The Conservative Strategist

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"Higher for longer": The right thing to do, but it will bring pain

On September 20, Fed Chairman Jerome Powell announced that the Fed was set on keeping interest rates "higher for longer" than the market had assumed. Apparently, longer means 2026, as the Fed pulled back on some interest rate cuts set for 2024 and 2025. This sent bond prices lower and set off a downward spin in stock prices as well — an ugly end to an already difficult quarter.

This tight monetary policy may be the tough medicine we need to wring inflation out of the system after years of artificially low interest rates. But sometimes the initial stages of tough medicine can feel worse than the malady itself.

Take the housing market. Already mortgage rates have been over 7% for five weeks, and now in late September they are inching closer to 8%, a kind of Maginot Line beyond which residential real estate transactions, which have already slowed to a crawl, may freeze up entirely.

Consider that 92% of US homeowners with a mortgage are currently paying below 6%, and 62% of homeowners are paying less than 4%. Who would want to give up such great mortgages by selling?

Beyond housing, consumers will have to pay higher borrowing costs, as will corporations and the federal government itself. So a continued slowdown is in the offing.

The bond market itself has been predicting a recession for a long time. The so-called yield curve (difference between short-term rates and long-term rates) has been inverted for over a year, with Two-Year Treasuries yielding 5.13% while 10-year Treasuries yield 4.47%. Inverted yield curves have been accurate predictors of recessions. They certainly reflect the consensus of expectations of bond market investors, who are generally pretty savvy. When bond investors think a slowdown is imminent, they will move out on the yield curve to lock in high yields, causing longer-term bond prices to rise relative shorter-term bond prices. Of course, yields move inversely to prices, and this causes longer-term bond yields to move lower relative to short-term yields — thus the inversion.

***14:** The number of times that "2 percent inflation" was mentioned by Chairman Jerome Powell as a Fed policy goal in his 9/20 prepared remarks and Q&A session that followed. Is 2 percent a realistic goal? Or a dangerous obsession that could tip the economy into recession? The next several quarters will tell.*

So today, we see something of chaos and confusion in the bond market, with a clash between the expectations of bond investors for an eventual slowdown (thus eventually causing rates to fall) and the real actions of the Federal Reserve to hike interest rates. By hiking, the Fed is telegraphing that its primary concern is not an imminent economic slowdown, but incipient inflation from an economy running too hot.

Of course, the stock market hates uncertainty. So amidst this bond market chaos, stocks are beginning to reverse their first-half strength. While seasonal patterns point to a rebound in Q4, the fundamentals and market sentiment are weighing heavily at the moment.

In a higher-inflation, higher-interest rate regime, the SuperDiversified portfolios tend to outperform, as our Real Assets and SuperCash positions in particular offer ballast in such environments, and even our Bond positions, invested substantially in floating-rate securities, hold up well. ■

The Markets September 30, 2023	Price/Yield	Gain, Qtr	Gain, YTD
US Stocks (S&P 500/Vanguard Index)	4288.05	-3.30%	12.95%
International Stocks (Vanguard Index)	17.18	-4.02%	4.96%
Emerging Markets Stocks (Vanguard Index)	24.97	-2.18%	2.37%
Real Estate Stocks (Vanguard REIT Index)	25.15	-8.56%	-5.48%
Bonds (30 year US Treasury/Vanguard Index)	4.73%	-12.17%	-8.57%
Dollar (US Dollar Index)	106.17	3.17%	2.56%
Gold (London Afternoon Fix)	$1873.55	-2.02%	3.30%
Money Market Funds (Vanguard Federal - VMRXX)	5.43%	0.24%	1.19%*

*change in yield

Portfolio Planning

Niche assets: The next step in our portfolio diversification

Q3 was a sloggy, sluggish quarter for conventional assets. The S&P in mid-September was precisely where it started the quarter (4450), yet investors had to endure a 5% drawdown in three weeks in August. International stocks were down between 1% and 2% depending on your index. Bonds as measured by the *Barclays Aggregate Index* were down a choppy 1.5%.

Our current alternative funds are shining

In such a meh quarter, our alternative assets, particularly our private credit interval funds, were quite supportive. Again as of mid-September, Cliffwater Corporate Lending (CCLFX) was up 3.02% on the quarter, *Cliffwater Enhanced Lending* (CELFX) was up 2.66%, *First Eagle Credit Opportunities* (FECRX) added 2.71%, *Variant Alternative Income* (NICHX) rose 1.97% and *First Trust Alternative Opportunities* (VFLEX) gained 2.50%.

Moreover, while equity markets exhibited substantial volatility, these funds ascended in smooth, sleep-at-night mode. Of the five above, only one had a down week during the quarter, a mere 0.3% drawdown for NICHX in late August on a minor writedown taken on one of its investments. That week, the other four funds did well enough to more than offset that hiccup. So the five-fund group did not suffer a down week this quarter. Their yields range between 7% and 11% and we are confident they will continue to add both return and diversification to our portfolios.

