

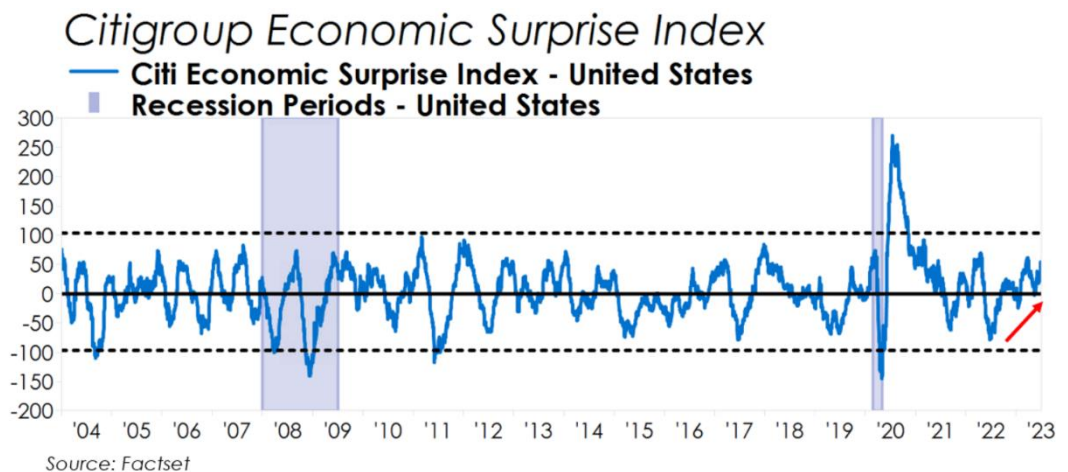
Eye of the Storm or End of the Storm?

“In the summertime when the weather is high, you can stretch right up and touch the sky.”

– In the Summertime by Mungo Jerry (1970)

If you're a resident of the midwest, lately you've had to contend with the unusually hazy conditions as a result of the Canadian wildfires. While driving into work, it's been hard to differentiate between the fog of a warm summer day or the smoke from the fires burning up north. In much the same way, investors have been wondering if the haze is simply the precursor to brighter economic conditions or something that's more sinister.

With the Nasdaq putting in its best first half performance in 40 years – we think its pretty clear which way investors are now leaning. To be fair, there have been reasons to be optimistic. As can be seen in the chart at right, economic data



has been surprising to the upside and closing in on year-to-date highs – a ninth decile reading relative to history! Additionally, housing data and consumer confidence measures look like they are recovering off the cycle lows. Meanwhile, the analyst community remains constructive with bottom-up earnings estimate revisions getting better resulting in improving growth prospects. Finally, inflation data has been moderating – notwithstanding some stickiness in core measures. Much of the narrative above could describe an “early cycle” setup EXCEPT for what it leaves out – the continued Fed tightening cycle, an inverted yield curve, tight lending conditions and a fully employed labor market. All of these latter conditions suggest a “late cycle” setup. And therein lies the debate.

