CAPITAL CREEK STRATEGY REPORT– OCTOBER 2023

Navigating Investment Complexity

Key Insights from the 2023 Capital Creek Annual Conference

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About Scott

Partner, Chief Strategist

Scott is a partner of the firm and 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 Committees. Scott has 35 years of investment experience as a strategist, portfolio manager and asset allocator. 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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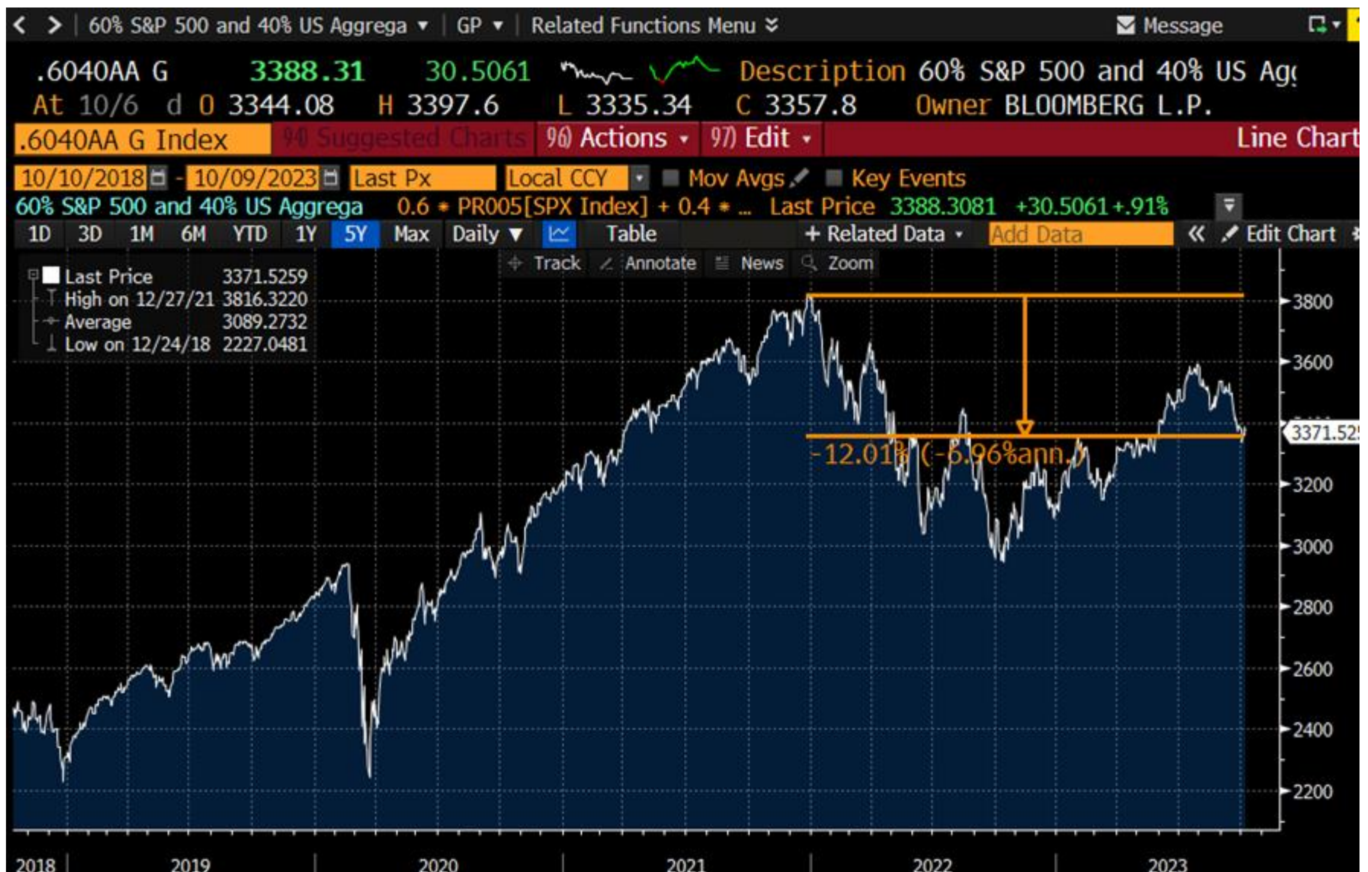
"Artificial Intelligence is a fundamental increase in the supply of global intelligence."

Rob Hutter of Learn Capital

Austin, TX - October 6th, 2023

In late September, Capital Creek Partners held our third annual investment conference in downtown Austin. This gathering included approximately three hundred investors, several of our general partners, along with a few high-powered Wall Street luminaries. There was a wide diversity of skills, backgrounds, and opinions generated by the conference speakers. Below is my attempt to describe the key thoughts and takeaways from the event.

Exhibit 1: The Traditional 60%/40% Portfolio Continues to Struggle



Source: Capital Creek Research, Bloomberg

- **Asset Allocation:** A new asset allocation model may be necessary for the next 10-20 years. The macro tailwinds that helped drive above-average returns for publicly traded equities and bonds have turned into headwinds. Easy money, low inflation, globalization, and US geopolitical hegemony have turned from tailwinds into headwinds. The traditional 60/40 portfolio may be structurally challenged. What has worked so well for investors since the early 1980s, namely owning publicly traded stocks and bonds, may not produce enough return and diversification to allow

investors to keep up with inflation and grow their wealth. A more creative approach, which includes a greater amount of private investments tied to cash-flowing assets, will likely be necessary.

