ALPHACORE
WEALTH ADVISORY

2023 First Quarter Commentary

ECONOMIC RECAP AND MARKET SUMMARY

Strong equity market performance and overall decent economic growth characterized the first quarter of 2023, save for the unexpected banking crisis that emerged in March across the United States and Europe. Given this recent development, the Fed's battle to combat inflation will likely take a pause, as it shifts its focus toward maintaining financial stability. Banking stress is inherently deflationary, as lending slows due to increased credit risk, which oddly enough helps cool inflation. In response to the new Fed policy expectations, traders are pricing a year-end rate that would be approximately 0.50% lower than the current rate. The Fed's "dot plot" is still signaling another 0.25% increase before then. Our view differs from the market consensus. With inflation still so far above its 2% target, we believe the Fed will continue to refrain from lowering rates. To pivot now would further stain their credibility and potentially trigger even greater interest rate volatility the next time inflationary pressures emerge. It would make little sense to cut rates to levels below the level of inflation, especially if there are structural conditions in place that are not yet well understood by both the Fed and the market.

FIGURE 1: ASSET CLASS RETURNS

Asset Class Returns	1Q 2023
NASDAQ Composite TR USD	17.05
Russell 1000 Growth TR USD	14.37
S&P 500 TR USD	7.50
iShares 20+ Year Treasury Bond ETF	7.45
MSCI EM NR USD	3.96
Bloomberg US Agg Bond TR USD	2.96
ICE BofA US High Yield TR USD	2.80
Bloomberg US Treasury 3-10 Yr TR USD	2.77
Russell 2000 TR USD	2.74
Russell 1000 Value TR USD	1.01
US Fund Multistrategy	1.00
US Fund Systematic Trend	-4.82
Bloomberg Commodity TR USD	-5.36

Figure 1: Source: Morningstar, 3/31/2023

The most notable development during the quarter was the banking crisis set in motion by the fall of Silicon Valley Bank on March 9, followed shortly after by Credit Suisse. By now, the reasons behind these bank failures have been thoroughly expounded upon. What is important to highlight are the consequences and secondary impacts from these events. Ultimately, the banking crisis will serve as an impediment to growth. The collapse of several large banks will force both households and businesses to re-assess their consumption and borrowing, softening short-term demand. There are thousands of regional and community banks with less than $250 billion in assets, which account for nearly 50% of commercial and industrial lending and a majority of commercial real-estate lending. It is also important to recognize that real estate-related output makes up about a quarter of the U.S. GDP. Our attention now shifts to the uncertainty that will trickle down into the real estate, private equity and private credit markets. We currently maintain a cautious perspective on both the general economy and our investment allocation, as it remains unknowable the severity of the earnings recession to come.

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ECONOMIC OBSERVATIONS AND OUTLOOK

During the fourth quarter of 2022, U.S. real GDP grew by 2.6%, concluding the full calendar year with a growth rate of 2.1%. [1] Inflation data showed some improvement, but prices in general remained elevated through the end of February, with a one-year increase of 6%. The past three months also witnessed a robust pace of job creation with approximately 351,000 jobs added per month. At the same time, wage growth is decelerating, which should be positive news for the Fed. With that said, a closer look at employment data reveals a decreasing number of overtime hours worked and an increasing number of initial claims – both of which reflect a slowing job market corresponding to the Fed's hawkish policies. Indeed, rate hikes are impacting economic momentum and putting pressure on the most credit-sensitive segments of the economy – housing and real estate.

The S&P CoreLogic Case-Shiller 20-City Home Price Index declined 0.6% month-over-month in January, its seventh consecutive decline with 19 cities registering a drop. Yet, home prices more broadly have only experienced a 5% decline from their June 2022 peak. Rising inventory levels and falling industrial output levels have also been observed over the past several months. Altogether, these factors place us firmly in the late stage of the business cycle. From this point on, we expect to see further slowing of the economy. While markets may fluctuate optimistically in the short-term, we believe our defensive positioning for stagflation remains the most prudent posturing for client portfolios.

