ALPHA CORE
WEALTH ADVISORY

2023 Third Quarter Commentary

MARKET UPDATE

Several economic data points and policy news may have spooked investors into pausing their bid for risk during the third quarter, as risk assets seemed to reverse their strong positive performance trend.

- **While disinflationary forces have been in place for certain parts of the economy, inflation metrics in aggregate remained firmly above the 2% guidance laid out by the Fed.**
- **The Fed reaffirmed its hawkish stance on borrowing rates.**
- **Tight energy inventory supply caused crude oil prices to rise meaningfully throughout the period.**

FIGURE 1: ASSET CLASS RETURNS

Asset Class Returns	3Q 2023	2023 YTD Returns
Bloomberg Commodity TR USD	4.71	-3.44
US Fund Systematic Trend	1.20	1.30
ICE BofA US High Yield TR USD	0.53	5.97
US Fund Multistrategy	0.16	3.23
Bloomberg US Treasury 3-10 Yr TR USD	-1.91	-0.74
MSCI EM NR USD	-2.93	1.82
Russell 1000 Growth TR USD	-3.13	24.98
Russell 1000 Value TR USD	-3.16	1.79
Bloomberg US Agg Bond TR USD	-3.23	-1.21
S&P 500 TR USD	-3.27	13.07
NASDAQ Composite TR USD	-3.94	27.11
Russell 2000 TR USD	-5.13	2.54
iShares 20+ Year Treasury Bond ETF	-13.04	-8.80

This past quarter reminded investors of the unique challenges in place during this cycle, persistent inflation and rising interest rates. The 10-year Treasury bond yield continued its steady rise, closing the quarter at 4.58%, a level not seen since October of 2007. By now, most allocators should be aware that these high interest rates can invert the typical correlation between stock prices and bond yields, which has largely driven the 60/40 portfolio's strong historical performance.

Recall, over the past couple decades, falling bond yields acted as a ballast for poor stock returns, until this relationship failed in 2022. In a reversal from first quarter and second quarter, both stocks and bonds posted negative returns in the third quarter, underscoring the relevance of diversifiers and alternative investments. Equities, represented by the *S&P 500 Index*, delivered -3.25%, while the bond market, represented by the *Bloomberg U.S. Aggregate Bond Index*, delivered a -3.23% return.

Conversely, alternative asset classes and most strategies delivered gains. Commodity markets earned a +4.71% return for the quarter, while alternative strategies, such as trend following (represented by the Morningstar U.S. Systematic Trend peer group), and multi-alternative funds (represented by the Morningstar U.S. Multistrategy peer group) delivered +1.20% and 0.20%, respectively.

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ECONOMIC UPDATE

U.S. economic growth at the headline level remains in decent shape as real GDP growth has moderated, amounting to 2.1% during the second quarter. Consumer spending tapered off slightly, contributing approximately a half percent to overall growth. During the third quarter, private as well as public spending both rebounded, with fiscal spending in particular continuing at a rapid pace. The Atlanta Federal Reserve Bureau's GDP Now tool projects GDP growth to be +4.9%.[1]

Additionally, inflation proved stickier than expected, going along with GDP data. The CPI revealed a 1% increase during the quarter, corresponding to a 3.7% increase year-over-year. Another important metric, crude oil, increased in price 28.5% to $90.79 per barrel over the past few months. Taking all of these factors into account, inflation still remains far elevated above the Fed's 2% target.

For the Fed, a welcome sign during the quarter was the softening seen in the labor market. On average, 150,000 jobs per month were added during the three-month period ending in August. Unemployment ticked higher, from 3.7% in May to 3.8% currently. Wage growth moderated as well, but year-over-year figures are still over double the long-term average of 2%.[2]

However, the housing market painted a slightly different picture. In the past quarter, this market began to experience a rebound. The *S&P Case-Shiller 20-City Home Price Index* showed a +2.9% rise during the three-months through July and 0.1% during the trailing 12-months.[3] Despite the rise in prices, transaction data has faltered over the past year, and affordability remains poor given the rise in rates. For example, U.S. Pending Home Sales fell -7.1% in August and is now down -44% from its peak in 2020. Mortgage applications still hover at multi-decade lows. These dynamics are likely to persist given the Fed's objective of controlling inflation. With the recent rise in yields, we maintain a cautious outlook on the housing market. All in all, the latest economic mosaic reaffirms the Fed's messaging of "higher for longer" and keeps the pressure on asset prices.

FIXED INCOME AND CREDIT

The U.S. bond market, represented by the Bloomberg U.S. Aggregate Bond, closed the quarter with negative performance. If rates rise further, this will likely be the third consecutive year that bond markets deliver a negative total return to investors. To further illustrate the strain this new regime has put on bond investors, the "long bond," proxied by TLT (an ETF holding 20+ year basket of U.S. Treasury bonds), is down nearly 43% over the past three years. A drawdown of this magnitude was previously unheard of in the Treasury market, as these were once considered one of the safest assets. In fact, not a single Treasury bond issued in 2023 is above water this year given the subsequent rate rise experienced post-auction. We are indeed in uncharted waters.

