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THE FAMILY OFFICE℠

Tactical Allocation Viewpoints

JULY 2023

Key Takeaways

- **Investor sentiment and market momentum have markedly improved** in the past quarter, driving equity valuations to loftier levels, specifically in U.S. Large Caps. Other asset classes such as Small Cap and Non-U.S. equities offer more attractive relative returns.
- **Economic fundamentals remain mixed**, with strong employment data persisting while corporate profit growth has softened in the past three quarters despite falling inflation.
- **We believe central banks are nearing the end of their tightening cycle**, as inflation continues to cool, but future interest rate cuts remain far off in the distance given solid GDP growth.
- **A slowdown in private market exit activity** has led to a slowdown in fundraising activity and therefore a reset in private market prices. This may well pave the way for more robust returns for those that have the capacity to deploy into private equity and credit markets.
- **The greatest risks in the marketplace surround the need to refinance debt in the near term** given more onerous borrowing rates. In addition, tighter lending standards raise the probability of choking off economic activity. Though the risk of recession may be reduced, we believe stretched valuations increase the risk of a normal market correction.

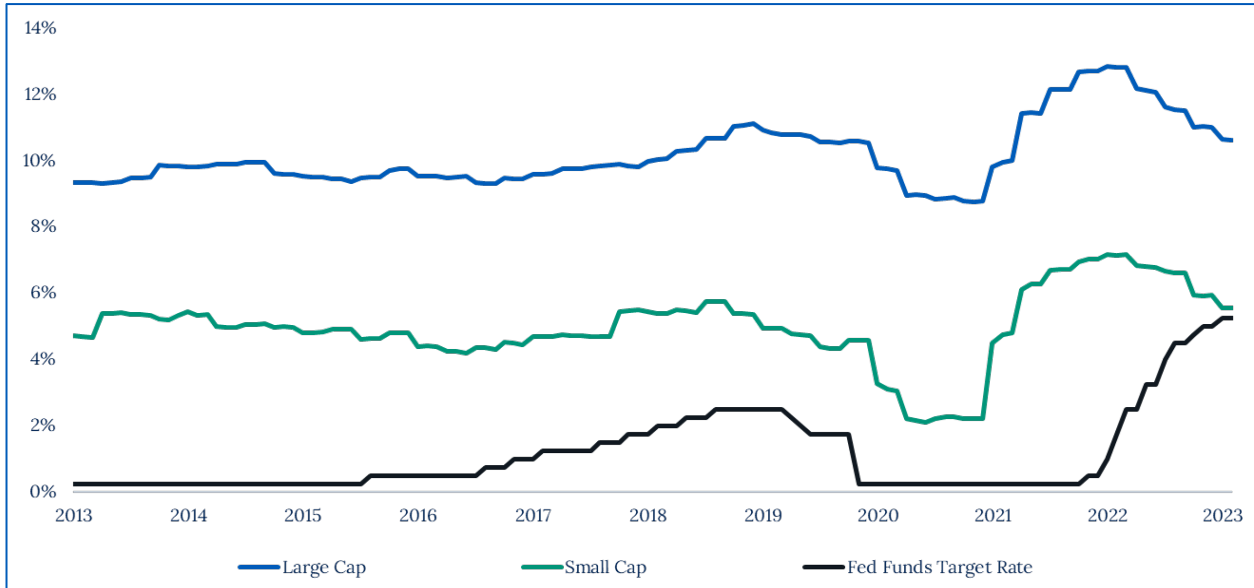
The Macro Picture

Risk markets have performed very well thus far in 2023 for a variety of reasons. Earnings have held up better than expected, low unemployment has buoyed consumer spending, the Fed has slowed the pace of rate hikes thanks to a steady reduction in inflation, and investors are beginning to unwind bearish positioning. Add to that list the hope that a significant productivity boom driven by advancements in artificial intelligence (AI) technology is forthcoming, and you have a remarkably different market sentiment, including discussions of a new bull market, than witnessed in March during the failure of Silicon Valley Bank (SVB).

Against a 12-month increase of 350 basis points in the Fed Funds rate, the S&P 500 Index has delivered a 19.4% total return – not exactly playbook. It is well documented that a large portion of the gain has come from a small number of technology companies. The more recent broadening of return source suggests either an improvement in institutional investor sentiment or market expectations that inflation will decline significantly in the short-run, supporting strong earnings growth in 2024. Or perhaps both. These short-term positive economic and technical changes since our last communication make our macroeconomic outlook slightly more balanced and reduce, though certainly don't eliminate, the odds of recession.

