WILDE CAPITAL MANAGEMENT

Newsletter and Capital Markets Review

Q3 2022

Sometimes information in the market is coming so quickly that it is stale by the time you write about it. The end of Q3 was clearly not the end of a fast moving story, much less a chapter, so we again hit 'pause' on the newsletter to let the market tell us a little more. In our late-Summer commentary we discussed the S&P 500 stock market index's March and July gains in the context of what we believe were classic short-term bear market rallies in a longer-term downward trending market. Carrying that forward and straddling the quarter end, from the S&P's near-term high on August 16th through October 12th the index fell nearly 17%. That was bad news. Worse, on October 12th the index breached 3,500 to touch a low of 3,491. Fortunately the stock market recovered that day to close at 3,583 and when we struck this chart on October 21st, had rallied about 3% to mark the end of that drawdown episode. Signs and portents though.

Presaging troubles yet to come, falling below 3,500, even for a brief moment on the 12th, may prove to be ominous from an investor psychology perspective. The 3,500 level for the S&P is only about 3% higher than the pre-Pandemic high of 3,386 on February 19th, 2020. If the current market begins to approach pre-Pandemic levels, erasing all the stimulus-supported gains of the past 28 months, all that investors will be left with is the future effect of significantly higher national debt, a bloated Federal Reserve balance sheet, sharply higher interest rates, high energy costs, high commodity prices, inflation at 40-year highs and a stagnating economy.

Capital market and macroeconomic conditions are not getting better. They are getting worse. Soaring interest rates are making debt servicing much more expensive for governments, corporations and individuals, straining Federal, State and local programmed and discretionary spending, lowering corporate earnings and impeding consumer spending.

The increased pace of the Federal Reserve balance sheet reduction, the "QT" or quantitative tightening that follows QE, just began in September. Investors are also expecting another 75-basis point increase to get to the upper bound of the Fed's target rate of 4%, and many see it rising further in 2023 while money supply growth is decelerating at a pace that we have not experienced in at least 25 years. Overall tightening liquidity conditions will likely persist for several more quarters as the Fed "right sizes" the balance sheet and continues its battle with inflation while the economy is still responding to lingering remnants of previous fiscal stimulus programs.

Living in the moment it does not feel good. But, frame of reference is everything. If at the inception of the pandemic we had predicted hundreds of millions of people sick globally, millions dead, and major parts of the economy stopped dead in its tracks, but don't worry – equities will be in the same place they were before COVID-19 got to the US – our judgment would likely have been called into question, and that would have been without predicting a massive stock bubble in the middle of it all. The reality is, with all the stressors accounted for, including a pandemic, a Russian war, a massive increase in the money supply, supply chain disruptions, inflation, and a sharp reversal of central bank policy, things could have been worse.

[Charts by Wilde Capital Management LLC from data from Standard & Poors (c)2022]

Market Review [cont'd]

As of the end of Q3 2022, three- and five-year total returns of the S&P 500 exceed 9% on an annualized basis, which remains above the longer-term average and is a significant amount higher than any reasonable trusted advisor would put in a client's financial plan or actuary would put in a pension's capital markets assumptions. But, 9% is history. Going forward, we believe the environment warrants lower exposure to stocks and bonds globally and higher cash levels than normal. We expect and in fact look forward to a time to reinvest but that time is not upon us yet.

