

Second Quarter 2023 Key Takeaways:

Global equity markets continued their rally into the second quarter, led by surging U.S. mega-cap technology and growth stocks.

U.S. slow growth stocks ("value") experienced flat returns for the second quarter, significantly underperforming fast growth U.S. stocks.

Fixed Income markets struggled in the second quarter amidst fears of additional rate hikes from the Fed, though the riskier High-yield sector outperformed other sectors, earning just under 2% for the quarter.

The market-cap-weighted S&P 500 Index's rally this year has been one of the narrowest on record, with less than 28% of the index's constituents beating the overall index return.

It remains to be seen whether this extremely narrow market rally resolves via the rest of the market catching up or the seven companies mentioned above "catching down," though it appears that the stock market rally is *potentially* broadening to include more of the 72% of component companies that under-performed the broad index.

The U.S. economy has grown at a better rate than was expected in light of being in a rising interest rate environment, but the potential still remains for a recession in late 2023 as other indicators, such as the inverted yield curve, are pointing to recession.

Headline inflation has dropped meaningfully, thanks to a sharp decline in energy prices, but it is still above the Fed's 2% target, so we should expect at least 1 or 2 additional rate hikes.

The Fed paused at its most recent FOMC meeting, but signaled additional rate hikes are likely.

A strong labor market, rising disposable income, strong corporate balance sheets and a high level of personal savings remain reasons for optimism.

My 5-year base case for the broad U.S. stock market returns is mid to high single digit returns, though current U.S. growth stock valuations make low positive to low negative single digit returns more likely.

Attractive valuations of foreign developed and emerging market stocks, and the prospect of a declining dollar, have me feeling more constructive about returns in the international markets; high single-digit to low double-digit returns over the next 5 years looking possible.

Broadwing portfolios continue to hold meaningful "defensive" positions, which in light of current economic and market uncertainty should help to protect investors if events take a turn for the worse.

Market Recap

Global equities continued to rally in the second quarter, led by surging U.S. mega-cap technology and growth stocks, particularly any companies connected to Artificial Intelligence (AI).

The S&P 500 index gained 6.6% in June and 8.7% in the second quarter, driving its year-to-date return to 16.9% overall. The technology heavy Nasdaq Composite has experienced some of the best returns in U.S. stocks, rising over 13% in the second quarter, and 32% year to date.

The slower growth companies found in the S&P 500 Index, such as mature companies focused on shareholder dividends, experienced flat returns for the quarter compared to the tech-oriented sectors of the index. This has led to a large divergence in investment results, similar to what we witnessed during the 2020-2022 Covid recovery rally. There is no shortage of hand ringing amongst investment managers with an appreciation for historical context. We all know what followed the wild enthusiasm for companies whose stocks benefitted from the movement to a remote work environment.

Outside the U.S., stocks in Europe and the emerging markets have also posted solid results. Developed international stocks (MSCI EAFE Index) rallied 4.6% in June, gaining 3% for the quarter and 11.7% YTD. Emerging markets stocks (MSCI EM Index) rose 3.8% in June, resulting in a 0.9% gain for the second quarter and a 4.9% return YTD.

Moving to the fixed-income markets, core bond returns (Bloomberg U.S. Aggregate Bond Index) were slightly negative for the quarter as interest rates slightly rose/prices fell. The benchmark 10-year Treasury yield ended the second quarter at 3.8%, up from 3.5% at the end of March. Riskier high-yield bonds (ICE BofA U.S. High Yield Index) gained 1.6% for the quarter and are up 5.4% YTD. Municipal bonds (Morningstar National Muni Bond Category) were generally flat on the quarter and up 2.3% YTD. Actively managed flexible/nontraditional bond funds (Morningstar Nontraditional Bond Category) gained around 2% and are up over 5% for the year.

Finally, multi-alternative strategies (Morningstar Multistrategy Category) and managed futures (SG Trend Index) underperformed stocks but outperformed core bonds for the quarter. Trend-following managed futures had a strong rebound after a tough first quarter, gaining around 8%.

