



CIO QUARTERLY COMMENTARY

Q4 2022

So Many Moving Parts

2022 is a year most investors will be glad to put in the rearview mirror. Capital markets were unkind, almost all of them. Rather than try and dig into all the reasons why, we'll summarize by saying that anything that *could* create inflation *did* – money printing, war, supply chain bottlenecks, slow response from the Fed, etc. – and the subsequent rise in rates derailed stocks, bonds, and just about everything else. If one could have known in advance just how high rates might go, then 2022 might not have been such a surprise, and maybe it could have been navigated better. With correlations high, it still would not have been easy, but maybe a bit easier.

What about 2023? Will there be a “big event” that will define 2023 in the way that inflation became the hallmark of 2022? Only time will tell, but we'll try to identify some of the important debates and give you a sense of what we expect might happen as we look forward here at year end. We certainly don't presume to be right about all of these topics and we may not foresee something that proves to be even more important. As always, though, we will try to identify pockets of opportunity where we can seek out great partners with specific knowledge to search for above average returns for the risk they are taking.

What Do We Know?

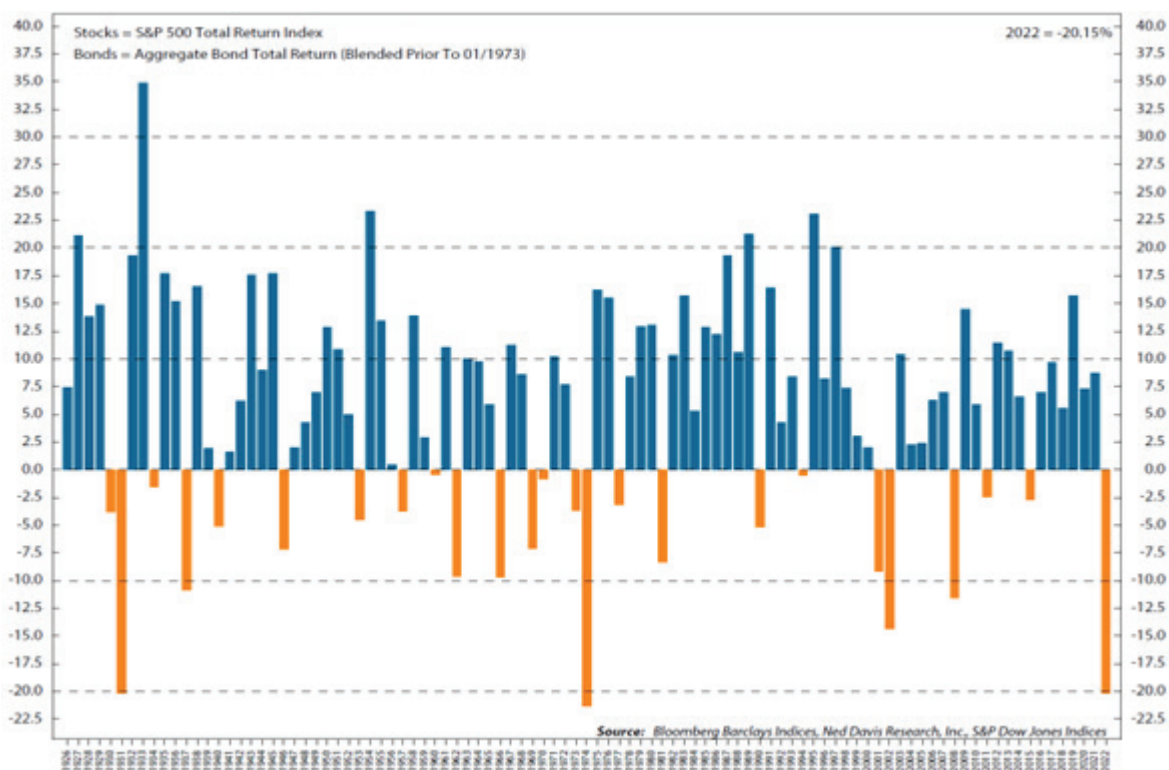
We know that 2022 was one of the worst years ever for returns of a 60% MSCI All Country World Index/40% Bloomberg US Aggregate Bond Index portfolio (60/40). Returns through the first three quarters of 2022 were the second worst in the past 96 years. On the two other occasions when market returns for this simple portfolio were comparably as bad (and for the next five worst cases, too!), subsequent returns were pretty good. Small sample size to be sure – but encouraging.

