Glass Half Full or Glass Half Empty

August 2023 Investment Outlook

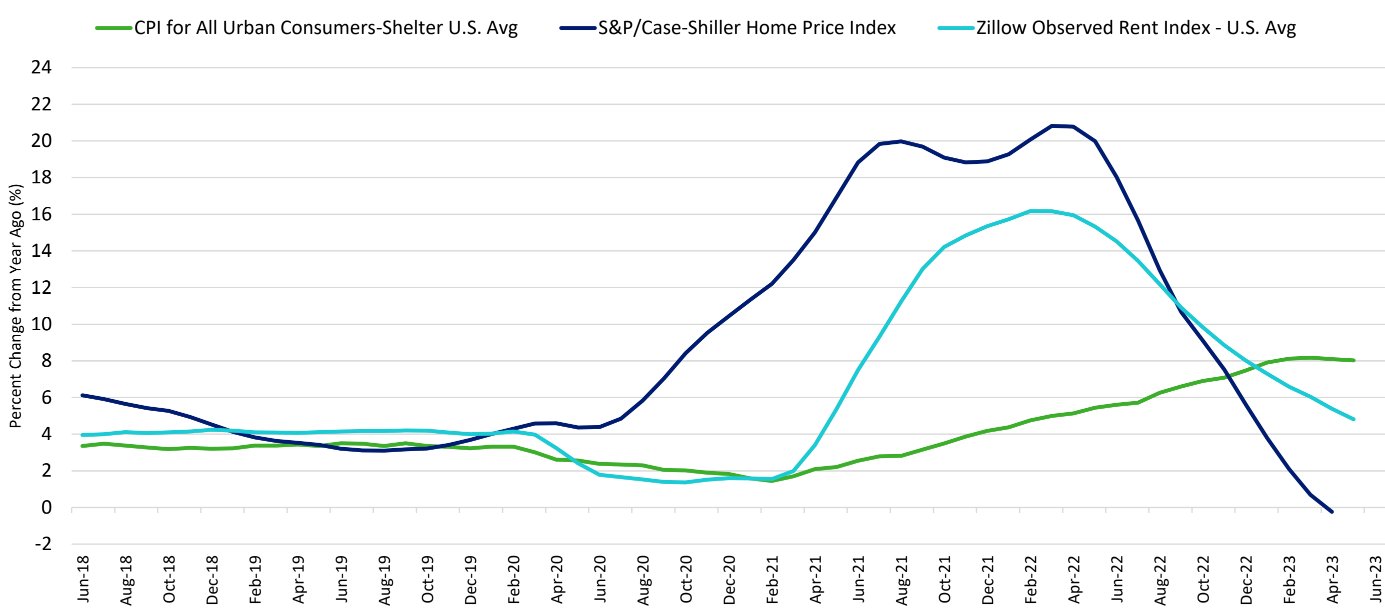
Segal Marco Advisors

Overview

We are halfway through 2023 and pondering the proverbial question; is the glass half full or half empty? This aptly sums up the dichotomy of views related to growth, interest rates, inflation and the consumer, to name a few. As we enter the later stages of the economic cycle, it is common to have disparate views on the future trajectory of the markets, as economic data becomes more nuanced and the timing of when the cycle might bottom and turn into a new one is murky. It is easier to get the direction right than it is to time a turn in any cycle. It is one of the reasons why we don't spend a lot of time on projecting or attempting to project the data, but rather to provide information of what the data is showing. However, despite all the headlines churning back and forth each day, there are a couple of areas where "consensus" views have formed. Such as:

- We are in the later innings of the Federal Reserve's rate rise cycle.
- We are in the late stage of the economic cycle.
- While inflation may not be at levels to declare victory, progress is real and *should* continue. When you consider the June CPI data, the stickiest component was shelter. But consider the lagged inputs to CPI data in the graph. This underscores why inflation *should* continue to decline is the expectation.

Housing in the U.S.



This *Investment Outlook* was written in July 2023.

While there is no consensus on the back half of 2023 in terms of GDP growth and soft landing or recession, the general acknowledgement is that the Federal Reserve has succeeded in slowing economic growth. The question remains, it is enough? Or is it too much?

