



# Q3 2023 Outlook

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05 July 2023

## Hike, Pause, Cut!

By **Michael Crook**, Chief Investment Officer

Economists and forecasters have recently done a lot of hand-wringing around Fed policy. Going into the June FOMC meeting, opinions ranged from hiking 50bps to a 25bps cut. The Fed ended up meeting market expectations by pausing rate hikes while (1) signaling two additional hikes by the end of the year and (2) marking their projections for economic growth and inflation meaningfully higher.

In our opinion, the specific path of Fed policy over the remainder of the year is less important than the simple recognition that, after spending two years behind the curve, the federal funds rate is finally within a range that would be considered neutral based on commonly accepted policy rules, and the inflation-adjusted fed funds rate is about as high as it has been since the Global Financial Crisis (Fig. 1).

Absent exogenous shocks to the system (a spike in oil prices, systemic banking failures, etc.), monetary policy moves going forward will be focused on fine-tuning policy based on incoming economic data. The market-implied path for short-term interest rates currently indicates the Fed will hike one more time in July and then cut the fed funds rate back to today's level by the end of the year (Fig. 2). We wouldn't read too much into market expectations for rate cuts. Market pricing has underestimated Fed policy through this entire cycle, and if inflation remains above target (Fig. 3), we shouldn't expect significant rate cuts from the Fed.

### Soft landing, hard landing, or no landing?

We've published a chart of aggregate private payrolls many times over the last two and a half years (Fig. 4). We view aggregate payrolls as an important indicator for inflation and growth because they provide a timely proxy for the nominal gross domestic product (NGDP). The US economy can only expand so fast in real terms. It takes time to permit and build new businesses to expand capacity. If income growth exceeds the top-line growth rate for the economy, the difference will show up as inflation (too much money chasing too few goods).

Aggregate incomes grew at 4.5% between 2011 and 2019. Demand-focused stimulus pushed aggregate income growth significantly higher during COVID, but it has been slowly declining for the last two years. While the year-over-year growth rate remains a bit above the long-term average commensurate with 2% inflation, the previous few monthly readings have been right in line with a target inflation rate of about 2%. Several more months of similar data will be welcome confirmation that the economy is back in balance.

We'll also watch aggregate payrolls more intently than real GDP growth to indicate potential economic and market downside risks. It is very possible that we could have a recession, defined as a decline in real GDP growth and/or an increase in the unemployment rate of 0.5% or more, without significant damage to financial markets, businesses, or households — assuming aggregate payrolls do not decline. Suppose aggregate payroll growth remains flat or positive (even if it drops in inflation-adjusted terms). In that case, households won't experience a cut in the dollars they take home each month. They can pay their mortgages, car loans, credit card bills, and other expenses. Corporate earnings would remain flat to positive in such an outcome. It

would be an unusual recession for the US, but one that is looking more and more likely. Aggregate incomes (NGDP), not real GDP, are the indicator to watch for markets.

### The Powell trade

Fed Chair Jerome Powell at the press conference on June 14:

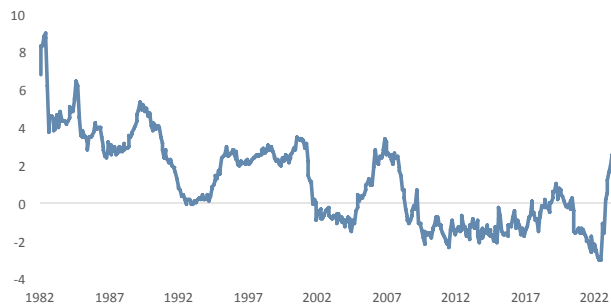
And...actually, you know, since we're probably going to — we're having real rates that are going to have to be meaningfully positive, and significantly so, for us to get inflation down, that probably means — that certainly means that it will be appropriate to cut rates at such time as inflation is coming down really significantly. And, again, *we're talking about a couple years out*.