We know interest rates are back up above 4% for many different maturities along the US Treasury curve. 2022 was the worst year we can find for US bond returns for at least the past 40 years or so. So much for the risk-free asset!





Balanced Portfolio (60% Stocks, 40% Bonds) First Three-Quarter Performance (January 1, 1926 to September 30, 2022)¹



We know that stocks went into a bear market in 2022, with some of the high-flying tech leaders of yesteryear losing 75% and more. SPACs are again relegated to the trash heap, as are meme stocks. Crypto currencies are down 75% or so, and some are gone. The P/E of the S&P 500 has come down from 30x or so at its peak to about 18x forward earnings today. This multiple is still somewhat elevated versus the long-run average of about 16x, but not terribly so. Viewed this way, many of the prior excesses of the equity markets have been reduced.

Tempering Expectations

We hope that the worst is behind us, but stocks are not yet cheap, and we are staring at a possible recession in 2023. Here in the US, according to the Philadelphia Fed, nearly 45% of economic forecasters are calling for a recession in the next four quarters, the highest level ever predicted ahead of a recession. There are a few bulls around, but even most of them believe the Fed has done enough now to slow the economy and inflation down.

¹ Source: Clissold, Ed; Kalish, Joseph F; Anderson, Rob. Benchmark Review: Cash is King. NDR, 2022.



Few expect a bad recession – more of a Goldilocks recession: cool enough to bring inflation down, but not so cold as to crush corporate earnings. In a normal recession, earnings decline 15% or more. We tend to agree with the bulk of investors that this time doesn't have to be quite as bad as normal, but we are still smarting from our erroneous agreement with the Fed that inflation was “transitory” at the beginning of last year. Thus, a dose of caution may be warranted, especially early in the year. Elevated interest rates, rising wages, and a weakening US dollar could weigh on corporate margins. An uglier surprise would be the tough-talking Fed pivoting too soon and allowing inflation to regain the upper hand, pushing us backwards in the fight with inflation. We are nervously optimistic that the second half of 2023 might make any pending near-term pain worthwhile. But we also remain cognizant that (as opposed to the past three or four recessions) the inclination for monetary and fiscal intervention may be somewhat less. If inflation remains high or merely normal, the Fed's desire to “ride to the rescue” may be less than normal. With the US central government having added \$6 or \$7 trillion to the national debt in the past few years, yet another large fiscal stimulus plan may also be less likely than in prior recessions.

Wildcards

A couple of other, somewhat-related wildcards include the Russia/Ukraine war and China. The war has receded in the news cycle. Ukraine seems to want weapons and victory, and Zelensky sounds reluctant to negotiate for anything less than the complete return of the entire country (including Crimea, which was seized in 2014) and reparations to rebuild. Nobody appears to know what Putin wants. The range of possible outcomes is wide, bounded by a peaceful, negotiated settlement at one pole and potential limited nuclear engagement (according to geopolitical experts) at the other. We are obviously rooting for peace for all involved. We also doubt that anything less will allow for the return of free-flowing Russian energy. This disruption pushes up prices, but it also accelerates the green transition, especially in Europe. Because of the likely duration of this conflict, plus recent decades' reduced investment in resources and various policy overlays, we think it's likely that energy prices remain higher for longer.

Europe's immediate future depends greatly on how this war evolves. It remains dependent on foreign energy as it continues to ramp up new sources of renewable power. With Russian energy off the table, Europe becomes dependent on Middle East and US energy, both of which are less-certain supply sources than in the past.



The US has curtailed production, and the West's relationship with the Middle East – particularly Saudi Arabia – is less certain now that China has become the largest and most friendly buyer of Middle East oil.

