BALENTINE

Quarterly Market & Economic Report

Q3 | 2023

Patience and Discipline in the Face of Uncertainty

"In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could."

So famously said Professor Rüdiger Dornbusch, one of the most distinguished macroeconomists of his generation, and an expert on how much expectations matter to economic fluctuations.

His insight is especially relevant in the current environment as a reminder that things can change on a dime. With cash now yielding more than 5%, many have questioned whether it is worth the risk of investing in a broadly diversified portfolio given the unusually high degree of uncertainty in the economic outlook — especially those who have come into liquidity by monetizing their life's work of building a business.

As we point out in Balentine's Cardinal Rules of Investing, attempting to time markets is a fool's errand, for a variety of reasons. As we enter the last quarter of 2023, the need to remain patient and apply our unemotional, time-tested discipline, which has navigated several market cycles, is paramount. In this update, we will explore the opportunity that after-tax cash management offers, how we continue to be cautious and selective in public markets, and the enthusiasm we have for committing to our private capital managers, who are poised to take advantage of the coming disruption.

Cracks Finally Appearing in the Economy?

At the end of June last year, stock, bond, credit, and commodity markets predicted a short, shallow recession 12 – 18 months hence. 15 months later, it has not yet materialized,[1] and only the bond market remains convinced a recession will occur, with the difference between short-term interest rates and long-term interest rates remaining deep in negative territory (i.e., the slope of the yield curve remains inverted). During the third quarter, the slope of the yield curve steepened slightly, with long-term rates resuming their steady march higher and the 10-year U.S. Treasury bond breaching the 4.6% level. It is now within touching distance of its average level since 1790,[2] suggesting the era of great moderation in interest rates since the early 1980s is well and truly in the rear-view mirror for investors. As we first discussed in our 2023 Capital Markets Forecast, 2023 has brought a new era of more expensive and scarcer capital.

This has occurred against a backdrop of further moderation in underlying (i.e. "core," stripping out energy and food costs) inflation, which dipped below 4% during the third quarter for the first time since Q2 2021. When adjusted for inflation, the "real" 10-year cost of capital is now significantly into positive territory, which the Federal Reserve (Fed) normally judges as restrictive enough to slow the economy significantly.

History suggests that when monetary policy is this tight, the economy becomes vulnerable to shocks that could suddenly, contagiously undermine it – despite its current resiliency. By the end of the third quarter, many candidates for such a shock had emerged, including:

- lagged effects of prior interest rate increases;
- continued tightening of lending standards in banks;
- disruption of the automobile industry, which is so significant to the overall economy, by the United Auto Workers union strike;
- consumer spending impacted by surging energy costs;
- political dysfunction that may still precipitate a government shutdown; and
- fiscal austerity that may be required to service the increased cost of the national debt.

According to The Economist, the last time the 10-year Treasury bond yield was at its current level, the national debt was around 35% of GDP. Today the national debt is 98% of GDP. Wall Street is starting to ask Washington the question in earnest about a pathway to the long-term sustainability of federal debt.

In a press conference on September 23, the Federal Reserve Chair Powell conceded that "we understand that it's a real rate that will matter and that needs to be sufficiently restrictive. And, again, I would say you know sufficiently restrictive only when you see it. It's not something you can arrive at with confidence in a model or in various estimates." That high level of uncertainty is reflected in its disparate measures of real-time GDP forecasts for Q3 2023, with the Atlanta Fed GDPNow Index signaling nearly 5% growth and the St. Louis Federal Reserve GDP Nowcast Index dipping close to 0%.

[1]Gabe Lembeck, MBA, CFA, Director, Investment Strategy Team recently wrote about why a recession has not occurred — and why it still might. (Balentine, Market Commentary: September 2023).
[2]According to Bank of Bank of America Global Investment Strategy using Bloomberg and Global Financial Data.

