EQUI

Quarterly Outlook

Q3-2023

Dear Clients,

We are mid-way through 2023, and the last six months have produced data and headlines that seem to defy all logic. Inflation has cooled, but services inflation remains dichotomously sticky. The labor market appears to be strong, but business owners are pessimistic about future consumption and reducing inventory volume. The stock market continues to rally despite global liquidity tightening. The SPX-Reserves spread continues to widen as a handful of AI stocks drive valuation expansion despite deteriorating earnings, which is highly unusual in a rising interest rate environment.

In light of seemingly contradictory signals, our most recent quarterly outlook report focuses on what it takes to remain a logical investor during seemingly illogical times. We analyze the different conclusions that are drawn when one analyzes lagging indicators vs. leading indicators, and we share our thoughts on whether our outlook on the economy is as rosy as the media portrays. Lastly, we share why we think taking a contrarian view over the next 6 to 12 months can potentially position investors for success.

Itay Vinik
Chief Investment Officer

Logical Investing During Illogical Times

Over the past few months, Equi has been diligently tracking the wide discrepancy between investor sentiment, pricing of equities, and economic data.

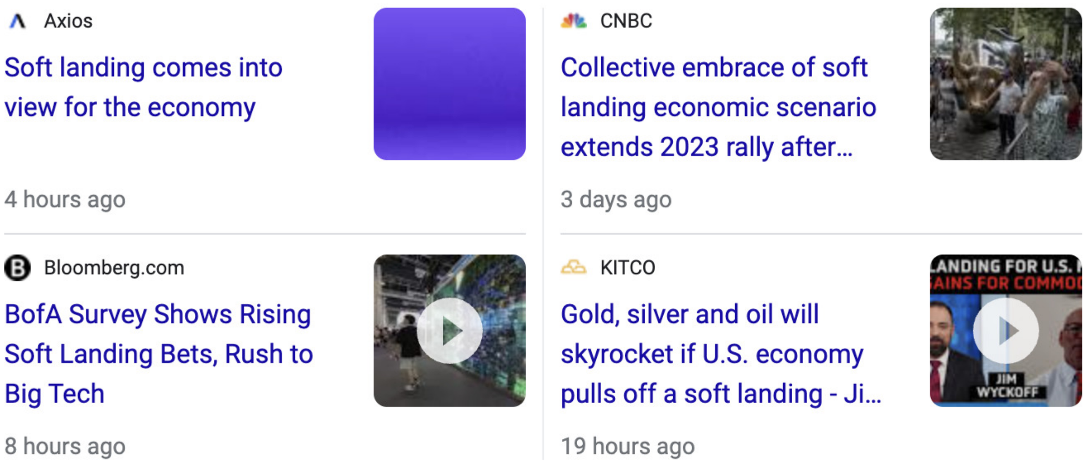
Tracking discrepancies is especially relevant for the Equi investment team because our investment philosophy emphasizes:

1. Trading spreads rather than trading on pricing
2. Taking advantage of volatility itself

As the discrepancy widens, Equi continues to position itself to take advantage of upcoming volatility, market corrections, and a recession that we believe to be increasingly likely despite recent media headlines.

What the Media is Saying

A soft landing is very possible



Headlines as of July 18, 2023

Despite the prevalent recent headlines touting the high likelihood of a soft landing, our investment team has reason to believe that the likelihood of a soft landing is low. Historically, we have seen the media predict a soft landing ahead of several recessions.

In 2007, former Federal Reserve chair Ben Bernanke was praised extensively in the media for his ability to navigate the country towards a soft landing. Shortly after, we experienced the Global Financial Crisis of 2008 which could not be ameliorated even with an emergency $800 billion bank bailout.

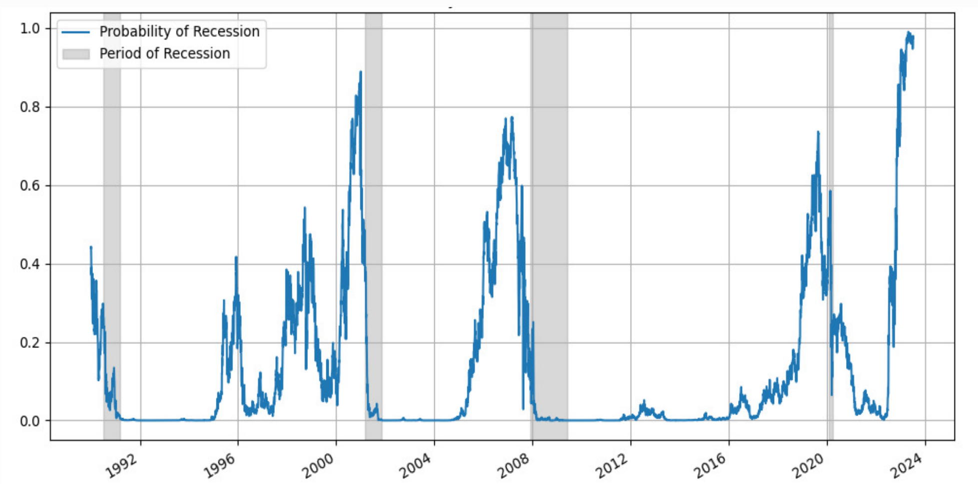
In May 1989, the New York Times reported: “Top business economists predicted today that the United States economy is headed for a ''soft landing'' this year.” Five months later, the U.S. experienced a recession during which unemployment rose from 5.3% in October 1989 to 7.8% by June 1992. It subsequently took almost 3 years for unemployment rates to recover by February 1995.[1]