US Crude Oil Spot Price
(December 31, 2020 to December 30, 2022)²



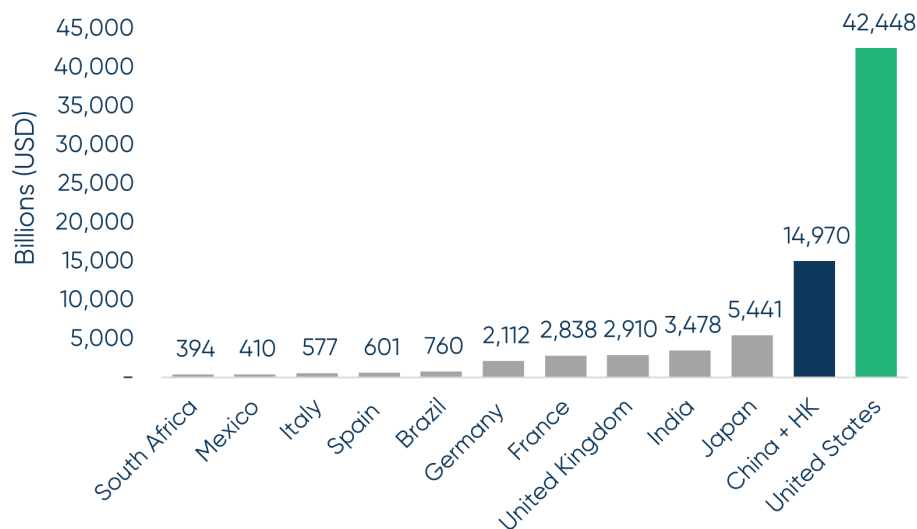
In China, the government seems to be yielding to the will of the people, who are fed up with lockdowns. (As we all have learned, it's nice to be in your home, but only until you must remain in your home.) Many who had expected the re-elected Xi to exercise even tighter control are surprised. Relaxation of its Zero Covid policy may lead to a spike in cases and stress the local healthcare systems, but also should ultimately bring about the long-awaited re-opening trade in China that most countries experienced in 2020 and 2021.

The risk is that this could bring the second biggest economy back online fully and create additional inflationary pressures: Supply chains have been healing as can be seen in the goods components of US inflation coming back down. Services components are rising and offsetting some. China's increased use of inputs (to fuel faster domestic growth and consumption) could boost goods prices. It would be good for global economic growth, but could push resource prices and bond yields still higher across the globe.

² US Crude Oil West Texas Intermediate – Cushing, OK daily spot price. Source: Bloomberg.



Equity Market Capitalization by Country (November 30, 2022)³



Other Factors

Modern Monetary Theory

We've complained in the past about Modern Monetary Theory (MMT) and the massive printing of money, and we'll continue to do so here. MMT did help boost the economy out of the Covid collapse, but it also contributed to inflation in the aftermath. Monetarists believe that, as Milton Friedman said, "Inflation is always and everywhere a monetary phenomenon."⁴ Using the year-over-year change in M2⁵ as a proxy, money growth peaked at 26.9% in February 2021, correctly signaling the inflation we are still battling now. M2 collapsed to 1.3% growth in October 2022 – the lowest in more than 25 years – signaling an end to inflation ahead. In fact, with quantitative tightening in place (whereby the Fed is selling \$95 billion of bonds each month it had previously bought during quantitative easing), we expect monetary conditions may be even tighter than current paltry M2 growth suggests. Tight money constrains economic growth and financial conditions, and, hopefully, inflation.

US Politics

US politics has returned to a split government, with each party controlling at least one house of congress. Split government is usually good: When the parties have to work together it usually results in better policy, especially for capital markets.

³ Sources: Goldman Sachs Investment Strategy Group; Bloomberg.

⁴ Milton Friedman, Counter-Revolution in Monetary Theory, Wincott Memorial Lecture, Institute of Economic Affairs, Occasional paper 33 (1970).

⁵ M2 is the measure of money supply that includes cash, checking deposits, and other types of deposits that can be readily converted to cash.





In fact, the best markets over time have been under a Democratic president with Republican control of the House and Senate. A less-polarized and more productive political environment would be a positive harbinger for 2023 and beyond. With US debt at \$30 trillion and the pandemic winding down, we will watch with interest as our new split government considers additional deficit spending. The size of the government's debt may come back into focus as higher interest rates result in larger interest payments that crowd out other spending priorities.

