Overview

Amidst concerns over inflation, the economy, the dollar, the potential banking crisis, and the Federal Reserve, the first quarter of 2023 was marked with higher volatility in both equity and fixed-income markets.

The repercussions of the Federal Reserve's resolute stance to fight inflation through higher rates became apparent during the quarter, particularly with entities whose liabilities adjust with short-term rates. The crisis with Silicon Valley Bank demonstrated the risks of an asset-liability mismatch, particularly when short-term rates rise quickly to levels higher than long-term rates. Fears of a widespread bank run dissipated with the rapid response by Central banks to step in and insure all deposits, which sent a clear message that even one small financial institution is too big to fail if there is a risk of contagion.

Despite increasing the Federal Funds rates by 4.75% over the last 12 months, U.S. unemployment has hovered below 3.7%, and year-over-year inflation has remained over 5%, well above the Federal Reserve's target of 2%.

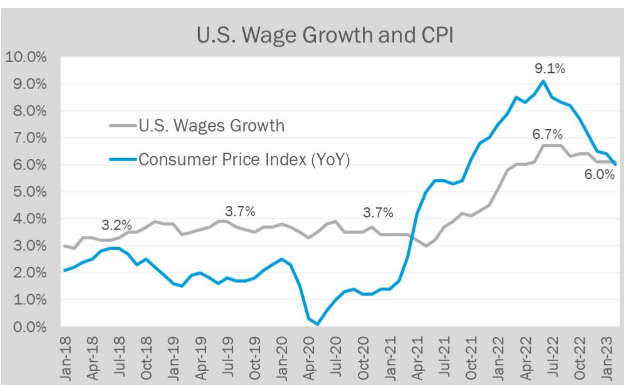

Figure 1. Source: Bureau of Labor Statistics

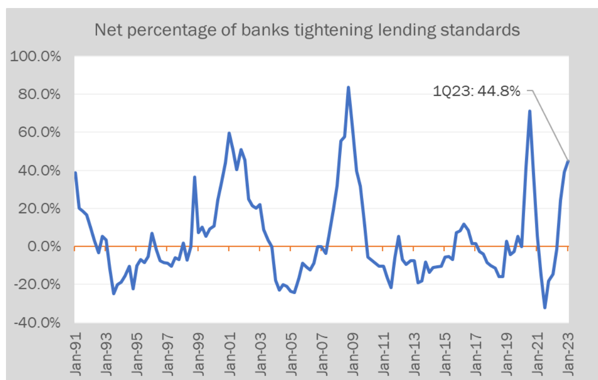

Figure 2. Source: Federal Reserve of St. Louis

The impact of higher rates is, however, coming through in the form of declining inflation, a leveling of wage growth, and a slowdown in housing activity. Banks have also tightened their lending standards to small to medium size companies. As the stimulus from the COVID period is spent down and borrowing rates stay elevated, the slow down in spending will likely impact service industry and travel as well.

We have seen similar dynamics of higher inflation and rates across Europe, Japan and other countries, but there are distinct differences. Despite the Russia-Ukraine war, the European region has continued to grow. The global supply chain continues to ease with China lifting its COVID restrictions, albeit amidst greater political overtones of deglobalization and building "just in case" supply sources. The divergence in economic activity across countries has created opportunities in non-U.S. investing. For the first quarter, both equity and fixed-income markets performed ahead of their peers in the U.S.

We've taken the opportunity with higher rates to make some changes on the margin in our fixed-income portfolios. As investment-grade bonds now provide over 5% yield, we've pushed up our exposure to U.S. Core fixed income and cut back elements such as high yield and currency. In particular, as allocations to fixed income have fallen to the lower end of their permissible range, we look to reduce those fixed-income elements that can have a higher correlation to equities. At current rates, our capital market assumptions show higher expected returns on fixed income, but the expected returns are still below the return threshold for most institutional clients. We continue to look towards public and private equities to be the primary drivers of long-term growth.

Equities

Amidst heightened volatility, U.S. and non-U.S. equities were up over 7% for the first quarter. Concerns about the magnitude of the economic slowdown, margin compressions amidst rising borrowing costs, and a potential banking crisis were some of the concerns just in the U.S. Banking stocks came under pressure with news of the run on Silicon Valley Bank and a few other regional banks.