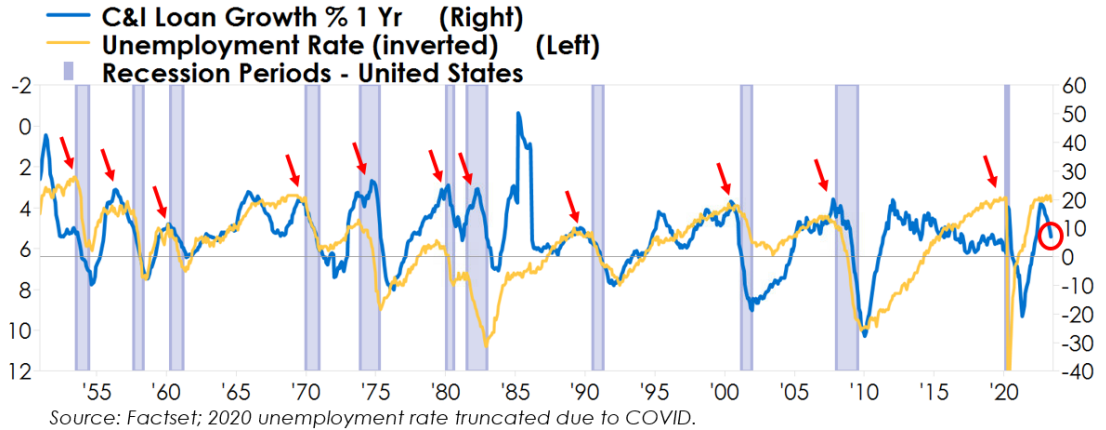
In our view, a refreshed cycle would have to presume an unemployment rate that goes even lower and an immediate productivity boom as the masses quickly learn on how to optimize “AI” technology. We think this is possible but not probable. Instead we come back to monetary policy's influence on the tried and true



historical relationships that have played out over history. When the Fed inverts the yield curve (such that long-term rates fall below short term rates), banks find pricing conditions challenged. As a result, credit standards

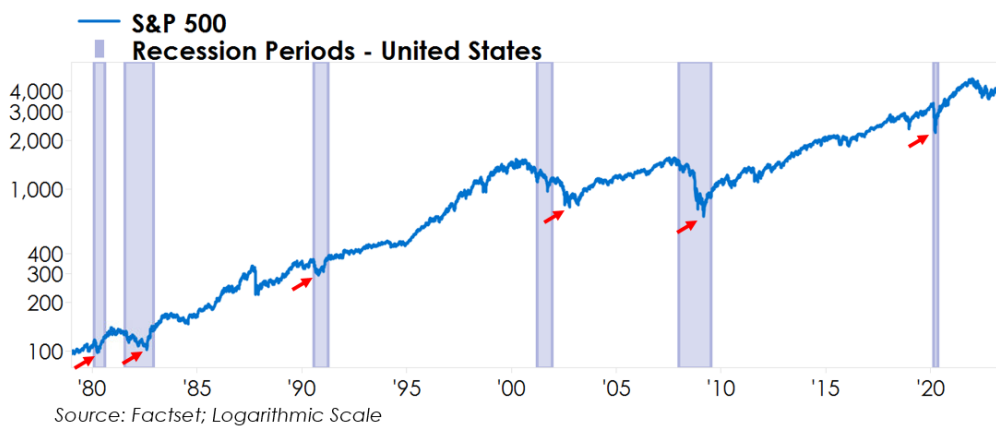
tighten leading to a swift drop in loan growth. As can be seen in the chart at right, precipitous drops in loan growth lead to material increases in the unemployment rate (inverted on the chart)

Loan Growth vs Unemployment Rate



coincident with recessions. This has happened in most cases over the last eighty years with few exceptions (mid '60's, mid '80's and mid '90's when the curve was not severely inverted if at all). Today's yield curve is the most inverted its been in over 40 years and credit standards are as tight as they've been since 1Q09 (ex COVID). Loan growth is now well off its peak and we expect it to roll into negative territory. If financing conditions shut off, then (small) businesses might not be able to retain marginal workers to finance growth. This

S&P 500 Bottoms IN or THROUGH Recessions



will likely pressure labor markets especially if the Fed feels the burden of maintaining an inverted yield curve to counteract sticky (core) inflation.

Many an investment pundit has claimed that because

markets are forward looking, a recession may have already been priced in last October when the S&P 500 was roughly 20% below today's levels. The problem with that argument is that it has no historical merit. As can be seen in the chart above, over the last forty years and six recessions, the S&P 500 has NEVER bottomed ahead of that event. The market low has always occurred in or through the recession. As the good book says, "we know neither the day nor the hour" but we can't help but think the "End of the Storm" may still not yet be the highest probable case.