The Narrowest Stock Market in at Least 50 Years

The market-cap-weighted S&P 500 Index's rally this year has been one of the narrowest on record, with less than 28% of the index's constituents beating the overall index return. As shown in the Ned Davis Research chart on the following page, in an average year around 49% of the index's 500 companies beat the overall index. The only other year on this chart comparable to this year was 1998, when the Tech/Internet stock bubble was inflating. That didn't end well, but it took another 15 months before it started to burst.

More granularly, with the sudden frenzy in all things AI, the *average* YTD return for Amazon, Google, Meta, Microsoft, NVIDIA, and Tesla is a whopping 96%. The gains in these six mega cap tech stocks are responsible for almost the entire S&P 500 return for the year. Moreover, the combined market cap of these six stocks (plus Apple), now comprises over 27% of the total index, the largest concentration in history for the top seven stocks.

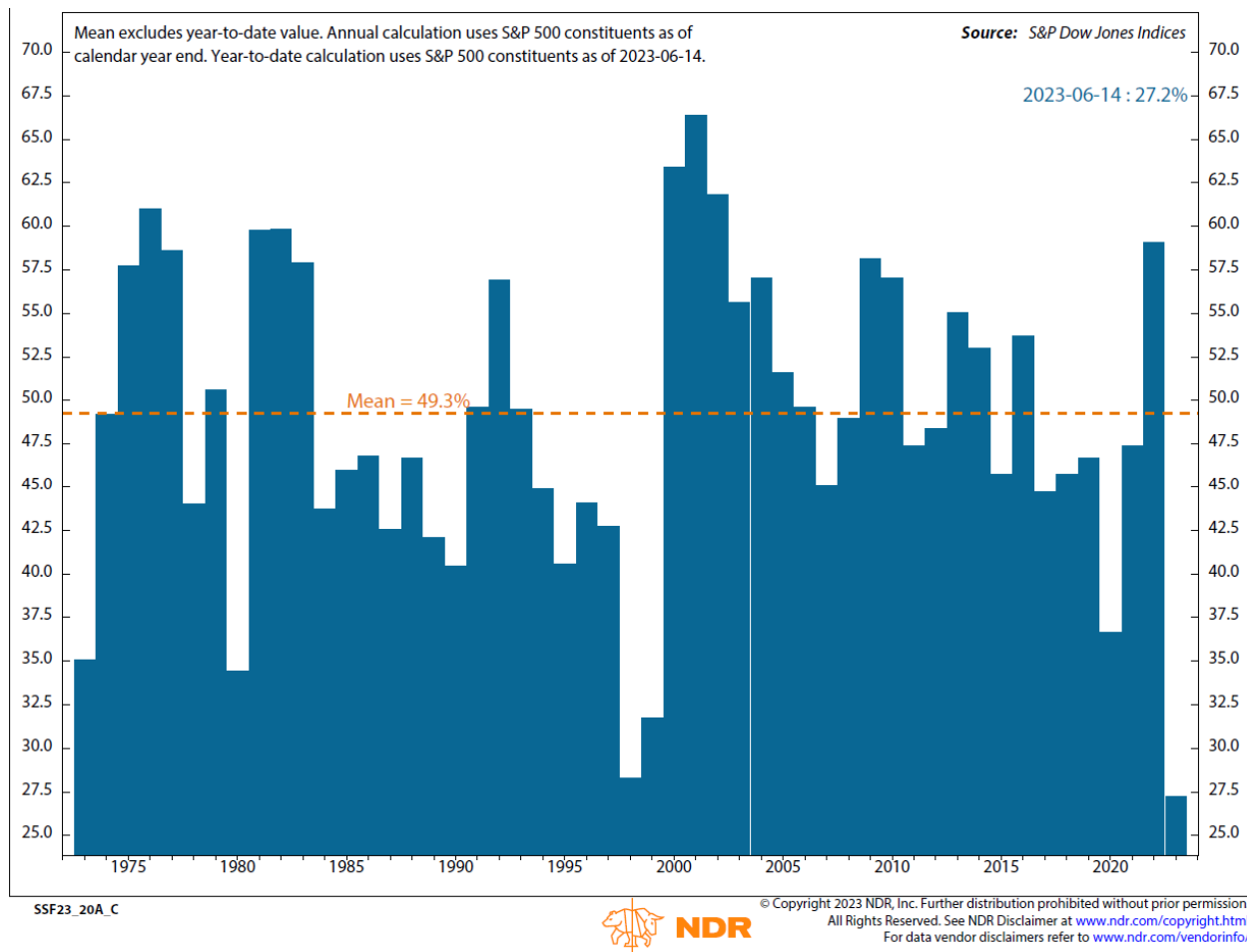
There is nothing inherently bad about a concentration of returns in an index, if the price returns are justified by the earnings of the companies generating those returns. A helpful measure of value is to compare the prices being paid for the top 10 companies in the S&P 500 index with the average earnings per share of those same companies. According to J.P Morgan, as of June 30, 2023, investors were paying an average price of \$29.30 for every \$1.00 of annual earnings generated by the top 10 companies in the index. For the last 25 years, investors have paid on average \$20.10 for every \$1.00 of annual earnings for the top 10 companies. In other words, investors are now paying 46% more for \$1.00 of annual earnings than they have historically paid. Draw your own conclusions from this, but if

