Canterbury Outsourced CIO

Second Quarter 2023 Commentary

"...there's a "common factor" that has driven price increases higher. It's the pandemic, and it's everything about the pandemic: The closing of the economy, the reopening of the economy, the fiscal support, the monetary support. All the things that happened went into high inflation. And I think we've come to expect that — expect it to be more persistent." - Jerome Powell, June 21, 2023, excerpt from his testimony to the House Financial Services Committee

2Q2023 OCIO Commentary

The strong performance of global equity markets in the first half of 2023 create a perception of strong economic prospects, but it is hard to dismiss the forces that collectively can only slow economic activity. Even as overall inflation (CPI-U) figures have continued to decline, the service sector inflation, of which wages is a bigger component, has remained high and wage growth, which tends to be "sticky", has remained close to 6.7%.

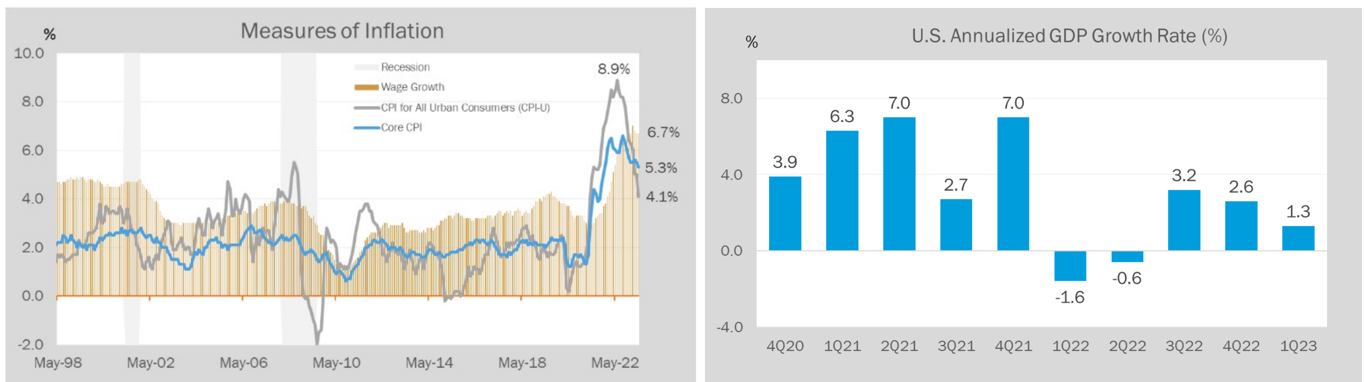


Figure 1. and Figure 2. Source: Bureau of Labor Statistics, Bureau of Economic Analysis

Even as the Federal Reserve stepped back mid-year with a "hawkish pause", the Federal Reserve Chair set expectations for further rate increases, albeit more moderately, "given the tight labor market and high inflation". GDP growth has been positive, but more moderate as consumers have spent down most of the pandemic disbursements. We're also experiencing other areas of tightening as what was quantitative easing has turned to quantitative tapering in the open market purchases of fixed income securities.

Banks have had multiple challenges: Cash Deposits flowed out to higher rate options elsewhere. The bonds that they hold at cost from a few years ago are generating low interest but cannot be traded away given they would be worth less at market value. Most have tightened lending standards and have also seen a decline in borrowing at current higher rates. The result of both public and private efforts has been a distinct decline in the M2 money supply from peak levels in late 2021, which can help reduce inflationary pressures, but all

these activities have historically also unmistakably pushed the economy towards some level of a recession.

