ACKERMAN
CAPITAL MANAGEMENT

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ACM QUARTERLY MARKET COMMENTARY – FIRST QUARTER 2023

Capital Markets

The first quarter of 2023 was a good one for investors. Global stocks rose 7.4%, building on their fourth quarter 2022 rally. Similarly, bonds continued their price recovery as U.S. aggregate and municipal bonds returned 3.2% and 2.6%, respectively. The path to these gains, however, was not smooth. In January, both stocks and bonds were strong as economic and inflationary data raised optimism for the Fed ending its aggressive rate hikes. But in February, the next wave of data points pointed to the opposite, causing significant erosion to the January gains. Then in March, negative economic data coupled with concerns regarding regional banks caused stocks and bonds to rally right back to the January highs. In sum, the market preferred weak economic numbers to stronger economic numbers.

Like last year, interest rate expectations and inflation continues to drive stock price volatility and their high correlation to bond prices. We do not believe that this is a sustainable mindset for the stock market. Over the long term, it is earnings growth that drives stock prices, and at some point the historical relationship between stocks and bonds should normalize. We believe the process of normalization may be beginning. As of April, stocks and bonds have started to trade contrary to each other.

Economic and Markets Outlook

In our opinion, the stock market will soon recognize that rapidly receding inflation is a given. The chart below that compares the Atlanta Fed's Flexible CPI (gray) to its Sticky-Price CPI (orange) and makes it clear to us that headline CPI is declining.

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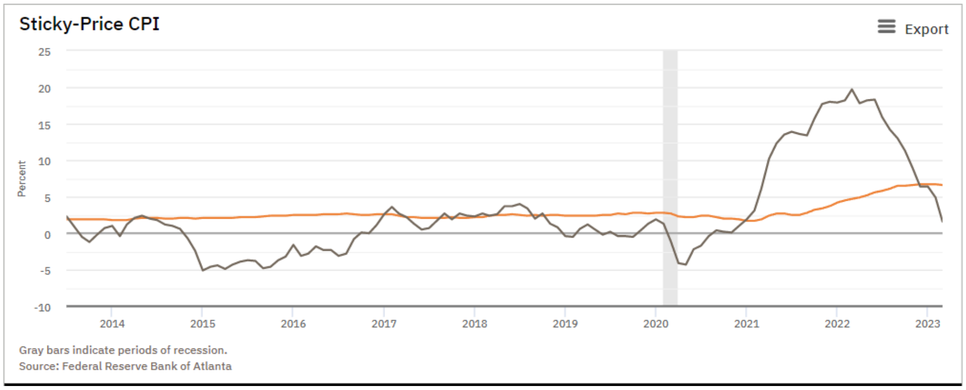

The shelter component of Sticky CPI accounts for more than a third of headline CPI movement. Average rents in the U.S. peaked in August 2022 and have since fallen by about 5% with an accelerating downward momentum. In fact, year-over-year rents turned negative in March for the first time in three years. Likewise, the Case-Shiller Index for U.S. housing prices is down 5% since last June and will continue to fall. Seasonally-adjusted total home sales are down a whopping 30% over the past year, almost equaling the rate of price collapse during the height of the 2008 housing crisis. How can all of this be reconciled with the Shelter CPI which is at all time highs with a 5% gain since August of 2022? The answer is that Shelter CPI is calculated in a way that that lags well behind present conditions. During the 2007-2008 housing collapse, the Shelter CPI did not turn down until about eighteen months after total home sales peaked, which is right about where we are now relative to the recent November 2021 peak. So, in addition to the chart above, the shelter component of Sticky CPI is creating a false and lagging picture that is contrary to economic reality.

Headline CPI is a year-over-year calculation. One can never know what the new monthly headline CPI reading is going to be, but it easy to look back and see what month will become the new starting point for the the twelve-month calculation. Over the next three months, the starting month of the CPI calculation will rise by 2.5%. The result is that the June CPI reading will fall to ~2.6%, assuming prices rise at the same pace they did in March.

Bond yields should adjust downward with CPI. As an example, over the past decade, when CPI has been between 2% and 3%, the average yield on the ten-year U.S Treasury has been about 2.5%. That is a full percentage point lower than it stands today, and would result in a total return of more than 13% over the subsequent twelve months. As for stocks, the psyche of the market could soon shift from excitement over declining inflation and lower interest rates to concern over corporate profits, especially when it becomes apparent that the economic recession is upon us.

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We believe the result will be a double dip market correction that will take us back down to the lows of October.

Finally, if one had any doubt as to the certainty of a recession, then the turmoil in the banking sector should completely erase it. Bank lending was already tight leading up to the failures of Silicon Valley Bank and Signature Bank. In fact, the Fed's year-over-year measure of banking liquidity was already at minus 10%, which is near a historical record. We would not be surprised to see banking liquidity fall to as low as minus 20%. That would be the steepest fall in bank liquidity our economy has ever experienced. It is hard to quantify, but I would compare the economic effect of this to that of another 1% to 2% in Fed rate hikes, and it now makes a recession a near certainty. In fact, when the NBER Economic Dating Committee, the official recession scorekeeper, determines the recession's start date, we would not be surprised if it turns out to be April, 2023.

Portfolio Management

The positioning of our portfolios is consistent with our valuation and price trend analysis, as well as our economic outlook. We are overweight bonds at the expense of equities. Bonds offer competitive interest rates, relative to the dividend and earnings yields of stocks. Our bond portfolios are heavy on Treasuries, and we have lengthened maturities despite the inverted yield curve. Our equity portfolios continue to have a tilt toward value and international stocks. Given the relatively strong performance of U.S. growth stocks in the first quarter, our positioning caused a modest lag relative to our benchmarks, but we remain confident that we are well-postioned for what is to come.