46 PEAKS
INVESTMENT ADVISORY GROUP

Nice Work If You Can Get It.

ERIK MOSHOLT, CFP®
Chief Investment Officer

July 2023

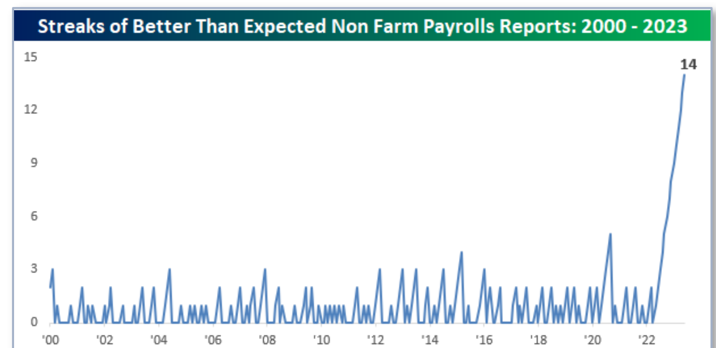
Halfway through 2023, so far this year the financial markets and the economy have produced a comedy of forecasting **errors**, a litany of **surprises**, a sense of **déjà vu**, and a bevy of **opportunities**. And oh, by the way, attractive gains as well.

At the beginning of the year, we wrote about how we were encouraged by the near uniform negativity of market analysts. We noted that when there is near unanimous conviction in a particular outcome, that it's unlikely to happen. For the first time on record, Wall Street analysts, in aggregate, were **predicting a down year for stocks in 2023**. So, what's happened so far? In the first quarter, the S&P 500 index shrugged off bank failures and gained 7.5%. Then it ignored the debt ceiling standoff in the second quarter and advanced another 8.7%, finishing June up 16.9% year-to-date. Oh, to be a well-paid Wall Street analyst. Nice work if you can get it.

Stock market returns this year, however, have been so concentrated that they could easily trigger a sense of déjà vu for many. Tech stocks have rallied like 1999's Tech Bubble or 2020's COVID bounce. Thanks to the sudden emergence of Artificial Intelligence (AI) as the next-big-thing, Tech stocks rallied over 17% in the second quarter and are up a whopping 46% over the first six months. Benchmark performance has been largely fueled by gains in large, well known stocks including Apple, Microsoft, Meta (Facebook), Google, and Nvidia. The 8.2% year-to-date gains of stocks of smaller companies, as measured by the Russell 2000 index, are about half of the gains of larger stock benchmarks.

Another déjà vu moment could be triggered by the performance of Bonds this year. For the longest time, decades in fact, Bonds were boring. But when interest rates started rising from near zero, Bonds were suddenly exciting - in a bad way. The Core Bond index declined over 13% in 2022. Yields have been on somewhat of a roller coaster this year – falling in the first quarter, fueling a 3.1% return for Core Bonds, but then spiking back up in the second quarter, leading to a 0.90% loss for Core Bonds over the last three months. While this year's volatility is certainly lower than last year, it is still elevated compared to the previous few decades.

A defining characteristic of recent market developments is how amazingly **wrong** professional economists have been. I mean, really, really, wrong. Like, it's hard to be *that* wrong. Take a look at this chart for one embarrassing example. It shows, going back over 20 years, the number of consecutive months that economists, in aggregate, underestimated the *strength* of the jobs market.



As you can clearly see, it's rare for them to underestimate the jobs market for more than 3 consecutive months. Why? Even if they're not good at what they do and they're wrong 2 or 3 months in a row, historically they would adjust their forecasts month to month to reflect new data. In this cycle, they've been wrong a wildly unprecedented 14 consecutive months! Yet, I bet none of them have been fired. Again, nice work if you can get it.