history is any guide, it's likely we'll see share prices regress over time toward the long-term average, which implies challenging times ahead for the holders of these stocks, which includes everyone invested in the S&P 500 index, not a small group of investors.

It remains to be seen whether this extremely narrow market rally resolves via the rest of the market catching up or the seven companies mentioned above "catching down," but improved market breadth would be a positive indicator for the market's continued rally.

On a positive note, it appears the stock market rally is *potentially* broadening to other sectors and market caps, the small-cap Russell 2000 index shot up 8.1% in June, while the large-cap Russell 1000 value index delivered similar gains of 6%.

The "Narrowest" Stock Market in At Least 50 Years



Investment Outlook and Portfolio Positioning

The current macroeconomic data continue to send mixed signals. On the one hand, the U.S. economy has been more resilient than I (and many others) expected through the first half of the year. The economy has grown, albeit at a subpar rate. The labor market has remained very strong, supporting consumer spending; and headline inflation has dropped meaningfully, thanks to a sharp decline in energy prices. On the other hand, key leading indicators of an

impending recession are still flashing red, including a deeply inverted yield curve and tightening credit conditions, among others. Moreover, although the Federal Reserve paused its aggressive interest rate hiking campaign in June, core inflation (excluding food and energy) remains stubbornly high, with the Fed signaling it will resume rate hikes later this year, further raising the likelihood of a recession.

As I read the muddy economic tea leaves through my cloudy crystal ball, I maintain my view of a 50/50 chance of recession occurring over the next few quarters. Historically, the odds are unfavorable for the economy avoiding a recession after the Fed has been aggressively tightening. And we have yet to see the full (lagged) impact of this cycle's monetary tightening on the real economy. That said, the labor market continues to be stubbornly strong and historically a strong employment environment is not the best fallow for a recession.

Historically, rate hikes are often followed by a recession, but each cycle is somewhat different, and this one is considerably so due to the pandemic dislocations. There have been three instances (out of 13) where the Fed tightening cycle ended without a recession. So, a more benign near-term outcome is certainly possible, and the current growth and inflation trajectory is not inconsistent with that.

One could argue that all this gnashing of teeth over whether we will experience a recession is wasted energy, because it's likely any such recession will be shallow and transitory. And the potential for interest rate reductions to follow on the heels of this tightening cycle could be the catalyst that turns the current stock market rally into a bonafide bull market.

Just as the U.S. economy has been more resilient than expected in the face of aggressive Fed tightening this year, the U.S. stock market (S&P 500) has been as well -- and then some -- gaining nearly 17%. There are always multiple factors driving the markets, but I think the key drivers of this year's strength include the fact that the economy and corporate earnings have held up better than many expected, the markets are optimistic that the Fed will soon end its tightening cycle, and most importantly, investor euphoria around Artificial Intelligence.

