BLUMBERG B + V ADVISORS

OCTOBER 1ST, 2023

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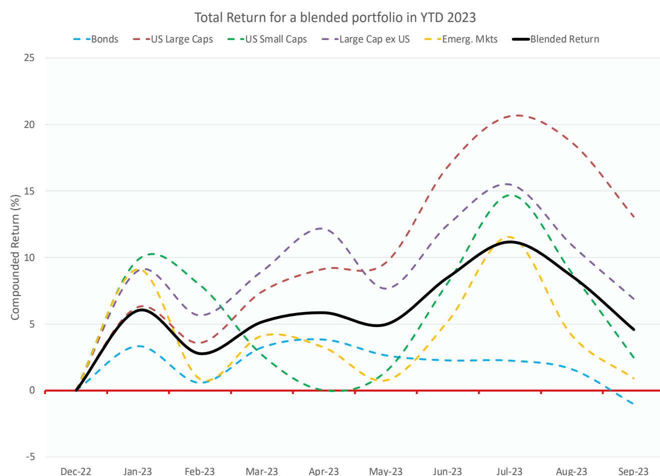
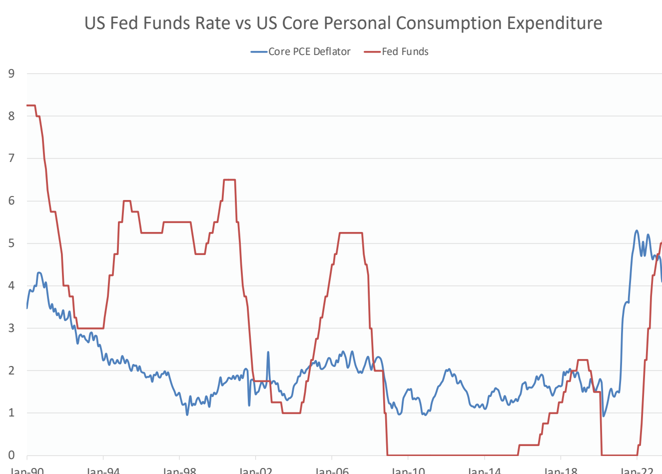
WHERE WE STAND – Q3 2023

In Q3 of 2023, a typical blended portfolio* of securities had a total return (capital appreciation plus income) of -3.6%, reversing all its gains in Q2 2023. For the year-to-date, such a portfolio is up 4.6% (black line in the chart below). Leading advances are US Large Caps (+13.1%) and Developed Markets ex USA (+6.9%). US Small Cap stocks (+2.5%) and Emerging Markets (+0.9%) gave up most of the year's gains during the quarter. Bond returns have turned negative, being down, now, 1% on the year. See the colored broken lines in the chart.

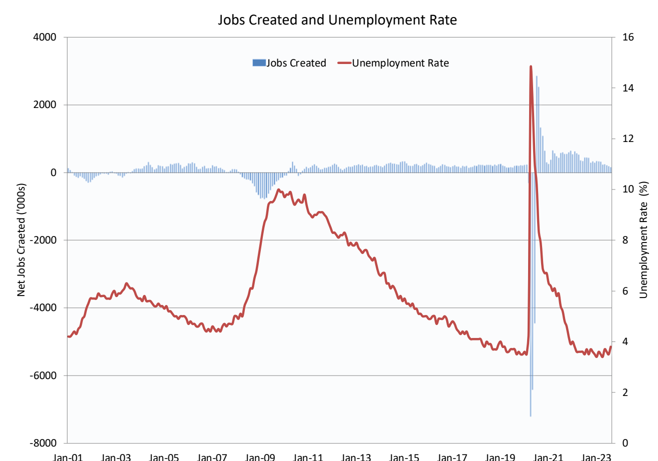


*A typical blended portfolio would be comprised of 60% equities and 40% bonds. For a benchmark, such a portfolio would arguably be 30% large cap US stocks, 10% US small caps, 10% developed markets ex-US, 10% emerging market stocks and 40% US government, investment grade corporate and GSE bonds.

