Quarterly Market & Economic Report

Q2 | 2023

Could This Time Be Different?

The U.S. stock market is up over 15% since the start of 2023 and up over 20% since the lows of October 2022 despite short-term interest rates rising from 0% to over 5% in little over a year. The Legendary investor Sir John Templeton is credited with saying the four most dangerous words in investing are "this time it's different," acknowledging there are fundamental laws with respect to risk and return that can bend for a while, but do not ultimately break. With strong stock performance hinting at the beginning of a new bull market and an economy that has so far skirted a recession, everyone is wondering: Is this time different? Could these clues signal that the Federal Reserve (the Fed) has successfully resolved the thorny policy trilemma we wrote about in our last letter?

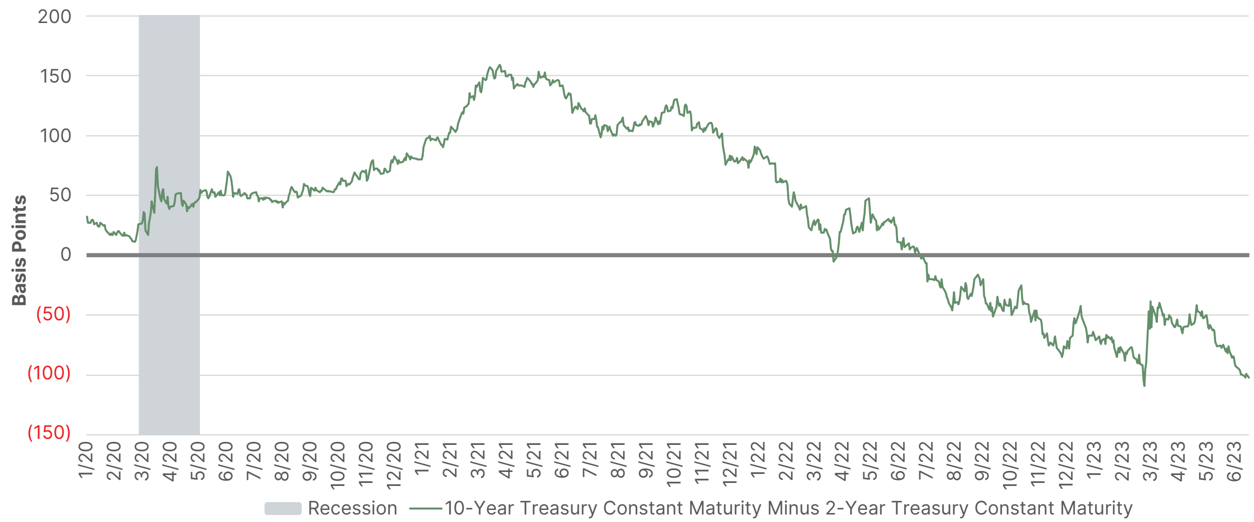
Investors have been encouraged by two hopes: firstly, Artificial Intelligence may have a revolutionary impact on future productivity and corporate profitability; and secondly, that inflation expectations over the medium term are anchored close to the Fed's target of 2% as a result of its campaign to raise interest rates and withdraw liquidity from markets by reducing its balance sheet. The Fed paused interest rate hikes at its June meeting to observe more incoming economic data and judge the impact of its past actions, reminding markets that their blunt tools typically operate with "long and variable lags." However, that does not necessarily herald the end of its effort to vanquish inflation, especially since the unemployment rate remains very low by historical standards, causing pressure for wages to grow at an above average rate.