A *higher-for-longer* scenario implies an environment that will be fine for equities, challenging for fixed income, and supportive of alternative strategies that offer a “cash + credit spread” or “cash + risk premium” return profile.

Breaking this view down a bit, higher for longer will be reasonable for equities because it implies an environment of supportive economic growth and inflation at or above target.

**Fig. 1: Monetary policy is tighter than it has been since 2007**

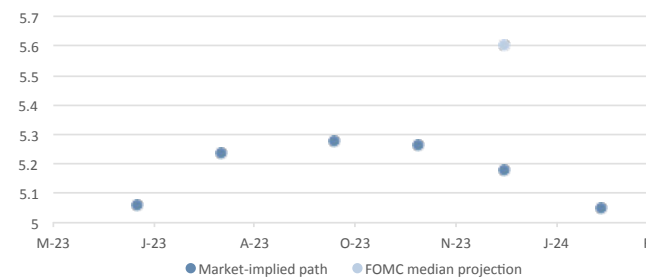
Inflation-adjusted fed funds rate



Source: Bloomberg, Mill Creek.

**Fig. 2: Market expectations are dovish relative to the FOMC**

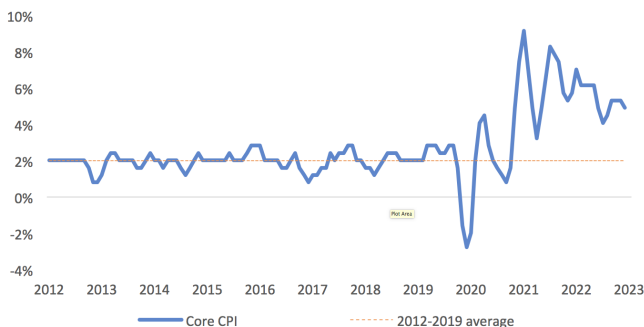
Market-implied fed funds rate path



Source: Bloomberg, Mill Creek.

**Fig. 3: Inflation remains elevated**

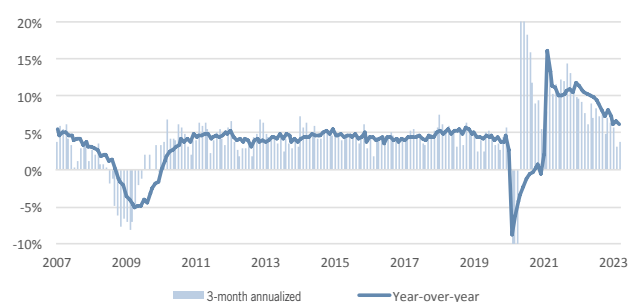
Consumer Price Index ex Food and Energy (3-month annualized)



Source: Bloomberg, Mill Creek.

**Fig. 4: Aggregate payroll growth continues to decline**

US Index of Aggregate Weekly Payrolls (Total Private)



Source: Bloomberg, Mill Creek.

Higher bond yields can be a headwind for the equity market, but we believe earnings will have a bigger impact than rates now that we are past the initial rate shock.

On the other hand, high-quality bonds will face a headwind as the market prices out rate cuts and longer-term interest rates modestly rise. Again, we don't expect a replay of 2022, but longer-term rates should drift higher over the next 12 months if Powell gets his way.

Finally, the "Powell trade" appears to be a strategy that offers a *cash + credit spread* or *cash + risk premium* payoff profile. He's telling us to expect short-term rates to stay high and the environment to remain supportive of risk assets. We prefer certain types of private lending and absolute return strategies to gain this type of exposure because, while a short-duration, high-yield position would fit this criterion, spreads within public credit remain relatively modest (Fig. 5).

### Low correlations

We've written quite a bit about the concentrated returns in US equity markets this year. Performance broadened in June, but mega-cap tech — and particularly a small subset

of mega-cap tech — remains the primary driver of US market performance year-to-date.