The chart below shows the Federal Reserve's preferred measure of inflation (Core Personal Consumption Expenditure Deflator in blue) plotted against the Fed's primary monetary policy tool, the Federal Funds target rate, in red. As can be seen from the chart which goes back over 30 years of data:

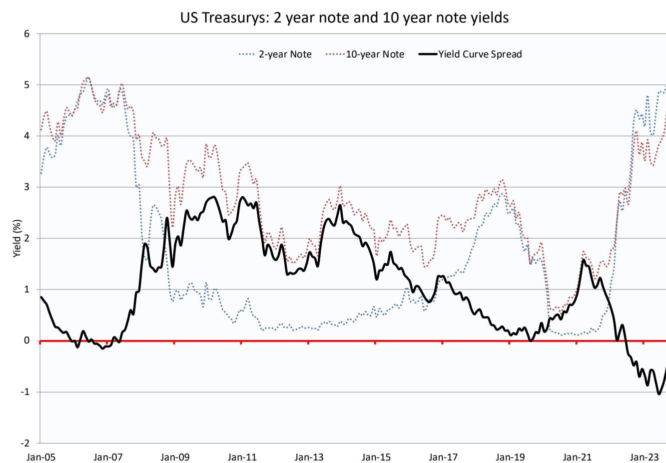


- Interest rates were relatively restrictive (restrictive policy = interest rates, in varying degrees, higher than the inflation rate) until the great recession/financial crisis. And very stimulative subsequently. Recently, though they are turning restrictive again.
- Inflation was largely subdued (and within the Fed's target range of 2%) up until the post-Covid period. (Note: there are other factors including fiscal policy, supply chains and consumer behavior that determine inflation levels, but ultimately it is Fed Policy and the cost of money that is the primary determinant of inflation in any economy).
- In response to the rapid rise in inflation from 2021 (after insisting, erroneously, that this rise was transitory) the Federal Reserve, realizing its mistake, raised this benchmark rate extremely rapidly, from 0% to, as of now, 5.25%.
- As a result, the rise in the inflation rate abated and started to turn lower, from a high of >5% to now <4%.
- However, the US economy, primarily as measured by employment, has recovered all the



losses from the pandemic and the unemployment rate has remained extremely low for now (red line in the previous chart), notwithstanding the rapid interest rate increases from the Fed. This fact weighs on policy maker's minds: that we are not out of the woods in the fight against inflation and leaves open the question of how high interest rates will ultimately have to go and how long they will stay high before the Fed can begin an easing cycle.

Where does this all lead the debate regarding the Fed's monetary policy, the primary macro determinant of asset values going forward? Although the Fed raised rates by a further 0.25% during the 3rd quarter (to 5.25% in July), it paused, for the first time in this cycle, at the September meeting. But, at the same time it signaled that it is prepared to raise rates further if inflation trends reverse and indicated that it intends to keep current levels of interest rates for an extended period: in market parlance 'a hawkish pause'. This action garnered a very strong response from financial markets: In September, the dollar rose by 2.5%, the S&P 500 fell by 5% and interest rates (especially long-term rates) rose substantially. See the chart below.



The narrative in financial markets has completely shifted in the last 18 months. Understandably. Before, cash and near cash investments yielded 0%. Now they yield well over 5.25%. With no risk of capital depreciation.

So, in a world where investor confidence for reasons we all know, is tenuous at best, money is flowing into money market funds, increasing by 50% since the pandemic to almost $6trillion. On balance this is limiting flows into many fairly valued equities and bonds and will continue to do so until it becomes apparent that the Federal Reserve has reached the end of its tightening cycle and in particular, that interest rate cuts are on the near horizon.

Where We Stand

Suddenly, competition for global capital has become fierce. Its availability has declined, and where it is available it comes at a relatively high cost.

For consumers, credit card rates are over 25% APR; 30-year mortgage rates are now over 8%; auto loans are approaching 7% for new cars and 9% for used cars; home equity loans are over 9%; student loan repayments restart on October 1st and rent prices have risen substantially.

On a corporate level, the private equity and venture capital world in many instances are dealing with existential issues: many are companies with negative cash flow and floating rate debt, the cost of which has exploded higher. And in the public markets, various companies in the real estate, financial, transportation, even technology and consumer areas, with leveraged balance sheets and or exposure to a slowing consumer, are feeling pressure.

The Fed determines its policy on coincident data, but its policies work with lagged effects.

We think that the lagged effects of the increased cost of money in the US economy will slow down economic growth in the coming months, as is typical of all economic cycles. As a result, inflation will continue to slow, and the market will start to discount cuts in the Federal fund rate going forward. The timing of this is uncertain and there is even the possibility, albeit with a lower probability, that before this eventuality, there is a resurgence in economic activity and the need for further rate hikes.

Our strategy is to be fully invested in a balanced portfolio of stocks and bonds. Our equity investments are fairly priced, have excellent free cash flow, pay dividends and promise good returns over the medium term. Our fixed income investments have been primarily very short duration, and we intend to extend that duration at the beginning of October to take advantage on the now attractive long term interest rates.

Any notion that the Fed is done with tightening and is going to begin easing, will again change the narrative towards deployment of capital out of money market funds into longer duration assets with both yield and the potential for capital gains.