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FFG Partners Market Pulse Newsletter, Q2 2023

As we end the second quarter and begin the latter half of the year, we find ourselves straddling two opposing realities. Based solely on market performance, it seems like the issues of 2022 are behind us and everything is honkey-dory (technically speaking). The market has rallied significantly to start the year, and fears of a severe recession have diminished considerably. This has led to a "risk-on" attitude where fear of missing out (FOMO) has overtaken the fear of losing out (FOLO). This is most obvious when considering the Nasdaq's year-to-date performance. However, if you dig a little deeper under the surface, everything is not as it seems.

The recent market rally has been led and upheld by the eight largest companies in the world, all of which happen to be technology companies. This Big-Tech rally has caused very narrow breadth in the markets and is masking the lackluster performance of most other stocks. Due to their size, these companies have an outsized influence on market performance. They tend to drag the market along with them in either direction they happen to be moving. This is usually a symptom of poor market mechanics and tends to lead to future underperformance as this overreliance inevitably corrects itself. In other words, if Big-Tech stocks start to fall, the market will fall right along with them.

In addition to the poor market breadth, there are many systemic economic issues that remain unresolved. Inflation continues to be high in absolute terms, the Fed has all but guaranteed that interest rates will continue to rise, and the labor market is extremely tight. These are the factors that led to the severe market downturn last year and will likely remain as an overhang on the markets in the near term. In addition to these more well-known issues, we are troubled by others that are less discussed. These include a slowdown in lending, the potential for increased commercial real estate defaults, and the blatant recession that is already occurring in the goods sector. I believe it is important to address these risks in more detail, lest we consider that they are unimportant.

A shift in the lending environment will have significant impacts on economic activity. Since the failure of a few major regional banks, the tides in the banking sector have slowly been shifting. Many banks are now contending with decreased asset values, increased capital requirements and the risks of deposits

fleeing. Away from public view, these banks have been selling off assets, including high-quality assets, to raise cash and decrease capital requirements. Simply, when banks are required to hold more capital, they are forced to lend out less. These banks are increasing their liquidity in preparation for a more difficult economic environment ahead. The buyers of these loans are specialty finance companies that tend to extract huge fees, discounts and concessions when negotiating these purchases. Typically, banks are reluctant to realize losses on their loan portfolios, especially when the loans are in good standing and expected to mature at full value. However, the banks are working to get ahead of what they believe will be a wave of delinquencies. This is not the type of activity you would expect in a booming economic environment.

Many of the loans being sold are concentrated in the real estate sector. With the work from home trend still in full force, commercial real estate, and office buildings specifically, have been negatively affected. The increase in vacancy rates and decreased rents have led to diminishing property values. Many of these properties are now worth less than their underlying debt, leaving many banks holding unprofitable loans. We have already begun to see landlords and property owners defaulting on their debts, and the increase of underwater loans will likely accelerate that trend. If this becomes a more widespread issue, banks will likely curtail lending further as they will need to maintain sufficient liquidity, stay compliant with regulations and offset losses. In addition, there is a significant spillover effect occurring due to this dynamic. All types of industries are being negatively affected including restaurants, construction, brokerage, furniture, retail, and others. These industries employ thousands of people and are dependent on a thriving commercial real estate market, including downtown office buildings. What used to be a vibrant driving force of our economy is now anemic and struggling for its survival. The more drawn out this contraction becomes, the more broad-based and severe the downturn will be.

Another major risk that we are monitoring is the recession in goods. Although a smaller part of our overall economy, this is potentially an early warning sign of an upcoming recession. Retailers have been steadfast at reducing inventory as consumers dial back their purchases of hard goods in exchange for services such as travel and dining out. Pallets are building up across the country as shipping and delivery of goods has come to a screeching halt. Store shelves are emptier than normal as the pace of replenishment has slowed. Just like commercial real estate, the goods slowdown has cascading effects across the economy. From shipping, trucking, logistics, retail and beyond, ultimately the lower demand for goods will eventually lead to increased unemployment and decreased spending throughout the economy. We are already beginning to see signs of this as evidenced by the latest jobs report, which came in weaker than expected. Many of the jobs created were concentrated in the public and construction sector. This is not data that screams economic

recovery. Typically, you want job creation to be widespread across the economy and certainly not concentrated in government. If not for the increase in government employment, the jobs report would have been abysmal. It appears that once again the headline numbers are masking the underlying weakness of the economy. Although one month does not make a trend, we are very focused on how the above risks will manifest themselves throughout the broader economy.

To manage these proliferating risks, we have shifted the makeup of the portfolio significantly. When the markets are optimistic, many risks tend to be overly discounted or ignored, which leads to a complacency that can be very damaging. Instead of attempting to manage the portfolios based on the latest news cycle or market developments, we focus squarely on the overall risk/reward profile of the current environment. It is extremely important to be aware of the less obvious or telegraphed risks. We have altered our positions to include organic cash flow generation from dividends and interest. This insulates the portfolio to an extent by shifting some of the return profile from market-related movements to less-correlated income generation. This along with our structured note exposure has enabled us to reduce variability in the portfolio without giving up much upside.

We believe this comprehensive view allows us to better manage the portfolios in this more uncertain environment. We strongly believe that the best offense is a great defense. This does not mean that we are ignoring the upside. Rather, we need to be confident that we are being compensated appropriately before taking on a certain level of risk. At this point, we believe the risk/reward dynamics will favor those who are more cautious and exacting when constructing and managing their portfolio.

We hope you have a wonderful summer!

Yours Truly,

Gabriel Levy, CFA
Portfolio Strategist, Fiori Financial Group

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