CAPITAL CREEK PARTNERS REPORT APRIL 2023

The Washington Consensus

Scott T. Slayton, CFA

About Scott

Partner, Chief Strategist

Scott is a partner of the firm and the Chief Strategist. Before 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 investment experience as a strategist and portfolio manager. Scott spent most of his career in New York, working at Kidder, Peabody, Morgan Stanley, and Tudor Investments. Scott studied at the University of Texas at Austin, where he received a BBA in finance in 1988. Scott is also a Chartered Financial Analyst, CFA.

About 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*.

CAPITAL CREEK PARTNERS

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“No battle is ever won…. they are not even fought. The field only reveals to man his folly and despair, and victory is an illusion of philosophers and fools.”

– William Falkner

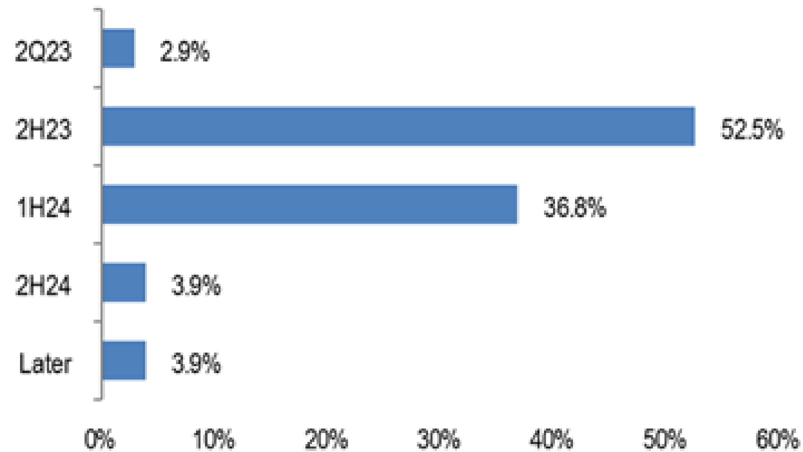
Washington D.C.

The annual IMF/World Bank meetings, hosted by JP Morgan in Washington D.C., underscored a prevailing bearish sentiment with 90% of participants anticipating a US recession soon. The global landscape is shifting, marked by "fragmentation" and a notable US/China decoupling. Significant concerns include the US's precarious fiscal health, potential debt ceiling issues, and the transformative yet potentially disruptive role of AI in business and society. Notably, the future of global markets appears intrinsically tied to the uncertain trajectory of inflation.

For most of the last twenty years, I have attended the spring IMF/World Bank investor track meetings hosted by JP Morgan. JPM combines their own senior management, strategists, economists, and traders together with seasoned policy experts from the IMF and World Bank. Hundreds of global investors gather in Georgetown to listen to these august panels discuss current events and attempt to peer into the future. Among the compelling subjects this year were the US/China cold war, Russia/Ukraine hot war, recent regional banking crisis, US debt ceiling, high inflation/Central Bank policy, de-dollarization, artificial intelligence (AI), energy transition, and climate change.

