



Q3 2023 Market Synopsis

Economic & Market Update:

The third quarter of 2023 marked a significant change in sentiment and direction across almost all traditional assets. From October 2022 through early July 2023 stocks were up roughly 20% (albeit with extreme concentration among the seven largest technology companies), while bonds were near breakeven. Starting in July of 2023, long term interest rates skyrocketed from 3.8% to 4.6% over a period of three months. Similar to 2022, this rapid rise in interest rates (this time longer term rates increased, while short term rates remained steady) sent bonds, real estate, and stock prices down materially in the quarter.

Just as important as the rapid increase in longer term rates was the realization by many that it is likely that rates could stay elevated for an extended period of time (commonly referred to 'higher for longer' in the media). Early this year it was assumed by markets and most investors that rates would begin to decrease or stabilize at lower levels after a short-term spike. Recently there has been more evidence that we have entered a new 'regime' of structurally higher inflation, rates, and possibly nominal economic growth.

Below: Year to Date 2023 Performance for Select Asset Classes (Yellow = TFG Alternatives)

Select 2023 YTD Asset Class Returns (9/30/2023)	
Digital Assets (Bitcoin)	+ 165.0%
Insurance Linked Securities (XILSX/SHRIX/CBYXX)	+ 16.1%
S&P 500 (US Large Cap Stock Market)	+ 13.1%
Middle Market Lending (CCLFX)	+ 9.4%
Diversified Private Credit (NICHX/CELFX)	+ 8.1%
MSCI EAFE (Foreign Developed Stock Market)	+ 5.4%
Private Farmland, Timberland, Infrastructure (VCRRX)	+ 1.7%
MSCI Emerging Market (Emerging Stock Market)	+ 0.5%
Nat Gas/Oil Pipeline Companies (TPYP)	+ 0.5%
Private Equity (PIIVX, XPMIX)	- 0.5%
Consumer Lending (LENDX)	- 0.9%
Investment Grade Corporate Bonds	- 1.5%
Private Real Estate Equity (TIPWX, BREIT, JPREIT)	- 2.0%
US Mid/Long Treasury Bonds	- 3.4%

** All private assets offered to accredited or qualified investors (\$1M+) in assets will be discussed separately*

From 2009 through 2021 (since the financial crisis) the US and the rest of the world existed in a very low inflation, low interest rate (near 0% in the US and even negative rates in Europe/Japan) and low nominal growth environment. It seems that after unprecedented government stimulus (fiscal and monetary) across the world in response to COVID, more volatile supplies of many goods/services, a tighter labor market, and a trend towards ‘de-globalization’ have caused us to enter this new ‘paradigm’.

Although this is a very uncertain time, Traphagen is increasingly of the belief that we are indeed entering a new regime and have been investing client portfolios on that basis. This requires some significant changes in investment strategies, risk management techniques, and adjustments for return/risk expectations for different asset classes. We will dig deeper into the concept of a new ‘investment regime’ later.

Year to date through October 1st the global stock market (ACWI) is up 10%, with US stocks again outperforming significantly, continuing the trend of the last 15 years. Traphagen sees no reason why this pattern of US outperformance vs. the vast majority of foreign assets will not continue. Emerging markets are near breakeven on the year, while different high quality bond classes range from down 1% to down 5%. This bond market underperformance has been adding to the longest and deepest drawdown in modern history. Through the beginning of October the US bond aggregate drawdown entered its 37th month with a total cumulative loss of – 16.5% in the period. Amazingly, long term US Treasuries (considered a ‘safe haven’ investment) have returned – 50% in the same period!

