Lynx Capital Group Ltd

Disciplined Strategic Investment Management

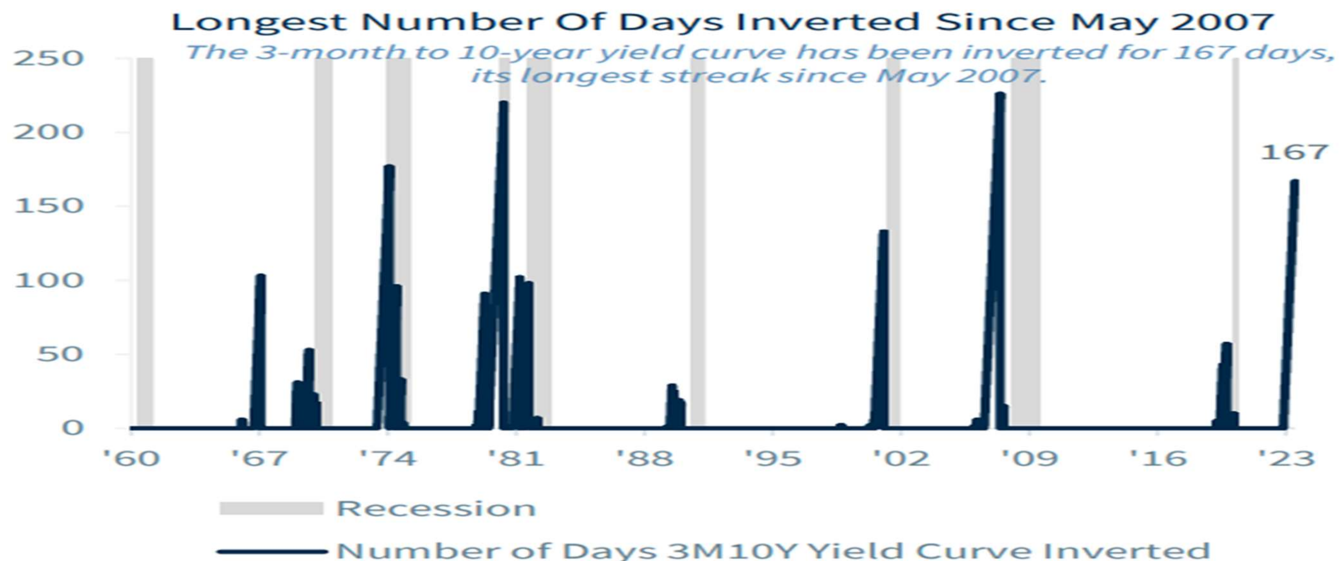
http://www.lynxcap.com

Market Outlook as of July 2023

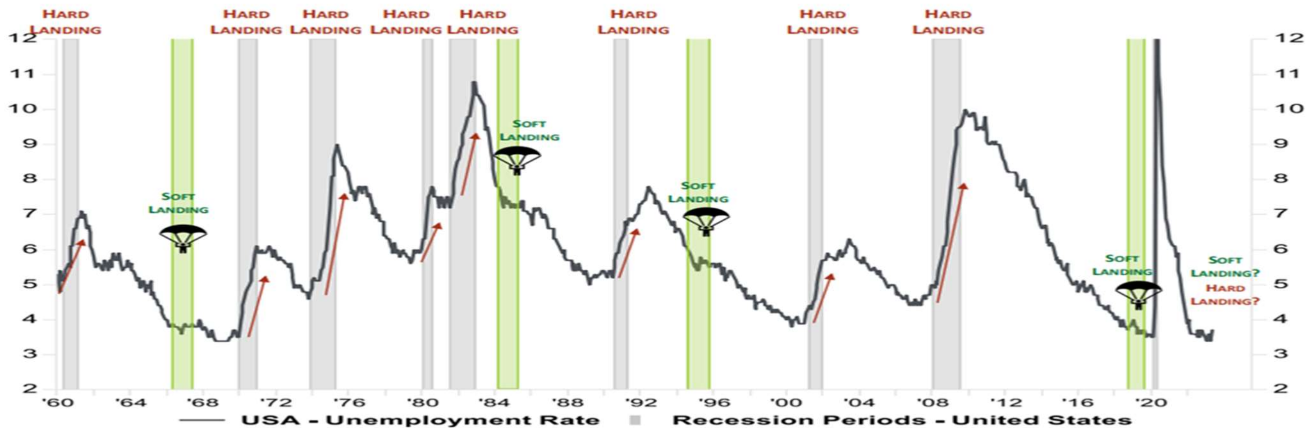
"History repeats itself" and "History never repeats itself" are about equally true ... We never know enough about the infinitely complex circumstances of any past event to prophesy the future by analogy.
G. M. Trevelyan (February 1876 – July 1962) was a British historian, author, and history professor at the University of Cambridge.