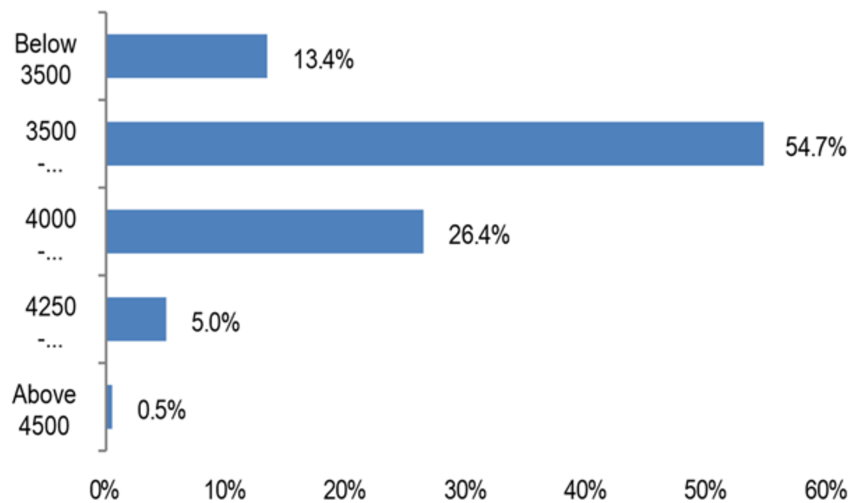
I have learned over the years to lean against a strong consensus coming out of IMF week. JPM conducts a survey during the Conference which gives a keen sense of investor sentiment and positioning. I have never seen a more bearish group of investors outside of the 2008 Global Financial Crisis (GFC). The survey revealed that 90% of investors expect a US recession to begin in the next 14 months. In addition, more than 70% of investors surveyed expected the S&P 500 to end the year below the 4,000-level compared to 4,150 today. The speakers this year sensed the pessimism of the crowd and mostly added to the gloom. Dr. Doom himself, Nouriel Roubini was there highlighting his new book appropriately entitled “MegaThreats.” The good doctor did an excellent job of weaving together the extensive list of challenges facing humanity and policy makers. The sheer number and magnitude of challenges from climate change to artificial intelligence left the audience gasping.

Exhibit 1: When does the next recession start?



Source: J.P. Morgan Strategic Research.

Exhibit 2: Where do you see the S&P 500 at year end?



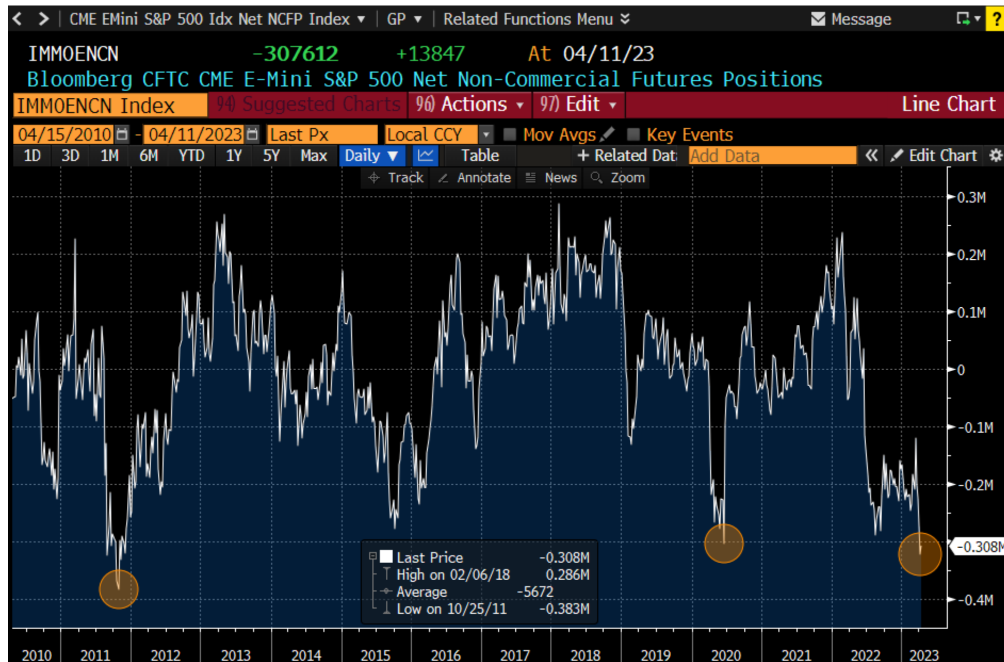
Source: J.P. Morgan Strategic Research.

The excellent lineup of speakers was mostly bearish on global equities, US technology stocks, US and European government bonds, and credit. There were a couple of structural bulls on commodities. Gold and Bitcoin were not mentioned a single time by any speaker. Only one economist reluctantly proposed that he did not see a recession in the next year. The consensus view on the Fed was they would hike twenty-five basis points on May 3rd, and that would end the tightening campaign for this cycle. Economists were divided on the future evolution of inflation with some agreeing with the IMF that inflation would be close to the 2% target by the end of 2024, while others forecasted that inflation would remain sticky and above 3% over the long-term. Nobody really knows, including the Fed.

