Quarterly Market Letter

GENTER CAPITAL MANAGEMENT

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Inside This Issue:

Introduction 1
Review and Outlook 1
Fixed Income Report 2
Equity Report 3
Conclusion 4

Highlights:

- Economy surprises and does well
- We still expect "low unemployment", "recession"
- Inflation persists
- Fed tightening, but with "pauses"
- Equity investors using rose-colored glasses
- A threshold of secular growth cycle

Introduction:

There is a baseball story about Hughie Jennings, manager of the old time Detroit Tigers. Jennings received a letter from a young man who claimed that he could strike out Ty Cobb in three pitches. Jennings figured, "what the heck, you never know" and sent the young man train fare to Detroit. When the kid arrived at Tiger Stadium, Jennings let him warm up and then brought Cobb up to the plate.

On the first pitch, Cobb slapped the ball hard to left field. On the second pitch, Cobb drilled a line drive to center field, just a couple feet over the pitcher's head. And on the third pitch, Cobb drove the ball deep over the right field fence. Jennings walked out to the mound to hear what he had to say. "You know what?!" said the kid, squinting towards home plate, "I don't think that's Ty Cobb."

This market is providing investors with excellent opportunities to rethink their assumptions. It has been a long time since we have seen a reflating economy. It has not rewritten the rulebook—an inverted yield curve is still an inverted yield curve—but timing the inflection points, like striking out Ty Cobb (or *any* big leaguer), is a tough piece of business.

Review and Outlook

The quarter began on shaky ground, with the regional bank crisis in its early stages. Significant questions remained about the viability of lower-tier banks and the risks associated with tighter credit standards. A political impasse over the debt ceiling was quickly approaching. Inflation, and the Fed's future policy path, seemed variable and uncertain.

The economy has survived, for the moment, the bank runs and the regional bank crisis. The quarter ended with global systemically important banks (GISBs) passing the Fed stress test. On the fiscal side, the debt ceiling was resolved with a compromise and no rating downgrade. Barring brinksmanship in the upcoming budget negotiations—a real possibility—it looks as though the economy will continue with reduced, though still adequate, fiscal support. Meanwhile, headline CPI continued to cool down, dropping from annualized numbers of 6.0% to 4.0% in four short months. While the Fed tracks the core PCE inflation number more closely, the market regards the decline in headline CPI as a positive development.

Whatever the Fed has been doing to limit inflation, it has not made much of a dent in the employment picture. At 3.6%, unemployment remains near historic lows. There is noteworthy strength among the lowest tier of earners, where marginal propensity to consume is highest. This means more spending, or more demand for the prodigious productive capabilities of the American economy.

Beyond these positive developments, 1Q GDP was upwardly revised from its 1.1% advanced estimate, to a 1.3% first revision, and from there to a final revision of 2.0%. Higher consumption, rising inventories, and a reduced trade deficit are the main reasons why we saw such strength. Keeping in mind the strong 4Q 2022, at 2.6%, it pointed to surprising strength during a period of gloom and doom.

Still, despite the good news, traditional recessionary indicators are signaling an uncertain future. The short end of the yield curve is still inverted, and the two-year/ten-year inversion has persisted since April 2022. The ISM manufacturing number was below 50 for the eighth straight month. The Leading Economic Index (LEI) has been in negative territory for eleven consecutive months. Despite this, core CPI, a measure of how embedded inflation has become, remains stubbornly high at 5.3%.

The range of negative data points is impressive. Persistently high inflation has the dampening effect of inducing consumers to scale back purchases. That process can only be accelerated by diminishing household cash balances, and the credit squeeze, which we expect to be reinforced by the resumption of student debt payments. And while we are not necessarily predicting a resurgent bank crisis, the weak links haunting the banking system in March have not disappeared. The Fed has created a credit facility, and that helps, but small- and mid-sized banks remain vulnerable.

While the Fed will probably take a more measured approach from here, there is another hike to come, and maybe more. Meanwhile, the economy is still absorbing the brutal pace of hikes over the past sixteen months. Higher rates have already taken a toll on interest-sensitive sectors of the economy, like housing, automobiles, and banks. With reference to that, there is always the possibility that a rolling recession for these sectors has already occurred. All three sectors are apparently stabilizing, as housing statistics have improved, auto deliveries have risen, and the banking crisis has seemingly gone away.

In our judgement, the growth-positive factors seem more generalized, while the growth-negative factors are more specific. Are we in the "eye of the storm" of a delayed recession? Or are there sources of hidden strength in a high nominal GDP economy which is not captured by the usual analytics? It is a close call, but we lean towards "yes" on the first question and "no" on the second. If we had to put a number on it, we would say 60/40.

We expect growth to slow from current levels, probably to the -1% to +1% range. If we do tip into the negative growth—recession territory—we think it will be a low impact recession. Of course, inflections are never easy, and as we undergo cyclical transitions, they can seem scary, especially when triggered by an exogenous event. This is true in slowdowns, much less full-blown recessions. Only in the fullness of time are we able to clearly see the mechanisms driving any given economic moment. In that moment itself, there is all kinds of noise.