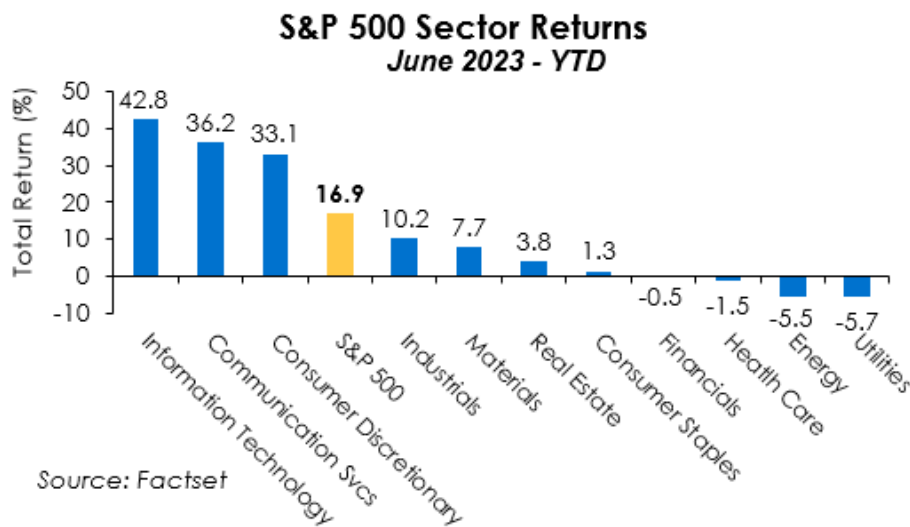
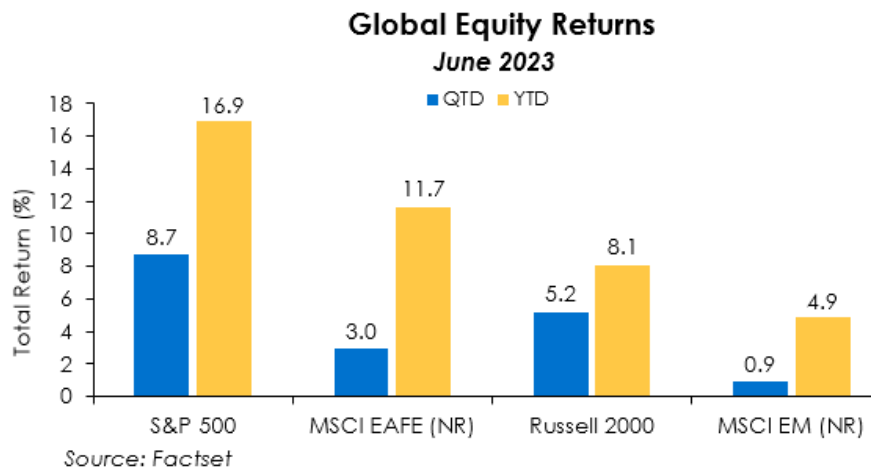


Market returns broadened out in June with Stocks, REITs and Commodities all posting positive, mid-single digit returns. Year to date, the S&P 500 led the rest by turning in its best first half performance since 2019 – benefiting from resilient economic data and improving earnings estimate revisions. Meanwhile, Real Estate and Fixed Income markets posted low single digit returns as inflation moderated. Finally, Commodities posted negative returns driven mostly by the drop in Energy prices.