While headline inflation has eased significantly since last year, the sticky "core" element (excluding food and energy prices) has not declined by nearly as much. In May, the Fed's preferred gauge[1] showed a 3.8% annual headline rate, the lowest since April 2021, and a 4.6% annual core rate over the same period — a level that is still uncomfortably high. Figure 1 shows that the yield curve (the difference between short- and long-term rates) remains significantly inverted. You can see a comparison between the 10-year Treasury bond rate and the 2-year Treasury bond rate with officially dated recessions highlighted in grey bars. **This means the bond market continues to signal that at least a short and shallow recession will ensue as the economy slows further — and this time will not be different.**

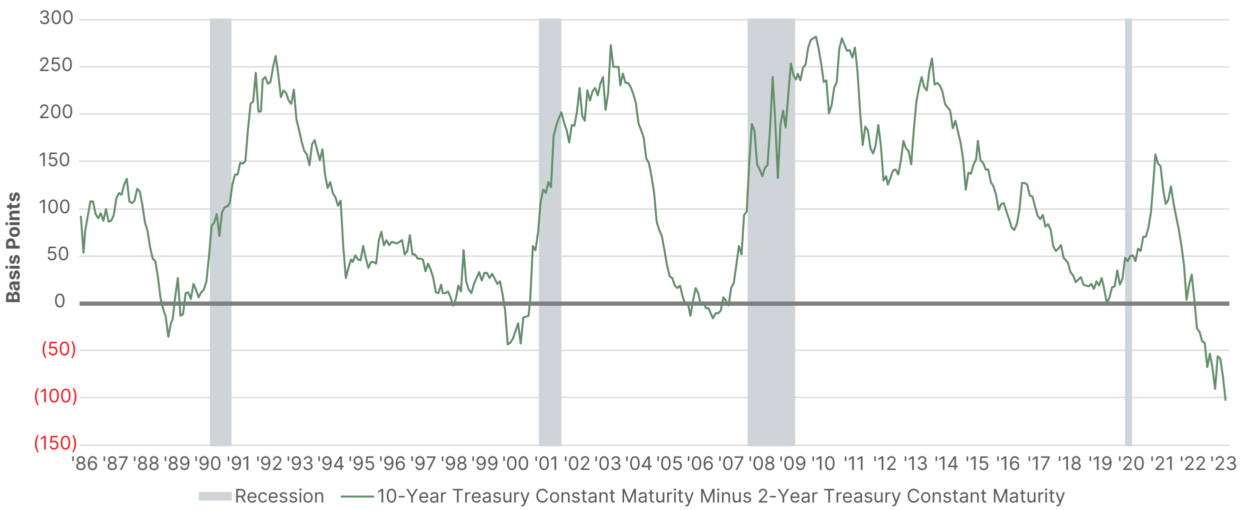
[1]*The Personal Consumption Expenditures (PCE) deflator.*

Figure 1: The bond market continues to say “No!”

The yield curve remains significantly inverted, and the bond market continues to signal that at least a short and shallow recession will ensue as the economy slows further.



Source: Balentine & Bloomberg



Source: Balentine & Bloomberg

The yield curve first flashed this signal in June of 2022, putting us on notice for a slowdown and likely recession at some point this year. While cracks are finally starting to appear, such as temporary employment falling and layoff announcements increasing, how much further a strong labor market can continue to support consumer spending is key to an economy that grew just above stall speed at around 1.5%–2.0% during the first half of the year.

