O’Neill Investment Letter

Dear OSIF Board of Directors,

We are excited to contribute meaningfully to the O’Neill Student Investment Fund and make informed decisions. Our sincere appreciation goes to the O’Neill board for providing us with valuable insights. Throughout the semester, we had the privilege of learning from Karan Iraddi and Chris Magaña about the intricacies of equity and debt markets.

This fall, we strategically managed the current portfolio, considering key macroeconomic events such as a late-cycle investment strategy, semiconductor tensions in China and Taiwan, the Israel-Palestine conflict, and the prospect of higher interest rates for an extended period. This summary will delineate our decisions in light of these factors and provide our near-term outlook for the investment fund.

Macroeconomic Events

We managed the portfolio from August 31, 2023, to December 1, 2023, and observed the market through many macroeconomic events including late cycle investment strategy, semiconductor tensions in China and Taiwan, the Israel-Palestine conflict, and high interest rates. We also paid special attention to the Federal Reserve and their higher interest rates for longer.

Inflation and Federal Reserve

In 2023, the Federal Reserve aimed to tackle high inflation while considering economic growth and the labor market. Interest rates, which were initially low during the early stages of COVID-19, increased in 2022, reaching nearly 8% in October—levels not seen since 2000. In July 2022, inflation surpassed 9% but it has gradually decreased to around 3.25%.

Federal Reserve Chairman, Jerome Powell has adopted a hawkish monetary policy, prioritizing the prevention of high inflation through interest rate hikes and tighter monetary measures, even at the cost of slower economic growth or increased unemployment. In 2023, the Federal Reserve executed multiple rate hikes to curb inflation, starting with a 25 basis point increase in March 2022 and concluding with a final hike of 75 basis points in July 2023.

Inflation remained a significant concern, with consumer price inflation measured at 5.4% in January, down from 7% in June of the previous year. The Fed's balance sheet policy entailed substantial reductions in Treasury and agency securities holdings. Future rate decisions depend on inflation trends, and the Fed is awaiting signs of economic cooling before concluding its rate-hike campaign to achieve the 2% inflation target. Powell's statements suggest potential future rate hikes, but they are currently satisfied with their trajectory. The federal funds rate was targeted to remain within a range of 5–5.25%.

Core Personal Consumption Expenditures (PCE) prices, which exclude volatile food and energy prices, also showed increases. The labor market remained tight, with robust job gains and a historically low unemployment rate. Despite some moderation in labor demand and nominal wage gains, the labor force participation rate remained essentially unchanged. Real GDP growth showed signs of recovery in the latter half of 2022. Consumer spending continued to rise, though manufacturing output declined, and the housing sector contracted due to elevated mortgage rates. Financial conditions tightened, with increases in Treasury yields, corporate bond yields, and mortgage rates to compensate investors. The rise in interest rates affected financing activities, with a notable decline in mortgage originations and an increase in consumer loan growth. Global economic growth moderated, influenced by geopolitical events and the COVID-19 situation in China. Many foreign central banks, like the Fed, have tightened monetary policy in response to high inflation. This context led us to consider late-cycle views of the market as essential to our portfolio, and shifting our positions to favor essential consumer goods.

Late Cycle

We have adopted a late-cycle investment strategy, focusing on the macroeconomic narrative associated with this phase. In the context of late-cycle conditions, characterized by sustained but potentially peaking growth, factors like rising inflation and tight labor markets impact profits, leading to elevated interest rates. The inversion of yield curves serves as a notable indicator for late-cycle periods, historically predicting the last 10 recessions since 1955, with only one false positive in the 1960s. While late-cycle periods have traditionally heralded recessions, the transition from late-cycle to recession typically spans around a year and a half.

During late-cycle phases, investors commonly reallocate from cyclical stocks (nonessential consumer goods companies) to sectors deemed less sensitive to economic cycles. This shift directs funds toward consumer staples, materials, energy, utilities, and healthcare. These sectors are considered less prone to economic fluctuations because consumers are less likely to cut back spending on essential goods vital for survival and well-being.

Applying this late-cycle approach to our investment strategy, we have divested from cyclical stocks, exemplified by exiting positions in companies like Volkswagen, and redirected our portfolio towards late-cycle stocks such as Procter and Gamble and Mondelez. Additionally, we have tempered our exposure to iShares Investment Grade Corporate Bond ETF, a passive bond fund, given the prevailing sentiment that interest rates will persist at higher levels for an extended duration. This anticipation of prolonged higher interest rates serves as a negative catalyst for a bond fund due to the inverse correlation between bond prices and interest rates.

Geopolitical Climate

Geopolitical conflicts continue to significantly shape the landscape of the global economy, with notable reverberation for the U.S. stock market. The escalating tensions between China and the West, particularly over issues like the competition for technological dominance and the status of Taiwan, have compelled companies like Intel to adapt their strategies. In response to the geopolitical landscape, Intel has shifted its focus to chip fab production through Intel Foundry Services, reflecting the intricate dance between technology, national interests, and global power dynamics. Trade restrictions have become prevalent amid geopolitical tensions, prompting a reevaluation of supply chain vulnerabilities. The concept of 're-shoring' or 'friend-shoring' critical supply chains has gained traction as nations seek to secure essential resources and minimize dependencies on potentially adversarial countries.

The Israel-Palestine conflict has added another layer of complexity to the global economic scenario. The heightened uncertainty stemming from this conflict has driven up the price of gold, a traditional safe-haven asset. While investor reactions have been marked by short-term volatility, the lasting impact on financial markets has been relatively limited. Meanwhile, the Russia-Ukraine conflict has contributed to the broader trend of deglobalization, with nations reconsidering their interconnectedness in various sectors. Persistently higher oil prices resulting from geopolitical tensions have further underscored the delicate balance between geopolitical events and economic stability.