Stocks

Year to date, equity performance favored US Mega-Cap Growth stocks (S&P 500) though June saw positive returns broaden out to US Small Caps (Russell 2000). Sector outperformance was narrow and primarily driven by the higher priced “Magnificent 7” within the cyclical growth sectors

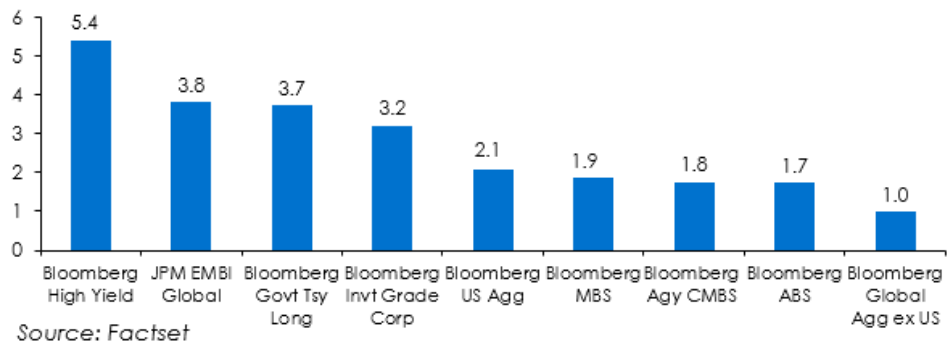
(Technology, Discretionary and Communication Services). Meanwhile, both cyclical value (Energy, Materials & Financials) and defensive sectors (Health Care, Utilities and Staples) starkly underperformed despite the former group seeing some relative strength in June. Elsewhere, equity performance in International Developed Markets was solid – helped by a better than feared start to the year given warmer weather and the avoidance of an energy crisis in Europe along with better economic data out of Japan. Finally, economic reopening in China underwhelmed relative to expectations and commodity weakness in other areas led to more subdued Emerging Market (MSCI EM) returns.



Bonds

Following aggressive moves by the Fed – having now hiked short-term rates by 500 basis points (to 5.0-5.25%) amid ongoing balance sheet reduction – policymakers continue to “hold the line” on rate policy (with a pause in June). Longer term rates have been volatile and traded sideways, year-to-date, amid a moderating (though still sticky) inflation backdrop. Meanwhile, the yield curve remained deeply inverted – an indication of macro stress as monetary policy restricts to the point of deteriorating growth prospects with the entire Treasury curve having moved below the Fed Funds rate. The sideways movement in rates combined with solid carry and tightening credit spreads have combined to produce positive broad-based returns year-to-date. As such, Corporate bonds (High Yield, Investment Grade) and Emerging Market debt (JPM EMBI) outperformed as did duration represented by Long-Term Treasuries (Govt Tsy Long). Securitized credit (MBS, CMBS, ABS) and International debt (Global Agg ex US) were positive but lagged.

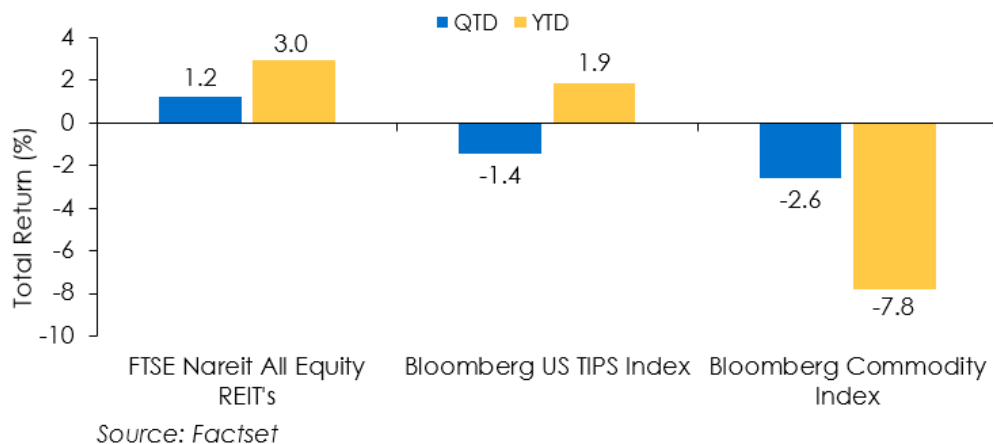
Global Fixed Income Returns
June 2023 - YTD



Alternatives

Commodities finished lower year-to-date as positive returns in Precious Metals were more than offset by weakness in Energy and Industrial Metals. Meanwhile, publicly traded Real Estate (REIT's) saw a nice bounce in June though year-to-date returns have lagged comparable stock returns. Finally, Treasury inflation protected securities (TIPs) benefited from the positive carry in bonds year-to-date while inflation expectations have effectively moved sideways.