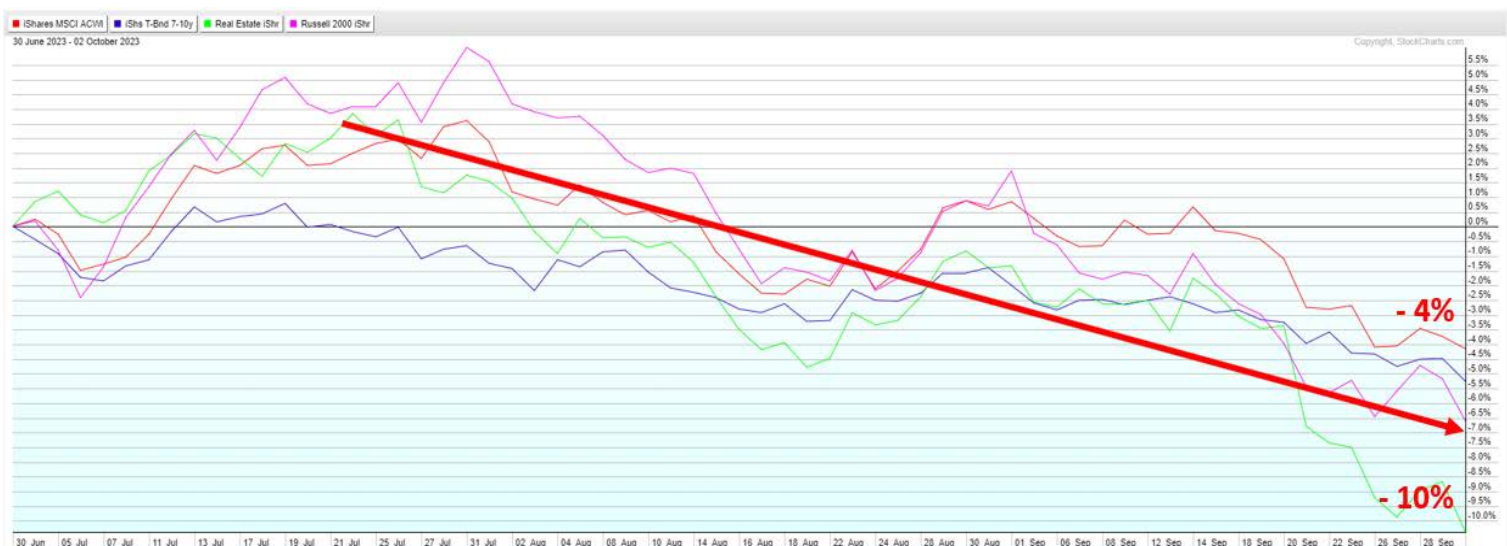
The major factors which impacted markets in Q3 2023 are highlighted below:

- **Rapidly rising long-term interest rates:** Since May long-term interest rates have risen dramatically to almost match shorter term bond yields. The 10-year benchmark Treasury rate increased from 3.5% in May to the current level of just below 5%. This has caused a rapid increase in mortgage rates (now averaging 7.5% for a 30-year fixed), auto loan rates, corporate debt financing costs, and consumer loans. If rates stay at these much higher levels for an extended period of time we believe this will cause a slowdown in the economy in addition to placing some valuation pressure on highly valued stocks and weaker real estate sectors.

Below: Year to date (2023) chart of the 10 Year Treasury Yield



- Increased Geopolitical Stresses:** Even before the Hamas attacks on Israel occurred in the beginning of October, the ongoing war in Ukraine and increasing tensions between China and the west have created a volatile geopolitical backdrop. The Russia/Ukraine war continues to be of limited impact to the US economy outside of increased spending on Ukraine defense and the energy markets. The relationship between China and the US (along with a weak Chinese economy) is impacting all types of supply chains, reshoring efforts, and the ability for cross border commerce. Although there is no war with China, this is still the most impactful in terms of global growth and inflationary forces. Lastly, the unfortunate events in the mid-east, although having little economic impact to date, could be another high impact issue if the conflict expands. For many years Traphagen has held little to no international stock or bond exposure for our clients, and these geopolitical issues continue to support that position.
- Generally poor returns for all traditional assets:** Since July as rates have rapidly increased, almost all traditional assets have struggled. The most negatively impacted parts of the market are similar to those hurt the most in 2022 including high valued growth/tech stocks, publicly traded real estate, small cap stocks, and all types of bonds. In addition, renewable/clean energy companies, utility stocks, and highly levered companies were hit hard with increasing financing costs likely hurting future profits. Through October this downward trend has generally continued across all traditional assets. Our alternative/private suite continued to perform quite well through the period.



