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2023 Q2 Review and 2H Outlook

Executive Summary

- Q2 continued to be a chaotic quarter on the macroeconomic front. The US continues to avert the most predicted recession of all time but flirted with a debt ceiling default and saw its second largest bank failure in history. Germany tipped into a recession. The war in Ukraine turned more chaotic with a brief revolt from Russia's mercenary group. China is rebounding sluggishly from COVID with youth unemployment at record levels. Artificial intelligence (AI) broke its own records reaching new users at an exponential rate.
- Despite, or perhaps because of these events, global asset prices ground higher. US stocks fueled in large part by a handful of AI beneficiaries, jumped over 8%. Bonds were mixed with high grade bonds showing losses but high yield bonds topping cash. International markets gained just over 2% while alternative asset returns were muted.
- Most importantly, we continue to advise clients to remain close to their long-term strategic targets but do remain slightly cautious for the reasons discussed below.

Q2 and 1H Macroeconomic Review

We noted the quote "if you're not confused, you're not paying attention" summed up Q1. This theme continued in Q2. Famed investor Stanley Druckenmiller, who stated in June that he has never lost money in any given year, felt this was the most complicated backdrop he has ever seen. In Q2, the United States flirted with a debt ceiling default testing investors nerves before reaching a last-minute compromise. First Republic became the second largest bank in history to fail when regulators seized the bank in May. Investors continued to worry over further bank failures as concerns around bank exposure to the beleaguered commercial real estate market dominated Q2 headlines. For now, although traditional recessionary indicators abound, the US continues to avert the most predicted recession of all time.

Outside of the US, Germany, Europe's economic powerhouse, dipped into a recession in Q2 with retail sales plummeting at rates not seen since the pandemic. While European inflation has cooled, it remains uncomfortably high at over 5%. The combination of slowing economic growth and stubborn inflation creates a conundrum for central bankers in Europe and globally. For now, most central bankers remain in tightening mode, with global money supply shrinking by the most we've seen since 1960. Japan, however, continues to confound investors, remaining the only developed economy still in easing mode despite fifteen straight months of inflation topping its 2% target. This helped Japanese stocks finally top their 1989 levels after three lost decades, but leaves investors concerned about the ultimate impact when and if such stimulus is removed.

Impacting Germany's recession and global sluggishness in Q2 were the war in Ukraine and the anemic post zero-COVID recovery in China. While lower energy prices versus last year's war-influenced prices helped drive global inflation growth lower, the war continues unabated and took a chaotic turn with Russia's mercenary Wagner group briefly marching toward Moscow before standing down peacefully.

China's ultimate role in the war and on the global stage remains in doubt. While China continues to promote a peace plan, parts made just this year in China were found in Iranian drones shot down over Ukraine in April. Americans Anthony Blinken, Henry Kissinger, Elon Musk, Janet Yellen, Jamie Dimon and John Kerry all recently visited China to presumably strengthen relations. At the same time, President Joe Biden called Xi Jinping a

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"dictator" while Xi called on his national security to "be prepared for worst-case and extreme scenarios." Internally, China continued to face stress with its economy growing just 0.8% in Q2 despite continued stimulus measures and a Chinese consumer unleashed from zero-COVID lockdowns. Youth unemployment in China reached new all-time highs at over 21% while consumer confidence remains near all-time lows.

To put a cap on confusing Q2 events, humans grappled with two potential world changers. With Canada, Greece and Turkey all battling record breaking wildfires, the world recently saw four straight days of record-breaking heat. Artificial intelligence or AI also broke records in Q2 with ChatGPT reaching over one hundred million users and generating 1.6 billion visits in June alone. AI enthusiasm drove both retail and professional investors into related names at a frenzied pace. While most US stocks have gained little ground to date in 2023, AI-related stocks, concentrated to seven mega-cap names, jumped 80% driving nearly all the S&P 500's first half gains. AI mentions on earnings calls reached record levels with grocer Kroger's CEO using it 8 times in Q2 versus none in Q1. At Berkshire Hathaway's annual meeting, Charlie Munger cautioned investors against this AI hype. His partner Warren Buffett warned that while AI can do amazing things, it cannot be un-invented and "changes everything in the world except how mankind thinks and behaves" quoting Einstein on the atom bomb.

Despite, or perhaps because of this laundry list of concerns and confusing events and data, global asset prices generally ground higher in Q2 climbing the proverbial wall of worry.

US Cash and Bonds

Cash gained 1.2% in US dollar terms. Cash yields also improved in Q2 with the Federal Reserve hiking its cash rate north of 5% in May. While they "skipped" a rate hike in June, they are expected to hike rates again in July. While investors cheered June's better than expected 3% consumer price inflation print, the Fed remains focused for now on bringing down core inflation (excluding energy and food costs) which remains above 4% and above the Fed's average inflation target of 2%. We remain slightly overweight cash. This is not due to the confounding macroeconomic backdrop. At 5+%, cash has rarely yielded so much over inflation, longer-term bonds, and equities.