Alternative Market Returns
June 2023



Market Outlook

“Woods are not like other spaces...Stand in a desert or prairie and you know you are in a big space. Stand in the woods and you only sense it.”

– Bill Bryson, *A Walk in the Woods* (1998)

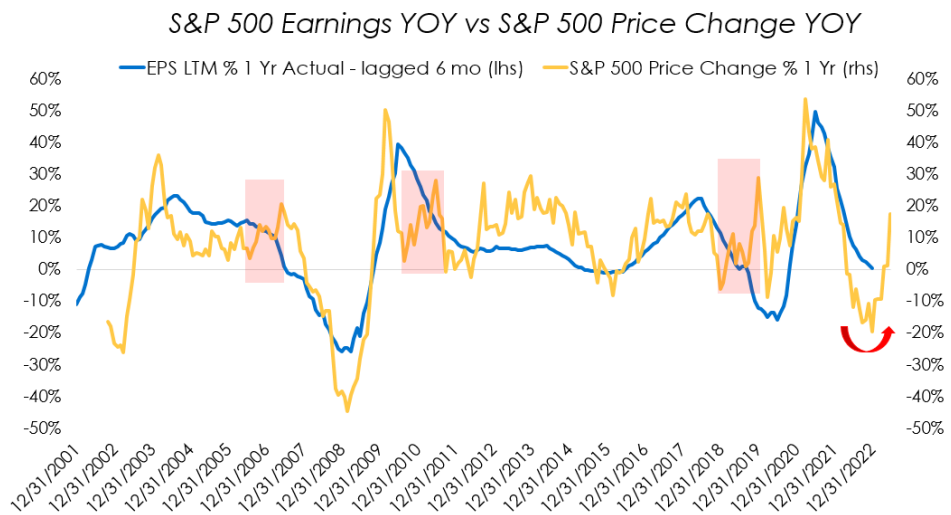
We’ve dubbed our main theme for 2023 as “Seeing both the Forest AND the Trees”. As such, we think it’s especially important to have two frameworks for managing portfolios – the cyclical (shorter-term) and the secular (longer-term). The cyclical perspective is an attempt to assess where we are in this particular business cycle while the secular perspective evaluates where the structural tendencies might be over multiple business cycles.

From a secular lens, we remain sympathetic to the notion that the economic paradigm is changing to one that ushers in the potential for more persistent inflation which is likely to result in a higher cost of capital world. We find historical parallels today to the higher inflation regime that existed back in the ‘60’s-80’s and we think the Fed is re-learning the painful lesson of falling behind inflation – one that it hopes not to repeat any time soon.

Additionally, we believe there are structural considerations that exist today that might also support this changing paradigm including changes to both aggregate demand (money supply) and supply (de-globalization, labor markets, energy complex).

At the other end of the spectrum is the cyclical perspective, which we think

currently carries greater weight given its more immediacy and potential divergence from the secular view – at least for a time. As noted in the opening, the debate between “early cycle” versus “late cycle” continues contrasted by the frame one uses – “bottom-up” or “top-down”. The chart above suggests the balance of investors are voting on the former with the S&P 500 anticipating an acceleration in corporate profit growth. While the two lines above (EPS growth and the S&P 500) tend to be correlated through time, there have been