Two major dynamics will likely lead us there:

1. **U.S. consumers will become exhausted by the fight against inflation and depleting savings.**

2. **In addition, an environment in which there is a higher cost of capital will persist, along with a worsening of global challenges - thereby increasing the consequences for missteps by central bankers, policy markets and corporations.**

FIXED INCOME MARKETS

Bond yields retraced significantly from their 2022 highs in response to slowing inflation and fears of a recession arriving later this year. The 10-year Treasury yield closed at 3.494% by the quarter end, a decline of approximately 0.70% from its October 2022 high. The Bloomberg Barclays Aggregate Bond Index delivered a +2.96% total return during this same period, providing 60/40 portfolios some reprieve after a dismal 2022. Credit spreads remained largely unchanged for the quarter, but a higher starting point for yield levels offered some value for investors bidding on duration. Front end rates in the Treasury markets also became very attractive in early March, hitting levels of ~ +5%. We opted to reallocate capital to secure some liquidity and yield in the form of short duration fixed income, but still remain underweight duration and credit relative to our benchmarks.

[1] Source: Bureau of Economic Analysis

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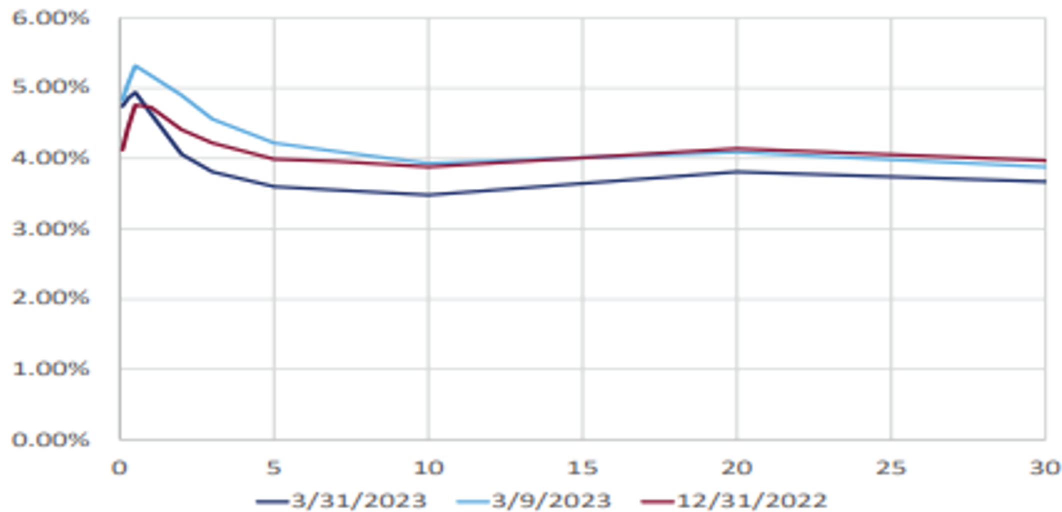
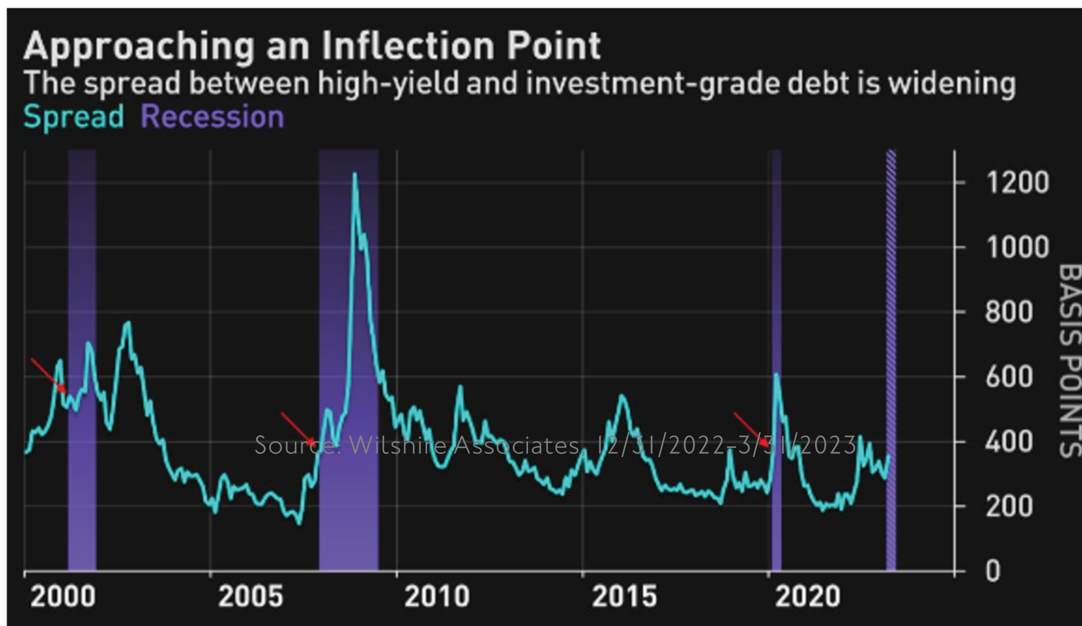
The inverted yield curve, depicting a situation in which front-end borrowing rates exceed longer-end borrowing rates, has forecasted a slowing economy for several months now. The spread between the three-month T-Bill Yield and the 10-Year Treasury yield increased 1.37% by quarter end. This level of inversion has not been seen since the early 1980s. As the below graph illustrates, all points beyond the short end of the yield curve highlight inversion. Historically, an inversion of this magnitude was considered a very strong signal for an economic contraction. Additionally, we are starting to see other market signals that advise caution with increasing frequency. These include rising risk premiums for borrowers and higher spreads between high-yield and investment grade debt.