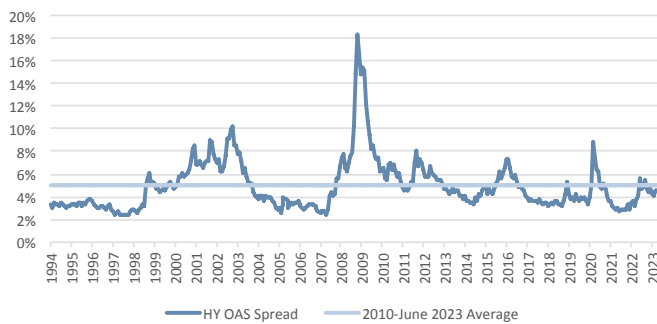
There are a few mid-to-late 1990s analogies that we can draw upon. Then, as now, the Fed had mostly completed a hiking cycle with economic growth intact. We had internet hype then versus artificial intelligence hype today. We're once again experiencing exaggerated moves in the relative market-cap of mega-cap growth versus the rest of the market (Fig. 6). We had large companies trading at eye-popping 10x revenue or more then, as we do again today.

Market participants also expect continued dispersion between stocks in the S&P. The CBOE Implied Correlation 1-Year Index, which is an estimate of the expected average correlation of the stocks that comprise the S&P 500, has fallen to an all-time low (Fig. 7). There are a couple of areas we will be watching intently if the low correlation environment persists:

**1. Active management:** Many active equity managers pointed to high correlations between stocks as a reason for their underperformance post-Global Financial Crisis, but all indications we've seen this year indicate active management

**Fig. 5: High yield spreads are near their long-term average**

Bloomberg US Corporate High Yield Average Option-Adjusted Spread



Source: Bloomberg, Mill Creek.

**Fig. 6: Mega-cap growth is nearly 30% of the US market**

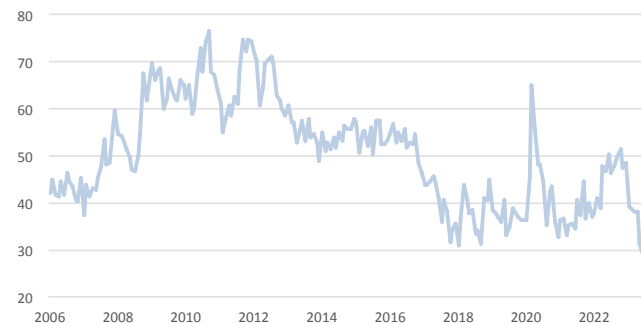
Mega-cap growth / total market cap



Source: Bloomberg, Mill Creek.

**Fig. 7: Correlation within equity markets is at an all-time low**

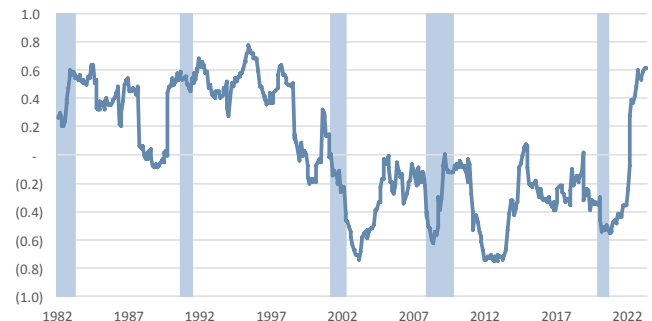
CBOE 1-Year Implied Correlation Index



Source: Bloomberg, Mill Creek.

**Fig. 8: Stock/bond correlations have jumped post-COVID**

24-month rolling correlation, S&P/Treasury Bonds



Source: Bloomberg, Mill Creek.

is struggling overall. High intra-market correlation is a double-edged sword, but it should create opportunities for active managers who can take advantage of it.

**2. Direct indexing:** Direct indexing is a strategy that attempts to track a market index while generating tax losses for the investor. The current environment could be challenging for some direct index providers and result in increased tracking errors within those portfolios. We intentionally focus

## Market pricing has underestimated Fed policy through this entire cycle, and if inflation remains above target, we shouldn't expect significant rate cuts from the Fed.

