



## ***Q1 2023 Market Synopsis***

### **Economic & Market Update:**

After a very challenging 2022 for most investors; where both bonds and stocks were down between 14% and 20%, the first quarter of 2023 delivered solid returns for most assets.

The SP500 and global stock market returned roughly 8% for the quarter while the bond index was up 3.4%. Stock markets reacted positively from the perceived (and likely) ending of the FED rate tightening cycle, along with an unexpected liquidity injection to the financial system. These factors combined with lower and less volatile longer-term interest rates gave growth/technology stocks and digital assets especially strong tailwinds.

The bond market had two consecutive negative returning years, with 2022 being one of the worst in modern history. So far in 2023 the bond market has recovered nicely with mid-single digit positive returns. This comes on the back of interest rates that were extremely volatile, but ended lower on the quarter, falling from 3.8% to start the year to just under 3.5% by the end of March.

Interest rate levels and stability are extremely important to all financial assets and the economy. As longer-term rates stabilized and drifted lower in early 2023, this gave many investors a green light to invest in the same assets that were hit the most in 2022.

The third leg of our portfolios (alternative/private investments) after an excellent 2022, continue to perform well in early 2023. In aggregate, our alternative suite is up between 1.3% and 2.0% through March, which on an annualized basis equates to 5% to 6.5%. The top performing alternative assets are insurance linked securities, which currently have cash yields in the low to mid-teens and carry no recession linked risk.

Although we are pleased that the first quarter of 2023 returned solid performance across almost all asset classes, we remain cautious and expect further volatility throughout the remainder of the year.

The banking stress experienced earlier this month was noteworthy and extreme within that specific industry, but as our brief communication indicated we do not think it presents a systemic risk to the overall financial system with the recently enacted government backing. That said, we do not view regional/community banks offering attractive risk adjusted returns going forward. To this end, we have sold the only security with any meaningful exposure to smaller

banks earlier this month and replaced it with a unique Treasury bond option writing strategy that currently yields around 11%.

**Below: *Year to Date 2023 Performance for Select Asset Classes***

| Select 2023 YTD Asset Class Returns (3/31/2023)      |         |
|--|---------|
| Digital Assets (Bitcoin & Ethereum)                  | + 96.1% |
| MSCI EAFE (Foreign Developed Stock Market)           | + 9.8%  |
| S&P 500 (US Large Cap Stock Market)                  | + 7.8%  |
| Investment Grade Corporate Bonds                     | + 5.3%  |
| MSCI Emerging Market (Emerging Stock Market)         | + 4.4%  |
| US Mid/Long Treasury Bonds                           | + 4.4%  |
| Insurance Linked Securities (XILSX/SHRIX)            | + 4.0%  |
| Diversified Private Credit (NICHX/CELFX)             | + 2.3%  |
| Middle Market Lending (CCLFX)                        | + 2.3%  |
| Private Farmland, Timberland, Infrastructure (VCRRX) | + 1.7%  |
| Nat Gas/Oil Pipeline Companies (TPYP)                | 0.0%    |
| Consumer Lending (LENDX)                             | - 0.6%  |
| Private Equity (PIIVX)                               | - 1.9%  |
| Private Real Estate Equity (TIPWX)                   | - 4.1%  |

*\* GPB Holdings II, Mosaic/RC, BREIT, and KKR Fund Performance included within the private investment section on page; Yellow Highlights: Alternative/Private Assets*