I left Washington asking myself when have I ever seen ninety plus percent of the investing crowd right about anything? Markets usually do not work to reward a heavy consensus. My tactical view is that if 90% of investors expect a recession, either it will not happen or even if it does happen, it is likely discounted in current prices. The "pain trade" for stocks is higher as a massive wall of worry has been constructed. Late last week, we learned that net short positioning in the S&P futures is the largest since 2011!

Exhibit 3: Net Short Positions in S&P 500 Futures

Source: Bloomberg, Capital Creek Partners Research



An Increasingly Fragmented World

The word "fragmentation" kept coming up during the presentations from speakers across the spectrum of disciplines. Fragmentation was used to describe an emerging world order, where the US is no longer at the center of the universe. The US/China decoupling came up in practically every discussion. The consensus view is that there will be no going back to the era of constructive cooperation between the US and China. I learned that both sides are deeply divided and are not speaking to each other at the executive or diplomatic level. Decoupling has major long-term implications for supply chains, defense spending, climate change, and for the allocation of capital and inflation. Decoupling and deglobalization will slow global growth and profits. I am convinced that decoupling is also inflationary over the intermediate to longer-term because the cost to purchase the same goods away from China will be less efficient and more expensive.

US Fiscal Outlook

The US fiscal situation is a trainwreck and there appears to be no political will to deal with it. The public does not understand the issue and politicians of both parties have lost their fiscal discipline. We were repeatedly told that Social Security is headed for bankruptcy over the next 5 years. Unfortunately, President Biden recently used the State of the Union Address to ice any debate over how to fix it. Political polarization has left the US with little ability to compromise. It will take a fiscal crisis to get either party to step up and deal with our government's long-term addiction to profligate spending. The political system seems broken and can only react during times of crisis brought upon by economic contraction or a financial market riot.

Debt Ceiling Shock?

The US debt limit is back on my radar as a major concern for the markets. OMB estimates are that the Treasury will run out of money to pay its bills by August. President Biden and Speaker McCarthy are not talking to each other about this. Both sides think they can "win" politically by using brinksmanship against the other. I was surprised to learn that seasoned political veterans on both sides conclude there is around a 1 in 3 chance of a technical default by the US on its debt. This would be catastrophic for the country and there is no justification for it. The current situation reminds me of 2011 when S&P downgraded US Sovereign debt from AAA to AA. Another downgrade could easily happen again this summer and all indications are that we are careening toward a government shutdown at the very least. I do not think markets are prepared for what could be ahead of us in 3-4 months.

Exhibit 4: One Year Credit Default Protection on US Treasury Debt

Source: Bloomberg, Capital Creek Partners Research

Banking Crisis

The recent banking crisis was described as "over" by some and a tempest in a teapot by others. However, most agreed that the recent bank failures will lead to tighter credit conditions for borrowers over the remainder of 2023. Banks will continue to see deposit flight to higher yielding alternatives, not so much out of fear but more out of a hunger for higher money market and T-bill yields. A very keen eye is set on bank earnings that will be reported in the coming days. The major banks, JPM, BAC, C, and WFC have collectively reported strong earnings and that has been a big relief. We will see how the regional banks report, but the expectations are rock bottom low.

Killer App

Artificial Intelligence (AI) was a major topic of discussion at IMF week. There was a clear sense that the world is changing so rapidly that humans are losing their ability to cope. AI will only add to the rate of change. Corporate managers who spoke described AI as an invest heavily now or perish later situation. If a competitor invests heavily and you fall behind, you could be out of business quickly. I was not sure if this was hyperbole but there was no doubting their seriousness about this key emerging technology. Speakers cautioned about the dangers of unbridled AI and its potentially devastating impact on society, mental health, and employment. Everyone agreed that it was almost hopeless that government regulation could keep pace with AI innovation. AI has quickly gained critical mass and there is no putting this genie back in the bottle. As a strategist, I am most interested in AIs impact on productivity and inflation. AI could be the most deflationary innovation since the personal computer (PC) in the early 1980s. As I recall, that was also a period of malaise and high inflation from which a bull market in stocks and bonds emerged.

