Sanctuary Asset Management Investment Outlook August 2023

Active Asset Allocation Views

Overview

Markets continued their grind higher in July with a risk-on attitude that has yet to be deterred by signs of a slowing global economy. Global PMIs remain below 50 and LEI has been in decline for 15 months. The multiple on the S&P 500 has expanded, yet S&P500 earnings are unchanged from a year ago and the risk-free rate is elevated. The same risk-on attitude is pervasive in the bond markets as spreads remain below 20-year averages and the lowest rated high yield corporates outperform investment grade YTD by a wide margin. The employment picture continues to be resilient, despite over 500 bps in rate hikes. Upgrades to real GDP continue to push economists to downgrade recession probabilities. To date, slower inflation, solid growth and better than expected earnings are all the market has needed to rally. Market breadth, previously limited to the Magnificent 7, expanded in June and July with Small and Mid-Cap indices finally participating. We believe security selection is paramount, and investors should continue to focus on quality in both equities and fixed income as this rally gathers its bearing. Fed rate hikes have long and variable lags and despite the resiliency of the economy now, we continue to be on guard and will continue to monitor the markets here and abroad for signs of a change in market sentiment that would dictate a change in our outlook.

Economy

U.S. consumer sentiment is improving, with inflation pressures easing and labor markets remaining solid. Business sentiment in the developed world is soft for both services and manufacturing. U.S. gross domestic product grew 2.4% in the second quarter, 1.1% of that contributed by personal consumption. Fixed investment turned positive in the quarter, adding 0.8%, with business equipment investment rebounding. Consumer Sentiment rose to 71.6 in July, the highest final monthly reading since October 2021. Consumer confidence also improved, reaching its highest reading in two years, at 117.0. Lower inflation readings and a strong labor market are supporting consumer attitudes. Inflation data continues to moderate, with year-over-year employment costs rising just 4.5% through the second quarter. Meanwhile, the Fed's preferred inflation measure, the core Personal Consumption Expenditure deflator, ex food and energy, rose 4.1% for the same period, easing from the 4.6% pace in May and well below the 5.4% peak in February 2022.

Equities

In response to equities strong first half of the year, and P/E multiples at ~20X, the Council maintains its neutral view on Equities. At present, consensus earnings expectations for 2023 and 2024 are approximately $218 and $244 per share, respectively. At these levels, the S&P 500 trades at roughly 21 times the 2023 estimate and 19 times the 2024 estimate, both at the high side of fair based on data that extends back to 1997. For the year, three sectors - Communication Services, Consumer Discretionary and Information Technology are up between 35% and 45% while three others -Energy, Healthcare and Utilities are negative. This varied performance is typically associated with the equity market pricing in stronger economic growth and earnings. Conversely, July's performance was broad-based across indices and sectors with all being positive. Broader market breadth is typically indicative of a market poised to trend higher.

Fixed Income

In response to yields broaching 4%, the Council increased its Fixed Income view to neutral and our preference for duration to neutral. Both the Fed and European Central Bank (ECB) raised policy rates 0.25% while the Bank of Japan (BoJ) announced it will let 10-year Japanese bonds trade at slightly higher yields. The offsetting impacts of tightening monetary policy vs. strong investor risk appetite may create opportunities across fixed income markets. Return opportunities in high-quality bonds have improved meaningfully, with yields around 5%, and price headwinds may start to fade as central banks contemplate pausing rate hikes. The Fed continues to reduce its Treasury and mortgage bond holdings, which has the potential to nudge bond yields higher, dampen liquidity and, in turn, reduce a portion of the fuel to fund future economic growth. Corporations and municipalities generally have strong credit fundamentals but face ongoing headwinds from high borrowing costs.

Alternatives

Credit contraction reduced capital access and raised borrowing costs, which was favorable risk-adjusted for private lending; sentiment improves from lower inflation, strong jobs, stable growth. Caution for potential lingering inflation effects. The chance to provide support capital under favorable terms arises, yet selectivity is crucial in the high-default private equity ecosystem. The secondary market for private equity gains traction due to limited funds, requiring cautious navigation and emphasis on quality. Recovery signs prompt Q2-Q3 potential, focusing on growth-driven, less-leveraged companies.