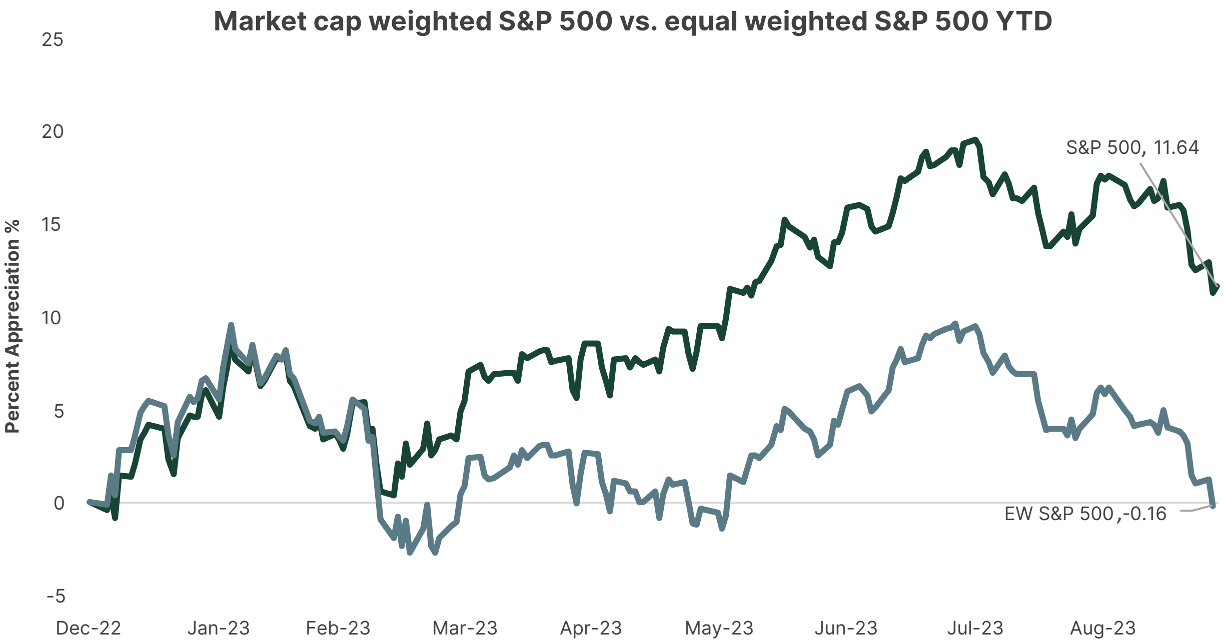
Investment Policy: Public Markets

Given the cloudier outlook, the stock market cooled during the third quarter, correcting mildly after a significant rally in the headline indices since the Fall of last year. The ebullience of the stock market over the last year appears to stand in sharp contrast to the concern on Main Street about the effects of sustained price increases and interest rates on the affordability of consumption and housing.

Or does it? When digging beneath the surface, the rally in stocks has not been as broad as headline indices suggest. Figure 1 below compares the return of the S&P 500 market capitalization index against the return of its constituents on an equally weighted basis.

This illustrates the point that a concentrated handful of technology stocks have driven the headline index to its gains during 2023. The stock market may be skating on thin ice, as the average stock has not bought into the hype that the revolutionary productivity gains from Artificial Intelligence may offset the effects of restrictive monetary policy on current and future corporate earnings.