Above: Q3 2023 Chart of global stocks (ACWI; red), Treasuries (Blue), Small Cap Stocks (pink), and public real estate (green).

- **Overall Economic Resilience:** At the end of 2022 the predominate view for the economy in 2023 was a significant slowdown and/or a recession. Stocks and bonds were reflecting this, with the SP500 hitting 3500 in October of last year and the Treasury yield curve in the deepest inversion in decades. Deep inversions (or where long-term rates are lower than short term rates) usually is a high conviction sign of a recession in the future. Although our Traphagen Recession Index (TRI) remains elevated, through Q3 2023 there certainly has been no recession in the US. Consumers remain relatively strong, unemployment is low, and Q3 2023 GDP came in at a red hot 4.9%. Through the current period we have seen a combination of much higher growth, higher long-term rates, and to some extent stickier inflation than many thought. For a combination of reasons, we see lower growth in 2024, and a continued heightened chance of a recession. Given the unique nature of the current environment and a high degree of uncertainty, we positioned portfolios to outperform whether we do enter a recession or not, with unique long term Treasury bond strategies, short term T-Bills, and private/alternative exposure.

Traphagen 2024 Portfolio Changes & Performance Update

Our alternative/private investment suite continues to perform particularly well through 2023 with very low volatility, correlations, and solid positive returns regardless of the stock and bonds markets. We will be trimming some exposure to areas where we have seen outsized profits over the last couple years and reallocating these funds to other areas where future risk adjusted returns look particularly attractive. In addition, we continue to make changes to our traditional portfolio allocation of stocks and bonds, as we proactively overweight certain areas and avoid others. We believe our current portfolios include a significant level of defense/capital protection if a recession does emerge over the next 6 – 12 months, while able to produce significant positive returns if we get a more positive outcome.

The most consequential investment changes made over the past 6 - 9 months are highlighted below:

- **Increased allocation to both short term T-Bills and a Long-term Bond/Option selling strategy:** Over the past 9-12 months we have been adding more Treasury Bond exposure for our clients in two forms. For most clients we are utilizing a ‘barbell’ approach where we feel a combination of 1 month to 3 year T-Bills yielding around 5.3% with no principal risk and very long term bonds yielding between 10% - 15% (combination of bond yield and call option selling yield) makes the most sense. When these two strategies are combined we get a yield in the upper single digits with no credit/default risk and tempered interest rate risk along with a great recession hedge. To date with rapidly rising rates, our short-term T-Bills have returned the yield since purchase while the ‘TLTW’ strategy is

down between 7% and 12%. From this point, however, as long as long-term rates rise very gradually, chop sideways, or come down, we feel we are in a good position to make high single digit to mid double digit returns going forward.