Looking at broader measures, the Citigroup Economic Surprise Index, which compares consensus *estimates* of economic data against actual *realized* figures, has been positive since early February. This means that in aggregate, economists have been (wrongly) surprised at the strength of the overall economy each of the last **five months in a row**. *(Will they get to 14 months?)*

Since the worst bear markets are associated with recessions, we take recession forecasting very seriously and subscribe to an independent research service largely focused on recession forecasting. They have 14 different recession forecasting models – every single one has fired a warning shot indicating that, based on historical data, the economy should already be in a recession. Half – seven – of these models say that the recession should have started last year! We, and many other institutional investors, pay good money for this service every year. Nice work if you can get it.

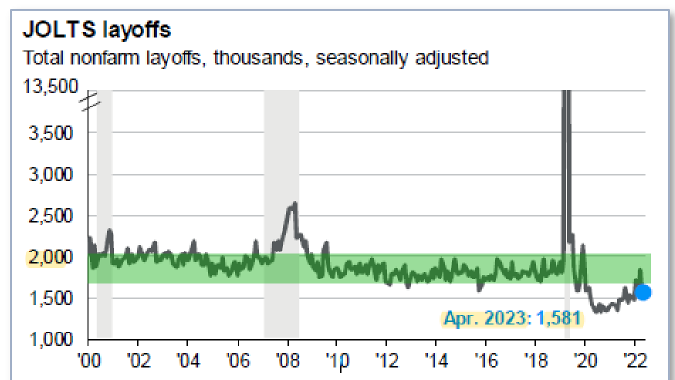
We mentioned it last quarter, and we think it bears repeating – What we think most economists, and their models, are getting wrong is the continued impact of two things related to COVID. For one, COVID-related stimulus was so large, and unprecedented, that historical models have never had to consider the enormity of this level of money printing. Ned Davis Research estimates that, compared to pre-pandemic levels and historical trends, there is still **$3.2 Trillion** (with a "T") of excess savings in the developed world. This printed money does not just disappear due to higher rates.

Secondly, the pandemic resulted in millions of workers dropping out of the labor force permanently (mostly over the age of 55). With fewer workers, the job market remains exceptionally tight. Anecdotally, we recently spoke with a retired CEO of a packaging company who said that he thinks many CEOs will be very hesitant to lay people off since it's so hard to find and hire good people. It's hard to get a recessionary decline in GDP until people start losing their jobs and consumer spending takes a hit.

With Federal Reserve policy still the center of any market analysis, we must continue to keep a close eye on the most important factor to the Fed - inflation. Recent developments are encouraging. June's inflation figures reflected that both the widely followed "Headline" CPI as well as "Core" CPI were lower than consensus forecasts. Economists got it wrong again - **Surprise!**

If we dig a little deeper, the statistics reveal two important developments that are also encouraging. For one, used car prices have been a major source of inflation the past year. (I can vouch for this as earlier this year I bought a used car, and it was a hellish experience.) In June, the Manheim Used Vehicle Value Index dropped 4.2% - down for the third consecutive month. Secondly, housing expenses remain a major source of headline inflation, yet many analysts agree that the government's figures for housing inflation are slow to react to reality on the ground, meaning that in today's environment, housing inflation is likely lower than the government's figures. If we remove Shelter, Core CPI was only 2.7% over the last 12 months – the slowest rate since March 2021. Looking at just the month of June, if we remove Shelter expenses, inflation was near zero – a major win!

These improvements in the inflation picture have occurred without much damage to the labor market. This chart of nonfarm layoffs shows how layoffs have spiked to well over 2 million during each of the past three recessions (the grey shaded areas). Yet, we're currently at fewer than 1.6 million layoffs. If job losses are needed for a recession, then we're still far away from labor market dynamics that would create those events.



If analysts would pull their heads out of their historical models, they'd see other evidence of an economy that is standing strong in the face of higher rates. To wit:

- **Travel is thriving**. Have you tried booking a hotel lately? The busiest day EVER in the history of commercial aviation occurred earlier this month – nearly 135,000 flights globally in one day.

- Despite higher mortgage rates, **housing is holding up**. As a group, the stocks of publicly traded Homebuilders have hit 52-week highs, with the iShares Homebuilders ETF up 41% year-to-date through June.
- The NFIB Small Business Optimism Index rose 1.6 points in June, the most in ten months, to 91.0, the highest level since November.

