Q3 2023 MARKET COMMENTARY

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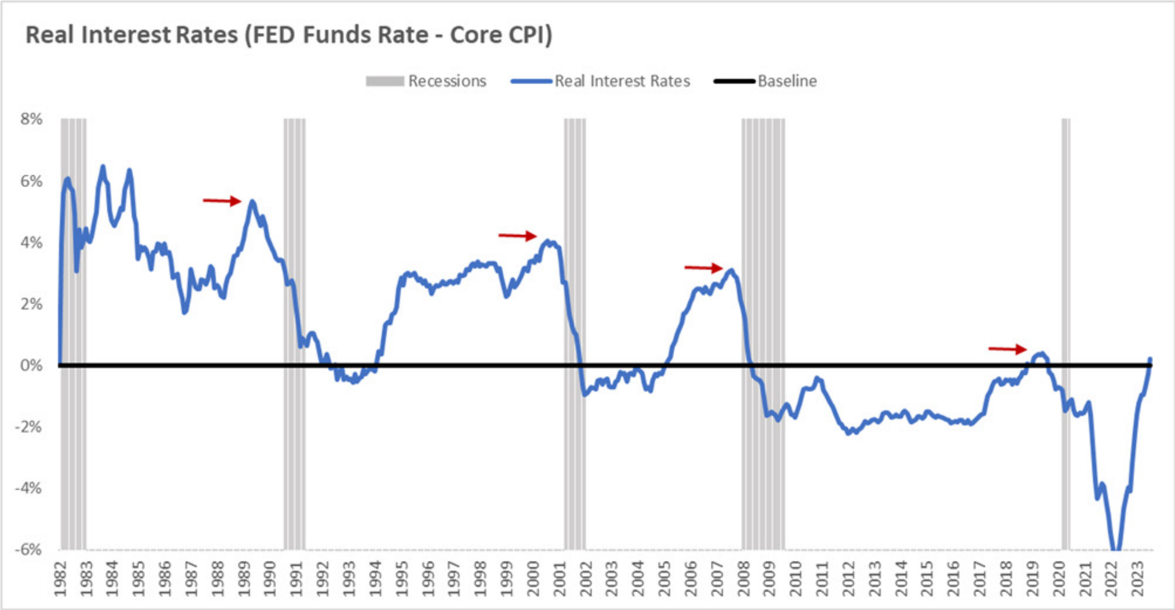
As we've progressed through the first 9 months of 2023, economic conditions appear to align with the Fed's expectations- moderating inflation, softening of the economy, and no recession. However, the labor market (a core focus of the Fed currently) continues to be robust, although new hirings and wage growth have decelerated from its above-trend levels. This mitigates the risks of wage price spirals similar to those of the 1970s which should reduce the probability of the Fed having to aggressively tighten financial conditions. Economic resilience we've experienced thus far can be attributed to the lagged impact of monetary policy tightening, stimulative fiscal policies, resilient consumer, and underlying structural growth trends. Fiscal policies that have supported economic growth have come at a cost, which we will discuss further later in this commentary. Finally, we believe that the recent market volatility to close out the quarter was primarily driven by market re-pricing factors, and less so by economic factors. Although dark clouds among segments of the economy are beginning to emerge, the degree of its impact remains uncertain, further complicating economic and market projections in the near term.

