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Monthly Market Update

October 2023

Market Overview

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Highlights

- **Israeli/Hamas War:** Hamas' cowardly attack on Israel is undoubtedly the October surprise of 2023. Israel is now involved in a hot war with very few potential positive outcomes. Probabilities currently favor the conflict being contained to Israel and Gaza, however, the potential for escalation is significant. The impact on financial markets could be dramatic if the war spreads and escalates. The risk to equities is a-symmetric to the downside in our view. We continue to be tactically underweight the equity asset class as we have been since last July.
- **Bond Bear Market:** Benchmark 10-year U.S. Treasury bonds are locked in a historic bear market. The bond bear market began in mid-2020 and has continued for over three years. The carnage has been significant, with long-duration bond ETFs such as the popular (TLT) down more than 50% over three years (see page 8). Most investors never imagined they could lose so much money in the Treasury bond market. This is what can happen when inflation explodes higher with long-duration yields below 100 basis points. The bond bear has major implications for 60/40 portfolio investors, banks, insurance companies, pensions, and even the Fed's balance sheet.
- **The Fed – Data Dependent or Not?:** Fed Chairman Jerome Powell has claimed the Fed is data dependent, yet the Committee seems to have lost its willingness to raise policy rates further. Numerous data points, from retail sales to unemployment claims, point to a robust economy. The inflation data have also come in hotter than estimated. Perhaps the Israeli/Hamas war has dampened the Fed's desire to hike rates. If the data continues to come in stronger than expected, the Fed may have little choice but to hike again in December or begin to lose credibility.
- **D.C. Dysfunction:** On October 5th, Speaker of the House, Kevin McCarthy, was ousted in a narrow vote catalyzed by members of his own caucus. This historic event has thrown Congress into chaos. From a market perspective, the dysfunction in the House is spotlighting the increasingly unsustainable fiscal trajectory of the U.S. It is also causing America's friends and adversaries to question our political will to make basic decisions like funding the government or supporting allies Israel and Ukraine during wartime. D.C. dysfunction is raising the geopolitical risk premium for both bonds and stocks.
- **Fiscal in Focus:** The U.S. government is running unprecedented deficits of 6-8% of GDP during an expansion. Spending is running very hot, and tax revenues are falling short as capital gains from financial assets and real estate are under pressure. America's interest costs are now roughly in line with defense expenditures. With $34 trillion in debt and no credible plan to reduce spending or raise taxes, investors are beginning to question sustainability. In our view, this is part of the story behind the bond bear market.

Market Indicators

- **Models:** Our equity model (TES) is now bearish after being neutral for the last several months. Our Tactical Asset Allocation (TAA) model remains negative on stocks, bonds, and commodities. The TAA model is now neutral on public credit. Cash is a clear tactical overweight in our TAA model.
- **Leading Indicators:** U.S. Leading economic indicators from the Conference Board and the OECD still point to the high probability of recession over the next four quarters. However, exceptionally strong fiscal spending has offset monetary tightening and has lowered our confidence in the predictive capability of leading indicators in this cycle.
- **Cycle Monitor:** Our Cycle Monitor (see page 4) has become more mixed and has shifted from almost exclusively recessionary readings to now mostly a mix of mid-to-late cycle readings. This underscores how the probabilities have shifted away from recession to a more extended cycle.
- **Inflation:** While inflation has come down steadily so far in 2023, the outlook has become clouded by rising oil prices. High-profile wage gains by big labor may begin to undermine inflation expectations. In addition, medical costs and used car prices are unlikely to continue to decline. According to Case Shiller, housing prices are on the rise again. Our sense, in looking at the full inflation picture, is that the easy declines in the rate of inflation could be behind us.
- **Volatility:** Equity volatility has been on the rise since mid-September. The VIX Index has decisively broken 20 for the first time since March. Fixed income volatility remains historically elevated, partly owing to the relentless bear market in Treasury bonds.
- **Policy:** Recent Fed speeches and market pricing make it abundantly clear that the Fed will not hike rates at the November 1st policy meeting. The markets are now only pricing a 20% rate hike probability in December. The combination of the Middle Eastern war and sharply rising longer-term interest rates have removed the Fed's appetite for more policy action.
- **Liquidity:** Liquidity remains constrained due to global central banks hiking rates and quantitative tightening policies. U.S. M2 growth remains moribund. The Fed and ECB balance sheets continue to contract. The BOJ and PBOC balance sheets show little to no growth. Global liquidity growth is unusually weak and remains a headwind for risk assets.
- **Credit:** Credit availability continues to become more constrained at the margin. Corporate credit spreads continue to remain tight and have yet to respond to tighter financial conditions.
- **U.S. Dollar:** The U.S. dollar has been grinding higher since mid-July of 2023. However, the reaction to the Israel/Hamas war has been underwhelming. We currently see the dollar as stable to trendless. We think high real interest rates support the dollar, but we remain bearish longer-term for structural reasons such as de-dollarization, political dysfunction, and large chronic deficits.