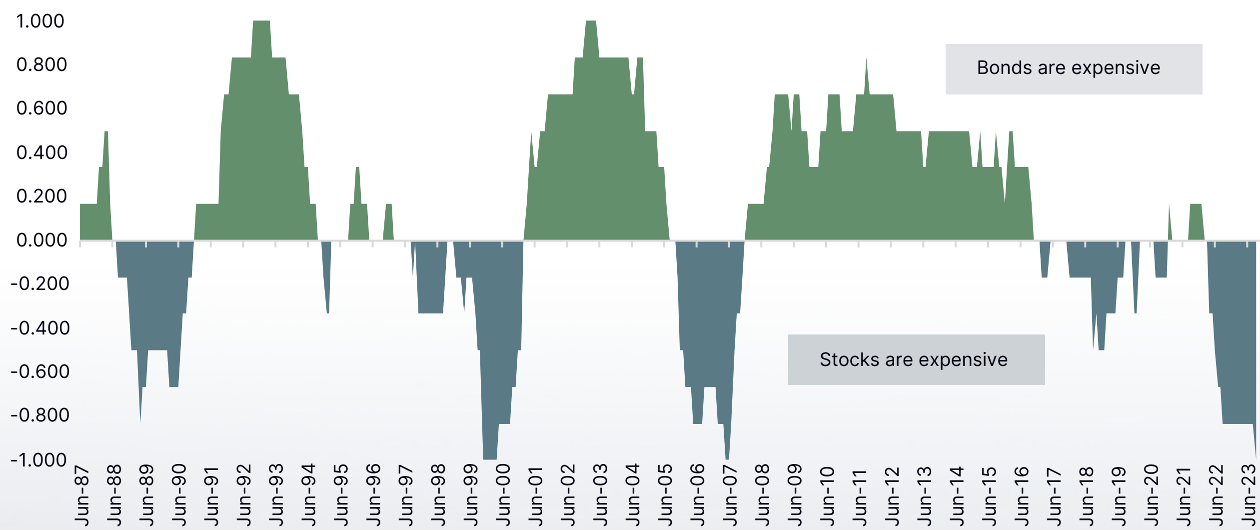
Figure 1: Skating on Thin Ice?



Source: Balentine and Bloomberg

In addition to being narrowly driven, the aggregate stock market also remains relatively expensively priced when compared to safer fixed income as Figure 2 illustrates.

Figure 2: Stocks remain Relatively Expensive Compared to Bonds



	S&P500/1Y T-Bill Yield Differential	S&P500/10Y T-Note Yield Differential	MSCI ACWI Earnings Yield-(World Govt Bond Yield+US Yield Spread)	US Yield Curve Composite (10Y-2Y)	US Yield Curve Composite (5Y-2Y)	US Yield Curve Composite (30Y-10Y)	RV Reading
8/31/23	Bonds	Bonds	Neutral	Bonds	Bonds	Bonds	(0.83)
9/30/23	Bonds	Bonds	Bonds	Bonds	Bonds	Bonds	(1.00)

Source: Balentine and Bloomberg

For reasons discussed in past quarterly letters, we do not anticipate the potential for a 2008–09 stock market meltdown, but we remain underweight in stocks. We made no changes to investment policy in public markets over the quarter. While it has been frustrating to not capture more of the upside a concentrated pocket of the U.S. stock markets has offered this year, our unwavering philosophy is to balance the need to avoid permanently impairing capital against the need to take enough risk to meet our clients' goals.

Our process has navigated several market cycles over the last thirty years, and today it is calling for continued patience while positioning strategies to preserve capital given the possibility of an eventual short and shallow recession, falling corporate earnings, and a correction of a narrow and expensive stock market. We reaffirm our counsel to average new money into portfolios over a period of six months in a disciplined way. Attempting to time the exact peak or trough of the stock market is a fool's errand; as surfers know well, to catch the wave, you have to be in the water.

We do see several opportunities:

After-tax cash management.

We recommend clients always have two years of spending needs net of their portfolio yield in cash to avoid the risk of permanently impairing capital. Given the height to which the Fed has increased short-term interest rates, we believe there is a unique opportunity to build customized cash portfolios using tax-free instruments to immunize expected cash flows in the coming years.

