Third Quarter 2023
Market Commentary

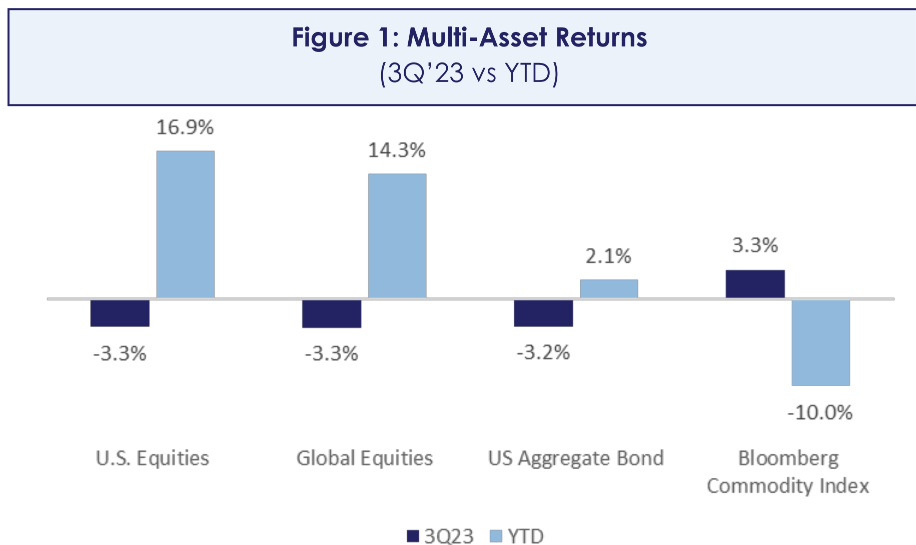
October 24, 2023

Macro Conditions Taking Over

One short quarter after writing that we felt the markets were irrationally acting like we were in the late-1990s, market conditions deteriorated in the third quarter, with equity and bond indices turning negative while commodity prices rallied in the teeth of rising crude oil prices. The equity market's rapid rise in the first half of the year left us nonplussed, feeling that the stunning lack of breadth in the market's rise was more evidence of a reactionary AI-fueled FOMO[1] trade than it was proof that we'd entered a new bull market. Bonds have been dreadful for a second year in a row, with proxies for total returns on 10-Year US Treasurys ending 3Q23 down 14.8% YTD and other indices tracking investment grade and high yield flat to down in both the quarter and the year. Even with this recent weakness taken into account, we continue to see better opportunities in private credit and equity markets than in public markets at this time.

Of course, after the quarter ended, the horrific and tragic events in the Middle East have further thrown the world into chaos – only further adding to our conviction that public markets have much to work through before a clearer path forward emerges. We are as convinced as ever that patient capital, wisely deployed and structured to minimize downside where possible is the best path forward. Sometimes, sitting on your hands is the best trade.

Figure 1: Multi-Asset Returns
(3Q'23 vs YTD)



Source: Bloomberg, Nordwand Capital as of 9/30/2023.
Note: US equities = S&P 500 Index; Global equities = MSCI ACWI Index

[1] That's "fear of missing out" for the uninitiated.

On the macro front, we begin again with interest rates and inflation. Core personal consumption expenditures (Core PCE) continues its moderation, while headline CPI – the measure that grabs more headlines and tends to reflect consumer attitudes and sentiment more closely due to its inclusion of food and energy – began moving higher.

Figure 2: Consumer Price Index
(1962-Present)

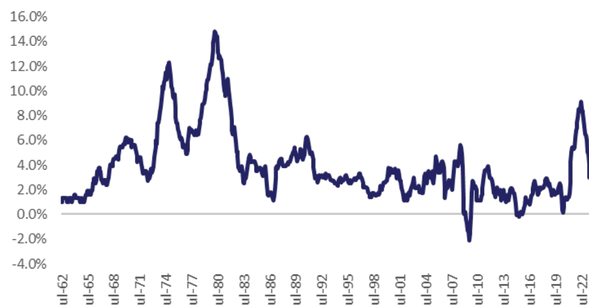


Figure 3: Core PCE Index
(1962-Present)

