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2023 Q3 Review and Year End Outlook

Executive Summary

- Most assets lost ground in the third quarter. Like 2022, energy-related assets were the only asset to outpace cash. Outside of energy, only US high yield bonds delivered a positive return in Q3. We were generally well positioned for this pullback with an overweight to cash and an underweight to other assets for reasons discussed in previous letters, but now must decide whether to redeploy this excess cash.
- This exercise is fraught with error in normal times and why we stick close to our long-term objectives. It is even more difficult today with heightened geopolitical risk and confounding markets.
- We noted last quarter that famed investor Stanley Druckenmiller saw this as the most complicated backdrop he has ever seen. Following Hamas's abhorrent terrorist attack on Israeli citizens, fellow famed investor Paul Tudor Jones called the current geopolitical environment the "most threatening and challenging" he has ever seen. While we are beginning to see pockets of opportunity to deploy cash, we expect to remain relatively patient given current valuations in this chaotic backdrop.

Cash & Bonds

We think it is important to start with what we do know about the least volatile but perhaps most important asset in the market, US cash. Cash today, as measured by the US 3-month Treasury bill, yields roughly 5.5%. For the first time since a brief period in 2018, cash yields more than overall inflation as Jerome Powell and the Federal Reserve seek to cool the economy and inflation. Moving forward and based on their most recent projections, the Fed expects to hike rates one more time this year and hold there for some time into 2024. We should note that Jerome Powell humbly noted in Q3 that the Fed is "navigating by the stars under cloudy skies." Heading into last year, the committee expected to hike rates by less than 1% but ended up hiking to above 4% in one of the fastest rate hiking cycles in history. At least one Fed member thinks rates could surpass 6% next year. JP Morgan's CEO, Jamie Dimon, advised clients to at least be prepared for a world of 7% cash rates and echoing Tudor Jones just noted that "this may be the most dangerous time the world has seen in decades." While neither we nor all the PhDs at the Federal Reserve can know where cash yields are heading, we do know they are yielding more than inflation. The Federal Reserve is also shrinking the overall supply of cash, which is even rarer. Against this backdrop, we expect to remain overweight cash while patiently awaiting higher yielding opportunities elsewhere.

The next logical and "safest" place most investors look for added yield over cash is in the longer-term US Treasury market. Given long-term bonds just suffered one of their worst quarters in history pushing yields back to their long-term, post-American Revolution average and above inflation for the first time in four years, one might be tempted to add here. We, however, think it pays to remain underweight for various reasons. First, with 10 and 30-year bonds at 4.7% and 4.8% respectively, they are still just barely outyielding inflation. At current inflation rates, investors typically demand an extra 1-2% in yield which would portend more losses ahead. One could argue this premium should be even higher as the US is still running extraordinary deficits that have caused our interest expenses and debt to GDP levels to surge to unprecedented levels. Washington seems ill-equipped to deal with these issues with the level of dysfunction rising recently. Moody's, the last agency still rating the US AAA, warned that it too may downgrade our debt as we stare down yet another government shutdown in November. Both leading 2024 presidential candidates face legal issues, and both joined the UAW strike pushing for higher wages which all else equal generally leads to higher inflation. We remain underweight US Treasury bonds.

Outside of Treasurys, we do see some pockets of opportunities in the bond market. As noted above, high yield taxable bonds, where we remain neutral, managed to deliver a positive return in Q3 despite broad losses elsewhere. We continue to find good opportunities in the space with 8+% yields in strong companies with limited interest rate

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risk. Also on the taxable side, we are attracted to both government-backed and non-government backed real estate mortgage securities given the constant barrage of headline risk surrounding real estate. Given the lack of demand from both banks and the Federal Reserve, government agency-backed mortgages today trade at above average spreads to comparable Treasurys. Said differently, with the 10-year Treasury at 4.6% we would typically expect government guaranteed mortgages to be offered at rates closer to 6.4% versus the near 8% offered today. Non-agency commercial backed mortgages look even more compelling to us where we can source senior non-office related debt with low leverage on investment grade tenants at 11% yields with limited duration.

Closing out the bond and cash space, we are also seeing more opportunities on the tax-exempt side. After declining -2% in Q3, high grade, shorter duration municipal bonds are yielding close to 4% and near 7% on a tax-equivalent basis which makes them relatively attractive against current cash rates. High yield municipals with additional credit risk have even stronger yields approaching 5% pre-tax and over 8% on a tax equivalent basis albeit with added duration. Municipals broadly also do not have the same debt and deficit issues that our federal government is facing today and may benefit should tax rates push higher to close our deficit gap. We have been slightly under weight this space for most of the last two years and will look to be more neutral at these levels.

Global Equities

Taking another step out on the risk spectrum, we now turn to equities. US equities fell 3% in Q3, but still stand up over 12% for the year. Confounding most active investors is the concentration of these gains to the "magnificent seven" stocks which are up over 50% driven in part by the enthusiasm for artificial intelligence. The magnificent seven stocks are Apple, Microsoft, Google, Amazon, Nvidia, Meta and Tesla. With equal weighted, mid, and small cap indices essentially flat on the year, investors adding to US stocks must choose from the relatively richly valued leaders above or the relatively cheaply valued laggards. For example, while the standard market cap weighted S&P 500 trades at a near decade high of 18X next years' expected earnings, the equally weighted S&P 500 trades near a decade low multiple of just under 15X next years' expected earnings. The divergence is even more pronounced if we look at mid and small-cap stocks with the S&P 400 mid-cap index and the S&P 600 small-cap index both trading near 12X expected earnings and near decade low multiples.

