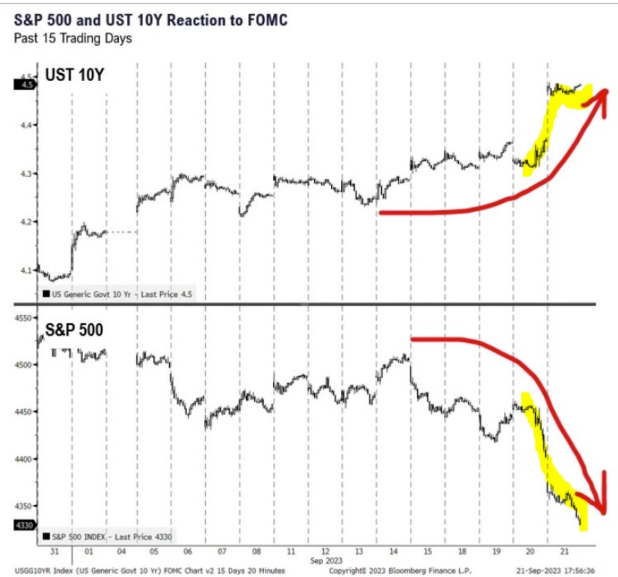
Market Commentary | Third Quarter 2023

The Fed's Word Goulash—spicy and soggy. September 20th Press Conference.

What did I hear from Federal Reserve Chairman, Jay Powell's press conference? A muddled stew of Fed speak that would argue for a soft landing and a Fed voting bloc that leans hawkish in the face of their own economic estimates. In addition, the Chairman seemed to confuse the narrative a few times (contradicting previous statements earlier in the conference) and left me, at least, nonplussed by the number of times he said: "we don't know"—6x, "we don't really know"—1x, and 2 "not sures." (Thanks to LTI's John McGinn!) This from the much-heralded data dependent Fed. And about the data… What seemed to really trouble the market is that the SEP or Summary of Economic Projections released by the Fed showed GDP higher and unemployment lower than the previous SEP—the proverbial soft landing. But the chairman spooked investors when he responded to the first question indicating that a soft landing was no longer a priority then later in the presser suggested the opposite was true.

Bonds sold off, yields rose, and stocks sold off. The markets, after all, do not like uncertainty—a specialty of this Federal Reserve for the last three years.