Niche assets

I like to say that if diversification adds value, then SuperDiversification adds even more value. Similarly, *if alternative assets enhance diversification and lower risk, then even more 'alternative-y' assets should lower risk even further.* It will soon be possible for us to allocate to an interval fund that specializes in investing in overlooked and undercapitalized niche assets that are a step out on the alternative spectrum beyond our existing private credit investments — and an excellent supplement to them.

What are niche assets, often called *the alternative to alternatives?* They are strategies based on straightforward proven assets or businesses with steady, repeatable and transparent cash flows. Examples include aircraft leasing, marine barge financing, electrical grid trading, government payment factoring, taxi medallion finance, helicopter leasing, and railcar financing and leasing. These categories are subject to idiosyncratic risk, not systemic risk, and are therefore non-correlated to our other holdings. They are often too small and/or research-intensive to interest even our existing private credit interval funds, and are certainly not serviced by a banking industry under increasing regulatory scrutiny since the recent regional banking debacle.

Enter niche asset specialists like *Wingspan Capital,* a firm started four years ago by two gentlemen with a combined half-century of investment experience, including for two of America's richest families. Andrew Eberhart was the Chief Investment Officer for the Heinz family office, while his partner Paul Ghaffari ran *Vulcan Capital,* which was the family office for recently deceased Microsoft co-founder Paul Allen.

Wingspan Capital will be introducing an interval fund (same structure as those discussed above) in the first half of 2024 that invests quite similarly to its existing multi-strategy partnership fund. We'll have more about *Wingspan* and its coming interval fund in future issues. But we are excited about this opportunity to further diversify our client portfolios. ■

Wingspan Capital and Niche Assets: A Solid Start

	WINGSPAN CAPITAL	10 YEAR TREASURIES[2]	HIGH YIELD BONDS[2]	S&P 500 (TOTAL RETURN)[2]	HEDGE FUNDS (EQUITY)[3]
Historical Returns (IRR)	11.3%[1]	-12.9%	1.8%	10.6%	3.2%
Drawdown[4]	-0.2%	-36.4%	-15.8%	-20.3%	-5.7%

1 Net of fees and expenses, represents the composite return of all Wingspan Funds from 3Q20 to 1Q23.

2 Gross returns except for Hedge Funds. Source: CapiQ, Divident Adjusted historial returns from 3Q20 to 1Q23.

3 Source: Cambridge Associates Private Equity Index historical returns from 3Q20 to 1Q23.

4 Drawdown defined as highest local maximum price or NAV over investment period to lowest local maximum price or NAV (3Q20 to 1Q23).

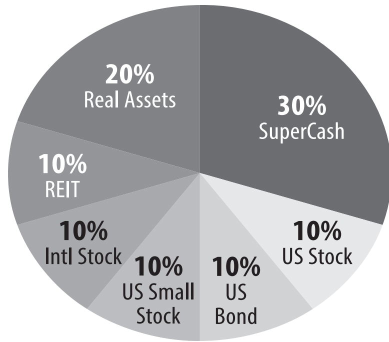
Wingspan Capital *has been operating 11 quarters, just short of the three-year vetting process we have. (It will be more than three years since inception when its interval fund debuts in the first half of 2024). In that time, its returns have narrowly beaten the S&P 500. But the S&P has seen a more than 20% drawdown, while* Wingspan Capital*'s worst drawdown during the period was a mere 17 basis points (0.17%).*

Source: Wingspan Capital

SuperDiversified Portfolios (SDPs)

Commodities power SDP outperformance

SDP1 *Conservative*

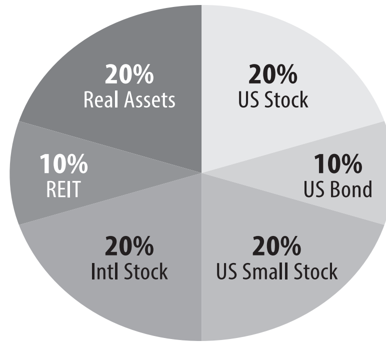


3rd Quarter **-2.20%**

Year-to-Date **1.23%**

A second consecutive quarter of mediocre-to-poor performance for most of our asset classes. But not so for the commodities complex, which enjoyed a stellar quarter amidst steadily firming oil prices.

SDP2 *Moderate*



3rd Quarter ***-2.71%***

Year-to-Date ***0.23%***

Our benchmark Real Assets fund PIMCO Commodity Real Return advanced smartly. Given that Real Assets are 20% of both of our model portfolios, this added strongly to SDP returns.

The above model portfolios are not intended to indicate the performance of any real account, but reflect the composite performance, before fees, of the percentage allocations in the asset classes and funds listed in the table below. Seasonal Strategy's actual allocations vary from these models, and among portfolios.