Monetary Policy Hasn't Been As Restrictive As One Might Think

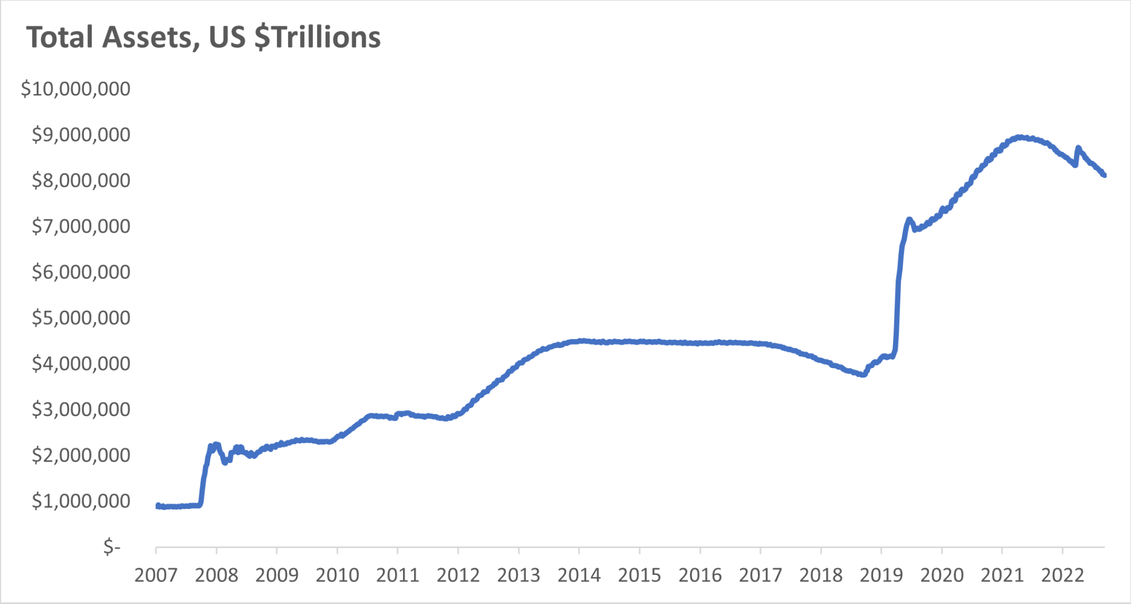
Despite one of the fastest rate hiking cycles in almost four decades, interest rates are not as restrictive as one might think. Real interest rates measure the real cost of money after accounting for inflation. When looking at this measure, interest rates have for the most part, been lower than inflation for the past year. When interest rates (cost of money) is lower than inflation, it usually encourage more borrowing, not less, hence not being as restrictive to lower demand. Additionally, past recessions have historically occurred when real interest rates were at levels that are much more restrictive than today.



Source: Federal Reserve Board of Governors, August 2023

The reason high interest rates may not be as restrictive when inflation is high is because inflation reduces the intrinsic value of the principal borrowers have to pay back, making it a net benefit to the borrower. To better illustrate this, we will use the example of the "pencil economy". Assume that we have an economy that is made up of only pencils and that inflation is 10% while interest rates are at 5% for the next year. If I were to borrow $10,000 from the bank to buy pencils, the value of those same pencils bought would be worth $11,000 next year due to inflation at 10%, while the interest to borrow is $500 ($10,000 loan x 5% interest = $500). Because I only need to repay the principal that I borrowed of $10,000 to the bank at the end of the loan, I have a net $500 in profit after paying back interest and principal. In other words, I would be incentivized to borrow if inflation is higher than my interest payments. This is synonymous with having a negative real interest rate, which has been the case for most of the past year. The Fed has indicated that they want to keep interest rates at a restrictive level to cool demand and allow time for supply to catch up. As a result, the Fed may need to raise rates further if inflation is more persistent than anticipated, or they can hold rates steady at today's levels should inflation continue to fall. Both scenarios would result in real rates becoming more restrictive, which is intended to slow the economy.

Another reason why monetary policy is not as restrictive as one might think is because there is still plenty of liquidity in the financial system.