- U.S. Economic Health: There was a very wide dispersion of views concerning the future path of the US economy, inflation, fiscal spending, and the outlook for US large-capitalization technology stocks. Our general partners were positive about the outlook for their own businesses but were guarded about the macro-outlook. There was concern expressed about the impact of rising interest rates, chronic US fiscal deficits, sticky inflation, and the adversarial state of US/China relations. The wide dispersion in views hammered home the need for thoughtful asset allocation, diversification, and the ability to lean on the best managers who have the experience and discipline to execute well, even in highly uncertain times like today.
- Artificial Intelligence: Artificial Intelligence may be the most impactful technological innovation of our lifetimes. Fortunes will be made and lost by investors in this emerging investment space. A thoughtful, disciplined, and experienced approach to venture capital investing in AI will be necessary. In public markets, the so-called "Magnificent Seven" (M7) or large capitalization US technology titans are very well positioned in terms of talent and resources to capitalize on this mega-trend. The US has the pole position in developing AI, with China at #2 and Europe at #3. Interestingly, we learned that China is losing some of its best AI talent despite pouring hundreds of billions into AI research and development. Europe will be a player but is more focused on regulation than innovation. So far, the US seems to be thriving by striking the proper balance between innovation and regulation. Our AI panel made the case that the US continues to enjoy a meaningful talent edge over the competition.
- The Magnificent Seven: There were strongly divergent views about the future of the M7 technology companies. The views were well-informed on both sides. One camp made the case that at an average of fifty-two times earnings, the M7 represents a major risk to passive investors who own the S&P 500 Index. Two other speakers remained bullish on large capitalization tech, with one forecasting that the technology sector will achieve a 50% share of the S&P 500 Index over the next ten years, up from approximately 30% today.
- Austin, Texas: Austin, Texas, shined at our conference. We were able to attract very high-quality investors from around the US and the world to come to Austin. It was remarkable how many people attending the Conference had recently moved to Austin or were contemplating such a move. It was summed up well by an investor who said that Austin has the right combination of innovation, demographics, education, taxation, regulation, and entrepreneurial spirit to become the next Silicon Valley. The University of Texas at Austin was described by a legendary venture capitalist as the wellspring that continues to feed the Austin and central Texas ecosystem with intellectual and human capital.

- **Hybrid Equity:** One of the brightest minds on Wall Street stimulated the crowd with the concept of "hybrid equity" as a new asset class that could provide investors with a diversified, highly rated, high-yielding, and moderately growing pool of assets that could plausibly produce an "all-weather" return of 12%-15%. This private asset class can be engineered to have moderate liquidity and should be able to produce returns in excess of the traditional 60/40 portfolio with less volatility. In theory, the investor gives up some liquidity to gain higher returns with less experienced volatility. This seems like a good tradeoff for many investors who don't need instantaneous liquidity.

What Was Conspicuously Absent from the Conversation

The words digital assets were never mentioned at the conference. Nobody asked a single question regarding this relatively new and controversial asset class. Perhaps investors have lost interest in the asset class after it crashed almost 80% in 2022 and then proceeded to rally 50% so far this year. Many must have found this price action and constant negative headlines exhausting. Long-term pessimism toward digital assets may now be so pervasive that apathy has replaced the wild bullishness that was evident at this same conference in October of 2021.

With the Fed suppressing liquidity by keeping rates higher for longer and QT (Quantitative Tightening) running in the background, I believe it will be exceedingly difficult for digital assets to sustain a rally in prices. The Fed's current "higher for longer" monetary policy is pure "kryptonite for crypto." When the Fed changes course and begins to allow liquidity to flow back into the financial system, digital assets should be among the very first to go up in price. Strategically, I am waiting for a rally in the US 2-year Treasury note before anticipating a sustained upside in digital assets. The 2-year note tends to rally ahead of the first Fed rate cut of the cycle. Frankly, I am surprised that with real rates surging higher that Bitcoin and Ethereum have managed to trade sideways in recent months.

The Godot Recession Rolls On

Like the characters Vladimir and Estragon in Samuel Beckett's play, "Waiting for Godot," the investment community has spent most of the last year waiting for an economic recession. Like the play, the recession has never come, and investors remain waiting, stuck in a cycle of anticipation and uncertainty. The audience at our conference seemed split between those who continue to expect a recession beginning sometime in the next six months and others who expect a soft landing or even no landing.

The Conference speakers did not change our view very much. We have not expected a recession in 2023 and are skeptical of a recession starting any time before the second half of next year. The Biden Administration and Congress have been highly adept at releasing an enormous amount of fiscal stimulus into the system since the onset of the pandemic. Fiscal deficits are projected to come in between $1.6 and $1.8 trillion, or approximately 8% of GDP, for 2023 and again in 2024. These are unprecedented fiscal deficits for a US economy growing above trend.

A chaotic and divided Congress should be able to prevent further stimulus from passing into law. However, the Administration still has significant discretion over the timing and release of programs already passed into law. In other words, Biden can compress more spending into 2024 to help his reelection campaign. Biden has also shown that he will use the Strategic Petroleum Reserve (SPR) as a political lever if oil and gasoline prices rise too high next year. Fiscal deficits in 2024 are projected to continue to be unusually large. While that does not necessarily mean additional fiscal stimulus, it does mean that fiscal spending will continue to be a strong underpinning for the US economy in 2024. Think in terms of the stock of fiscal spending rather than the flow. The current stock of fiscal spending is enormous by any historical standard.

The Capital Creek Partners' annual conference in Austin underscored the volatility and uncertainty in today's investment landscape. The traditional 60/40 investment model is under scrutiny, warranting a shift towards a more innovative and productive mix of asset classes, which includes 25%-to-45% alternatives. While there is justifiable optimism toward AI, there is also broad caution due to macroeconomic uncertainties and rising geopolitical tensions. The direction of large-cap tech stocks will have major implications for passive equity index investors and for overall equity asset class returns. In essence, the event highlighted the need for diversified, agile investment approaches in a complex, ever-changing marketplace.