Q3 2023 Asset Management

Index	2nd Quarter Return	YTD Return
S&P 500 Index	8.74%	16.6%
Nasdaq Composite Index	12.81%	31.59%
US Aggregate Bond Index	-0.84%	1.85%
Russell 2000 Small Cap Index	5.21%	7.78%
Bloomberg Commodity Index	-3.82%	-9.71%

Markets continued where they left off in the 1st quarter with another strong quarter to close the first half of the year. The Nasdaq continued its strong start of the year with their best first half performance in their history. The gains were led by Mega Cap tech companies having a better-than-expected earnings season and rapid growth in Artificial Intelligence (AI).

Small Caps struggled during April and May before having a solid June to put them in the positive for the year led by better-than-expected economic data. The Bloomberg Barclays US Aggregate Bond index was down for the quarter as the yield curve continues to invert across each level. There was additional interest rate volatility as markets continue to try to balance the effects of the banking crisis from March, the economy, and the potential actions of the Fed. Finally, had another negative quarter as oil continued to fall as OPEC+ cuts were not enough to dent supply that continues to come in from other sources.

Will We Have a Recession?

Odds of a recession continue to stay elevated though the timing of the occurrence continues to be pushed back. Consensus is now for Q4 2023/Q1 2024, though economists have been known to be wrong. According to the variables looked at by the NBER (National Bureau of Economic Research) only two are at contractionary levels, real sales and industrial production. Income growth, employment levels, and consumer spending are all at solid, though slowing, levels.

The bullish case for a soft landing is that 2022 showed signs of a rolling recession where different parts of the economy suffered contraction but not all at once. Inflation levels continue to come down and the Fed is near the end of their rate hiking cycle.

The bearish case for a recession is that the LEI (Leading Economic Indicators) signal is currently flashing recession. This was led by a deterioration in credit conditions, yield curve, consumer expectations, and business new orders (see chart below).

My base case is for a recession to occur in the short-term. The bond market is predicting that we will end up in a recession as the Fed is believed to have overtightened more than needed. This unnecessary tightening to fight already subsiding inflation will disrupt the economy.

The best-case scenario of a soft-landing as I discuss below is a real possibility and will keep markets elevated for longer. Previous episodes just kicked the can down the road and led to a recession within five years.

Reasons to be Bullish

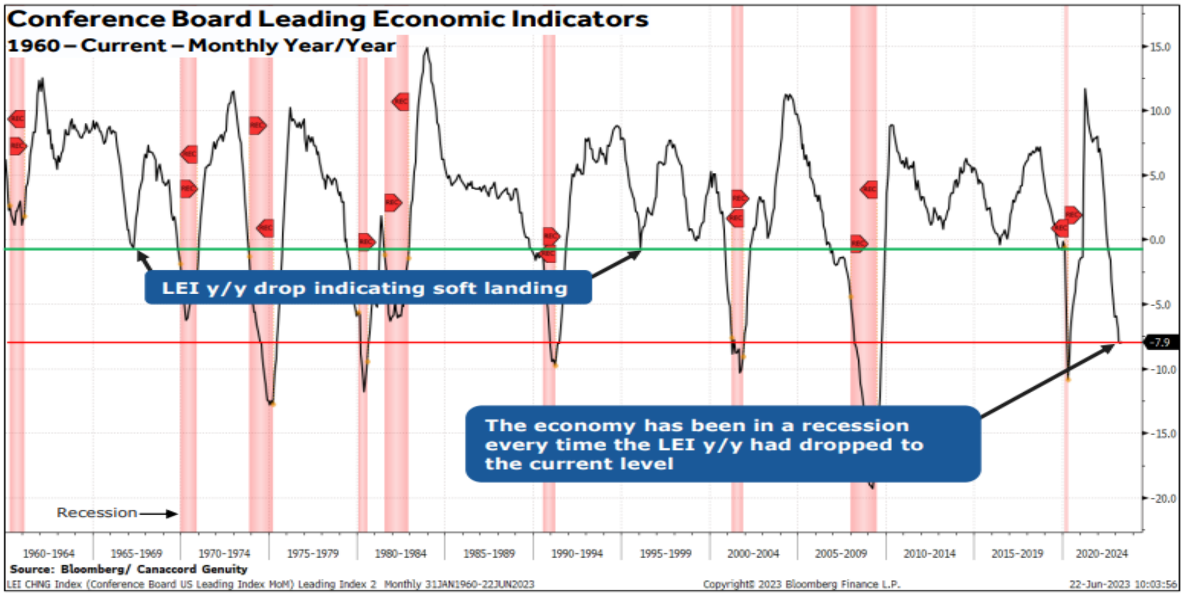
- **Soft-landing expectations –** in this scenario the Fed tightens just enough to drive inflation to manageable levels without driving the economy into recession and a jump in unemployment. Previous periods of a soft landing occurred in 1967 and 1996 (recessions occurred in 1970 and 2001)
- **Disinflation –** Most inflation variables continue to show signs of retreat. Much of the good's inflation over the previous 3 years did end up being transitory in nature. Services inflation continues to stay sticky but there are signs that even in these readings that inflation seems to be subsiding.
- **FOMO –** Entering the beginning of the year, most institutional investors were sitting on the sidelines with a conservative allocation. With the escalator style move in the market (and the elevator style move in the Nasdaq following the AI hype) there is the feeling of needing to get invested before you miss out on the market's continued upside.
- **Near-peak Fed hawkishness –** The Fed is currently pricing in a hike at their July meeting and one more for September. Recent inflation numbers may eliminate their need to hike after July and this would eliminate a major headwind in the market going forward.

Reasons to be Bearish

- **Market is overbought –** the market has been sitting at overbought levels (especially in Mega Cap tech) entering July. Even the Nasdaq-100 Index announced a special rebalance to bring down the sizable overweight of the largest companies in the index.
- **Higher for Longer Fed –** The Fed is unlikely to cut rates any time soon and interest levels will remain higher for longer. This will have an impact on companies that have maturing debt and will need to reissue at much higher yields than before.
- **Liquidity Drag –** The Fed is also still operating under a quantitative tightening regime where they continue to let their balance sheet go lower thus not providing additional liquidity to the markets. With the curve inverted and the Fed keeping rates higher, we are also seeing less bank lending to small and mid-sized companies which will have a drag on the economy.
- **TINA → TIARA –** the 2010s was characterized by "there is no alternative" as bonds, CDs, and money markets had very low to no yield and stocks were attractive. We are now entering a period where "there is a real alternative". The risk/return of stocks vs bonds does not look as attractive today as it did in the past. Short-maturity bonds can fetch up to 5.5% which is higher than the S&P 500's earnings yield.

Model Changes

- In our Alternatives sleeve I removed our Merger Arbitrage strategy and our Tactical Allocation strategy and added a new Global Macro strategy and added to our Managed Futures strategy. This move was meant to increase our exposure to low/negatively corelated strategies compared with Stocks/Bonds.



Past performance does not predict future results

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