Inflation Evolution

I left Washington believing that the direction of markets will mostly be determined by the evolution of inflation. After significant disappointment in the January and February data, the disinflation theme has recently gotten back on track. We can now point to a recent streak of in line or better than expected readings on inflation. ISM Manufacturing and Services Prices Paid Indexes printed well below expectations. Both are now back to pre-pandemic levels. Producer prices released last week came in lower than expected across the board and even deflated on a month over month basis by -0.5%. PPI Final Demand has now fallen over the last year from 11.65% down to 2.7% (see chart 5).

Anyone who is paying attention knows that housing prices and rents are no longer rising outside of a few isolated pockets of severe supply shortages. The timelier Core Logic Data makes this clear. As the severely lagging Owners' Equivalent Rent (OER), which makes up a sizable portion of the CPI and Core PCE Indexes, begins to turn down in the second half of 2023, disinflation could really kick into gear. Admittedly, progress on core services inflation has been grudging slow to date but appears to have peaked. The decline in inflation will not be linear, but I am convinced the overall trend remains down. Lower inflation remains the key propellant needed for global bond and equity markets to continue to grind higher.

Exhibit 5: US PPI Final Demand YoY

Source: Bloomberg, Capital Creek Partners Research

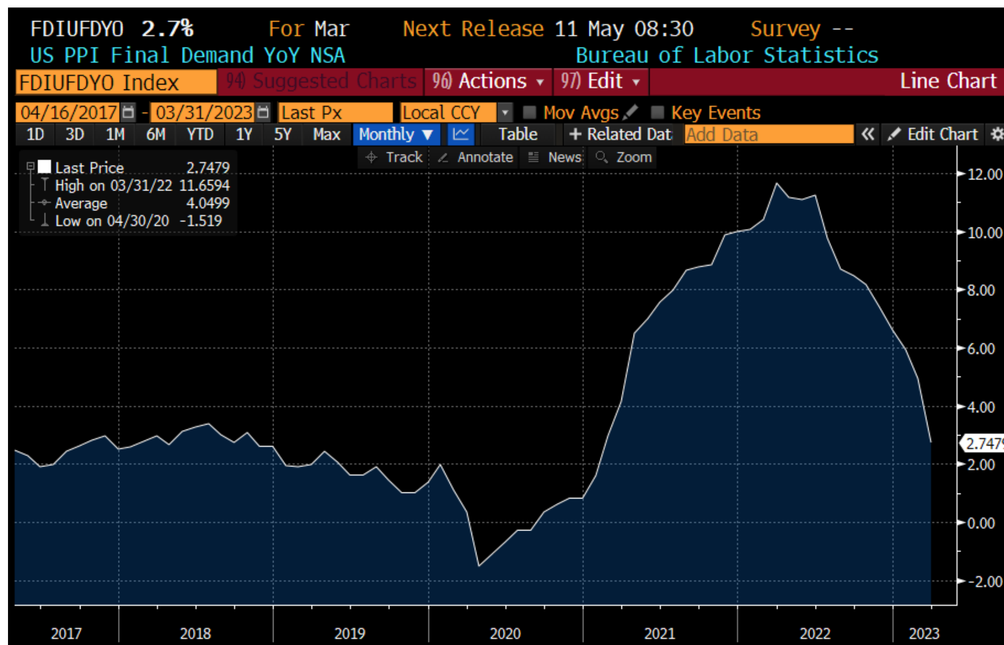


Exhibit 6: ISM Services PMI Prices Paid

Source: Bloomberg, Capital Creek Partners Research

Prices paid Index
GP
Related Functions Menu
Message
NAPMNPRC 59.5 For Mar Next Release 03 May 10:00 Survey --
ISM Services PMI Report on Business Pri... Institute for Supply Management
NAPMNPRC Index
94) Suggested Charts
96) Actions
97) Edit
Line Chart
04/16/2017 - 03/31/2023
Last Px
Local CCY
Mov Avgs
Key Events
1D 3D 1M 6M YTD 1Y 5Y Max Monthly
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Edit Chart
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Annotate
News
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