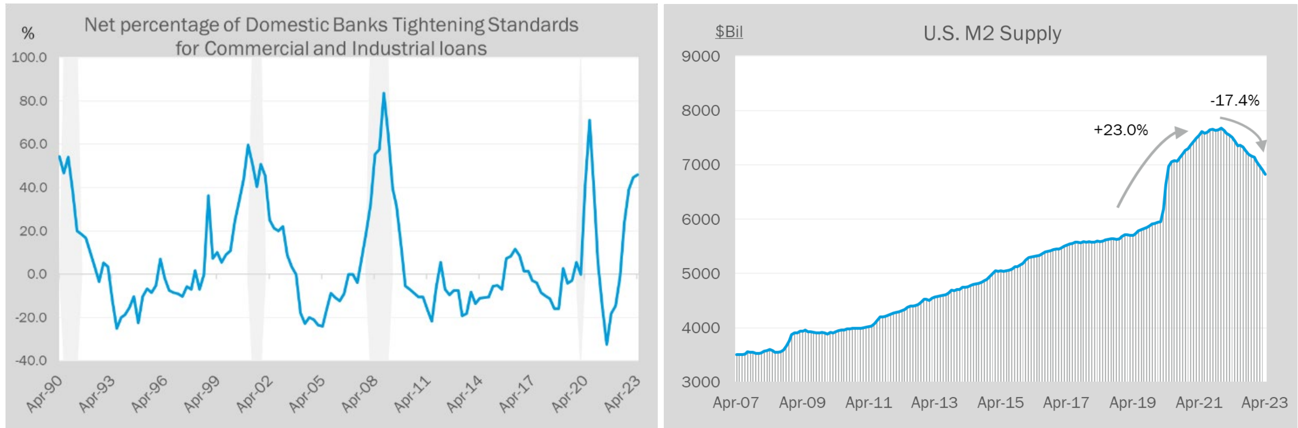


Figure 3 and Figure 4. Source: Federal Reserve of St. Louis, Data through April 2023

Equities

The broad equity market indexes were positive for the quarter and the first half of 2023 with considerable performance dispersion across economic sectors. U.S. large-cap equities were ahead of non-US peers, but much of this was driven by the few very large Technology names that make up the top holdings. The S&P 500 index was up 16.9% in the first six months of the year. At a closer look, 7 names were responsible for a large part of that performance:

Company	1/1/2023 Weight	1H 2023 Return	Contribution to S&P 500 Return
Apple Inc	6.0%	49.7%	3.00%
Microsoft	5.6%	42.7%	2.37%
Nvidia Corp	1.1%	189.5%	2.14%
Amazon	2.3%	55.2%	1.27%
Google	3.1%	35.9%	1.11%
Meta Platforms	0.8%	138.5%	1.16%
Tesla Corp	1.0%	112.5%	1.16%
Total	20.0%		12.22%

Figure 5. Source: Standard & Poor's

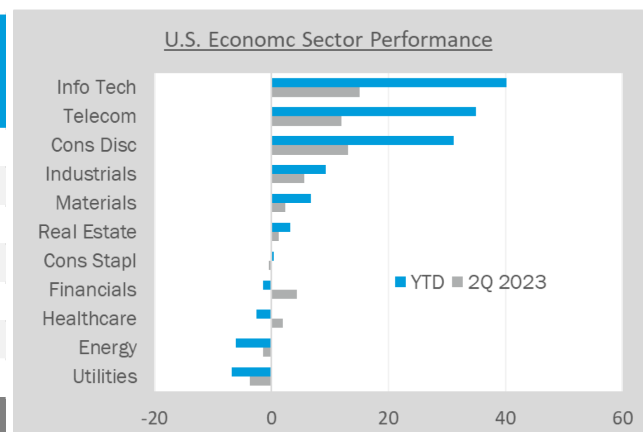


Figure 6. Source: Standard & Poor's, Bloomberg

The seven top performing large technology companies account for 12.2% of the S&P 500

index's performance while the remaining 493 names in aggregate returned 4.7%. This narrow performance has also manifested in Value indices that tend to have higher weightings in Financials, Staples, Energy, and Real Estate, lagging their growth style counterparts by over 1000 basis points across the different market capitalizations. To date, many companies have continued to raise prices successfully to offset higher costs, but there is often a point at which higher prices curbs demand and revenue. The potential for companies to surprise on the downside is higher today than even a year ago and we feel at best cautious given the speed and narrowness of the gains in the equity markets. This has been a particularly challenging period for active managers as performance relative to the market indices has become largely dependent on the weighting of this narrow list of companies over the more recent periods.

In many ways, the US economy emerged stronger and faster from the pandemic compared to developing countries. The equity markets have also appreciated earlier in light of the recovery. Many other countries are still at the earlier stages of Central Banks hiking interest rates in the face of higher inflation. The EAFE index is up over 12% year-to-date while emerging markets are up over 5%.

