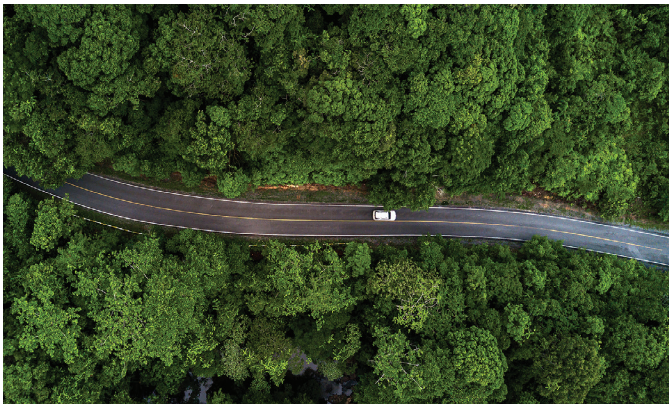
Nearly Out of the Woods

The Path to Today



Back in March of 2022, we at TIFF looked at the challenges that lay ahead and thought discretion was the better part of valor. We trimmed our equity exposure to target weights as equity valuations dropped from stratospheric levels. We also kept our bond exposure short and tried not to take on any extra risk; interest rates rose the most in decades. This strategy worked in relative terms, but we still saw large portfolio drawdowns in 2022.

More recently, the avoidance of 1) a US banking crisis – at least so far, and we think it's essentially over except for the long-term earnings problems that increased government regulation and higher fees will bring – and 2) a US government debt covenant violation have heartened risk-taking in stocks. Bonds have not yet recovered meaningfully, but are trading in a broader range, with the 2-year Treasury yield between 4.0% to 5.0% and the 10-year Treasury between 3.4% and 4.0%. It's still not clear whether the Fed has inflation under control. We don't think they do, but if employment gains falter and consumers retreat, we think this period of high rates, too, would end. Equities have benefited from the recent Fed pause (end?) in rate hikes, trading in a range of about 3800 to 4200, and currently stand near 4300. Earnings prospects appear to have stabilized as measured by the percentage of companies that beat analysts' Q1 earnings estimate, which came in slightly above 70%. Although this may sound like a high number, it is in line with historical averages – and earnings are actually *down* about 13% from where they finished a year ago. It's just that over that time analysts had become even more glum, lowering expectations. Nevertheless, it is a good sign that companies beat estimates.

US equities have rebounded 20% from last fall's lows into "a new bull market" in June, and we are seeing some nice gains here in 2023, though less than our benchmarks. (It would have been great to take on some additional risk in early Q4 of 2022, but we didn't think the risk was worth it.) It has been one of the most tumultuous times we can remember – though a return to bluer skies and sunshine may be coming into sight.

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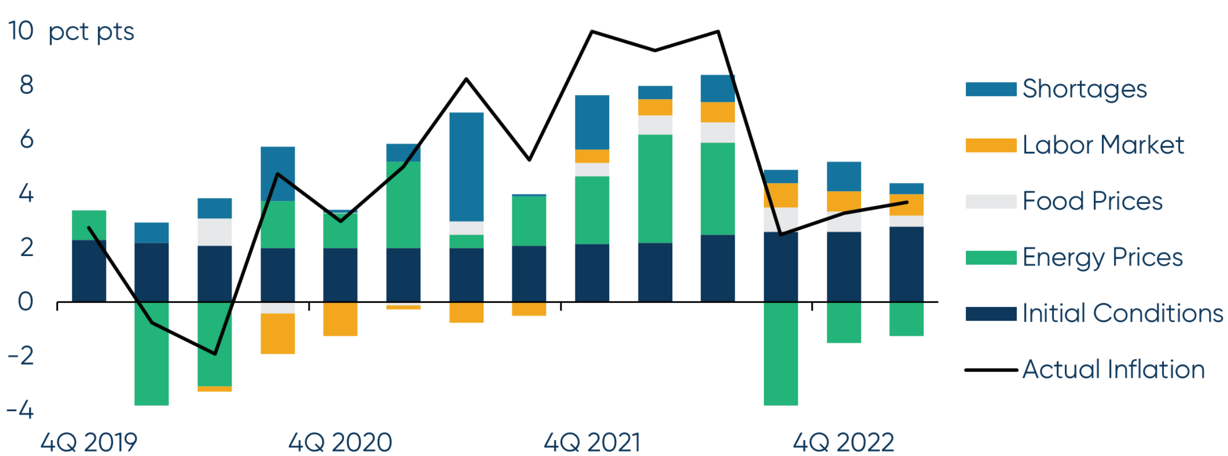
Maintaining Portfolio Balance, at Least for Now