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on periods like the current one in our evaluation of direct indexing providers and are comfortable with our partners' ability to manage through this period effectively.

### High correlations

In January, we flagged a potential structural shift in markets. The correlation between stocks and bonds, which has been mostly negative since the dot-com bust in 2000, was headed back to positive territory. Since then, the correlation between stocks and bonds has continued to rise and is firmly back to the type of regime we experienced pre-2000 (Fig. 8, preceding page).

Our observation around correlation is just that, an observation, not a forecast. However, we believe a likely change in the future response function for monetary and fiscal policy to a crisis might be responsible.

On June 16, former Federal Reserve Vice Chair Richard Clarida said:

We think we're going to be in a world in which, at the margin, there's probably going to be less policy support provided in economic downturns than we've seen... We're seeing some early evidence of what we call (quantitative easing) fatigue.

Between 2000–2020, monetary and fiscal policy responded to every downturn with the same playbook: lowering interest rates and increasing fiscal spending. These policy reactions became more extreme over time, but the result was always the same. A sell-off in equities was typically accompanied by accommodative monetary policy and stimulative fiscal policy. Accommodative monetary policy led to lower interest rates and positive fixed income returns, which protected portfolios and enabled investors to rebalance from bonds to stocks. Stimulative fiscal policy pushed the economy out of recession, resulting in robust equity market recoveries.

As Clarida points out, policymakers simply cannot provide the same level of policy support during downturns as they have in the past. After 30 years of providing abundant liquidity, the Federal Reserve once again must consider inflation in its response to economic or market stress. Fiscal policy will be constrained as well. Current status quo fiscal policy for the US would have been considered emergency-level deficits by any historical gauge. The political will and fiscal capacity to add to those deficits during a downturn are uncertain at best.

In addition to driving higher portfolio volatility, it is reasonable to believe declines in plain vanilla 60/40 stock/bond portfolios could be deeper and longer in an environment of fiscal restraint and two-sided monetary policy than investors experienced over the last two decades. We believe these conditions bolster the case for diversifiers in a well-constructed portfolio.

# House View Summary

## Global economy

- We are in the latter innings of coordinated global central bank hiking, but the cycle isn't over. The Fed has paused but signaled more hikes to come, Canada recently resumed hikes after a pause, and the European Central Bank has signaled an intent to hike at least through the summer.
- The much-anticipated reopening in China has fallen flat. Their central bank has been cutting policy rates and policymakers are considering broad fiscal stimulus to support economic growth.
- Market participants expect the Fed to cut policy rates in late 2023, but Fed Chair Jerome Powell has said it might take two years for inflation to decline enough for rate cuts.
- Fed policy is tighter than it has been since 2008, but many interest rate-sensitive sectors of the economy, like residential real estate, have shown resilience after initial contractions in 2022. Bank failures in the spring did little to tighten credit conditions or slow economic growth.
- Several developed countries might fall into mild technical recessions over the next 24 months, but this will not be important from a market or central bank perspective. Germany, for example, fell into recession this year but also experienced 17.5% equity appreciation year-to-date through June 15.

## Market perspective

- A “higher for longer” policy regime will support equities, a headwind for high-quality fixed income, and be positive for strategies that offer a cash + spread return premium.
- Real interest rates remain near the top of their post-Global Financial Crisis range, but credit spreads are at or below their long-term averages.

- Significant outperformance of mega-cap growth has left it relatively expensive versus other equity market segments, including small-cap and international equities.
- A [contraction in lending from regional and community banks](#) has provided additional opportunities for private debt strategies.
- Private commercial real estate valuations, which generally lag public valuations, fell [5% in 4Q22](#) and have continued to decline this year.

## Portfolio positioning

- We are neutral duration and credit in our taxable and tax-exempt fixed income portfolios.
- Within equities, we are slightly overweight US equities, value equities, [low-volatility equities](#), high-dividend equities, and quality equities.
- We are overweight private lending and absolute return strategies versus fixed income.
- We recommend allocating a portion of equity exposure to [private equity](#).

