



“You don't climb mountains without a team, you don't climb mountains without being fit, you don't climb mountains without being prepared and you don't climb mountains without balancing the risks and rewards. And you never climb a mountain on accident - it has to be intentional.”

~ Mark Udall

70 years ago, Mount Everest let Sir Edmund Hillary and Sherpa Tenzing Norgay stand for the first time ever on its summit, with support from 320 porters and 10 climbers. Before this monumental feat for humanity, 10 major expeditions had been defeated.

Since then, climbing Mount Everest has become commercialized, with about 500 people attempting to climb it each year. The risks are still considerable, with a death rate estimated around 1% per attempt from various causes such as avalanches, falls, hypothermia, and acute mountain sickness. While this statistic is still relatively high, it is a lot lower than it used to be, especially when we consider that the summit success rate per attempt has steadily increased and is now above 60% over the last 10 years, with a ratio of support (sherpa) to climber at slightly above 1.

This incredible progress has been possible thanks to a combination of improvements in different areas: regulations, communication systems, physical and mental training, support quality, personal Sherpas, guide experience, expedition teamwork, climbing gear, acclimatization, health monitoring, hyperlocal weather forecasting, supplemental oxygen, fixed rope, and ladders as well as safety protocols.

One of these measures is the dreaded Turnaround Decision: balancing getting to the summit when it is in sight a few hundred yards away, including all the time and energy invested and seeing other climbers successfully coming back, with the reality of your climbing conditions: exhaustion, physical and mental limits, exposure, low oxygen level, changing weather conditions, and what is sure to be an incredibly exhausting down climb

ahead of you. An experienced guide or Sherpa alongside you will help make that decision, with careful consideration of the potential risks and consequences. But sometimes climbers are unable to resist the emotions of “summit fever” and climb on with devastating consequences, as depicted in the book and subsequent film, *Into Thin Air*, an account of the 1996 Mount Everest disaster.

When we advise our clients climbing their financial Mount Everest during a bear market rally, we stress the importance of resisting the emotions of an economic “summit fever.” It is important to work with an experienced guide to help you weigh the potential risks and consequences of this moment.

Let's assess the current conditions.

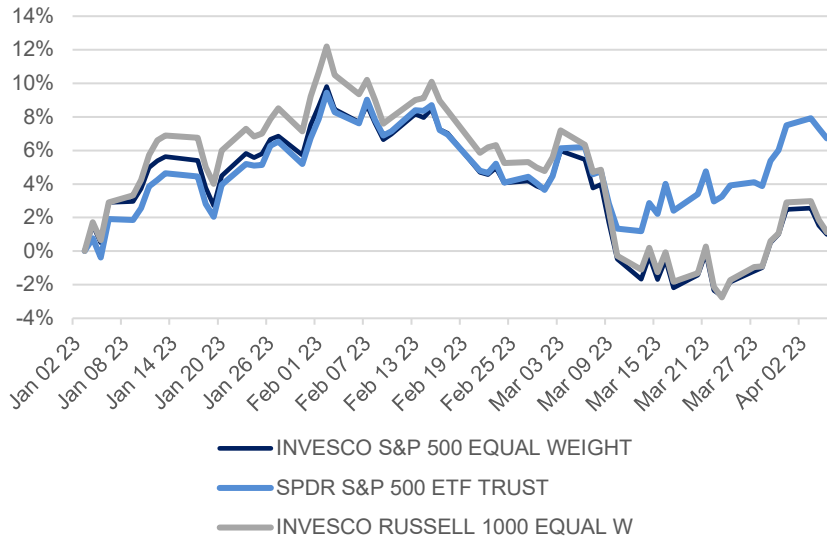
A CIO's View

Here are my summaries on several topics affecting markets, all monitored daily by our models. We regularly cover these topics in our monthly Navigator.

Market Dynamics: While the S&P500 is up 7.23% year-to-date, the performance has been concentrated in a handful of mega cap holdings. The median stock in the S&P500 is actually flat, and if one were to remove the performance contribution of Microsoft, Apple, Amazon, Meta, Nvidia and Tesla, the S&P500 would only be up 1.3%.

This separation occurred sharply in March, as the diagram below illustrates (Exhibit 1). One explanation is that the recent emergency influx of liquidity might be interpreted as quantitative easing, along with the prospect of an earlier Fed pivot. We tend to think more conservatively.