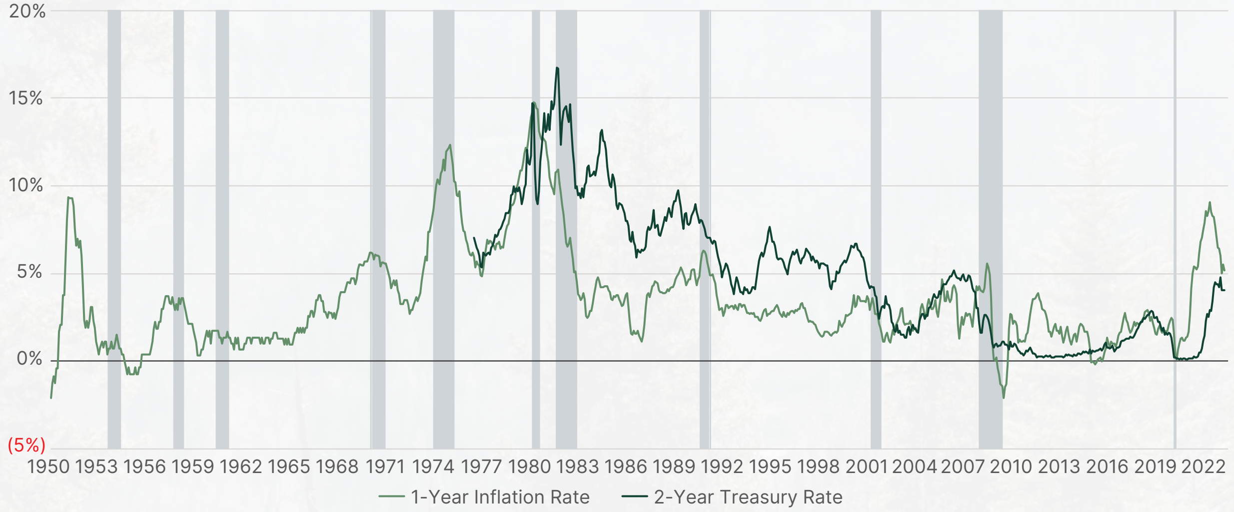
Figure 2 on the following page puts mid-2023 in the longer run context, highlighting how unusual the decade prior to the pandemic was, characterized by artificially free money and abundant capital. It compares the 2-year Treasury bond rate and the trailing 1-year inflation rate, highlighting in grey bars officially dated recessions. The figure also shows how the real (inflation-adjusted) risk-free rate has become positive for the first time since prior to the Global Financial Crisis in 2008–2009.

Today’s Fed is anxious to avoid inflation expectations from becoming unmoored like they became in the late 1970s and early 1980s, which required it to raise interest rates into the high teens. This caused several back-to-back deep recessions before it tamed them. The Fed is likely to keep interest rates higher for longer to ensure that outcome is avoided this time, even if that comes at the price of at least a short and shallow recession.

Figure 2: In 2023, there has been a bumpy transition to an era of more expensive money and scarcer capital.

Today, the real risk-free rate has become positive for the first time since prior to the Global Financial Crisis in 2008–2009.

1-Year Inflation Rate and 2-Year Treasury Rate



Source: Balentine & Bloomberg

Investment Policy: Public Markets

We have positioned strategies defensively since the summer of last year, heeding the recessionary signals that markets have been sending since then. Our defensive stance includes a strategic focus on capital preservation and a tactical focus on lessening the economic sensitivity of portfolios. These steps protected capital meaningfully during the rocky markets of 2022, but they have led our diversified, disciplined approach to lag the rally concentrated in U.S. stocks this year.

Earnings yields and dividend yields relative to risk-free interest rates today remain towards the lower end of historical ranges and the yield curve remains significantly inverted. **Our time-tested discipline shows that sustained new bull markets in stocks have not started from a point of such overvaluation relative to bonds. We therefore remain underweight our long-run targets to equities and overweight bonds and believe it is still too early to increase the sensitivity of our fixed income exposure to declining interest rates.**

During the quarter, we changed our emphasis from Value stocks, which we first established in 2021, towards Growth stocks. Market cycles have wide dispersion, so our discipline is built to identify entry points, seeking to capture the bulk of trends rather than time the exact top or bottom of each cycle. As such, we initiate positions when momentum confirms the beginning of a new relative trend.

History supports Value's underperformance during weaker economies as the more cyclical Financials, Industrials, and Energy tend to carry a larger weight in the Value indices than the more defensive Healthcare, Utilities, and Staples industries.

With cash today yielding close to 5% and perhaps more in the coming months as the Fed continues to increase interest rates, it may be tempting to resist building out a diversified portfolio of stocks and bonds in the public markets and committing to long-lived private capital strategies in the hopes of a better entry point. However, **trying to time markets perfectly is always a fool's errand. *Time in the markets* is more important than timing the markets,** as the long-run evidence shows. Averaging into longer duration assets in a disciplined way is the only way to ensure a high probability of meeting financial goals over time, especially in a new era of higher-than-average inflation. **Investment strategy should always balance the need to avoid permanent impairment of capital against the need to take enough risk to meet your funding, lifestyle, and aspirational goals over time. Such a goals-based approach emphasizing disciplined, diversification over time will be out of lockstep with the stock market from time to time, often for several quarters or more.**

