The Grayhawk Perspective

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The calm before the storm?

There is a growing consensus among experts that we are likely to experience a period of negative economic growth over the next three quarters, consistent with our comments in the first quarter that a recession was not likely before later in 2023. The key question now is whether the economy will undergo a relatively gentle decline (referred to as a "soft landing") or a more severe and abrupt downturn (known as a "hard landing").

In the second half of the year, we anticipate a moderation in economic growth as the positive factors stemming from stronger consumer spending and cost management from companies lose momentum, and the negative impacts of restrictive monetary policy and tightening credit conditions become more prominent. Persistent inflationary pressures will likely keep central banks under pressure to maintain their restrictive stance and potentially tighten policies further as seen in recent large interest rate increases by the Bank of England and Bank of Canada. As a result, private sector balance sheets are expected to weaken as demand weakens. This dovetails nicely into the inflation narrative as the supply side of inflation has softened while the demand side remains stubbornly high. Central Banks have little control over the former and focus efforts on curtailing the latter, a point we have discussed at length in prior missives.

We foresee a more challenging environment for stocks in the second half of the year and believe that the risk-reward ratio is unattractive given the slowing economy, the likelihood of a recession starting in late 2023 or early 2024, softening consumer spending, and elevated valuations in certain areas of the market that have driven performance this year. We remain modestly underweight U.S. and emerging market equities and overweight Canadian and International equities. Within the U.S., we maintain our bias towards growth with a tilt towards quality while in international markets, we are more evenly split between growth and value with a modest tilt towards the latter. Our Canadian equity exposure is focused on dividend-paying companies and financials though we are actively monitoring for the opportunity to increase our commodity-linked exposure on any sense of strength in the broader commodity spectrum.

In terms of bond yields, we expect a modest decline in the second half of 2023 though contend that the floor in rates remains higher than expected. This was reinforced in the strong labor market data out of the US in early July, indicating the FED's job is far from over. The U.S. 10-year yield rallied sharply back above 4% on the news though has traded lower after inflation moderated in June data. Supportive fundamentals and technical factors are expected to limit credit spread widening in the near term, but we anticipate spreads to start widening later in the year and anticipate a shift towards a more defensive market environment. We remain underweight interest rate sensitivity though had increased this earlier in the year when 10-year interest rates were above 4%. Our bias towards higher-quality corporate credit is consistent with our positioning from earlier in the year while we have maintained a modest exposure to cash given the current higher interest rate environment.

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Private equity remains an appealing area of the market, especially for investors who seek stability in their portfolios over the short term. In the current market environment, private equity tends to underperform when public markets experience significant rallies. Our investments in private equity funds have deployed around forty percent of the committed capital on average. Given the significant amount of available capital ("dry powder"), we believe these funds are well-positioned to make investments in the coming years. Our strategy also includes investments in private equity secondaries funds, which have been generating returns above the market average over the past three years.

Considering the ongoing strength in interest rates and their floating-rate nature, the conditions remain favorable for private credit. The actions taken by the Federal Reserve, along with the reduction of risk in public bank balance sheets, will continue to tighten financial conditions and limit available capital across various asset classes. These factors will increase the value of available capital in private credit and influence deal terms, selectivity, and pricing. We anticipate that higher-risk areas of the private credit market, such as high-yield and leveraged loans, may experience a slight increase in default rates, although these rates are expected to remain low compared to historical standards.

Despite some uncertainty surrounding the Federal Reserve's plans for interest rates, we are observing signs of slowing inflation in both developed and emerging markets. This is a positive development, as it indicates a potential slowdown in the increase of prices. Emerging markets, in particular, are showing promising growth potential, with a projected growth rate of around 4.5% in 2023.

The global economy is currently facing various challenges, including persistent inflation, strict monetary policies, and concerns about a potential global economic slowdown. However, amidst these challenges, there are positive signs of resilience and growth that are showing signs of recovery. It is important for investors to remain vigilant and adapt to the evolving dynamics of the market, given its uncertainties and vulnerabilities.

During the second quarter of 2023, we witnessed a tumultuous period characterized by persistent inflation, strict monetary policy, and concerns about a potential economic slowdown. This environment led to heightened volatility and uncertainty in markets. Interestingly, despite the prevailing high interest rates, certain technology-oriented stocks managed to shine, exhibiting robust earnings growth and generating strong free cash flow growth. These companies possess substantial cash reserves on their balance sheets, allowing them to capitalize on the higher interest rate environment and generate income from their cash hoard. Despite the looming specter of inflation and rising interest rates, equity markets continued their upward trajectory, much to the dismay of those predicting a recession and the most vocal market bears.

In the United States, the labor market experienced some signs of weakness, with the unemployment rate ticking up to 3.7%. Inflationary pressures have somewhat abated, with the Consumer Price Index (CPI) showing a year-over-year increase of 4.0%. In June, the Federal Reserve maintained the benchmark funds rate at a range of 5% to 5.25%, demonstrating their cautious approach in the face of economic uncertainties and consistent with their data-dependent narrative rather than providing forward guidance, a change they implemented last year.