- **Large and increased allocation to insurance linked securities:** We increased our exposure to insurance securities significantly entering 2023 to around 10% of most portfolios. We did this due to record high premium income yield in addition to the benefit of getting the risk-free rate of T-Bills. The combination of these two return sources has delivered the highest returning asset class in the portfolios outside of Bitcoin this year. Year to date these two funds (XILSX) and (SHRIX) have returned + 19% and + 16% respectively. We continue to think this sector represents great value going forward with 12% - 14% yields (assuming normal insurance activity) with no economic, stock, or interest rate risk to principal. A much smaller allocation was made to (CBYYX) , which has returned + 11.7% since purchase in March.
- **Addition of asset backed lending private credit fund (AMCJX):** Over the past month for accredited investors, we have made a material allocation to a new private credit fund that focuses on asset backed lending. This strategy makes private loans with specific collateral in the form of financial or physical assets (inventory, real estate, machinery, etc.) as opposed to making loans based on the cash flows of a business. The advantage to this type of lending is in the case of default, there is a specific asset the lender can seize and liquidate to make a recovery. Historically, recovery rates on asset-based lending has been higher than cash flow based credits. Depending on the source, average recovery rates (the % of each dollar you get back if the loan defaults) ranges somewhere in the low to mid 90 cents on the dollar for asset-based lending, while cash flow based corporate credits average in the 70-cent range. This fund has returned 7% year to date; and has returned the yield since we purchased it over the last month.
- **Sale of all public corporate bonds:** With risk free rates in Treasuries at around 5.4% and private credit/insurance securities yielding between 9% and 14% we see little reason to hold public corporate credit. This asset class yields only around 1.2% more than Treasuries; but has more interest rate risk and a significant amount of credit/economic risk at current valuations/spreads. Currently the spread between what you can get on higher quality corporate debt and Treasuries is quite low, which is a sign of rich valuations. Because of this, we sold our entire exposure here and reallocated to much higher yielding private credit and risk-free Treasuries. Since selling 'GIGB', corporate bonds have fallen by about 1% due to higher rates and some spread 'widening'.

Below: *Chart of the last 10 years of corporate ‘BBB’ investment grade spread over Treasuries.*



2024 Market and Economic Outlook Update:

We remain in one of the most uncertain rate/economic environments we have seen in about 15 years. It is our opinion that we are in the process of transitioning from the investment regime of 2009 – 2021 to a very different one that started in 2022. Below you will find an overview of how we are viewing this transition and the main themes that mark each period.

Below: *Overview of the different economic/market regimes.*

2009 – 2021	2022 & Forward
1.0% - 2.0% Average yearly inflation	2.5% - 3.5% Average yearly inflation
3.0% - 5.0% mortgages, low savings	5.5% - 7.5% mortgages, high savings
Abundant energy, credit, labor, etc.	Volatile labor, energy, credit constraints
Favorable geopolitical trends	China, Deglobalization, Russia, Mid-East
Greater % of Cash Flow to Equity	Greater % of Cash Flow to Debt
Extremely Accommodative Fed Policy	Uncertain or Restrictive Fed Policy

The above assumptions dictate that we adapt our portfolios to this new regime. It has been about 15 years since we have seen interest rates, bond yields, and mortgages at current levels. These rapid rate changes along with tighter supplies of energy, labor, and credit is reshaping how we think about preserving wealth, making solid positive returns, and outpacing higher inflation. Traphagen is avoiding areas such as emerging markets/China, European stocks, speculative/unprofitable growth stocks, higher levered companies, discretionary stocks, and

corporate credit. We think these areas continue to lag in this new environment. We are making higher conviction allocations to the areas highlighted below:

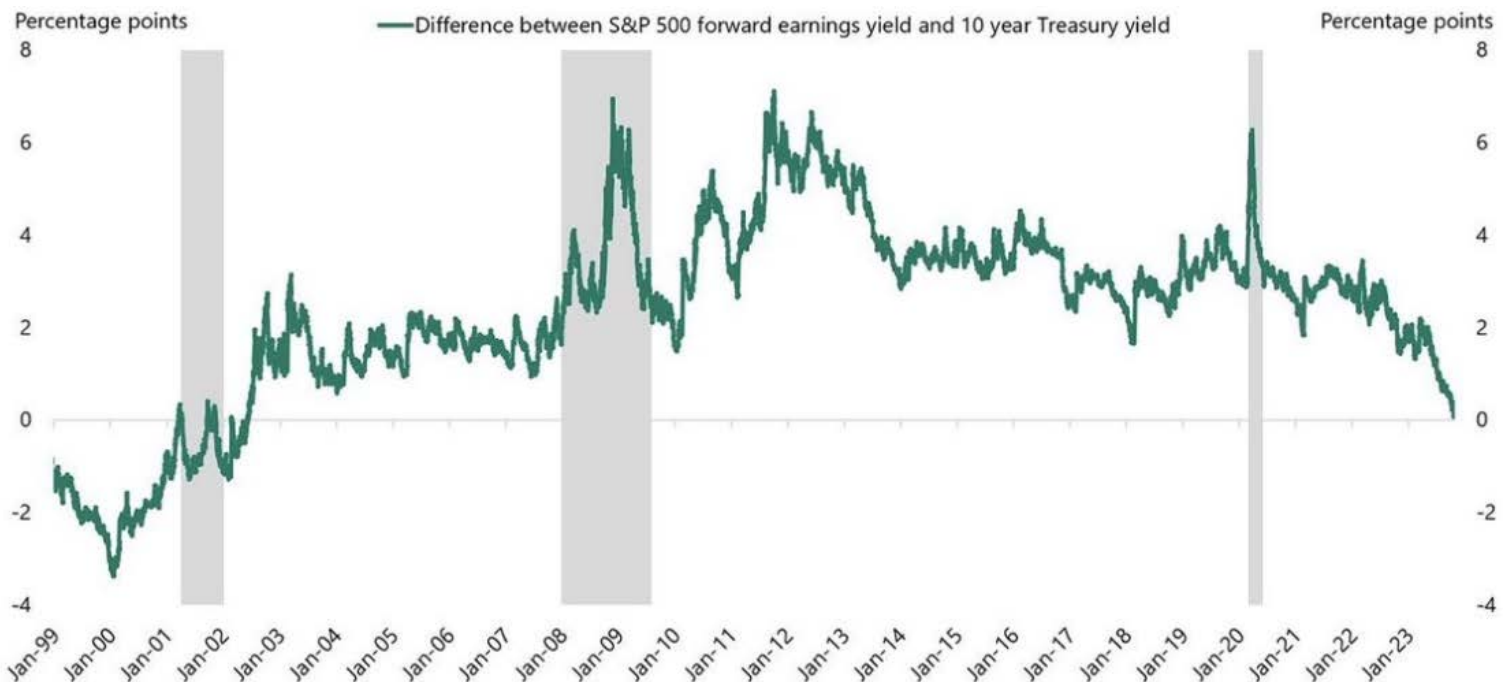
- **Diversified private credit with net yields of 8% - 10% and no rate risk.**
- **Treasury Bills/Notes with risk free rates of 5% - 5.5%**
- **Infrastructure Debt/Equity with low volatility and total returns of 7% - 9%**
- **Insurance linked securities with yields of 12% - 14% and no economic risk**
- **Defensive, low debt, and high free cash flowing US stocks**

With an overweight to these areas along with allocations to other quality diversifying assets we can use this economic change to our advantage. Much higher yields on bonds, private credit, and other alternatives in addition to many investors mispricing assets based on the 'old framework' can be the source of outsized returns for our clients. As Jack Welch once stated, "Change before you have to". We are embracing this change and investing based on that, while others will only shift their thinking and portfolio strategy when they 'are forced to' by the markets. That point will be too late to maximize profit from several of these strategies.

Most of the investments we mentioned will perform well regardless if we experience an economic slowdown or not in 2024. This provides a bedrock for portfolios. On the stock side many variables will determine their returns, but in our opinion interest rate levels and the health of the consumer/unemployment levels will be the major drivers.

Valuations are less important in the short to intermediate term, as outside of the top seven technology stocks, the 'S&P 493' trades at about 16X which is quite reasonable. If you include the top 7 stocks it is closer to 19X, which is somewhat elevated, but not concerning if inflation can stay below the 4% level.