Medium to long-term valuations of Growth assets are determined by interest rates and earnings. The current market multiple is meaningfully higher than the long-term average (roughly 19x vs 16x) and is more in line with a much lower interest rate regime. Coincident with this high multiple is the expectation of a third straight quarter of earnings declines. To justify this backdrop of high valuation and declining earnings, the future needs to be different in (either or both) rates and earnings. We think the Fed's 2% inflation target is still far away, with uncomfortably high wage growth pressuring rates to remain high. Without lower rates, we think it is going to be difficult to achieve the double-digit earnings growth currently forecasted for 2024. Moreover, profit margins remain high relative to history and have not yet completely erased the overearning experienced during the Covid pandemic. The scenario of strong earnings growth will likely require strong revenue growth rather than higher margins; this is not a likely scenario without lower rates.

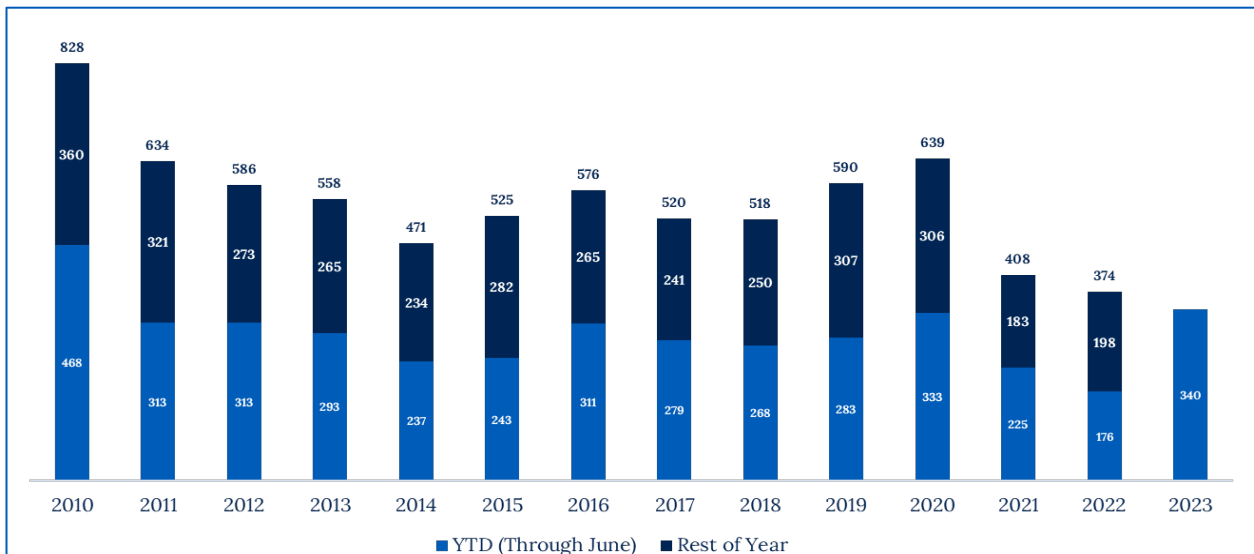
U.S. Large Cap and Small Cap Net Income Margin vs. Fed Funds



Source: FactSet as of July 12, 2023. U.S. Large Cap (S&P 500 Index), U.S. Small Cap (S&P600 Index).

The impact of higher rates has initiated a default cycle, albeit a shallow one thus far. Looming over the horizon are walls of debt maturities in the commercial real estate and corporate debt markets, which grow in 2024 but substantially increase in 2025-27. Will inflation slow fast enough to relieve this pressure driving debt defaults? Is there enough liquidity in the hands of alternative lenders, as the banking sector retreats, to support good borrowers with bad balance sheets even if rates stay high? This collision course in the timeline is one we are watching closely. We expect the liquidity support provided by the Fed and regulators post-SVB to reverse over the rest of 2023. If so, and irrespective of whether defaults rise materially, fresh capital in the private credit markets is being priced at attractive returns and preparing for this early-cycle allocation seems prudent.