Portfolio Positioning

Our outlook and portfolio decisionmaking in early 2022 has, regrettably for the capital markets, proven correct, and we are maintaining that stance as the markets continue to swoon. In the first half of the year, we took steps to reduce our exposure to equity risk as the capital markets digested their nearly unprecedented run- up since the pandemic nadir in March of 2020. Our feeling has been that signals of transient inflation are becoming more systemic and, combined with a regime change from the Federal Reserve from stimulating to tightening, the short-term prospects for equities are less attractive. Since that time markets took a brief respite and even rallied a bit before continuing to grind and sometimes lurch lower. We subsequently took a further incremental step away from equities in both US and foreign markets as we look for the catalyst that will define the bottom of this downward trajectory, the recent bear market rally in US equities notwithstanding. Within our ETF models, we made the shift primarily in US large cap growth and in Developed Europe equities, and in our ESG models through core and growth-biased large cap equities and broad international equities. All proceeeds were committed to cash and cash equivalents for the moment.This further reinforces our underweight allocation to equities overall as well as keeping a modest underweight in fixed income, with cash now even more overweight. Within global equities, we materially lowered US exposure, kept an underweight in Emerging Markets, and established an underweight with respect to Eurozone stocks while continuing an underweight in Japan. Within fixed income, we are overweight in the US with a preference for mortgages and investment grade corporate credit.

We have little to no exposure to non-US fixed income except through Green Bonds in our ESG series portfolios. All portfolios holding fixed income maintain lower duration than the benchmark.

Risk Review

In the prior couple newsletters we outlined our "dirty dozen" factors holding back markets. For regular readers of our newsletters, you undoubtedly noticed that our risk outlook does not change dramatically from month to month. We focus on big, persistent risks that do not come and go in a month or a quarter, like Russia's or China's geopolitical aggression, global inflation, the pandemic or the size of the US Fed balance sheet. What we are going to do here is erase the chalkboard and start clean using our dirty dozen as the outline. Our views on the risks we have been repeating have not changed, but this is an opportunity to peer into the haunted house through a different window. And with that tortured but seasonal mixed metaphor:

Inflation – Energy, Commodities, Housing

Even with signs of moderation, mostly emanating from declining oil prices, inflation is locked in and it is global. When we first started talking about inflation during the pandemic, we saw it as localized around specific circumstances related to the pandemic from the now almost-cliché supply chain disruptions to worker shortages in service-related businesses to dislocations in very specific industries like the "crack spread" between lumber at the stump vs. milled and ready for use. These economic kinks did not have an opportunity to work themselves out before trillions of dollars of stimulus and new money were poured into the economy driving increased appetite, and as a result there is demand and price pressure exceeding a still-disrupted global economy's ability to satisfy from microchips to chicken. Add in the effect of the Russia-Ukraine war and related sanctions regime on gas, oil, grains, steel, etc. and we anticipate some extended inflationary pain until global economies can work off the pandemic spending that compounded latent problems with overly accommodative policy since the Financial Crisis.

Reduction in monetary expansion

The proverbial punchbowl has finally been taken away. Central banks are printing less, quantitative easing is giving way to neutrality or even quantitative tightening, and policy rates are rising. There is less money (M2) being created and the cost to borrow it is going up. Even though it can be credibly argued that central banks, and in particular the Federal Reserve, remained expansionary for too long and this is a healthy and necessary change, it is still a regime change that has consequences after a decade-and-a-half going the other direction, and the steepness of the rate of change is inflicting meaningful short-term pain, particularly for those closest to the economic fringe. More ideal would have been the Fed moving much sooner and more incrementally instead of having to slam hard on the proverbial brakes and bang everyone's foreheads on the dashboard. Or, as Professor Steve Hanke of Johns Hopkins University has repeatedly pointed out, if those with control of the presses had printed less new money from the beginning of this crisis, inflation would not now be the entrenched problem it is with the only real solution being an undershoot on money creation to bring us back to normal.

Rising interest rates

Which brings us to rates more specifically. To put the clamps on inflation the Fed and other central banks will continue to withdraw stimulus and raise rates. There is certainly a benefit to savers that, for the first time in nearly a generation, savings accounts, time deposits, CDs and money markets are paying decent rates rather than just providing stability and safekeeping. But, inflation is more than doubling those rates so real returns are still negative. At the same time, the cost of capital to individuals, businesses and governments is rising which will make debt service more expensive and slow new borrowing. That is the intended effect, slowing economic activity and cooling inflation. But, higher rates will filter down through the economy and make goods and services more expensive and put housing further out of reach for many families while making variable rate debt like credit cards more expensive and more likely to tip borrowers into default or bankruptcy. For those with greater wealth security, the idea of bonds as an investable safe harbor is sorely challenged and will force a change in ownership patterns. Collective vehicles like mutual funds and exchange traded funds investing in bonds will be treated as riskier because of price volatility when not holding individual issues inside the funds to maturity.

