Getting Closer

We saw a glimpse of what equity markets could do this summer when, for a couple of months, investors started to believe in a soft landing and the markets began to price in this economic optimism. Year over year, CPI inflation dropped to 3.0% - from 9.1% a year earlier. The Fed has begun to believe that a recession can be avoided, and stocks rallied 9.4% in June and July. In the end, a weaker August and September interval pushed markets a touch lower for the quarter, though our managers generally outperformed.

Inflation (Still)

Fortunately, the Fed appears serious about bringing inflation back toward its 2% long-term target and has reiterated that it will keep rates elevated until the goal is within reach. We say "fortunately" because, after such a long fight, we would hate to see them stop just short and allow inflation to re-emerge. Although some may believe inflation is whipped, we remain cautious about getting the last 1 to 2% out of the system and the risk of remaining stuck in a long-term higher regime of 3 to 4% inflation. So we applaud the Fed's recent actions – even if it means a delay in the market receiving the all-clear signal.

We are gaining confidence that the Fed's determination can prevail, but several near-term hurdles remain. Specifically, oil prices have risen 30% from their June lows, and medical care prices seem unlikely to continue to fall (-3% since September 2022) given that they have never declined year over year in 85 years (CPRMSERV Index). Home prices (SPCSUSA Index) and rent (Steady As She Goes: Rent Growth in June Was Perfectly Average (June 2023 Rent Report) - Zillow Research) appear to have bottomed for now. The strength of the jobs market has moderated some, with job openings below 9 million for the first time in 2 years (JOLTTOTL Index), and wage growth down to 5.3% (Wage Growth Tracker- Federal Reserve Bank of Atlanta (atlantafed.org)).

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If the Fed can stay on course to return inflation to its 2% target, we will become more aggressive in adding equity exposure, as indicated last quarter. In the meantime, we have used the more recent backup in interest rates to extend our duration to

4 years as yields on the 10-year Treasury reached successively higher levels above 4%. Locking in these rates should help provide additional portfolio balance, assuming the Fed achieves their target. Even with this longer duration, our portfolios are still 30 to 40% below duration, though this does represent the longest duration we have had in years. We will explain the rational for this change in a coming paper.

China

We've been overweight China for a long time, which has been correct *and* wrong over different periods; most recently it has hurt our returns. This position has been revisited often over time, and we have recently done so again after two members of our investment team recently returned from China. What follows is a synopsis of things we learned firsthand and some things we've read. These observations may include more detail than is typical in these letters, but we believe it is an important topic for us to analyze and share with our stakeholders.

We agree that Xi is all powerful, has put Party ahead of country, and will be in charge for a long time. Government is now more involved in business than in the past as Xi attempts to root out corruption and pursue his "common prosperity" initiative. Although the reduction of corruption and income inequality are commendable objectives, the exploitation of these policies to marginalize political opponents heightens ethical concerns. The collateral damage caused by Xi's policies today leaves the Chinese people with less confidence about the future than we've seen in more than a decade, excepting the period of global quarantines caused by COVID. Declining confidence has reduced once-strong animal spirits and economic vibrance as everyone waits to see what the government will do to stabilize a weakening economy and avoid persistent deflation. Yes, the economy has softened, but more worrisome is the burgeoning crisis of confidence that could lead those with significant financial or educational investments to try to leave China for better opportunity. An extended "brain drain" would be detrimental to China's future prospects (refer to page 3 for relevant charts).

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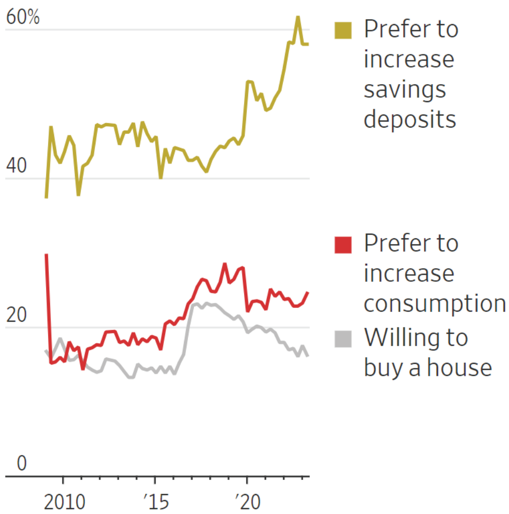
The absence of a robust post-COVID economic rebound has weighed down stocks and is increasingly likely to result in economic growth below the government's 5% target in 2023. Although it's still early, recent actions by the government to relax home purchasing requirements and reduce interest rates to cushion real estate markets have not yet produced the hoped for results. Some investors believe a Western-style big bang economic plan is needed before confidence can return. Xi does not appear willing to risk China's balance sheet in the longterm for this shorter-term outcome. We expect continued smaller actions around the edges that will take longer to bear fruit.

