CAPITAL CREEK PARTNERS REPORT AUGUST 2023

A Mid-to-late Summer Night's Dream | A Midyear Strategy Update

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About Scott

Partner, Chief Strategist

Scott joined Capital Creek Partners in 2023 as a partner of the firm and Chief Strategist. Prior to joining Capital Creek, Scott was the Head of Asset Allocation at UTIMCO where he served on the firm's Management, Investment, and Risk Management Committees. Scott has 35 years of experience having worked as a portfolio manager at Morgan Stanley, Jamison Capital Partners, and Tudor Investments. Scott studied at the University of Texas at Austin, where he received a BBA in finance in 1988.

About Capital Creek Partners

CAPITAL CREEK PARTNERS

A Private Investment Firm, Founded by Families.

We are an investment partner organized to serve the needs of family offices, foundations, endowments, and private investment companies.

Established in 2018, Capital Creek Partners was founded as a boutique multi-family office to serve a small number of prominent families.

Our firm's culture is rooted in *Integrity, Humility, and Excellence*.

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"The course of true love never did run smooth."

– William Shakespeare

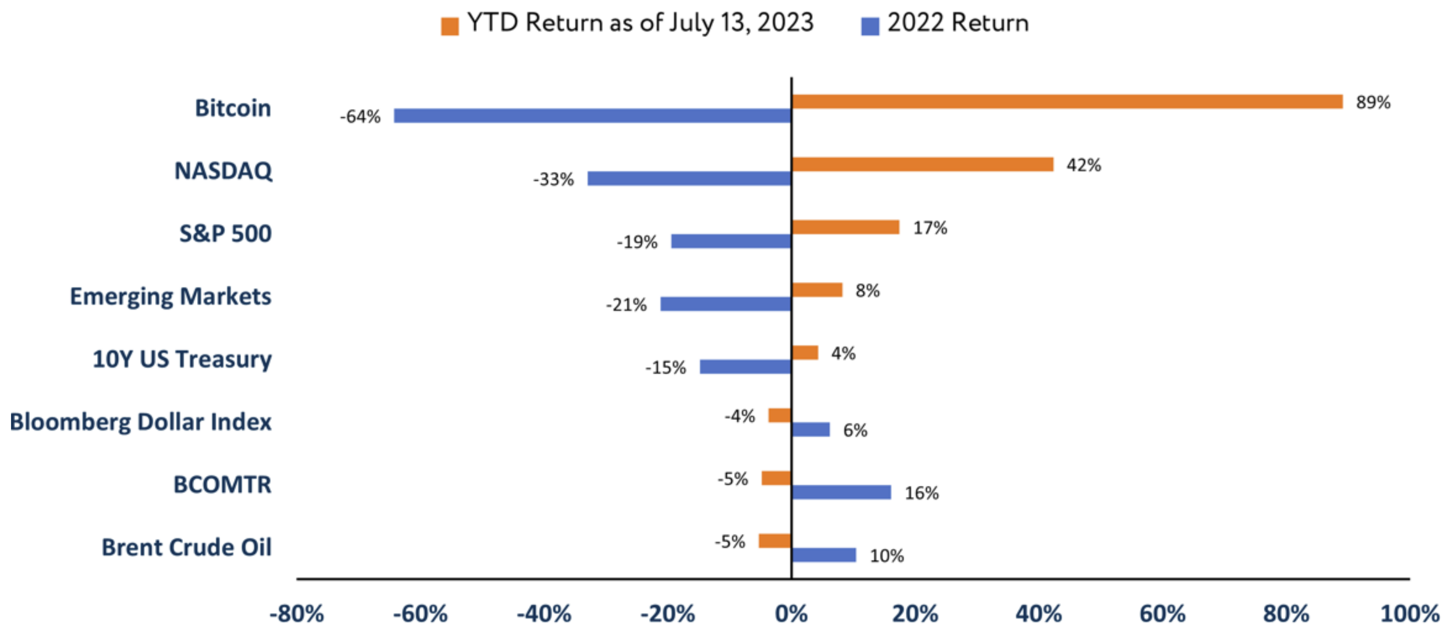
Shelter Island Heights, NY.