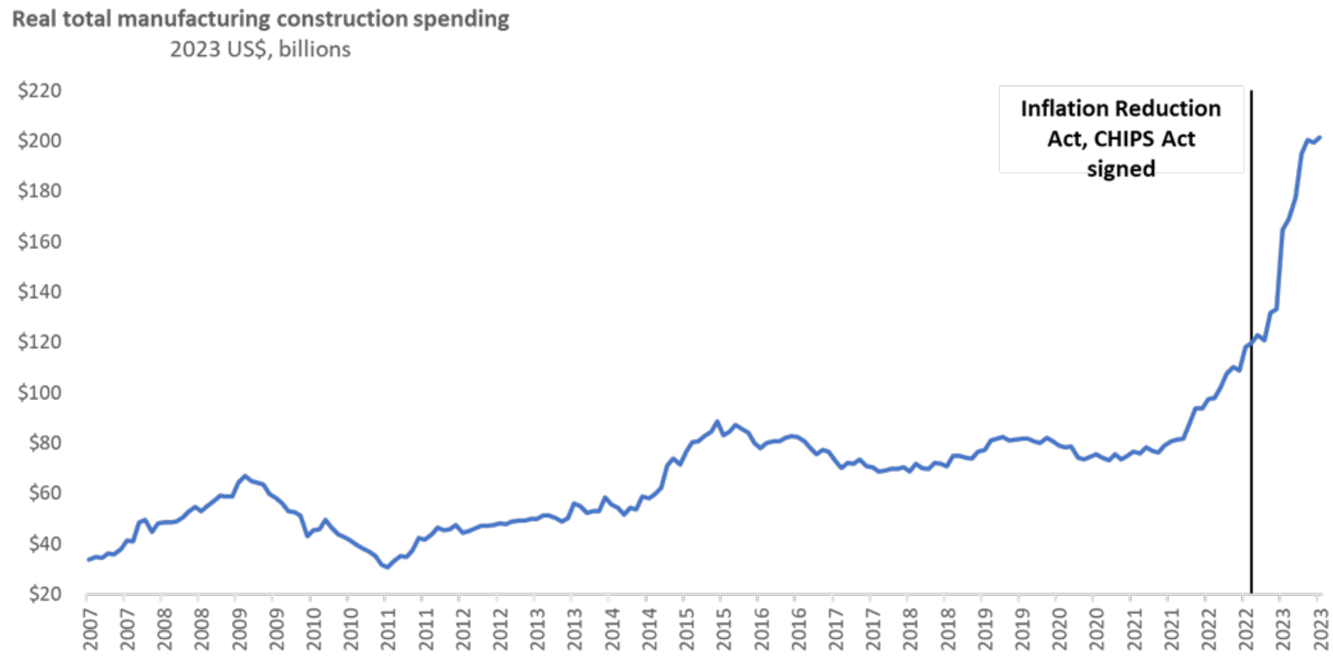


Source: Federal Reserve Board of Governors, August 2023

The Fed has only reversed 20% of the stimulus it injected into the financial system since the COVID-19 pandemic. The Fed is taking its time in reducing its balance sheet to avoid the risks of financial accidents. However, this patience may come at the cost of driving up probabilities of asset bubbles or reducing the Fed's ability to provide support in the next economic crisis. Bottom line, there is still plenty of liquidity in the system and the real cost of money has not been prohibitive enough, helping explain the resilience we are seeing in the economy.

