Mid-Year Outlook

June 30, 2023

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The bull market run broadening out will hinge on a variety of macro considerations with monetary policy at the top of the list. After the most front-loaded Federal Reserve tightening campaign since the Paul Volcker-era of the 1980's, interest rates are plateauing. The Fed did not raise rates in June for the first time in a year, as they could cite strides in pulling inflation down. Namely, in June 2022, the Consumer Price Index (CPI-U) had increased 9.1% over the preceding year. In May 2023, this bellwether inflation reading was more modest at +4.0%. And with 10-year implied inflation rates having remained below 2.5% for most of 2023, the consensus is that high prices will not become entrenched in the economy over the long-term[5]. Nonetheless, the Fed persists with a tough-talking tone, but there is a disconnect, as few believe they will follow their rhetoric with action. Currently, there is an 88.5% implied probability that the Federal Funds rate is lower this time next year[6]. On the surface, this should be good for long-duration assets and companies that are captive to external financing (neither are our current preference). But a closer look reveals that if the Fed were to cut rates, it would be due to a deteriorating economic situation that the bears have been long calling for.

Finding reliable predictors of change in our data-rich world is not easy, but two we have found to be historically effective: the slope of the yield curve and the Conference Board Leading Economic Index® (LEI). Both are forecasting a worrisome path forward. For the latter, the LEI, a composite index of financial and economic conditions, tends to peak approximately 11 to 12 months ahead of a recession[7]. It peaked in November 2022 and the Conference Board projects "the US economy will contract over the Q3 2023 to Q1 2024 period." For the former, the inverted yield curve (i.e., yields on shorter-dated Treasuries rise above those for longer-dated ones) has a telling history of preceding recessions. The 2- to 10-year yield curve has inverted six to 24 months before each recession since 1955 and currently the gap in yields is the largest since 1981. We have two reliable signals that are flashing red, but recession has not yet arrived. The U.S. consumer, with their many jobs, has not let it.

"The government produces data on literally 45,000 economic indicators each year. Private data providers track as many as four million more statistics."

- Nate Silver, The Signal and the Noise (2012)

Americans continue to spend, despite a bevy of headwinds. Some of this resilience is due to unemployment levels still at near generational lows, but an under-estimated aspect is how much stimulus the U.S. consumer received. Households still have $1.2 trillion of the $2.3 trillion in excess savings from Covid-19 stimulus initiatives. Most have anticipated this running out by Q3 2023, but at this pace it will not dwindle to a normalized level until Q1 2024[8]. Also under-estimated was a resilient housing market. Even in the face of a material rise in mortgage rates, the S&P/Case-Shiller U.S. National Home Price Index is flat over the trailing year through April 2023. A supply-demand imbalance is behind this phenomenon and amplified by a disincentive to move, as roughly 85% of U.S. homeowners with conventional mortgages have a rate below today's level of 6-7%[9]. These steady housing prices have buttressed the wealth effect and thereby consumer spending. Nevertheless, with inflation-adjusted wages flat for two years and the continuation of higher borrowing costs, these financial backstops could erode and, if they materially do, the bearish crowd may finally be vindicated.

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Looking Ahead

As the Fed tackles inflation with more restrictive monetary policy, so, too, will innovation. There is a historical pattern of new technology, ideas, and the like following and fixing high prices. Previously, for instance, fracking and horizontal drilling were a response to rising gas prices. Another past example is the mapping of the first human genome, costing initially more than $100 million, but now with a price tag less than $1,000. The focus on AI, which allows us to do more with less, is unsurprisingly coming into focus now after the elevated inflation in the past years and should have a disinflationary impact by enhancing productivity and eliminating costs. That has far-reaching and material effects from corporate profit margins to the direction of monetary policy. But there are other innovation realities that are similarly in their early stages. Some secular themes of ours that we carefully study for actionable ideas, such as autonomous driving and renewable energy, hinge on AI. High prices often cure high prices, but often overlooked is the acceleration of technological innovation change quietly doing so.

We believe there are intriguing prices already in the marketplace. For instance, venture capital secondary transactions are at 30-40% discounts as compared with 12% in 2021[10]. These venture companies could be the ones that are molding new AI solutions and services (among others), and this dynamic presents an intriguing opportunity to buy these innovators on sale. We've identified private funds capitalizing on these themes and are reviewing more.

The growing reach of tech has also played a role in another compelling opportunity we see now: private credit. The recent demise of large banks, including Silicon Valley Bank and First Republic, happened at blistering speeds, given the more digitized nature of money movement. Consider that the largest bank failure remains Washington Mutual, which occurred during the credit crisis. In 2008, it took 9 days for the bank to lose $18 billion in deposits[11]. Fast forward to 2023, and it took 4 hours for Silicon Valley Bank to lose $42 billion of deposits. Ever since this flurry of failures, bank lending has been curtailed. Private lenders are poised to fill this capital void, and when you couple this with the generational rise in interest rates, have a rich opportunity set in front of them. This backdrop is why we have secured several lending funds to take advantage.

Yet, even with the excitement on the prospects of AI, private lending and secondary opportunities, and a good start to the year, we remain disciplined and dispassionate. We do not want to talk ourselves out of what an inverted yield curve and declining LEI are telling us. Further, our proprietary market risk dashboard is pointing into a more conservative direction, which is sensible given the history of sharp rallies. Notably, the S&P 500 had the 11th-best start of the year going back to 1928, being up 15.3% in the first 114 trading days. In each of 1   years that had a better start, the index did finish the calendar year higher; however, only one time (in 1954) did the S&P have a stronger second half of the year versus its first six months, whereas most years gave back some of the early gains garnered[12]. Moderating index returns in the coming months is a conservative baseline to plan for and project out. As such, accelerating distributions, opportunistic debt payments, and portfolio rebalancing back to strategic targets are efforts we espouse to take advantage of the current market surge. But for those with longer horizons, we advocate adding select investments to capitalize on the opportunities we see within the private credit and venture space. All told, in this complex, eclectic financial landscape, we see trends that have us on both offense and defense right now.

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