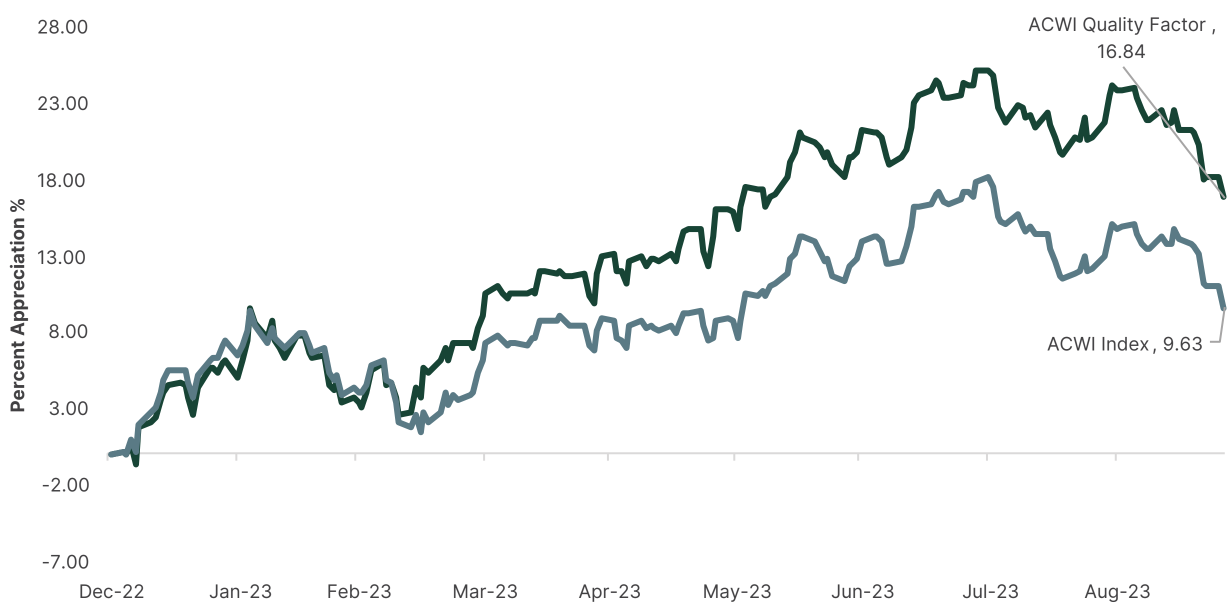
Short-Duration Bonds.

Short-duration bonds are less sensitive to interest rate increases and have outperformed the broader bond market this year, benefiting our portfolios. We still think that long-term rates are likely to remain higher for longer and that it is too early to lengthen the duration of our Fixed Income portfolios.

Quality Stocks.

At the beginning of this year, we outlined our reasons for tilting the strategic allocation we make to stocks in favor of those that exhibit High-Quality characteristics, such as low leverage and stable earnings.[3] We anticipate such baskets of stocks to potentially outperform over the long-term, but also to do well over the medium term of a higher cost of capital and slower economic growth. Year to date, Quality stocks have done incredibly well — outperforming the market by 850 bps (Figure 3)- and should continue to outperform regardless of whether the stock market goes down in the near term. Quality factors are implemented as 35%-40% (depending on the specific strategy) of current client equity portfolios.

Figure 3: ACWI Quality Factor vs. ACWI Index



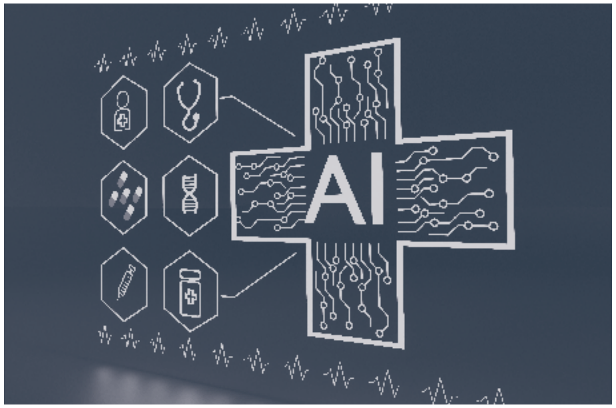
Source: Balentine and Bloomberg

[3]*Susie Wang, CFA, SCR, Director, Investment Strategy Team wrote about Quality Factors in the 2023 Capital Markets Forecast (Balentine, Quality as a Core)*

Investment Policy: Private Markets

As a reminder, we believe Private Capital at Balentine provides a strategic foundation in long-term active management, acting as a portfolio return enhancer and diversifier which complements our tactical public market process. We seek to build well-rounded portfolios in private equity, real assets, and debt, acknowledging that market cycles will reward a multi-faceted approach over the 10 – 12-year holding period of these investments.