2023E Economic Assumptions

Cycle Scoring	Late-Cycle	Fed Policy:	On Hold with Tightening Bias
Headwinds / Tailwinds	Trending to Headwinds	Fed Funds Rate:	5.5%
Real GDP:	1.5% to 3.0%	Debt Levels / Spreads:	High / Tight
Inflation:	2.5% to 4% (2024) / 2% to 4% (Long-Term)	Volatility:	Moderate/Rising
Unemployment:	3.5% to 5.0%	Earnings:	$220 - 2023 / $235 - 2024
Consumer Spending & Confidence:	Neutral	Equity Valuations:	Expensive relative to history

Directional Views

Strategic (Long-Term) and Tactical (6-12 month) Views on Broad Asset Classes

Asset	Strategic View	Tactical View	Commentary
Cash Strategies	+1	+2	On a nominal basis, cash is very compelling with the highest nominal yields in many years. Cash has the added benefit of providing ballast to a portfolio and valuable optionality. Real cash yields are also rising as the Fed keeps rates higher for longer and inflation falls.
Fixed Income	-1	-1	Given bearish price trends, massive fiscal spending, and heavy supply overhangs, we are strategically and tactically underweight fixed income. However, we acknowledge that the lagged impact of tighter monetary policy could hit late this year or in 2024, pushing yields back down.
Credit	-1	-1	We are strategically underweight public credit as spreads are tight and a credit downcycle is underway. Tactically, we are underweight, seeing little value and potential vulnerability as the credit cycle downturn matures. Our view is that private credit is much more attractive than public credit.
Equities	Neutral	-1	We are strategically neutral weight and tactically underweight equities. Our tactical models remain cautious. We envision better buying opportunities in October through November within the context of a new bull market. We see the S&P 500 as vulnerable down to the 4100-4200 range.
Private Markets	+1	+1	We believe non-traditional return streams offer substantial upside opportunities along with diversification benefits.

Source: Capital Creek Research

Underweight | Neutral | Overweight

Cycle Monitor – Mid-to-Late Cycle

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	Metric	Early Cycle	Middle Cycle	Late Cycle	Recession
Economic Metrics	**Overall Economic Output**	Below potential, rising	Near potential, rising	**Above potential, rising**	Contracting
	Consumption	Low, lagging income	Recovering	**High, ahead of income**	Falling
	Capital Investment	Low as % of GDP	Rising moderate as % of GDP	**High as % of GDP**	Falling
	Residential Investment	Low as % of GDP	**Rising moderate as % of GDP**	High as % of GDP	Contracting
	Vehicle Sales	Low	**Moderate, rising**	Peaking, high	Past peak, falling
	Price Inflation	Below central bank target, stable	Below CB target, rising	**At/Above CB target**	Falling
	Wage Inflation	Low, stable	Moderate, rising	**High**	Falling
	Private Credit Formation	Low, starting to rise	Rising in line with output	Rising faster than output	**Falling**
	ISM New Orders (Manufact.)	Improving	Mid 50s / Moderate	Past peak, falling	**Below 50, falling**
	Personal Savings Rates	High relative to income	Starting to decline	**Low relative to income**	Rising vs. income
	Unemployment Rate	Well above NAIRU	Above NAIRU	**Above or Below NAIRU**	Rising sharply
	Unemployment Claims	Past peak	Falling Sharply	**Trending lower / Stable**	Rising
	Consumer Confidence	Low	**Moderate**	Exuberent	Falling

	Metric	Early Cycle	Middle Cycle	Late Cycle	Recession
Asset Mkt. Metrics	**EPS Revision Ratios**	Downgrade cycle, improving trend	**Upgrade cycle, improving trend**	Second derivative falling	Downgrade cycle, falling trend
	Corporate Margins	High	**High/Peaking**	Declining	Low
	Credit Spreads	Wide, contracting	**Tight, stable**	Past cyclical trough	Wide, unstable
	Aggressive Issuance	**Low as share of total**	Moderate as share of total	High as share of total	Nonexistent
	M&A Activity	Low	**Moderate**	High as share of total	Nonexistent
	Yield Curve	Rates low, curve steep	Rates rising, curve flattening	**Rates high, curve inverted**	Rates falling, curve steepening
	Volatility (Implied)	Vol high, skew falling	**Vol low, skew high**	Vol starting to rise, skew rising	Vol high, skew high

Implied Cycle	**Current macro indicators suggest the market is between a mid-to-late cycle**