In any event, and this has been true all along, we are fundamentally bullish on the domestic economy. Not only is American-style capitalism flexible and resilient, unlike most countries, but there are good technical reasons, which we have discussed in prior newsletters, for thinking that we are on the threshold of a new secular cycle of growth and prosperity. The fullness of time also holds the answers to *that* one. The challenge facing the American economy, and investors, is the next several months.

Fixed Income Report

In times of uncertainty, we focus on areas of higher confidence. One area where we have consistently forecast better than the market is the path of the Fed funds rate. For the better part of the last year or so, we have said the market (as expressed by Fed funds futures) was underestimating the stickiness of inflation and the Fed's resolve to get inflation under control. Fed funds' future rates are finally reflecting a path which is not too different from our own outlook.

We think inflation will stay on a steady path lower. It may not retreat as fast as the Fed would like, but enough so that the Fed's default mode is "pause" rather than "hike." One reason we think inflation will continue to drift lower is its shelter component. Shelter is the largest part of both headline CPI, the widely watched inflation barometer, and core PCE, the Fed's inflation target. One year ago, we estimated the shelter component would top out in March 2023: it peaked in April 2023. Now that home prices and rents are not moving much, we expect a reasonably rapid retreat in the shelter component to play a large part in steadily moving CPI and core PCE lower.

In terms of employment, we see a slowdown where job losses only rise 1%, as opposed to the normal 3% in a recession. Employers have had well-documented struggles finding qualified employees. This seems largely due to retiring boomers, reduced immigration, skill mismatches, and drug dependency. Assuming that our outlook for a "low unemployment recession" is reasonable, it raises the prospect that a more severe recession will be avoided. It also implies that inflation may not fall as rapidly as widely hoped.

We see core PCE potentially ending 2023 around 4%. We think 4% is a level that the Fed regards as more manageable. We also think the Fed would be secretly happy to reach 3%, a target which may be reached by year-end 2024. While Chair Powell has slapped down the notion that anything other than 2% is the Fed's target, he also has a record of wantonly using his jawboning power to drive behavior. Jawboning is less expensive than actual policy, but it also leads to those "Powell pirouettes," where policy turns on a dime.

Guidance is the key tool in Fed's toolbox and there is no downside to the public *thinking* that the Fed is targeting 2% inflation, even if the Fed itself is happy with 3%. Whatever else about the 2% target, it leaves paltry little margin for error. Other than inflation-on-target, the alternative to inflation-over-target is inflation-under-target. We experienced inflation-under-target in the 2010s. During that period, the Fed haplessly sought to *induce* inflation, at the cost of creating major distortions in the financial markets. As we approach the target from the other side, we think the risk managers at the Fed will err on the side of caution.

Municipal Bonds

The benchmark AAA curve continues to maintain a concave shape. Yields are higher on both the short-end and long-end than in the belly. Given this unique circumstance, we are working to structure our intermediate-duration products to a more distinct barbell profile.

Our largest overweight is in the 0–3-year part of the curve. If the Fed does wind down its hikes, the short end of the

curve will be poised to rally. For purposes of duration management, and to take advantage of the positively sloped portion of the curve further out, our other overweight is in the 12–15-year segment. Overall portfolio durations are basically neutral to our benchmark.

Rating trends have been surprisingly favorable for municipalities throughout the first half of 2023. Despite the talk of a potential economic downturn, the pattern of upgrades outpacing downgrades has continued from 2022. From a credit perspective, we are seeing cracks in some sectors on the Muni space, notably healthcare, lifecare, and higher education. Sectors which provide less ambiguous opportunities are airports, sales tax revenues, school districts with strengthening demographics, and pre-paid gas backed by well capitalized banks. We are also utilizing AMT and puttable bonds as ways to earn extra income for our clients.

We think that any economic slowdown would likely spillover to municipalities. We also foresee potential problems from the evaporation of COVID-related fiscal support. Still, our overall view of municipal credit is positive for the remainder of 2023.

Taxable Bonds

The supply of corporate debt is still running below last year's level. Corporations are expecting higher borrowing costs and have decreased overall debt growth. When this is combined with improving credit ratings for lower tier investment grade corporations, credit investors seem well positioned to weather further turmoil.

The Bloomberg Aggregate Bond index, a proxy for the broad bond market, is yielding more than 5%. Fixed income investors are looking at levels not seen since the Great Financial Crash. These attractive yields provide potentially strong returns, both in terms of high income and attracting new demand.

We are positioning portfolios for slow, but positive economic growth. We think rates will stay higher for longer, with the front end of the curve especially providing extra yield. We have taken advantage of this by holding short floating rate notes.

In summary, despite an unrelenting increase in short-term interest rates, a brewing credit crunch, fiscal impasses, ongoing fears of a tapped-out consumer, and multi-decade high levels of inflation, things are…just fine. The Bloomberg "Economic Surprise" index is at its highest level in the last two years. The "most forecasted recession ever" keeps getting kicked further and further up the road. We think the downturn will eventually come, but barring some severe sequence of events, we do not think it will particularly disrupt the fixed income market.