FIGURE 2: INVERSION IN THE U.S. TREASURY CURVE



Source: Wilshire Associates, 12/31/2022-3/31/2023

FIGURE 3



Source: Bloomberg, 2000-2023

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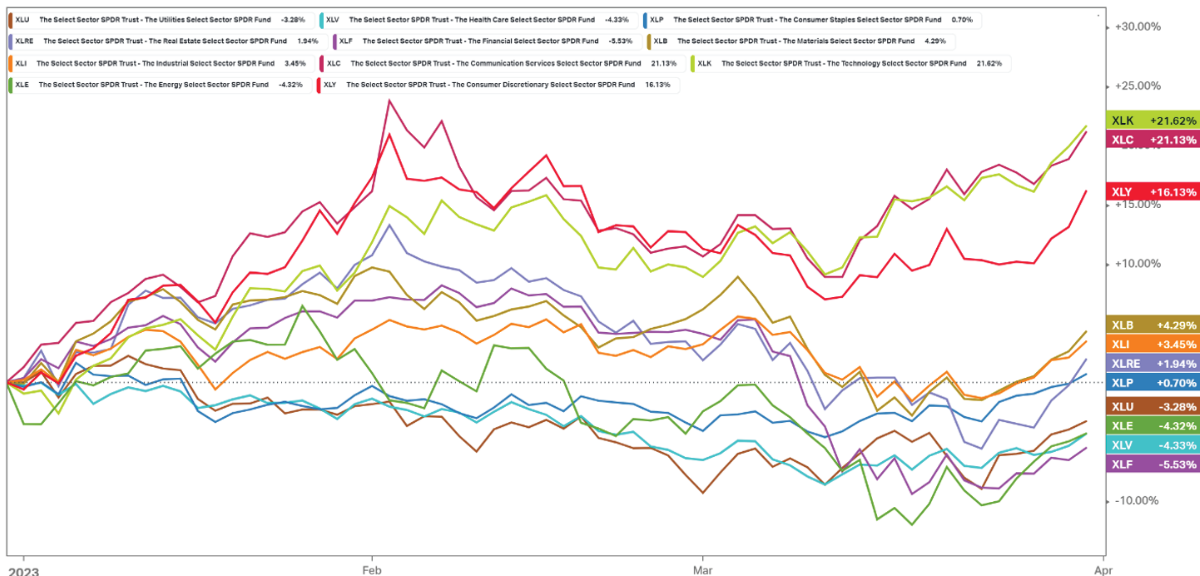
Looking forward, our investment team plans to remain underweight broad credit exposure, since much of the tightening cycle appears yet to be fully priced in. As recessionary conditions emerge, we aim to avoid default risk and gain exposures in this market at a more attractive valuation commensurate with the risks at-hand. An elongated period of higher capital costs should, in turn, compensate lenders with higher all-in yields, given the increased probability of borrower default.