We witnessed a similar pattern in 1973 just ahead of the 1970s recession, which was exacerbated significantly by the 1973 oil crisis and the fall of the Bretton Woods system, which aimed to stabilize currencies.

[1] https://fred.stlouisfed.org/series/UNRATE

What the Data is Saying

A hard landing is nearly inevitable

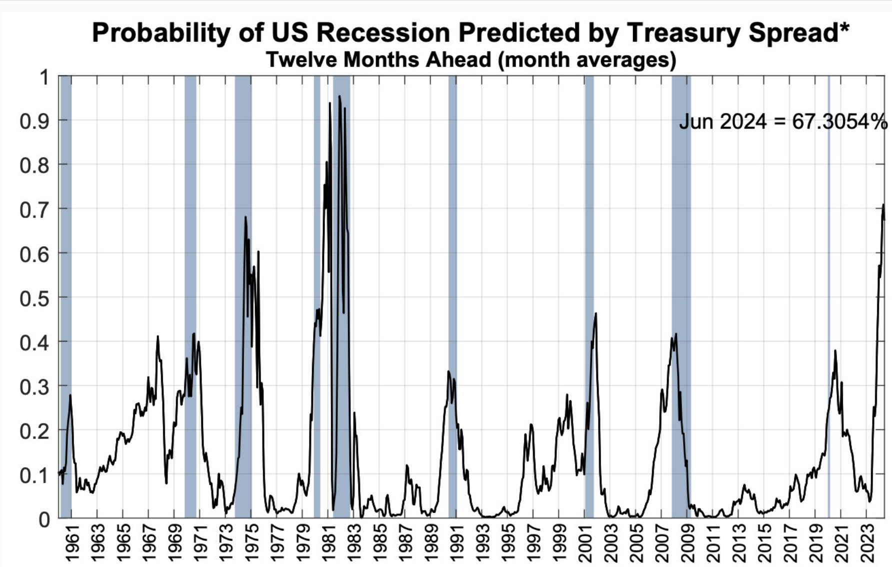


Equi proprietary macroeconomic model as of July 18, 2023

97.7%

probability of recession according to Equi's model

Equi's macroeconomic model, which is the foundation for our Dynamic Alpha strategy, predicts a 97.7% probability of recession as of July 18, 2023. We find that our data is corroborated by the NY Federal Reserve, which is predicting a 67.3% likelihood of recession by June 2024.



*https://www.newyorkfed.org/medialibrary/media/research/capital_markets/Prob_Rec.pdf

67.3%

probability of recession according to NY Federal Reserve

Leaning on Leading Indicators

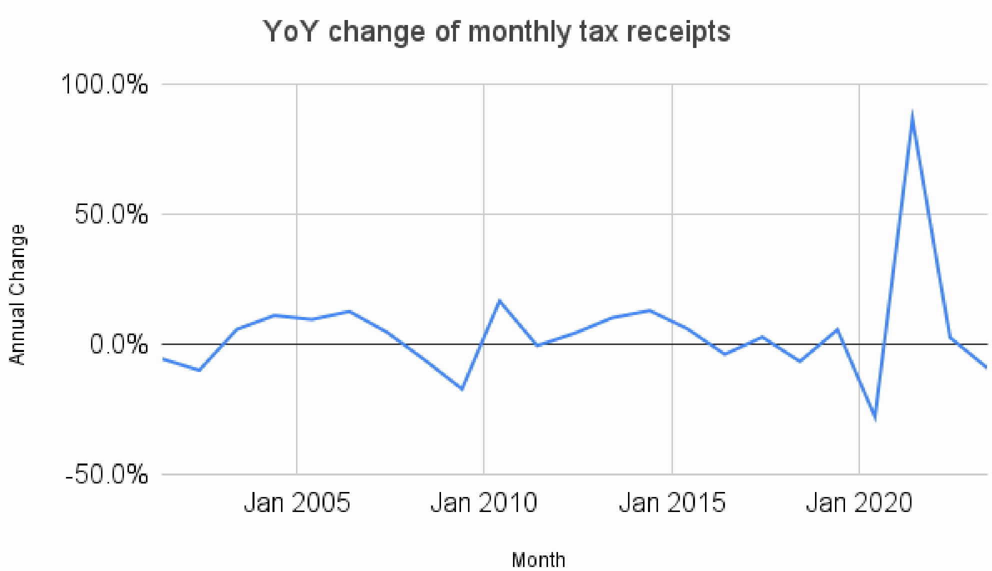
How do we know whether these predictions are robust?