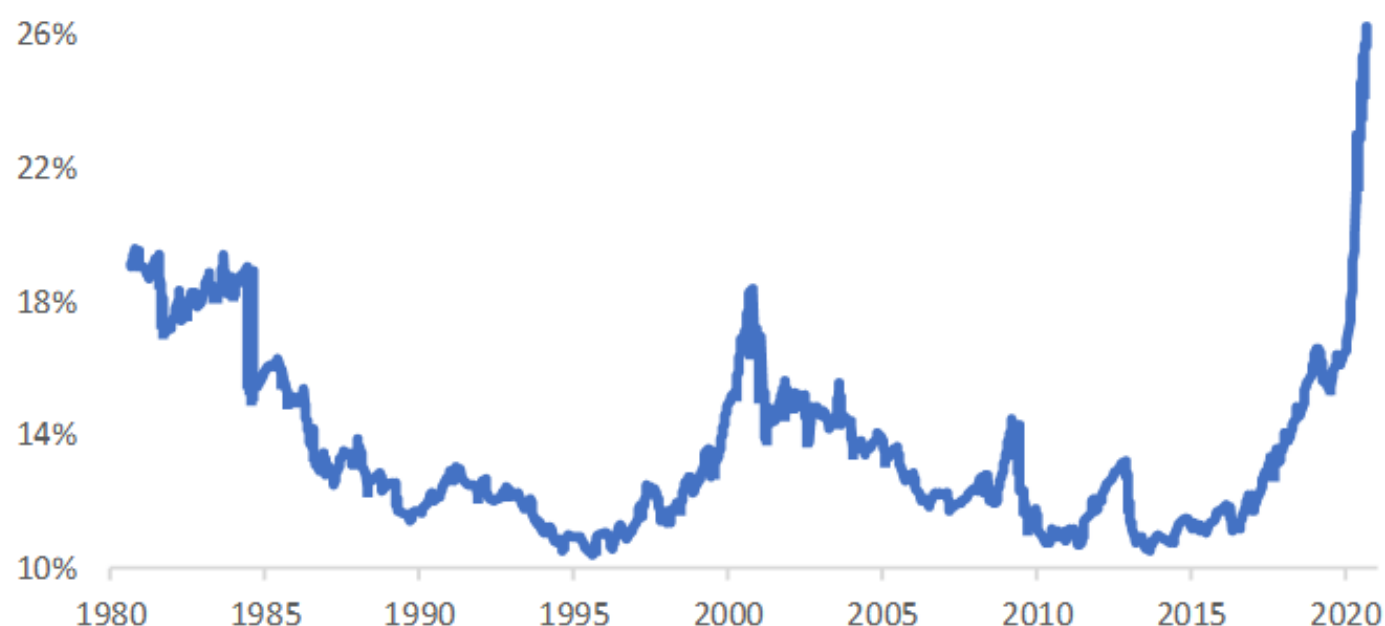
We do see the logic behind commodities and oil/gas having more muted returns with slowing economic growth. In aggregate, the alternative/private investments should continue to act as steady performers regardless of market/economic conditions.

**The major factors which impacted markets in Q1 2023 are highlighted below:**

- Conflicting Signals on Future Interest Rates/FED Policy:** After the blistering pace of rate hikes in 2022, going from near 0% last March to over 4.3% at the end of the year, we have slowed considerably in 2023. The FED has continued to hike rates with two quarter point raises so far this year, but from this point on, the future of FED policy should be more ‘neutral’. The recent banking stresses along with many signs of slowing economic growth augers for at least a ‘pause’ in rate hikes, if not actual cuts later this year. At the same time, inflation remains stubbornly above FED targets, unemployment remains near historic lows, and the stock market has been very resilient. These metrics point in the direction of some continuance of FED rate hikes and tightening policy. The bond market is predicting a pause then a fairly aggressive rate *cutting* cycle, reflecting more than 1% in Fed cuts within the next 12 months.
- Reversal of 2022 Asset Class Return Pattern:** With rates possibly topping out and starting to come down over the next couple months we have seen the sectors

