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2nd Quarter 2023 Market Commentary

Conflicting Factors Result in Strong 1st Half for Markets

Markets battled through conflicting factors in the first half of the year to produce strong results. We often remind investors that the stock market and the economy are two distinctly different things. While interrelated, they do not always move in tandem. We say the economy is like the climate and the stock market is like the weather. While areas have certain climates, leading to some amount of long-term predictability, the daily weather can vary significantly from the normal climate. In the long run, climate does tend to prevail, and weather tends to settle into reasonable ranges.

In this commentary, we will talk about these conflicting factors. On the one hand, the economy is dealing with the risk of recession, stoked by a flurry of interest rate rises from the Federal Reserve's attempts to cool inflation. Some economists are convinced a recession cannot be avoided; other prominent economists are predicting a 75% chance a full recession is avoided altogether. On the other hand, the bull market in stocks continues to barrel on, driven by exceptional results for US MegaCap stocks (which we call the MegaCap-8). Most of these gains have been driven by increased stock valuations, not direct increases in earnings. Therefore, it remains a question whether these companies can deliver on the tickets to future success investors have already purchased. Underlying both economic and stock market footing is consumers, who are gobbling up services at massive levels, to offset weakness in goods purchases.

Overall, our portfolios navigated these conflicting factors to deliver strong results for the first half of the year, with returns ranging from mid-single digits for conservative portfolios to low double digits for aggressive portfolios. In this commentary, we will provide information on how markets overpowered the economic concerns in the first half and what we feel are the major items apt to affect markets in the near future.

After discussing Q2 2023 financial market results, we will address three general themes important to TOPS portfolio returns and strategies:

1) The Stock Market vs. The Economy
2) The Federal Reserve's Pause
3) Is AI the Boost Markets are Looking For?

Second Quarter and Year-To-Date Markets Review

Most equity indexes saw positive returns in the second quarter. Growth stocks (S&P 500 Growth) outperformed value stocks (S&P 500 Value), returning +10.6% and +6.6%, respectively. Midcap (S&P 400, +4.6%) outperformed small cap equities (S&P 600, +3.4%). Developed international (MSCI EAFE) returned +3.0%, outpacing emerging markets (MSCI Emerging Markets), which returned +0.9%. Real estate (MSCI World Real Estate, +0.3%) was slightly positive for the quarter, while Natural resources (S&P GSSI NA Natural Resources, -0.1%) saw slightly negative returns for the quarter.

Equity indexes have seen positive returns so far this year. The exception here is natural resources (S&P GSSI NA Natural Resources), which is down -2.9% for the year. Growth stocks (S&P 500 Growth) outperformed value stocks (S&P 500 Value), returning +21.2% and +12.2%, respectively. Midcap (S&P 400, +8.8%) is outperforming small cap equities (S&P 600, +6.0%). Developed international (MSCI EAFE) returned +11.7%, outpacing emerging markets (MSCI Emerging Markets), which returned +4.9%. Real estate (MSCI World Real Estate) has returned +1.0% for the year.

Unlike equity indexes, fixed income saw mostly negative returns in the second quarter. The Barclay's US Aggregate Bond Index had a -0.8% return for the quarter, while the Barclay's US TIPS Index was down -1.4%. Credit (ICE BofA US Corporate Index, -0.2%) outperformed government (ICE BofA US Treasury Index, -1.4%). In the second quarter, high yield (Solactive USD High Yield Corporates, +1.3%) and international bond indexes (Bloomberg Global Aggregate ex-USD, +0.4%) were positive, while investment grade corporates (iBoxx USD Liquid Investment Grade Index, -0.4%) were negative. The 10-year US Treasury yield increased from 3.48% to 3.81% in the second quarter.

For the year, fixed income has seen positive returns. The Barclay's US Aggregate Bond Index had a +2.1% return for the year, slightly outpacing the Barclay's US TIPS Index, up +1.9%. Credit (ICE BofA US Corporate Index, +3.2%) outperformed government (ICE BofA US Treasury Index, +1.6%). High yield (Solactive USD High Yield Corporates, +5.2%), investment grade corporates (iBoxx USD Liquid Investment Grade Index, +4.0%), and international bond indexes (Bloomberg Global Aggregate ex-USD, +3.6%) are all positive year-to-date. The 10-year US Treasury yield decreased from 3.88% to 3.81% in the first quarter.

The Stock Market vs. The Economy

There are always thousands of factors (or variables) which affect movements of stock markets and economic results. We will summarize a few main factors in each area, which we feel have had the most impact recently and will make the most difference for investors.