First, it's important to keep in mind that those who are predicting a soft landing often refer to lagging data, such as unemployment data, rather than analyzing leading economic indicators to determine the likelihood of a recession.

At Equi, we analyze leading indicators, such as U.S. tax receipts, the housing market, and even the lumber market, to help determine the probability of various macroeconomic scenarios.

Tax Receipts Have Slumped

Tax receipts slumped 9.2% from $461 billion to $418 billion, resulting in a trailing twelve month (TTM) drop in government receipts of over 7.3%. This is the biggest drop since June 2020 when the U.S. was reeling from COVID. Tax receipts have not dipped this severely in the past without being followed by a recession.[2]



Source: U.S. Treasury, Equi

Historically, the U.S. has failed to avoid a recession after experiencing a significant drop in year-over-year (YoY) monthly tax receipts.

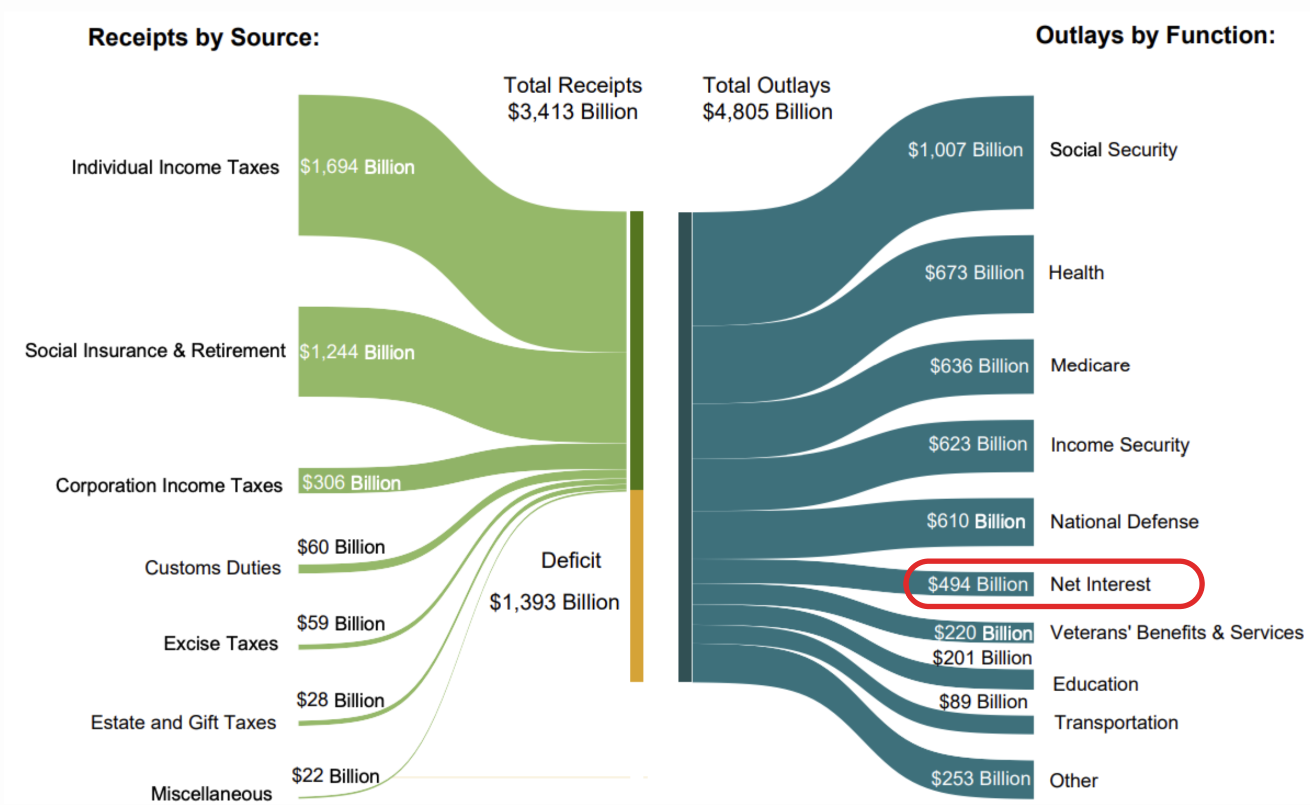
[2] https://www.fiscal.treasury.gov/reports-statements/mts/current.html