Asset Allocation Views

		UW			N	OW				
		Conviction							Change	
BROAD ASSET CLASS	Equities				●					Equity valuations are more expensive and mega-cap technology leadership is unlikely to be sustained.
BROAD ASSET CLASS	Fixed Income				●				▲	Yields on high quality fixed income offer investors an opportunity to take advantage of attractive valuations.
BROAD ASSET CLASS	Cash				●				▼	Maintaining benchmark weight to cash and reallocating into longer maturity investment grade fixed income.
ASSET CLASS – EQUITIES	U.S.				●					Falling inflation and resilient corporate profits should support domestic equities.
ASSET CLASS – EQUITIES	U.S. Large Cap				●				▼	Large caps typically perform better during periods of economic uncertainty but have become expensive..
ASSET CLASS – EQUITIES	U.S. Mid Cap				●				▲	Would benefit from a soft landing. Attractive valuations but tight credit conditions pose a headwind.
ASSET CLASS – EQUITIES	U.S. Small Cap				●					Receding regional bank fears and attractive valuations could drive gains.
ASSET CLASS – EQUITIES	U.S. Growth				●				▼	Benefiting from lower inflation, lower interest rates and strong balance sheets. Valuations are high.
ASSET CLASS – EQUITIES	U.S. Value				●				▲	Value stocks remain attractively valued and could benefit in a soft-landing or no-landing scenario.
ASSET CLASS – EQUITIES	Intl. Developed				●				▼	Resilience of European economies, and attractive valuations. The U.S dollar is the wildcard..
ASSET CLASS – EQUITIES	Intl. Emerging Markets				●				▲	Deteriorating technicals due to soft earnings and geopolitical uncertainty.
ASSET CLASS – FIXED INCOME	Duration				●				▲	The compensation for adding duration to portfolios is sufficient given the recent uptick in yields.
ASSET CLASS – FIXED INCOME	Credit Quality					●				The risk/reward favors owning core bond sectors over most of the riskier Plus sectors.
ASSET CLASS – FIXED INCOME	Treasuries				●					The move higher in Treasury yields offers an attractive entry point.
ASSET CLASS – FIXED INCOME	MBS				●					With yields and spreads at multi-year highs, we think MBS remain an attractive investment option.
ASSET CLASS – FIXED INCOME	Corporate IG			●						There is an opportunity to invest in shorter maturity corporate bonds as fundamentals remain strong.
ASSET CLASS – FIXED INCOME	+ Corporate HY					●				Attractive yields, but the additional compensation for the risk is below longer-term averages.
ASSET CLASS – FIXED INCOME	+ Intl. Developed				●				▲	Attractive valuations but currency volatility remains a challenge.
ASSET CLASS – FIXED INCOME	+ Intl. Emerging Markets				●				▲	Reasonably attractive valuations but currency volatility remains a challenge.
ASSET CLASS – ALTERNATIVE	Hedge Funds					●			▲	Favorable macro environment for alpha generation.
ASSET CLASS – ALTERNATIVE	Private Credit						●			Private credit gains favor amid credit contraction.
ASSET CLASS – ALTERNATIVE	Private Equity					●				Recovery signs emerge, enhancing asset acquisition potential, caution prevails. Consider PE secondaries.
ASSET CLASS – ALTERNATIVE	Real Estate				●					Shrinking deals and rising costs put private real estate funds in a bind.
ASSET CLASS – ALTERNATIVE	Crypto				●					Crypto market is finding a bottom amid rising inflation and interest rates, while developers continue to build.

Sector Views

EQUITY SECTOR

EQUITIES

	UW			N	OW				
	Conviction							Change	
Communication Services						●			A strong start to 2023 and resilience displayed during earnings season are notable. Traditional telecom stocks are attractive based on valuations and yield, but they remain out of favor. The sector valuations are fair and cheap to the Nasdaq.
Consumer Discretionary				●					Inflation is eroding purchasing power, but disposable income remains strong even against risking debt levels. Consumers are spending on experiences especially on summer vacations. A strong jobs market along with risking consumer confidence is aiding consumer spending. The risk is high valuations.
Consumer Staples	●								The market is shifting to cyclicals as earnings have been better than expected and the economy has not slowed significantly. Staples remain expensive. Over the next few months, we expect Discretionary to outperform.
Energy				●					Oil prices appear to be stabilizing. Earnings season has been a challenge as comps from last year were tough to beat. Valuations remain attractive. Demand for crude oil is expected to remain elevated out to 2040. This sector is favored long-term.
Financials	●								Financials remain attractive based on valuations, but we are concerned this sector has become a value trap. We expect banks, especially the regional banks to struggle with unrealized losses on their bond portfolios. Big banks are getting bigger and are favored over smaller banks. We believe we are in the early stages of a consolidation of the regional banks. Moody's recent downgrades and negative warnings are also a negative.
Health Care						●			The sector has corrected sharply and is now trading at a discount to the market. The sector has quality companies with dividends. Still under-owned by long-only funds.. Growth in Biotech but with idiosyncratic risk. Overall long-term demand as baby boomers age.
Industrials						●			Fiscal spending, capital expenditures and defense spending trends are supportive for this sector long-term. Onshoring benefits this sector. We favor this sector longer-term.
Information Technology						●			Technology is maintaining its leadership status with a relative price breakout. Artificial Intelligence is the next major growth area in technology and the economy. We favor semiconductors and software. We would be cautious with the FAANG+ names as they still dominate market indices with Nasdaq 100 have 47% in mega technology. Stocks are correcting and can correct sharply. We expect them to maintain leadership.
Materials				●					We remain neutral as the commodity sector continues to be under pressure. We would favor metals, particular gold longer-term.
Real Estate	●								Valuations have improved as the sector has corrected. We believe with the uncertainly of the direction of interest rates keeps this sector at risk. This sector also has competition from the bond market for income.
Utilities				●					High Quality sector with dividends. Demand rising with resilient fundamentals. Higher rates historically a negative due to high leverage. If the Fed pauses on additional rate hikes this sector could be a beneficiary.

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