While history is a great guide to the past it never repeats exactly as planned. In the past aggressive Fed tightening to tame inflation has led to a fairly severe economic recessions. This time ***so far***, it's being particularly challenging to predict as we have had massive and unprecedented stimulus from the covid pandemic which we are still working off, the resolution of the debt ceiling, an ongoing war between Russia and Ukraine, and the emergence of new disruptive technology in the form of AI (Artificial Intelligence). We have learned from the past to respect the Fed and still see a lot of headwinds ahead.

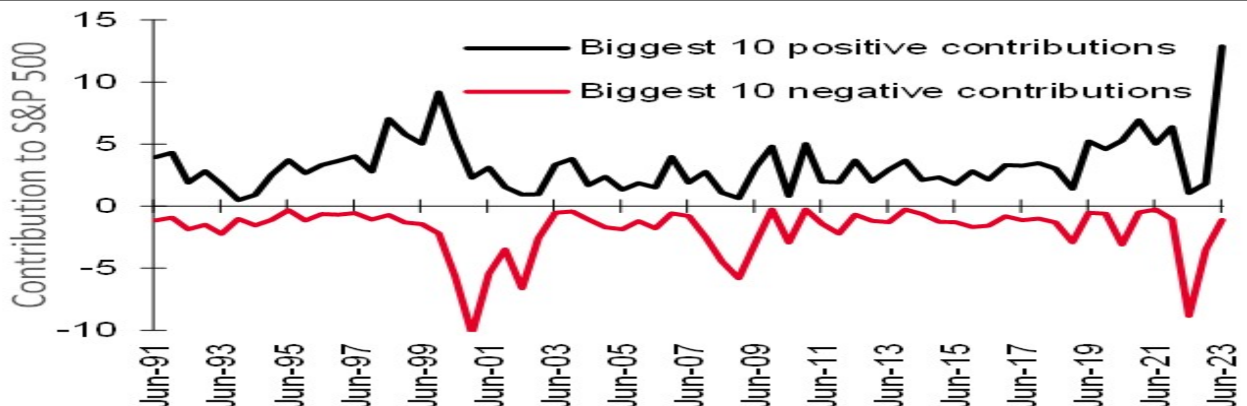
While equity markets are pointing to a solid economic picture, the bond markets inverted yield curve (when the yield on the 2 year or 3-month treasury is higher than the 10 year treasury) is severely flashing recession signs. We have had 10 interest rate increases since March 2022, the largest and fastest tightening cycle in over 40 years that still have to work their way through the economy, normally taking 12 to 18 months for the full effects to be felt. The Fed has signaled they will raise rates at least one more time and possibly more, and that ***"rates will stay higher for longer"*** until inflation is much closer to their 2% target.



Earlier this year, several large regional banks failed as they weren't prepared for rising interest rates. In response, ***banks have tightened credit*** which will have another depressing effect on the economy. In the past, every time the Fed raised rates causing ***an inverted yield curve due to elevated inflation, coupled with bank tightening***, we have had a recession (see chart below) (Hard Landing - 8 for 8 times). The other 4 times the Fed hiked that did not lead to as recession, we did NOT have a spike in inflation and lending standards were not restrictive.