Tax revenues are collapsing, while our debts are ballooning. The U.S. government is only bringing in $3.4 trillion in tax revenue, and that revenue is decelerating. Despite the deceleration in revenue, the government is actually spending more money.

If you view “Net Interest” under “Outlays by Function” in the chart below, you’ll see that it’s currently our sixth largest line item at just under $500 billion. However, as more and more loans and debt get carried into the next market regime, that line item can potentially increase to over $900 billion or close to $1 trillion, making it the largest line item. If this were to happen, about a third of total tax receipts would go towards paying interest on debt. This is not sustainable.

Given where inflation already is, we believe it is unlikely that the government will be able to spend its way out of this situation by either fiscal or monetary means. Additionally, the rate of increase in net interest payments in proportion to tax revenues has outpaced that of the 1970s recession.

Cumulative Receipts, Outlays, and Surplus/Deficit Through FY 2023



https://www.fiscal.treasury.gov/files/reports-statements/mts/mts0623.pdf

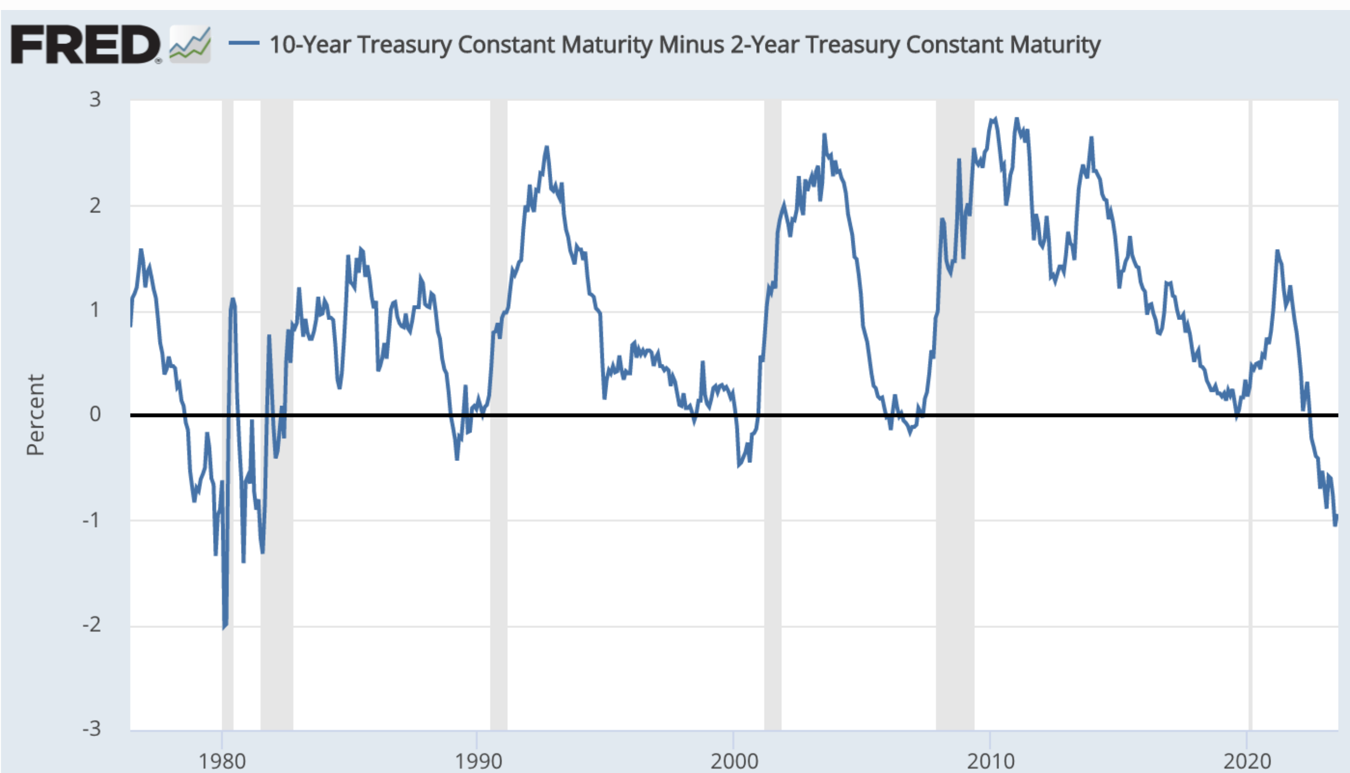
The Bond Market is Usually More Realistic than the Stock Market

The yield curve is also a great leading indicator of where the economy is heading. Generally, we find that the bond market tells a more accurate picture of the economy whereas the stock market tends to be overly frothy and optimistic.