Turning from the economy to the markets, despite the already strong returns this year, we think that for those willing to look beyond the S&P 500 index, there remains significant investment **opportunity**. For the first time that we can recall, we like Bonds. Yields are attractive. Unlike last year, we think risks are low since we believe it will be difficult for yields to climb much higher (which would lower bond prices). With rates bouncing back in the second quarter, we took the opportunity to add a meaningful amount of U.S. Treasury exposure to most portfolios in early June.

But there's much more to the Bond and Credit markets than just U.S. Treasuries. Late last year, at a friend's house for dinner, someone asked me where I thought the best investment opportunities could be found. I answered, Private Credit. He looked at me puzzled. *"Private Credit? What's that? Loansharking?"* I laughed, as I'd never thought of it that way. But to be honest, yes, kind of.

Investable debt takes several forms. The most common forms of "Public Debt" are bonds issued by large corporations and government entities. But there are tens of thousands of businesses not large enough to issue publicly traded bonds or to get loans from banks. Many banks also have rigid underwriting standards and may shy away from certain types of lending, regardless of a company's size or strength.

Enter Private Credit – **Non-Bank Lenders** who make loans to individuals and businesses. These lenders make a wide variety of loans, some secured by underlying collateral. Many of them made to strong private companies that are both profitable and stable. In other words, they're safer than they sound. So, if U.S. Treasury debt is yielding 4-5% and a new 30-year mortgage on a house would yield around 7% to the bank, what do you think the interest rate on a private loan would be? Well, it's not the 20-25% rate found on most credit cards, but it's a lot higher than U.S. Treasuries and a home mortgage - Interest rates are now well over 10% on a wide spectrum of private business loans. Thanks to innovations in the financial product marketplace, we can now invest in these loans. In June, we added a Private Credit strategy to many of our portfolios. We plan to add another in about six months, as we think it's prudent to stagger these additions.

Other opportunities that we're excited about in the Alternative Investment category are Private Equity (PE) "secondaries". Our PE managers are pounding the table on the opportunities in the secondary market (when PE fund investors wish to sell their existing positions). They say the secondary market is the most attractive it's been in a decade, with many deals being done at 20% discounts to net asset value. Following relatively flat performance for many PE funds the first half of the year, we think the opportunity in secondaries, plus the potential for Private Fund values to "catch up" to the robust returns of the public markets in the first half, could produce attractive returns in Private Equity in the second half.

Elsewhere, we've found opportunities in Mid Cap stocks, which are trading at a 28% valuation discount to Large Caps, the largest in over 30 years. In light of this, we trimmed some Large Cap exposure and increased our allocation to Mid-Caps in many portfolios. We also continue to hold an ETF that invests in Emerging Market stocks and utilizes options to hedge away the first 15% of downside over a 12-month period. The price to pay for this downside protection is that gains are limited to about 18% over 12 months. We think this is an attractive tradeoff, especially for this asset class.

So, markets are off to a good start, higher yields are creating opportunities, some Alternative investments may be unusually attractive, and the inflation picture is improving. What's not to like? While we do feel good about things in general, real **risks remain**.

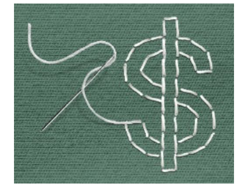
For one, we have a hard time concluding that all 14 of those previously mentioned recession models will turn out wrong. In the forecasting business, it's not uncommon to claim…*"I wasn't wrong, I was just early!"* Time will tell, but not enough time has passed yet to be sure. Many of the economists that have been wrong this year are simply pushing their recession forecasts back to 2024.

Secondly, the concentration of the S&P 500 is a concern. The performance of its top stocks has the index

concentrated to a degree not seen in decades. This graph, courtesy of JP Morgan, shows the weight of the top ten stocks in the S&P 500 rising to a whopping 31.7% - far above the peak of about 27% reached at the height of the Tech bubble in 2000. At this weight, you would like to see the weight of these stocks' earnings close to that of their market cap - at 30% or more. But alas, the top ten stocks account for only 21.5% of the S&P 500 earnings. The P/E ratio of the top ten stocks is about 29.3x earnings while the remaining 490 stocks sport a P/E ratio of only 17.8x. Quite simply, "the market" as most people view it, is far from diversified. And expensive.