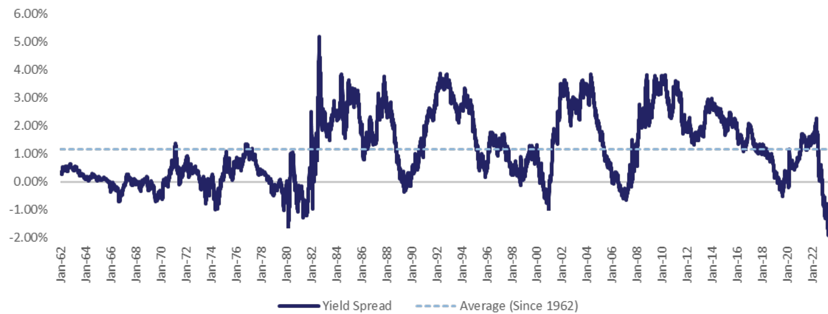
Source: Bloomberg, Nordwand Capital as of 9/30/2023.

Headline CPI (Figure 2) moved from 3.0% in June to 3.7% in August (the most recent period with data) as food prices remained stubbornly high and energy prices climbed anew after a prolonged period of receding crude prices. It's notable that the energy prices we are referencing do not reflect the events in Israel in early October. These prices began moving higher reflecting supply-demand factors and OPEC+ policy decisions; barring unforeseen changes, the price of crude is likely to be a source of troublesome headline inflation readings through 2Q24. Keep this in mind when considering the monetary policy response from the Fed and other central bankers going into next year. Even though the Fed's preferred inflation metric is Core PCE (Figure 3), which has moderated to 3.9% in the latest reading, it continues to be 1) well above the Fed's target 2% figure, and 2) stuck at a higher level, dominated as it is by labor costs that prop up the services sector. As we've discussed before, high labor costs are difficult to unwind, particularly in an employment market with sub-4% unemployment. Notably, the recent successes of private sector labor unions in the US to extract better compensation should be seen as a contributing factor to employees' requirement for cyclically higher wages that can put ongoing upward structural pressure on core services inflation.

A (Brief) Primer: Yield Curves & Their Impacts

We recognize that just because we live in this world every day, many of our clients do not, and there are a few things going on with the yield curve that we think merit a quick explanation before our commentary. The 'yield curve' – simply understood as the yields on offer for debt instruments of varying maturities – is generally upward-sloping. In other words, in a normal economic environment, the longer timeframe a borrower needs to repay a debt, the higher the rate of interest a lender requires. In periods of stress, the curve can become inverted (i.e. the yields at the front end are higher than the yields at the back end). This tends to occur because a central bank raises short-term rates (overnight through ~3 months) to cool credit creation and therefore slow the economy. Over the last 60 years, the average spread from short-term to long-term has been ~116 basis points (bps). Banks tend to make less money on loan generation when the curve inverts, since they borrow on the short-end to lend on the long-end.

Figure 4: US Treasury Yield Curve
(10-Year Minus 3-Month, 1962-Present)



Source: Bloomberg, Nordwand Capital as of 10/24/2023.

This slowdown in credit creation is what the Fed means when it refers to the "long and variable lags" in setting monetary policy.

While we focus on the inversion of this usual term premium in the yield curve, the event that tends to precede trouble is when the curve 're-steepens.' The curve steepens due either to 1) the front end coming down, generally as a result of the central bank lowering interest rates to avert or minimize an economic recession or credit problem, or 2) the long-end rising, generally due to improved prospects for economic growth and pricing. Since the Fed has been messaging for months that it expects rates to stay higher for longer, the front-end of the curve has stayed more or less constant; the back end has risen as investors demand higher interest rates – higher rates of return in general – in a world where inflation stays persistently above 2-3%.