Results from People's Bank of China urban-depositors survey



Source: CEIC

Source: China's Crisis of Confidence in Six Charts - WSJ

Net emigration from China

Note: Figure for 2022 is a forecast, under the U.N.'s medium fertility variant.
Source: U.N. Population Division

Source: China's Brain Drain Threatens Its Future - WSJ

A recent Charles Gave piece addressed the Chinese real estate situation in a unique context, through the lens of two French economists: Clément Juglar (1860s), who explored cycles as recurring events based on periods of 8 to 12 years; and Albert Aftalion (early 1900s), who wrote about the "Investment Acceleration Phenomenon." Gave notes that the annual number of apartments built in China rose from 2mm in 2002 to 8mm in 2012, before leveling off in the ensuing decade. Demand required enormous investment in the production of cement, steel, copper, and glass. As banks lent to all these industries and the apartment buyers, banks became over levered. The past eight years have seen the Chinese government attempt to recapitalize their banks, launch a Belt and Road Initiative to encourage other countries to build infrastructure (with these Chinese inputs), and deregulate new sectors of the economy to fill the growth deficit. If all this is correct, Gave hypothesizes, the Chinese market could be nearing the end of this Juglar Cycle, and future returns could improve (https://research.gavekal.com/article/has-china-experienced-a-juglar-cycle/).

To some extent, these Chinese initiatives are working. China is the global leader in the electric vehicle (EV) market, a fact underscored by our team's observations that up to half of the vehicles in Tier 1 and some Tier 2 cities are EVs – predominantly domestic brands that outcompete their Western counterparts in price and affordability. Battery and clean energy infrastructure are also progressing at an industry-leading pace. Advances in automation allow facial-recognition systems access to payment systems, banks, and healthcare, rapidly transforming China into a nearly cashless society. Despite the lack of local confidence, we encountered several who believe the lack of capital in China today (much of which is "locked up in local savings accounts") is creating "opportunities for returns which were previously unavailable." We regard this as an early green shoot.

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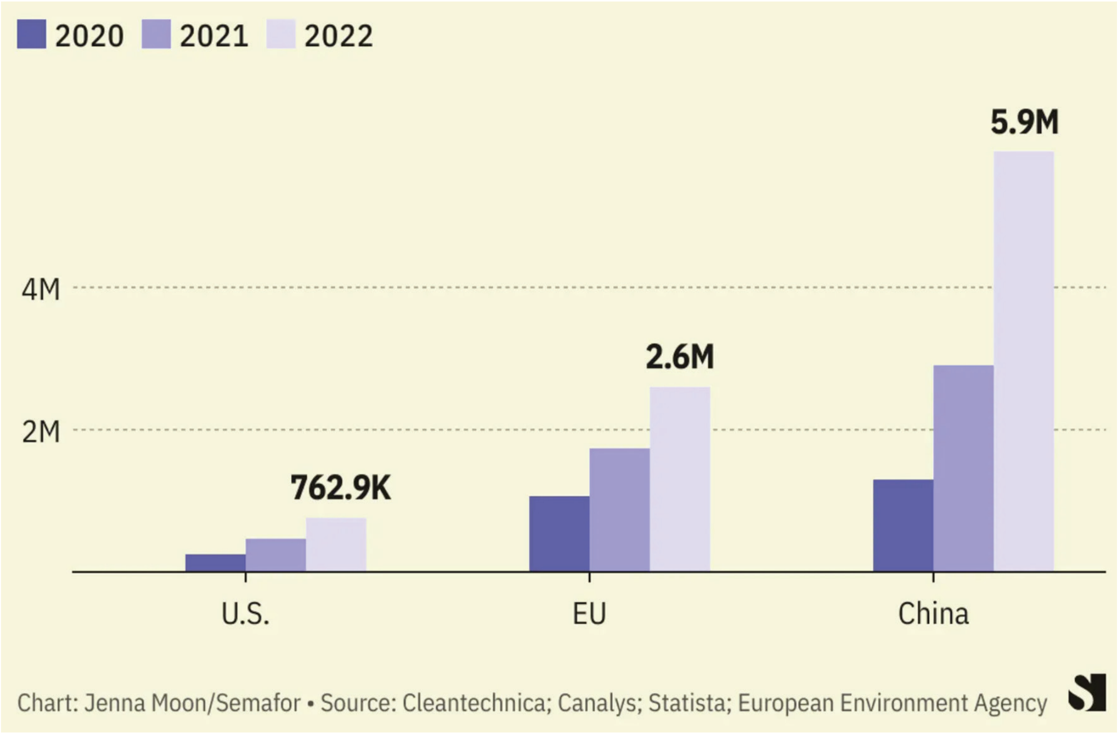
Leading the Charge