USD and TIFF Approach to Foreign Currency Exposure

The future strength of the US dollar (USD), which hit near-all-time highs in 2022, is also an important question. USD strength proved a real tailwind for investors in US markets in 2022, especially foreign currency-based investors who benefited from translation gains. The USD benefited from the uncertainty over Russia's invasion of Ukraine and policy in China, which encouraged investors to pile into dollars as a safe haven. As the world normalizes, some of these flows will likely reverse. Lower US inflation allows the Fed to lower interest rates, which could make the USD even less attractive. A softer USD would be good for global liquidity and economies, but real weakness would not; either could undermine the inflation fight in the US. At the margin, the USD should be less of an issue for markets in 2023.

Before we leave the dollar, we do want to report a change in how we will hedge currencies going forward. The big dollar rise in 2022 makes now a good time to begin to manage our currency exposure more in line with how we manage our equity sector exposure: Namely, we will try to keep all bets down to a manageable size of +/-3% versus ACWI currency weights. (For sectors, we manage to +/-4%.) So, beginning in 2023, in addition to our historic policy of hedging away overweight exposures to different foreign currencies, we expect to add to underweight foreign currency exposures to maintain target exposures broadly in line with ACWI weights. This does not mean we won't try to take advantage of pricing anomalies when we see them, but that as a general practice, we will be more balanced than in the past, when the US dollar was less highly valued.

Employment and Wages

And, yes, the future direction and level of inflation remains in the forefront. To be fair, we don't find many folks who expect inflation to keep rising. The bigger debate today seems to be about how quickly it will fall and to what level. On the





former, if you focus more on wages, food, and shelter you tend to be more hawkish. Those looking at improving supply chains and moderating import and commodity prices tend to be more optimistic. We think employment and wages are the linchpins. The Fed still has only two tools (raising short rates and quantitative tightening) at its disposal. Both operate through the capital markets, in which increasing the cost of capital is expected to slow economic growth and hiring, in turn taking pressure off wage growth. All makes sense. The problem is that jobs keep being created and layoffs seem more talk than action. That's not bad mind you, but if the unemployment rate climbs only to 3.9% or so at the end of 2023 and 4.2% or so at the end of 2024 as many on Wall Street expect, it is hard to imagine too much relief on the wage front.

So far, employment has remained strong. 2022 will go down as one of the best job-creating years on record. After losing approximately 10 million jobs in 2020, the US economy created about 7 million in 2021 and another 4 million or so in 2022, finally exceeding the pre-pandemic level. Even in November, despite talk of layoffs by tech companies and others, the economy created 269 thousand jobs. Corporate America believes there is a worker shortage and so is fearful of laying off workers that would be hard to rehire. Additionally, there continues to be 10.3 million job openings in the US and only about 6 million who are unemployed and looking for work.⁶ This setup likely keeps wages from falling much; in fact, the most recent Atlanta Fed wage tracker shows wage growth at 6.4%, down modestly from a peak of 6.7%.

Consumer Sentiment

Sentiment is hard to gauge. When markets rise 15% over a short interval, as they did in Q4 of 2022, it becomes obvious that animal spirits are not far from the surface. On the other hand, many Wall Street strategists believe 2023 is the year of income – buy bonds and be happy with 4% to 6% returns. Although a Q4 rally in bonds is heartening, we doubt there is much headway for yields to fall too far, given still-elevated inflation levels and the Fed's fighting stance. Nobody is professing any fondness for stocks which, of course, attracts us to them. In general, we like to buy assets when everybody else hates them. What is stopping us from buying now? A possible recession and valuations that are improved, but not yet attractive. One or two bad, unexpected, economic numbers early in 2023 could create a better opportunity to deploy capital into equities at attractive levels.

⁶ US Bureau of Labor Statistics, Job Openings release dated November 30, 2022.





Inflation Now A “When,” Not “If”

Lastly, the Russia and China wildcards seem likely to produce more – not less – inflation in 2023. We want to be optimistic, but find ourselves wondering what happens if inflation proves stubborn and hovers at 3.5% to 4% a year from now. If that is the case, will we choose to try and grow our way out of that problem? Or will we be willing to suffer more pain and continue to raise short rates to squeeze inflation out? Ideally, inflation will fall back to 2% and all can end well before we would have to face that difficult choice.