Underpinning our approach are several intergenerational themes that we have identified as powerful tailwinds to investors over the coming decades. These are: the decarbonization of our energy infrastructure; the changing face of healthcare; the proliferation of Artificial Intelligence and robotics; and the persistent growth of the Sunbelt region of the United States.

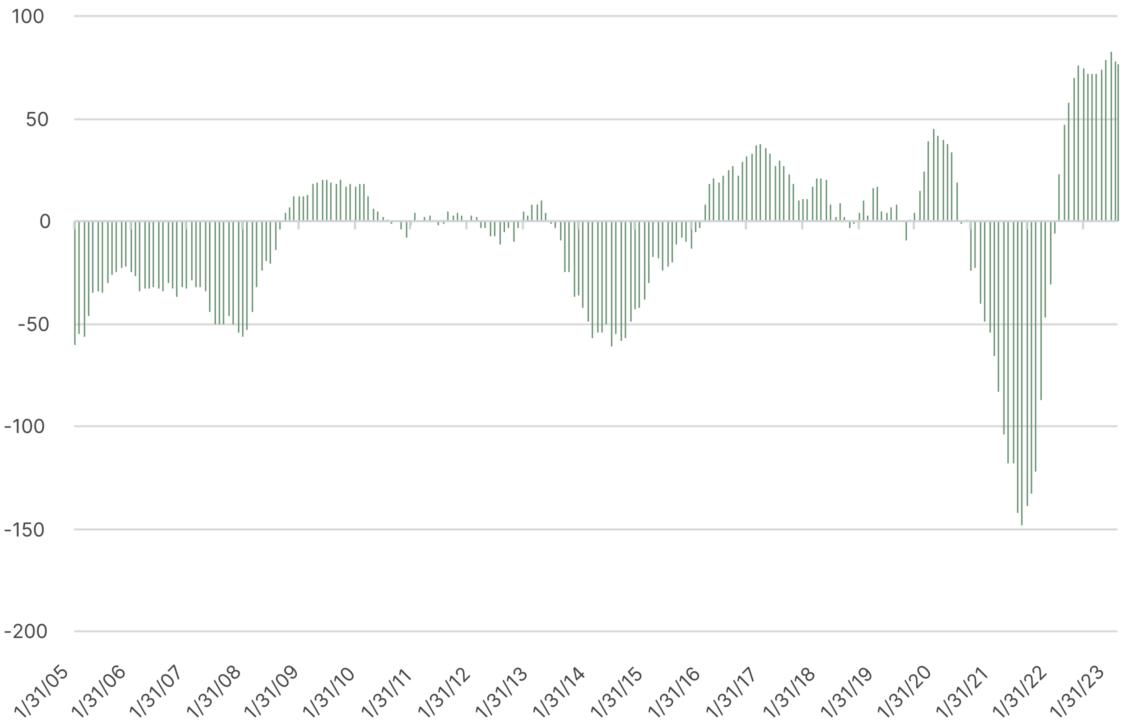


Developments

As 2023 continues to unfold, two developments are worth highlighting: the disruption in the venture capital markets and the belief that we are entering a particularly attractive environment for private credit.

Let's start with the tepid Initial Public Offering (IPO) market. While there have been successful IPOs this quarter, notably Arm and Instacart, we are at nearly 20-year highs for companies that need to conduct an initial public offering, but have not been able to do so, according to Pitchbook.