Earlier in the year, we wrote about the transformative nature of 2022 due to the increase in interest rates. We also discussed the ramifications for asset classes, including increased capital market assumptions for many assets but, in particular, bonds. We also discussed the negative impact of higher financing costs, which would impact companies and other assets, such as real estate and private equity. Each of these factors were apparent in the first half of 2023, but with a couple of upside surprises like the equity performance in the second quarter (more to come), and a couple of downside surprises, like the banking turmoil resulting in the closure or forced sale of four banks during the first half.

So, as we take stock of the first half and look towards the back half of the year, here are some key metrics to consider:

- **Labor strength.** U.S. unemployment remains near all-time low of 3.6 percent, but is up from the low of 3.4 percent (albeit not much).
- **Consumer strength.** The consumer continued to support growth in first half, but moved from spending on goods (headline figure June -0.4 percent month over month and global manufacturing data supporting this trend showing June PMI falling to 46.3 percent from May 48.4 percent). While services were strong (up 0.2 percent month over month and GDP services at 54.1 percent down slightly from 54.9 percent in May but still strong).
- **Retail.** Data was strong in the first half but softening as reflected in June with personal consumption data (PCE) flat and revised downward in April and May.
- **Earnings.** They are expected to decline, as well as margins. Passing through increasing costs to the consumer seems to have peaked. Wage pressure has continued leading to many of the layoffs being announced in corporate American, although it is softer over the last few months.
- **Growth.** On a worldwide basis, it has diverged (creating opportunities), but has been more resilient than expected to date. China's recovery expectations have declined in line with recent data and the Central Bank has room for further stimulus above the recent cut in key lending rates. The eurozone has strong employment, and currently is being helped by stabilized energy prices below levels most people thought were not possible when the war broke out in Ukraine. Inflation is still higher than the U.S. but has slowed (10.6 percent to 6.1 percent in May) with certain inflation points (shelter, wages) stickier than desired.

Notice we did not include interest rates, as, barring a black swan event, it appears that the Federal Reserve will not likely raise rates much more this year. So, since that is baked into the markets, it seems the bulk of the work on rates is behind us.

So, we arrive at today, where consensus views on the second half of 2023 are divided, thus the name of this outlook. Is the glass half full or is it half empty? Here is the scenario for each of those glasses.

Glass half full: soft landing

Factors that need to be present for this to play out:

- Continued strength in labor markets
- Continued strength in the consumer (e.g., secondary factors continued wage growth, lower inflation and savings rate stabilizing)
- Continued declines in the rate of inflation with a long-awaited slowdown in the shelter component of CPI (35 percent of the CPI index), needing to become apparent and other services data to slow

Glass half empty: recession

Factors that need to be present for this to play out:

- Substantial tightening in lending; with lending curtailed, headwinds for both businesses and consumer are adding to downward pressure on growth.
- The consumer is tapped out; consumer savings is declining, pandemic stimulus is gone and student debt payments are resuming in Fall
- Mortgage rates will continue to pressure housing and construction in particular (coupled with little to no lending available)
- Interest rates increase further and longer
- Inflation remains sticky for longer requiring continued rate hikes

We are not making a call on either scenario, but rather we look to build a diversified portfolio that takes into account the long-term outlook of your needs. Within that diversified portfolio, consider having a variety of views and assets that respond to the various scenarios.

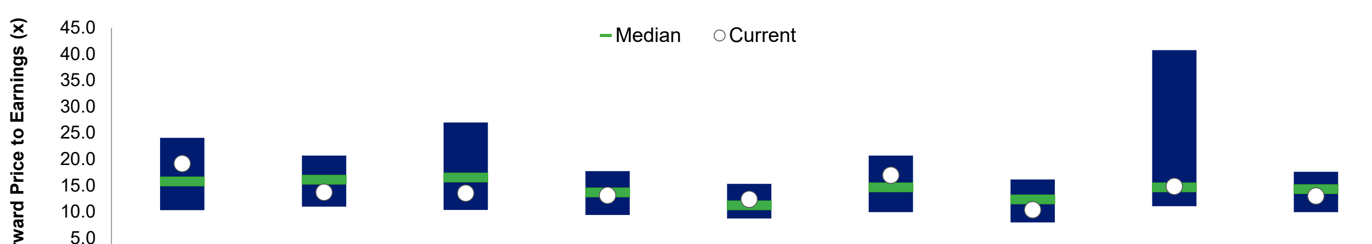
What is in store for equities?