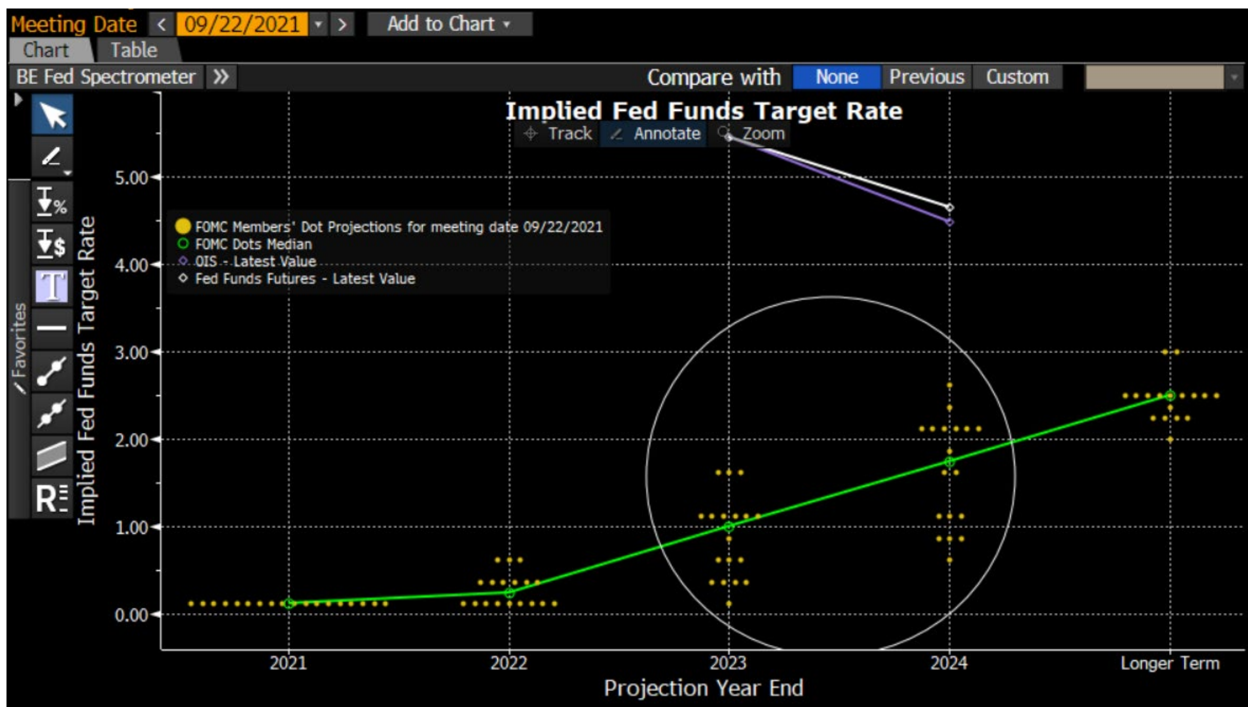


Source: Fundstrat, Bloomberg

September 21, 2023

Since the presser, the financial media has been full of speculation around how much higher for how much longer the Fed will remain hawkish. (Barron's had this to say: "The Fed's Dot-Plot Told One Story. Powell Gave Us Another.")

They cite the latest dot plot which indicates we will only see 50 basis points of cuts next year. As though it were gospel. Yet the dots represent the view of 19 FOMC members, most of whom do not vote on monetary policy. This is not the gospel according to anyone, it is merely a best guess based on what the members know now, or think they know. Therefore, I thought it would be instructive to look at the September 2021 dot plot when the Fed Chairman was still referring to inflation as "transitory." Note how wrong the "guesses" were. The vast majority expected to see rates slightly above or below 1.0% in 2023 (reference point: we are at 5.5%) and slightly above or below 2.0% by 2024 (current estimate is 5.1% by the end of 2024). In other words, as the Fed Chairman so aptly put it (repeatedly) in his press conference they just don't know.



Why then does the market react so dramatically to every word uttered and some that are not uttered? It's the short-term traders using algorithms who drive near-term volatility…and create opportunities for long-term investors. Last fall we added to technology when the algos were running for the hills. We think this sell-off will also provide excellent opportunities and are examining our watch list for high-quality, well-managed companies that will generate excess returns over the next few years.

Finally, I think it is important to note that *real* yields are hovering just above 2.0%. During the productivity (and stock market) boom in the 1990s, ***real*** yields traded in a range of 2.0%-4.5%. A 4.5% nominal yield is not, as Tom Lee, puts it "a P/E killer. In fact, the "sweet spot" for P/E is 3.5% to 5.5% yields which have seen an average P/E of ~20X. In fact, US yields below 3.5% are associated with lower P/E."

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The third quarter has been volatile. We suggested we would, and likely should, get a correction in the quarter. We get one, on average, every 12 months. Think of a correction as a release valve for rapidly rising stock prices which allows the engine to recalibrate. Remember that time in the market rather than timing the market is the best strategy. LTI adjusts risk around the edges, but our goal is to keep you invested. In my new book, The Women's Guide to Successful Investing, I cite the following study from our friends at Strategas: *Even more deleterious to returns is trying to time the market. Strategas Research Partners analyzed stock returns as measured by the S&P 500 from January 1, 1995, to December 31, 2022. For the investor who remains fully invested in the market over that 27-year period, the average annual return is 8.0%. By missing just the five best days, the annualized return drops to 6.2%. (Think; a cost to your $100,000 portfolio of $291,393. Missing the 30 best days over that 27 years results in an annualized total return of 1.3% or a cost in dollar terms of $657,078. Staying put during bear markets is important to achieving returns in stocks. Peter Lynch, one of greatest growth investors of all time once said: "The real key to making money in stocks is not to get scared out of them."*

Nancy Tengler,
CEO and Chief Investment Officer

Convertibles | Third Quarter 2023

Convertibles Commentary:
J. Stanley Rogers, Jr.
Senior Portfolio Manager

NEW POSITIONS

We finally got a new deal that fits our strategy. **Apollo Global Management (APO)** issued $1.25 billion of a mandatory convertible preferred. They priced this security with an attractive 6.75% yield and a 20% conversion premium. This preferred received an investment grade rating, and it will mature/convert on 7-31-2026. APO is a leading alternative investment management company, and this will be a nice total-return security in our portfolio.

We started a 2% position in **Two Harbors (TWO)** 6.25% convertible bond. At purchase it offers an attractive 6.75% current yield and a 9.85% yield-to-maturity (January 15, 2026). With a 99% premium and low delta, this is a nice yield-alternative security and an attractive place to park some cash. TWO is a REIT that invests in residential mortgage-backed securities that are backed by government-supported enterprises. The company also has a mortgage servicing rights (MSR) portfolio.