Risk Review [cont'd]

Widening US High Yield interest rate spreads

Low-quality debt (junk) issuers have enjoyed an extended period since 2017 of economic advantage where it has been fairly inexpensive to borrow as the market has not demanded a significant risk premium for lower-rated issuance. All of the many strains on economies and markets are forcing a re-rating of junk bonds and a return to a historical spread over investment grade corporate or Treasury bonds to pay for the additional risk. This will become more of a self-fulfilling prophecy as rates continue to climb and it becomes harder for risky enterprises to borrow at interest rates they can sustain without default. In some cases the environment will force companies to clean up their balance sheets to lower their cost of borrowing, and in other cases Warren Buffett's maxim "It's only when the tide goes out that you know who's been swimming naked" will be in effect.

Full, although declining, equity market valuations

This risk may be declining, although only by virtue of a significant grind lower already in the books interrupted by brief bear market rallies. Valuations are definitely below where they were when we described them as "full", but conditions have also changed (see the 11 other risks) and based on today's macro outlook even priced at a lower valuation equities may still be characterized as full.

Corporate earnings still growing but the pace is slowing

Corporations have been able to capitalize on various price dislocations from food and basic materials to oil, airlines and automobiles to keep the good times rolling even into the current challenging market conditions. But, 15+ years of cheap capital are over with easy Fed policy giving way to QT and rising rates, which combines with rising wages, supply chain costs and less liquidity for consumers to put margins under pressure. Quality will certainly matter more both in terms of how capital is obtained and deployed and how crisp business execution is in order to sustain and even grow earnings.

Negative real wage growth

Wages are rising which is a hard-won victory, but inflation is rising faster, erasing those gains in real terms at the kitchen table. That reality reverberates through the economy as purchasing power for those most likely to spend their paychecks – the middle class and the working poor – declines.

Consumer sentiment – lowest since August 2011

Declining sentiment tracks with inflation overriding wage gains. The various components of inflation as experienced by consumers further aggravates those negative sentiments. Even if a consumer commits personal capital to make purchases, goods have been harder to get and pricing power is currently vested with merchants over consumers, leaving a palpably bitter taste. Automobile supply, for instance, remains tight and has opened the door to almost predatory pricing on dealer lots as even very ordinary and utilitarian vehicles are being sold for thousands over MSRP. This kind of disempowerment of consumers is discouraging current purchasing behavior and is very likely to come back around in the next stage of the economic cycle as the proverbial shoe ends up on the other foot when supply chains catch up and the power is vested back in the hands of those same consumers.

Supply chain issues

We have seen graphic examples of how interdependent world economies and supply chains are and how fragile they were with just-in-time inventory management. While investors have extolled just-in-time inventory since Toyota popularized it, it introduced an inelasticity into global supply chains that was not capable of absorbing the blow of COVID. We liken this to everyone on the highway cruising at 70 MPH riding bumber-to-bumper and doorhandle-to-doorhandle. It works fine until somebody swerves or stamps on their brakes. This was further exacerbated by climate-related issues, international conflict, and ongoing concentrated lockdowns in China. The results were issues such as a microchip shortage affecting the ability of factories to finish automobiles for delivery. The global sanctions regime surrounding Russia will also continue to play in, challenging energy markets and holders of Russia debt, which will almost certainly add volatility to the inflation situation. In the meantime, as investors and market watchers, we are looking at the confluence of business practices that are not sustainable, resilient or adaptive and externalities like global health, territorial conflict and climate change which can and will disrupt businesses and markets again.

