July 2023

INVESTMENT REVIEW AND OUTLOOK

Eventful

An aborted coup in Russia, a last-minute debt ceiling agreement by Congress, and a second prominent bank failure were just some developments in an eventful quarter. Behind the headlines, the economic news was generally constructive: inflation trends continued to ebb, employment remained firm, and real global GDP for 2023 is projected to grow by 2.1%, according to the World Bank.

Stocks were strong in the quarter, with the S&P 500 posting a total return of 8.7%. Continuing the reversal of last year's trends, growth stocks outpaced value stocks, and the Citigroup Index of Growth stocks returned 10.6% vs. a gain of 6.6% for the Citigroup Value Index. The stock market's leadership was quite narrow, with a handful of stocks providing the majority of the year-to-date gains. According to Strategas Research, 77% of the year-to-date gains for the S&P 500 have been driven by the 10 largest stocks.

Interest rates edged higher during the quarter with short-term interest rates rising in particular; the yield on the 2-year U.S. Treasury note rose from 4.1% to 4.9%. The combination of steady economic growth, the recent debt-ceiling agreement in Washington, and ongoing monetary tightening by global central banks has placed upward pressure on interest rates.

A Bifurcated World

In many respects, today's world is filled with contrasts that create a sense of bifurcation. As noted, today's stock market is sharply divided between strong leadership at the top of the market and more pedestrian returns for the bottom half of the market. A vivid illustration of this phenomenon is Apple's market capitalization, which stands just below $3 trillion; this is a figure equivalent to the entire Russell 2000 Index of small capitalization companies.

Within the global economy, there are also many contrasting signals. In the U.S., measures of consumer confidence remain near multiyear lows, and the Purchasing Manager's Index, a measure of industrial activity, has been declining for over a year. Nevertheless, employment in the U.S. remains strong, with the unemployment rate reported at 3.6% by the Commerce Department for the month of June. Additionally, the ADP private payroll change for June was a robust 497,000. U.S. spending on new manufacturing construction has also risen meaningfully this year, and sales of new and existing homes have also risen, according to the National Association of Homebuilders.

Outside the U.S., the picture is also mixed. Germany, Europe's largest economy, is expected to show negative real GDP growth in 2023, according to the Bundesbank. Similarly, France, Europe's

second largest economy, is expected to grow less than 1% in real terms, according to the Organization for Cooperation and Development (OECD).

Offsetting weakness in Germany and France, the United Kingdom, Spain, and Nordic countries are managing modest economic growth in 2023, according to the OECD.

In Asia, there is also a mixed economic picture. In early 2023, China, the world's second-largest economy, emerged with robust GDP growth following the end of the country's "Zero COVID" policy. More recently, weakening consumer spending and signs of deflation have taken hold in China; the YiCai measure of Chinese economic activity has declined steadily since surging earlier this year. Asian economies closely tied to trade with China have also experienced moderating growth, including Australia and South Korea. In contrast, economic growth in Japan, India, Indonesia, and Vietnam remains resilient.

What are the causes of this bifurcated world? There are many factors at work, but a few common themes emerge. Within the U.S. stock market, the emergence of artificial intelligence (AI) has had a measurable impact on the business fundamentals of a number of leading companies, including Microsoft and Amazon, among others. Following decades of development, AI is being widely adopted for many mainstream applications. To be sure, the recent stock market enthusiasm for "all things AI" may be overdone in the short term, but much like the Internet in the early 2000s, the adoption of AI is real and will impact company growth trends in the years ahead.

There are many crosscurrents within the global economy; however, several are worth noting. In the U.S., the combination of labor shortages, pent-up demand for housing, and a shift toward domestic manufacturing have kept employment steady, while sustaining modest income growth. Outside the U.S., conditions vary greatly from country to country.

In general, receding inflation, and energy prices in particular, have had a positive effect on global economies. This has been especially true in countries such as India, which benefit from purchases of Russian crude oil at below-market prices. The Japanese economy has been greatly aided by the trend toward corporate reform and greater efficiency. It has also been favorably impacted by the decade-long depreciation of the Japanese Yen, which has improved the competitive positioning of the Japanese economy. To place the Yen's decline in perspective, a McDonald's Big Mac in Tokyo was recently priced at $2.85, while the same Big Mac was quoted at $5.23 in New York City, according to local news sources. The weaker Yen makes Japanese goods and services more competitive globally.

Elsewhere in Asia, countries such as India and Vietnam are experiencing an expansion of their manufacturing economies, as companies like Apple seek to diversify manufacturing and assembly operations away from China. Apple recently signaled its intention to increase its iPhone manufacturing in India from 3.5% of global production to 25% by 2030.

On the surface, the disparities in our "bifurcated world" appear stark. However, upon closer examination, there is a logical progression that helps explain the different economic conditions that prevail across geographies.

A Note of Caution

After a difficult year in 2022, the strong equity returns of 2023 have come as something of a surprise to investors. For the year to date, through June 30, the S&P 500 has returned 16.9%, and the NASDAQ has gained over 30%. A number of the large capitalization technology stocks that dominate the NASDAQ have risen over 100%. Encouraging news on inflation and a resilient global economy help to explain some of the gains. While the war in Ukraine and more assertive Chinese leadership provide

reasons for caution, it is also heartening to witness the coalescence of U.S. allies around the globe, and this provides some counterbalance to the difficult backdrop of the last 18 months.

Following the robust stock market gains during the first half of this year, we feel that a note of caution is appropriate for a number of reasons. As mentioned, much of the stock market's return this year has come from a handful of winners. Experience has taught us that narrow stock market leadership often precedes a period of consolidation; the years 2021–2022 were recent examples of this phenomenon. Another reason for caution is the role played by quantitative investment strategies in today's stock market (quantitative strategies refer to model-based investment strategies which are often not tied to fundamental company analysis). Morningstar estimates that passive, index-based strategies have received net inflows of over $6 trillion since 2009. Similarly, quantitatively driven hedge funds account for close to 25% of hedge fund assets according to industry sources. While quantitative investment strategies by themselves do not pose a systemic risk, history has shown that, particularly during bull markets, large inflows to quantitative strategies (such as we have recently experienced) can have a deleterious effect during market downturns (the sharp decline during the COVID pandemic is a recent example).

An ongoing reason for caution is the tighter monetary policies of Western central banks and the accompanying higher interest rates. The year 2022 showcased the impact of higher interest rates on a variety of investments; should interest rates rise materially from current levels, additional ramifications are likely to occur.

Boring Is Good

We are fortunate to hold several of this year's stock market winners for our clients. However, it is our judgment that now is the time to "lean out" from the big winners of 2023; valuations and expectations for these names have increased during the first half of the year. For new client funds today, we are emphasizing short-term U.S. Treasury bonds, which are yielding close to 5%. In addition, the shares of many companies that have been "laggards" in this year's stock market generate significant free cash flow and have dividend yields of 2.5%–3.5%.

As always, we welcome your comments and questions.