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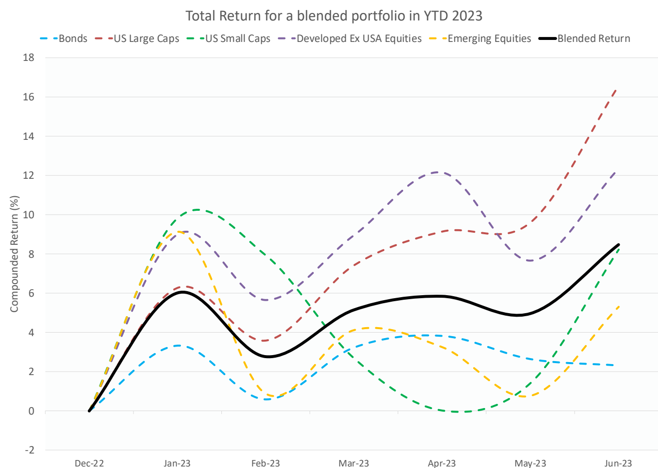
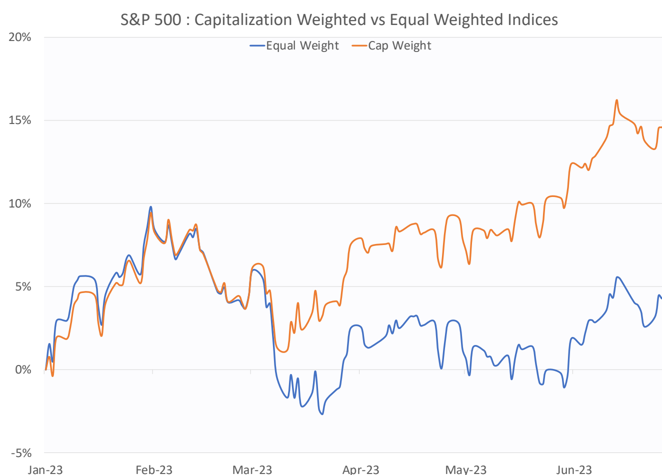
WHERE WE STAND – Q2 2023

In Q2 of 2023, a blended portfolio* of securities had a total return (capital appreciation plus income) of 3.2%. For the year-to-date, such a portfolio is up 8.5% (black line in the chart below). Leading advances are US Large Caps (+16.6%), Developed Markets ex USA (+12.4%), US Small Cap stocks (+8.2%). Emerging Markets (+5.3%) and Bonds (+2.3%) are lagging. See the colored broken lines in the chart.

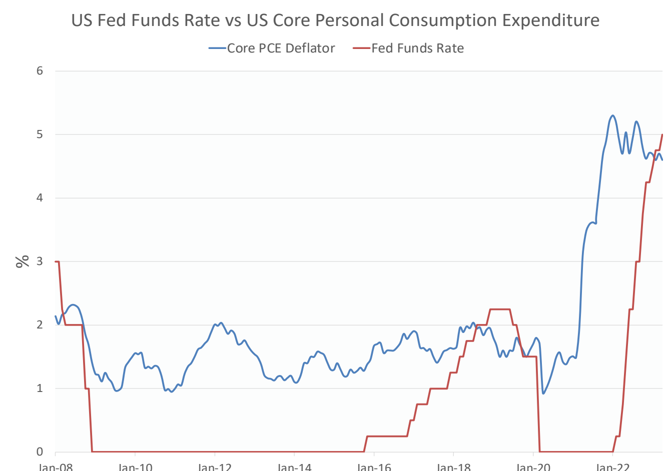


*A typical blended portfolio would be comprised of 60% equities and 40% bonds. For a benchmark, such a portfolio would arguably be 30% large cap US stocks, 10% US small caps, 10% developed markets ex-US, 10% emerging market stocks and 40% US government, investment grade corporate and GSE bonds.

As an aside it is interesting to note the divergence between the Equal Weighted S&P 500 Index and the Capitalization Weighted S&P 500 Index (the latter being the one we are all most familiar with) as shown in the next chart. Beginning in March the two indices started to diverge resulting in unusually different year to date returns. A very select group of mega-capitalization stocks rose much more than most of the other components of the S&P 500. This has created quite the debate amongst market prognosticators, most fitting their conclusions as to what this phenomenon means, to their own bullish/bearish predisposition. The bears argue that the 'narrowness' of the rally points to its fragility; the bulls saying that it is related to those stocks that will benefit from the revolution of artificial intelligence (AI) and that those stocks that haven't enjoyed price gains, will do so in the second half of the year as the 'breadth' of the market expands. Note too that this has resulted in a bifurcation of valuation in the equity market. Those stocks that have rallied have done so due to multiple expansion: for example, Microsoft (an AI leader), up 40% YTD, now trades at an unforgiving 36x PE (twice the market multiple) vs 26x at the beginning of the year, which in itself was not cheap. On the other hand, a more pedestrian S&P 500 member like CVS which is down 25% on the year, trades at a cheap 7.7x PE multiple, off from 12x at the beginning of the year.