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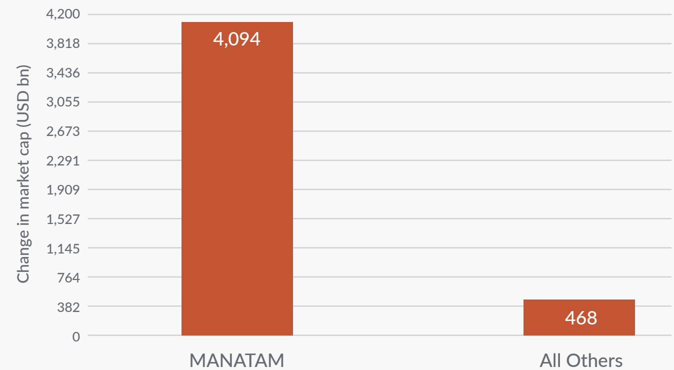
Canada's economy exhibited its own share of volatility. The unemployment rate rose to 5.2% in June, deviating from the downward trend observed over the past few decades. Inflation decreased to 3.4%, prompting the Bank of Canada to adopt a more hawkish stance by raising its benchmark interest rate to 4.75%. This reflects their commitment to addressing inflationary risks though is a blow to consumers already faced with an impending increase in the carbon tax.

The bond market faced challenges in the second quarter, especially after the resolution of the banking crisis triggered by the collapse of Silicon Valley Bank in March. The Federal Reserve responded swiftly, raising the federal funds rate to a range of 5.0% to 5.25% in early May. Hints of further rate hikes emerged, aiming not only to curb inflation but also to manage inflation expectations. However, this upward adjustment in rates played a significant role in the bond market sell-off. Although volatility has subsided from its recent peak, it remains relatively high compared to the past two decades.

Stock market performance in the U.S. was heavily influenced by a small group of companies. In the first quarter, twenty stocks had a large influence on performance, but when we look at the performance for the year so far, it has been mainly driven by the newly anointed acronym MANATAM: Microsoft, Apple, Nvidia, Alphabet (the parent company of Google), Tesla, Amazon, and Meta (formerly known as Facebook). These companies have been the major drivers behind the overall performance of the S&P 500 index, and their success has played a significant role in shaping the market's performance this year.

Change in Market Cap in 2023



Source: Bloomberg, Grayhawk Strategies Inc.

Greg Gipson, MSc ESSOR
Chief Investment Officer

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Q2/2023 by the numbers

Public Market Strategies	Q2 2023	Year to Date	Inception to Date
Grayhawk Core Pool[1]	2.34%	7.19%	5.53%
Grayhawk Global Growth Pool[2]	2.19%	5.34%	7.42%
Grayhawk Income Pool	0.06%	2.33%	3.49%
Grayhawk Fixed Income Pool[3]	-0.09%	2.96%	-0.64%
Alternative Strategies			
Grayhawk Alternatives Pool	-0.97%	0.48%	0.01%
Grayhawk Opportunistic Alternatives Pool[4]	0.02%	0.89%	2.11%
Grayhawk Structural Alternatives Pool[5]	1.90%	2.15%	17.42%
Grayhawk Credit Alternatives Pool[6]	1.08%	3.12%	2.57%
Select Market Indices			
Canadian Equities: S&P/TSX Composite Index	1.10%	5.70%	8.13%
US Equities: S&P 500 in CAD	6.38%	14.29%	12.00%
International Equities: MSCI EAFE in CAD	0.72%	9.18%	4.54%
EM Equities: MSCI Emerging Markets in CAD	-1.30%	2.55%	-0.43%
Global Bonds: Bloomberg Global Aggregate Index	-1.53%	1.43%	-0.43%
Balanced Strategy Comparison[7]			
40/60 Global Balanced Strategy	0.63%	5.42%	2.92%
50/50 Global Balanced Strategy	1.17%	6.42%	3.75%
60/40 Global Balanced Strategy	1.71%	7.41%	4.59%
Currencies & Commodities			
USD vs CAD	-2.03%	-2.30%	-0.49%
WTI Crude in USD	-6.65%	-11.99%	6.00%
Spot Gold in USD	-2.54%	5.23%	6.95%

Source: Bloomberg, Grayhawk Investment Strategies Inc. ("Grayhawk"). Estimates are used where performance for the quarter is not finalized. Figures are annualized for those time periods of twelve months and longer. Performance for the Opportunistic, Structural, and Credit Alternative Pools is through May 31, 2023.

[1]The Grayhawk Core Pool was launched on April 1, 2019.

[2]The Grayhawk Global Growth Pool was launched on May 1, 2017. Prior to January 2020, the Pool held a non-immaterial exposure to private investments which impacted performance. As such, performance is shown from January 1, 2020 onwards.

[3]The Grayhawk Fixed Income Pool was launched on August 1, 2020.

[4]The Grayhawk Opportunistic Alternatives Pool was launched December 11, 2020 with initial investments made on January 1, 2021.

[5]The Grayhawk Structural Alternatives Pool was launched January 29, 2021 with initial investments made in February 2021.

[6]The Grayhawk Credit Alternatives Pool was launched July 1, 2022.

[7]Balanced strategy returns are a blend of the MSCI ACWI Net Total Return in CAD for the equity portion and the Bloomberg Global Aggregate Bond Index for the bond portion.

Disclaimer: The information above is based on the performance of the managed accounts managed by Grayhawk Investment Strategies Inc., the portfolio manager of the managed accounts. The returns shown were calculated by Grayhawk net of fees, are reflective of the past performance of the managed accounts and are not indicative of future performance. Performance figures are estimated using readily-available information pending final valuation of the respective pools. Investments are subject to market risk, including loss of principal. Performance figures were calculated internally by Grayhawk. The investment strategy of the managed accounts focuses on providing broad market exposure complemented by alternative sources of return which provide a desired level of long-term risk-adjusted return. This is neither an offer to sell nor a solicitation of an offer.