Risk Review [cont'd]

Slowing home sales

As we have been cautioning for some time, we see housing as ripe for a significant correction, compounded by the current state of affairs. This market cycle is unlike any previous one because we have what we would characterize as an unnatural market participant – private equity firms – not present in prior cycles. Where home ownership was concerned, financial products related to homes were largely derivatives of the actual dwelling, like mortgage portfolios. PE firms went a step further and rather than accepting the dwelling as collateral for a mortgage, they purchased the actual home, effectively "productizing" it. Now you have institutional-scale market players that are strictly governed by the economics of the assets (homes), and not the intangible value an individual or family derives. This introduces new opposing forces because an institutional owner is more likely to want to sell the asset when the market is under stress because of economic conditions, while a traditional homeowner is more likely to hunker down in place and use the home as an anchor of stability. At the same time, the pandemic accelerated what we see as five to ten years of outward migration by Millennials and others from the urban cores to suburbia into the two years of the pandemic, which converged with historically low mortgage rates to drive a bubble in home prices. While we do not expect the same kind of damage in housing as was left in the wake of the Financial Crisis, we do anticipate homeowners will be frozen in place because housing values will fall, destroying equity, and rising rates will make it very unappealing to obtain a new mortgage for a different home because the exact same mortgage amount would be substantially more expensive to finance in a new loan.

Waning fiscal stimulus

"Waning" might be too passive a term to describe conditions. The US Congress is likely done with major spending legislation for the foreseeable future, particularly if one or both chambers change hands. The Federal Reserve is aggressively drawing down QE and raising rates to reel in inflation and move us back to some semblance of a historical normal. Easy money for financial institutions, corporations, mortgagees, consumer borrowers and the US Government, States and municipalities is over. This regime change which combines the end of at least 15 years of stimulative support and more than 40 years of declining rates will change the growth dynamics in capital markets for the foreseeable future.

Geopolitical flashpoints

There are too many to count, but the Russia-Ukraine conflict is a leading example of the risks. As we have written previously, neither country is particularly large in terms of GDP when compared to greater Europe, North America, Japan or China. But, cutting off "Europe's breadbasket" and disrupting steel and other industrial materials flowing from Ukraine to Europe and beyond, combined with the consequences of the global sanctions regime against Russia, which is basically a petrostate, have turbocharged inflation in food and fuel globally. China of course is still for the most part the world's manufacturing floor and their flexing over Hong Kong and Taiwan, both significant global economic engines in their own rights, poses military as well as economic risks globally. Looking to the future China's aggressive moves in Africa to secure access to natural resources may become the source of future contests as well. More regionalized but hardly less concerning, a bellicose North Korea poses threats to both South Korea (#13 largest economy by nominal GDP) and Japan (#3 behind the US and China).

ESG Considerations

This Summer has seen the rise of an "anti-woke" backlash against corporations and the stakeholders, including shareholders, lenders and customers, that have pushed them to focus more on environmental, societal and ethical factors. Let's start by giving the borrowed term "woke" back to the African American community instead of trying to appropriate it and recast it as an empty pejorative. From there, let's call out that this argument is fairly contradictory if one truly believes in free and unfettered markets. Here's why.

In a free market, a shareholder, who is a proportional owner of a company, should have the freedom to exercise their franchise as an owner, including holding that ownership, selling some or all of it for an agreed upon price, exercising the right to vote the shares, and exercising the right to promote shareholder proposals. To the extent shareholder governance is one share one vote, the process is fairly democratic. The exception of course is that there are other share structures that distort this by granting super-votes to certain classes of shares or having one class with votes and one class without, but those are structures specifically created to remove shareholder power from the broader market. It is then a free market choice. Investors can choose not to own these companies, or to discount the value of those shares because of their restricted rights.

Similarly, companies are free to pursue opportunities and unlock value in step with the expectations (and votes) of their owners and financers. They can seek that value by innovating a new product or service, conducting a branding or advertising campaign, entering a new market, acquiring IP or even another company, etc. Part of that value creation process involves being good stewards of all the different forms of capital available to the company. That capital includes cash, but it also includes IP, brand equity and reputation, and human capital among others.

