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2023 Q3 OUTLOOK LETTER & Q2 REVIEW

I hope you all are having a nice start to the summer. A belated Happy July 4th to all. I'm going to bet that many of you are travelling this summer. Everybody is travelling. Travel stocks have been en fuego. Let's hope covid stays at bay and we all can enjoy getting away a bit safely. The heat and humidity have started in earnest back here in Jersey. With the hot weather upon us, my drink tip for the summer is the ***Italian Aperol Spritz***. Prosecco, Aperol, a splash of lemon-lime seltzer and Orange slice over ice and you can transport yourself to the Piazza's in Italy in case you can't get there in person!

The second quarter was marked by slowly declining inflation, still rising interest rates, a fixation on AI (Automated Intelligence) and calming in the banking industry which had rattled financial markets in Q1. As a result, the S&P 500 exited its bear market from October '22 lows and entered a bull market phase after rising 20% from that bottom. Equity markets marched higher as investors are getting more comfortable with a possible soft landing by the Fed. Again, investors gravitated to Mega Cap growth stocks as both a flight to safety and the best play on AI.

Which brings me to this quarter's investment quote. ***"The stock market clearly values companies that can deliver disruptive innovation" – Steve Blank***. This quote certainly applies to the mania we are seeing over AI stocks. Nvidia started the surge when they surprised investors with a massive lift in guidance due to the strong demand for their AI chips. Many tech stocks followed suit on the way up and although valuations are stretched, the lure of more upside in future sales was too much to pass up. The Nasdaq 100 rose 15.4% as a result while the S&P 500 returned 8.3% with much of those gains coming from a handful of large stocks. The Equal-weighted S&P 500 returned 3.92%, more in line with the broad market. For the year, the equal-weighted S&P 500 is up 6.9% compared to the S&P 500 which returned 16.8% and the Nasdaq 100 which has climbed 39%. Here are price returns of several asset classes for Q2.

ASSET	% RTN	ASSET	% RTN
Lean Hogs	27.3%	S&P SmallCap 600	2.9%
Nat Gas	26.3	US Dollar	1.3
Nikkei 225	18.4	CAC-40 France	1.06
Nasdaq 100	15.4	Euro STOXX	0.9
S&P 500	8.3	Euro	0.65
Dow Transports	7.6	Ishare High Dividend	-.05%
Bitcoin	6.4	Vang Tot Bond	-0.1
Russell 2000	4.8	Ishare HY Bond	-0.6
S&P Midcap 400	4.4	Ishare Muni Bond	-0.9
FTSE MIB Italy	4.1	FTSE 100 (England)	-1.3
Equal Weight S&P 500	3.9	1-3 Yr US Treas	-1.3
IBEX 35 Spain	3.9	Barclays Bond Aggregate	-1.7
Dow Jones Industrial	3.4	Comex Gold	-2.4
DAX German	3.3	Nymex Crude	-6.7

A few other highlights – Aside from Lean Hogs, the Q2 winner was Natural Gas which bounced back after a 50% decline last quarter to rise 26% as summer cooling season started. The Japanese Nikkei 225 has been on a roll and jumped 18.4%. US Stocks otherwise outpaced International stocks. Bond prices declined as yields rose and had negative returns in the quarter. Also, dividend stocks continued to be weak as investors look for growth and prefer bond yields over stock yields. On the downside Crude Oil fell -6.7%, Gold dropped -2.4% and the Bond Aggregate declined -1.7%.

CAPITALIZATION AND STYLE

Growth stocks outperformed Value stocks across all capitalizations again. Large Growth was the top performing group returning 10.55%. In terms of size performance, Large Caps outperformed as the S&P 500 returned 8.68% compared to the Midcap 400 at 4.9% and Small Cap 600 returned 3.49%. Below are total returns for the various indexes. All were positive.

SP 500 Value	6.59%	SP 400 MC Value	4.65%	SP 600 Sm Cap Value	2.11%
SP 500 Growth	10.55%	SP 400 MG Growth	5.23%	SP 600 Sm Cap Growth	4.96%
SP 500	8.68%	SP MC 400	4.92%	SP Sm Cap 600	3.49%

SECTOR ANALYSIS - S&P SECTORS

Technology	16.9%	Basic Materials	2.76%	Utilities	-3.26%
Communic Svcs	12.8%	Industrials	6.0%	Health Care	2.51%
Consumer Discretion	14.3%	Real Estate	0.8%	Energy	-1.79%
Financials	4.8%	Consumer Staples	-0.2%		

Technology led the way again thanks to Apple (+17.5%), Microsoft (+17.8%), and Nvidia (+53.2%). Communication services were led by Meta +(35.3%) and Alphabet (+15.8%) while Tesla (+33.2%) and Amazon (+26.8%) led the Consumer Cyclicals. These are huge moves by big stocks which drove the market as discussed earlier. Energy declined with lower crude prices and financials rebounded somewhat after a poor Q1. Utilities declined 3.3% due to higher bond yields.