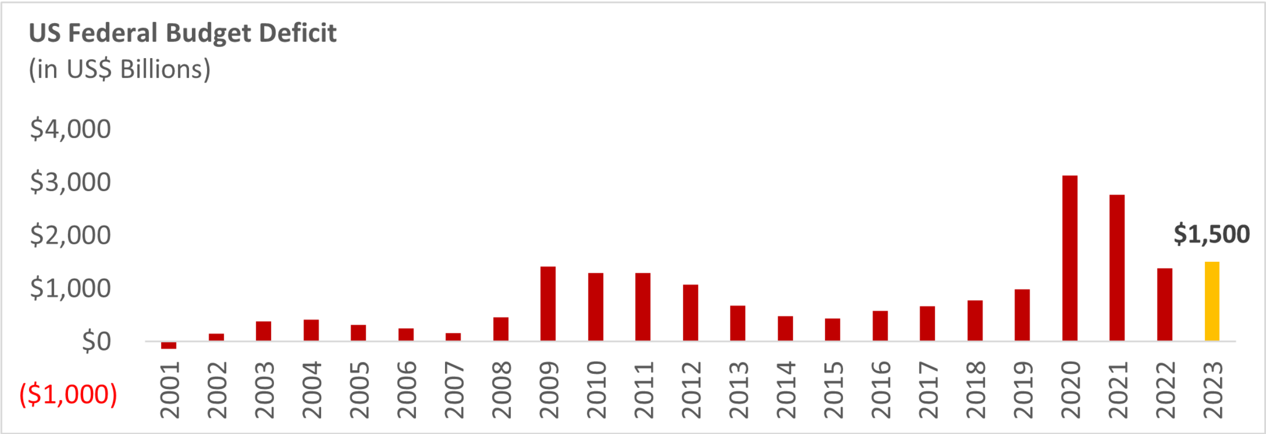
Loose Fiscal Policies Offsetting Some of the Headwinds Posed from Higher Rates

Fiscal industrial policies (2021 Infrastructure Bill, Inflation Reduction Act, and CHIPS Act) have provided a tremendous boost to the economy in the form of greater regulatory clarity which consequently is encouraging increased private investment and capital spending. Despite the uncertainty surrounding the economic environment over the next year, capital expenditures have continued to expand, led by the industrial and manufacturing sectors.



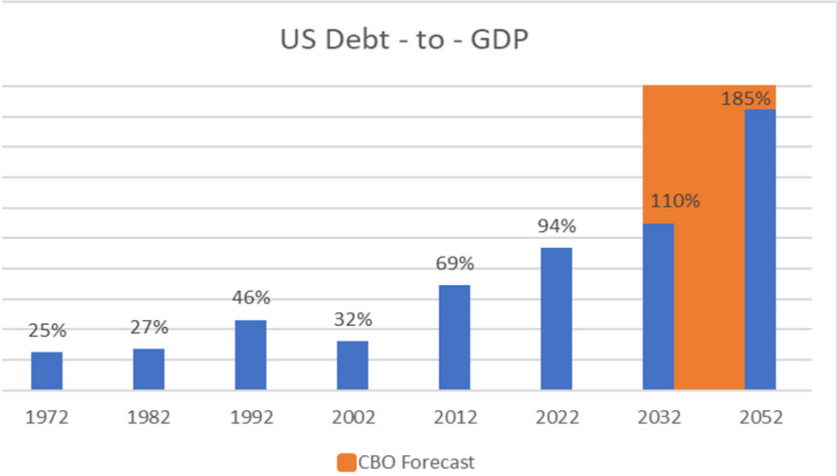
Source: U.S Census Bureau, August 2023

Additionally, factors stemming from the supply chain disruption, geopolitics, and clearer regulatory direction for creating a more self-reliant and sustaining American manufacturing industry is also attracting record foreign direct investment into the United States and thus, creating thousands of jobs. As new communities are benefitting from global companies reshuffling their corporate footprint, this has a net beneficial impact on our economy. That is because people always need a place to work, eat, live, shop, and play. Therefore, it is not just manufacturing plants and offices that are being built, but so are restaurants, housing, and entertainment centers, which leads to more job creation and a stronger economy. A more self-reliant American manufacturing sector could also help reduce our trade and budget deficits, which has caused our country's debt burden to increase significantly over the past few years.



Source: US Treasury, Q2 2023.