Paying attention to environmental, social and governance considerations in the management of a company is one way to steward those forms of capital. On the contributory side of the ledger, happy workforces, happy customer bases, and good relations with communities in which a company operates help to drive the realization of value through access to talent and resources and making the company competitive. On the defensive side of the ledger, managing climate risk, or stranded asset risk, or safety risk helps defend value from internal and external forces that can deplete it.

Professor Michael Porter of Harvard Business School published a seminal piece in 2011 entitled "Creating Shared Value" which goes into depth on this thesis. It should be noted that Prof. Porter is no bleeding heart tree hugger. He is a self-professed ruthless capitalist who was responsible for the Five Forces Framework for competition in business that is taught in business schools globally.

All of this is preamble to saying in a free market, companies should be free to operate in agreement with their various stakeholders, again – owners, lenders, workers, customers, suppliers, etc. – how they see fit. Those stakeholders are free to express their views and exercise their rights in ways that might change the behavior of that company. If those stakeholders are not successful in pursuing their own priorities, whatever they are, in the free market they can make other choices. Sell shares, sell loans (e.g. bonds), resign and work for another company, purchase products from a competitor, and so on. In Professor Porter's competitive framework, that is how free enterprise operates. Those competitive forces, competition for capital, competition for talent, competition for market share, will generally bump and nudge the company toward a more optimal outcome if it is relatively well managed.

The argument being made against ESG-informed company management, and ESG-informed portfolio management, is that somehow the decision to emphasize environmental, social or governance priorities is limiting opportunities to realize value and create wealth. That argument is a red herring. A company cannot be all things to all people, and a portfolio manager cannot possibly invest in everything that is investable. Decisions must be made to narrow focus. Even the broadest, crudest portfolio instruments like a broad market index exchange traded fund start with a set of limiting assumptions, such as only investing in equities, and holding those equities in proportion to their capitalization in the market. One portfolio manager may make the decision not to own companies with high debt-to-equity ratios, while another manager in roughly the same asset space may actually favor companies that aggressively use debt to finance operations and growth. Some criteria managers use in the construction of portfolios can be incredibly soft and subjective, like tenure or track record of the management team. If there was definitive, incontrovertible evidence that a seasoned leadership team always outperformed, the whole market would gravitate to that factor.

ESG Considerations [cont'd]

But that evidence, such as it is, is subjective and nuanced, and for every manager that believes in a seasoned team there will be a manager that believes that a fresh and new team has a greater likelihood of unlocking value because of fresh perspective, creative energy, and willingness to break from historical practices. Nobody is running campaigns to prohibit managers from considering these very subjective inputs.

And yet, in the ESG space, certain market constituencies are now aggressively campaigning against including these considerations in the management of a company or the creation of a portfolio, even going so far as to state it is a breach of fiduciary responsibility. But, there is ample quantitative data available for ESG that helps to understand on- and off-balance sheet risks, adds dimensionality to long term strategic outlooks for companies, and assists in locating sources of value, and plenty additional data that demonstrates that these approaches are non-concessionary and ought to deliver market-like returns with market-like risk as a baseline expectation. Of course as any company manager or portfolio manager would hope, there is a desire to use these inputs to improve on that and deliver better-than-market outcomes and get paid for that improvement in value.

Yes, there is also subjectivity and judgment in ESG management, as there is with every other aspect of corporate or portfolio management. What is the rationale for espresso bars, foosball tables and napping pods in an office environment? Where are the campaigns demanding tech unicorns prove the tangible improvement in multiples from having video gaming suites, or big banks prove that golf retreats for management unlock value for shareholders?