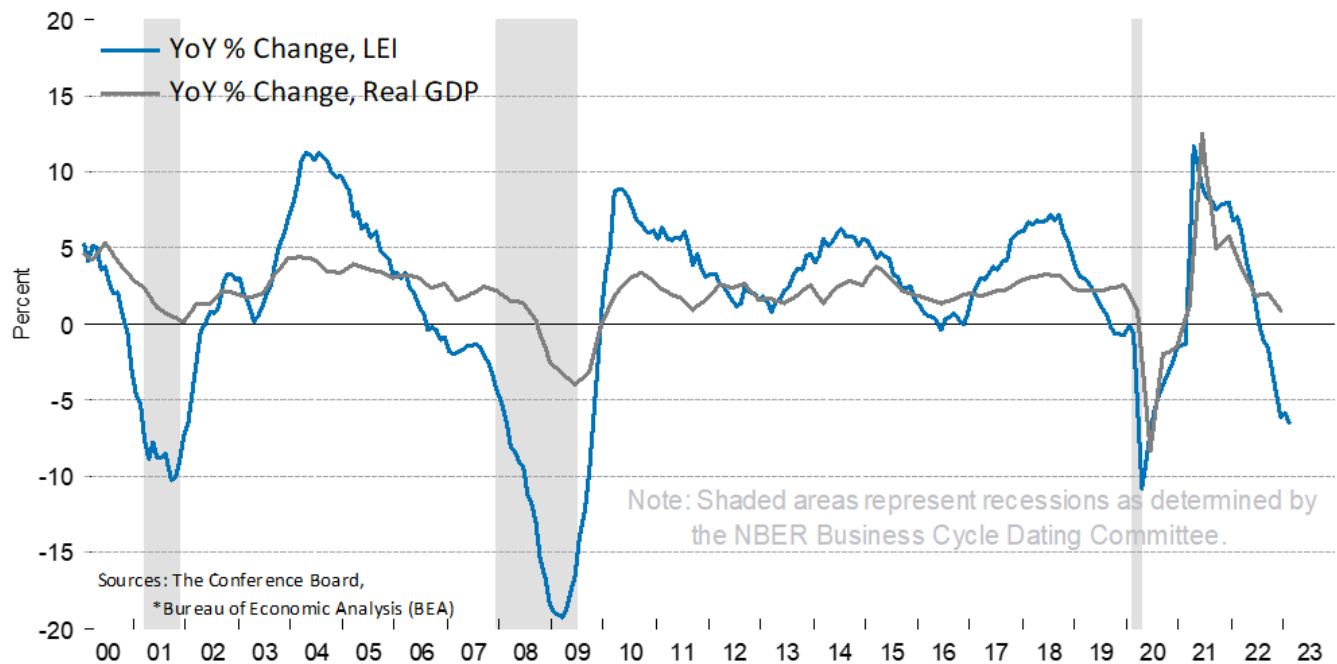
and asset classes hit the hardest in 2022 rebound the most so far in 2023. Technology and growth sectors have been standout performers within US stocks, while digital assets such as Bitcoin and Ethereum are up close to 100% in the last three months. All these types of assets are very interest rate sensitive and suffered along with bonds last year. On the flip side, commodities, and more defensive sectors, such as healthcare and utilities have been relative underperformers with negative mid-single digit returns. Of note, the SP500 would actually be down slightly without the top 10 holdings providing outsized gains. These 'mega-cap' technology stocks have been viewed as a 'safe-haven' this year, although when we look at their growth rates and valuations we do not view them as particularly attractive. Currently Apple's market cap of \$2.6 trillion is the same as the entire small cap US stock market, made up of just under 2000 companies!

**Below: *Concentration of current SP500 in Top 10 Stocks through Today***



- **Growing evidence of slowing economic growth:** As the FED has communicated over the past year, the side effects of rising rates, tightening policy, and bringing down inflation will be much slower economic growth over an extended period of time. Current forecasts still have a mildly positive Q1 of between 1% and 2% GDP growth, but between tight policy, severe bank stress, credit tightening, and dwindling savings, we view it likely overall GDP growth could be close to zero or turn negative later this year. As we review all available economic and market data, Traphagen does see a relatively high percentage chance of a recession over the next 6 - 9 months. This is an outcome we have prepared for already within client portfolios. It should be recognized that this is an outcome desired by the FED to a large degree, along with slowing economic growth and demand, inflation has been declining materially as well.

