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Capital Management LLC

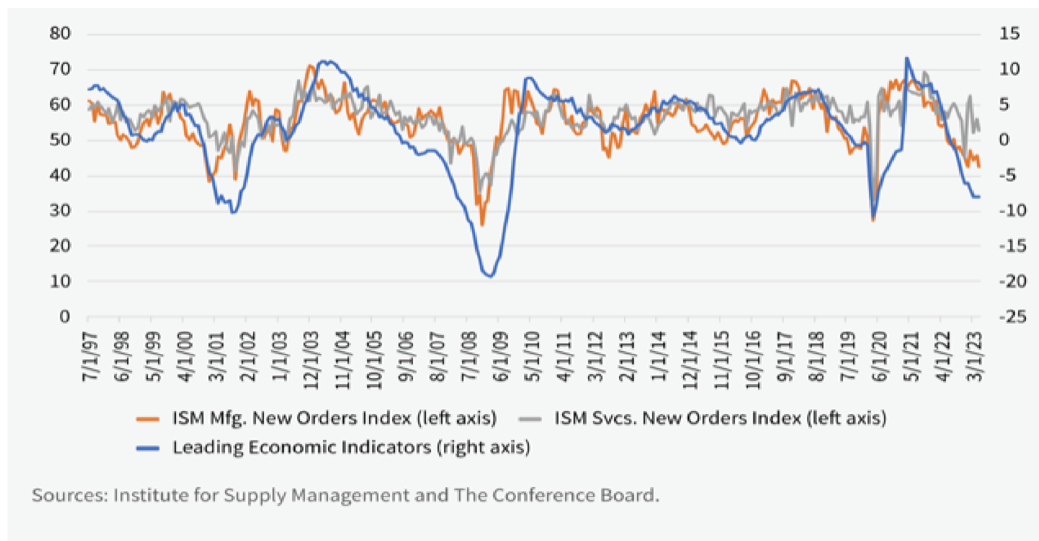
2023 *SECOND QUARTER* SUMMARY

Defying consensus expectations, U.S. equities ended the quarter sharply higher. A narrow group of U.S. mega-cap growth stocks spearheaded the rally in riskier assets; non-U.S. equities registered more modest gains. The advance came amidst still elevated but moderating headline inflation and expectations that FOMC interest rate increases were near an end. Surprisingly, resilient economic growth also contributed to the market's overall strength. Continuing their first quarter momentum, growth stocks outperformed value stocks by their strongest relative performance in 25 years, albeit with extremely narrow participation. The traditionally more defensive sectors, including healthcare, consumer staples and utilities, ended the quarter with small declines. The Energy sector was also notably weak. The seven largest stocks in the S&P 500, dubbed the 'Magnificent Seven', buoyed by the potential for artificial intelligence, have been responsible for a significant part of the Index's first half performance. The return spread between these seven and the rest of the constituents in the Index was at its widest since 2000, according to Bloomberg data. Excluding this group, the Index would only have returned 6.3% in this year's first half. Performance in developed international markets was mixed, though the MSCI-EAFE Index (an equity index that captures large and mid-cap representation across 21 Developed Markets, excluding the US and Canada) finished the quarter up 2.95%. The concentration of leadership in larger stocks has been a worldwide phenomenon, but it has been most pronounced in U.S. indices. Developed markets broadly outperformed emerging markets. Treasury bond yields moved higher across all maturities. The yield curve remained significantly inverted (short-term rates higher than those on longer maturities), underscoring the continuing expectation that higher interest rates will eventually succeed in slowing the economy. The 10-year Treasury closed the quarter with a yield of 3.84%, up from 3.47% on March 31st. Shorter duration bonds outperformed those with longer maturities. Credit-sensitive fixed income categories, such as emerging market debt and corporate high-yield bonds, posted positive returns, but rising interest rates dragged most bond categories lower in price. The Bloomberg Aggregate Bond Index ended the quarter lower by 0.84% but was still positive for the first half. Commodities were broadly lower. Industrial metals and oil were notably weak. Crude oil fell more than six percent to nearly $70bl; oil prices are down 33% over the last year. Gold was lower by two percent. The U.S. dollar appreciated modestly. Interest rates have been the key driver of currency performance this year and the dollar benefited as the Fed kept hiking rates. On a long-term basis, non-U.S. currencies appear undervalued relative to the dollar.