When reviewing the 2-10 yield curve, we notice that short term rates are higher than long term rates. In general, one should expect to be rewarded with a higher rate of return in exchange for locking up capital for a longer amount of time. However, when institutional investors have a higher expectation of recession, they prefer to lock their capital up for a longer period of time at a higher rate. Thus, we generally see the yield curve invert just before a recession unfolds.

That's exactly what we're seeing in bond markets today with 2-year rates exceeding 10-year rates. To exacerbate the situation, an inverted yield curve often leads to decreased liquidity in the overall economy as bankers become more reticent to lend money.

Going back to the 1970s, we have not had an inverted yield curve that did not serve as a leading indicator for a recession. Generally, a recession starts just as the yield curve begins to disinvert.



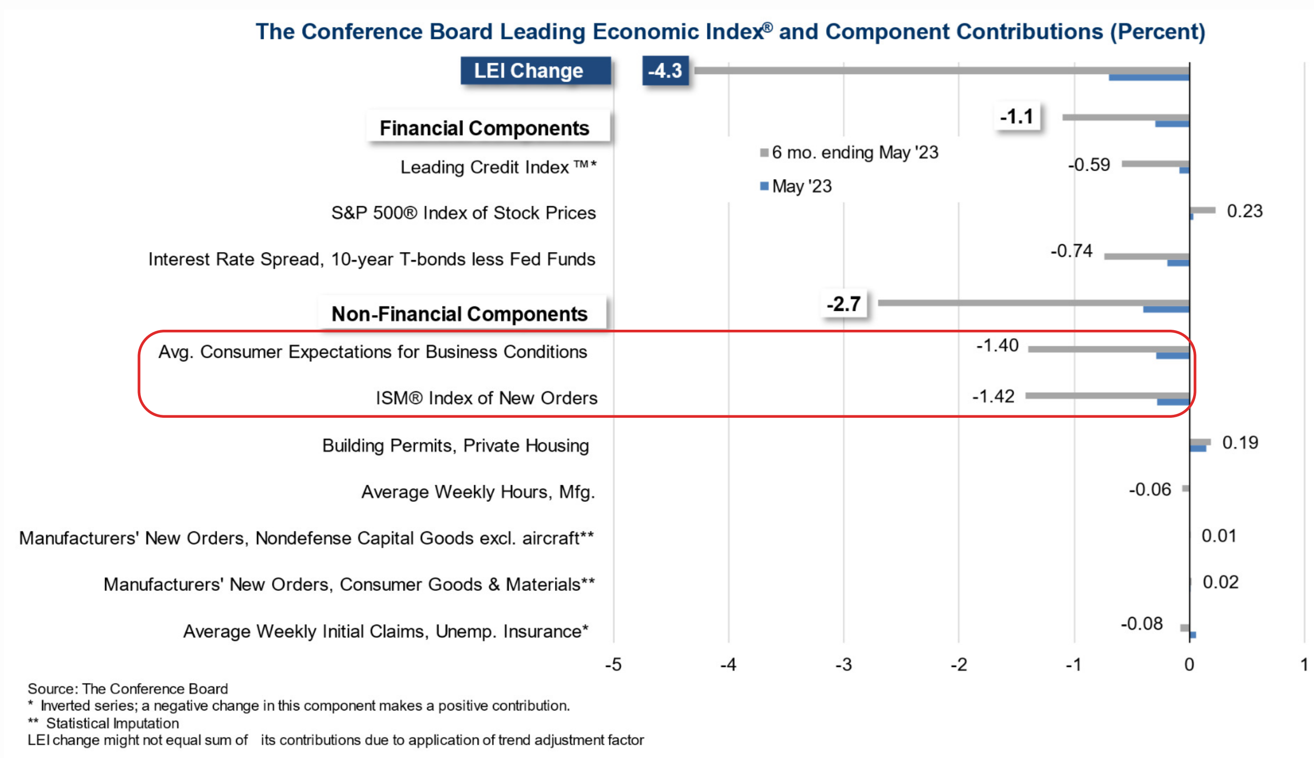
https://fred.stlouisfed.org/series/T10Y2Y

Businesses are Pessimistic about the Future

The Conference Board's Leading Economic Index (LEI) indicated as of June 22, 2023 that LEI had dropped significantly, driven largely by decreased expectations by business owners.