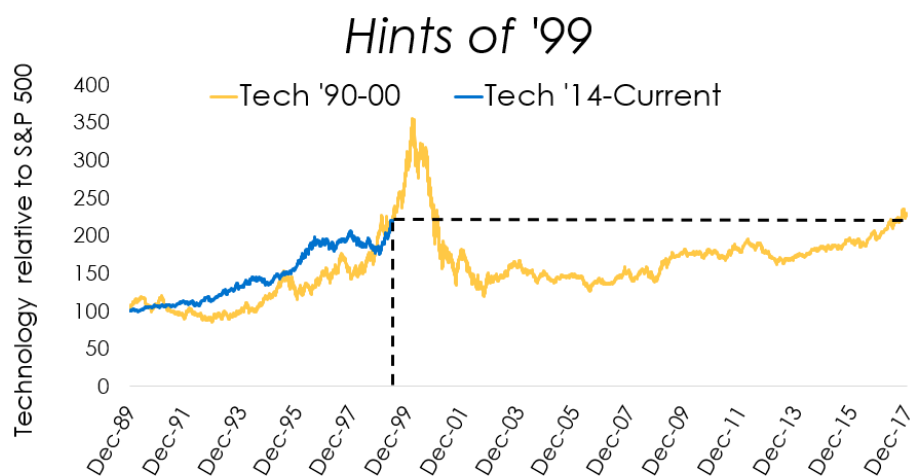


some notable disconnects along the way including 2006-07, 2010-11 and 2018-19 (red shaded regions). The bottom-up is often – but not always – right so the answer is not necessarily a given. As noted previously, “early cycle” supporters highlight the series of strong economic surprises, the recent bottoming in housing, consumer confidence and earnings estimates along with moderating inflation data. Meanwhile, our more cautious view is based on the following set of conditions:

- We remain in the latter stages of the business cycle. What inning we’re in remains up for debate, but a combination of liquidity, labor market, capacity and confidence measures all support the conclusion of being late cycle. Perhaps the simplest measure is a 3.7% unemployment rate – which puts this reading in the 95th percentile relative to history dating back to the early ‘60’s.
- Liquidity is being drained from the economy. Lots of data support this notion including a dramatic decline in the savings rate, negative year on year money supply growth (approximately \$900b off the peak), the continued Fed tightening policy (notwithstanding this month’s pause), a deeply inverted yield curve and credit standards that are the tightest since 1Q09 (ex Covid). As noted previously, eighty years of history suggest that when the curve inverts for an extended period of time, loan growth shuts off. We believe we’re in the process of seeing that now.
- Growth is slowing. The combination of the above points to slowing growth conditions. We expect nominal GDP growth to be impacted by last year’s weakening money supply growth with about a 12 month lag. Meanwhile, the leading economic indicator composite is suggesting deteriorating real GDP growth. Precipitous drops in loan growth often coincide with rising unemployment (and recessions). Finally, our top-down leading profit cycle indicators are pointing to earnings growth remaining under pressure six months out. This remains at odds with the consensus forecast for an earnings reacceleration.

We’re left to surmise that investors are speculating that this time is different. A downshift to “early cycle” presumes an even lower unemployment rate and an

immediate productivity boom from “AI” technology. We think this notion has had a clear impact on Technology related stocks. It’s interesting to observe that the degree of cumulative outperformance in the Tech sector over the last decade has been roughly equivalent to the magnitude of outperformance in the ‘90’s.



Source: Factset; Technology Sector relative to S&P 500. Tech '90-00 indexed to 100 as of 12/31/89. Tech '14-Current indexed to 100 as of 12/31/13.