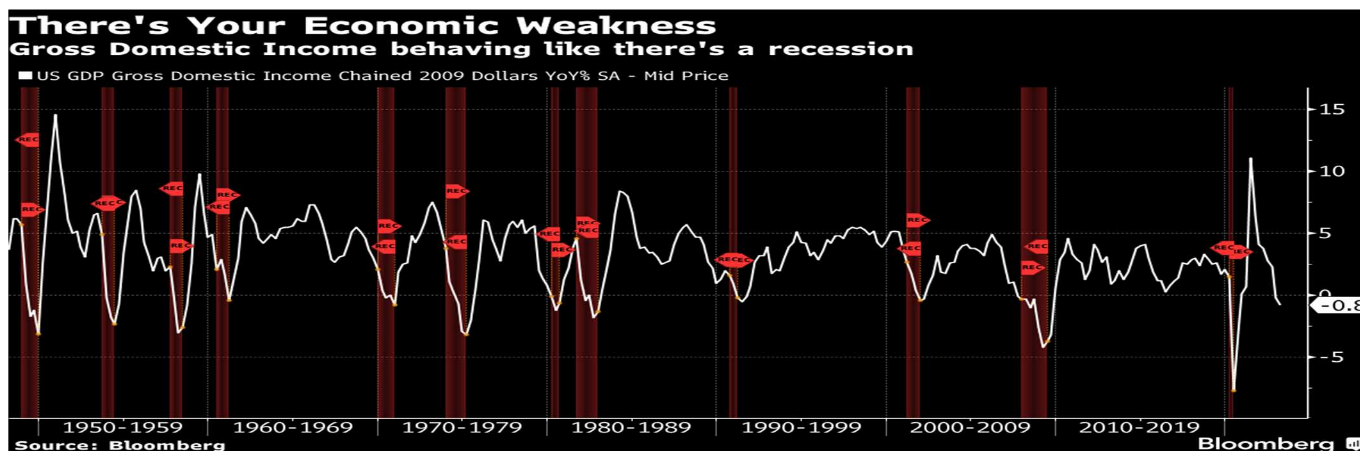


The performance of the market so far this year has been very narrow and concentrated in less than 10 behemoth companies, referred to as "bad breadth". This has produced ***extreme concentration risk***. The majority of those gains were on high-flying technology stocks, related to the excitement around artificial intelligence. These are all great companies, such as Apple, Microsoft, Tesla, Facebook and Google. The gains so far were NOT a result of earnings growth but from PE expansion, meaning that their valuations are currently very extended with a lot of good news priced in. ***The top 10 stocks out of 5000***, account for 25.9% of the market valuation. Higher than at the height of the dot.com bubble that ended in 2001. It will be telling later on this month when quarterly earnings are reported. Outside of the concentrated large technology names most of the market offers fair value, and there are areas that remain relatively cheap such as healthcare, industrials and large financials.