Executive Summary

- The first half of 2023 was punctuated by persistently falling inflation, the emergence of artificial intelligence, a slowdown in the pace of Fed rate increases, and the avoidance of a widely anticipated recession in the US. This was indeed a "dreamlike" outcome for investors who chose to participate.
- What a difference a year makes. Returns in several key assets are the mirror image of the devastation experienced in 2022 (see Exhibit 1). However, one anomaly from this dreamlike picture is the US Treasury bond market, which has produced practically zero return in 2023 and may well remain trapped in a bear market, despite a dramatic fall in inflation (see Exhibit 5).
- Equities are relatively early in a bull market, and we advise clients to be at target weights of exposure to the asset class. However, we expect returns for public equities to be more muted in the second half of this year as investors are now excessively optimistic heading into the historically difficult seasonal period from late July through late October. Our 4,500-price target on the S&P 500 Index has been achieved and we have chosen NOT to raise our target at this time. We are unable to raise our top-down earnings estimates and we see no justification to raise multiple assumptions in a period of rising real interest rates.
- Our Tactical Asset Allocation model is now close to the most bearish toward equities in its history. This is a strong warning we are inclined to heed given the excellent performance of this model since its inception. The TAA model now has an extraordinarily strong preference for cash over other major asset classes. In addition, our Tactical Equity Strategy Model (TES) based upon fifty disparate indicators has become bearish on the SPX for the first time since August 2022.
- We are anticipating a material slowdown in US economic growth in the second half of 2023 and into 2024, as the long and variable lags of the Fed's tight monetary policy begin to bite. Earnings in the second half and in 2024 could be at risk. The positive offset to slower growth will be the continued fall in inflation as lower shelter costs work their way into the inflation data.
- The US dollar should remain in a bear market as the rate differential between the US and the rest of world continues to narrow and the Fed becomes less hawkish at the margin. A weaker dollar should help commodities perform better in the second half of the year. A China that becomes more focused and sincere about using policy to stimulate growth could make commodities the surprise outperformer during the remainder of the year.

Exhibit 1: The Mirror Image of 2022

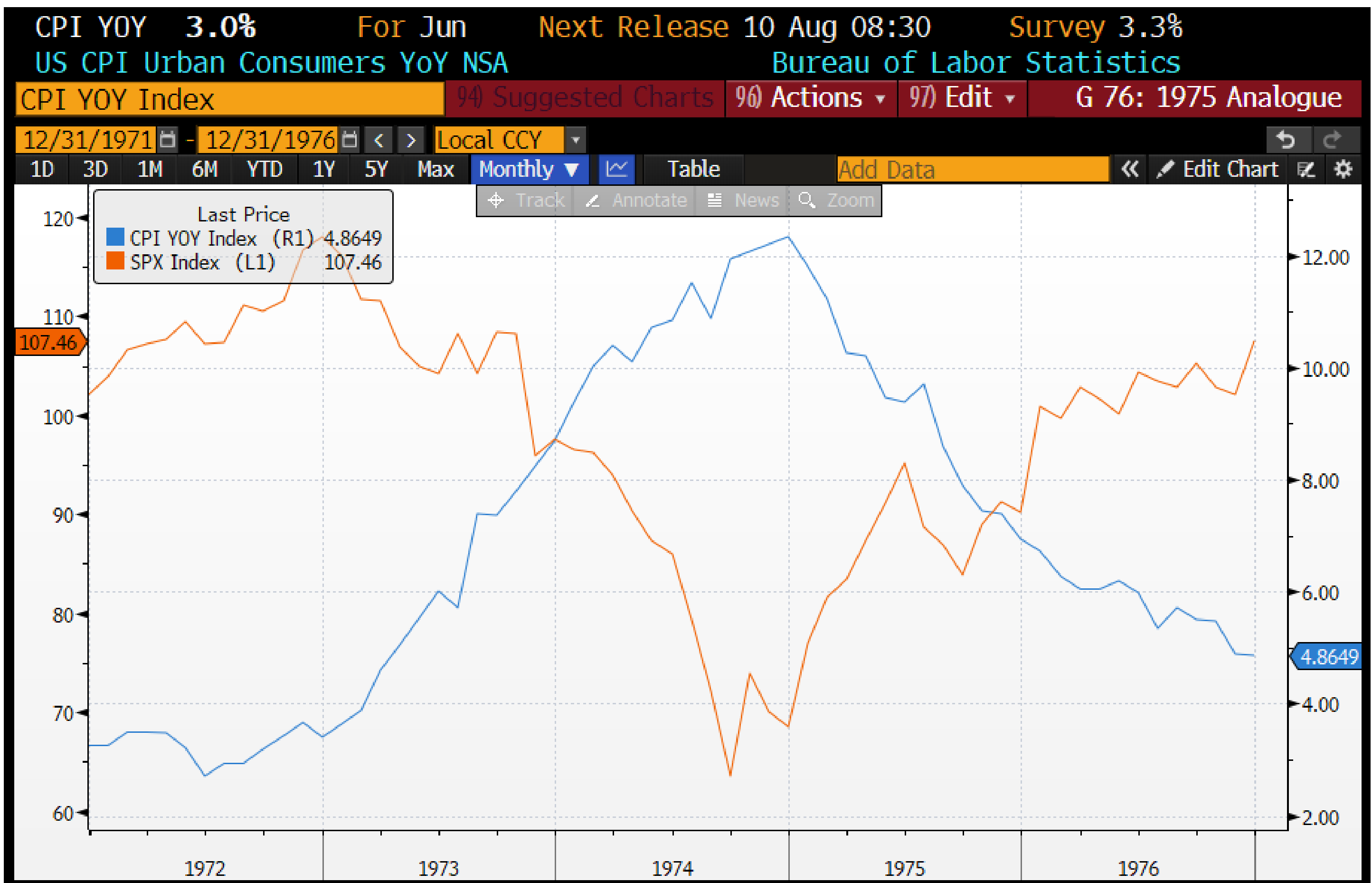
Source: Bloomberg, Capital Creek Partners Research