Assets perform very differently depending on whether the curve steepens because of a pending economic problem or the re-emergence of growth. Traditionally, the long-end rising is a pattern we refer to as a 'bear steepening' – so-called because it is indicative of rising inflation prospects that bring higher nominal growth but also dark clouds on the horizon. A curve that re-steepens due to the short-end moving down is known as a 'bull steepener' because it is generally a harbinger of lower borrowing costs and monetary stimulus coming in to support the economy. In short: a bull steepening sees a recession in the short-term with growth to follow; a bear steepening sees short-term gain and long-term pain from inflation. Right now, we are in the midst of a bear steepening pattern.

In a bear steepening period, equities often perform better in the early stages because they will benefit from higher prices and revenues from inflationary growth. Bonds with longer duration get hurt due to the requirement for higher rates (recall that bond yields and price move inversely to each other), while those on the short end of the curve are more insulated from these moves. The challenge in this period, relative to a more ordinary cycle, is that inflation has already been here, so its re-acceleration has the potential to be disastrous. These are short-term trade commentaries, rather than long-term strategic investments, however.

Where Do We Go From Here?

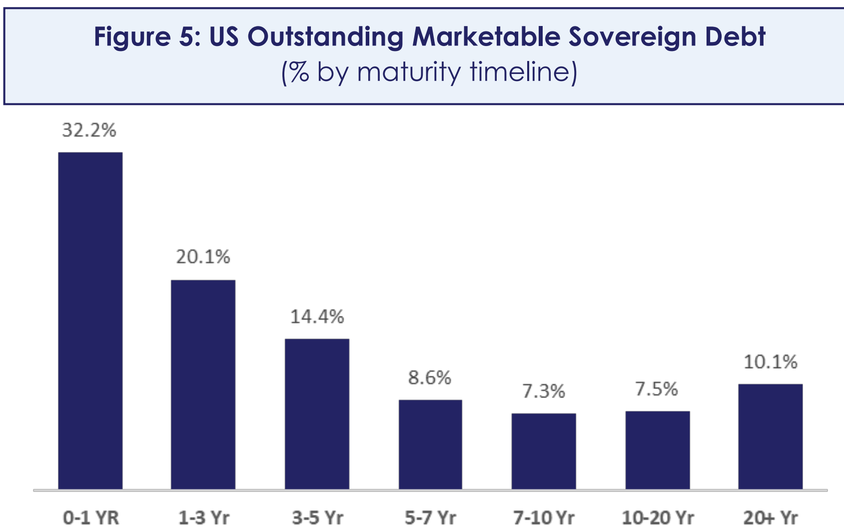
In our view, liquid markets still offer at least as much risk as reward. Overall, we do not generally believe short-term value in liquid equities and bonds is compelling at this moment and at these prices.

Credit Markets – Liquid Still Uncertain, Private Looks More Attractive

In bonds, the market is extremely schizophrenic. If the market believed the Fed's 'higher for longer' posture, then today's midpoint Fed Funds rate of 5.33% when added to the 116bps of average term premium over the last 60 years (see Figure 2) implies that yields on 10-year Treasuries should

be closer to 6.5% than their current (as of this writing) 4.9%. Instead, the market is discounting approximately three 25bp rate cuts from the Fed in 2024. Even if that were to play out – and there are strong arguments on both sides of this issue – it suggests that 10-year yields at the end of 2024 should be ~100bps higher than today. This is obviously problematic for adding risk to the long-end of the yield curve.

On the other hand, with over 50% of US Treasuries maturing in the next 3 years (Figure 5), the combined pressures on the monetary and fiscal authorities to moderate future debt issuance and servicing costs is considerable. This suggests the Fed may find a way to rationalize reducing rates in 2024 even in the absence of an economic financial crisis that would otherwise be the trigger for such a move, even if that risks reigniting inflation.



Source: Strategas, "3Q Review in Charts", as of 10/2/23.

As we cannot see the future with respect to policy or markets, we attempt to analyze the probabilities. These suggest that rates will remain high – at least over 4% - for the foreseeable future, which portends poorly for long-term debt purchases even at these yield levels. **Within credit, we find better value and higher yield in diversified shorter-duration private loan portfolios and continue to source portfolio options for investors in that area.**

Equity Markets – Valuation Still a Concern

Equity markets have looked – at the headline level – much more constructive in 2023. While US equities were up 16.9% at September 30 and global equities were up 14.3% (Figure 1), those figures now stand at +11.0% and +8.4% as of this writing, as the equity market correction that began in late July has continued for much of the last three months. From the recent peaks, equities are off ~8-9% on average. Notably, this correction was well underway prior to the attacks in Israel on October 7.