EQUITY MARKETS

Broad equity market indices posted positive returns during the first quarter of 2023, with the tech-heavy NASDAQ Composite Index delivering a +17.03% return for the period and the S&P 500 delivering +7.03%. Upon closer examination, individual sector and factor performance reflected very little breadth in returns. Investors heavily favored large-cap and growth-oriented market segments. The YTD sector performance shown in Figure 4 tells a similar story. The technology sector and communication sector both far outpaced other segments during the period, posting returns of +21.62% and +21.13% respectively. With the recent "flight to quality," investors are showing a strong preference for companies with favorable balance sheet characteristics – high interest coverage ratios, high margins, and strong revenue growth. Much of the rally in large caps and growth stocks we believe is unsustainable in that many of the names that participated in this "quality" bid were chased at too high a price.

Looking ahead, we still feel that earnings growth expectations are likely overestimated and that investors will be underwhelmed by generally lackluster corporate profitability. The below charts highlight the clear lack of breadth in this recent rally and the overconcentration of contribution at the S&P 500 Index level.

FIGURE 4



Source: Koyfin, 01/2023-04/2023. Any ETFs in the above chart are solely being used as a proxy for market indices due to availability of current data. This is not intended to reflect securities bought and sold by AlphaCore.

During the first quarter of 2023, our equity allocation lagged in the broader global equity markets. We were underweight in U.S. large-cap growth and were slightly overweight in ex-U.S. financials, which acted as a headwind. Despite a quarter of underperformance, our equity holdings remain biased toward firms with strong free-cash-flow yield and strong balance sheets. With recessionary conditions looming, we are prioritizing the durability of profits.

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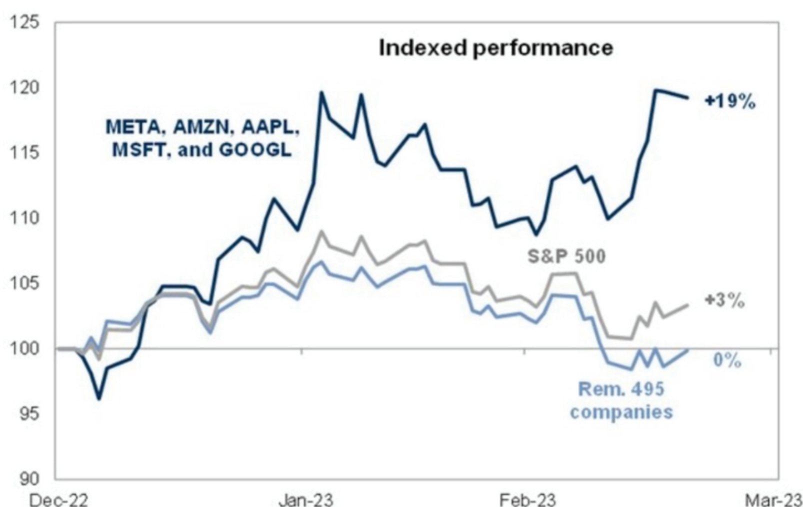
FIGURE 5



Source: Goldman Sachs, 12/2022-03/2023

ALTERNATIVE INVESTMENTS

Alternative investments performance was overall mixed this quarter. The most notable detractors were global macro hedge funds.

Many macro hedge funds were caught off guard when the banking crisis unfolded in early March, as their previously profitable long-inflation positions from 2022 abruptly faltered. These managers were poised for interest rates to continue rising by shorting bonds. Such a position expressed a view that inflationary pressures would persist, therefore forcing central banks to keep financing costs higher for longer. Though macro data appeared to support this strategy, at the onset of the SVB banking crisis, investors flocked to bonds as fears of financial instability consumed the market. Many hedge funds, including our CTA/Managed Futures and Discretionary Macro funds, were forced to abandon their inflation trades, and were thus negatively impacted.

Our long-short equity manager delivered positive returns for the period. A combination of net long positions in technology and communication services drove consistently strong performance throughout the quarter, while a net short position in financials contributed positively during the month of March. Other winners included exposures in various private credit lending platforms and structured credit hedge funds. Strong performing loans and strong credit selection contributed to positive returns. Most of the remaining alternative strategies and asset classes in our portfolios were either up modestly (real estate) or generally flat (multi-manager platforms).