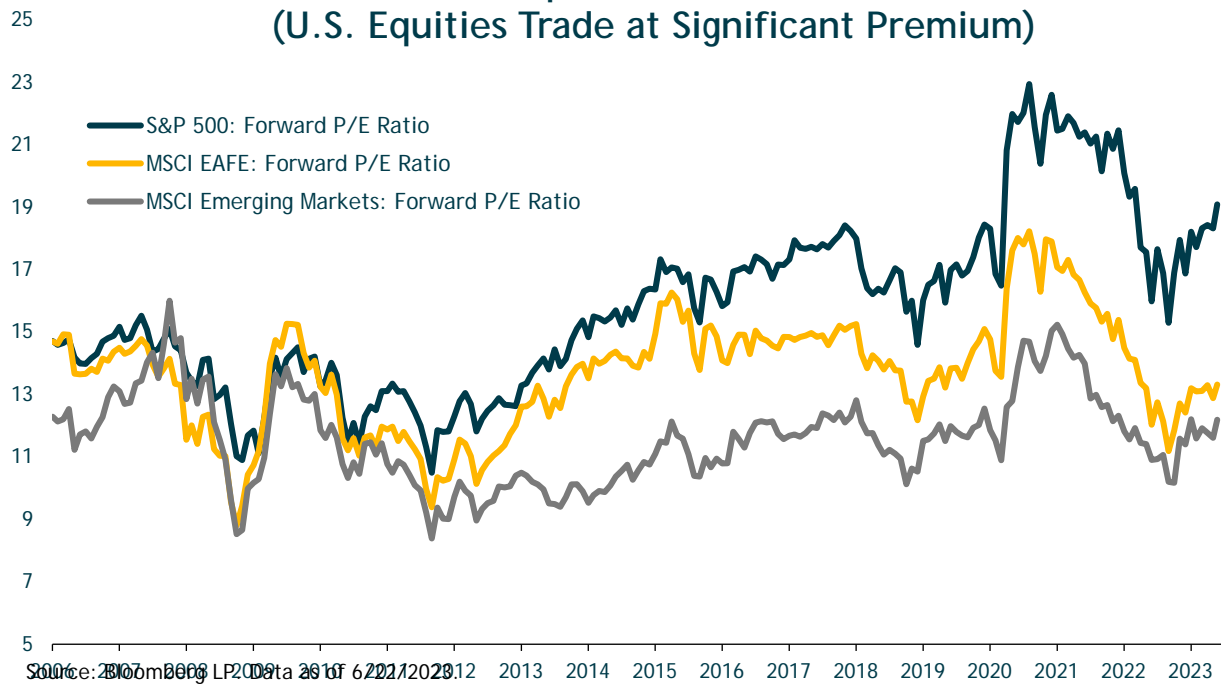
Specific to the last point, I'd argue that while it is likely AI will have a huge impact on society and the global economy, that doesn't necessarily mean the current AI stock frenzy is justified by these companies' underlying earnings fundamentals. It may be in some cases. But I can also remember the tech/internet stock bubble in 1998-2000. The internet obviously has had a huge economic impact over the past 25 years, but very few tech stocks were priced appropriately in early 2000.

As an example of the current AI exuberance, Nvidia, a graphics chip maker used in AI applications, has seen its stock price rise by over 200% this year (as of June 30, 2023), pushing its market cap over \$1 trillion and into the top-10 largest constituents of the S&P 500. Nvidia has strong fundamental earnings growth potential, but its stock is currently trading at a Price-to-Earnings ratio (P/E) of more than 220x! (The overall S&P 500 index has a P/E around 20x, currently.)

While our portfolios maintain significant exposure to U.S. stocks overall, and many of the mega cap tech stocks mentioned previously through our investment in the Invesco QQQ Trust, our portfolios remain slightly underweight U.S. stocks in favor of foreign stocks, and underweight fast growth U.S. stocks in favor of slow growth ("value") U.S. stocks. Put simply -- my analysis continues to suggest U.S. stock in general are trading at marginally expensive valuations; and large U.S. *growth* stocks at nosebleed valuations. These valuations don't adequately reflect the possible economic and earnings recession that could unfold over the next year or so. And while it is true foreign

stocks will likely decline as much as U.S. stocks in a recessionary scenario, foreign stocks are far less expensive than their U.S. counterparts, setting them up for more attractive medium-to-longer term expected returns.