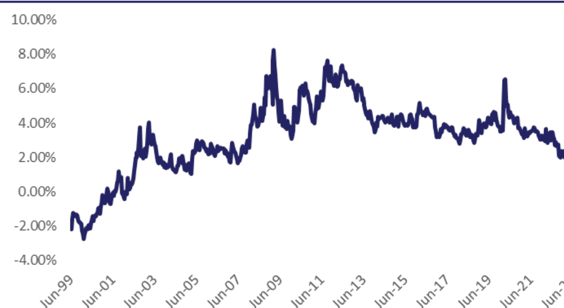
What's more troublesome about these moves is that most of the stocks in the S&P 500 are down slightly on the year. Through the time of this writing, the so-called "Magnificent Seven" stocks (AAPL, AMZN, GOOG, META, NFLX, NVDA, TSLA) are up 80% YTD, while the full market-cap neutral S&P 500 (Ticker: SPW) is down 3% YTD. In fact, even the 'Magnificent Seven" have been down ~8% since late July, suffering from the same malaise as the rest of the US equity market. In spite of this, equities do not look compelling here as valuations still don't screen attractive here.

Figure 6: S&P 500 Forward P/E Ratio
(Historical over 10 years)

Source: Bloomberg, Nordwand Capital as of 10/24/23.

In Figure 6, we show the 10-year history of forward earnings multiples for the S&P 500. This is a gauge of the market's willingness to pay for future growth. Following the recent post-July correction we've discussed above, the S&P 500 is trading just below a full standard deviation expensive versus its recent history, but still a full 5-6% above trend values. It's also worth noting that the rally in equities that ran from October 2022 through July 2023 never made a new high above the prior January 2022 peak. Depending on the severity of this correction, we may just be looking at a prolonged bear market rally, rather than the start of a new market. Given where we are in the economic and geopolitical environment, we would find this outcome very unsurprising.

Figure 7: Equity Risk Premium
(1999-Present)



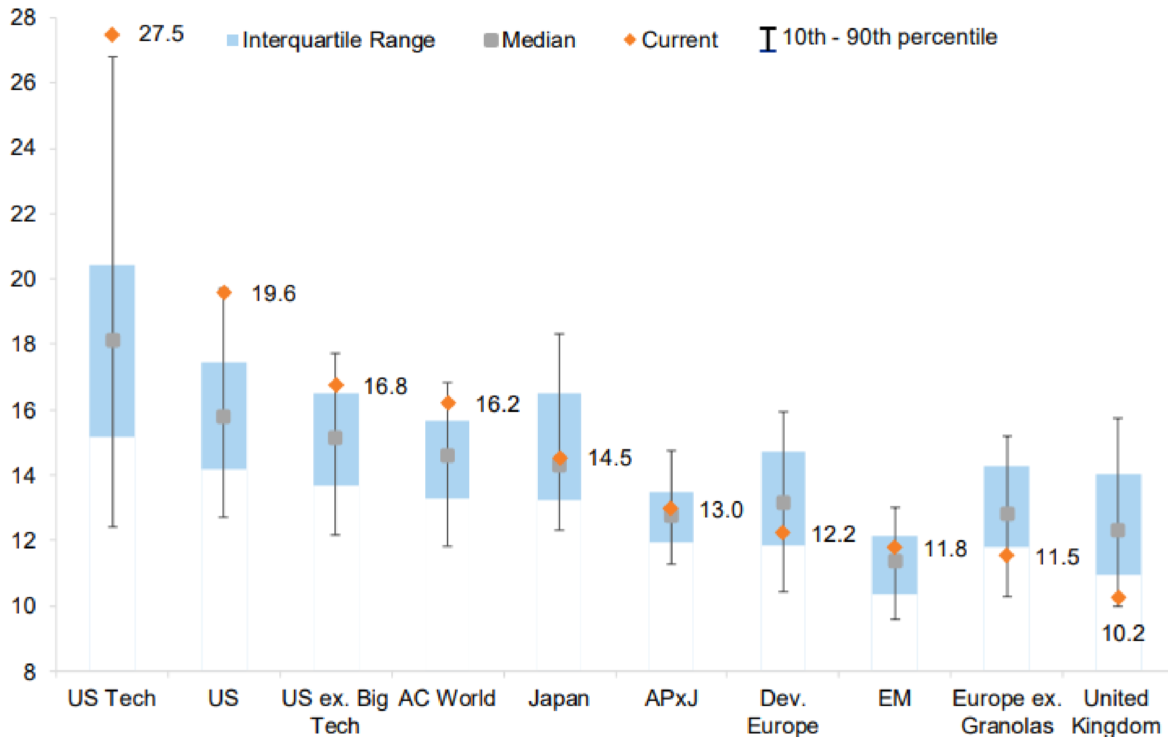
Source: Bloomberg, Nordwand Capital as of 10/24/23.