## Risks we're watching

- Bank lending practices. Lending standards tightened and commercial and industrial loan demand stabilized in May and June.
- Additional geopolitical risk spilling out of China or Russia that would result in supply chain disruptions or an oil price shock.

*Please click any link to access additional information and insights.*

# Second Quarter 2023: Market Review

## Fixed Income

- Rising rates led to slightly negative returns for taxable and municipal bond portfolios.
- After rising briefly in May, corporate bond credit spreads fell back to the levels that were previously seen before the banking issues in March.
- Declining credit spreads helped offset the headwind from rising rates in taxable bond portfolios.

## Equities

- US large-cap growth equities continued to lead equity market performance.
- International equities underperformed the US in 2Q23 after outperforming in 1Q23.
- Small cap continues to trail large and mid-cap.

Benchmark Returns	Q2 2023	Q1 2023	YTD 2023	1 year	3 years	5 years	10 years
Global Equities	6.2%	7.3%	13.9%	16.5%	11.0%	8.1%	8.8%
US Equities	8.4%	7.2%	16.2%	19.0%	13.9%	11.4%	12.3%
Large Cap US	8.6%	7.5%	16.7%	19.4%	14.1%	11.9%	12.6%
Mid Cap US	4.8%	4.1%	9.0%	14.9%	12.5%	8.5%	10.3%
Small Cap US	5.2%	2.7%	8.1%	12.3%	10.8%	4.2%	8.3%
US Growth	12.5%	13.9%	28.1%	26.6%	13.2%	14.4%	15.3%
US Value	4.0%	0.9%	5.0%	11.2%	14.4%	7.8%	9.1%
Int'l Developed Equities	3.0%	8.5%	11.7%	18.8%	8.9%	4.4%	5.4%
Emerging Market Equities	0.9%	4.0%	4.9%	1.8%	2.3%	0.9%	3.0%
US Taxable Bond Market	-0.8%	3.0%	2.1%	-0.9%	-4.0%	0.8%	1.5%
US Municipal Bond Market	-0.5%	2.0%	1.5%	2.2%	-0.3%	1.6%	2.0%
Hedge Funds	0.5%	0.0%	0.5%	1.2%	2.4%	1.7%	1.5%
Diversified Commodities	-2.6%	-5.4%	-7.8%	-9.6%	17.8%	4.7%	-1.0%
Gold	-2.5%	8.0%	5.2%	6.2%	2.5%	8.9%	4.5%

Key Rates (as of stated date)	6/30/23	3/31/23	12/31/22	6/30/22	6/30/20	6/30/18	6/30/13
US 10-Year Treasury	3.8%	3.5%	3.8%	3.0%	0.7%	2.9%	2.5%
Barclays Aggregate Bond Index	4.8%	4.4%	4.8%	3.7%	1.3%	3.3%	2.4%
BBarc Muni 1-10Yr Blend (1-12) Index	3.1%	2.7%	3.1%	2.6%	1.0%	2.2%	1.9%

Source: Bloomberg, Mill Creek. Returns for periods greater than one year are annualized. Index rates are yield to worst.

Indices used to represent periodic capital markets returns include: MSCI ACWI (Global equities), Russell 3000 (US equities), Russell 1000 (Large Cap US), Russell Mid Cap US (Mid Cap US), Russell 2000 (Small Cap US), Russell 3000 Growth (US Growth), Russell 3000 Value (US Value), MSCI EAFE (International Developed), MSCI Emerging Markets Index (Emerging Markets Equities), Bloomberg Aggregate Bond Index (US Taxable Bonds), Bloomberg 1–10 Year Municipal Bond Index (US Municipal Bonds), HFRX Global Hedge Fund Index (Hedge Funds), Bloomberg Commodity Index TR (Diversified Commodities), and Gold Spot Price (Gold).