Much of the story of 2023 is about the MegaCap-8 stocks, including Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, NVIDIA, and Tesla. The S&P 500 is one of the leading diversified equity benchmarks so far this year, gaining 16.9%. However, 8 of the largest stocks in the index (the MegaCap-8) have driven nearly all the return for the index of 500 stocks. In a recent commentary, we wrote four pages of analysis about the MegaCap-8 stocks. While we will not rehash the full analysis, we will summarize a few main points in this commentary.

Here are some eye-opening stats about these stocks:

- They have a combined market cap of $10.5 trillion. (Yardeni)
- They account for 26.4% of the total market cap of the S&P 500 index. (S&P)
- They have a combined forward P/E ratio of 29.4, versus 18.3 for the S&P 500 and 16.0 for the S&P 500 -ex MegaCap-8. (Yardeni)
- For the first time in history, the S&P 500 now has 2 companies which each represent over 7% of the index. Apple and Microsoft represent about 7.5% and 7%. (S&P)
- Last month, Apple's stock market capitalization climbed to the point where that single company exceeded the size of the entire Russell 2000 Index, a commonly referenced index of smaller company stocks. (etf.com)

Several years ago, we wrote a piece highlighting that these large company outperformers should be looked at in a different bucket. At the time, we called them FAANG stocks, an acronym for the leading five companies. While the gang has increased to eight stocks, the narrative has not changed; the stock market continues to be led by a small group of leaders. In every part of society, there are unexplained talents. In sports, art, etc., there are always individuals and organizations which do things others have not been able to do. Looking at the MegaCap-8, we see the success of Elon Musk (Tesla), Bill Gates (Microsoft), Steve Jobs (Apple), Marc Zuckerberg (Meta), Larry Page / Sergey Brin (Alphabet / Google), and Jeff Bezos (Amazon). Along with Netflix, these are companies which have revolutionized modern life. Is Amazon the greatest company in the history of the world? Maybe. Even if they don't prove to be, just being considered in that debate is quite an accomplishment and a logical justification for the success Amazon stock has had.

While the seven companies listed above were big contributors, it was Nvidia which may have been the impetus for much of the return so far this year. If you are not familiar, Nvidia is a U.S. tech company who originally found success creating graphics processing units (GPUs) for video games. Lucky for Nvidia, the GPUs required for video games run similar parallel computations required for artificial intelligence (AI). Unless you have been on vacation without access to the internet this year, you will recognize AI as the leading buzz word of 2023.

While Nvidia is the seventh U.S. company to have reached a $1 trillion market cap (FactSet), it has done so on promise, not statutory earnings. Unlike the other members of MegaCap-8, Nvidia is selling at astronomical valuations. To justify the current valuation of Nvidia, the company must capitalize on AI in one of the greatest transfers of promise to realized profits the U.S. market has ever seen.

With help from the MegaCap-8, the Nasdaq had its best first half since 1983, the S&P 500 Growth index is leading, and the S&P 500 is not far behind. Despite this strong run, the S&P 500 still sits below the pre-COVID highs though. Likewise, large cap US stocks are overvalued through nearly every measure. The MegaCap-8 currently has a forward P/E ratio of about 30 (Yardeni). Remove the MegaCap-8 and you get a P/E of about 16 for the rest of the S&P 500, not much above the historical long term average valuation for the index.

Large cap U.S. stocks are the highest equity concentration in the TOPS portfolios. Likewise, large cap growth stocks are the highest concentration in our growth-oriented portfolios. Therefore, TOPS investors have benefited significantly from the MegaCap-8's incredible run. However, TOPS has also benefited from diversification into a wide variety of other asset classes, which helps to reduce our expected risk. Fortunately, many of these other asset classes currently exhibit attractive valuations below historical averages. Since valuations play a large role in expected return calculations for most institutional investors, every report of expected returns we have reviewed so far this year has the diversifier asset classes held in TOPS portfolios expected to outperform U.S. large cap stocks over the next 10 years. We hope to be able to provide appropriate returns under either scenario, as our disciplined process has done for the last two decades.

There is no doubt stocks have been popular this year, maybe driven from a feeling of FOMO (fear of missing out). However, we believe the biggest question for the near future is, "will the economy drag down the market?" While the market seems to want to keep barreling on, classical economics seems to say that we should have a recession. True, there is no period in history quite like this anywhere in the world, and there has potentially never been a more difficult time to forecast. However, some of the basic numbers are just too hard for economists to ignore.

Through the process of quantitative easing the Federal Reserve carried out over the last 15 years, the Fed Balance sheet increased 10-fold (10x) since 2007. According to First Trust, GDP was only up 180% over that period. Those who follow Milton Friedman, the Apostle Paul of economics, will know if you increase money supply significantly you should expect growth to pick up; then you will get inflation. If Friedman is right, as M1, M2, and M3 money supply decreases, we should see an economic slowdown. M1, M2, and M3 have all gone down in the last year. If it worked on the increase, it should work on the decrease, right? Along with a decreasing money supply, interest rates are up, and we will even see a claw back of about $30 billion of previously approved stimulus spending. The college economics professors must be sweating in their elbow-patched sport jackets, right? Well, many are.