Number of EV sales per year in the U.S., European Union, and China, 2019 to 2022



Source: [How China dominates the EV market in three charts | Semafor]

As with other nations, there are dichotomies within the Chinese economy. Manufacturing is very weak, with several businesses we met considering shuttering some factories due to a lack of export orders and weak internal demand. Simultaneously, domestic travel has rarely been stronger, with some hotels and restaurants experiencing record high demand. In general, we would suggest that the Tier 1 cities are most affected today by Xi's policies, with smaller cities remaining less impacted, especially on the real estate front, where prices are down 10 to 25% from the 2019 peak. Longer term, we expect to see the real estate business in China become less important as the government continues to shift growth efforts to other parts of the economy.

On a slightly more positive note, the people we met do not believe that China will invade Taiwan. They do not want to risk going to war with the US. Most Chinese people still view the US as a friend and want China to mend ties with us. Although we read about businesses trying to move from China to such other countries as Vietnam or India, we also heard that Chinese businesses are often the ones setting up the factories to facilitate such moves. People still have money; they just lack an appetite to spend it on the "big stuff": Houses and luxury items are out of style until the economy picks up and people feel better. This pent-up demand could delay the consumer-driven economic recovery hoped for by those at the top.

From a valuation perspective, China, seems very inexpensive. This recent WSJ article ([Yes, There Is a Bull Case for Investing in China - WSJ]) noted that the weight of the entire Chinese equity markets in global stock benchmarks is today less than that of Apple alone.

Half Price
12-month forward price/earnings ratio

Source: Refinitiv

Apple is a great company – the largest in the world by market capitalization. It also derives nearly 20% of its revenue from China and has 95% of its iPhone production in China (Apple's Reliance On China Poses A Problem For The Company (forbes.com)). The idea that one company represents a larger share of global stock indices than the entire second-largest equity market in the world doesn't seem sustainable to us. We expect this will prove virtually unimaginable to investors 20 years from now. The one big caveat to that is Russia in 1917 and China in 1949; these are two of the only stock markets to have ever gone to zero, both after regime changes. Although we consider a repeat of such an extreme scenario unlikely, it's a possibility that merits acknowledgment.

After reflecting on what we know, what we learned, and our view of current markets, we have decided to trim our Chinese equity exposure to about benchmark weight. Until we see the Chinese government become more transparent about their longer-term goals and put the Chinese people and the country back in front of politicians, we think reducing position sizing makes sense. To be clear, we hope and expect to look back on this as a mistake, but a manageable mistake. The Chinese equity markets continue to be dominated by retail traders and represent a strong alpha-generation opportunity. However, the beta of Chinese markets remains in question, and maintaining a meaningful overweight in China could be very painful if things eventuated poorly. As of now, we expect this positioning to stand for the long term.

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We will continue to have some exposure in China, but will focus even more on other geographies where the potential for unexpected government policy surprises is lower and where we can maximize our ability to benefit from superior manager selection. Importantly, this policy will extend not just to our public market positions, but also to our private market positions. In funds where we have private investments, we have very modest existing exposure to China. (For those interested, our Private Markets team hosted last week the webinar Independent Sponsors: Rising Significance in the Lower Middle Market, which focused on some of the areas where we see the best opportunities for private market investors today, specifically some of the direct deal opportunities being presented to us from lower middle market managers.)

Current Positioning

We remain very much in line with our strategic asset allocation targets of 65% in equities, 20% in hedge funds, and 15% in fixed income (versus our benchmark of 65% equities and 35% fixed income). We are both adding duration in fixed income as rates continue to rise and preparing for a meaningful extension of duration if/as it becomes clearer to us that inflation will recede toward the Fed's 2% target. This could coincide with a more aggressive posture in equities as well, if the economy continues to hold up as appears more likely each day. We're not quite there yet, but we are getting closer to a normal environment where stocks and bonds can both provide important return and diversification to our portfolios. Who knows, maybe we'll see a "normal" bout of market weakness in the historically weakest months of September and October that results in an attractive price to add equities ahead of the seasonally stronger months of November and December. We'll be on the lookout.

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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INVESTMENT MANAGEMENT

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