We believe that the higher volatility we have experienced in the equity markets will persist through this period of economic uncertainty. Even as Central banks seek to overshoot inflation without unduly weakening the economy, we see that the upside for equities may be muted in the near term while the downside risks may be more heightened.

Fixed Income

Fixed income has become a more attractive segment within the portfolio as rates have become more attractive, particularly at the short end. However, given the possibility that rates may go up further, long bonds continue to remain at greater risk for price decline. We feel the most challenging environment for core bonds may be behind us as where the impact of the rapid increase in rates was particularly hard on bonds that were yielding under 1.5%. Corporate bonds have held up their value as they provide higher income and many secured financings at low rates during the COVID years. Despite higher interest rates, both investment grade and high yield bond spreads have remained tight.

We are in an unusual environment where short-term U.S. government bond yields are more attractive than those of bonds that hold more credit or duration risk. The yields on Investment grade bonds are at 5.55, which are not much higher than those of 3-month Treasuries at the end of June. Equity yields are close to 4%, which are higher than those of 10-yr US Treasuries. Thus even as yields have gone up for Treasuries, long term bonds are less attractive than Equities. High Yield offers some attractive opportunities with yields close to 9%, but the risk is also high for default for companies that may be overlevered.

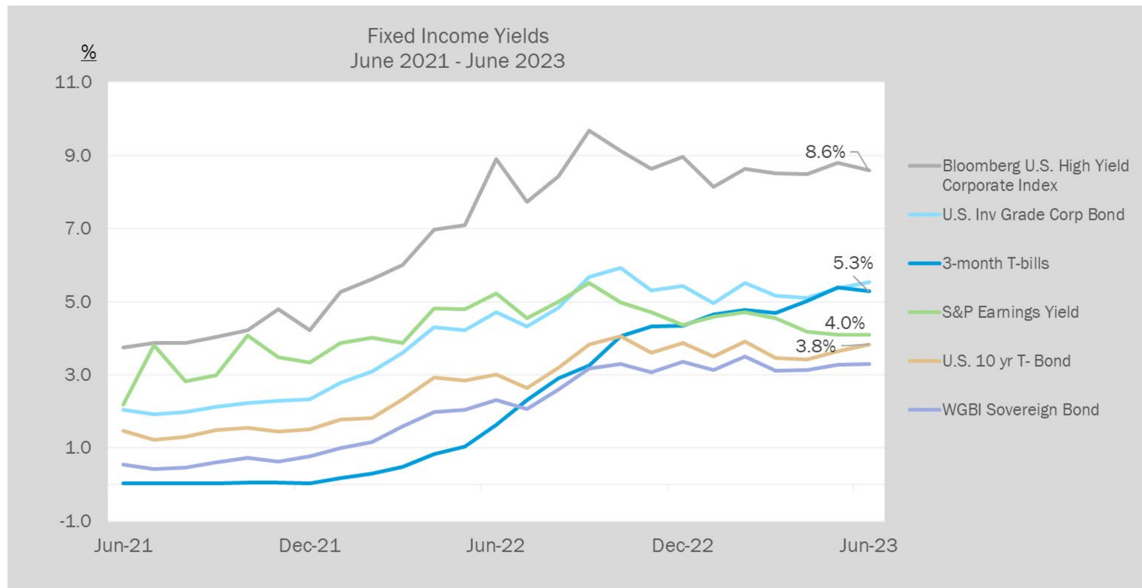


Figure 7. Source: Bloomberg, Nasdaq

We took this opportunity during the quarter to reshuffle this segment and increase the allocation to core bonds while simultaneously reducing the weighting in high-yield and non-US bonds. At a time when equity volatility will likely remain high and spreads across corporate bonds are tight, we have chosen to reduce the components that tend to have increased correlation to equities during down markets, including high yield bonds and bonds subject to non-US currency fluctuations.