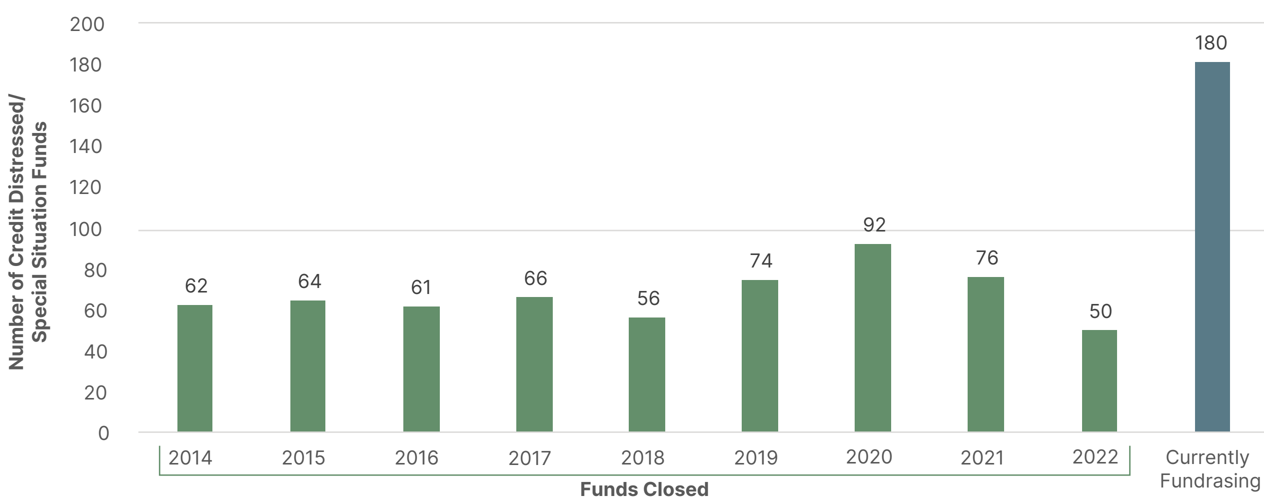
Investment Policy: Private Markets

Private capital at Balentine provides a strategic foundation in long-term active management. We strive to build well-rounded portfolios in private equity, private real assets, and private debt, acknowledging that unpredictable market cycles will reward a multi-faceted approach over the 10–12-year hold period of these assets. It is our view that this approach complements our public market process, serving to further diversify portfolios, enhance returns, and boost the probability of our strategies helping our clients reach their goals.

We've identified several intergenerational themes that we anticipate will provide powerful tailwinds to investors in private markets over the coming decades. These themes 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. These themes will appear in many forms throughout our private portfolios, whether in dedicated internal partnerships focused on one theme or in the selection and approval of single managers.

The start of 2023 has shown two interesting developments in private markets of which we are poised to take advantage. **The first development is the rise of the credit dislocation fund as many private market investors are aiming to take advantage of further economic weakness.** In Figure 3, we plot the number of credit distressed and credit special situations funds that were closed each year since 2014 and the number of credit distressed/special situations funds currently fundraising. More than likely, all 180 of these funds will not close in 2023 for various reasons. This data suggests private debt managers also anticipate this time will not be different and that further economic weakness will lead to opportunities.

Figure 3: Private debt managers also anticipate that this time will not be different and further economic weakness will lead to opportunities.

