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"We're just not there yet."

Dear Clients and Friends: July 15, 2023

The U.S. stock market continued its upward march in the second quarter, thanks to stronger than anticipated economic growth, declining inflation, and investors' exuberance around Artificial Intelligence ("AI") and a handful of growth stocks. Nothing could get in the way – not the Federal Reserve, not a series of bank failures, not geopolitics, not even the down-to-the-wire debt-ceiling drama in Washington. Stocks even endured constant predictions that a recession was always just around the corner. Lots of doom has been predicted for this year…we're just not there yet.

Equity performance around the world was positive for the quarter, although some areas did better than others. Larger companies in the U.S., represented by the S&P 500, led the way, returning almost 9.0% for the quarter. This puts year-to-date returns at a surprising 16.5%. Smaller companies were less buoyant, up 3% for the quarter and about 6% for the year. Developed international followed a strong first quarter with a 3% second and up 12% for the year. Emerging markets lagged this quarter with a modest 1% gain and 5% on the year. Bond markets, on the other hand, struggled a bit as the failure of a recession to show up forced intermediate and longer-term yields higher. The index fell -1% in the quarter but is still up 2.25% on the year.

As we mentioned in last quarter's letter, this year's performance of the U.S. stock market has been historically narrow and led by a handful of technology companies that are both large and highly weighted in the S&P 500. The group of gunslingers dominating this rally have been tagged the "Magnificent Seven" and include Nvidia, Tesla, Meta (Facebook), Apple, Amazon, Microsoft, and Alphabet (Google). All seven stocks closed 2022 with deeply negative returns, ranging from losses of -65% for Tesla to -25% for Microsoft and Apple.

In 2023, these stocks have made U-turns and rocketed higher, ranging from up 40% to over 150%. These seven companies have now grown to over 30% of the index and have been responsible for about 12% of the 16.5% gain this year. The Equal Weighted S&P 500, a version of the index where all 500 companies contribute equally to performance instead of being weighted based on their size, is up only about 6%. Even the Dow Jones Industrial Average is up less than 5%. We feel the Dow and equal weighted index returns are more indicative of how most stocks have performed in 2023.

The fuel for the Magnificent Seven's rise has been investor excitement in generative artificial intelligence software. ChatGPT, the newest AI tool that lets users enter prompts to receive humanlike images, text, or videos, has captured Wall Street's attention. Much like we saw in the 1990s dot-com boom and the crypto phase of 2020-2021, companies related to AI have seen stock prices soar, often well ahead of any earnings. These seven companies are at the forefront of both current development and future deployment. While we believe AI will be a transformative technology and its hype likely real, the long-term potential is still hard to assess. The actual beneficiaries have been limited thus far, and the resulting direct financial impact of AI…is just not there yet.

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The Fed and Inflation

Investors have lived under a specific narrative for most of the last 18 months. The Fed would engineer an economic soft landing by raising interest rates high enough to choke off excess demand, bringing down inflation, and then start lowering rates just before economic weakness set in, causing a recession. The inverted yield curve showed the three or four rate cuts investors anticipated would come in the second half of 2023. However, as inflation has remained above the Fed's 2% target, rate cut expectations have dissipated and been pushed further into the future.

Although still above target, inflation has come down. The just released June Consumer Price Index showed a year-over-year increase of only 3%, the lowest level since March 2021 and a fraction of the 9.1% inflation peak seen in June 2022. The Fed's preferred reading, Core CPI, which strips out the more volatile food and energy categories, was at its lowest level since October 2021. Consumers are finally paying less for groceries, airfare and used cars while housing/rent increased at the slowest pace since early 2022. We expect additional declines in inflation as goods and commodity prices continue to move lower, supply chains continue to improve and housing/rent stop rising. We are trending in the right direction, but just aren't at the Fed's target yet.

So, instead of rate cuts, we can look forward to additional rate hikes. The Fed did pause at their June meeting but left the groundwork in places for hikes in July and possibly September. "The bottom line is that interest rate policy hasn't been restrictive enough for long enough," Chairman Powell recently remarked. He reiterated his view that prices for services, such as restaurant meals, hotel rooms and health care, are still rising too fast, driven in part by the need of many companies to raise pay to attract and keep workers. The new narrative is slowly becoming "higher for longer" when it comes to interest rates. Consequently, we are close to a peak in the rate cycle, but we are not there yet.