ECONOMY AND KEY TAKEAWAYS LOOKING AHEAD

The Federal Reserve paused its rate increase series last month to let the prior increases percolate and see what the effect on inflation would be. Well, CPI is hot off the press today and better than expected with monthly CPI at .2% and headline inflation at 3%, both lows from over a year ago. The good news is that the CPI has dropped for 12 straight months. The not-so-great news is that although Core inflation dropped under 5%, it is still high at 4.8% annually. The current range for the Fed Funds is 5.0% - 5.25%. The CPI numbers are good, but expectations are still for them to resume increases and raise them .25 in July and another .25 this year. Perhaps we are nearing the end. I think they should stop here and let the increases they've put in place continue to take hold and maybe we get the soft-landing we all want.

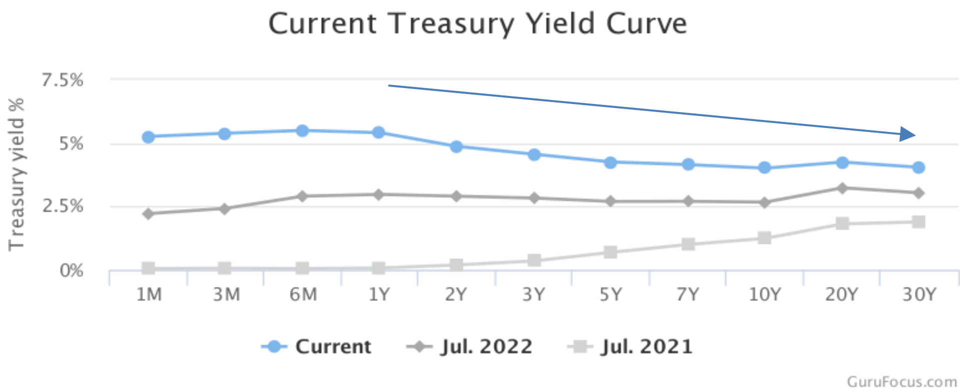
The labor market is continuing to show solid job growth with the unemployment rate at 3.6%. The jobs report for June did show payroll growth slowing but still above 200K. Wages are up 4.4% in the past year helping the consumer to remain somewhat resilient. Along with continued discretionary spending, consumers are still buying houses as housing is constrained by supply for sale. New home sales were up 20% year-over-year, but existing home sales are dropping as consumers don't want to leave their 3% mortgages for a 7% mortgage.

The ISM manufacturing Index remained under 50 (46) for the 8th month in a row, showing contraction. If the economy does head to recession, the goods sector seems to be leading the way. Meanwhile the ISM Services Index rose to 53.9 showing expansion. The service sector is offsetting the manufacturing sector and is a source of strength in the economy but also positively influencing inflation.

GDP growth for Q1 was revised to 2% in the final reading. With corporate profits likely to decline in Q2 (more on that later), GDP growth is likely to remain subdued although positive. Whether we will enter a recession is being fiercely debated with both sides making a compelling argument. I still subscribe to the theory that more are accepting -- that we are in a rolling recession over the past year with industries taking turns entering and exiting. Unless the Fed must raise rates more aggressively and longer than expected, I don't see a traditional recession of 2 quarters negative growth.

BONDS

Bond yields rose in the quarter causing a negative return for bonds. But with short-term bond yields above 5%, there remains an attractive alternative to stocks and for excess cash. The Barclays Bond Aggregate Index returned -.94% while the yield on a 1-Yr UST is at 5.4% as of today . The 10-year yield recently cracked 4% but the Yield curve inversion still persists after 1 year, but longer-term yields are higher than a year ago as you see below. The inversion continues to signal a recession is forthcoming as an inverted curve has predicted the last 7 recessions. But is it??