**Below: *Composite of US Leading Economic Indicators (lower the blue line higher chance of economic contraction); at current levels we have never avoided a recession***



- Regional/Community Banking Stress:** Starting early in March regional/community bank stress quickly boiled over causing swift action by the Federal reserve and the FDIC. During the first week of March, Silvergate bank collapsed causing some market tremors. Shortly thereafter rumors started circulating about the health of other high-tech/VC related banks such as Silicon Valley and Signature. On March 10<sup>th</sup> SVB collapsed after a classic bank run and a couple days later Signature was also taken over by the FDIC.

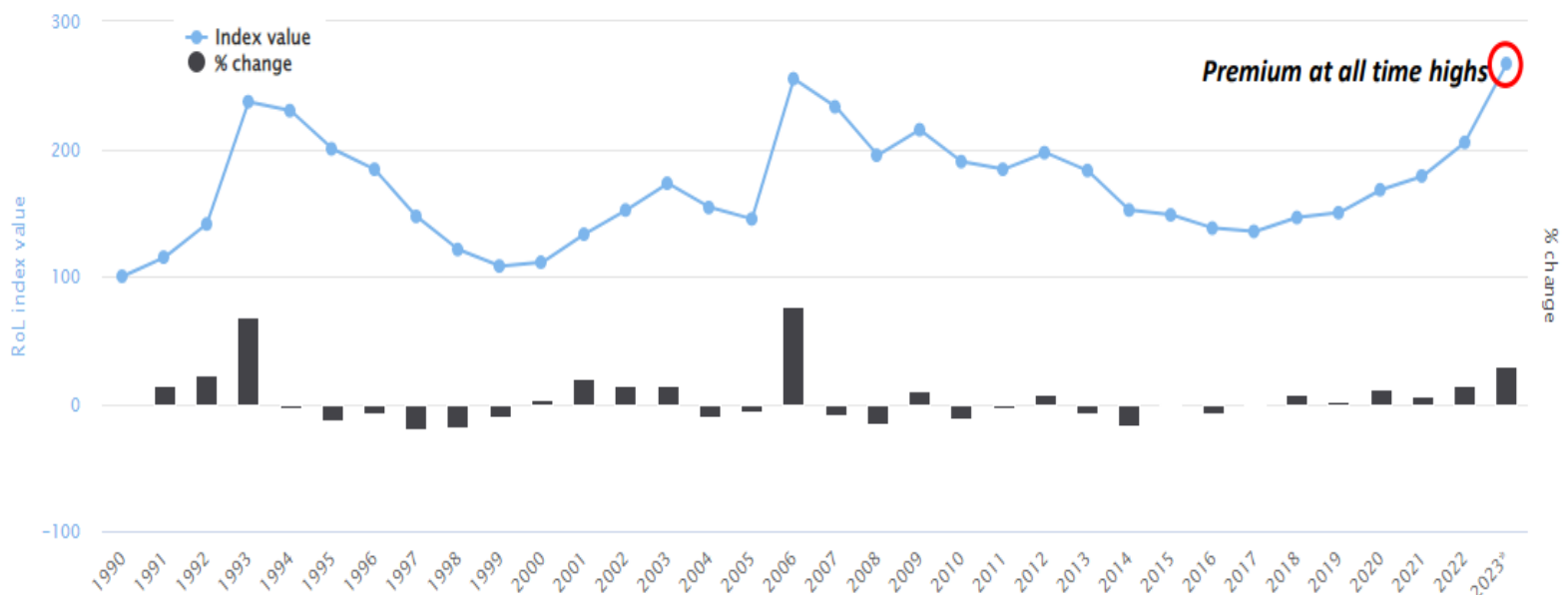
Although we do not view these stresses as ‘systemic’, Traphagen does view the interest rate, economic, and likely new regulatory framework as generally hostile to small/regional banks. The continued removal of deposits from smaller banks either to larger ‘more protected’ banks or into higher yielding money market or T-Bills remains a strong trend. Although we never had more than 1% or so of a total portfolio in regional banks we recently sold the only security with a material allocation to the industry. We will continue to monitor how other related asset classes such as insurance companies, asset managers, and commercial real estate perform over the course of the year.