What we are more interested in is the relationship between stocks and bonds, not absolute



valuation levels. In our opinion if Treasury bond yields go up materially from here and offer yields of 6% or more, the competition to stocks for new investment will be significant. Even at current levels, 5% to 5.5% rates seem to be putting a ceiling on further stock valuation advancement. On the flip side, if inflation abates into the 2% to 3% range without a recession and the FED becomes more sanguine, we can get a swift and material rally in both stocks and bonds.

Below: Difference between SP500 stock earnings yield and 10 Year Treasury yield. Currently bonds are the most attractive relative to stocks since 2002.

On the macro-economic front, unemployment remains historically low with a consistently tight labor market. As of the October report unemployment stands at 3.9%, however a more impressive statistic is how many job openings there are vs. job seekers. Right after the great recession there were over 6 job seekers for every 1 job opening. This of course was a very daunting job market for the unemployed and caused persistent high unemployment and underemployment. Currently we are seeing the opposite ‘problem’ of having 1.4 job openings for each job seeker. This has both positive and negative impacts for the overall economy. It is a sign of resilience and a labor force that can experience higher wages through competition among employers. This also helps goods/services spending and housing through a healthy consumer. On the flip side, this is inflationary as wages continue to increase at an accelerated pace in addition to causing inefficiencies and occasional good/service shortages if ample labor cannot be found.

Other economic data such as real estate, manufacturing, and corporate earnings/margins are more mixed.

In terms of housing/real estate, as mortgage rates have risen from near 3% for a 30-year fixed to current levels of near 7.5%, we have seen several conflicting impacts. On one hand this has decreased affordability for new homeowners/‘mortgaged movers’ to levels we have not seen in more than 40 years. This also has essentially froze many residential and commercial markets where buyers and sellers are not yet willing to meet on a price. On the supply side, we have seen record low supplies of existing homes available for sale as many low mortgage rate holders are ‘trapped’ in their homes with golden handcuffs. In addition, with the rising costs of construction/development, looking forward we see new supply coming on the market dropping by about a third vs. what was being built in 2021.