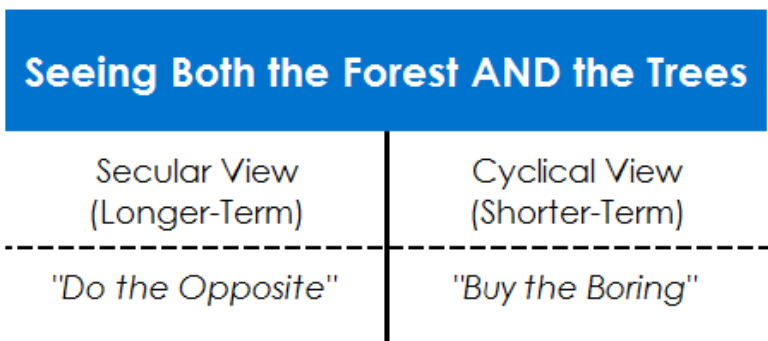
As can be seen in the chart on the prior page, today’s cumulative outperformance would be approximately equal to buying the Technology sector in the middle of 1999. This was, of course, before the considerable blow off top that crested in March of 2000, but had an investor not sold shortly thereafter, it would have taken about eight years to break even in relative terms. It should also be noted that the liquidity backdrop was different back then with a relatively flat but still positively sloped yield curve. With all of this in mind and, despite the robust equity returns year-to-date, it still doesn’t appear to be a great setup for significant risk taking – particularly in areas where there’s a limited margin of safety.

From a cyclical perspective, we can’t help but wonder if markets are just trading one cyclical risk (Inflation) for another (Recession). The S&P 500 is still trading (~19X) well above levels where multiples have typically bottomed during major valuation corrections over the last thirty years (10-15X) at a time when earnings are biased downward (based on top-down indicators) and inflation is still elevated (albeit moderating). And with bond yields notably higher, there’s now a real alternative to stocks (i.e. skinny equity risk premium).

So what are the implications and key takeaways for portfolios?

With an eye on both the Secular and Cyclical views, we think it might make sense to keep two simple phrases in mind – “Do the Opposite” and “Buy the Boring”:

- From a longer-term point of view, if the economic paradigm is changing, then it may pay to “do the opposite”. In other words, the relative winners over the past 10-15 years may not be the same winners over the next decade. Businesses that took advantage of free money to leverage up their balance sheets in the hopes of high growth payoffs far out in the future might now offer greater risk in a higher cost of capital world. Conversely, the losers over the past 10-15 years might now become the new areas of opportunity. These might include companies built to be a bit more insulated from inflation with more balanced business models, more immediate cash flows and a focus on the bottom line.
- From a shorter-term point of view, late cycle conditions that might suggest we’re trading one cyclical risk (Inflation) for another (Recession) argue to “buy the boring”. Should growth continue to slow leading to a profit and/or economic downturn, it might be more beneficial to buy the things that people need over the things that people want.



From a portfolio positioning perspective, we continue to believe that it’s important to “See both the Forest AND the Trees”. To us, that means managing the overall exposure and mix of risk assets consistent with a maturing



cycle (i.e. Cyclical) while also being cognizant of the potential changing paradigm (i.e. Secular). Since late last year, we've given an increased weight to the cyclical over the secular as we've maintained an underweight to risk in portfolios given the late cycle setup – siding more with the top-down relative to the bottom-up perspective.

Within equities, our positioning is generally EW/UW and continues to favor a value sector tilt while also leaning toward the more traditionally defensive sectors (Staples, Health Care, Utilities) within our US LC exposure. We continue to be decidedly UW the most expensive, cyclical growth areas (Tech, Discretionary, Communication Services) as investors have taken on a “Heads I Win, Tails You Lose” mentality with speculative fervor.

Within fixed income, we remain UW the most cyclical parts of the bond market (High Yield and Emerging Market Debt) while our US Core Fixed Income exposure remains among our biggest OW in portfolios. Our US Core Bond managers are slightly OW corporate bonds, though we've previously moved up in credit quality by adding some Treasuries and lengthening duration consistent with a downshifting of risk in portfolios.

Within alternatives, we're slightly OW in aggregate with a bit more defensive skew. We remain OW to Diversified Alternatives which provides some hedge against market volatility (especially in an environment where there's lower correlations between stocks and bonds). We're generally EW to Commodities as a way to bolster inflationary hedges. Meanwhile, we're slightly UW Real Estate as a way to further reduce overall portfolio risk.

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