## Traphagen Late 2022/ Early 2023 Portfolio Changes & Performance Update

With all three portfolio pillars performing well so far in 2023 we are happy with client portfolio returns, however as we stated prior, we remain cautious given all available data. Fortunately, with both high quality bonds and alternative/private investment offering good returns with uncorrelated risk to stocks or a possible recession, even if it turns out we were overly defensive in 2023, portfolios are positioned to still produce upper single digit or low double digit returns. In some cases, we are able to play both defense and offense with the same investment (insurance securities).

**The most consequential investment changes made over the past 3-6 months are highlighted below:**

- **Increased allocation to high quality bonds and a unique Treasury/Call Selling Strategy (IEI, GIGB, TLTW):** Over the past 9 months we have gradually added high quality bonds (Treasury, investment grade corporate, and municipals) to all client portfolios. This is due to credit risk-free or lower risk yields of 4.5% to 5.5% available with the added benefit of these securities acting as a recession hedge. More recently we have added 'TLTW' to portfolios which is a combination of long-term Treasury bonds and continually selling call options on those bonds. Currently this security yields around 12% between the 'straight bond' and 'option premium' components with no credit/default risk.
- **Large and increased allocation to insurance linked securities:** Insurance linked securities (specifically cat bonds) are the most attractive they have been since their inception in the early 1990s. Currently with no credit/recession risk (only risk is excess insurance claims related to natural disasters) these securities offer a cash yield of around 15%. This is a combination of a cash/collateral yield (T-bills) of 4.5% and a net insurance premium yield of around 10.5%. This is a good example of both playing defense and offense with the same security.



**Above: *Historical Graph of insurance premium per unit of risk from 1990 – Current (blue line) and yearly average premium increase (gray bars). We are currently at all-time highs in premiums after an increase of around 25% over last year.***

- **Addition of High Dividend/Defensive Stock Strategy (SCHD):** Over the past month we added exposure to a strategy that invests in roughly 100 stocks that have a value, quality, and dividend growth tilt. This fund currently yields around 3.4% in dividends alone (2X SP500 level) and holds a quality/defensive selection of equities. If an investor invested \$100,000 in 2013 within this fund and simply held through today, the original \$100,000 would have turned into roughly \$320,000. Just as importantly, the cash flow produced would have grown from about \$2,700/yr. to close to \$8,000/yr. We feel this strategy is a great source of prudent capital appreciation and income growth over the longer term.
- **Small additions to emerging markets in aggressive portfolios:** As a more opportunistic and tactical play we have purchased a small amount of emerging market stocks (2% to 3%) for risk-tolerant portfolios. This offers some diversification benefits as most emerging market countries are loosening monetary policy as opposed to the US. As China finally reopens from severe COVID lockdowns we think there is some opportunity for a burst of growth similar to what the US and Europe saw in 2021 and 2022.

**Private Investment Update** (*for accredited investors only; \$1M+ with Traphagen*)

**Private Equity (GPB Fund II):** As we enter 2023 we continue to wait for a substantial cash distribution to be released from the fund to all investors (current fund cash position is \$353M). GPB Management/SEC monitor sent a letter in late February to the district court/judge presiding, pressing them to allow this distribution to occur. In terms of their remaining operating divisions (Healthcare/IT and Energy) revenue grew 28.6% from 2020 – 2021 and an additional 24.6% from 2021 – 2022 totaling \$193M in 2022.

**Private Equity (KKR Fund):** This well diversified private equity fund continues to perform well on a relative basis with a final 2022 return of -8.6% vs. -18.4% for the overall stock market. Through February 2023 the fund is up slightly with a + 0.8% return. The fund is materially invested in the information technology and healthcare sectors, which represent 45% of the total allocation.