As we always point out, we don't have a crystal ball, but here are couple of data points that will inform the second half of the year:

- In the first quarter growth outperformed value by over 13 points (whereas value had been leading over the last year). In the second quarter, growth continued to outperform value and now leads by close to *24* points (Russell 1000 Growth 29.02 percent versus Russell 1000 Value 5.12 percent for six months ended June).
- The market return concentration continued in the second quarter and the top seven stocks in the S&P 500® have contributed 74 percent of the total return year to date (so of the 16.89 percent return for first six months, 12.47 percent was contributed by seven stocks and only 4.42 percent from the other 493 stocks), with the vast majority of the return of these large stocks coming from multiple expansion rather than earnings. This is not a sustainable attribute for continued market performance. By the way, the new dominant market performers, Microsoft, Apple, NVIDIA, Amazon, Tesla, Alphabet and Meta, were growth-oriented stocks and/or beneficiaries of the artificial intelligence (AI) theme that has taken over the market. The actual impact of AI on most companies' bottom lines is years ahead, so it seems AI may be the new meme/dotcom/bitcoin hype for 2023. The U.S. market P/E currently stands at 19x, which is strongly influenced by the names noted above. Still this P/E is above long-term average, as shown in the following graph, while other markets — namely, smaller stocks and select European countries — are less pricey.

The bottom line is we remain cautious, especially on areas of the market that have outperformed in the first half, so we encourage rebalancing back to targets.

Price to Earnings Ratios



	S&P 500	S&P 400	S&P 600	MSCI EAFE	MSCI EM	MSCI World	MSCI UK	MSCI Japan	MSCI Canada
High	24.1	20.7	27.0	17.8	15.3	20.7	16.2	40.7	17.6
Low	10.3	11.0	10.4	9.4	8.7	10.0	8.0	11.1	10.0
Median	15.8	16.1	16.6	13.7	11.3	14.7	12.4	14.7	14.3
Current	19.1	13.7	13.5	13.1	12.4	17.0	10.4	14.8	13.0
Previous	18.1	13.5	13.0	12.9	12.2	16.2	10.3	13.1	12.7

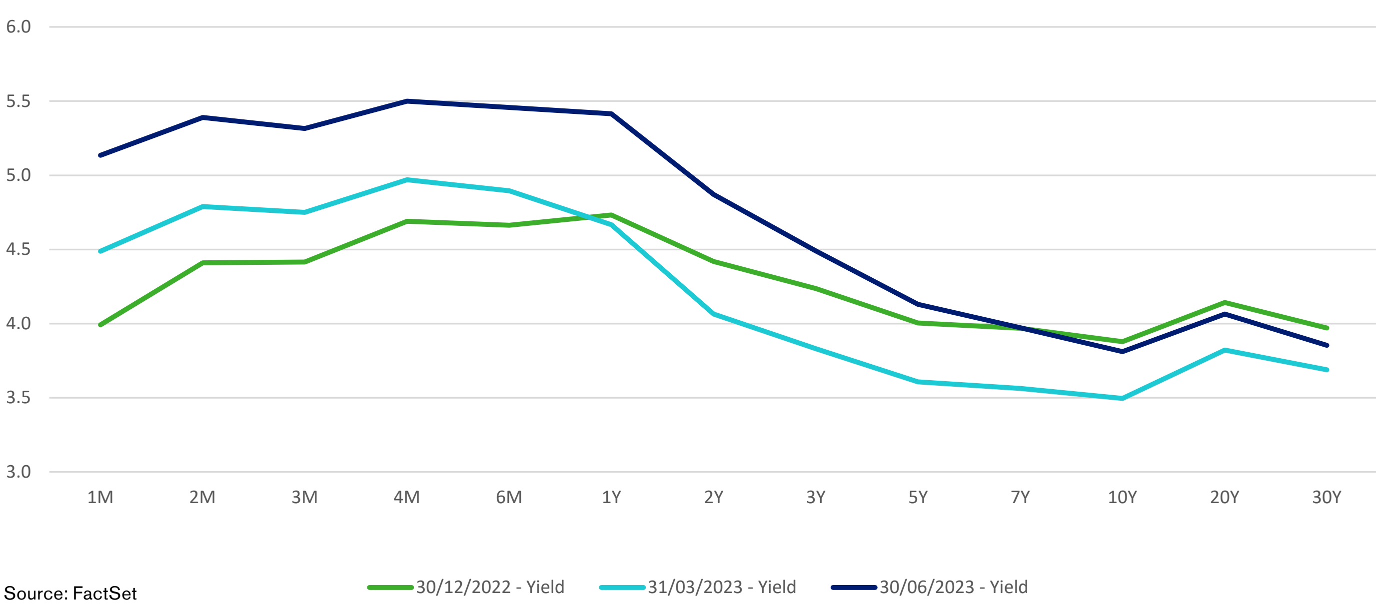
Data range is from 3/31/00-6/30/23. P/E ratios are forward 12 months.