There is more to the story though, hence the theme we chose of conflicting factors. Not many prognosticators believe we are out of the woods yet; however, there are some unique factors Milton Friedman could not have foreseen. He never met the modern-day consumer, and we do not believe he anticipated the impact of the spending of happy Baby Boomers.

Before we even get to discussing the Baby Boomers, let's touch briefly on the current consumer experience. There are two jobs available for every one available worker. Therefore, consumers feel safe in their jobs, and they feel they could get a new one relatively easily if needed. Also, while consumers may exhaust what is left of their pandemic savings soon, that does not mean they are out of purchasing power. Along with rising wages and salaries, Yardeni Research highlights a record $7.6 trillion in unearned income over the last year, including interest income ($1.8 trillion), dividend income ($1.7 trillion), proprietors' income ($1.9 trillion), rental income ($0.9 trillion), and Social Security ($1.3 trillion).

Now for those Baby Boomers. Yardeni reports, "*the consumers' excess saving of roughly $0.5 trillion currently is dwarfed by the net worth held by the Baby Boom generation that is retiring. The Baby Boomers are currently 59-77 years old. The number of seniors (65 years old and older) rose to a record 58.0 million in May. Of this total, a record 46.9 million are not in the labor force, leaving 11.1 million still in the labor force. The Baby Boomers will all be seniors by 2029. The Baby Boomers had $74.8 trillion in net worth at the end of Q1-2023. They have just started to spend it. Their progeny undoubtedly expects to inherit some of that wealth and therefore can save less.*"

Milton Friedman would expect Baby Boomers to cut spending and wait for a more economically sound time to spend. With all due respect for Friedman, the Baby Boomers do not seem to care. They have $75 trillion in wealth creating trillions of dollars in income and they have a definitive window to spend that money (largely on services). This conflicting factor may be leading to one of the key reasons we are not seeing a full-blown recession. Consumers are effectively spending us through the possibility of a cyclical slowdown and that could continue if they do not run out of jobs and money, or the Fed doesn't completely spoil the party to terminate inflation.

This has been possibly the most expected recession in history. But here we are, still waiting for it like a rain cloud on the horizon. Dr. Ed Yardeni thinks we have been in a rolling recession for about a year. He points to the hit housing took and the bottoming in goods and manufacturing. Dr. Yardeni also recently posited, "could rolling recession be evolving into a rolling expansion?"

Stock market investors seem to think the Fed is nearly done *and* will not induce a recession. In other words, stocks appear to be pricing in a "soft landing," a situation where the Fed positions monetary policy to be tight enough to bring inflation back down to its 2.0% target but not so tight that we have a recession. That would be great! We also understand though, while stocks are supposed to discount future earnings,

that does not mean it is a straight line. The narrative right now has some green shoots, which have driven stocks. This does not mean many of the longer-term concerns still do not exist.

We feel this environment favors our TOPS portfolios, and we are encouraged by the opportunity we believe exists to provide appropriate results for our investors over the next decade. What is the alternative? Well, investors could choose to double or triple down their bet on the MegaCap-8. Fortunately, it appears most investors understand the risk in doing that. According to CNBC, while the tech sector had incredible returns, there was about $1 billion in outflows from tech related ETFs in the first half of the year.

This time of year, we always start building our Christmas list. This year, we are asking for a “soft landing,” disinflation towards the Fed’s 2% target, a healthy consumer, and a rally for diversifier stocks to finish the year. Whether Santa delivers or not, our long-term prospects look promising.

The Federal Reserve’s Pause

As we have discussed in previous commentaries, the Federal Reserve has been on a consistent path of increasing the Federal Funds Rate (FFR) since March of 2022. The increases are designed to slow down economic activity to reduce high levels of inflation towards the Fed’s 2% inflation target. In the previous section, we talked about the conflicting factors, which have helped the economy to avoid a full-blown recession to date. A significant amount of uncertainty remains though, and the battle is far from over.

At their June meeting, the Fed decided to forego a change to the existing FFR target. They struggled with what to call it. Was it a “skip” or a “pause”? Either way, they wanted to be clear the committee was not communicating they had reached the terminal rate (the end of the rate rise cycle). Chairman Powell stated after the meeting, “If you look at the data over the last quarter, what you see is stronger than expected growth, a tighter than expected labor market, and higher than expected inflation. So that tells us that although policy is restrictive, it may not be restrictive enough and it has not been restricted for long enough.”