We do not like to let markets dictate what we do, but rather prefer to anticipate the right allocations to best take advantage of what we believe may lie ahead. We didn't have any big changes to announce as Q2 came to a close, but we do think we are getting closer to the end of this period of hunkering down.

The ideal scenario for your portfolios would be a small economic contraction that gets magnified in corporate earnings via negative operating leverage. Wages, interest rates, and cost of goods sold have all risen over the past year, and a slowdown in nominal revenue growth could magnify these impacts, leading to a larger earnings decline than most expect. This happens because nominal prices cannot be raised faster than nominal input costs, which causes nominal profits to fall.

Companies report earnings in nominal terms, whereas economic reports are in real terms. Thus, a decline in nominal prices – or any increase in nominal prices that is less than the rise in input costs – will push reported profits lower, regardless of inflation. This could create an attractive opportunity to increase equity exposure at lower prices, which should lead to superior long-term returns.

Contributions to Inflation by Sources
(December 31, 2019 to March 31, 2023)[1]



If the economy surprises us and keeps chugging along – a "soft landing" – then earnings are likely to continue improving. A soft landing could see employment soften and consumer demand slow. Inflation would likely decline in this scenario,

[1] "What Caused the US Pandemic-Era Inflation?", Ben Bernanke and Oliver Blanchard, Hutchins Center on Fiscal & Monetary Policy at Brookings, May 23, 2023.

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helping push bond prices higher. This would be the best overall environment for stocks and bonds. We would certainly benefit, but probably not as much as if we get the opportunity to buy a few more stocks on price weakness first.

Remaining Storm Clouds

Ukraine's Summer Offensive

Before we see the sun return, we do have a few unresolved concerns. First, the catalyst for the 2022 drawdown was Russia's invasion of Ukraine. As time has passed, the Western world has provided increasingly modern weapons to Ukraine to help in its heroic defense. The world has been waiting so long for Ukraine's spring offensive that it has morphed into summer. If it goes better than expected, and Russia loses large swaths of previously claimed territory, Putin could retaliate by doing something even more horrific (assuming the Wagner uprising hasn't materially curbed his hold on the Kremlin).

The recent destruction of the Nova Kakhovka Dam on the Dnipro River may be a glimpse of that. The Dnipro has now flooded Kherson and many other cities downstream, forcing emergency evacuations. It has also destroyed tens of thousands of farmland acres. The Ukrainian Agricultural Ministry has said that the dam failure has left most irrigation systems in the region without a water source, leading to "fields in southern Ukraine perhaps turning into deserts."[2] Most of Ukraine's wheat exports go to Asian and African countries. Additional agricultural losses could result in further catastrophic events that push global grain prices significantly higher as supply falls. Food prices are a global contributor to inflation.

We own hedges in the form of the Bloomberg Commodity Index to protect against a repeat of last year, when commodity prices spiked at the start of the war.

[2] "Collapse of Ukraine's Nova Kakhovka dam an 'ecological catastrophe' ", John Pennington, Jo Shelley, Olga Voitovych, Julia Kesaieva, Helen Regan, CNN, June 7, 2023.