Stock investors seem to think a soft landing is coming. But the inversion says bond traders maybe don't believe it. We continue to recommend short to intermediate bonds (1-3 Yr) for protection of principal and a decent yield (4.5%-5.5%). But we are starting to get interested in extending duration to medium/longer-term bonds as they move above 4% yield. Muni bond yields are attractive and should be compared to taxable yields for taxable accounts. Our view that the Fed may reduce rates in 2024 hasn't changed and if so, bonds can produce an attractive return (5%+) over the next 12-18 months. The inverted yield curve already prices in over 150 basis points of rate cuts as you see the 10Y-1Y spread is -1.4%.

EQUITIES

Stock leadership remained narrow to Mega-Caps, but other sectors and cap sizes are finally starting to participate. The coming earnings season will be closely watched as analysts are predicting a decline of over 7% EPS for the S&P 500. This would be the largest EPS decline since Q2-2020. Interestingly, the market started its rally just ahead of this last inflection point and continued upward to the end of 2022. Beginning in Q3-2023 earnings are projected to begin rising after 3 quarters of decline, a coming inflection point.

Regarding valuation, stocks aren't cheap overall but many stocks outside of the huge caps remain attractively valued. Based on the current consensus estimates, the forward 12-month P/E ratio is 18.9x, which is above the 5-yr average (18.56) and the 10-year average (17.4). It ended 2022 at 16.7x. Interestingly, the Equal-weighted S&P 500 forward PE is 15.7x offering a more attractive valuation at a nearly 20% discount to the cap-weighted S&P 500. It also underscores the relative attractiveness of mid-cap and small-cap stocks compared to large. Among sectors, although technology has momentum, it is due for a pause while earnings catch up. Other sectors which have lagged may finally start to perform better. Keep an eye on financials as they report earnings. Bank stocks have woefully underperformed, and any positive news could help this group outperform.

I am still stubbornly recommending a diverse portfolio with Large, Mid, Small cap and international stocks represented. International stocks, specifically European equities, are attractive on relative valuation. At some point, valuation should matter and something other than Large Caps could outperform and narrow the performance gap. However, in these uncertain times, large caps do provide stability, so they continue to make up the bulk of the portfolio. I'm cautiously optimistic for the 2nd half of the year for further stock gains but after July we do enter 2 seasonally week summer months. If I were to map out the usual pattern, I'd suggest good earnings could lead to a gain in July followed by some weakness into October. Assuming the economy doesn't falter, the last 2 months could resume the climb.

SUMMARY THOUGHTS

The first half of the year against odds, saw stocks appear to outperform dramatically. The headline total return for the S&P 500 is over 16%, all good right? Below that, as mentioned earlier, the Equal-Weight S&P 500 has returned 6.9%, a solid return itself but about 10% below the cap-weighted S&P 500. A handful of mega-cap stocks is what is making the biggest difference. Midcaps (+8.9%) and Small caps (+6%) also have turned in decent performance, but are overshadowed by the large caps. Absent the stunning performance of the Mega-Cap stocks, it would still be considered a nice first half. Meanwhile, bonds have returned about 2.25% for 6 months, not bad for a lower-risk asset. Where to from here?

In my base case and highest probability, I don't see a traditional recession happening given the labor market resilience unless the Fed must get more aggressive to tame inflation. The rolling recession theory, if you believe it, could allow stocks to continue to move higher in the 2nd half as sectors improve. It will not be in a straight line, but by year-end I believe we will be higher 5%-10% in this scenario and the S&P 500 taking out its January 2022 high. I also think the non-Mega-caps outperform the Mega-caps as they make up some lost ground. Something like the equal-weighted S&P index should perform better than the S&P 500. I expect European equities can perform in line with US stocks as well. All this assumes we do not enter a traditional recession because of higher rates and inflation. I think bonds will return 2%-2.5% or so in the second half as the Fed does raise rates a few more times. I continue to recommend holding equities and bonds for balanced accounts and am more a buyer on weakness, though would look to trim some winners back a bit on strength. I wouldn't be surprised to see a traditional seasonal pullback later in the summer in August and September. My bear case to which I assign a much lower probability (especially after today's CPI) is persistent inflation and a recession to occur leading to even lower corporate profits for a few more quarters. The Fed could also overshoot and raise rates too high. This would likely mean a 10%+ fall in stock prices until the Fed stops raising rates and investors key on their likely pivot to lowering rates. This is a lower probability but still can happen in this uncertain environment.

Have a great summer and as always feel free to call or email me with your thoughts.

Bob