The issue surrounding fiscal sustainability has become a focal point of discourse not only in the investment community but also on Capitol Hill. Indeed, the current path is unsustainable: Congressional Budget Office (CBO), a non-partisan government agency, projected in May 2022 report that under its baseline scenario of current fiscal policy, government debt-to-GDP ratio will rise from 94% in 2022 to 110% and 185% in 2032 and 2052, respectively- Options for Reducing the Deficit, 2023 to 2032--Volume I: Larger Reductions. (2022). This suggest that the U.S. national debt growth will outpace national income growth as the result of large budget deficits: CBO, in the same report, projects that the federal deficit will average approximately 5.1% of GDP per year between 2022 to 2032. As the US economy is projected to grow less than 5.1% annually over the next ten years, debt growth is expected to outpace income growth, exacerbating an already fragile fiscal position.



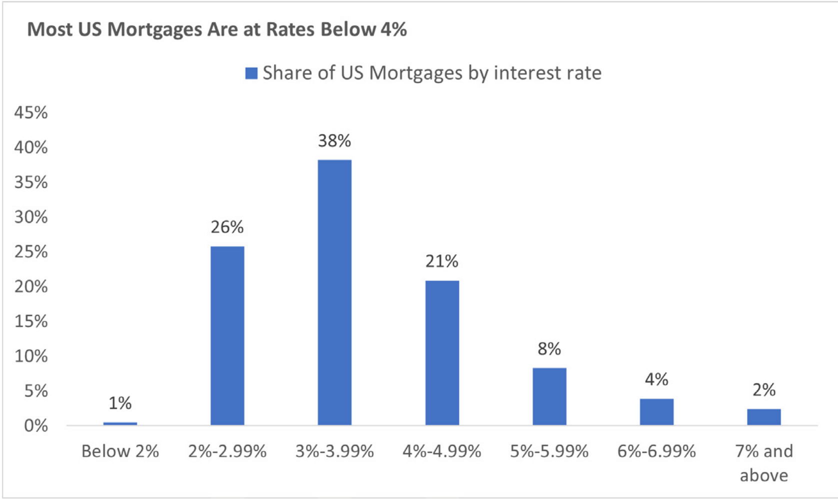
Source: Federal Reserve Bank of Saint Louis, Congressional Budget Office, 2023.

Although there is no clear understanding as to how much debt is too much, history has shown that an overly leveraged economy faces issues of confidence, which ultimately leads to anemic growth followed by tough periods of deleveraging. Historically, periods of deleveraging coincided with high levels of unemployment and low levels of growth. Achieving a sustainable fiscal path is therefore important, and a sustainable fiscal path would require debt growth to run below GDP growth, that will result in a declining ratio over time. The challenge in reducing debt growth lies in the challenge in reducing budget deficits. There currently is no clear consensus on how this can be accomplished or by how much, but it can be argued that a 1-2% reduction in the budget deficit as a percentage to GDP should be adequate to bring our debt burdens on a more sustainable path. The bottom line is that it will have to come through either spending cuts or changes in tax policy- both of which would face unpopular sentiment and potential political suicide.

Consumer Balance Sheet Less Affected by Higher Rates Thus Far

Consumers continue to spend as many remain employed and retain healthy balance sheets. When looking at consumers' balance sheets, most of their debt burden is concentrated in home mortgages, typically making up a significant portion of their debt burden.

65% of the US population are homeowners, with a significant amount of their wealth tied to their homes. Most homeowners took advantage of low rates in 2021 to refinance their mortgages, with approximately two-thirds of homeowners today owning mortgages at rates below 4%.



Source: BlackKnight, Liberty One Investment Management, August 2023.

In addition, households historically spend 28% of their income on their mortgage payments while that figure is approximately 21% of their income today. Furthermore, tappable homeowner's equity has also reached a record $10 trillion. This tappable homeowner's equity along with higher incomes from a strong job market and lower mortgage payments have dramatically improved the financial position of many American households and are supporting their spending trends. The average American household's net worth has also surged to record levels since the COVID-pandemic, leaving many in a stronger position today than where they were three years ago. Nonetheless, the increase in wealth and improvement in balance sheet are not distributed evenly among the average American. Most of the benefit and spending trends have been concentrated among the top 10% of households, who hold approximately 90% of the privately held stock, financial securities, and real estate assets in this country. Their spending has mostly been supported by the increased wealth effect in the last three years. Spending leeway for most Americans are relatively thin, with almost all excess savings depleted and many relying on credit card debt to make ends meet. This is primarily why we believe that labor market trends are one of the most important indicators to follow, as the average American is one job loss away from rendering a significant struggle in consumption.