Source: FactSet

What about bonds?

The inversion of the yield curve remains intact through first half of the year.

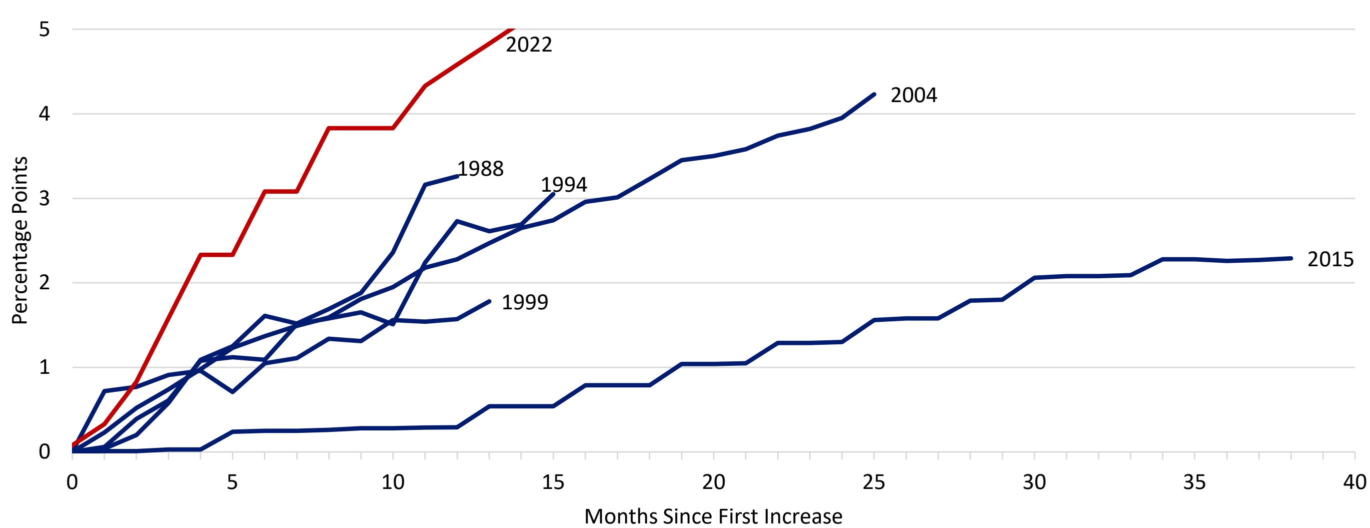
United States Treasury Yield Curve



Source: FactSet

Interest rate increases continued in first half of the year, with the first pause in June bringing the current total to 10 increases, the fastest pace we have experienced. The pain of rising rates has been difficult and while overall fixed income returns have not yet reflected current yields available in the market, longer term, this positive yield environment is good for investors and for the functioning of markets and the economy.