Credit markets, on the other hand, have fared better overall than generic high-grade fixed income. All-in yields are at

[1] Bureau of Economic Analysis

[2] BLS, Bureau of Labor Statistics

[3] Standard & Poor's

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historic highs (high single digits yields) thanks to the combination of wider spreads and lower defaults. Unfortunately, the tide may be turning. Small business bankruptcies are increasing at the fastest pace since 2020. As long as financing costs remain elevated, putting pressure on businesses and causing spreads to widen, we remain cautious and highly diligent in our approach to credit selection.

Over the past few months, we have pivoted our attention to the unprecedented "fiscal dominance" that remains following massive spending in the COVID-era. The effects of this spending are finally trickling down to capital markets. According to DoubleLine, the U.S. budget deficit now stands at 7.5% of GDP, a level not seen since the depths of the Great Financial Crisis. Why is this problematic? For one, it appears that fiscal authorities are prematurely blowing through ammunition prior to the economy entering a downturn. More importantly, we believe that the pace of this spending increase is completely unsustainable. In just two years, the interest expense on the nation's shopping spree has skyrocketed from $500 billion to $900 billion. This exorbitant spending and deferral of 2022 tax collections led to increased bond issuance to make up for budgetary shortfalls.

Previous commentaries have highlighted mounting concerns around Washington's deficit spending, including how it has been a key driver of inflation. Until this spending can be brought under control, our economy will continue to shoulder its burden. Mounting public debt crowds out private investment and potentially risks the durability of the U.S. dollar. In sum, unproductive debt and slowing growth combined with an ongoing inflation problem is cause for concern for bond holders.

SO, WHAT DO WE DO WITH THE BOND MARKET?

Despite these headwinds, we are selectively deploying capital across both bond and credit markets. We favor shorter duration (<2 years duration) fixed income instruments, namely Treasury bills. We recognize the reinvestment risk here but prioritize mitigating interest rate risk from potentially higher inflation. There is also a risk of oversupply in the face of unprecedented issuance that may harm bondholders.

Fixed income risk will be added via structured bonds, such as agency bonds (govt. backed mortgage bonds) and non-rated forms of mortgage credit. Mortgage bonds have little to no refinancing risk at this juncture, since mortgage rates have risen so much. Additionally, mortgage bond holders are benefiting from convexity for the first time in history. For these reasons, we believe mortgages are currently less risky than Treasuries, and could generate a higher yield than corporate investment-grade bonds.

At the same time, our alternative managers are identifying a plethora of attractive opportunities in fixed income markets and utilizing their skillsets to tactfully execute on these deals.

EQUITY MARKETS

Much of the AI-related exuberance that pushed equity valuations up during the first half of 2023 waned in the third quarter. While equity market multiples are up year-to-date, real rates (bond yields less inflation) and costs of capital have tightened rapidly, indicating potential trouble ahead. Looking at the broad indices, which posted negative returns for the third quarter, it appears that rising capital costs have already started catching up. Equities face numerous challenges at this point:

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1. The price/earnings ratio (price multiple paid for stocks per unit of forward earnings) sits around 19X on a forward basis – this is about three points higher than the historical 25-year average.
2. Bond yields, which compete as a source of capital, are very high, making equities less attractive on a relative basis. On a variety of valuation yield metrics, stocks look overpriced relative to bonds.
3. Earnings must be robust to support investors purchasing equities at this lofty price level.

FIGURE 2

We maintain our cautious view on equities, primarily due to the ongoing situation with interest rates – higher borrowing costs will continue to hurt consumers, forcing them to pull back on spending. Corporate profits will bear the brunt simultaneously of higher wages, rising debt burdens and falling demand.

SO, WHAT DO WE DO WITH THE EQUITY MARKET?

Our model portfolios are currently underweight equities relative to a 60/40 portfolio. When allocating to stocks, we are extremely selective and favor specific attributes. We remain strong proponents of active investing and believe investors are best served at this stage in the cycle to prioritize profitability and quality factors. Our focus is on companies with high free cash flow, high ROE, low leverage, strong earnings quality and low earnings variability. The below exhibits highlight just how burdensome interest rates have become for both consumers and corporations. As rates rise, both consumer demand and profit margins will fall, as they are intrinsically interlinked.