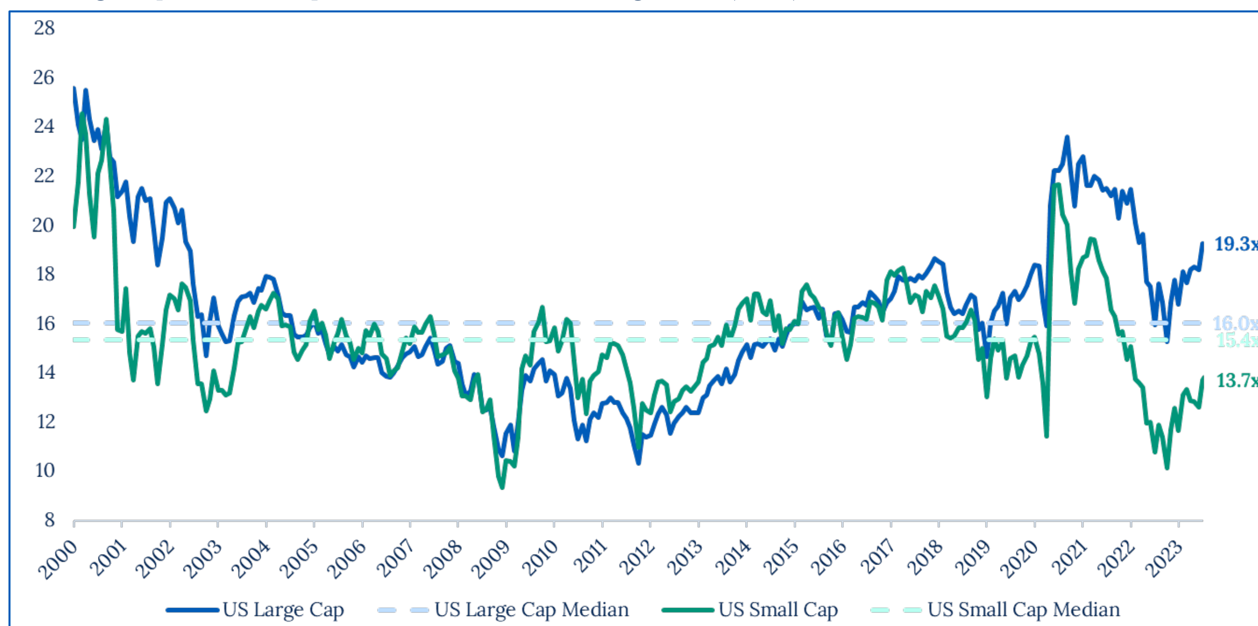
U.S. Bankruptcy Filings (Annual)



Source: S&P Global Market Intelligence as of July 3, 2023.

There is relative value in Small Caps if the U.S. economy avoids recession. To be clear, Small Caps are much more sensitive than Large Caps to economic growth and, correspondingly, interest rates, and this is why we are underweight. However, for longer-term investors, our capital market assumptions suggest a significantly richer opportunity for this asset class based on relative valuations. There are cyclical and secular drivers in play now versus the pre-Covid environment that could provide support, namely the shortage in housing stock and an apparent policy commitment to infrastructure and re-shoring of manufacturing supply chains. Year-to-date through June, these drivers have led to over 100 basis points of outperformance for the Russell 2000 Index versus the equal-weighted S&P 500 Index. While not a pound-the-table moment, Small Caps look attractive relative to Large.

U.S. Large Cap vs. Small Cap Historical Price-to-Earnings Ratio (NTM)



Source: FactSet as of July 12, 2023. U.S. Large Cap (S&P 500 Index), U.S. Small Cap (S&P600 Index).

The Micro (Bottom-up) Picture

The "thread-the-needle" case, where Fed rate hikes bring down inflation without causing a tough (or even shallow) recession, appears to be the market's base case. We therefore continue to recommend small tactical adjustments to portfolios to account for our assessment of valuation-driven risk/reward tradeoff, direction of our economic market cycle dashboards, and a general sense of what asset types do better tactically in the current phase of the business cycle.

Valuation primarily keeps us underweight Growth, just as it keeps us overweight Stability. In other words, bond yields should attract capital from equities. However, inside this broad direction are a number of recent shifts outlined in this and prior tactical memos, some of which reflect the classic anticipation of a business cycle inflection:

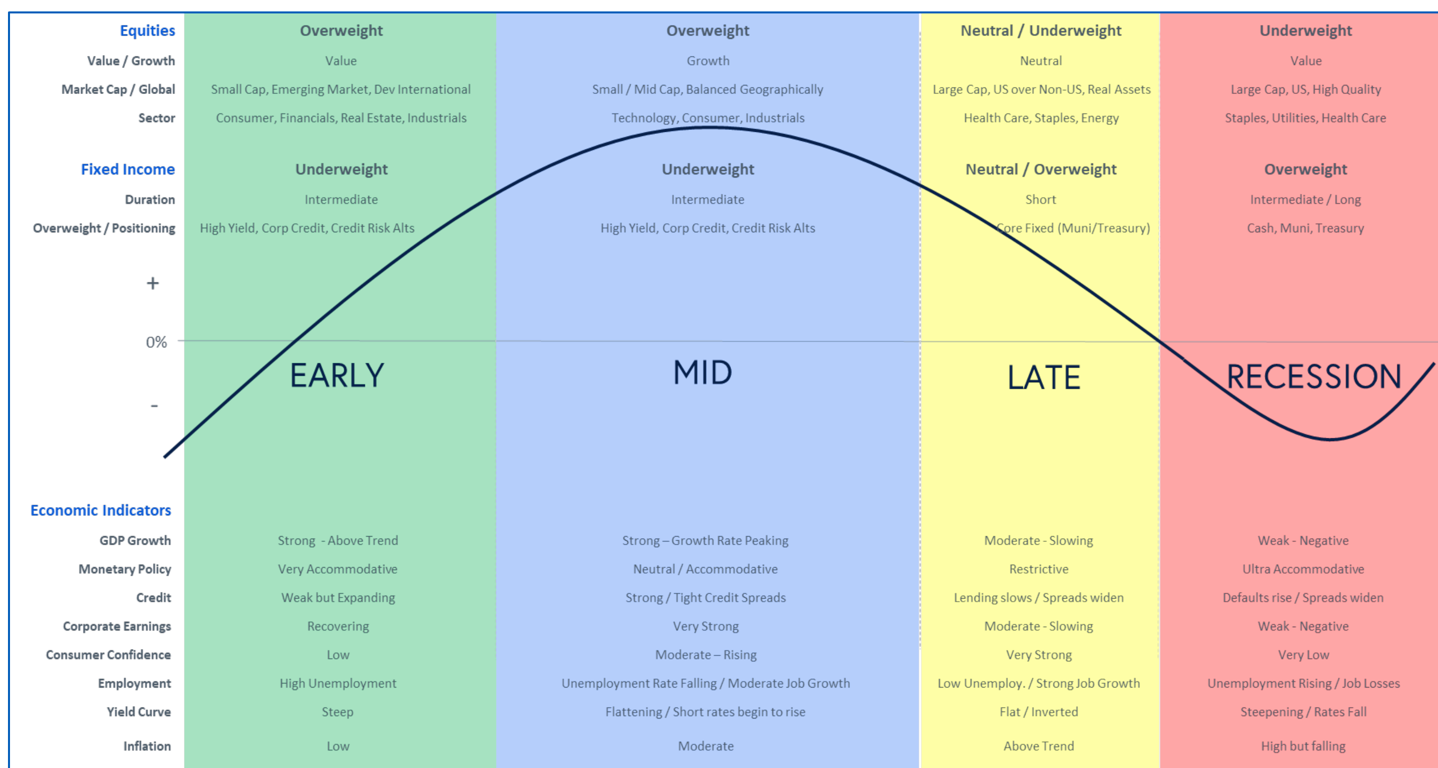
- Second consecutive increase to Core Fixed Income with the goal of further normalizing duration. Further emphasizing the hedge against falling rates and/or an equity correction.

- Taking advantage of improved outlook for Credit Risk Alternatives by moving back to Strategic target weights.

- Trimming overweight to Equity Risk Alternatives back to neutral versus Strategic targets. Recognizing that it will take time to receive proceeds for LP investors, we are lifting Small Cap U.S. Equities back towards target in anticipation of the end of the interest rate hiking cycle.

- Reducing holdings of Short-duration/Cash to fund extension of duration and Credit Risk Alternatives looking to lock in yields in anticipation of a near-term peak. The remaining short-duration exposure is an offset to the underweight to Growth ("equities") which we have maintained while the U.S. Market Cycle Dashboards register negative readings.

- Though not a tactical adjustment, a strong recommendation to assess overall liquidity budget for portfolios to allocate to Private Markets, as valuations offer the potential for improved vintage returns.



After a difficult 2022 for financial assets, we expected 2023 to deliver the road back to normal. We just expected it to be bumpier (with all due respect to those in the regional banking sector). Macro risks — for example, geopolitical ones such as U.S./China relations, fiscal ones such as rising U.S. debt service, and the far-from-conquered developed market inflation battle — drive our cautious positioning. However, we are guided and disciplined by the medium- and long-term outlooks embedded in our tools like the Dashboards and Capital Market Assumptions. Indeed, while 2023 is far from over, we have witnessed some market normalization that long-term, goals-oriented investors should cheer. Specifically, the return for each unit of risk in fixed income has increased dramatically. Along the same lines, we think the deconditioning of investors to expect low interest rates is in process, and we are hopeful this lack of low rates suggests better capital allocation across the board for risk assets.

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