	Value	Core	Growth
Russell 1000	1.0%	7.5%	14.4%
Russell 2000	(0.7%)	2.7%	6.1%
Russell 3000	0.9%	7.2%	13.9%

Figure 3. Source: FTSE Russell & Co.

However, the ensuing Fed response and decline in Treasury yields pushed up the price of growth-oriented companies. This large dispersion in returns across sectors is reflected in the gap of 1300 bp in performance between the Russell 3000 Growth and Value indexes. Large-cap Technology companies that make up the top holdings of most large-cap indexes drove much of this performance. At the end of March, Apple and Microsoft had grown to make up over 13% of the S&P 500 index, making it challenging for active managers to perform ahead of the broad benchmarks without holding these large names or holding them in allocations less than the benchmark. We think the equity market volatility will remain high relative to the last decade, particularly as the broad indexes have become much more "top heavy" and there remains uncertainty around the direction of interest rates in the near term. We have also continued to see strength in the performance of non-U.S. developed countries. The MSCI EAFE index was up 8.5% for the quarter, ahead of the U.S. equity indexes. The MSCI Europe index was up 15.6% for the quarter. Each country is at a different stage in the interest rate cycle as they emerge from COVID at their own pace and face their unique hurdles. Many central governments are still in the early stages of raising rates and may seek to tighten less if global supply chains continue to open up.

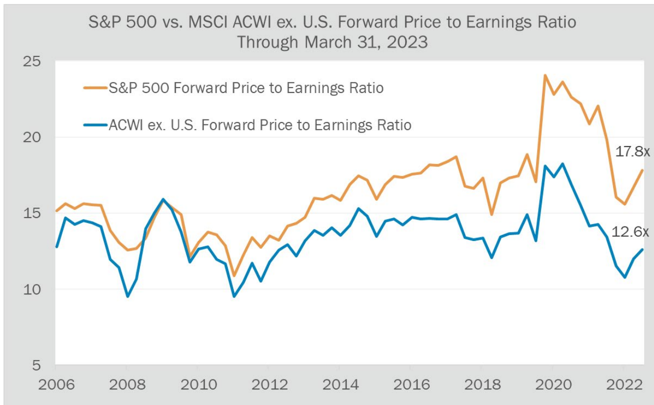

Figure 4. Source: Standard & Poors, MSCI

Across developed and developing economies, non-U.S. stocks have traded at a lower valuation for the last decade, giving them more upside potential. Many global franchises domiciled outside of the U.S. have continued to see their businesses improve with the re-opening of economic and trading activities.

Fixed Income

Over the last 12 months, we have seen dramatic spikes in the MOVE index, which measures the expected volatility of the price of U.S. Treasury bond futures. Relative to the VIX index, which measures the volatility of S&P 500 index equity futures, the MOVE index reached all-time highs during the first quarter, which is unusual for Treasuries, which are otherwise seen as more stable in their value. Over the three months ending March, the yield curve shifted down across most maturities longer than 1 year, making the curve more "inverted" than at the beginning of the year. The decline in Treasury yields also boosted pricing for other fixed-income securities priced off of the Treasury curve, including agencies, investment-grade corporate bonds, and municipal bonds. Compared to two years ago, the current bond market dynamics provide a very different set of opportunities for core fixed income.