Against the backdrop of geopolitical tensions, the International Monetary Fund (IMF) has revised its U.S. growth forecast, reflecting the uncertainty and volatility introduced by global geopolitical dynamics. The upcoming 2024 U.S. elections add a layer of complexity, as political shifts can influence economic policies and market sentiments. Investors closely monitor government debt sustainability and the fiscal trajectory, recognizing that geopolitical conflicts often prompt increased government spending on defense and security measures. This heightened expenditure and existing economic challenges contribute to concerns about long-term debt sustainability. Furthermore, geopolitical tensions can exacerbate inflationary pressures, impacting everything from commodity prices to consumer confidence. The delicate balance between global political stability and economic well-being requires investors to stay vigilant, adapt to evolving scenarios, and factor in geopolitical considerations when navigating the U.S. stock market.

Investment Decisions

Our decision to increase our position in Intel (INTC) was driven by the company's strong standing with larger corporations and their global multi-billion dollar investments in manufacturing plants. The stock price reflected the market uncertainty in the highly competitive central processing unit (CPU) market. Despite the uncertainty, we believe INTC will generate positive returns in its global plants and remain a major player in its respective fields.

We initiated positions in PepsiCo. (PEP) and Mondelez (MDLZ) as a defensive measure in response to the market uncertainty regarding potential adjustments to the Federal Reserve's interest rates. Both companies allowed exposure to consumer defensive markets as a way to diversify our greater portfolio, decreasing volatility and increasing resiliency in the event of an economic downturn.

We increased our position in TJX Companies Inc. (TJX) to grow exposure in the retail sector. While online shopping has impacted retail stores, we believe TJX is well protected from this as they operate in the off-price sector. The company’s global presence, substantial discounts, and inventory management system highlight their strong returns for the previous decade. Coupled with consumers' persistent retail spending, we perceive TJX will provide an enduring holding in our portfolio.

In the face of challenging economic conditions, including variable interest rates, a looming recession, and high inflation, we've added Procter & Gamble (PG) to our portfolio for its stability. PG's diverse range of essential consumer products guarantees consistent demand, providing a haven in volatile markets. The company's robust market presence, global distribution, and steady dividend payouts offer a combination of resilience and reliable income.

T-Mobile (TMUS) was picked based on the telecom sector's track record of consistent, stable growth and the company's solid standing within this sector. Its lower volatility relative to industry peers and a 'slow and steady' operational strategy underlines its resilience. TMUS's strategic partnerships and acquisitions with companies like Mint and SpaceX point to further growth avenues. Importantly, it stood out in recent financial quarters, with its earnings per share (EPS) exceeding expectations in Q2 and Q3, reinforcing its suitability for stable growth in our portfolio.

The inclusion of the XMHQ Mid-Cap Blend Fund (XMHQ) in our portfolio strategically addresses our previously heavy concentration in large growth stocks. This decision reflects our recognition of the untapped potential within the small to mid-cap market segments. While the fund carries a management fee of 25 basis points, its historical performance, consistently outstripping its benchmark index, demonstrates its value. With XMHQ focusing on fundamentally sound companies with bright prospects, we are positioned to capture gains beyond the large growth space, enhancing our portfolio's diversification and growth potential.

The LQD Corporate Bond ETF stood out as the weakest performer in our portfolio, prompting our decision to divest. Its value declined significantly in the persistently high interest rate environment, a typical scenario for fixed-income assets amidst rate increases. We acted decisively to sell LQD, responding to its prolonged downturn. This move was done to curb further losses in anticipation of a higher longer interest rate environment.

We divested our position in Volkswagen (VWAGY) due to our evaluation indicating that it is not a late-cycle company. This decision was driven by a decline in their global market share for electric vehicles (EVs) and ongoing challenges with their slower-than-expected supply chain recovery. Furthermore, the company's primary EV supplier in Asia faced a corruption investigation, contributing to a sustained decrease in share price since the previous fund managers' tenure. While the price is representative of all these issues, there was continued value lost to the overall market with their high inventories and loss of capital, leading us to exit our position.

Fund Performance

Between August 31 and November 16, 2023, our portfolio outperformed the S&P 500, achieving a holding period return (HPR) of 8.89% compared to the S&P's 3.03%. This success was driven by our top-performing positions in Microsoft (MSFT), Adobe (ADBE), Amazon (AMZN), and Intel (INTC). On the other hand, Volkswagen and the LQD Corporate Bond ETF underperformed, leading us to divest from these positions to mitigate losses and reallocate resources. Additionally, our strategic acquisitions, totaling seven new buys, collectively appreciated by 5.26% from their respective purchase dates.

Market Outlook

The Federal Reserve has been trying to curb high inflation through a series of interest rate hikes since March 2022. However, we expect that by mid-2024, the central bank might shift gears and consider lowering interest rates instead of continuing to increase them or maintaining the status quo, as long as inflation starts to ease. Crude oil prices are on the decline, prompting major oil producers to consider reducing their oil production, rendering the future of the oil market less speculative.

Global economic trends are heavily influenced by geopolitical tensions, particularly affecting the U.S. stock market. Investors closely observe government debt sustainability, especially with rising defense expenditures. The potential government shutdown in early 2024 poses a risk of disrupting the ongoing stock market rally.

Note of Thanks

Thank you to the O'Neill family, board members, and faculty for granting us the privilege to oversee the O'Neill Student Investment Fund. This journey has proven to be a priceless encounter that has enlightened us on the significance of thorough research, lively discourse, and the intricacies of various investment landscapes. We extend our thanks for your unwavering confidence and express our sincere appreciation for the continued trust you bestow upon us.

Sincerely,

The OSIF Fall 2023 Team

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