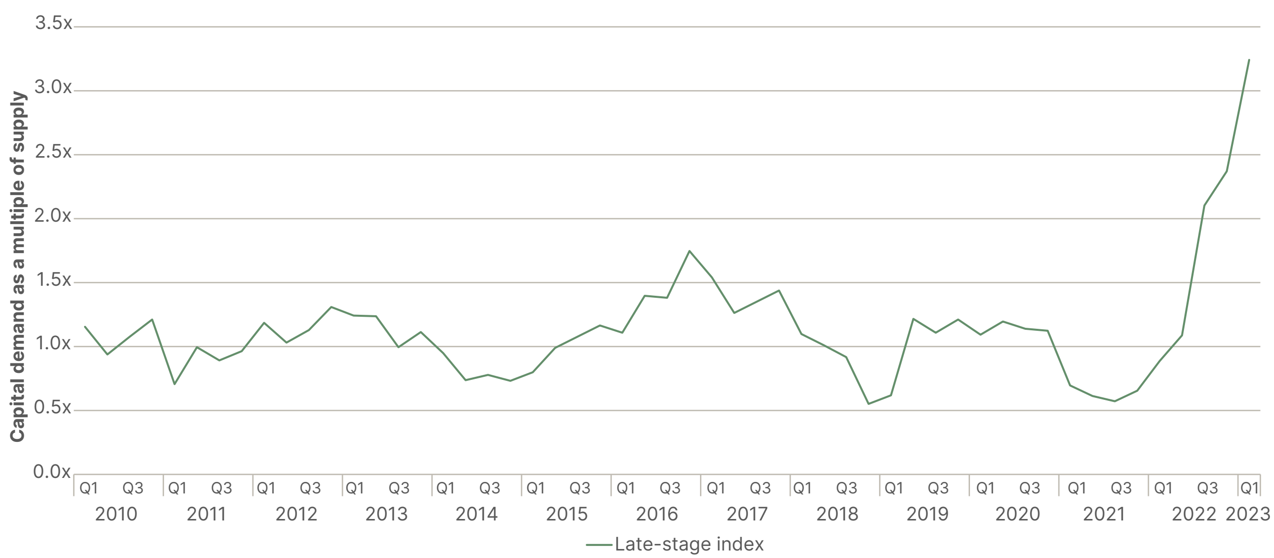


Source: PitchBook

This is important as we deploy capital through our Credit Opportunities 2023 access vehicle[2]. We will rely on our time-tested underwriting discipline to navigate these crowded waters, ensuring we have vintage diversification (not putting all funds to work in one period), focusing on managers with a niche and unique sourcing, and staying away from large asset-gathering funds that will need to deploy capital to maintain their high-cost structure regardless of the opportunity. This is the case with our current approved managers, the Dell Family Office and Whitehawk. We look to continue to apply this discipline as we round out the manager lineup for this vehicle.

The other interesting development is the slowing supply of capital in the venture and growth markets. The transition to a new era of higher interest rates and scarcer capital has hit the venture market hard. The below graph from PitchBook details the capital demand-to-supply ratio in the late-stage venture market. Going into the second half of 2023, the graph indicates that the market could be capital rationing for the first time in a long time.

Figure 4: As we enter the second half of 2023, the market could be capital rationing for the first time in a long time.



Source: PitchBook

[2]Balentine earns no additional incentive for creating this pooled access vehicle for clients.

This dynamic bodes well for the types of managers we have always emphasized, especially those coming to market in the second half of 2023. We recently approved Fulcrum V for use in private capital portfolios. Fulcrum is an Atlanta-based firm that began investing in growth companies that have graduated from the venture stage and are looking to grow and mature in their markets. Fulcrum has honed its craft over four previous funds, focusing on technology and healthcare companies. Our confidence in Fulcrum stems from their long track record of sourcing small, fast-growing companies and digging in operationally to professionalize and improve the businesses in which they invest. Their growing focus on Artificial Intelligence, continued focus on healthcare, and emphasis on the Southeast fit very well with our thematic approach.

We are underwriting Adams Street Innovation IV for use in portfolios in 2023. This would be another beneficiary of the drying up of early-stage capital. Adams Street has a 40+ year track record of accessing the top venture manager and co-investment opportunities around the globe. We believe an investor's core holding in venture capital is best expressed in a diversified manner in the top-tier managers, such as the strategy Adams Street offers.

A lack of supply in late-stage venture capital in 2023 could bode well for both Fulcrum and Adams Street Innovation, as managers can be more selective in the companies they invest in, have a longer period for due diligence, and command better terms and conditions for their investment.