**Private Real Estate Equity (JPM REIT):** This new private real estate fund is poised to take advantage of any possible dislocations or distress in the real estate market over the next couple of years. It is working with fresh capital and is poised to purchase properties with motivated or forced sellers at attractive prices in the residential, strip mall, logistics, and industrial/warehouse sectors. So far this year the fund is up just over 7%, and up 6.7% in February alone.



**Private Real Estate Equity (Blackstone Fund):** The Blackstone private real estate fund continues to perform very well in an increasingly challenging environment. The fund was up 8% in 2022 and is up 0.4% through February of this year. They continue to be invested in the more coveted areas of the real estate asset class (residential and industrial/warehouse properties) in the best geographies. The vast majority of their properties are located in the southern US where demographic trends and supply dynamics remain favorable.

### **2023 Market and Economic Outlook Update:**

We have a divergent view as we look over the investment landscape for the rest of 2023. Traphagen has high confidence for the rest of the year on the bond and alternative/private side of the portfolio with solid returns likely. Most bonds are already up 3% - 5% this year and even if yields remain at current levels, total returns would likely be in the upper single digit to low double-digit range. Similarly, we do think a mid-single digit return is likely in aggregate within our private/alternative suite. These returns for bonds and private/alternative investments have a high chance of occurring regardless of any recession.

Where there is much more uncertainty is on the stock side of the portfolio. To date, stocks have performed well, especially technology, growth, and more speculative securities. Going forward in order for stocks to continue to perform, we would need inflation to come down significantly, rates would need to stabilize near or below current levels, economic activity needs to remain positive, and unemployment increase slightly (but not overly so). There is a pathway to achieve this combination, but it is rather narrow, and we are not willing to position portfolios with that as the base case. This is why we have portfolios invested in a manner where we can take advantage of the more likely bond and alternative returns, while benefiting to an extent from stocks if they continue to perform well, but be well defended if we do get a notable slowdown/recession.

**Below: *Year over Year Inflation for past 10 years; Red area is expected range at end of 2023***



Although we do think the rest of 2023 and early 2024 presents challenges, once into mid and late next year we think a much more optimistic backdrop is in place for US corporations, stocks, and economic growth.

**Below: *A summary of positive catalysts we think will take shape over the next 12 – 18 months***

**Much lower Inflation vs. 2021 – 2023 Period:** We are already in a strong downward trend for inflation and although it will likely remain above the FED target of 2% for an extended period of time, we do think it can get to 3.5% to 4.0% by the end of 2023. This, in combination with a more stable outlook, can be a significant economic catalyst.

**Lower and Less Volatile Interest Rates:** The 10-year Treasury is already down more than 1% over the past 6 months, and across most maturities interest rates have already likely hit their highs. Although the FED could hike further, we think the chances of materially higher short term rates are low, and unlike last year, there should be more long term stability.

**Progress on Supply-Chains, Demand Imbalances, and Inefficiencies:** Significant progress has already been made, but further improvement in companies logistics, supply chains, and efficiencies will likely continue over the next year. Some of this will be due to logistical changes made between countries, some will involve streamlining workforces (layoffs), and some recent significant advances in robotics and especially AI can stabilize or reverse the recent trends of lower profit margins.

**Correction of Economic Imbalances/Valuations:** Over the past 15 years with near zero interest rates many economic imbalances, inefficiencies, and malinvestment took place on a large scale. We have been going through a period of correcting this since late 2021 and we continue along that path. We expect periods of significant stresses through this transition (like the recent banking failures), but once the overall economy and asset valuations have adjusted to a more normalized regime, that presents much better and stable long-term investment choices.

We are cautious over the next 6-12 months, but believe portfolios are uniquely and very well positioned to make it through the current economic transition, regardless of the path the markets take to get there. As always we are open to any new economic data or trends we see in the markets and will take any portfolio actions we think are warranted. Despite this near-term caution, once this ‘transition’ is complete and we move into a more ‘normalized’ environment, we think there will be opportunities to invest not seen in 15 years.

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 much anticipated spring season. Lastly, we hope all who celebrate had a wonderful Easter, Passover, and Ramadan.

Best regards,

**Your Traphagen Investment Team**