2023 SUMMER INVESTMENT OUTLOOK

The month of June annually marks the beginning of summer which occurred earlier this week. This year, June also heralded the end of the latest bear market for S&P 500 as stocks officially entered a new bull phase two weeks ago today. A bull market is defined as a 20% rise from the bottom and the market's close on June 8th eclipsed this advance from the recent low which took place in early October. For the past eight plus months, the equity market has risen despite facing a number of challenges, giving credence to the Wall Street proverb that stocks often climb a "wall of worry."

Investors have looked past several concerns in recent months. Geopolitical issues remain centerstage as the war in Ukraine continues and tensions with China persist. The regional banking crisis, which saw some of the biggest failures in U.S. history, now seems like an afterthought with little impact on the broad economy. Similarly, investors' worries over the potential for a federal debt default never truly manifested themselves in capital markets. Oil prices have come down despite new calls by OPEC to reduce production while fears of a reckoning in the commercial real estate market remain premature. Finally, while headline inflation has come down from its peak of 9.1% in June of 2022, the latest reading of 4.0% remains uncomfortably above the Federal Reserve's 2.0% target. In an ongoing effort to rein in rising prices and keep inflation expectations in check, the Fed has embarked on an interest rate raising campaign which has resulted in a five percentage point increase in short term borrowing rates. To date, this additional cost of funds has had no outsized impact on consumer behavior as a still relatively robust job market and pent up savings continue to bolster Americans' ability to spend.

Our view continues to be that the dramatic increase in interest rates over the past fifteen months will eventually impact consumers and hinder economic progress. Higher borrowing costs work their way into the economy with a long lag. The bulk of the Fed's rate hikes were instituted only 6-12 months ago so it is likely that their full impact has not been felt yet. Economic prognosticators seem to agree as the current consensus forecasts call for a recession to occur later this year and into next. Interestingly, at the same time that economic growth prospects appear to be waning, Wall Street's S&P 500 earnings estimates show a notable improvement over the balance of this year and continuing into 2024. This discrepancy between consensus economic forecasts and corporate earnings estimates is inconsistent with the historical record; either growth will come in better than forecast or rosy earnings expectations will not be met. Investors will be wise to follow developments in this area closely. Since the late 1950s there have been ten recessions. In every one of them, corporate earnings have fallen, with an average drop of nearly 30%. Even if one were to exclude the particularly devastating declines following the 2001 technology bubble collapse and the 2007-2008 global financial crisis, earnings on average have dropped over 18% in recessionary times.

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While stocks have moved higher so far in 2023, the advance has been uneven. As shown in the chart below, there is an unusually wide disparity in the returns for the major stock market averages with the Dow Jones Industrial Average up a low single digit percentage this year while the technology heavy Nasdaq has moved 30% higher. The S&P 500, which is weighted by market capitalization and is dominated by many of the same companies that have powered the Nasdaq, has returned 14.6% year to date. The rally has been very selective with a small proportion of stocks driving that gain. Through last night's close, the top seven stocks in the S&P 500 accounted for nearly 80% of the total index return in 2023. Said another way, excluding those seven stocks the S&P 500's total return would only be 3.1%. Such narrow breadth has historically not been associated with a healthy and sustainable stock market rally.

Equity Markets – 6/21/2023

	Index Price Level	2023 YTD Total Return
Dow 30 Industrials	33,952	+3.5%
S&P 500	4,366	+14.6%
NASDAQ Composite	13,502	+30.0%
MSCI All Country World Index ex-USA	304	+10.3%

Outlook

The U.S. economy has proved to be more resilient than most observers thought possible, particularly in the face of the many challenges noted above. Consensus estimates, which called for a recession to have begun by now, have gone unrealized. Consumer spending remains robust and has been powered by the service economy in recent quarters as pandemic era restrictions are lifted. Americans, still sitting on excess savings and buoyed by a strong job market, are eager to splurge on travel and other experiences that had been limited for much of the past three years. The San Francisco Federal Reserve Bank estimates that perhaps $500 billion of excess savings still exists today at the same time that the 3.7% unemployment rate suggests that work is relatively easy to find. Data for the latest month note that there are an estimated 10.1 million open jobs today while only 5.7 million people are actively seeking employment, a further sign of tightness in the labor market. Year to date in 2023, nearly 1.6 million new jobs have been filled, extending recent gains in the labor market as 4.8 million new jobs were created in 2022 and 7.3 million in 2021.

Still, economic activity continues to moderate with growth slowdowns expected this year and next. The nation's gross domestic product (GDP) advanced 2.1% in 2022. Growth is predicted to slow to 1.2% in 2023 and 0.7% in 2024. While we have avoided an economic downturn, a recession is still the market's base case with two consecutive quarters of negative GDP growth predicted for the fourth quarter of this year and the first quarter of 2024. At the same time, Bloomberg consensus estimates call for the U.S. unemployment rate to rise from its first quarter average of 3.5% to 4.2% in the first quarter of next year and 4.6% by year end 2024. Similar trends are expected globally with worldwide growth expected to moderate to 2.1% this year compared to 3.1% in 2022 according to the World Bank, leading to higher unemployment outside the U.S. as well.

The number one reason for this expected slowdown is tighter central bank policies in the face of stubbornly high inflation. The Fed raised its key short term lending rate at ten consecutive meetings by a total of 500 basis points before pausing at its recent June gathering, though it indicated it is likely to increase interest rates again in July. The cumulative effect of these rate hikes will feed into the economy over time as interest costs are rising for individuals, corporations and government entities at the local, state and federal levels. Higher borrowing costs are also likely to hit the private equity industry. A recent Bloomberg article estimated that over three-quarters of floating rate debt taken out by the

industry in recent years is unhedged so as those balances need to be refinanced, the cost of doing so will be quite steep in some cases. The article noted that the median private equity backed company had interest costs equal to 43% of EBITDA last year, some six times higher than the median S&P 500 company. The longer that interest rates remain elevated, the greater the risk to these highly indebted enterprises.