Foreign Equities Absolute Valuations Remain Attractive and at a Deep Discount to U.S. Stocks (U.S. Equities Trade at Significant Premium)



Unlike U.S. stocks, my view of the U.S. fixed-income markets is more positive. With rising yields over the past year, most bond market sectors now offer attractive expected returns relative to their risk.

For example, the yield on the core U.S. Aggregate Bond Index is currently around 4.7%. With inflation very likely to drop below 4%, core bonds are finally providing a positive real (after-inflation) yield. With a duration of around 6 years, the core bond index will also generate strong price gains if interest rates fall during a recession, as I'd expect.

In addition to our core bond exposure, there are many fixed-income sectors outside of traditional core bonds that offer attractive risk-return potential, and I want to access them via our active bond manager, PIMCO Investment Management. Some of the bond sectors in which PIMCO invests are currently yielding in the high single-digits. While the higher yield indicates they carry more credit risk than core bonds, PIMCO is very attuned to risk management, especially heading into a late-cycle/recessionary period. And they have the flexibility to tactically vary their portfolio exposures in response to market risks *and* return opportunities.

Finally, our portfolios maintain a position in trend-following managed futures funds (3% in a typical balanced portfolio) and hedged equity (4% to 10% in a typical balanced portfolio).

Managed futures returns were very strong in 2022 (up over 20%) while traditional bond and stock investments fell double digits. This year has seen sharp reversals in some major market trends that caused losses for trend-following funds in the first quarter. However, managed futures rebounded nicely in Q2, gaining around 4.4%.

Hedged Equity has continued to deliver attractive returns, up 5.7% for the quarter and 13% year-to date. During the steep stock market sell off in 2022, with the S&P 500 index down nearly 20%, the JP Morgan Hedged Equity fund lost just 8%. In short, the fund did exactly what I would have expected it to do in a market like the one experienced in 2022.

I remain confident in trend-following managed futures' powerful *long-term* portfolio benefits in providing alternative and non-correlated returns relative to traditional stock and bond holdings. Trend following strategies are also much less dependent than traditional investments on any particular macro environment. That is, they can perform well whether the macro backdrop is deflationary, recessionary, inflationary, or growth-oriented. That's true diversification.

Closing Thoughts

While I believe a recessionary bear market is a possibility over the next 12-months, there are reasons to believe it could be relatively moderate given the strength of the labor market, ample household savings, and solid corporate balance sheets.

As I extend the time horizon over the next five to ten years, I see reason for optimism. Within the U.S. stock market there are companies and sectors that are reasonably priced and offer attractive return potential. The fixed-income landscape is also attractive, thanks to higher yields and inefficiencies that can be exploited by skilled active managers.

I also see strong total return potential from international and emerging market stock markets, which have been out of favor and underperforming for more than a decade. These markets are not "priced for perfection" as the U.S. market seems to be. Instead they are susceptible to "upside risk" – better-than-expected earnings growth and valuation expansion. While foreign markets will get hurt in a near-term recession, I don't want to try to time "getting out and getting back in" given their attractive five-year return outlook.

I'm an investor not short-term market trader. Strong short-term market trends can trigger emotions and make one want to act – either chasing (buying into) a rising market or fleeing from (selling) a falling one. That is not the path to successful long-term investment outcomes. At the risk of dating myself, I'll quote Louis Rukeyser, who was quick to advise, "Don't just do something, stand there."

Successful investing requires a balance between offense and defense. Earning superior long-term returns does require one to take calculated risks when opportunities present themselves, but to also exercise caution during periods of market exuberance. By maintaining a disciplined and balanced investment approach, our portfolios are well-positioned to weather the inevitable market storms and capitalize on the opportunities sure to arise.

Thank you for your continued trust and confidence.

Best,

Kelly D. Kane, ChFC, CFP®