How the Sectors Performed

Wide dispersion among our asset classes

Asset Class	Mutual Fund	Performance 3rd Quarter '23	Performance Year-to-Date	
SuperCash	PIMCO Instl Low Duration	0.88%	1.94%	Best
	Merger	3.47%	2.37%	Worst
	Calamos Market Neutral	0.71%	6.59%	
US Stock	Vanguard Index Trust 500	-3.30%	12.95%	
US Bond	Vanguard Long-Treasury	-12.17%	-8.57%	
US Small Stock	Vanguard Small-Cap Index	-4.63%	4.13%	
Intl Stock	Vanguard Intl Index	-4.02%	4.96%	
REIT	Vanguard REIT Index	-8.56%	-5.48%	
Real Assets	PIMCO Commodity Real Return	5.62%	-3.57%	

It's rare to see a 10-percentage point differential between real assets and real estate, but this was such a quarter. Our categories were all over the place this quarter, and that dispersion is a sign of investor confusion, but also an argument for our approach of broad diversification.

The conventional US Stock/Bond combination ended the quarter in negative territory, but the strength of the Real Assets and SuperCash categories pulled the SDPs higher, while small stocks, foreign stocks and Real Estate detracted somewhat.

TIPS: Getting juicy

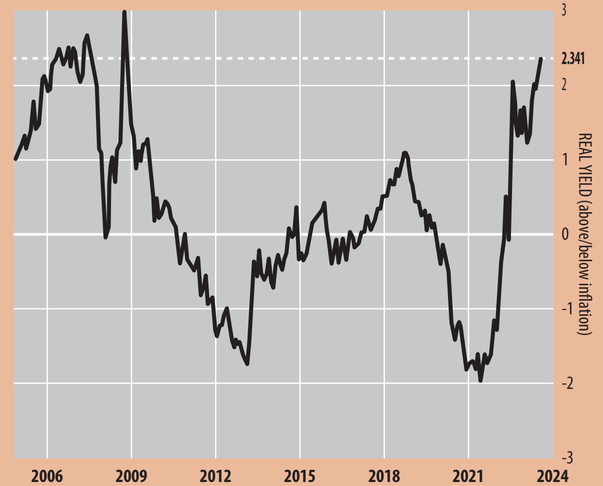
In the aftermath of Fed Chairman Powell's remarks on 9/20, yields on *Treasury Inflation-Protected Securities,* or TIPS, soared to their highest level in nearly 15 years.

Bear in mind that TIPS allow you to lock in a yield over and above the rate of inflation. Today's yield of 2.34% on five-year TIPS has not been seen since November 2008, in the midst of the Great Financial Crisis. That proved to be a fine time to own them, as their yields subsequently fell to zero within two years, and to negative 1.95% within another 2½ years.

Today, the entire TIPS yield curve, from 5 years out to 30 years, is above 2%, and the average of that curve is more than 2.15%. Getting a guaranteed 2.15% above inflation when stock prices remain historically pricey represents an attractive alternative to risk-taking.

TIPS yields soaring

Yields of Treasury Inflation-Protected Securities, 2005-2023



TIPS were at a record negative *yield as recently as 2021. Now they are at their highest level in 15 years.*

Source: YCharts

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Lots going on: Schwab, Paperless, Reno

The only constant is change, right? Several important developments are taking place in the last few months of 2023, all in the name of progress.

We are all Schwabbies now

The massive Labor Day Weekend shift of all *TD Ameritrade Institutional* accounts to *Schwab Institutional* has been a success. We saw a minimum of problems or delays — surprisingly smooth for a firm-wide move that saw 7,000 advisers and their hundreds of thousands of clients come over.

And the downloads and reconciliations of all our client accounts also went smoothly, thanks to the excellent support from the team at *Tamarac,* which now owns and manages *PortfolioCenter,* the software we use to track, monitor and report on portfolios. There were a number of residual dividends that came over from *TD* during the month of September, and there may be a few more residuals to come for quarterly payers. But the software is taking care of all that.

Superior service

In my opinion, *Schwab* has always offered superior service to *TD,* so former *TD* clients will benefit. All clients of advisers like myself have access to the *Schwab Alliance* line (800-515-2157), where a dedicated team is there to answer any and all administrative questions. *Schwab* is in the process of combining the best of its technology with the best from *TD Ameritrade.* Consolidating all clients at *Schwab* will result in economies of scale and service for us, and that should be better for everyone.

First quarter of paperless

You are no doubt reading this newsletter on your computer, because it is part of the report package I emailed to you this quarter. We are no longer snail-mailing quarterly reports for several good reasons we outlined on page 2 of the last newsletter. One of the advantages of electronic delivery I neglected to mention in that issue is the ability for older eyes to read my newsletter in larger type simply by zooming in. Try doing that with the print version!

By next quarter, I intend to implement a vault system, so that you will download your report each quarter from my site, prompted by a timely email message.

Settling in

By the time you read this, I will be in the process of moving into my new home and office in Reno, Nevada.

The week following October 16 will be hectic, and I will have limited availability. By early November, the office will be fully set up and better than ever, with an AT&T-based fiber internet connection that is roughly twenty times the national average.

Streamlined custodial arrangement, all-digital delivery, and superfast Internet: Progress. ■

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