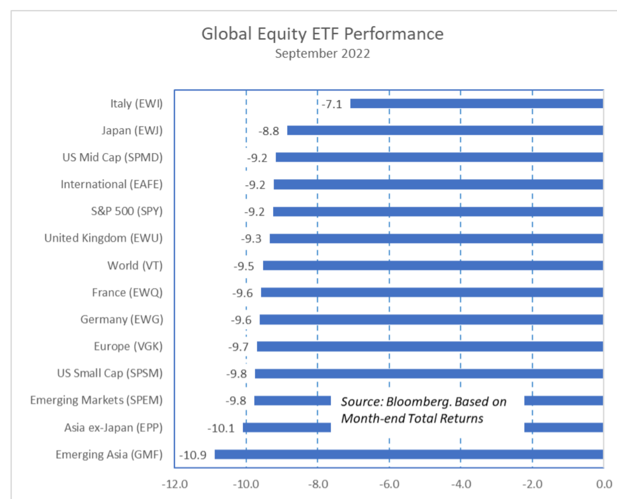
ESG is a choice just like the multitude of other quantitative and qualitative choices that are made by corporations and by allocators of capital. ESG adherents believe it is a good choice. Others may disagree. Everyone should be at liberty within a free market to vote with their dollars as they see fit.

Q3 Capital Market Review

Emerging markets finally caught up in the most negative sense to where the developed world had been tracking in terms of market performance. Both EM debt and equity were among the worst performers in a crowd of bad performers. Among listed stocks and bonds there were no real places to hide from the market drawdown in September, which continued August's work of wiping out the bear-market rally in July. Historically conservative safe harbors like sovereign debt at home and abroad posted negative returns as bad as equities, further damaging the diversification benefits of traditionally asset-allocated portfolios. Inflation remained high in major economies around the world, and, while not coordinated, central banks were about their work of winding down stimulative programs and reverting rates to long term historical norms. This environment and all the attendant risks continued to adversely affect the pricing of all manner of assets in September to close the third quarter.

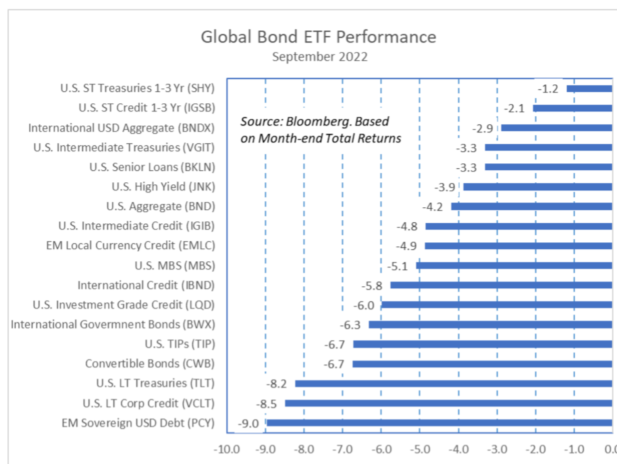
Equity Markets

As noted above, emerging markets, Asian markets in particular, led on the downside, although not by much. Global dispersion in equities was fairly tight in September, with most markets tightly clustered around a return +/- 100 basis points of 10% down. The outlier, such as it was, was Italy (EWI) by outperforming only being down -7.1%. This is not entirely out of step with the last several months where Italy has been in the middle of the pack, not rallying as much in July so less ground to give back in the drawdown that picked up steam in mid-August. At home in the US, dispersion across capitalizations was also unusually tight, with the largest cap (SPY) companies returning -9.2% and the smaller (SPSM) companies returning -9.8%.



Fixed Income Markets

Not the worst peformer, but the most notable call-out in the fixed income space for September was US TIPs (TIP), returning -6.7%. The adverse forces working against intermediate and long term bonds broadly more than overwhelmed the inflation protection aspects of these particular bonds. Little surprise, bonds with some amount of equity correlation (High Yield (JNK) and Convertibles (CWB) for example) also did not hold up, but for the most part the overriding consideration was interest rate sensitivity. US short term Treasuries (SHY) and Credit (IGSB) held up the best while long term Treasuries (TLT) and Credit (VCLT) dropped a further 600 basis points beyond the short term options.



The returns cited reflect total return performance of exchange traded funds listed in the corresponding bar charts

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WILDE CAPITAL
MANAGEMENT

Summit, New Jersey, 07901

(866) 894-5332

www.wildecapitalmgmt.com

contact@wildecapitalmgmt.com

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