The negative sentiment of business owners was expressed in the ISM Index of New Orders, which measures how much inventory business owners expect to hold. In aggregate, businesses are cutting back on inventory because they are expecting fewer transactions and less overall spending by consumers.

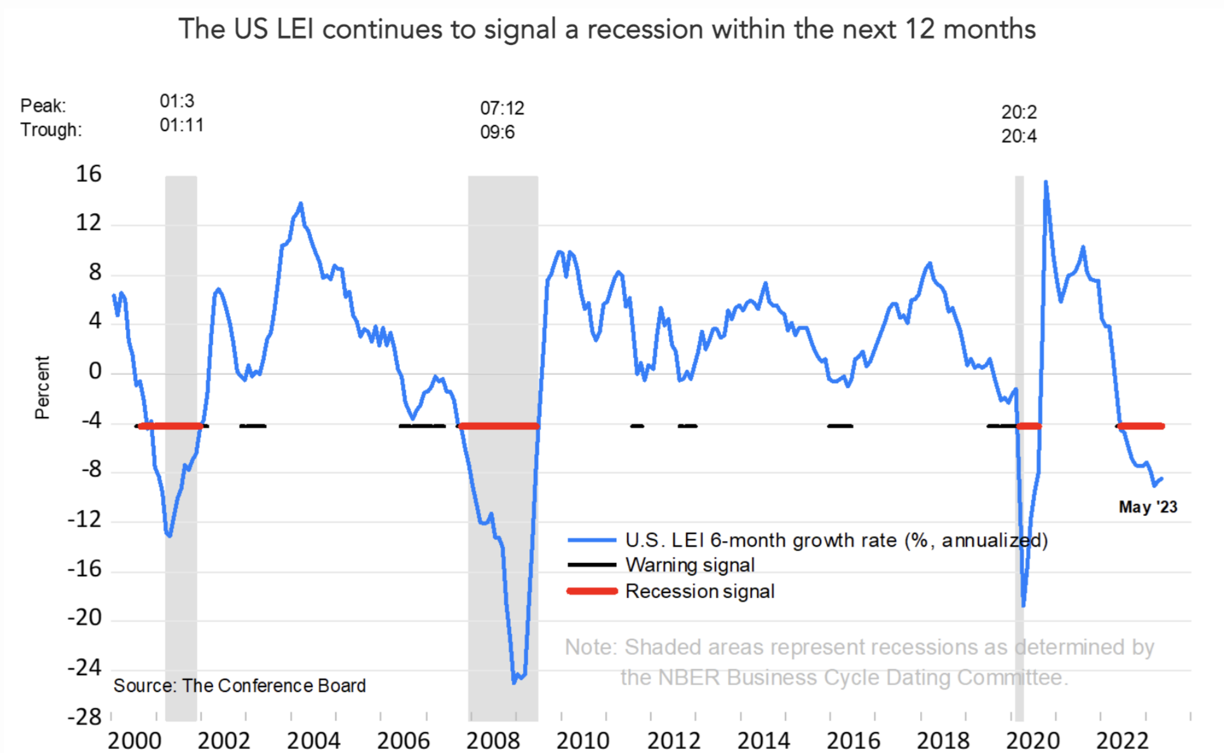
> *"The US Leading Index has declined in each of the last fourteen months and continues to point to weaker economic activity ahead. Rising interest rates paired with persistent inflation will continue to further dampen economic activity.*
>
> *The Conference Board*



https://www.conference-board.org/topics/us-leading-indicators

We've Exceeded the LEI Threshold for Recession

Historically, we have experienced a recession shortly after we've dipped below a -4 LEI. Currently, we are hovering at around -8.



