Investment Strategy Update October 2, 2023

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Estragon: He should be here.
Vladimir: He didn't say for sure he'd come.
Estragon: And if he doesn't come?
Vladimir: We'll come back to-morrow.
Estragon: And the day after to-morrow.

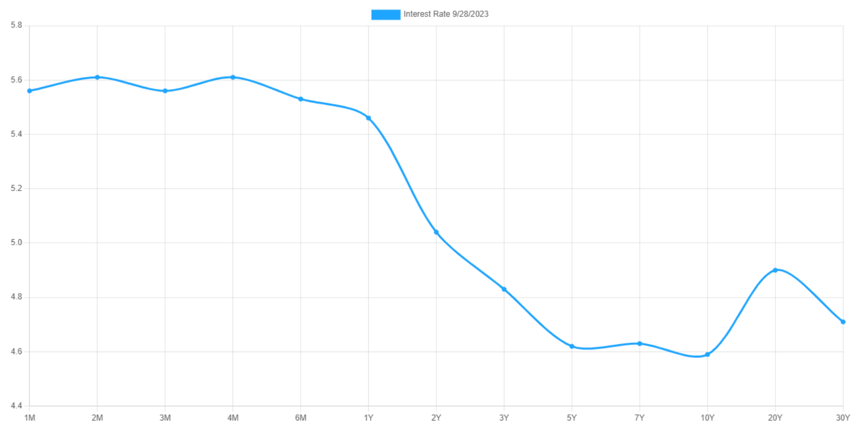
-Beckett, Samuel. Waiting for Godot: A Tragicomedy in Two Acts. United States, Grove Atlantic, 2011.

In Act I of Samuel Beckett's *Waiting for Godot*, two characters meet and discover they are both waiting for a man named Godot. They commit to waiting in the same location until he [Godot] comes. There is a parallel to investors waiting for recession. Like Godot's arrival at the tree, an economic recession is not a certainty, but investors, like the characters in the play, have persisted in predicting its arrival since the Federal Reserve began its aggressive rate hikes in March 2022.

Unlike in Beckett's play, where Godot never arrives, evidence today strongly suggests that a global recession remains a high probability over the next 12 months.

In this letter, we focus on the inverted yield curve, its implications, and the preparedness of client portfolios.

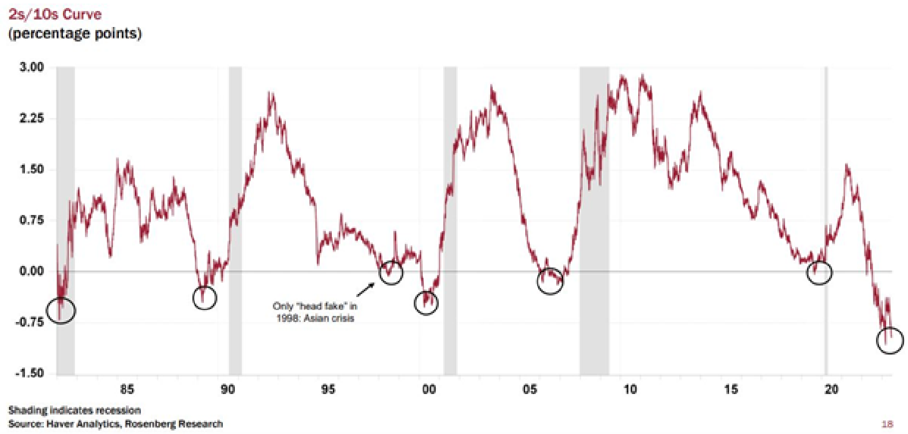
The yield curve (pictured below from USTreasuryYieldCurve.com) displays the yield of bonds over a series of maturities. Typically, short-term bonds yield less than long-term bonds and the yield curve slopes upward to the right. Occasionally, the curve can invert, and short-term bonds yield <u>more</u> than long-term bonds.



While an inverted curve has been a reliable signal that a recession is on the horizon, it has not reliably predicted *the timing* for the onset of a recession. From the initial inversion, the time to recession has historically ranged from six months to just under four years. The yield curve inverted in mid-July 2022, approximately 15 months ago. The current inversion was directly influenced by the historically significant and rapid increase in rates that the Fed has executed to arrest inflation.

Recession, this time around, has likely been delayed due to the extraordinary fiscal and monetary support that bolstered consumer balance sheets and kept the economy (and markets) from crashing during the Covid pandemic. Those bolstered balances appear to be running out as delinquency rates are climbing for all categories of consumer debt, student loan moratoriums expire in October, and retail spending numbers are slowing.

It is also the case that the larger the inversion and the longer it lasts, the greater the likelihood we have a recession. This inversion has been one of the deepest and longest we have experienced going back over 40 years. This is illustrated in the chart from our research partners at Rosenberg Research showing times when the 2y UST yield is greater than that of the 10y UST yield (yield curve inversion) and highlighting periods of economic recession with shaded vertical bars.



Source: Rosenberg Research, *Charts with Dave*, June 29, 2023.

All recessions begin as ‘soft landings’, and the debate currently seems to be centered on whether the Fed can orchestrate, and stick, a soft landing or if the economy will slide into a longer or deeper recession. It appears that the strong consumer has delayed the conclusion, but not the debate.

Unlike Estragon and Vladimir, we can do better than their “Don’t do anything. It’s safer” strategy. Diversified portfolios, by design, smooth out the highs and lows of market volatility. This smoothing effect, together with our disciplined approach to portfolio rebalancing increases our confidence in limiting the damage and seizing opportunities should the last two months of equity market volatility persist. One example of opportunity that we will continue to capture is the attractive yield in short maturity bonds as a method of de-risking portfolios and generating predictable returns.

Please let us know if you would like to discuss the specifics of your portfolio and how it is positioned to align with your objectives.

Thank you for the trust you place in us.