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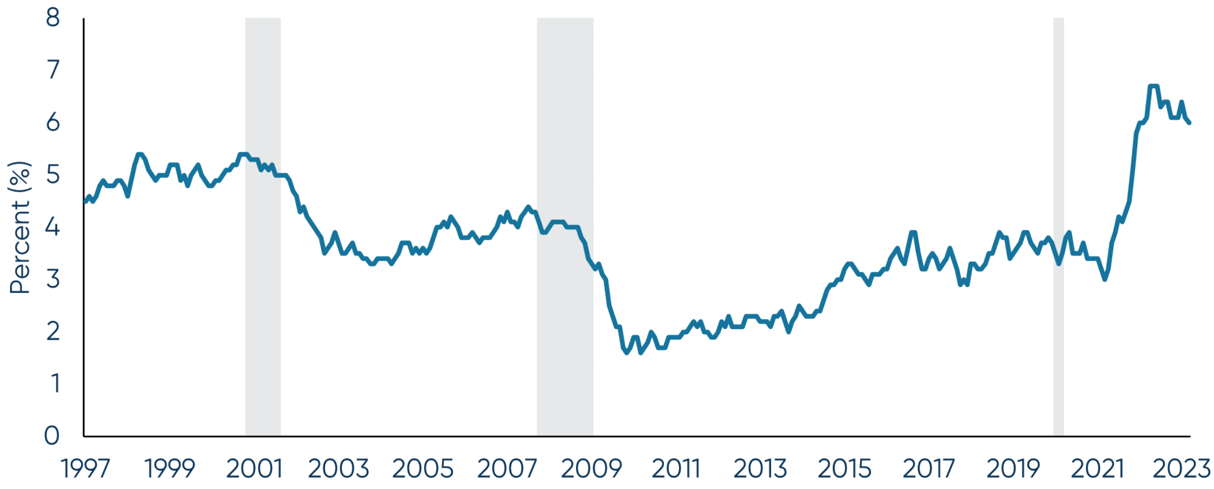
Late-Stage Inflation Battle

The inflation debate may be coming to a head. In the US, we have seen CPI inflation retreat to 4.0%, down from 9.1%. This is encouraging. Our concern has been that the final 2 to 3% reduction would be the hardest to achieve – and we are now in that zone. Normally, a recession reduces employment, cutting incomes and then consumer spending, allowing prices to moderate and inflation to fall. This time, we have yet to see employment fall. In fact, with unemployment at 3.7% and 14 consecutive months of job gains exceeding expectations, it seems just the opposite is happening.

The Atlanta Fed wage tracker shows year-over-year wage gains of 6% or more for the past 15 months. If this strong employment backdrop allows consumer spending to remain healthy, then the economy may not enter a recession – and inflation may not fall back to the Fed's 2% target. In fact, wage growth above the inflation rate keeps consumer spending robust and supports further job growth.

Historic Median Wage Growth

(Three-Month Moving Average, January 1, 1997 to June 8, 2023)[3]



We have not yet extended our fixed income duration, which currently stands at 2.4 years. If yields rise above 4% on the 10-year Treasury, or it becomes clear that the virtuous employment cycle is ending, you will likely see this extension occur. The greater the rise above this 4% threshold, the further we are likely to extend duration.

Earlier, we touched on the scenario we believe could lead to an earnings decline. Our strategy is to be patient until we can increase our equity holdings at more attractive prices. Today, the S&P 500 trades at about 19x next–12-months estimated earnings, compared to a historical average closer to 16x, 20% above average. When earnings

[3] Federal Reserve Bank of Atlanta using Current Population Survey and Bureau of Labor Statistics. Hourly data.

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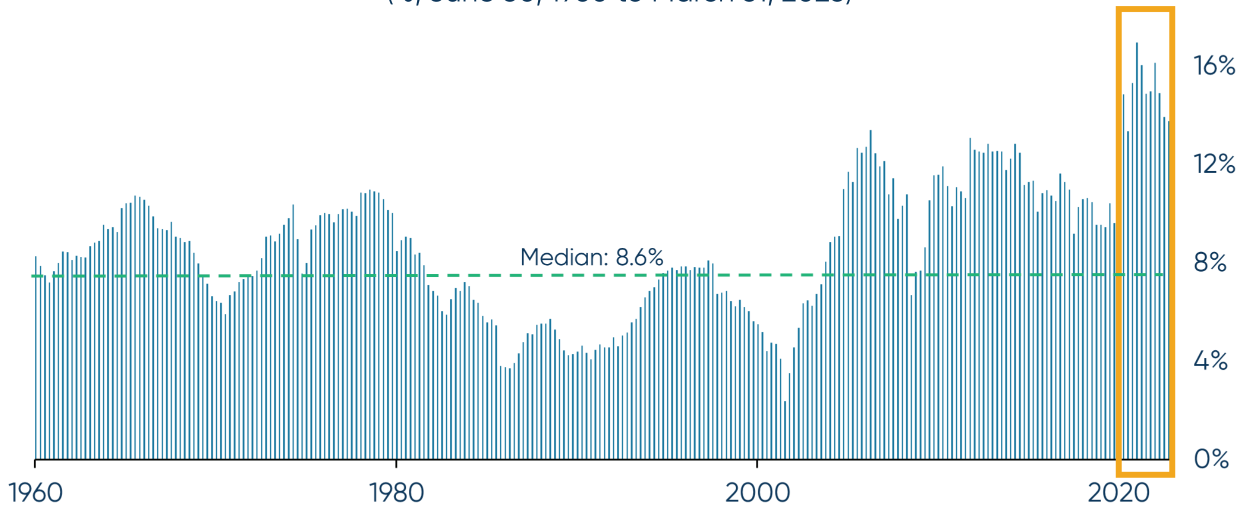
are coming out of a very depressed period, this can be a "good" entry point, but when earnings are peaking, this can be a very expensive entry point.