Exhibit 1: Mega Caps Soared in March – distorting the reality of most stocks

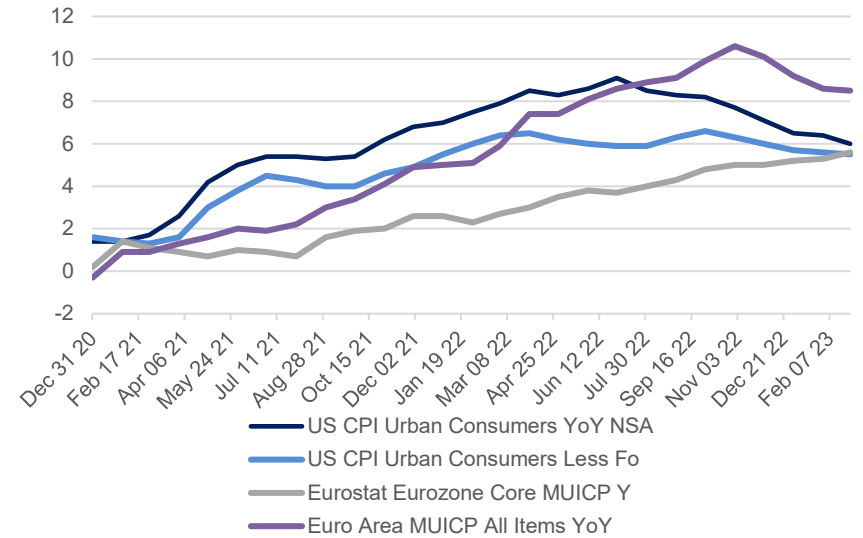


Source: Bloomberg.

Bank-rupcies: On March 8, Silicon Valley Bank was forced to raise additional cash by selling securities at a loss, precipitating its own demise. First Republic Bank, Signature Bank, and Credit Suisse soon followed, forcing government intervention to avoid further bank runs. Similar to previous episodes of tightening, the past excesses in liquidity become apparent when the tide goes out, and we still may see more bank failures. It is still too early to tell if this is the proverbial canary in a coal mine or a storm in a teapot. We expect stricter lending standards with already 40% of loan officers tightening, which should have a negative impact on economic growth.

Inflation: While lower than a few months ago, inflation remains high on both sides of the Atlantic Ocean. When we contrast headline inflation versus core inflation, the picture shows that core inflation is more stubborn and higher than 5% on a year-over-year basis (Exhibit 2). Some components of core inflation are likely to stay high (wage inflation), while others are showing signs of deceleration (shelter inflation).

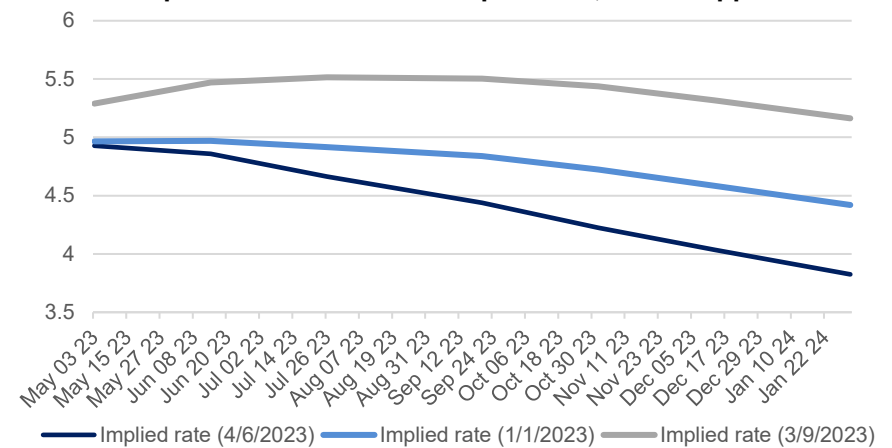
Exhibit 2: Inflation – US/Europe – Core/Headline trend towards 5%



Source: Bloomberg.

Rates and Fed actions: In March, the FOMC raised rates by 25 basis points with a nod to the failures in the banking sector, which the market interpreted as a dovish shift. Using data from the futures market, we can see below that the market tends to anticipate an earlier pivot as the implied rates moved sharply down in March with hopes of rate cuts in 2023 and beyond (Exhibit 3).