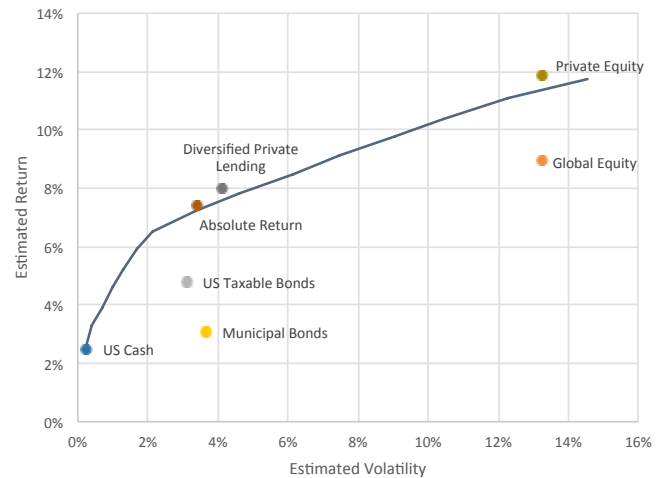
# Capital Market Assumptions

- Current economic conditions and stated Fed policy present a mild headwind to fixed income returns, but forward-looking estimated fixed income returns remain elevated compared to the last decade.
- Our US equity return estimate fell 1.4% due to higher valuations and a lower risk-free rate.
- Forward-looking estimated returns for balanced portfolios declined modestly over the first half of 2023.

Asset classes	Equilibrium estimated return	Estimated volatility	Sharpe Ratio
Cash and Fixed income	20.9%	26.3%	20.2%
US Cash	2.5%	0.3%	-
US Taxable Bonds	4.8%	3.1%	0.7
US Treasuries	4.3%	3.6%	0.5
US Agency Debt	4.8%	2.1%	1.1
US Corporate IG	5.6%	5.2%	0.6
US Corporate HY	6.8%	6.5%	0.7
Municipal Bonds	3.1%	3.7%	0.2
Municipal High Yield	5.5%	6.6%	0.5
<b>Public Equity</b>			
Global Equity	8.9%	13.3%	0.5
United States	8.0%	13.5%	0.4
International Developed	10.1%	14.1%	0.5
Emerging Market	11.0%	16.0%	0.5
<b>Non-traditional</b>			
Absolute Return	7.4%	3.4%	1.4
Diversified Private Lending	8.0%	4.1%	1.3
<b>Other</b>			
Inflation (CPI)	2.5%		

Source: Mill Creek. As of June 30, 2023.

Estimated Efficient Frontier



Source: Bloomberg, Mill Creek.

# Equity Market Overview

**Fig. 1**

- Global equity valuations are close to their longer-term averages.
- US growth equities are the most overvalued on an absolute and relative basis.
- International developed equities remain cheap to historical valuations.

**Fig. 2**

- Current S&P 500 valuations are a bit elevated for normal periods, but not extremely so assuming earnings expectations are close to reality.
- We're unlikely to see multiple expansions from this starting point, so earnings growth will be necessary to validate current pricing.

**Fig. 3**

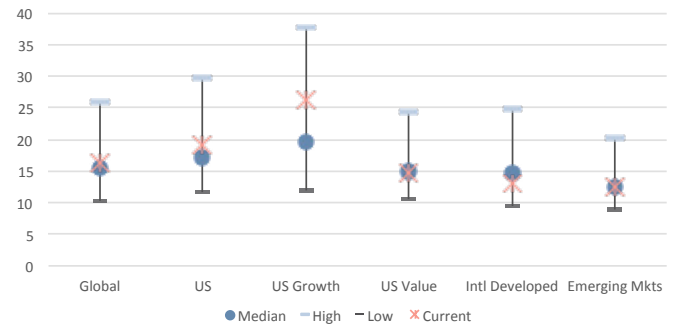
- The equity risk premium (ERP), a measure of the expected return for stocks over bonds, has reverted back to pre-Global Financial Crisis levels.
- The ERP has fallen due to higher equity valuations and higher real yields on bonds.
- The ERP is a measure of the relative attractiveness of equities versus bonds, not the overall expected return on equities (see page 7 for our updated capital market assumptions).