The chart below shows net profit margins for the S&P since 1960. What it *doesn't* show are forward analysts' estimates that suggest this a margin trough and that margins are expected to rise in the back half of 2023. If margins are higher, the market may also be higher; if they are lower, the market will likely be lower. To our eye, the direction of travel is clear: Margins are still on the high side, and any slowdown in revenue growth could be compounded by operating leverage. We remain patient.

Historic Net Profit Margin of US Non-Financial Corporate Business
(%, June 30, 1960 to March 31, 2023)[4]



China Equity Valuations

US / China relations have deteriorated and could get worse, especially in the run-up to the 2024 elections. It seems that each party will try to outdo the other on how tough they will be on China. To date, this escalation (along with the COVID lockdown and Xi Jinping's election to a third term as China's leader) has taken a toll on Chinese stocks. Since peaking in February 2021, as Q2 2023 drew to a close, the MSCI China Index had fallen as much as 63% and remains down 49%. (For comparison, the SPX is up 16% over this same period.)

In hindsight, much of this decline may be warranted, but multiple contraction has also contributed. Since peaking at nearly 20x in early 2021, PE multiples have contracted to less than 11x recently. Chinese stocks are always cheaper than US stocks on a PE-multiple basis, but it is rare that they are as cheap as they are today. Although we appreciate that they could move even lower, we are heartened that markets are

[4] Bureau of Labor Statistics. After-tax profits without adjustments as share of gross value added, using Bloomberg data for GVADNCPA and CPBINGDP indices.

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willing to pay 30x earnings for Apple, the world's largest company with an equity market cap of $2.8tn. We say this because Apple generates nearly 19% of sales in China and "more than 95% of iPhones, AirPods, Macs and iPads are made in China."[5] For Tesla, the numbers are similar: 70x earnings for the seventh-largest US company with a $790bn market cap, with 22% of sales and 52% of manufacturing in China.[6] Although both companies are trying to increase production facilities rapidly in other locations, it seems unlikely that investors would pay such lofty multiples if markets were truly concerned about an end to US / China relations. Rather, we suspect that the deterioration has impacted China's valuations more than the US', and that our Chinese overweight – averaging about 3% across all portfolios – may be due for some catchup.

We are optimistic about intermediate-term prospects. Further efforts by the Chinese government to stimulate their economy would be a welcome sign that could boost investor sentiment and returns. Longer term, we are concerned because the world depends on a stable US / China relationship. We are monitoring this situation very closely and would likely trim our overweight on meaningful strength.

Concentration of US Stock Market Gains

Lastly on the US stock market, leadership has been very concentrated this year. Normally, when very few stocks account for much of the aggregate SPX gains, it is not a good sign. Through May 31 of this year, the SPX, which is capitalization weighted, was up 9.6% – versus 0.7% *decline* for the equal-weighted version of the same index. This is a sign that not all stocks are healthy. The five largest stocks in the SPX comprise a record 24.7% of total index capitalization.[7] More than ever, it is important to manage your risk when 1% of the index names make up nearly 25% of your investment.