Credit

In an environment where credit spreads have remained tight for a number of years, even as economic conditions have steadily evolved, there is considerable anticipation of potential stress and even distressed over the upcoming years. Certain industries such as Retail, hotels, certain types of manufacturing and even banks have already seen some level of takeover and reorganization. This is the opportunity that managers are looking to see in other segments, particularly with companies that may be highly levered and likely to experience a slowdown in business in the face of rising borrowing costs. A few managers see this as the outcome of any recession we may go through while others anticipate the opportunity to be a "slow-moving train". Where this is the concern for high yield in general, the impact will likely be greater on public bonds that are marked to market. Private debt, which is in locked up vehicles and "marked to model" tends to be shielded from price volatility but is not immune to distress if the underlying company fundamentals deteriorate. The credit-oriented hedge fund managers

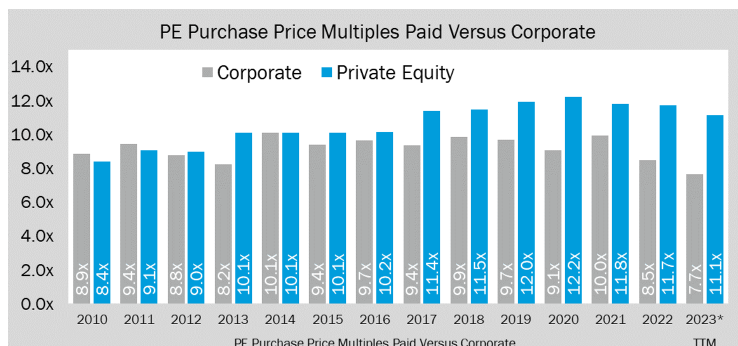
that we work with have been taking advantage of select opportunities to invest in both stressed and distressed bonds. The opportunity extends to structured securities such as Commercial Real Estate mortgages where there are already some “cracks” occurring in certain office and commercial sectors. If the distress opportunity expands further to other types of publicly traded credit, the hedge funds will be in a good position to take advantage of this.

We have therefore been particularly careful in our approach to investing with private credit managers making direct loans to companies. This is an attractive space if managers can generate 450-500 over SOFR while having the priority of being repaid by being senior in the company’s capital structure. The growth in private debt opportunities for direct lending funds that can step in to provide financing in place of banks continues to grow, but as the number of funds and capital flow into the space has proliferated, we have been particularly selective to go with managers that are small and prudent in their exposure to leverage, both at the company level and in the fund they manage.

Private Equity

We have seen some slowdown in the pace of deal activity over the prior 12 months. The correction in public markets has put some downward pressure on the pricing of exits while at the same time funds with “dry powder” funds to deploy have been looking to negotiate purchase price. The overall pace of activity in 2022 remained comparable to that in 2021 as funds find ways to deploy the capital, they have within their investment period. The tell-tale signs have been funds with 4–5-year investment periods coming back to market within 2-3 years looking to raise their next fund.

In general, we have seen a greater percentage of PE transactions taking place between private equity funds. It may be a growth-oriented fund selling their company to a buyout fund that is willing to take it to the next stage of growth or integration. In general PE funds pay a higher purchase multiple compared to strategic corporate buyers, but the differential has also grown over the years.



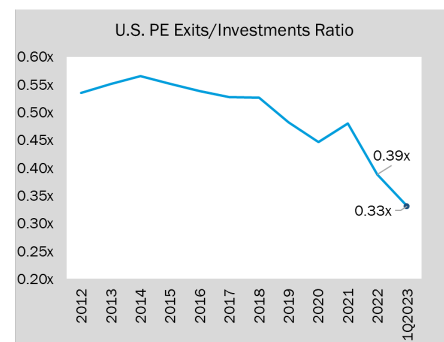


Figure 8 and Figure 9. Source: Pitchbook, Q1 2023

Whether this has been driven by the large levels of uninvested capital in funds, increasing institutional allocation to Private equity, and the availability of cheap debt, it has become increasingly important to scrutinize each manager's value add in the process. As exit activity has fallen in recent years, an environment where funds are flushed with capital may be vulnerable to making poor and hasty investment decisions. We have turned down a number of managers whose funds we had approved previously if they have drifted from their investment style in the most recent fund, either with their valuation discipline or in the nature of the underlying companies they invest with.

Overall

We find the current investment environment very challenging given near-term drivers for an economic slowdown amidst seemingly strong markets. However, we also know from experience that current challenges are what create future opportunities, particularly for clients that have long-term investment horizons. We seek to balance having adequate liquidity to meet near-term distribution needs and having the time horizon and ability to take advantage of longer-term opportunities when they arise.

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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