Cumulative Change in Federal Funds Rate Since Start of Initial Rate Increase



Source: Fedstat

Fixed income returns in first half of the year have ranged from 5 percent on high yield bonds to 1.6 percent on government bonds. Reflecting the shape of the yield curve, the 3-month T-Bill for the first six months of 2023 returned 2.4 percent. Given that the yield on shorter investment grade corporate bonds finished the quarter over 5 percent and most of a bond's return over time is yield, the future looks brighter than the past. Spreads have narrowed through the year with the recent decreases in high yield and ABS declining by 65 and 17 basis points respectively, now putting most spread assets at low average levels versus historical averages. Global bond markets followed similar return patterns, although emerging market debt returns were 7.8 percent for the first six months resulting in the best overall bond returns for the first half.

We remain positive on the outlook for fixed income assets and since we are in the late innings of the rate cycle; some stability should bring yield into focus. Cash returns remain a focus for many investors, as money market assets have continued to attract positive flows. Reinvestment risk in the short end will eventually come into focus, and given timing is difficult, implementation of a diversified portfolio in your fixed income portfolio makes sense.

How are private markets doing?

For the first time in a long time, we have seen a divergence in performance among private assets. Namely, real estate valuations so far in 2023 have seen negative valuations, and while private credit and private equity saw revaluations, most returns are still positive for the first half of 2023.

Real estate

There has been a lot of disparity within the real estate sectors which continued throughout the first half of the year. The second-half expectations are for a continuation of the pattern, albeit more muted. The office sector took the largest write-downs in the first half, with the second quarter coming in particularly negative. Depending on the appraisal firm and the manager, we saw an increase in negative valuations in the June quarter. So, for some managers with different appraisers, there will likely be further pain in the second half as the market continues to adjust downward.

However, those general statements are just that, generalizations, as some offices like class A or new offices are offering robust amenities, maintained pricing and tenant flow. In addition, certain geographies (South/Southwest) were more resilient as demographic shifts supported the market and pricing. However, the write-downs in several major urban markets were significant, reflecting lower occupancy, lower rents and higher financing.

In general, logistics held up well, as did specialty areas like data centers or medical office. The retail sector, which took its lumps several years ago, was relatively muted and only hotels and retail were positive for first quarter. Multi-family has also seen a decrease in values due to the increased rate environment. But longer term, the lack of housing stock across the country should provide support for the sector.

For those invested in open end funds, we do not expect material cash flows back to limited partners and given the lack of transactions, closed end funds will be challenged on distributions. Net operating income growth remained positive but insufficient so far to offset the negative impact of the cap rate changes. Returns in the second half will be dependent on how much further interest rates increase, as cap rates will continue to rise and thus will continue to challenge the positive income levels. Like private equity, the reduced valuation environment is likely to provide some good entry prices, for those with the ability to invest, especially in many of the closed end value add or opportunistic areas.

Private equity

Some of the market dynamics seen in 2022 seem to be coming to an end. While IPOs were virtually nonexistent in 2022, there have been a couple large IPOs this year, although volume is not back to pre-pandemic levels. Private equity marks have declined, along with an increase in down-round valuations, but we are not seeing holistic issues in the sector with acquisitions and other growth mergers still apparent. Clearly, in a slowing environment, rationalization will continue to be apparent as GPs evaluate the portfolio companies in the light of increasing financing, higher costs and slower growth.

In the face of higher costs of funds, buyout leverage has come down and we have seen some IPO and merger activity in the buyout arena. Cash flow in terms of distributions continued to be slow in the first half of the year, and while the expectation is for some pickup, we are not expecting material upticks like we saw in the post-pandemic period.

Venture growth and early stage will face a slowdown in available financing and, coupled with many negative-cash-flow, early stage companies, there will be a need to reduce cash burn and to find a quicker path to profitability. So, increasing selectivity will continue to be a focus for the balance of the year.