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Year to date, only 24.5% of SPX stocks have outperformed the index, which would be a record low if it holds through year end. These records go back to 1972 and 1973 start dates. NDR also notes that the number of stocks beating the market over the last three months was a record low of 20.3%. In the 12 months following periods where fewer than 30% of stocks have outperformed the index, the median return has been 1.8%, compared to an all-period return of 8.2%. Also, after such narrow leadership

[5] Bloomberg and "Apple's Reliance on China Poses a Problem for the Company," Steve Banker, Forbes, January 19, 2023, and Bloomberg.
[6] "Tesla China Plant Expansion in Doubt," Automotive News Europe, January 12, 2023, and Bloomberg.
[7] "Lessons From Previous Narrow Markets," Ed Clissold, Ned Davis Research©, May 31, 2023.

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periods (there have only been 10), small cap and value have tended to outperform large cap and growth. Always trying to keep the odds on our side, we recently added a small cap manager to our lineup and have rebalanced exposures to try and keep our growth/value split near our 50/50 target.

Suspending the Debt Ceiling

Lastly, the recent bipartisan vote to suspend the debt ceiling passed. Longer-term implications are for policy wonks to figure out, but most investors were happy to see a two-year suspension on the debt ceiling capping the total amount of money the government is allowed to borrow and ending the political infighting. Although this means the government can spend what it needs to spend to meet our obligations over the next two years, the deal also included provisions to trim non-defense discretionary spending and cap all discretionary spending to 1% growth in 2025 (likely below the inflation rate). Analysis of the proposal suggests reductions in federal spending of $55bn this year and $81bn in 2025 versus current Congressional Budget Office forecasts. Given current assumptions this results in total savings over a decade of about $860bn.[8] In our view, even these small changes are important because the CBO estimates that, over the next decade, the US budget deficit will never be less than -5.5% of GDP and our cumulative debt will grow by more than $24tn, putting debt at 138% of GDP in 2033. If interest rates stay at today's levels, then all else equal, this number will be even higher.

We don't believe the US deficit is an immediate problem, but it is likely to become a larger concern and political issue that will require attention in the future. Current efforts in some regions to de-dollarize are suggestive of future issues if the US doesn't take measures to get our financial house in order. Such an environment could see investors begin to incrementally favor gold and possibly even bitcoin, as stores of value.

Into the Sunshine

Impact of Artificial Intelligence

We are not experts in AI, but have learned much in the past year or so. It holds the promise of making the world a better place, and, yes, it could be used for ill as well. We will try to focus on the positive aspects of this new revolution, which we hope will become the dominant contribution of AI.

As computing speeds accelerate, AI continues to make huge strides. Today, AI can write new computer code, craft letters, answer questions, play games, and even generate

[8] "New Details in Debt Limit Deal: Where $136 Billion in Cuts Will Come From," Jim Tankersley and Alan Rappeport, *The New York Times*, May 29, 2023.