CONCLUSION

The investment landscape has moved in the last two years toward a market that necessitates a strong focus on both fundamental and macro-based investing. From a portfolio construction standpoint, we believe that remaining defensive today makes the most sense, especially since risk assets appear to have further room to fall in the likely case of disappointing corporate earnings. Furthermore, confidence in the banking system has been shaken. Another shock to the system could potentially worsen credit conditions and fuel a much sharper contraction than what asset prices currently account for. However, our base case remains a steady decline into stagflation, with central banks far more restricted in the short term when it comes to stimulating the economy with inflationary pressures persisting. Policymakers are pushing the boundaries of stimulus, and we possess the agility to pivot our positioning based on incoming data. As always, thank you for your trust and confidence in our team, and please reach out to me or your advisor if you have any questions.

JOHANN LEE, CFA®

Director of Research

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- BLOOMBERG BARCLAYS CAPITAL US AGGREGATE BOND INDEX: The index consists of approximately 17,000 bonds. The index represents a wide range of securities, from investment grade and public to fixed income.

- ICE BOAML HY INDEX: The index is a commonly used benchmark index for high-yield corporate bonds. It tracks the performance of US dollar denominated below investment grade rated corporate debt publically issued in the US domestic market.

- RUSSELL 3000 INDEX: The Russell 3000 Index is a market-capitalization-weighted equity index maintained by the FTSE Russell that provides exposure to the entire U.S. stock market. The index tracks the performance of the 3,000 largest U.S.-traded stocks which represent about 98% of all U.S incorporated equity securities.

- RUSSELL 2000 INDEX: The Russell 2000 Index is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

- MSCI ACWI (ALL COUNTRY WORLD) INDEX: The MSCI ACWI is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI Index is comprised of stocks from both developed and emerging markets.

- MSCI EMERGING MARKETS INDEX: The MSCI Emerging Markets Index is used to measure the financial performance of companies in fast-growing economies around the world. The index tracks mid-cap and large-cap stocks in 27 countries, dominated by Chinese, Taiwanese, and South Korean companies.

- S&P 500 INDEX: S&P 500 index is a float-adjusted market-cap weighted index, largely reflecting the large-cap US equities. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

- NASDAQ 100 INDEX: The Nasdaq 100 Index is a basket of the 100 largest, most actively traded U.S companies listed on the Nasdaq stock exchange. The index includes companies from various industries except for the financial industry, like commercial and investment banks.

- PURCHASING MANAGERS' INDEX (PMI): PMI Index is an indicator of economic health for manufacturing and service sectors. The purpose of the PMI is to provide information about current business conditions to company decision makers, analysts and purchasing managers.

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- ISM MANUFACTURING INDEX: The ISM Manufacturing Index is a widely-watched indicator of recent U.S. economic activity. The index is often referred to as the Purchasing Manager's Index (PMI).

- THE BLOOMBERG COMMODITY TOTAL RETURN INDEX: The BCOM TR Index is composed of futures contracts and reflects the returns on a fully collateralized investment in the BCOM. This combines the returns of the BCOM with the returns on cash collateral invested in 13-week (3 Month) U.S. Treasury Bills.

- CBOE VOLATILITY INDEX (VIX INDEX): The VIX Index is a real-time market index used to measure the market's expectation of future volatility. Being a forward-looking index, it is constructed using the implied volatilities on S&P 500 index options (SPX) and represents the market's expectation of 30-day future volatility of the S&P 500 index which is considered the leading indicator of the broad U.S. stock market.

MORNINGSTAR CATEGORIES

MORNINGSTAR MULTI-STRATEGY: This is a Morningstar alternative strategy category. For a multi-asset strategy to qualify in an alternative category, greater than 30% of a strategy's gross exposure must be allocated to alternative substrategies. Alternative substrategies should provide an 'alternative' exposure to the dominant risk factors found in traditional indices, and as standalone strategies, would generally fall into one of the other Morningstar alternative categories: Equity Market Neutral, Event Driven, Macro Trading, Options Trading, Relative Value Arbitrage, and Systematic Trend.

MORNINGSTAR SYSTEMATIC TREND: This is a Morningstar alternative strategy category. Systematic trend funds mainly implement trend-following, price-momentum strategies by trading long and short liquid global futures, options, swaps, and foreign-exchange contracts. Strategies invest across geographies and assets, including equities, fixed income, commodities, currencies, and more.

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