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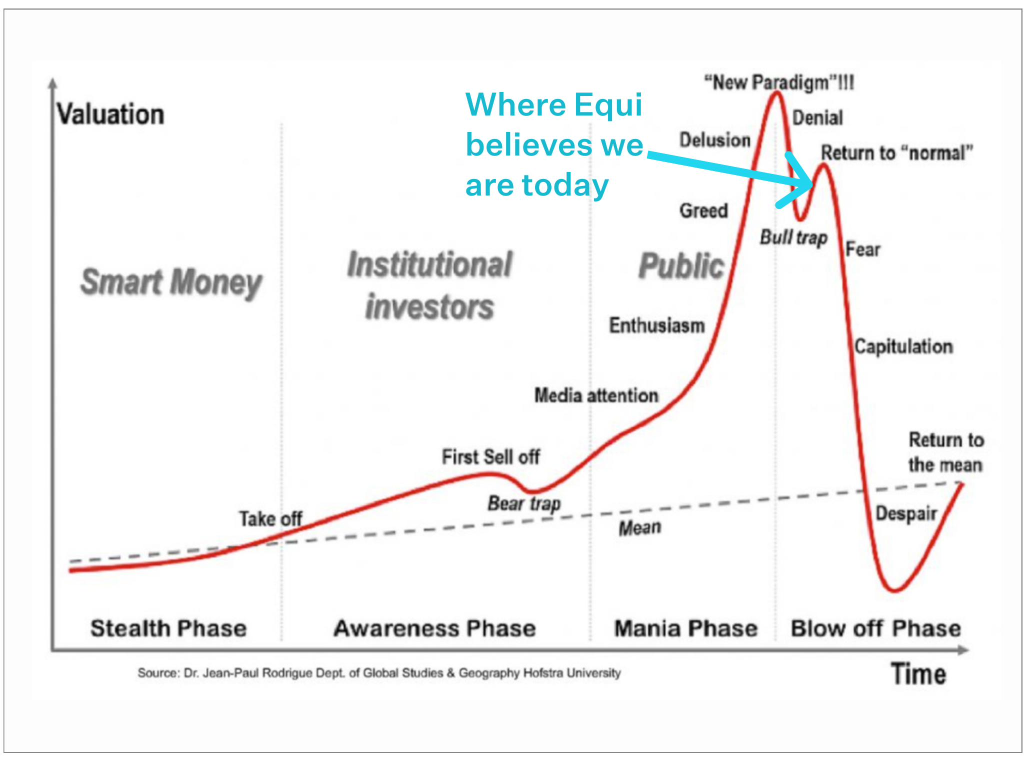
The "Return to Normal"

Economic cycles tend to follow the same pattern as outlined below. Early investors spot potential in new innovations and technology. Institutional investors follow. As word gets out, the general public rushes towards the latest hot investment -- tulips in the 1630s, railroads in the 1840s, dot-coms in the 1990s, crypto in the 2010s, and seemingly AI in the 2020s.

Regardless of the item of investor infatuation, the economic cycle tends to remain the same with the markets reaching a peak during a period that is often hailed as the "new paradigm." The "new paradigm" is often accompanied by claims such as:

- "*This time*, things are different!"
- "*This time*, the valuations are justified."
- "*This time*, we will make a soft landing."

When investors begin to realize that things are *not* in fact different under the "new paradigm," they begin to sell assets causing a dip in price. Because the public has been conditioned to accept prices that prevailed during the "new paradigm," they perceive the temporary dip to be an opportunity to buy "low," which usually causes a temporary increase in asset prices.



However, investors shouldn't be fooled. This temporary increase could simply be the early warning signal that the market is about to plunge as it works its way towards inevitable mean reversion.

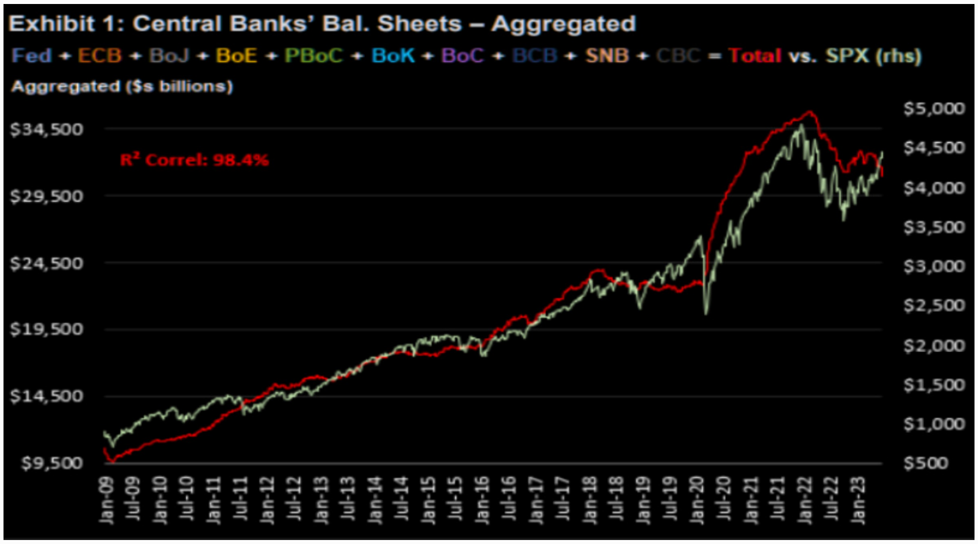
We are seeing the usual patterns of the economic cycle and have strong reason to believe that we are on track towards the "return to normal" phase.