Figure 4: IPO Backlog



Source: Pitchbook

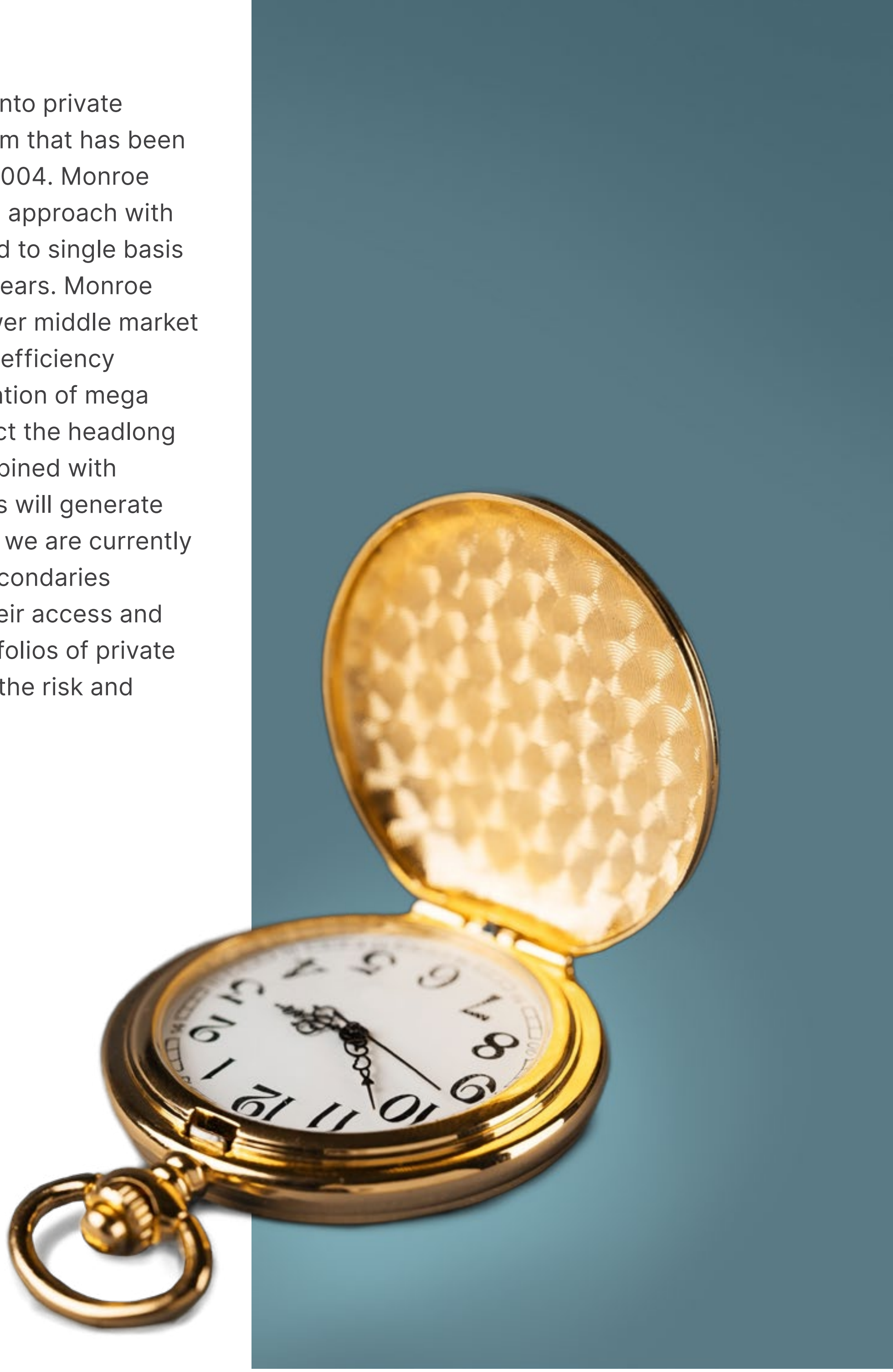
The knock-on effect of companies waiting in the queue to IPO is the delay in proceeds recycling back to venture capital allocators. This capital rationing could present a significant opportunity for managers with the capital and the demonstrated discipline to deploy it successfully. We think two of our managers, Adams Street and Panoramic, are well positioned to take advantage of more attractive pricing and terms, potentially leading to an above-average vintage for investors.