To be fair, small and mid-cap companies tend to pay higher interest rates on their debt and the indices carry a much heavier allocation to maligned and small enough to fail regional banks. However, whereas the S&P 500 has the magnificent seven, 30% of the index is concentrated in these names. This is a level of concentration not seen since the tech bubble and the comparisons don't end there. If we look at the earnings yield on the S&P 500, or the inverse of the PE ratio above, and compare it to the yield on 10-year US Treasurys (which may move higher still), we see the lowest relative compensation for owning stocks since the tech bubble. Cash yields, at their highest levels since the tech bubble, are also above the earnings yield on the S&P 500 for the first time since 2000. Finally, just like in 2000 during the tech bubble there is a heightened enthusiasm that a new wave of technology, (AI today, the internet back then) will usher in a new wave of productivity and earnings and economic growth. Interestingly the internet did unleash a boom in productivity after the turn of the century, but unloved small and mid-cap shares gained 85% over the next decade while hyped and expensive large caps rose just 20%. In sum, we find large caps to be relatively rich against cash and are more likely to add small and mid-caps moving forward.

Turning to international equities, we maintain the view that stocks overseas are cheap but for good reason. International stocks broadly trade at just 13X both trailing and forward expected earnings. This puts them near their cheapest levels over the past decade and this holds true across numerous other valuation metrics. But unlike the US, European cash rates are still well below inflation at a time when European inflation is running 1-2% hotter than US inflation. While many expect the European Central Bank is already be done with its rate hiking cycle, they may still have work to do, especially if energy prices move higher. This prospect looks even more likely with the war in Ukraine continuing, Israel declaring war on Hamas in the Middle East and the US investigating Iran's ties to Hamas' terrorist attack. With much of Europe, including Germany, either in or facing a potential recession, Europe faces the significant threat of stagflation or shrinking growth coupled with high inflation.

Outside of Europe, emerging markets (EM) also appear cheap and trade near decade low valuations. While we are attracted by EM valuations and the extreme pessimism surrounding EM's largest constituent China, we remain underweight. Facing record youth unemployment, China has made strides recently to shore up its economy but continues to do so in a heavy-handed autocratic manner (they will stop publishing the youth unemployment rate). While Xi Jinping just noted China has "a thousand reasons to make US-China relations better, and no reason to make them worse", we live with the real threat that relations could in fact become worse especially regarding Taiwan. Internal dysfunction in the US and resources spent on Ukraine and Israel may be perceived as weakness on a global scale and may lead again to worsening relations. This is not our base case, and in fact we are optimistic relations will improve, but would like to see action over words before committing more capital to China.

Alternative Assets

Finishing with alternative assets, we see both pockets of opportunity and strength surrounded by areas of concern and near-term disappointment. Hedge funds epitomize these extremes. Our uncorrelated hedge funds continued to deliver positive returns in a difficult Q3 just as they did in 2022. These funds have been able to capitalize on the complex geopolitical backdrop, the heightened regulatory risk especially stemming from the Federal Trade Commission and the disruptions in lending stemming from the recent banking crisis. On the other side, our directional hedge funds held up better than the broader markets in Q3 but have failed to keep pace with the concentrated nature of the equity rally to date in 2022. As we noted in our previous letter and above, hedge funds, which tend to focus more on small and mid-cap shares disappointed in the go-go days of the tech bubble, but then delivered following its pop. We are deeply focused on finding a handful of managers in specific industries who we believe can lead to meaningful alpha in the years to come.

Real estate also continues to be a space where we see pockets of opportunities surrounded by areas of concern. Real estate broadly continues to be maligned in the headlines with daily stories around office vacancies and defaults. We think this creates interesting opportunities outside of the office in specialty real estate including farmland, industrial warehouses, single and multifamily housing, cell towers and data centers. While real estate broadly has dipped back into negative territory in 2023, our liquid real estate fund has delivered a small positive return and is well positioned in attractive but under the radar and out of the headline's real estate opportunities.

We also continue to be quite optimistic about real assets and particularly energy related assets. In a world of growing hostilities, America is lucky to have access to abundant oil and gas supplies which can be sourced in the most environmentally responsible manner versus our global counterparts. We recognize the long-term need to transition to a greener economy, but also recognize that this will take time and as noted above our allies in Europe and abroad need our natural gas to provide some of the most cost effective and emissions efficient power. Given these long-term needs in the face of a significant lack of investment, we think the opportunity set is strong in energy and expect to continue to put capital to work here in both traditional and renewable resources.

Finally closing with private equity and venture capital we also see a mixed picture. With recent IPOs from Arm, Instacart and Birkenstock hitting the markets, many venture capitalists see the IPO market on the verge of a major re-opening. Unfortunately, each of these stocks have traded down from their IPO price suggesting there still maybe more markdowns ahead for privately listed assets. The median IPO from 2020-22 has in fact underperformed the broader market by a full 48%, a level that surpasses the 32% underperformance from the 1995-2000 class of IPOs

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during the tech bubble. While this creates some concern around existing private assets and their path to liquidity, it has created a great opportunity for investors willing to step into private markets during these chaotic times. We recently had the first close on our eighth private capital fund. We are excited to patiently put this capital to work and express a deep thank you to our clients who have entrusted us with this capital over the years to come. We do not take our roles as fiduciaries lightly and will work our hardest to deliver exceptional returns.

In conclusion, although Q3 saw a small broad pullback in almost all assets akin to the 2022 rout, we are loathe to put our cash, which is finally yielding a return over inflation, to work too quickly. We continue to see pockets of opportunity in a world full of chaos and as always will focus on the long-term and on assets we believe can deliver substantial returns above cash and inflation. Again, we sincerely appreciate the trust you have placed in us.