While the private equity market faces headwinds, just as public companies do, they have dry powder to ease the path. Private firms also have the advantage of delayed mark-to-market valuations and, thanks to the increase in value for public markets, the denominator effect is more favorable than at year end. We continue to think if investors have cash flow, that investing in the current or next vintages will provide good entry points for investors.

Private credit

While businesses within the private credit universe have been operating within the same higher-rate, higher-cost environment, the lack of bank lending and the needs of borrowers will continue to drive supply in the private lending space. This presents opportunity for lenders but puts a premium on the due diligence of the private credit managers with whom limited partners invest. Strong income is supportive of the space, with unlevered contractual cash yields in the ~10 percent range for first lien/unitranche assets and in the direct lending space are in the 11–12 percent range for subordinated loans.

Delinquencies have inched up but are still low. Forecasts continue to call for an increase in default activity late in year and into 2024 as the impact of rates and costs flow through to underlying businesses. This provides ample opportunity for lenders in most areas of the private credit universe, including stressed, distressed and direct lending.

Outlook for Canada

Canada's GDP grew by 0.8 percent in the quarter ended March 31, 2023, above analysts' expectations of 0.4 percent growth. Exports of goods and services grew by 2.4 percent with an increase in sales in automobiles, precious metals and grain. At 5.4 percent, Canada's unemployment rate in June 2023 was at its highest in 16 months. Still, that figure was relatively strong and below pre-pandemic averages. Some of the largest employment increases came in wholesale and retail trade, manufacturing and health care.

Inflation fell to 2.8 percent in June, the lowest it has been in two years. A steep drop in the price of gas when compared to last year was a major reason for this decline, though food and shelter costs did rise. The Bank of Canada hiked interest rates 10 times in the last 18 months to combat inflation. June marked the first time since March 2021 that the monthly inflation figure fell inside of the BoC's 1–3 percent target inflation range.

Canada's stock market made a 1.1 percent gain in the quarter, despite commodities' lackluster performance. (Canada's stock market indices are closely tied to the performance of commodities.) The TSX is up 5.7 percent through June 30.

Despite the first half's relative strength, some forecasters are still predicting a recession later in 2023. Inflation and the number and speed of interest rate increases, as well as the level of consumer spending, will also help determine whether a recession can be avoided.

Summary of Outlook Views

The tables on the following pages provide a snapshot of our forward-looking observations on the direction of specific asset classes.

Asset Class Signals and Outlook

There is a set of five signals for each asset class, represented by shaded circles ranging from an above-normal return outlook (dark green) to a below-normal return outlook (dark red), with the middle circle indicating a neutral outlook (gray). The views represented our 12–18-month perspective for each of the asset classes are *relative* to our longer-term expectations (10+-year capital market assumptions).

If our views on an asset class change from quarter to quarter, that change is represented by an arrow that stretches from the previous quarter's signal to that of the current quarter.

Return Outlook

Key:	●	●	●	●	●
	Below Normal		Neutral		Above Normal

Equities

Opportunity Set	Below Normal		Neutral		Above Normal
U.S. large cap	○	●	○	○	○
The one-below rating relates specifically to the overvalued parts of the large capitalization space, in particular the growthier names that have been dominating the index's return. There are parts of the large cap space that offer better risk return and valuations and, if flows in the market move beyond those mega cap names, there could be attractive returns to be had.					
U.S. small cap	○	○ →	●	○	○
Small cap stocks are neutral given the underperformance over the last six months. Valuations driven flows into small cap may offset any late-cycle disadvantages that are implicit in the small cap area.					
Int'l dev. large cap (unhedged)	○	●	○	○	○
Recent positive performance, despite continued inflation and rising rates, provides the backdrop for caution. However, there are multiple country-specific positive and negative factors that favor selection on an country-by-country and stock-by-stock basis.					
Int'l dev. small cap (unhedged)	○	●	○	○	○
As with international developed markets, positive valuation and stock- and country-specific positives and negatives favor selection over and index in the second half.					
Emerging markets (unhedged)	○	●	○	○	○
China dominates the emerging markets (EM) story, and recent growth-rate disappointments have put pressure on the EM space. While many EM countries have weathered the storms and performed well, valuations are still above average.					

