this turmoil and some warranted blame and distrust for the banking failures, the Federal Reserve remained resolved to battle inflation. The Fed hiked cash rates 0.25% in March matching their February hike. Though the market disagrees, the Fed has signaled they plan to hike rates another 0.25% to 5% at their May meeting and hold there for some time.

Chaotic events also occurred outside of the US. The war in Ukraine intensified a year after its initial outbreak. Credit Suisse, a 166-year-old institution that withstood two world wars, collapsed. Despite declining oil and gas prices on recession fears, European core inflation continued to tick higher reaching a thirty-year high of 7.5% on a year-over-year basis in March. Japan also experienced some of its strongest inflation in years. While its central bank remains extremely easy, it faces a change of leadership which may roll back these influential and long-standing policies.

US-China tensions also heated up in Q1. A Chinese spy balloon was shot down off the US east coast after traversing the nation and gathering data on sensitive sites. While the Western world worried over its banks, China strengthened its ties with Saudi Arabia and Iran, convincing the two to resume diplomatic relations after a seven-year rift. Although China purports to be interested in brokering a peace in Ukraine, it was also reportedly considering direct military aid to Russia. China condemned the meeting between US House Speaker Kevin McCarthy and Taiwan's President Tsai Ing-wen as a "dangerous act" and vowed to "fight back." President XI Jinping officially replaced China's longstanding foreign policy doctrine of "hide our strength and bide our time" to "dare to fight." While

China remains our largest trading partner, its US bond holdings fell by $250 billion in the past two years.

Yet despite all these disruptive and concerning events, markets, as discussed below, delivered strong returns in the quarter. We doubt many professional investors, even if they had known about these events ex-ante, would have predicted such strong returns. Many in fact were humbled navigating events and markets in real time. In times like these, we are reminded of some words of wisdom from Charlie Munger. He's noted that he's never made money making accurate predictions or forecasting macroeconomic events. He's made money owning great businesses at fair prices and having the temperament to hold and add to them in chaotic times. While we are defensively positioned currently, we remain close to our strategic targets with the humble knowledge that short-term forecasts are error prone.

Liquid Assets

Cash, proxied by the rolling 3-month Treasury bills, delivered a solid 1.1% return in Q1. While we don't think cash is a great asset to hold long-term, we are currently overweight our strategic targets. Our cash, held either directly in treasury bills or indirectly in government-backed assets through money market funds, yields close to 5% today with minimal volatility. We find this yield relatively attractive to more volatile assets discussed below. Our excess cash gives us the ability to buy these assets during inevitable, but unpredictable bouts of weakness and fear.

In terms of relatively unattractive yields, Treasury bonds across the yield curve offer less yield than cash and short-term bills but with added inflation risk. While bond investors were well compensated for accepting this risk in Q1 with the Barclays Aggregate up 3%, we remain underweight the space. 10 and 30-year Treasury bonds yield 3.6% and 3.8% respectively with cash and US inflation still at 5%. At these levels, US Treasury investors are betting on an imminent recession. We still see wage inflation as a risk and will look to add at higher yields.

Outside of Treasuries, we do see opportunities in the bond market and remain closer to neutral in other categories like high yield corporate and municipal debt. We are finding 8% yields in short duration high yield corporate bonds from solid issuers and are overweight here. We also remain near neutral to high yield municipals yielding over 7% on a tax equivalent basis.

Turning to US equities, which turned in a strong 7% return in Q1, we remain slightly underweight. The S&P 500 now trades near 19 times forward expected earnings for a 5.3% earnings yield which barely tops cash. Whereas the bond market expects a recession, large cap equity analysts still expect earnings to grow 1% this year and over 12% next year. Should the bond market prove correct, we would expect to see lower earnings and cheaper valuations and continue to hold some excess cash for this scenario. We do find small and mid-cap shares in the US relatively more attractive at 14 times forward earnings. Analysts here are already expecting a 9% decline in earnings. We are willing to buy here on corrections.

Outside the US, international stocks also turned in a strong Q1, up 6.5% despite all the concerns noted above. International stocks trade near 13 times forward earnings and we find these valuations compelling but are cognizant of a myriad of risks. Certain emerging markets like Brazil and China have rarely traded more cheaply, but both countries rank quite low in terms of rule of law. We remain underweight, finding many opportunities cheap for good reason, but continue to look for great businesses at these levels.

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Alternative Assets

Real assets turned in mixed results in Q1 with last year's winners and losers largely reversing. Last year's largest winner, energy, struggled in Q1 on recession concerns with energy and oil off 5% and natural gas off 50%. We think the selloff in energy stocks represents a buying opportunity as we continue to see long-term sustained demand facing curtailing capex and supply. Last year's largest loser, bitcoin, surged over 70% after falling 64% in 2022. We continue to avoid direct cryptocurrency exposure but do think the space correlates negatively with confidence in central bankers which declined in Q1.

We continue to maintain a small gold position which gained nearly 8% in Q1. We do not expect to own gold forever given its lack of cash flow but do think it can be a diversifier in the near term as it tends to behave well in recessions, crises of confidence, and against a weak dollar. Finally, real estate, despite being the eye of the storm in Q1 as banks fret over their exposure and rising office vacancies, turned in a small positive return. We continue to like our active managers in the space who can find opportunities amidst the volatility. Most listed real estate lies outside the office sub-sector, and we think there are some very good businesses at cheap prices here.

The asset weighted hedge fund indices we follow appear to have lost money in Q1 down roughly 1%. Some of the highest paid managers were among those that were most humbled by Q1 events and the resulting market returns. As we've noted in the past, we think it pays to be highly selective in partnering with hedge funds and we will continue to set a very high bar.

Finishing with private assets, the picture is about as murky as Q1 was. We are closely watching private valuations but have yet to see major markdowns across the industry. Most private equity indices in fact posted positive returns in 2022 despite the widespread market weakness. Actual deal activity fell precipitously though, and the IPO backlog stands at a two-decade high. There are wide spreads between buyers' bidding prices and sellers' asking prices with many private companies squeezing cash, delaying fundraising, and hoping for better times and prices ahead. The failure of Silicon Valley Bank, a bank that provided significant liquidity to the venture space, along with a tightening of lending standards broadly will likely delay realizations further. We think this creates a good opportunity to step into and provide liquidity to private markets while being mindful that current prices may not fully reflect reality.

Conclusion

In conclusion, Q1 was full of its share of shocks and surprises. We think it is more important than ever to have a strategic plan in place so that investors are not whipsawed by the chaotic events we are experiencing and the surprising market results. Tactically, we remain a bit defensive, and believe that a little extra cash yielding close to 5% may be able to find higher yielding opportunities soon. As always, we are thankful for the trust you place in us to navigate these markets and are available to address any questions or concerns at any time.

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