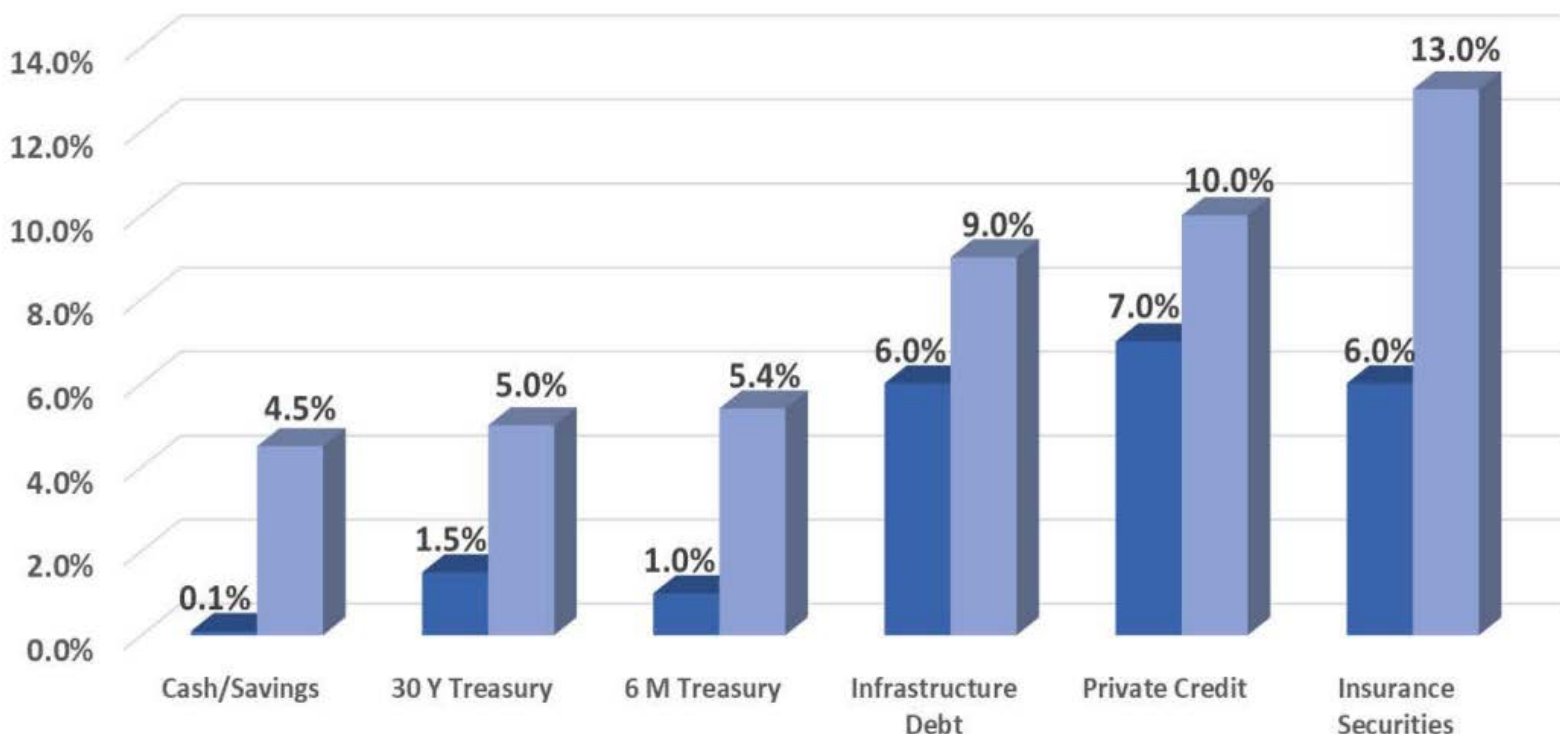
Commercial office has many problems, including extremely low vacancy rates, persistent work from home or hybrid models, and the beginning of ‘forced’ refinancing at much higher rates with lower rental income. We have little to no exposure here in any of our private real estate funds.

We are most bullish on data centers/industrial properties which have average rent growth in the 10% -20% range year over year with the insatiable demand for AI compute power, cloud, and data storage. On the industrial side, future supply is falling off a cliff, with a 78% decline in construction starts versus 2021, along with ever increasing need for space to accommodate ecommerce.

Finally, in terms of corporate earnings, margins, and the manufacturing sector we continue to see some headwinds. As the low-cost debt US corporations accumulated over the past 10-15 years comes due and the refinancing of this debt gradually occurs at much higher rates in 2024 and beyond, this should act as a persistent headwind to profit margins and ultimately corporate earnings. This is why purchasing quality companies at reasonable valuations with little/no net debt on the balance sheet is extremely important. On the manufacturing sector (usually cyclical and correlated with recessions) we see continued contraction.

In summary, with these various cross-currents we see an uncertain and potentially volatile market environment along with much lower inflation than 1 year ago and improved valuations for asset classes. This is also an investing landscape where there is more opportunity across bonds, private credit, certain sectors in real estate, alternatives, infrastructure, and some stocks in more than 15 years.

Below: Comparative yields available to investors for various asset classes between 2020 and today (2023). Significant improvements in future returns are likely across almost all assets.



As of this writing 2023 has turned out to be another challenging year, albeit much improved versus 2022. Looking into 2024, we see some challenges remaining, but are looking for another stair step improvement from 2023 to 2024 in the financial markets. This can be accomplished

with continued solid performance in private/alternatives, likely the first positive year for bonds since 2020, and a resilient stock market; especially in the areas where we are most overweight.

As always, we thank you for the continued trust you place in us, and all here at Traphagen wish you the best as we enter the holiday season. We wish all our clients get to spend time with their friends and family over the next couple months and into the new year.

Best regards,

Your Traphagen Investment Team