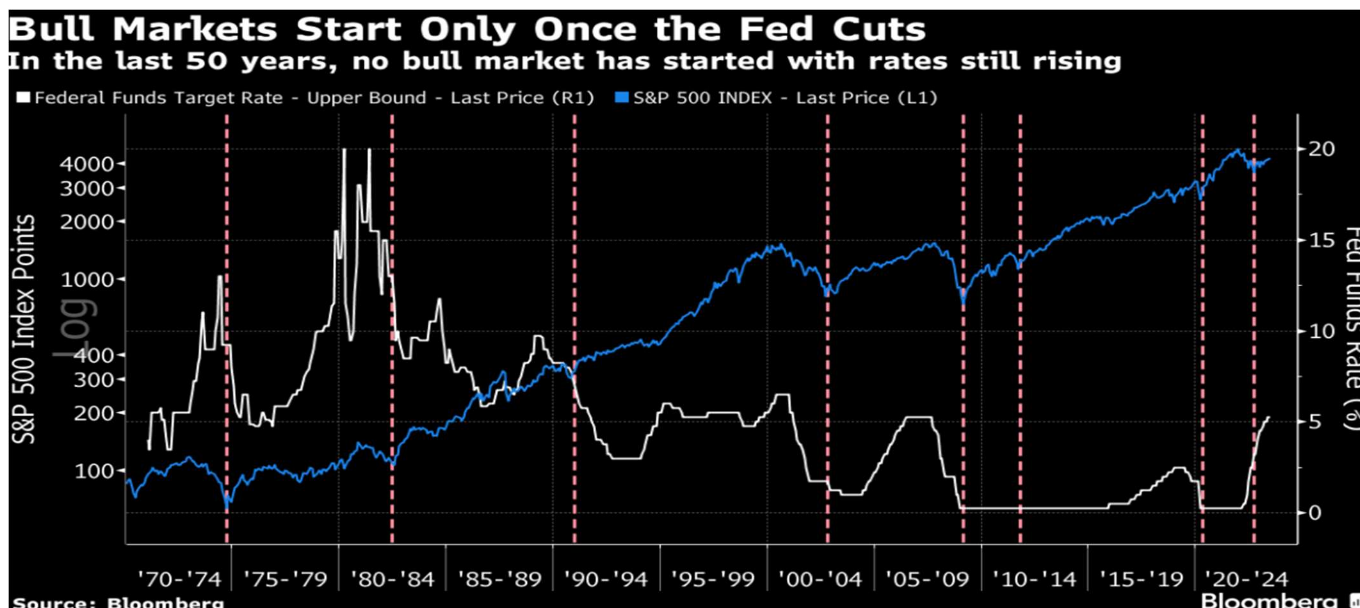


From Societe General SA

US Manufacturing is contracting and already showing signs of recession. The ISM manufacturing index has been below 50 for eight consecutive months; in the past this has led to pretty steep job losses. The Fed is also reducing its bloated balance sheet by a trillion dollars a year. From here on out, the economy will have to grow on its own without the Fed support and much less congressional stimulus. Student debt forgiveness that was rejected by the Supreme Court will also become a further headwind to the consumer as they start repaying their loans. ***Consumer spending*** (which represents 70% of the economy) is showing signs of fatigue with dwindling excess savings, higher debt servicing costs (car loans, credit cards, new home mortgage etc.) Even from the Fed minutes, they are starting to see consumer weakness in gross domestic income (GDI) which is flashing recession warning signs.(see chart below)



Core Inflation is still proving to be sticky but has come down from over 9 to 5.3% at the end of May 2023. Very tight labor markets are hampering the Feds inflation fight as workers demand higher wages. We are also seeing much more strike activity by workers (i.e. Railroad, UPS drivers and hotel workers in California). Bull markets have historically only begun when inflation is under control and the Federal Reserve begins ***cutting*** interest rates (during a recession) and we don't see that happening anytime soon. (See Chart below)



The key question is where do we go from here? Unfortunately, higher unemployment (slower wage gains) will be needed to squeeze core inflation out of the economy. In the past recessions are never priced into the market, until unemployment claims rise sharply. This is a key area to watch as the Fed is targeting the labor market.

Markets should broaden out from here. We are cautious overall, with a little more defensive tilt towards healthcare and critical software services to business and the government. Over the last 18 months our Dividend portfolio proved that it offers investors lower volatility due to the quality of the companies and with a history of increasing dividends. We are satisfied with that as we are actually ahead of the market on returns in the last 18 months with a lot less volatility (drawdowns). (see table below)

	18 Months Ended June 2023	2022 Return
S&P 500	-4.4%	-18.2%
Technology Stocks	-6.2%	-32.6%
Lynx Cap typical Dividend Strategy before fees	-0.6%	-7.4%

For investors who are VERY risk averse, treasury and select corporate bonds and preferreds now offer a better trade off from stocks due to much higher interest rates.

It is always advisable to review one's individual circumstances and tolerance for risk. If any of your financial circumstances have changed, or you want to adjust your portfolio's risk profile we always encourage you to contact us should you want to make any changes to your portfolio allocation.

As always, please feel free to contact us with any questions or concerns.

Brian Chait

President, July 7th, 2023

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