Not only do we find equity market valuations a bit stretched in light of the backdrop, but Figure 7 highlights that relative to other options equities are not cheap enough to merit wholesale buying activity. Equity risk premium is a measure of the additional return per unit of risk relative to risk-free assets that investors tend to require to own equities rather than US Treasuries. It is calculated as the S&P 500 earnings yield (the inverse of its P/E) less the yield on a 10-Year US Treasury. Figure 7 highlights that equities are more expensive relative to risk-free alternatives than at any point since 2005. To be fair, as risk-free rates climb, it should squeeze valuations for riskier assets – investors are and should demand higher returns if they can get 5.35% in cash. This is one of the reasons that higher interest rates tend to produce lower market multiples – investors simply are not as interested in overpaying for equity risk if safer alternatives meet their return requirements. Coupled with higher financing, materials, and labor costs in higher inflationary environments, and you end up with an environment where it becomes tricky for equities to produce the kind of returns to which investors have become accustomed in the last 12-15 years.

Within the equity market, better values are available, but one must be willing to look beyond the places we hear about most often – US companies and technology companies – to find it. Figure 8 illustrates the point we made above in a different way. US tech companies are trading above the 90th percentile of their own historical trading patterns; in other words, they're expensive even on their terms, much less when compared to the rest of the market. In fact, the US and US ex-big tech look historically expensive even after the 3Q'23 sell-off. Value is more evident in places like emerging markets, developed Europe, and the UK. Risk remains heightened in all of those places – US dollar exposure, structurally lower growth rates, and geopolitical tensions may all be felt more acutely in those places than in the US. With a medium- to long-term lens, however, the relative risk-adjusted returns should be attractive within these pockets, and it is for these reasons that we

have been performing deeper due diligence in these areas and are beginning to allocate to them accordingly.

Figure 8: Equity Valuations vs. Historical Standards
(12-Mo Forward P/E multiples, MSCI Regions)



Source: Factset, Goldman Sachs Global Investment Research.

Summary

Markets are a tricky thing in normal times, which these assuredly are not. The oddities of a post-Covid global economic reopening, fiscal and monetary responses to global inflation and supply challenges, geopolitical tensions on the rise all create complications that are reverberating across markets and are likely to continue doing so. In addition, uncertainty around the final landing spot for short-term and long-term interest rates leaves liquid credit markets unsettled, and US leadership in equities markets has resulted in too-high valuations that leave us looking elsewhere to invest incremental dollars. While we continue to find pockets of value in many of these liquid markets, we find value and return potential in private markets, along with the ability to reduce short-term volatility for client portfolios. Long-dated differentiated growth stage private equity investments married to shorter-duration loan portfolios with above-market yields strike our investment team as a good building block for ultra-wealthy portfolios that can provide some safe harbor from volatility along with yield and growth. While it's been a core focus of the team at Nordwand since our founding, we find the environment for these types of investments on behalf of clients more timely and attractive than perhaps ever before.

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