As a reminder, Arthur Burns served as the Chairman of the Federal Reserve from 1970 to 1978. Burns gathered criticism from his failure to raise rates high enough to curb inflation at the time. This decision resulted in one of the worst bouts of inflation in modern history. To correct the issue, Chair Powell’s idol Paul Volcker had to aggressively raise rates in the early 1980s and is revered for carrying out a tough job that needed to be done. It is common thought Powell wants to be remembered like Volcker, not Burns. Recently stating, “there is still a risk of doing too little to bring down inflation,” noting that he wouldn't take hiking interest rates at two consecutive policy meetings "off the table." Further, Powell reiterated at a central bank forum in Sintra, Portugal, that most policymakers expect two more hikes, a point he also made while testifying before Congress.

So, it is highly unlikely the Fed is done. How far will they go and for how long is uncertain and “data dependent.” As investors, the key impact is whether the restrictive policy causes a recession and what impact that would have on stocks. To that end, Powell said he thinks there is a “significant probability” there will be a recession, though he says he does not see that as the most likely case. The next Fed meeting is in July.

Is AI the Boost Markets are Looking For?

The world's economies and stock markets have grown over time primarily through demographics, innovation, and productivity growth. From the industrial revolution to the technological age, innovation has provided a boost on the backs of growing populations who figured out ways to produce more with less.

As investors look to these pillars for future growth, the story is not so straightforward. We have discussed in previous messages about the demographics issues faced by most of the world's major economies, including the U.S. Much like Japan, America is quickly becoming impacted by an aging population. Further, for the last two decades, technology has been sliced and diced every which way to help provide productivity growth. There are not many more industries left which will benefit from simply adding computers, if any. This leaves the world in search of an economic savior.

Welcome the idea of artificial intelligence (AI). As we have noted before, AI promises to do what the brain can do, but faster and with greater focus. A feasible impact of AI would be that AI can boost productivity growth enough to offset the demographic challenges the U.S. (and several other mature economies) face. This could be a huge tailwind for stocks, albeit some of the future success has already been built into stock prices (as discussed with Nvidia). Likewise, it has been highlighted as a major theme driving stocks in 2023.

Through our strategies, we hope AI delivers on the promise this innovative technology carries. As such, we stand to continue to participate in the success of many publicly traded companies who capitalize on growth in this area. However, we remain measured in our excitement and sober in our views of AI, recognizing there are still a lot of questions to be answered. We are reminded of the opportunity one of our portfolio managers had to attend training a few years ago at the acclaimed CalTech, one of the top robotics universities in the world. In meeting with the professors working on the technology, we appreciated the honesty and transparency they provided. Simply put, the world of robotics was nowhere near where many YouTube videos would lead us to believe. While robots of some fashion or another have changed the world in many ways for decades, the leading professor cautioned us regarding what to expect regarding the pace and impact of robotic technology development on the economy.

We have a similar view of the promise of AI. While we are excited about the technology and the promise it provides, we are not making significant portfolio allocations currently to place an outsized bet on AI technology. Instead, we continue to participate in AI from a market capitalization standpoint, recognizing many of the financial benefactors of AI are likely to be the leaders who can harness, develop, and capitalize the technology in the long run.

TOPS Portfolio Strategies

One of the most distinct differences we see between retail investors and the way in which we approach our system of professional institutional portfolio management is the number of variables each typically applies when analyzing a portfolio decision. We find many retail investors tend to focus on one or two main variables when making a decision. For example, a retail investor may dispose of REITs because they read an article about office vacancies, or double down on tech stocks after logging into ChatGPT for the first time. In other words, this is like solving the equation 1+ a = 3. However, while focusing on one prominent variable can sometimes lead to successful results, it is rarely a recipe for appropriate long-term risk-adjusted returns. As professional investors, our systems, experience, processes, and access to data enable us to digest thousands of variables and assimilate decisions into action. So far in 2023, the singular variable which would have produced favorable results is a bet on the largest companies. While we participated importantly in that opportunity, we did not take a big bet. Instead, we maintained measured exposure.

A trade we made this year involved reducing our overall exposure to China. While a key narrative at the beginning of the year was the "China reopening" trade after COVID, our research led us to look more holistically at how China's growth has stalled, as they have reversed the trend of opening their economy which gave them marked growth for over a decade. So far in 2023, this trade has benefitted our investors, as the EMXC position added is our best performing emerging markets position YTD. We also made some changes this year to better position our portfolios in the REIT market. We believe these changes are essential to our efforts to optimize risk-adjusted returns.

As we discussed throughout this commentary, there are a lot of conflicting factors at work in the economy and the markets. We are consistently humbled by the trust our investors continue to have in us, throughout the 20 years of serving them. Our goal primary goal remains to navigate markets in the best interest of our investors to provide appropriate risk-adjusted returns. We believe our strategies have never been more capable of delivering on that goal.

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