In important ways, 2023 is shaping up to be the mirror image of 2022. The histogram above illustrates that indeed "the last shall be first and the first shall be last." In our view, it all revolves around inflation. The striking decline in inflation has been the primary fuel driving the risk asset rebound so far in 2023. The 1975-76 analogue of falling inflation and rising equity prices has held perfectly to form this year (see Exhibit 2). If this analogue continues to project the correct path, then the equity bull market has further to run in both price and time.

Exhibit 2: The 1975-76 Analogue; Inflation Down, Stock Up

Source: Bloomberg, Capital Creek Partners Research



Interestingly, even in the 1975 bull market with inflation falling persistently, the SPX fell over 14% from mid-July to mid-September (see Exhibit 3). Even bull markets tend to correct around 10% at some point during the year. I would point out that 1975 was also the third year of the presidential cycle. The '75 bull went on to make new highs in January of 1976. We expect the current bull market to make new highs later this year or in 2024.

Exhibit 3: Even Disinflation Bull Markets Correct

Source: Bloomberg, Capital Creek Partners Research

The explosive adoption of Generative Artificial Intelligence (AI) was the other key factor that has revived animal spirits and has helped to propel equity gains, especially in the technology sector. We wrote extensively about this in our May report entitled The Artificially Intelligent Investor. While the hype surrounding this innovative technology has calmed down, my belief in its ability to transform the way humans work and produce has only grown stronger. AI is on a trajectory that reminds me of the commercial Internet in 1994-95. AI is likely to result in higher productivity, faster economic growth for the US economy, and higher earnings growth for corporate America. Investors are justified in bidding up the technology sector and the S&P 500 because of the emergence of AI.

Finally, the widely anticipated economic recession or what I have been calling the "Godot Recession," has simply not arrived so far in 2023. Because the seemingly inevitable recession was discounted in sharply lower stock prices last year, as the "soft landing" became the new consensus, equity prices glided persistently higher in the first seven months of this year.