In addition to higher borrowing costs, access to credit will be curtailed in the coming quarters. Forecasts of slowing economic growth have already led banks to tighten lending standards. Anticipated regulatory changes coming as a result of the regional bank crisis earlier this year are expected to exacerbate that trend. The likely consequence will be less credit available in the overall economy. Historically, with a lagged effect, this has been highly correlated with less investment, reduced employment and lower consumer spending, all of which impede economic progress over the intermediate term. Indeed, the Conference Board's leading economic indicators index is flashing a warning signal. Dating back to the late 1960's, all eight times the leading indicators have been at their present level, a recession has ensued. Two other factors are worth keeping in mind. Consumer spending has outpaced growth of real disposable income for well over a year, an unsustainable trend over the long term. Finally, student loan payments are set to resume shortly. The overwhelming majority of people with student loans have not made a payment in over three years. The resumption of those payments, which is estimated to cost some $5 billion monthly, will reduce consumers' ability to spend on other items beginning this fall.

Investors are taking a sanguine view of these latest developments, in the hope that the economy will steadily slow in such a way that inflation gradually moderates while the employment picture remains satisfactory, thereby allowing the economy to avoid a recession. This would achieve the so-called soft landing scenario. While possible, the historical record suggests this outcome is not likely. Typically, GDP must fall to rein in inflation while unemployment must rise. Indeed, Former Treasury Secretary Larry Summers has suggested that the unemployment rate may need to rise to 6% in order to achieve the Fed's 2% inflation target. A few recent trends present slight headwinds to bringing inflation down. The first is geopolitics and a cooling of globalization trend that has dominated the world economy for the better part of the past several decades. As companies re-shore supply chains and focus on security and stability over efficiency and cost, at least a bit of the deflationary trend of the past thirty years has been reversed. As one example, semiconductor plants being built in the U.S. today are estimated to cost over three times what a similar plant would cost in Taiwan. The shift to green energy, while important to our planet's future, will be a costly transition as it will require trillions of dollars of infrastructure updates. Finally, productivity has been weak recently, having declined for five quarters in a row. This trend bears watching, as lower productivity makes it more difficult to keep inflation in check as companies traditionally pass rising unit labor costs along to customers in the form of higher prices.

On a positive note, there are several signs which point to the potential for moderating inflation in the coming months. Supply chain challenges in many industries are improving, weaker energy prices have contributed to lower transportation costs, and gains in housing and rental prices are cooling off in many markets. Finally, National Federation of Independent Business surveys suggest that small businesses' pricing plans are coming down significantly and this has historically been a reliable predictor of falling core personal consumption expenditures index, the key inflation gauge for Fed policy makers. At the same time, for those who thought that the recent era of low inflation represented a new normal, it is worth remembering the words of Warren Buffet who noted that "inflation is never gone, it's always in remission. Any time you have government, you have to worry about inflation." Even assuming inflation is tempered, as long as the Fed does not cut its key lending rate, real interest rates will rise meaning monetary policy will become more restrictive in the coming quarters.

In addition, fiscal policy will be less supportive of economic growth over the intermediate term. The recent deal in Washington to avoid a debt default was a notable compromise in a highly partisan

environment. The country will be better off if the two sides of the political aisle can continue to find common ground for the good of our nation. As it stands, the arrangement would hold non-military spending flat in 2024 and allow it to increase only 1% the following year. J.P. Morgan economists predict this will shave 0.2% per year off of economic growth forecasts over those two years. However, non-defense, discretionary spending only accounts for approximately 15% of the total federal budget so the long term trajectory of federal deficit spending remains unchanged. Compromises on entitlement reform (Social Security, Medicare, Medicaid) remain unlikely in the current climate.

Former Federal Reserve Chair Alan Greenspan noted in 2005 that "history has not dealt kindly with the aftermath of protracted periods of low risk premiums." While those prophetic words were early, they did accurately foreshadow the pain that was to come in the Great Financial Crisis of 2008-2009. For most of the past fifteen years, until the Fed began to systematically raise rates in early 2022, monetary policy has been extremely accommodative and risk premiums have been historically low. A decade plus of easy money has distorted capital allocation in ways that have obscured some of the underlying risks to the outlook in our view.

Investment Conclusions

There are opportunities and risks in every market environment so, from that standpoint, the current investment setting is not unique. As noted, there are a number of concerns which suggest that caution is warranted regarding economic prospects over the intermediate term. This is important because the historical record is unambiguous that when recessions occur, corporate earnings and stock prices decline. Nevertheless, despite any near term worries regarding the outlook, there are always individual stocks that are selling at reasonable prices for long term investment, so security analysis remains critical.

Assuming near term liquidity needs are met, most investors should have the majority of their assets invested in a sound, thoughtfully crafted portfolio made up of stocks of high quality companies. Despite the inevitable challenging times that arise periodically, a well-diversified list of common stocks is the best protection against the ravages of inflation which is perhaps the greatest risk facing investors over the long term. Furthermore, while earnings fall during recessionary periods, stock dividends tend to be more stable and can help cushion portfolios during tumultuous times. Therefore, including a mix of such securities in a long-term investment plan can help moderate more extreme swings in values.

Finally, returns on investment grade, short term bonds and cash equivalents are at their highest point in nearly fifteen years, providing another underpinning for portfolio values and cash flows. These funds also offer liquidity to purchase shares of leading companies should prices become more attractive later in the year.

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