FIGURE 3

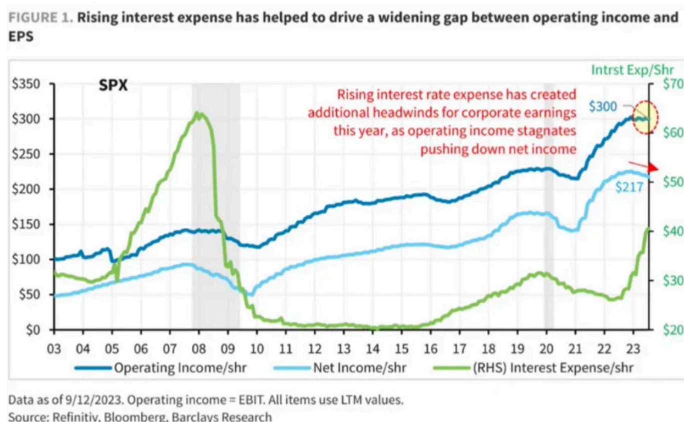
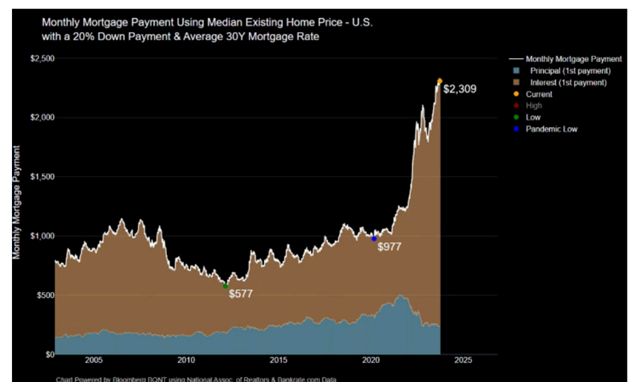


FIGURE 4



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ALTERNATIVE INVESTMENTS

Alternative Investments and strategies generally performed well, providing a ballast against the losses incurred by equity and fixed income holdings.

ALTERNATIVE STRATEGIES

- Our long-short equity manager generated strong absolute returns, mainly due to gains on the short portfolio especially during August and September. Arbitrage-focused strategies, such as convertible arbitrage and event driven equity, also generated modest positive returns during the period.
- Trend-following managers provided diversification benefits as investors repositioned their portfolios to accommodate higher rates for longer. Most systematic trend strategies are now either up or flat year-to-date, having recovered losses from the rate reversal in March. While YTD returns have not been stellar, we emphasize the dynamism that trend following strategies can offer. Bond yields rocketed higher again this year, while energy markets rallied on the back of supply constraints. Managed futures and trend following strategies are a unique exposure in the investment universe due to their ability to go both long and short across a variety of asset classes. With increased volatility in markets, such strategies should be able to harvest returns by taking positions in newly established trends.
- Multi-strategy hedge funds, designed to be duration and equity-beta neutral, delivered on their absolute return mandates this year.
- Our structured credit hedge fund manager capitalized on the mortgage bond dislocation that has played out over the past year. This manager's active approach to credit selection, along with duration hedging, produced outstanding year to date returns in the high single digits.

ALTERNATIVE ASSETS

Private markets performance varies, with some bright spots, and other uneventful areas.

- Corporate middle market lending performed well overall as underlying business fundamentals remained generally intact. Some areas of this market, lower middle-market in particular, are seeing non-accruals pick up, but defaults remain contained and below historical averages. If base rates continue to rise from here, interest burdens are expected to become more of a concern for credit investors. With that said, we favor well-underwritten loan portfolios from large credit platforms that apply cross-cycle experience. A typical loan's all-in-net yield ranges from 10-12%, providing an attractive total return profile. Considering the late cycle dynamics in place today, we believe it is imperative to size risks appropriately.
- Private real estate returns were modestly positive, primarily generated from the net operating income of underlying properties. In past commentaries, we highlighted challenges rising financing costs pose to this asset class. We still remain cautious on this exposure and reduced its weight in our portfolios over the past 12 months. Debt positions have so far performed better than equity positions, as investors are paid handsomely as a lender in today's market.

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CONCLUSION

Hopefully by now, after two years of rising rates, investors are convinced of just how drastically different this regime's investment landscape is from the one prior to 2020. Our goal is to deliver robust portfolios that can perform in a variety of environments. As we navigate portfolios through the end of the year and into 2024, we face many challenges and risks. It is difficult to reconcile our economic outlook with the way risk is currently priced into markets, since opportunity costs and the relative value of assets will change meaningfully as interest rates rise.

Prior to this current rate hiking cycle, cash yields were effectively zero. This free money dynamic triggered a cascade of risk seeking behavior that followed as such: Cash is cheap, so buy CDs, CD rates are low so buy investment grade (IG) credit, IG credit is tight so buy high yield junk bonds (HY), HY is tight so buy stocks, stocks are cheap because the cost of capital and discount rate is zero. This merry go round gets infinitely more complex when you consider derivative positions, but you get the picture. Well, cash is no longer free and now competes with risk assets for an allocation. Therein lies the problem. These risks are discounted, if not ignored, based on the view that the Fed will revert its course quickly if markets enter a drawdown. But the Fed's competing struggle to contain inflation challenges this belief. The good news is that we view this as a great opportunity for thoughtful portfolio allocators. This market more likely rewards diversification and breadth, and that is exactly how we've placed our allocations. Thank you again for your continued support, and please reach out to us if you have any questions.

JOHANN LEE, CFA®
Director of Research

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- **BLOOMBERG BARCLAYS CAPITAL U.S. 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 U.S. dollar denominated below investment grade rated corporate debt publically issued in the U.S. 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 U.S. 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.

- **ISM MANUFACTURING INDEX:** The ISM Manufacturing Index is a widely-watched

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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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Upcoming Events

Oct. 11, 2023
6 P.M. PST

CLIENT APPRECIATION DINNER: NEW YORK CITY

If you are interested in joining this event, please contact us to find out how to register.

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