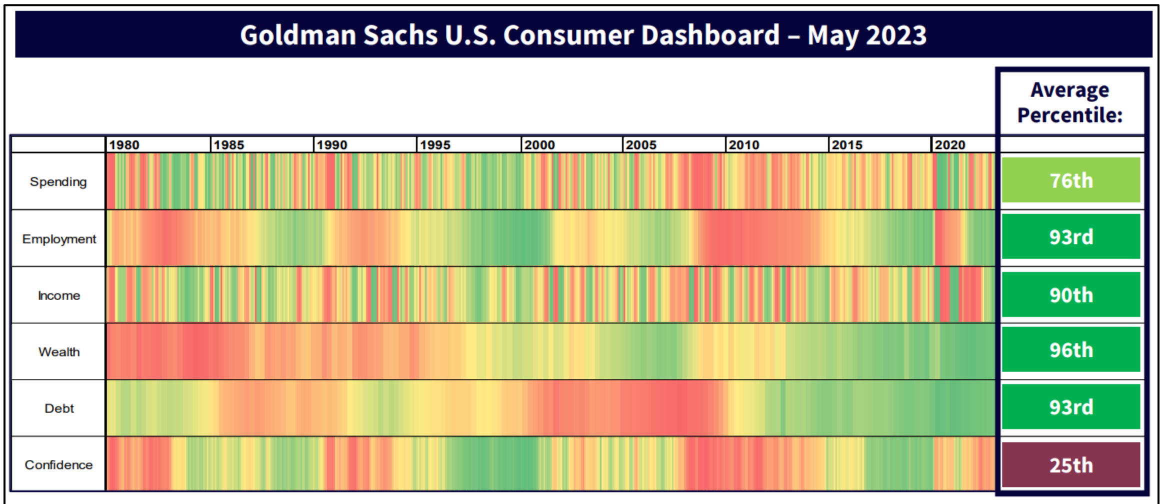
What happened to the recession we were supposed to have?

Ever since the pandemic started to subside early last year, experts have warned that the U.S. economy is destined for a recession. Citing the history of rate increase cycles, like the one the Federal Reserve is currently on, forecasters spent much of 2022 and early 2023 predicting an imminent economic plunge. Stocks and bonds declined precipitously last year as markets priced in an inevitable slow down and eventual job losses.

However, a funny thing happened on the way to the recession: Consumer spending continued to go up, the unemployment rate continued to go down, and inflation appears to have peaked. First quarter real GDP growth was recently revised up to 2.0% and the second quarter is tracking to 2.3%. As a result, those same experts who said a recession was unavoidable are no longer so sure. Some even think the U.S. economy may have dodged a downturn entirely. The increases we have seen in stock prices this year can be attributed to markets now pricing out the idea or delaying the onset of a recession.

To be sure, the economic picture is not perfect. The rise in interest rates has made all forms of borrowing more expensive. Since the mini-banking crisis in March, credit conditions have tightened as banks have implemented more stringent lending policies. Loan demand has also receded. While the unemployment rate sits at record lows, a deeper look shows some cracks starting to appear. All these factors tend to slow down economic activity. Many recent surveys of manufacturing businesses and leading economic indicators point to just that. The economy continues to grow but shows signs of cooling. There is a good bit of data that says we are still at an elevated risk of recession. We're just not there yet.

Facts don't always get in the way of what Americans think, however. A recent survey by Yahoo News/YouGov revealed that 43% of respondents thought we were already in a recession and another 18% said we were on trend to enter one. Goldman Sachs believes Americans might be "misperceiving" the economy. The chart below shows that most elements of consumers' finances, at least from an historical standpoint, are in extremely good shape. However, their confidence is in the tank.



Source: Goldman Sachs Research; Shading indicates most negative (red) to most positive (green) observations, 1980-present. Measures used in heat map are as follows. Spending: 3MMA of real spending growth. Employment: Unemployment gap (vs. NAIRU). Income: 3MMA of real income growth. Wealth: Ratio of household net worth to disposable income. Debt: Household debt service ratio. Confidence: Average of normalized UMich and Conference Board measures.

Outlook

In many ways, the economy is incredibly complicated. Yet, it can also be simple. If you give people money, they will spend it. Businesses see the demand and create more jobs. More jobs mean more people with money to spend. More people spending more money means more business demand and more jobs. It's a virtuous cycle. For investors, all of this helps drive earnings and explain the resilience of the economy and the upward tendency of stock prices.

Our client portfolios have benefited from the excess returns in the AI stocks and have presented us with opportunities to rebalance. We can take profits in areas that have likely gotten ahead of themselves and become expensive, while adding to areas left behind and showing better valuations. While the continuing consensus amongst economists is that the U.S. will soon face a recession, the resilience of core data in the face of rising rates has given investors some degree of confidence that the Fed is slowing a strong economy as opposed to wrecking a weak one. Recessions are inevitable. We're just not there yet.

Thank you again for your continued confidence and trust as we work through these extraordinary times. We welcome your comments, questions, and referrals. Please don't hesitate to contact us. Please stay safe and well.

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