COMMENT:

THE LAST MILE

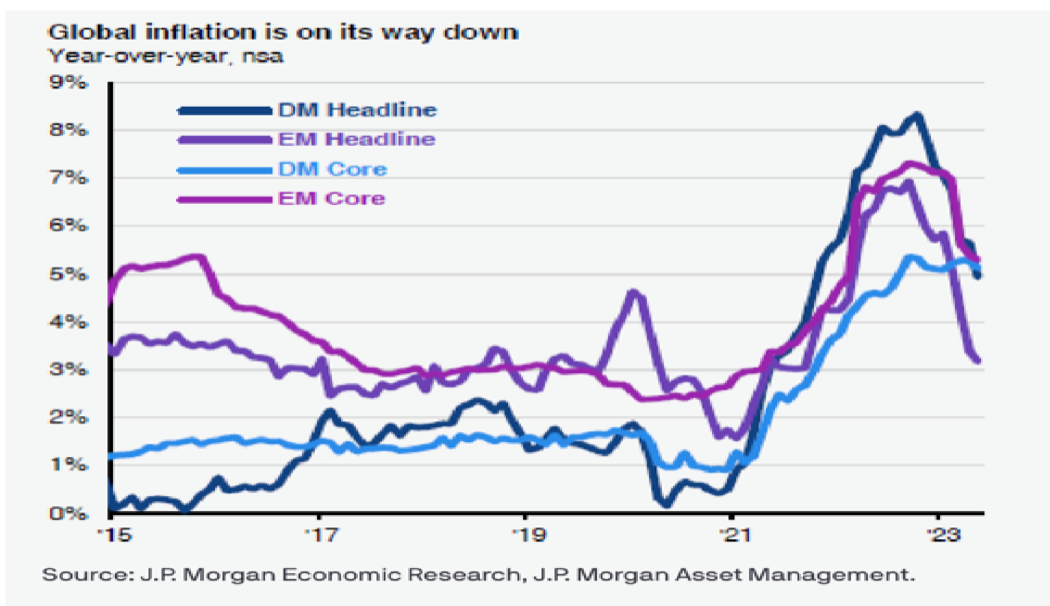
U.S. real personal consumption, supported by the strong labor market and rising wages, has been important in explaining the resilient economy and still expanding GDP, despite significantly higher interest rates. First quarter GDP was revised up to 2.0% (annualized), substantially higher than the earlier estimate of 1.3%. So far, job growth has remained strong with payrolls adding a monthly average of 283k jobs during the quarter. While the unemployment rate in May rose to 3.7% from 3.4%, a larger than expected move, the labor market nonetheless remains historically tight. The low unemployment rate, higher real wages, and this year's nine percent cost-of-living adjustment have helped, in part, to explain resilient consumer demand. About 70% of GDP is determined by consumer spending. "The question remains how resilient the sector can be in the face of an ongoing decline in manufacturing, and with the potential lagged effects of prior rate hikes (looming)," said the Chief economist at S&P Global Intelligence. US business activity expanded in June at the slowest pace in three months, held back by a deepening contraction at factories. The US Leading Index has declined in each of the last fourteen months pointing to weaker economic activity ahead.



First quarter earnings for the S&P 500 declined 2%. *The consensus analyst forecast is for second quarter earnings to decline about 7.4%, according to FactSet.* A Bloomberg survey's confirms this expected decline with analysts expecting lower margins on flat sales. If realized, there will have been no earnings growth in the first half of 2023. *However, these* surveys also show analysts projecting positive earnings growth in the year's third and fourth quarters. Therefore, consensus is expecting guidance that corroborates this more positive outlook. *Remember, it's usually 'change on the margin' that's important to the markets.* While strength in the labor market may continue to support the economy, near-term, tighter lending standards, a continued contraction in the manufacturing sector, stubbornly high core inflation and higher interest rates remain a challenging hurdle. In the short-term, the economy and corporate earnings often diverge, but longer-term, corporate profits are always linked to an economy's

vibrance. With strength in a narrow group of stocks masking the first quarter's relatively flat earnings picture with deteriorating profit margins, the critical factor for equities now is whether the lagged effects of higher interest rates have begun to impact the economy more broadly. While strong earnings typically drive higher equity valuations, so far, *multiple expansion has been largely responsible for the year's higher first half equity performance.*