Bonds delivered mixed results in Q2. Higher investment grade Treasuries, government-backed mortgages and municipals all fell roughly -1%. High grade bond investors continue to anticipate slowing growth and inflation with 10 and 30-year Treasuries yielding ~3.9%. Longer-term Treasury investors remain willing to lend to a US government still running deep deficits rarely seen outside of major recessions and wars at rates below cash and core inflation. While we will generally hold bonds as a hedge against recessions for all but our highest-risk clients, we remain underweight given the currently low yields. We continue to prefer both corporate and municipal high yield bonds and both outpaced cash post-tax in Q2. High yield corporates offer over 8% in taxable yield while comparable municipals can yield north of 4% often tax-free.

US Equities

US stocks led the way with the S&P 500 up over 8% and recently entering a new bull market. Receding concerns around the debt ceiling, recession and inflation coupled with AI enthusiasm buoyed investors. Investor sentiment in fact returned to the ebullient levels last seen in late 2021 from the near record pessimism seen in late 2022. Call option volume spiked to all-time highs.

While we currently remain close to US equity strategic targets, we see this rising enthusiasm and other factors as reasons to remain slightly cautious. US companies are currently reporting year-over-year earnings declines. This puts us in an earnings recession which is more consistent with the high-grade bond market's caution than the stock market's enthusiasm. Recessionary indicators abound outside the current earnings decline. Leading economic indicators are consistent with past recessions. US bankruptcy filings, ratings downgrades and lending standards all returned to pandemic levels.

While retail sales remain solid, the US consumer, the backbone of the economy, appears to be weakening. Excess stimulus savings are estimated to be fully drained within the next year. Despite these unusual savings aided by deep US pandemic and post-pandemic deficits, we are seeing credit card delinquencies near all-time highs and credit card interest payments at thirty-year highs. More Americans are getting auto loans that exceed the car's values; and used car prices are down over the last month and year. Outside of the years just prior to the tech bubble and GFC, consumers have never felt more pessimistic about their prospects. By the Fed's estimation (which is certainly prone to error), more pain is on the way. They estimate their rate hikes will push the unemployment rate up 1% costing 1 million Americans their jobs by 2024.

Despite these recessionary signals and the ongoing earnings recession, analysts still expect earnings to grow by 12% in the year ahead. If we take this growth at face value and ignore mounting recessionary indicators, US markets still yield just under 5% based on these expected earnings. Outside of the tech bubble and the post-pandemic ebullience of 2020-21, US stocks have never been more expensive on this absolute measure. On a relative basis and based again on next year's expected earnings, the S&P yields less than BBB-rated bonds for the first time since the GFC. On this measure, the S&P also yields less than "risk-free" Treasury bills for the first time since 2001 at the height of the tech bubble. The S&P dividend yield is also below Treasury bill yields for the first time since just before the GFC and tech bubble. For all these reasons, we remain slightly cautious on US equities but as always remain relatively close to our long-term strategic targets.

International Markets and Alternatives

International markets also gained just over 2% in Q2, topping cash but lagging their US peers. International markets continue to trade relatively cheaply to the US at just 13 times next year's expected earnings for a 7.7% earnings yield. While we find this valuation attractive, we remain slightly underweight. With Germany in recession, the war in Ukraine ongoing, Japan continuing its extraordinary monetary stimulus and China struggling to grow post zero-COVID, we see international markets as cheap for legitimate reasons.

Finishing with alternative assets, Q2 was a disappointing quarter relative to US markets. Hedge funds as a complex gained just over 1% in Q2 and just over 2% for the 1H of the year struggling to match the concentrated US rally. Many funds appear to be following Druckenmiller's further advice to avoid confounding markets. Others, however, should have heeded this advice more after wrong way bets on inflation and recession. While we continue concentrating our hedge fund portfolio in a select group of managers, we would also note another tech bubble comparison. In the last months of the 2000 tech bubble, hedge funds looked similarly foolish. While the S&P gained 11% from February to August 2000, hedge funds were flat. When the bubble finally popped, however, hedge funds turned in a positive gain while the S&P lost 45%.

In private markets, deal activity remained muted and price discovery slowly continues. Despite the AI enthusiasm in public markets and anecdotal stories of private investors piling into all things AI related, we continue to see venture pricing broadly showing flat to down marks in Q2. Traditional private equity marks are seeing more positive results, but again failed to match the 1H US equity rally. We still think now is a good time to step into private markets with more investors stepping away from the space given the abundant heightened uncertainty and tighter lending standards.

Finally, real estate in public markets delivered a small but positive return in both Q2 and 2023 to date despite a daily barrage of negative headlines focused on commercial real estate. We remain cautious on the space overall, but optimistic about the opportunities for active managers who can avoid or even short the beleaguered office and retail sectors while investing in secularly strong real estate industries like farmland, housing, cell towers, data centers, self-storage, and industrial warehouses.

Conclusion

We advised clients to avoid the siren song of cash following a difficult 2022 that ended with peak pessimism. We have held to this view in 2023 despite a myriad of concerning events and headlines. Now with US markets entering a new bull market and ebullience returning, we continue to think clients should stick close to their long-term targets albeit with some added caution. These long-term targets are always our guide in good, bad and confounding times.