Return Outlook

Key: Below Normal — Neutral — Above Normal

Fixed income

Opportunity Set	Below Normal		Neutral		Above Normal
U.S. core	○	○	○	●	○
With the bulk of the rate hikes behind us, adding duration seems like a good diversifier in the face of an eventual need for reinvestment off the inverted short end.					
Non-U.S. core (hedged)	○	○	●	○	○
The ECB is behind the Federal Reserve in its rate hiking cycle but has been quite vigilant in the quest to conquer inflation. Rates are attractive and positive for the first time in decades. The U.S. dollar has been weakening and could continue to provide solid backdrop for investors.					
Emerging market debt (hedged)	○	○	●	○	○
Recent outperformance of EM debt has brought the asset class to within normal valuation levels. But the attractive yields may continue to provide opportunity for higher yield and income, albeit with economic and currency risks.					
High yield	○	○	●	○	○
Spread narrowing has taken the wind out of the sails for below investment-grade valuation relative to core bonds.					
Bank loans	○	○	●	○	○
Bank loans' floating rate feature still is an asset as rates rise, though it's less of one if rate hikes continue to slow going forward as inflation moderates. Their senior position in the capital stack and typically secured status still are points in bank loans' favor.					
TIPS	○	● ←	○	○	○
With inflation coming down, the benefit of TIPS might be moderating as well. With the Federal Reserve focused on making sure that inflation does not spike higher again, it would seem that TIPS' value proposition is less relevant now.					

Continued on the next page

Return Outlook

Key: Below Normal · Neutral · Above Normal

Fixed income

Opportunity Set	Below Normal		Neutral		Above Normal
Private credit	○	○	●	○	○
While yields continue to provide a positive backdrop for private credit investments, and the late-cycle and high-interest rate environment creates headwinds for borrowers, the floating-rate nature of the loans have been a insulator; however, as the interest-rate cycle nears the finish line, selection on lenders will be a key to success.					
Municipals	○	○	●	○	○
Increasing revenue shortfalls for state and local governments are starting to provide headwinds for the municipal market, as indicated by increased default. But most of the defaults have been in areas like continued care or assisted living, where costs, such as wages, have impacted the bottom line. But the supply/demand dynamics and positive year-to-date performance could indicate the worst is behind investors.					

Return Outlook

Key: Below Normal — Neutral — Above Normal

Alternatives

Opportunity Set	Below Normal		Neutral		Above Normal
Hedge funds	○	○	○	●	○
Hedge funds have benefitted from their ability to be less directional than other types of strategies. Investment approaches that limit or eliminate beta exposure are believed to offer a relative advantage over the next 12 to 18 months. Equity long/short, long/short credit and relative-value-driven mandates are well positioned to combat volatility across asset classes and capitalize on idiosyncratic situations.					
Multi-asset class strategies (MACS)	○	○	●	○	○
MACS tend to be more directional than hedge funds, making certain strategies — particularly those with a strategic orientation — susceptible to persistent volatility and uncertainty across equities, fixed income and commodities. Manager selection, emphasizing those with experience over multiple-market environments, will be key over the foreseeable future, as the effects of changes in global monetary policy impact asset classes to varying degrees. Many of these strategies' equity and commodity positions may struggle relative to bonds in the near term.					
Private equity	○	○	●	○	○
Economic uncertainty and prospective downturn over the near term is poised to negatively impact deal volume and exit activity and continue to drive purchase multiples and corresponding valuations lower. However, buyout financing is generally available and leverage levels are likely to continue to moderate from recent past periods. Buy-and-build and operationally focused strategies are favored in the current cycle. Venture will remain challenged, especially growth strategies, while cost-cutting and revenue generation, will be top priorities. Well-capitalized early-stage investments offer promise. While lower valuations will impact interim portfolio returns, these also provide attractive entry pricing points for current vintage year commitments.					
Real estate	○	●	○	○	○
An upward move in interest rates will soften cap rates and continue downward pressure on valuations. A landing of recessionary conditions will likely weaken fundamentals, increasing headwinds on property NOI growth. Transaction volumes are anticipated to remain muted and well below historical levels given interest rate and financing uncertainties. Current property trades are exhibiting significant price corrections, which will factor into declining valuations over the near term. The office sector will continue to be the material drag on the asset class, as record-high vacancies show no sign of abating. While both the more generally resilient and better-performing multifamily and industrial sectors have experienced recent headwinds, fundamentals are expected to remain positive. Retail remains challenged, but neighborhood and discount centers offer some brighter spots. Additionally, certain niche strategies continue to experience strong tailwinds, particularly needs-based sectors, such as senior living, self-storage and data centers.					