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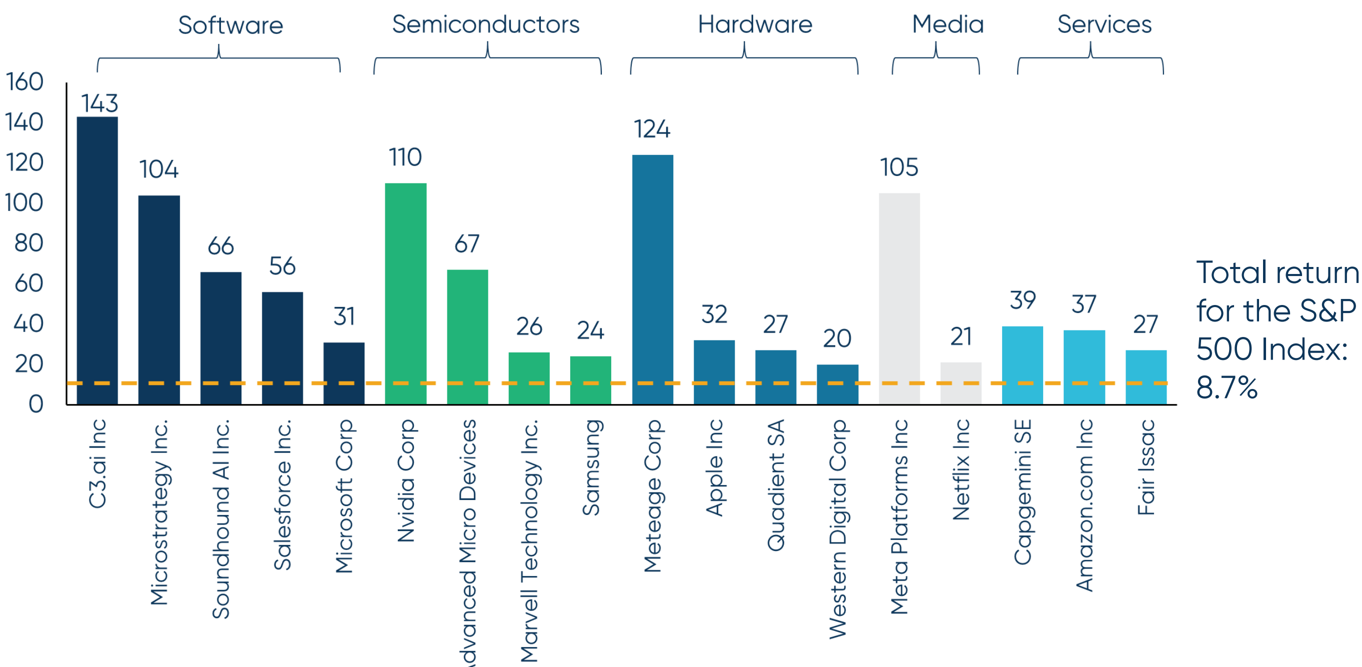
new ideas. More advanced users are asking it to write computer code that fits into larger programs, design new drugs for previously untreated diseases, and even answer phones, replacing the interminable hold periods, all with varying levels of success.

Bill Gates has said "The development of AI is as fundamental as the creation of the microprocessor, the personal computer, the internet, and the mobile phone."[9] He believes that an AI personal assistant can someday become so powerful that we won't need to do a Google search or buy something from Amazon. Such developments are not here today of course, but whichever company can lead this new field will likely become enormously valuable even by today's standards.

"The development of AI is as fundamental as the creation of the microprocessor, the personal computer, the internet, and the mobile phone."

Returns for Top Firms with AI Exposure Versus the S&P 500
(YTD Through May 23, 2023)[10]



The challenge for us all will be adapting. Much as we adapted to being replaced in the fields, we will need to adapt to being replaced in other jobs. In the past, machines could lift more or build things faster. In the future, they may actually be smarter than we are. AI will not be able to think original thoughts, but will have enormous data, recall, and logic capabilities. We will adapt by moving to higher–value-added jobs,

[9] "Artificial Intelligence as "Fundamental" as the Internet, Says Bill Gates," Katie McQuater, Research Live, March 22, 2023.
[10] "AI in Action: Where is the Smart Money Going?," Marion Laboure, Ph.D., and Cassidy Ainsworth-Grace, Deutsche Bank Thematic Research, May 25, 2023.

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just as we always have. None of the inventions that Bill Gates compares to AI have led to mass unemployment, but rather each has improved the lives of the population at large. We expect AI will be the same as it is used to make every business better than it is today.

Over the next several years, we expect AI can help accelerate growth and even improve margins of corporations around the world. Of course, those companies that lead in AI adoption could become the great companies of tomorrow. We are speaking to our managers about this on many different levels.

Conclusions

It has been a long time since we deviated much from our Strategic Asset Allocation target of 65% equities / 20% diversifiers / 15% fixed income. Many of the concerns –possible banking crisis, debt ceiling, etc. – we have shared in previous letters have been overcome, but others remain. We do believe though that we are approaching an inflection point, where remaining headwinds (inflation, earnings reset, geopolitics, etc.) will either have to reassert themselves or begin to fade into the past as they become part of our everyday lives and investor expectations while the economy and markets move ahead.

We remain vigilant, and expect that by year end, a clearer future path will emerge. It would be great if along the way we got an opportunity to increase our exposure to equities or to fixed income at attractive prices. We are prepared for either. We look forward to putting on a little sunscreen as needed and enjoying the higher returns that often accompany the sunshine.

As always, we very much appreciate the opportunity to help manage your capital and to help you achieve your organization's goals. We are here to assist you in any way possible, so please reach out and let us know how we can help.

Your TIFF Investment Team

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