While we're enjoying the stock market returns this year, the one **conundrum** we can't see a way out of is the current relationship between stock market valuations, higher interest rates, and the Federal Reserve. The challenge goes like this – We don't think the Fed will lower short-term rates unless it starts to see real weakness in the Labor market. (Why would they risk reigniting inflation until there is real visibility into meaningful job losses?) But weakness in the Labor market would reflect weakness in the economy. And a recession would be bad for stocks.

Alternatively, the economy and the job market do not weaken, and the Fed holds rates at current levels. But if the Fed leaves short-term rates around 5%, then we think both stock and bond valuations are too high. The only way out of this that is good for both stocks and bonds is if inflation declines enough (say to 2.5%), stays there, and the job market starts to weaken (but not too much). Under this goldilocks scenario, the Fed feels comfortable lowering rates and we avoid a recession. This seems to us like trying to thread a needle in an old car that needs new shocks, on a bumpy road, going 70 mph, with the windows open.



In the end, our differentiated, somewhat non-consensus view is that perhaps the economy is not as tied to interest rates, or at least bank lending, as it used to be. And we're open-minded to it being different this time - Thanks largely to COVID related factors, perhaps inflation can cool without a lot of people losing their jobs. If these theories turn out to be true, then the Fed should be done raising rates, and maybe the needle can be threaded. But we're also wise, experienced, and perhaps cynical enough to know that the most insidious outcome would be for investors to let their guard down and rush into stocks now that it looks like the coast is clear, only for a recession and another bear market to hit in '24.

I've mentioned it sarcastically a few times so far, but do you know what really IS good work if you can get it? Being an **INDEPENDENT** Investment Advisor. As an independent advisor, we're somewhat insulated from and immune to the Wall Street groupthink that was so convinced of an imminent recession only 6-9 months ago. We can access innovative Private Credit funds with attractive risk return profiles, some of which are only available to independent firms like ours. Private Equity and other Alternative investments are in our tool kit. And we can be very active some years (like this year), while patiently sitting on our hands other years, unworried about transactions or commissions either way. Our flexibility has us thrilled with our current portfolio positioning. And while we would not be surprised by a minor correction following such strong returns the past nine months, we do think investors should "take the win" of the first half – Therefore, your job now is to not worry about your portfolio, relax and enjoy the rest of your summer!

This report was prepared by 46 Peaks LLC, a U.S. SEC registered investment advisor, and reflects the current opinion of the firm, which may change without further notice. This report is for informational purposes only and nothing contained herein should be considered as investment advice or a recommendation or solicitation for the purchase or sale of any security or other investment. Opinions contained herein should not be interpreted as a forecast of future events or a guarantee of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be either suitable or profitable for a client's portfolio. Economic factors, market conditions, and investment strategies will affect the performance of any portfolio and there are no assurances that it will match or outperform any benchmark. Diversification does not ensure a profit or protect against loss in a declining market. Registration as an investment advisor does not constitute an endorsement of the firm by securities regulators nor does it indicate that the adviser has attained a particular level of skill or ability. Commentary regarding the returns for investment indices and categories do not reflect the performance of 46 Peaks LLC, or its clients. Historical performance results for investment indices and/or categories generally do not reflect the deduction of transaction and/or custodial charges or the deduction of an investment management fee, the incurrence of which would have the effect of decreasing historical performance results. Figures contained herein are obtained from sources deemed reliable, but we do not guarantee its accuracy or completeness. Past performance is no guarantee of future results. Investments fluctuate in value. 46 Peaks is independently owned and operated. Except where otherwise noted, index performance and economic statistical information sourced from JP Morgan Asset Management or Morningstar. ©2023 46 Peaks LLC.