We initiated a 2.5% position in **Dexcom (DXCM)** 0.25% convertible bond. The stock had recently been weak due to headline news concerning GLP-1 drugs and weight loss applications. DXCM is a developer of continuous glucose monitoring (CGM) devices. We felt the stock was unfairly punished, as the use of these devices is encouraged by physicians when patients are on GLP-1 drugs so glucose levels can be monitored. The bond trades below par and at purchase had a 0.26% current yield (the common does not pay a dividend) and a yield-to-maturity of 1.68%. The bond matures in November of 2025 and is the next debt due after the 0.75% mature in December of this year. With a mid-40s delta, this total-return bond provides exposure to a leading med-tech company in diabetes management.

EXITED POSITIONS

With the maturity upcoming and the high dollar price, we exited our position in **FTI Consulting (FCN)** convertible bond. Since we do not convert our securities, we sold the position prior to the maturity/conversion date.

On August 15th, our positions in **New Mountain Finance (NMFC)** 5.75% and **Illumina (ILMN)** 0% both matured and were redeemed at par for cash by the company.

KKR & Co. (KKR) mandatory convertible preferred was set to mature and convert on September 15. We received the last remaining dividend and exited the position prior to the maturity date.

REPLACED POSITIONS

None for this period

INCREASED POSITIONS

Solar energy related stocks came under pressure recently as some concerns over installations were slowing due to higher interest rates and working capital cost increases. **Enphase (ENPH)** stock was not immune to the group's correction. However, we took advantage of this and added about 1% to our position in the 0% convertible bond that matures in 2026. The bond trades with an upper 40s delta and mid 60s conversion premium, so it has a nice balanced profile with conservative exposure to a very volatile stock. The bond does not pay interest, but it does have a 2% yield-to-maturity, as the bond will accrete to par as it approaches the 2026 maturity.

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We added to our existing positions in **Bank of America (BAC)** 7.25% convertible preferred and **Blackstone Mortgage Trust (BXMT)** 5.5% convertible bond. These securities experienced a little weakness with the rise in rates, and with both having a current yield north of 6.20% we thought it was an attractive place to allocate some cash that resulted from the maturities mentioned above.

We also added to our position in **NICE Ltd. (NICE)** a 0% convertible bond. The company recently reported Q2 results where earnings and revenue were above expectations. However, cloud and recurring revenues were a little light. On the call, management highlighted many new deals signed that included their CXone artificial intelligence, which will support the long-term thesis. With the stock weak on the news, the bond cheapened, and we added to the position.

We added about 1% to our position in **Prospect Capital (PSEC)** 6.375% convertible bond. This investment grade rated name trades just below par and matures on March 1, 2025. With a current yield of 6.38% and short maturity, we felt this was an attractive place to place some cash and increase the yield on the portfolio.

We increased our position by 1.25% in the newly issued **Apollo Global Management (APO)** 6.75% mandatory convertible preferred. This investment grade rated equity-alternative security gives us exposure to this high-quality investment management company until the July 2026 maturity.

DECREASED POSITIONS

None for this period

LEADERS

Pioner Natural Resources (PXD) had a solid quarter. A primary driver of the stock's performance was the rebound in the price of oil, as the commodity appreciated close to 30% during the third quarter. Also, the company reported Q2 results, with earnings above estimates, revenues in line, and net income above expectations. The company also raised their production forecasts and commented positively on well productivity trends.

KKR & Co. (KKR) reported Q2 results that were largely positive. Fee-related earnings (FRE) and distributable earnings (DE) were both ahead of expectations. Fund raising of $13 billion was in line. Performance and investment income were well above guidance. Growth trends in the Global Atlantic (life insurance, retirement products) were highlighted.

Booking Holdings (BKNG) was another stellar performer during Q3. The company released Q2 results that were well-above consensus estimates on all metrics. Gross bookings reached an all-time quarterly high as travel demand remained robust and resilient. Room night growth (RNG) and average daily rates (ADR) were both strong. Management indicated that they see no slowdown in consumer behaviors related to travel.

LAGGARDS

Southwest Airlines (LUV) had a difficult report. While the company reported a largely in line quarter, their Q3 guidance was below expectations. Despite record bookings, non-fuel costs (labor) were up significantly, while fuel costs rose during the quarter as well. Management was still optimistic on travel demand.

Ford Motor (F) posted a solid Q2. Earnings and revenues were well above expectations, driven by gas-powered vehicle sales. Projected electric vehicle losses, however, were raised as the company dialed back their production as the price-war for battery-powered vehicles intensified. The stock (and group) was weak as the UAW implemented targeted manufacturing facilities for strikes and new contracts were being negotiated.

AES Corp. (AES) stock underperformed for the quarter. Despite reporting Q2 results that were in line, the company's intentions to fully exit coal generation by 2025 could prove to be more dilutive than thought. Also, the transition from coal to more renewable energy growth could present execution risks. AES also suffered due to the tragic wildfires in Maui, as AES operates a solar project that feeds into Hawaiian Electric's grid.

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