AI vs. The Fed

We continue to see tightening liquidity conditions around the world. Since the 2007-2008 Great Financial Crisis (GFC), central banks have been supportive of driving margin and expansion of markets via increased liquidity.

Quantitative tightening is a significant departure from U.S. monetary policy since the GFC as it attempts to temper inflation. We believe it is highly unlikely that asset prices will not be negatively impacted by further quantitative tightening when we've historically seen a 98.4% correlation between global liquidity and asset prices since January 2009.

Global Liquidity



Source: Bloomberg

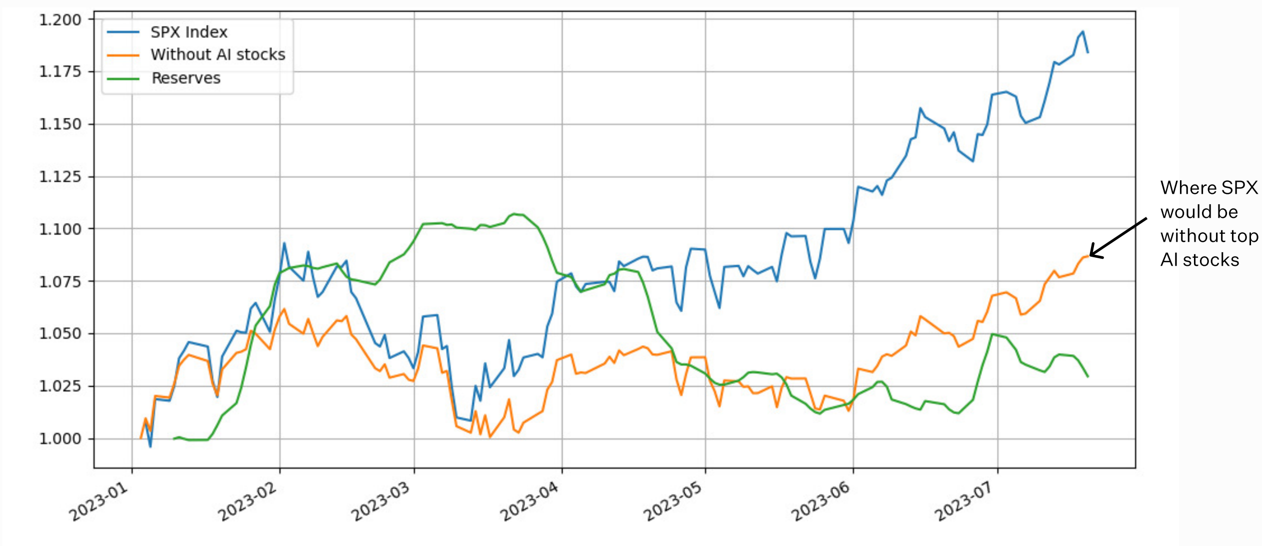
98.4%

correlation between global liquidity and asset prices (SPX)

Why hasn't the market responded to quantitative tightening yet?

The AI bubble has driven up SPX resulting in a breakdown in correlation between global liquidity and asset prices. However, when you remove the top drivers of the S&P 500 ('META', 'AAPL', 'AMZN', 'TSLA', 'NVDA', 'GOOG', 'GOOGL', 'MSFT'), the SPX Index drops dramatically. One can imagine how the spread will further narrow when the AI bubble pops.

SPX vs. Reserves



Source: Equi Proprietary Model

The Benefits of Being Contrarian

We believe that asset managers who are positioned defensively in anticipation of a hard landing will be able to generate returns for investors as the economy deteriorates. As the 2-10 yield curve disinverts and the spread between Reserves and the S&P 500 narrows, asset managers who prioritize trading spreads rather than trading pricing will benefit. In other words, funds that believe the hard landing scenario to be the more likely scenario will be able to capture the upside as spreads narrow.

One of the most challenging aspects of taking a contrarian stance will be patience. Few investors will likely have the patience and the discipline to resist chasing higher pricing that may manifest in the markets short-term. In our opinion, far too many asset managers are currently chasing higher pricing rather than strategically positioning themselves for the narrowing of spreads.

Based on leading indicator data, it is our hypothesis that asset managers chasing price will ultimately suffer losses if spreads narrow and prices decline as the economy enters a phase of mean reversion. Meanwhile, asset managers who take a contrarian view and are capable of managing risk are likely to be handsomely rewarded for their patience.

Positions in US Equity Futures by Asset Managers

Source: JPM