As home and financial asset prices have cooled, we'd also expect consumption from higher income groups- which has been responsible for the resilient consumption spending to date, to slow. The degree of which it slows could determine whether we see a recession in 2024, which could be determined by the strength of financial markets and level in which asset prices rise or fall.

Improving sentiment, strong consumer and corporate balance sheet, robust labor market, and supportive fiscal policies have led to a stubbornly resilient economy we see today.

Recent Market Volatility a Result of Re-Pricing

Most of this year's equity market gains have come from valuation expansion and not necessarily from earnings growth. Earnings growth in the S&P 500 for 2023 is estimated to be flat at 0.6%, yet it is up +13.07% as of September 30, 2023. This suggests that 95% of the market gains this year came from valuation expansion. Valuation expansion is a result of stronger optimism stemming from the prospects of Artificial Intelligence. The heavier weighted components of the stock market are the ones that stand to benefit most from Artificial Intelligence, thus driving their multiples and stock price higher, which helps carry the index higher given their significant overweight in the index.

Such multiple expansion with the lack of earnings growth suggests that a lot of optimism is being priced into the market, leaving less margin for error. In September's Fed meeting, the central bank reaffirmed their stance for restrictive monetary policy, intending to slow the economy further in 2024. The premise of this stance is that an economy cannot consume more than it produces, otherwise we will experience periods of persistent inflation. As normalization of supply and demand dynamics occur, we should see the brakes come off tighter monetary policies.

With rising interest rates, stagnant earnings growth, and rising market values this year, cross asset yields have converged for the first time since 2000. It is the first time since then that bond yields are trading at levels above equity earnings yields. This makes bonds a potentially more attractive asset class than equities from a valuation perspective. Nonetheless, there remains significant risks in bonds with the economy potentially being stronger than many expect, and inflation remaining volatile.

Looking Ahead

The economy continues to be extremely resilient despite their macro headwinds. Monetary policies continue to signal its restrictive stance while fiscal policies are still stimulative. The offsetting nature of both policies could help explain why the economy continues to be resilient and business confidence is improving. The overall market this year has been driven by valuation expansion, and not by earnings growth. This makes sense given the higher multiple investors are pricing these stocks at due to the prospects of Artificial Intelligence. Nonetheless, earnings growth is necessary for any bull market to have staying power historically. This poses significant risks to the broader market because sentiment has been driving valuation expansion and should investor sentiment sour, gains in equity markets could reverse easily. Therefore, it is our belief that one of the biggest near-term risks to equity markets is the change in investor sentiment, which could be driven up or down by a number of factors (interest rates, inflation, government stability, jobs market, consumer resilience to name a few).

We expect the economy to slow further in 2024, driven by continued tightening of financial conditions which should dampen business and consumption behaviors. Financial conditions can continue to tighten even if the Fed does not raise short-term interest rates, driven by rising long-term interest rates. Evidently, investors have experienced it firsthand, with the 10-year real yield have doubling in the last 6 months, while short-term interest rates have only increased by 10% in that same timespan.

The the convergence of cross-asset yields have for the first time in a while, given investors more options to deploy capital across the investment universe. With greater options for investors, it is leading to stronger price discoveries that make the market more efficient. This improved efficiency is causing stock dispersion to widen, broadening the gap between winners and losers. This creates an opportunistic environment for active funds to generate alpha and extract returns. We continue to believe that skilled active portfolios are likely to outperform passive funds in the foreseeable future, driven by stronger inflationary factors, a less market-friendly Fed, and relatively higher starting valuations for equities.

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