Equity Report

In the equity market, the second quarter of 2023 was characterized by further bifurcation. The economic data continues to pull in different directions, supporting either bullish or bearish views. The key indicator remains inflation: the pattern has been that inflation drives the Fed and the Fed drives the stock market. While key economic data shows inflation trending in the right direction, a more critical view of what is going on under the hood continues to paint a picture of core inflation that remains stubbornly high.

We also know from past high inflation periods that declaring victory pre-maturely is fraught with risk. The policy makers at the Fed seem to know it and market participants *should* know it. Unfortunately, the market seems content at this juncture to take a "hope for the best" attitude. We think a clear-eyed view of the all the data suggests that high degrees of crosscurrents are still evident everywhere. Our view remains that we are at a major inflection point for the economy that is still resetting from the unprecedented fiscal and monetary effects of the COVID period. And as we have noted in previous newsletters, there are rarely easy transitions in markets undergoing significant inflections.

The S&P 500 delivered another solid quarter, rising 8.3%, once again driven narrowly by the growth names that crashed last year. This continues to be evidenced by the equal-weighted S&P 500 up a more modest 3.5% during the quarter. The narrowness of the market remains a significant warning sign as equity investors show no let-up in terms of crowding into the same trades, and reverting to the same playbook, that dominated the "free money" era of the last decade.

The outperformance of the market-weighted index versus the equal-weighted index is at levels seen during the peak of COVID, the Great Financial Crisis ('07-'09) and the Tech Bubble ('99-'00). And almost on cue, this disturbing indicator has been met with a chorus of "this time is different". It is important to remember that half of the S&P 500 is still in correction territory (defined as >10% below their recent 52-week high).

The first half of the year has been dominated by what are dubbed the "Magnificent Seven" (Apple, Amazon, Alphabet, Meta, Microsoft, NVIDIA and Tesla). These seven stocks have contributed 80% of the total returns generated by the S&P 500 this year. They were down on average 46% in calendar 2022 and have rebounded on average 90% YTD. The leaders have been NVIDIA, META and Telsa which are up 190%, 137% and 127% YTD. Amazon, Apple, Microsoft and Alphabet (Google) are up 55%, 48%, 40% and 36%, respectively.

Technology and Consumer Discretionary once again led the market higher in the second quarter. In those sectors, like last year, it was just a handful of mega-cap stocks that were the standout performers. While investors may be seeking safety in the same crowded trades as the past, the mania surrounding artificial intelligence has added fuel to the fire.

Interest rate sensitive areas of the market were laggards in the second quarter. Telecom and Utilities were down 4.6% and 3.3%, respectively. Energy was also a laggard, down 2.0% (and 7% YTD). These performances reflected ongoing recession concerns. We find it curious that the market has convinced itself that recession concerns are real and growing for areas such as Energy and, more broadly, commodities, but finds little value in traditional defensive areas like Utilities or Healthcare.

The fact that volatility is approaching historical lows is another suggestion that complacency is running high. This is unwarranted in our view. Inflation is far from vanquished, significantly higher cost of capital presents a stiff headwind for businesses and consumers alike, and geopolitical risks have faded into the background more because of investors lack of focus rather than any real advancement in durable solutions.

The equity rally so far this year has driven equity risk premium to low levels. We are once again challenging the extremes achieved during the Tech-Bubble ('99-'00). While estimates have at least stopped falling, earnings have been declining for several quarters.

Market multiples seem to be anticipating a meaningful reacceleration, which we find overly optimistic, given that consumer spending is decelerating, and margins are coming off all-time highs. Future market returns are highly correlated to equity risk premiums. We think the current low starting equity risk premium is a headwind for broad market returns over the medium term.

Inflation persists. The market should be skeptical of the usual dose of "it's different this time," but that does not seem to be happening. As such, we would continue to counsel longer-term investors to maintain a more patient view of the equity market. This means focusing on incremental investments into areas of the market that have both lower absolute and relative PE, as well as high free-cash-generation.

We would also continue to avoid businesses that are more highly leveraged and face strong headwinds from refinancing costs. We expect elevated inflation will keep upward pressure on rates longer than most investors anticipate and ongoing quantitative tightening to drain excess liquidity from the market. This will also apply upward pressure to risk premiums. In other words, we do not think economic conditions today warrant complacency. Much of the market seems to feel otherwise.

Conclusion

In challenging market environments, where the warning signals are flashing red but there are good reasons for medium-term optimism, it is foolish to be unambiguous. There is another famous Ty Cobb story, equally apt. Later in life, Cobb was asked how he would fare against modern pitching. Cobb said something like, "oh, I don't think I would hit better than .300." The interviewer was incredulous. After all, Cobb had maintained a lifetime batting average of .367 over 24 seasons. "Keep in mind," Cobb said, "I am 73 years old."

Our assumptions about the economy and the market are often unconscious, but if we can revisit those assumptions, and rethink them, we may find new ways of thinking about things. Or not. After all, the rule book is not being rewritten. Risks manifest as reality like laws of nature rolling across the horizon. Our imperfect understanding of the rule book may be made a little less imperfect over time, but one thing we know for sure: there is no way that a 73-year-old, Ty Cobb or anyone that age, can hit .300 against major league pitching.

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