Portfolio Positioning

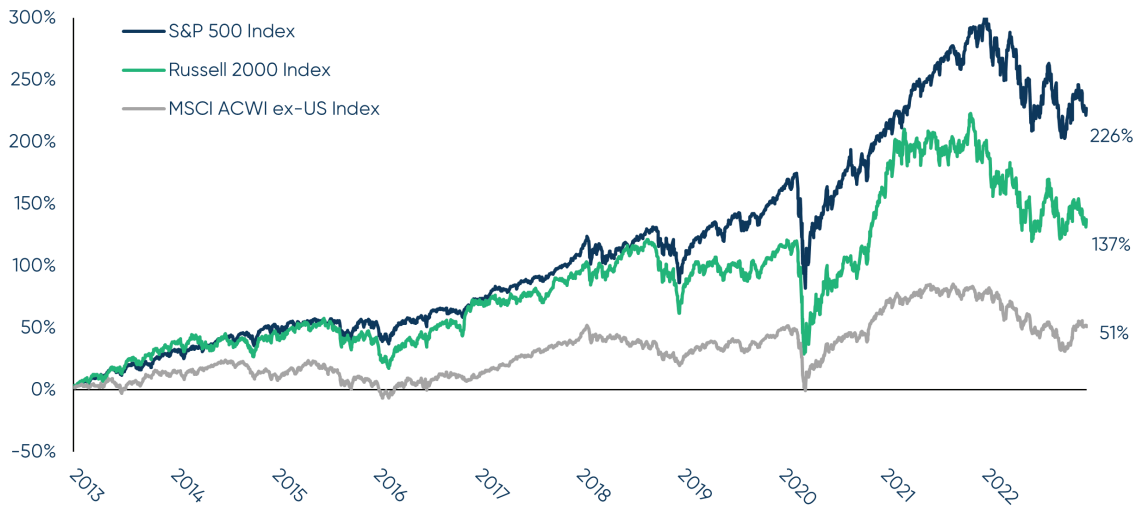
All in, we are pretty comfortable right where we are today. We are generally sticking close to our strategic asset allocation targets, taking about as little risk as we can. We keep looking for great managers to partner with and for areas of developing opportunity. To us, the nearest-term areas of opportunity we are exploring include high yield/distressed bonds and small cap stocks. If the economy is worse than expected in 2023, price dislocations may allow for attractive investments in high yield. Similarly, the small cap stock space has been out of favor for the past 5 years, underperforming the S&P 500 by 5% annually, suggesting possible opportunity here, too. Both of these are fruitful alpha-generation spaces. On the other hand, if the economy remains stronger than expected, we should get an opportunity to lock in some longer-dated fixed income rates that will be attractive when the economy finally does cool. Finally, capital flows to higher returning investments, until it doesn't. In equities, US stocks (S&P 500) have outperformed non-US stocks (ACWI ex-US) by nearly 10% annualized over the past decade. Our non-US investments could begin to outperform in 2023, and we will search for additional opportunities abroad where we can partner with great managers.

When the clouds do begin to part, we expect to increase our equity holdings by 3% to 5%, hopefully on weakness. Having re-underwritten our managers again this year, we believe some of our largest detractors in 2022 remain very capable – despite sporting several new battle scars. Until we get the opportunity to increase our overall equity exposure, we'll count on manager alpha in equities and hedge funds and our underweight to bonds and duration to fuel relative performance next year.





USD Total Returns for the S&P 500, Russell 2000, and MSCI All Country World ex-US Indices (January 1, 2013 to December 30, 2022)⁷



Many have heard us say that, after the second worst start for a 60/40 balanced portfolio in the past 96 years, now is not the time to get more defensive. The fourth quarter was better and demonstrates, we think, this point. While we are less optimistic about the first half of next year, we do expect that many of the concerns we discussed above will begin to work themselves out as 2023 progresses. It is likely that, as this begins to happen, there will come a point when investors will switch from discounting "how bad can things get" to "how strong will this recovery be." Being out of the markets when that happens can be the costliest mistake of all, because, over time, markets tend to move up and to the right.

As always, we very much appreciate the opportunity to help manage your capital and to help you achieve your organization's goals. We are here to assist you in any way possible, so please reach out and let us know how we can help.

Your TIFF Investment Team

⁷ Source: Bloomberg.



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