Another point of interest in our private portfolios is the rounding out of our Decarbonization 2022 internal partnership. We launched this partnership with allocations to Brookfield's global decarbonization fund and Kendall, a distributive scale solar manager. Both funds were infrastructure-focused, using today's technology to reduce carbon utilized in large-scale industrial processes. With the remaining capital in Decarbonization 2022, we will allocate to Energy Impact Partners (EIP) III, a growth equity fund focused on tomorrow's technology. EIP has built a brand in the market by partnering with large utility companies that use and discover new technology. EIP is the dominant manager in this niche area, and we look forward to partnering with them in Decarbonization 2022.

Private capital commitments often last for a decade or longer, and we appreciate the confidence you place in our team. If you have questions about opportunities or would like an update on your investments in this area, please do not hesitate to contact your relationship manager[3].

[3]*Two other funds are open: our U.S. real estate fund, Harbert VIII; and J.F. Lehman VI, a leverage buyout fund focused on defense, maritime, aerospace, and environmental services. We believe Harbert is well-positioned to be selective in the changing real estate market, as raising mortgage rates and changing resident/tenant behavior creates an opportunity across multifamily, office, retail, and industrial. J.F. Lehman continues to be positioned well, given its niche focus on sectors typically overlooked in private equity. Their lower use of debt and focus on mission-critical companies should provide it with a buffer as the economy slows further.*

In Closing

While it may be tempting to put the chaotic volatility of last year behind us, this time is unlikely to be different. A sustained new bull market in stocks rarely starts from such expensive levels or before the economy bottoms. Cracks are finally starting to appear in the economy after the violent interest rate shock the Fed has induced over the last 12 months to tame inflation — and the Fed appears set to go further to do so decisively. Our forward-looking, objective models, which continue to guide our decisions, have a long track record of navigating several market cycles successfully. They continue to call for caution and selectivity in public markets while we shape up to take advantage of credit opportunities and scarcer capital in private markets.

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

Sincerely,

Adrian

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

Disclosures

The views expressed represent the opinion of Balentine. The views are subject to change and are not intended as a forecast or guarantee of future results. This material is for informational purposes only. It does not constitute investment advice and is not intended as an endorsement of any specific investment. Stated information is derived from proprietary and nonproprietary sources that have not been independently verified for accuracy or completeness. While Balentine believes the information to be accurate and reliable, we do not claim or have responsibility for its completeness, accuracy, or reliability. Statements of future expectations, estimates, projections, and other forward-looking statements are based on available information and Balentine's view as of the time of these statements. Accordingly, such statements are inherently speculative as they are based on assumptions that may involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such statements. Investing in equity securities involves risks, including the potential loss of principal. While equities may offer the potential for greater long-term growth than most debt securities, they generally have higher volatility. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles, or from economic or political instability in other nations. Past performance is not indicative of future results. Balentine utilizes proprietary models to evaluate economic trends. The Tier 1 model gives us parameters to determine how we should allocate our assets across our building blocks. The Tier 2 model guides us toward allocating within building blocks. Balentine uses a combination of several factors, of which models are only part, when determining its investment outlook. Balentine is not soliciting or recommending any action based on any information in this document.

Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk. Therefore, it should not be assumed that future performance of any specific investment or investment strategy (including the investments and/or investment strategies recommended and/or undertaken by Balentine or any non-investment related services, will be profitable, equal any historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. The information provided in this report should not be considered financial advice or a recommendation to buy, sell, or hold any particular security. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. GTAA and SGA detailed strategy performance information and recommendations made in the last 12 months are available upon request.

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.

Chartered Financial Analyst® (CFA®) are licensed by the CFA® Institute to use the CFA® mark. CFA® certification requirements: Hold a bachelor's degree from an accredited institution or have equivalent education or work experience, successful completion of all three exam levels of the CFA® Program, have 48 months of acceptable professional work experience in the investment decision-making process, fulfill society requirements, which vary by society. Unless you are upgrading from affiliate membership, all societies require two sponsor statements as part of each application; these are submitted online by your sponsors.

Balentine LLC is an investment adviser registered with the U.S. Securities and Exchange Commission. Registration does not imply or training. More information about Balentine's investment advisory services can be found in its Form ADV Part 2, which is available upon request.

BALENTINE

WWW.BALENTINE.COM