Source: Capital Creek Partners Research

Market Dashboard – as of October 18, 2023

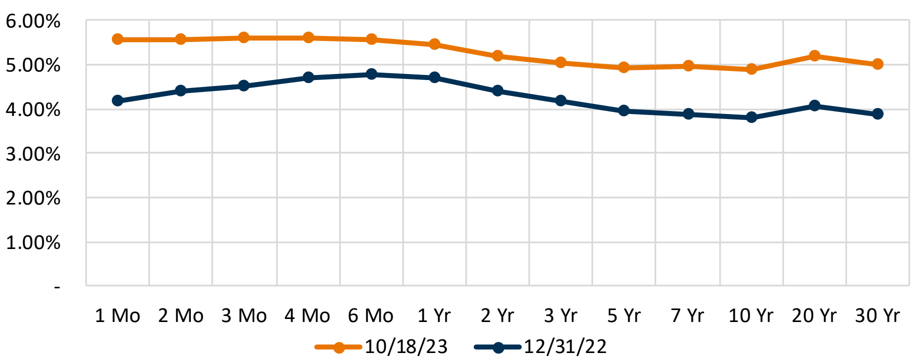
U.S. Equities	Current	MTD	QTD	YTD	LTM
Dow Jones Industrials (DJIA)	33,665.08	0.5%	0.5%	1.6%	10.3%
S&P 500 (SPX)	4,314.60	0.6%	0.6%	12.4%	16.0%
NASDAQ 100 (NDX)	14,909.26	1.3%	1.3%	36.3%	33.7%
S&P Mid-Cap 400 (MID)	2,456.33	(1.8%)	(1.8%)	1.1%	4.9%
S&P Small-Cap 600 (SML)	1,123.99	(2.4%)	(2.4%)	(2.9%)	(0.9%)
Volatility Index (VIX)	19.22	9.7%	9.7%	(11.3%)	(37.0%)

International Equities	Current	MTD	QTD	YTD	LTM
Developed Markets (EFA)	67.77	(1.7%)	(1.7%)	5.1%	19.9%
Emerging Markets (VWO)	38.50	(1.8%)	(1.8%)	0.2%	8.5%
Japan (EWJ)	58.95	(2.2%)	(2.2%)	9.0%	22.0%

U.S. Industry Sectors	Current	MTD	QTD	YTD	LTM
Communications (XLC)	67.21	2.5%	2.5%	41.0%	36.6%
Consumer Discretionary (XLY)	158.12	(1.8%)	(1.8%)	23.3%	11.9%
Consumer Staples (XLP)	68.03	(1.1%)	(1.1%)	(7.0%)	0.9%
Energy (XLE)	91.96	1.7%	1.7%	8.0%	16.4%
Financials (XLF)	33.14	(0.1%)	(0.1%)	(1.7%)	4.7%
Health Care (XLV)	129.85	0.9%	0.9%	(3.3%)	4.3%
Industrials (XLI)	100.66	(0.7%)	(0.7%)	3.7%	15.4%
Materials (XLB)	77.12	(1.8%)	(1.8%)	0.7%	10.5%
Real Estate (XLRE)	33.75	(0.9%)	(0.9%)	(6.3%)	(1.4%)
Technology (XLK)	167.72	2.3%	2.3%	35.6%	39.5%
Utilities (XLU)	59.23	0.5%	0.5%	(14.0%)	(5.4%)

Fixed Income	Current	MTD	QTD	YTD	LTM
Bloomberg Dollar Index (BBDXY)	1,275.36	0.7%	0.7%	2.3%	(5.4%)
7-10 Year Treasury Bonds (IEF)	89.39	(2.1%)	(2.1%)	(4.7%)	(2.9%)
US Inflation Linked Bonds (TIP)	102.62	(0.9%)	(0.9%)	(1.6%)	(0.4%)
Municipal Bonds (MUB)	101.56	(0.7%)	(0.7%)	(1.8%)	0.8%
Corporate Bonds (LQD)	99.08	(2.5%)	(2.5%)	(3.1%)	1.6%
High-Yield Bonds (HYG)	72.04	(1.8%)	(1.8%)	2.3%	4.7%

U.S. Treasury Yield Curve



Commodities	Current	MTD	QTD	YTD	LTM
BBG Commodity Index (BCOMTR)	240.50	1.3%	1.3%	(2.2%)	0.1%
Crude Oil (Brent)	91.50	(4.0%)	(4.0%)	6.5%	1.6%
Natural Gas (Henry Hub)	3.06	4.3%	4.3%	(31.7%)	(46.8%)
Gold (CMX)	1,955.30	5.8%	5.8%	7.5%	18.6%
Copper (LME)	3.58	(3.9%)	(3.9%)	(5.9%)	5.2%
Bitcoin	28,328.34	5.3%	5.3%	70.6%	46.5%

Note: All numbers are estimates. The data reflect total returns. Data reflect adjusted share price including dividends, splits, and fees. Please use statements as final value.
Source: Capital Creek Partners Research, Bloomberg

U.S. 10 Year Treasury Bond Yields Surge Higher

Source: Capital Creek Research, Bloomberg

2-10 Yield Curve Spread Bear Steepening Sharply in Sept/Oct.

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Source: Capital Creek Research, Bloomberg

A Three-Year Ursa Major Bond Bear Market Basis (TLT)

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Source: Capital Creek Research, Bloomberg

Disclaimers

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