The other development in private capital markets is what many refer to as the "golden moment" in private credit.[4] We believe private credit offers investors a meaningful floating rate spread above risk-free interest rates and has historically experienced few losses. At a time when equity valuations remain high and a potential recession looms, investors are looking to private credit as an attractive place to invest over the next cycle.

When you have been investing in markets as long as we have, phrases like "golden moments" are cause for skepticism. Just two years ago, for example, when venture capital was seeming to have its golden moment, and managers were throwing money at every startup, we stayed disciplined, emphasizing diversification over fads. We look to do the same in 2023 with private credit by emphasizing managers with discipline and unique access.

[4]*Blackstone, "Golden Moment" for Private Credit*

Balentine's first access point into private credit is through Monroe, a firm that has been investing in this space since 2004. Monroe takes a "zero loss, credit first" approach with strict underwriting that has led to single basis point losses over the last 20 years. Monroe also focuses on lending to lower middle market companies, a rich source of inefficiency that does not attract the attention of mega private credit funds. We expect the headlong rush into this asset class combined with sloppy underwriting standards will generate opportunities in the future, so we are currently underwriting private credit secondaries managers, who look to use their access and size to purchase existing portfolios of private debt at discounts that reflect the risk and return of that portfolio.



Fund Updates

As 2023 rounds third base and heads for home, several of our private capital offerings are doing the same. **Credit Opportunities 2023**, the access vehicle we created to take advantage of the dislocation that should arise from the rapid increase in interest rates, will be closing at the end of the year. After partnering with the Dell and Cousins family offices, we are rounding out the allocations to the underlying managers.

Our recommended growth equity manager, Fulcrum Equity Partners, is rounding out the fundraising for their fifth fund this year. **Fulcrum V** focuses on young but rapidly growing technology and healthcare companies in the Sunbelt, an area that, as mentioned above, should have tailwinds for the coming decades.

Harbert VIII, our U.S. real estate manager, remains open. Harbert looks to stay disciplined in the beginning years of its new fund, focusing on high-demand multifamily and industrial properties, while preparing for potential opportunities in office and retail if they present themselves later in the fund's life.

Industrial and Aerospace 2022, the access vehicle we created to allocate to J.F. Lehman VI and its co-investments, also remains open. J.F. Lehman is a buyout manager that focuses on non-cyclical sectors, looking for what it considers to be attractive valuation entry points. We recently called capital to fund a co-investment in a take-private transaction of an environmental remediation company, Crystal Clean, a similar co-investment opportunity to Atlas Air. We are pleased with J.F. Lehman's deployment of the fund so far and look to continue to take advantage of these types of opportunities.

Looking ahead, we will stay disciplined in the pursuit of keeping money deployed in private markets. Amidst the dislocation happening in the venture capital market and the excitement in the private debt market, Balentine is re-underwriting offerings that will be available soon for commitments.

In Closing

For many on Main Street who have experienced the frustration of surging inflation over the last two years, the apparent ebullience of the stock market of 2023 makes no sense. There is an unusually high level of uncertainty about the economy as we look ahead to another contentious election cycle. In this environment, it is easy to succumb to emotions, or be paralyzed by fear when thinking about making investments. This is why we continue to lean on our unemotional, forward-looking, data-driven investment process, which has helped our clients navigate several market cycles, with patience and discipline.

Thank you for the trust you place in our team and process.
As always, we welcome any questions you may have at any time.

Sincerely,

Adrian

Adrian Cronje, Ph.D., CFA®
Chief Executive Officer

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The MSCI ACWI (All Country World Index) Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 45 country indices comprising 24 developed and 21 emerging market country indices. The developed market country indices included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. The emerging market country indices included are: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

The MSCI World Quality Index is based on MSCI World, its parent index, which includes large and mid cap stocks across 23 Developed Market (DM) countries*. The index aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth and low financial leverage. The MSCI Quality Indexes complement existing MSCI Factor Indexes and can provide an effective diversification role in a portfolio of factor strategies.

The S&P 500® Index is the Standard & Poor's Composite Index of 500 stocks and is a widely recognized, unmanaged index of common stock prices.

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