Continued on the next page

Return Outlook

Key:

●	●	●	●	●
Below Normal		Neutral		Above Normal

Alternatives

Opportunity Set	Below Normal		Neutral		Above Normal
Infrastructure	○	○	○	●	○
Demand for infrastructure is expected to remain strong, which will sustain valuations. Robust fundraising and fiscal stimulus will continue to provide a variety of spending and subsidies to private companies prepared to deploy capital across the asset class. Slowing economic growth and declines in excess savings and consumer spending could provide short-term headwinds with economically correlated infrastructure such as airports, toll roads, rail and ports. However, strategies focused on energy transition, renewables and digital infrastructure will offer attractive growth opportunities.					
Commodities	○	○	●	○	○
In the short term, there are concerns regarding energy and industrial metals from slowing global growth and the pace and extent of China's economic recovery. Ongoing global geopolitical and monetary uncertainty, along with a possible tapering of U.S. rate rises, will be constructive for precious metals. Russia pulling out of the Black Sea grain deal will likely reduce wheat supply, thereby increasing prices. The U.S. dollar has declined off highs which could provide some level of demand support for emerging market commodity purchasers. The increasing pace of transition to solar, wind and battery power in developed economies is expected to be a major demand source for copper, nickel, lithium, cobalt and rare earth minerals. The ongoing shift away from coal towards natural gas will help to sustain demand and pricing levels.					
Energy	○	○	○	●	○
Focus on critical energy infrastructure security will offer attractive investment opportunities. Oil prices will be lifted by global consumption demand that will draw on built-up inventories along with anticipated OPEC production cuts. U.S, oil production and exports are expected to continue to grow, which reflects health of the sector and will further help to stabilize market pricing. U.S. natural gas production is poised to remain at record highs. Growth in renewable energy source utilization, especially solar and wind, as well as carbon capture and storage investments, provide additional asset class tailwinds.					
Timber	○	○	●	○	○
Relatively higher interest rates, weaker prices of logs and select liquidity pressures on asset owners will put stress on valuations, but at the same time offer an attractive entry point for new capital investment in timberland. While more moderate in scale, continued housing starts along with repair and remodeling demand should offer support to domestic softwood lumber and log prices in the short term. Although income-based gains have retreated from pandemic-era levels, additional gains forecasted from land transactions and complementary sources of return, such as biofuels, are expected to contribute positively to total returns. China's ongoing economic reopening offers support to weakening prices of logs and lumber, while wildfires, storms, and droughts continue to present risk during an unusually hot summer in North America.					

Continued on the next page

Return Outlook

Key: Below Normal | Neutral | Above Normal

Alternatives

Opportunity Set	Below Normal		Neutral		Above Normal
Farmland	○	○	● ←	○	○

Near-term outlook has become more mixed. Headwinds include a strong U.S. dollar, which could negatively impact demand and reduce competitiveness of agricultural exports, elevated input costs for fertilizer and labor and a looming economic slowdown affecting producers. Positivity includes increased prices for certain commodities impacted by supply constraints due to a variety of factors such as the ongoing Ukrainian conflict and dramatic weather disturbances, including historic flooding and heat waves. Also benefiting U.S. farmers is the increase in land values which are at elevated levels with certain areas, such as the Corn Belt, reaching record highs. Longer-term outlook remains favorable due to growing populations, demand for food, increased focus on renewable energy and a shrinking supply of arable land.

Overview
Asset Class Signals and Outlook
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Stay Informed

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