Exhibit 3: Implied Rates first moved up in 2023, then dropped in March

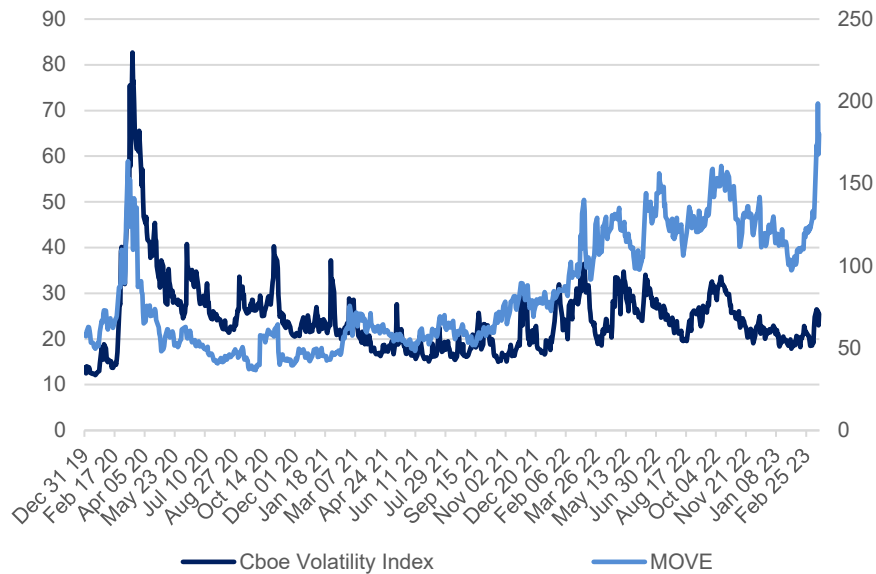


Source: Bloomberg.

Another more likely interpretation is that the economy is slowing down and might slow down more with the latest developments, thus the Fed may not have to raise rates as much as previously communicated however the Fed may also have to cut later than previously communicated. This would be a negative surprise for most market participants.

This creates considerable uncertainty as to the direction of interest rates, even higher uncertainty than in March 2020 (Exhibit 4). This is not yet reflected in the equities market.

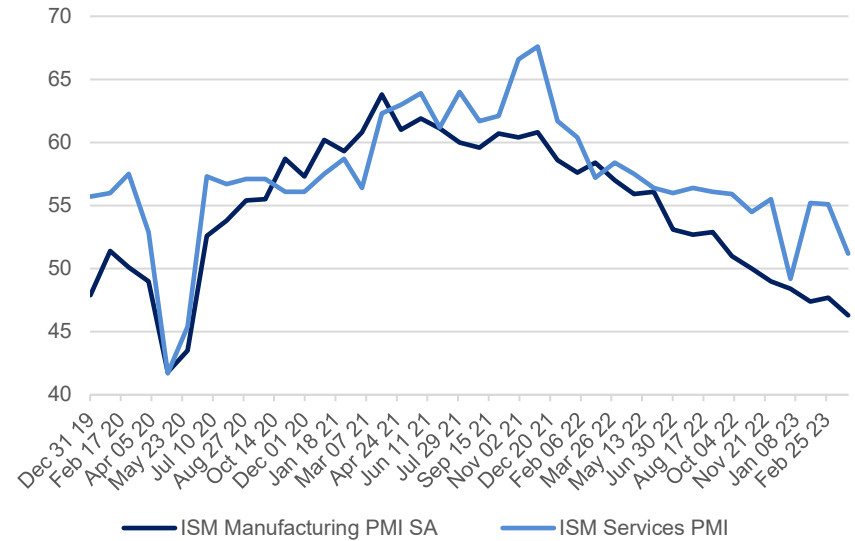
Exhibit 4: Uncertainty in Fixed Income is higher than in March 2020



Source: Bloomberg.

Economy: We are seeing signs of slowing down with a steady decline in both the manufacturing and services ISM indicators (Exhibit 5), the likely consequence of a more restrictive monetary policy intended to cool down inflation.

