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2023 Q3 Outlook

July 1st, 2023

Economy: Hollencrest expects positive economic growth, but with continuing moderation, as we continue through 2023. We have not changed our views about recession risk in 2024 despite growing market-based sentiment that recession may be avoided.

- Trailing data show continued economic growth and employment strength despite the Fed's past year and a half of liquidity withdrawals. Some negative effects have been felt but have not become pervasive throughout the economy, and, in fact, some of the sectors that appeared to be displaying signs of decline have stabilized and instead are showing signs of recovery. Some optimists are pointing to rolling economic growth paired with reduced inflation as a possible outcome where the biggest negative effects of Fed tightening policy may have already been experienced.

- With the regional banking crisis being perceived as behind us, the market seems to have concluded that the Fed has escaped its first major pitfall of this tightening cycle with the economy relatively unscathed. Anecdotal evidence, however, points to most regional banks having meaningfully changed their behavior, showing a reduced willingness to extend credit and send their precious liquidity out the door. This lack of credit availability will hamstring growth. Employment and consumer spending, however, remain surprisingly resilient (maybe even stubbornly resilient from the Fed's perspective), and we are constantly monitoring for a catalyst that could cause these data points to deteriorate and send stocks and other risk assets into revolt. While the likelihood that the Fed's "soft landing" tightrope act could end up successful appears to have improved, Hollencrest won't be giving the "all-clear" until tightening policy has been in place long enough to determine if there will be more extreme effects. Many of the indicators and historical studies we monitor point to 2024 as the year where the painful decline in economic activity would most likely occur, so any current declaration of a soft landing would be premature.

- Looking at current and more predictive data, particularly the cost of shelter, tells us that inflation is largely under control and could continue to decline as we move through 2023. Employment data, however, remains so strong that inflation could continue to run at above-target levels. These are the primary issues the Fed weighs as they continue to set policy. We question the necessity of further hawkishness and more rate hikes when inflation appears to be trending toward their goals and see this as a further risk that must be monitored.

Stocks: The S&P 500 ended Q2 at a new 52-week high of 4,450, up over 8% for the quarter and adding to Q1's 7% gain. We do see a path higher for stocks in the second half of the year as more stocks and sectors begin to participate in this rally, but we still expect trading to be range-bound with some risk of a pullback as more liquidity comes out of the system.

- Until very recently, nearly all of the major indices' gains for the year could be attributed to a small handful of mega-cap tech stocks. In June, more stocks began to meaningfully participate in 2023's rally, with this broadening participation pushing Hollencrest to become more bullish on stock market exposure. At the same time, the year's rally has pushed stocks to extremely overbought technical levels from both short and intermediate term perspectives. Despite improvement in the market indicators we track on a daily basis, we are maintaining a very cautious stance at these levels of valuation and may look to add to broad-based exposure on a pullback. Yields on cash alternatives (T-Bills) have only ticked higher, making the return that can be achieved with no risk an even bigger attraction relative to stocks.

- The concentrated advance of a handful of stocks in the first half of the year seemed to be largely driven by AI-related headlines (artificial intelligence). Hollencrest's investment team is enthusiastic about advancements in AI and the disruption and productivity it could bring in coming years, but we have been left confused as to how this became headline material that so powerfully drove stock valuations higher in such a short time period. ChatGPT and related generative AI products are certainly interesting tools that appear to have effective uses, but AI has been core to technological development for many years. The sudden rush to deploy capital into stocks that have some tangential AI story seems ill-conceived. These frenzied investment cycles, while occasionally highlighting a handful of long-term winners, usually don't have much duration and end poorly as the majority mean-revert.

Bonds and Rates: Treasury yields increased during Q2 with the 10-year's yield rising from about 3.5% to above 3.8%. Bond market fears that a recession was in our immediate future have dissipated, but we still expect the trend will be lower yields on the long end of the curve with any re-test of yields seen in late 2022 a possible buying opportunity.

- Fed Funds appeared to have likely reached their peak earlier this year, but that assumption was short-lived as a more hawkish Fed has let us know that more hikes are on their way. It is now apparent Fed Funds will go to 5.50%-5.75%, if not higher, and will stay higher for longer unless the economy deteriorates and forces a change in policy.

- Credit spreads are still one of our most important economic indicators and they have recently trended towards their lowest levels since the widening of early 2022. Given the significant change in cost of capital, particularly amongst floating-rate borrowers, it seems a meaningful share of companies should be experiencing distress in the form of elevated financing risk, but this has not yet been reflected in the broad credit spread market. A material credit spread widening is usually one of the clearest leading indicators of recession, with credit market fears and more expensive credit often having some causality in sparking the growth pullback. So, we are still a ways off from this indicator signaling distress and economic decline, but making allocations to credit remains a challenge from a relative value perspective.