Exhibit 4: Tactical Asset Allocation Model Extremely Underweight Equities

Source: AGMR

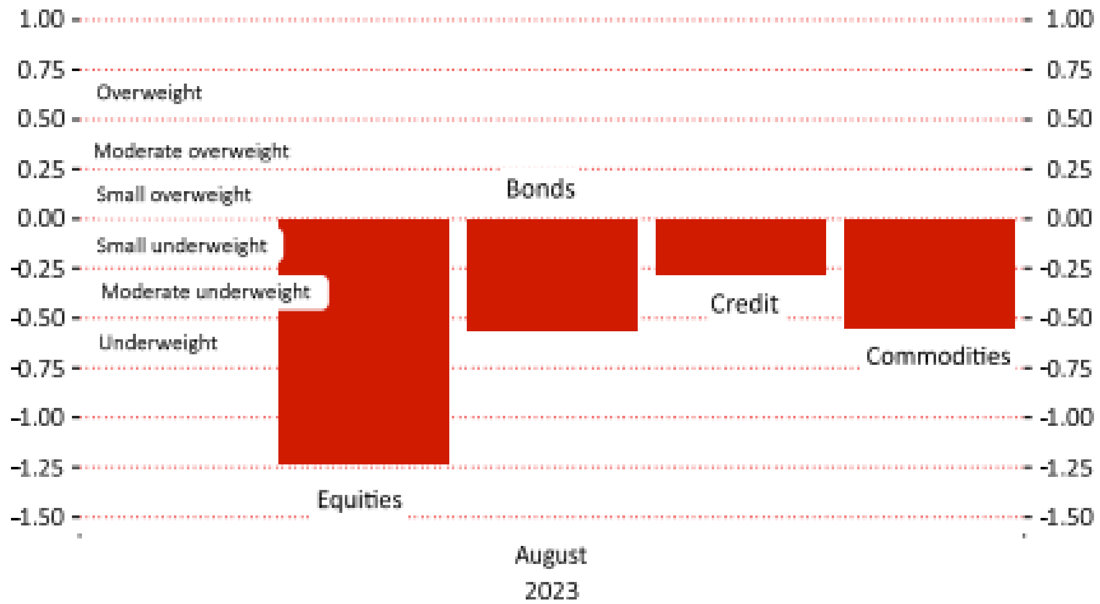
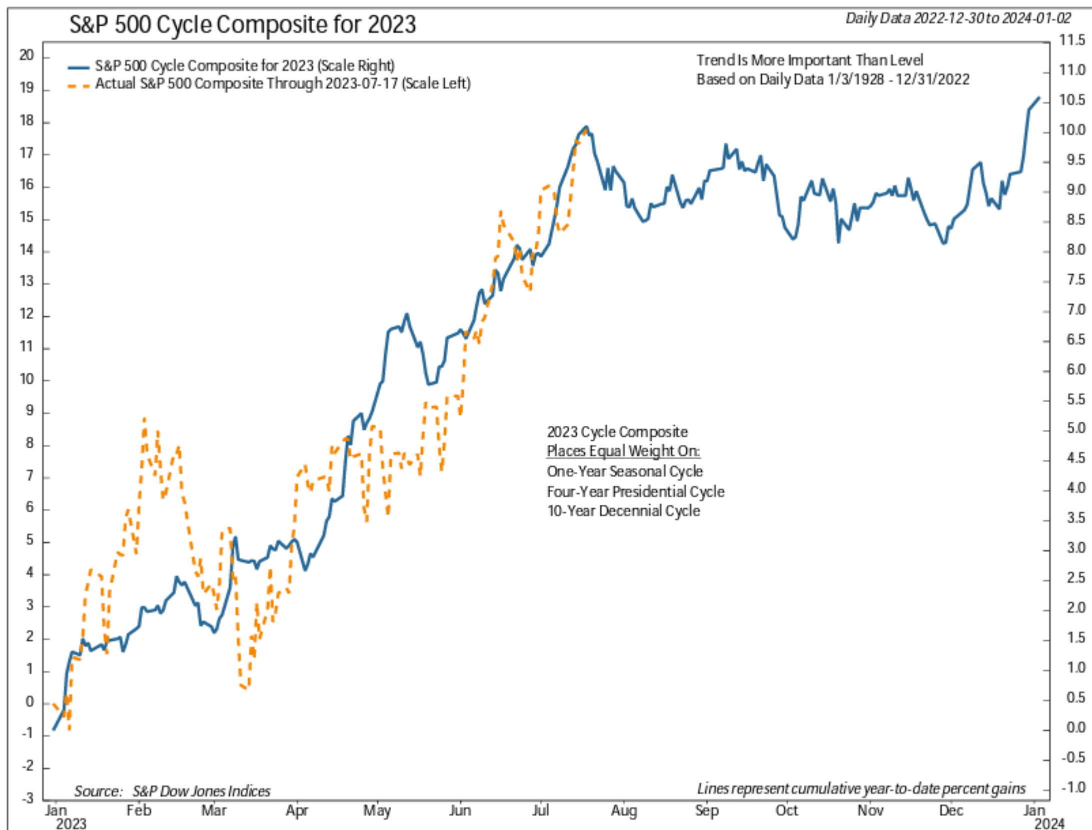