The *last mile* for tightening. In May, the FOMC increased the overnight rate by another .25%, targeting a new range of 5-5.25%. This was the Committee's tenth-rate hike since early 2022. The Fed has enjoyed significant progress in curbing *headline inflation*, which has fallen from a peak of over 9% to nearly 4%. However, core inflation (ex-food and energy) has been stickier, hovering near 5% for four months, and undercutting optimism. The Federal Open Market Committee's current median outlook (the dot plot) shows a rate of 5.6% by the end of 2023. *While the consensus still expects a mild global recession starting later this year or in early 2024, many financial and economic paradoxes have made it difficult to estimate this risk.* While global central banks seem near the end of their rate-hiking cycles, and disinflation trends continue to take shape, their rhetoric suggests none are close to easing policy or normalizing rates.



Not a reference to the classic Western film, the '*magnificent seven'* are the largest stocks in the S&P 500, Apple, Microsoft, Tesla, Amazon, Nividia, Google and Meta Platforms, that now make up 28% of the Index's value, its *narrowest breadth in its history.* The market's euphoria with artificial intelligence (AI), has trumped all major issues that have confronted sentiment this year, recession fears, elevated levels of inflation, prospects for still higher interest rates, geopolitical risks, the debt ceiling debate, and even the collapse of several regional banks. The market's narrow rally has drawn comparisons to the dot.com era. However, we suspect the long-term productivity benefits of AI will be more

enduring, though whose present value may be equally difficult to assess. While current valuations among many large-cap tech stocks appear extremely elevated, especially in view of limited near-term earnings benefits from AI, *the technology seems like a legitimate wild card factor.* Goldman Sachs is among those making the first attempt to quantify AI's potential financial impact. *It estimates that AI could boost productivity by as little as 0.25 percentage points or as much as three percentage points over the next 10 years, with a baseline of 1.5 percentage points.* Using the baseline outcome, it estimates there would be 5.4% compound annual growth in the S&P 500's earnings over the next 20 years, compared with the 4.9% rate that its analysts' models currently assume. Goldman Sachs says that would point to a fair value for the S&P 500 Index that is 9% higher than today's. *It adds, however, that deteriorating near-term economic growth "would likely more than offset the potential long-term boost from AI adoption, especially given the extreme uncertainty around AI implementation."* Buoyed by speculation on AI's potential contribution and emerging possibilities, the even more inclusive NASDAQ 100 Index now trades at twenty-six times forward earnings, or some 30% above its 10-year average. This tech-heavy benchmark is up more than 37% this year, after losing 33% in 2022. With the 'magnificent seven' stocks currently accounting for more than half this Index's capitalization, NASDAQ recently undertook a 'special rebalancing' to reduce the weight of these stocks in the Index.

BTW, how did that 'unrelated' Western film end? The analyst who coined the phrase "the Magnificent Seven" tapped into a deeper narrative of changing fortunes (*intentional or not*). In the 1960 film, four of the seven gunslingers hired to defend the village against bandits didn't make it out alive. The three survivors regarded themselves as no better off for their troubles.

Uncertain outcomes persist amidst aggressive monetary policy and resilient economic data. Rising interest rates are likely to remain a key theme for the rest of this year. We remain fundamentally cautious, but timeframe is everything. The short-term potential for this resilience to persist leaves us with conflicting signals. A frothy mix of momentum and exuberance over AI could coax the S&P 500 to levels last seen in the beginning of 2022. *At a relative P/E ratio of 1.8x, mega-cap stocks are more expensive relative to the rest of the S&P 500 than they've been since 2003.* Medium-term, we see more potential for markets to realize the lagging impact of higher rates, stickier than expected inflation, tighter financial conditions, and ebbing liquidity. We have expanded our commitments in hedged equity, which has performed well. These investments have allowed us to add exposure to the Index's large-cap growth sectors with a reduced downside risk. While diversified, we have maintained an overweight to healthcare, a more defensive sector. Although lagging year-to-date, this sector is supported by stronger fundamentals, higher dividends and has performed well in prior periods following yield curve inversions. Short-term bond proxies continue to offer attractive returns, though we will look for opportunities to extend duration.