**Fig. 4**

- Private equity markets remain in correction mode.
- Enterprise value/EBITDA multiples peaked in 2021 and have declined 9% since then.
- Enterprise value-to-revenue multiples, which can do a better job of capturing technology companies, held up in 2020 and 2021 but have fallen sharply in 2023.

**Fig. 1: Equity valuations are fair to elevated in most markets...**

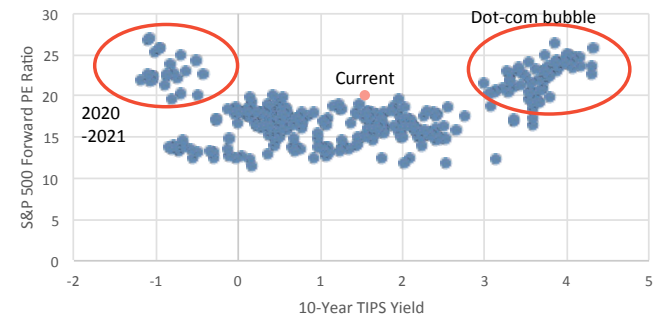
Forward price-to-earnings ratio, 2006–June 2023



Source: Bloomberg, Mill Creek.

**Fig. 2: But interest rates are no longer a big risk to the broader market**

S&P 500 forward price-earnings and 10-Year Treasury yield



Source: Bloomberg, Mill Creek.

**Fig. 3: The equity risk premium has reverted back to pre-GFC levels...**

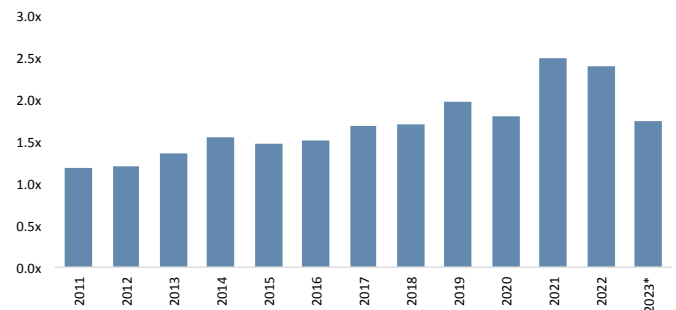
S&P forward earnings yield minus Cleveland Fed 10-year real yield



Source: Bloomberg, Mill Creek.

**Fig. 4: Private equity multiples have declined in 2023**

EV/Revenue multiples, North America and Europe buyouts

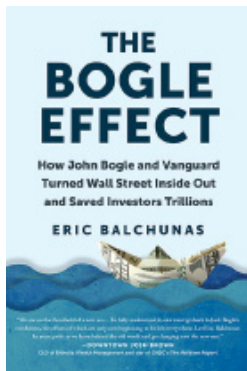


Source: Pitchbook, Mill Creek.



# Around Mill Creek

## Watch the Replay: Inside *The Bogle Effect*



Vanguard Founder **John Bogle**, often recognized as the “Father of the Index Fund,” is known for revolutionizing investing by drastically cutting fees and creating Vanguard’s first index fund (Vanguard 500 Index Fund). We hosted a moderated panel discussion where we were joined by guest speakers **Eric Balchunas**, the author of *The Bogle Effect*, and **Tom Chapin**, Investment Committee Chairperson at Mill Creek and a former execu-

ative at Vanguard, who began his career as the assistant to none other than **John Bogle** himself.

During the discussion, we covered the investment strategies Bogle introduced that revolutionized the financial industry and positioned Vanguard as one of today’s most successful investment firms. Additionally, Tom graciously shared his firsthand experiences working closely with Bogle at Vanguard.

[Access the replay here.](#) Please use this case-sensitive password: **\$7%icS@J**

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## New hires

**Debra Kodish**, Vice President

**Jasal Patel**, Intern

**Colin Cheshire**, Intern

## PUBLICATION DETAILS

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