Exhibit 5: Both ISM PMI steadily declined



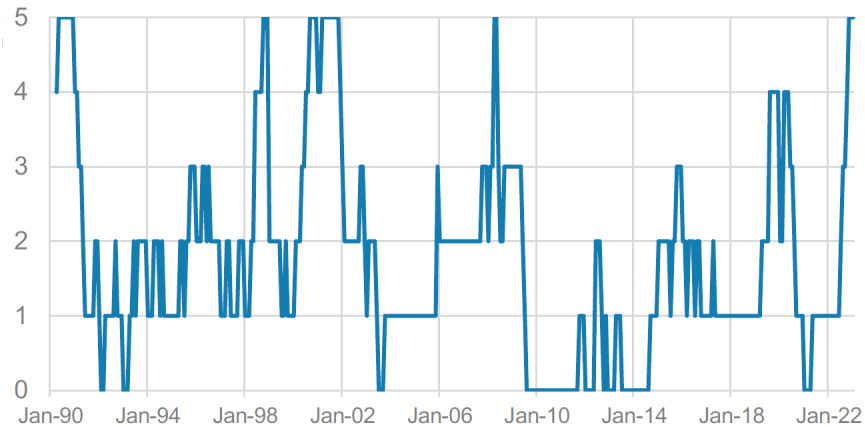
Source: Bloomberg.

The recession probability is still high at 65%, with a clearly inverted yield curve for several months, and while there can still be a soft landing, we would like to turn the attention to the earnings outlook.

The combined effect of operating leverage, inflation and growth slow-down can have a more pronounced negative impact on earnings than currently forecasted. There could be some negative surprises during the next earnings season.

The following circumstances may negatively affect future market conditions: declining S&P500 index earnings, an inverted yield curve, below average unemployment, US Manufacturing PMI below 50 and more than 40% of US banks tightening the lending standards. Over the past 30 years, data showing how many of these five factors were present at the same time generates the diagram below (Exhibit 6), illustrating the similarities of today's environment versus previous ones. Note that 2001 and 2008 scored 5 out of 5. This is not an encouraging sign, but since we have learned from some past lessons and the 2020 recession removed some excesses, we believe some of the previous pitfalls will be avoided. Nonetheless, while history does not always repeat itself, it does tend to rhyme. This is why our models continue to recommend a cautious stance.

Exhibit 6: Historical Occurrences of the Five Developments That are Consistent with a Strong Economy That is Starting to Slow



Source: Bloomberg, Morgan Stanley Research.

On the Horizon

These are other topics we are monitoring that we believe will impact the markets throughout the remainder of the year:

China tensions have increased lately, with suspected surveillance balloons postponing an anticipated diplomatic ceasefire. Beijing has also sided closer to Moscow during Russia's war with Ukraine and voiced that current US actions are driving us towards further confrontation and conflict.

The Debt Ceiling. The nonpartisan Congressional Budget Office estimates that the current budget can last at least until July, September at the latest. We anticipate this recurring issue to begin making headlines in the next few quarters and cause episodes of volatility.

The Age of AI. Artificial intelligence has been a part of our lives for many years, but the recent unveiling of chatGPT and generative artificial intelligence has taken the world by storm. We are exploring its different applications within our business and encourage you to read the following GatesNotes <https://www.gatesnotes.com/The-Age-of-AI-Has-Begun>.

Portfolio Management Remains Defensive

During the first quarter of 2023 we held defensive positions in our tactical strategies, either holding 50%+ cash in our equity portfolios or managing with a bias towards shorter duration and quality in fixed income. We took some long-term profits in January, avoiding some potential pullbacks in those appreciated positions as stated in my last letter. We have tactically slightly increased our exposure to take advantage of certain opportunities, but still remain cautious with 50% in cash in our tactical strategies. Also as stated in my previous letter, we still favor an overweight to fixed income and cash: fixed income is offering more attractive yields with diversifying correlations to risky assets, as well as capital preservation properties with potential appreciation if further economic deterioration were to materialize.

So, when you reach your Turnaround Decision while climbing what sometimes seems like your financial Mount Everest, don't succumb to "summit fever." Contact your experienced advisor to walk you through the challenge and the environment, one step at a time.

I hope this letter finds you and your family happy, healthy, and enjoying the holiday and Spring Break. We look forward to having fruitful conversations about your financial goals and how we can help you get there. As always, we thank you for your business.

Warm regards,

Patrick Jamin
President & CIO

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