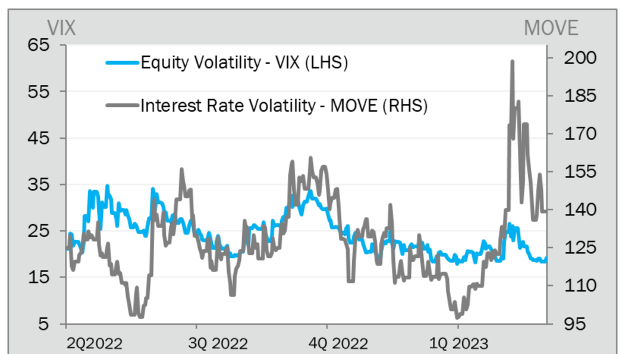

Figure 5. Source: Bloomberg

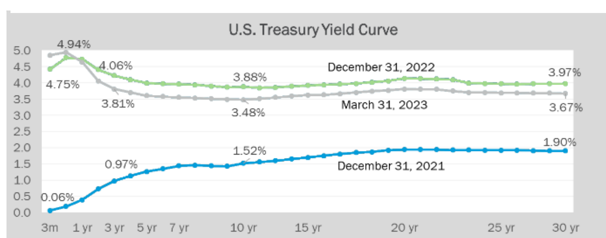

Figure 6. Source: U.S. Treasury Dept

Not only is there a higher level of interest income to be earned from bonds all along the yield curve, but intermediate bonds, while they may generate less yield than short-duration bonds, have the potential to appreciate when the Federal Reserve begins to reduce short-term rates and the yield curve is positively sloped with short rates lower than longer rates. As a 10-year bond becomes a 5-year bond in a few years, it will benefit from a price increase if the interest income generated by newly issued 5-year bonds is lower. This benefit will continue further as the bond's maturity further reduces.

We've taken advantage of this dynamic to restructure the fixed income segment in our portfolio. We have allocated more to the core fixed income managers by reducing allocation to areas such as high yield and non-U.S. currency denominated bonds. These elements were added a few years ago to take advantage of potentially higher yields when core fixed income was generating sub 1.5% yields and short rates were close to zero.

We had reduced fixed income allocation to the lower end of the client's permissible allocation range and continue to keep it there. Still, given the equity volatility, we can get paid to be in safer bonds and would prefer to have this segment operate with less correlation to equity beta.

Liquid Alternatives

We feel that this period of market uncertainty and dispersion in performance across securities provides a very fertile environment for hedge fund managers. The dynamics of higher borrowing rates and a possible slowdown in business activity have the potential to create stress in companies with high levels of debt. The pressure is particularly greater for companies that hold floating-rate debt where the interest adjusts in line with market rates. Bank debt or leveraged loans fall in this category.

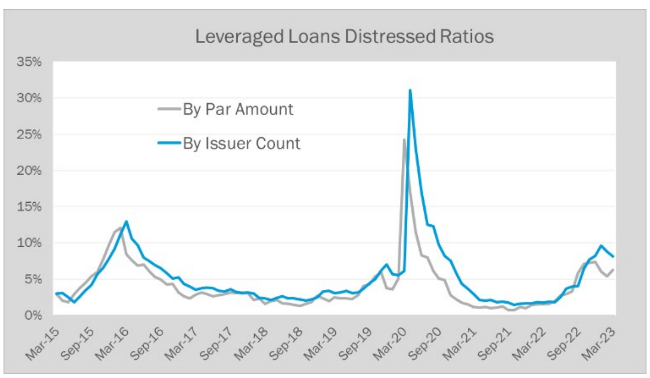

Figure 7. Source: Pitchbook

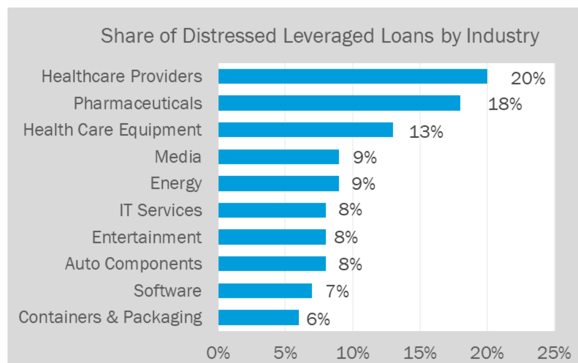

Figure 8. Source: Pitchbook

We have seen a small pick-up in default rates. Still, there has been a distinct increase in credit spreads among publicly traded loans, a growing area of interest for multi-strategy managers that can invest across equities and fixed income. Unlike the period in 2015 when most of the distress was in the Energy sector, this time around the financial stress is seen across a broader set of industries.

Managers can use this to select bonds trading at distressed prices but with better fundamentals. In some cases, they anticipate a financial restructure within the company where they are likely to recover more than the price they paid. As many of these loans are also the underlying holdings in collateralized loan obligations (CLOs) or collateralized debt obligations (CDOs), there are opportunities to trade in the tranches of these structured securities if their prices do not reflect potential underlying shortfall in interest generation.