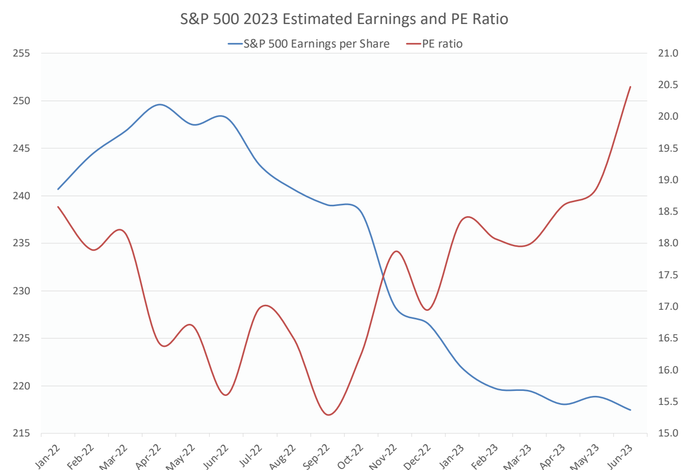
The Federal Reserve increased their base rate by a further 0.25% during the quarter. This action took the rate aggressively to 5% from 0% in March 2022. Red line in the next chart. For the first time in this hiking cycle, in



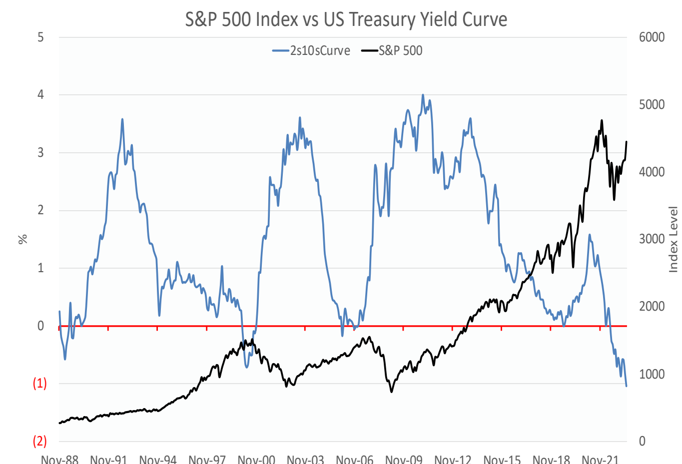
June the Fed passed up the opportunity of raising at successive meetings; pointing out though, that they considered this a pause and that they were likely to raise rates again later in the year.

Although inflation has started to decline (as seen in the blue line in the previous chart) and although the Fed's base rate is now above the current inflation rate (and very much above forward measures of inflation), the Fed feels its job is not done in raising rates, given that its inflation target is 2%. This is because the US economy is showing very few signs of slowing down. Demand for services (like travel) and housing is on the ascendency and unemployment remains at historic lows and wage gains remain robust. This demand, if excessive, fuels inflation pressure.

At the beginning of the year the consensus amongst forecasters was that a recession would develop in the US (due to the Fed's actions) and that earnings would decline to below $200 per share for 2023. However, at the half year mark, this has not materialized, and earnings forecast are hanging in above $215 per share. However, the PE multiple has risen to over 20x 2023 earnings, a reflection of exuberance and I dare say a speculative element infiltrating the zeitgeist. By the way, earnings are now expected to rise by 12% in 2024, as equity markets entertain a 'soft landing' (no recession) for the US economy. This implies a forward PE ratio of 18.5x 2024 earnings, which is not particularly cheap, considering the returns available to investors in risk free securities, like T-bills, of over 5%.



The Fed is achieving inflation fighting credibility, because in the process of raising short term rates, the yield curve has inverted to somewhat historic levels. The next chart (blue line) shows the amount that the 10-year T-note yield trades below the 2-year note's yield (over 1% lower) which is often considered a harbinger of recession (which, in turn, usually ameliorates inflation pressures). The black



line in the chart is the S&P 500 index which as explained above is discounting a soft landing. These two indicators are at odds and need to resolve one way or the other in coming months.

Where We Stand

We believe that somewhere between the AI hype (and the recent increase in momentum/speculative activity in pockets of the investing landscape) and the attractive valuations to be found in other sectors of the equity and fixed income markets, lies the opportunity for investing over the medium term. More towards the latter for us.

As strategized, we had treated 2022 and early 2023 as an opportunity to rebuild our portfolios with the next investment cycle in mind.

Having done so, into securities that we believe have a value bias, we have participated in this year's rebound while at the same time are now enjoying a respectable income on the portfolios.

We are cognizant of, but at the same time, deemphasizing macro issues like the potential for recession and the near-term path of inflation, in the belief that these issues will sort themselves out over time. Similarly, we believe sovereign self-interest will prevent current geopolitical tensions from deteriorating to the point that they become an existential threat to global investing.

Rather, we are concentrating on the bottoms up analysis of the blue-chip companies (and fixed income securities) we are invested in, comforted by the fact that they will prevail over the medium term given their market position and operating and financial leverage. We are enjoying

capital appreciation and our investments pay respectable dividends and interest that is available for reinvestment.

I am confident in the resiliency of our portfolios to unexpected shock and expect to be on the offense if short term negatives create opportunities.