Exhibit 5: NDR Cycle Composite Signals Choppy 2H23

Source: NDR



The Road Ahead

We envision a choppier and less dreamlike road ahead for equities during the balance of the year. Conditions today are the mirror image of when we rolled out our strategy work to clients last February. At that time, investors were highly pessimistic and defensively positioned toward equities and other risk assets. As late as last April, most investors were positioned for an impending recession. We recognized an opportunity to lean against this pessimism and position contrarily with a year-end price target range of 4400-4500 on the S&P 500 Index. We knew that the third year of a Presidential cycle is statistically by far the best year for stocks and that the SPX has never declined in a third year of the cycle after falling significantly in the prior year. Back in February, the technical case for stocks had rarely been more supportive. Fast forward to today, we find the opposite situation including excessive optimism, rising long positioning, rising consumer confidence, and most investors embracing a "soft landing." Add to this, the increasing belief that inflation has been vanquished and that the Fed is done tightening for this cycle. To sum up, the fundamentals have improved modestly while the market technicals have deteriorated sharply. Our models, which include fundamental, technical, and quantitative inputs, became bearish in July. All this informs us not to raise our SPX price target of 4,500 and to recommend a more cautious stance toward public equities heading into the statistically most dangerous seasonal pattern of the year from August through late October.

While inflation has fallen a long way over the last 13 months, the easy disinflationary gains may be behind us now. The tailwind to lower inflation from extremely high base effects is diminishing. Gasoline prices have been sneaking higher. Commodity Indexes have broken downtrends in the last two weeks. I have also noticed that the Cleveland Fed Inflation Nowcast has been trending higher too. The all-important CPI and PPI data will be released later this week and could set the tone for the remainder of August.

Interestingly, if you go back to Exhibit 1, you will notice that the only major asset that was crushed in 2022 and has not recovered in 2023 is the US Treasury bond market. US 10-Year Treasury bond yields appear to be breaking out to the upside after coming down to important moving averages and trend lines (see Exhibit 6). The slow-motion end of yield curve control (YCC) in Japan is pushing all yields higher. JGB yields close to zero were an anchor to higher yields in G-20 countries. Japanese investors have become the biggest buyer of US Treasuries and they may be called home to buy their own bonds at much more attractive yields. US Treasuries are no longer attractive to Japanese buyers when you consider having to hedge the currency. A massive new supply of Treasury bonds is coming to the market to fund growing US budget deficits.

The recent Fitch downgrade of US Treasuries from AAA to AA has been dismissed as "arbitrary" by Janet Yellen and the Biden Administration. The fact is the US fiscal outlook is indeed grim and not worthy of an AAA credit rating. Instead of taking the downgrade as a warning sign to get its fiscal house in order, the Administration and Congress are making excuses and using misdirection to deflect criticism of its

excessive spending. Fiscal spending exploded during the pandemic and surged well above trend for over three years. Now that the pandemic is in the rear-view mirror, fiscal spending remains well above the prior trend of the last 30 years. Extremely high fiscal spending is part of the reason that the US economy continues to grow above trend despite 550 basis points of Fed tightening. In my humble estimation, if 10-year US Treasuries make new cycle highs above 4.3%, equities are likely to come under pressure.

Exhibit 6: A Bear Market in Bonds May Still Be Underway

Source: Bloomberg, Capital Creek Partners Research

Conclusion

The first seven months of 2023 have been dreamlike for investors as the devastation of 2022 has been reversed and consumer net worth is approaching the old highs of 4Q21. We have a relatively new bull market for stocks driven by falling inflation, rising earnings estimate revisions, the emergence of AI, and the avoidance of economic recession. However, now that the Fed has removed a recession from its economic forecast and the consensus has embraced the "soft landing" we had better be on guard. My old friend and mentor, the late great Barton Biggs used to say that "markets are a violent beast with a sense of irony and cruelty." Now that most of the bears on the Street have capitulated to the bull market, we think it is time to be cautious on public equities and hence our neutral weighting in client portfolios.