Private Equity

The repricing of securities in the public equity markets in 2022 also affected private equity strategies. Among these strategies, venture capital, particularly early-stage venture capital strategies, saw the biggest decline in one-year IRRs. Real estate and private debt had smaller adjustments, partly because of the potential for these sub-strategies to generate higher income as short-term rates go up.

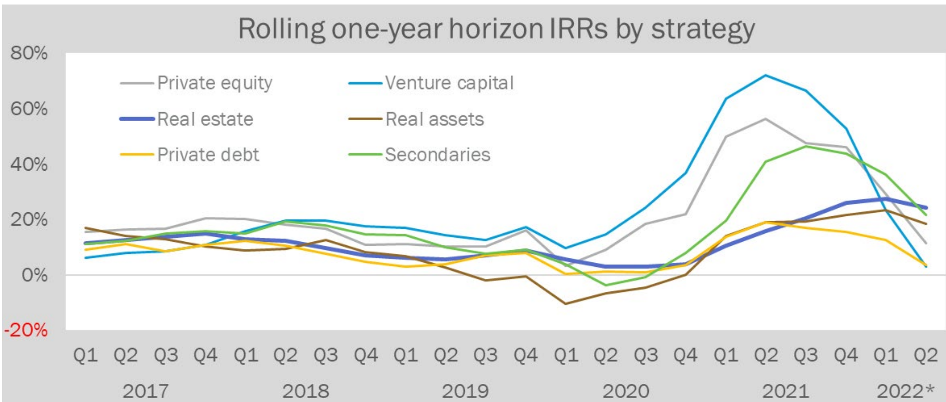

Figure 9. Source: Pitchbook

Unlike other periods of market crisis, there has not been a big spike in selling activity. There has not been a large volume of forced selling which would require portfolios to be marked down. There is still a lot of "dry powder" in active funds, which allows them to put more capital into underlying companies if needed. Certain funds may also be ready to purchase add-on investments to their underlying companies at smaller discounts if they feel that helps reduce the "blended" cost of that holding. We have seen some changes in the pace of fundraising activity. It is taking a little longer for managers to raise funds, and there have been cases where the fund size has been reduced.

We feel it is also important to recognize that new funds are going to have an advantage of being able to deploy capital at more attractive prices relative to 2-3 years ago. As we update our private equity pacing models with an adjusted "denominator" of total portfolio value, we see that in some cases, the allocation to private equity may be higher than at the end of 2021. However, the program requires multiple years of commitment that matures over time. The change in total portfolio value over one or two years has little effect in the long run. It is important, and we continue having vintage-year diversification in the portfolio to invest across market cycles.

We do not seek to make tactical shifts to capture short-term swings in the market. We don't think anyone can time those correctly. However, we are proactive in taking advantage of more pronounced opportunities. We shifted our fixed-income segment to take advantage of higher Treasury rates and improved return potential with less risky investment-grade securities. We remain cautious about equities, but they provide long-term opportunities. We have added private credit to portfolios where appropriate, as they offer a differentiated source of return. At the same time, we are always aware and seek to adhere to the values and criteria specified by each client for their investment assets.

We value the trust placed in us by our clients and consider it a privilege to steward their capital. We remain grateful to our clients for their confidence.

Sincerely,

Poorvi, R. Parekh, CFA
Director of Outsourced Investments
Ms. Parekh is a member of the Board of Directors, a shareholder of Canterbury, and directs the Canterbury Outsourced CIO platform, which caters to institutions and private clients seeking to outsource the day-to-day management of their portfolios. In this role, Ms. Parekh is the chair of the Canterbury Outsourced CIO Committee and a member of each of the firm's five Manager Research Committees. Joining Canterbury in 1996 as the manager of analytics, she directed the firm's account analysts and client services group, securing many of the asset allocation modeling and research software tools we use today. In 2001, she became the director of manager research — overseeing all manager, fund, and product research; maintaining Canterbury's proprietary research database; and chairing the Investment Manager Research Committee. Ms. Parekh graduated from the University of Hong Kong with a Bachelor of Arts in economics and completed her Master of Business Administration at Shenandoah University.

About Canterbury
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