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Investment Committee Perspective

Second Quarter 2023

Our Investment Committee meets quarterly to evaluate asset class performance, analyze macroeconomic data and trends, and review asset class valuations and risks to refine our market outlook and tactical portfolio positioning. This quarterly investment committee perspective summarizes the topics discussed during those investment committee meetings and provides guidance on our outlook and corresponding tactical investment strategy.

Reflections on the Second Quarter

Equity markets in the second quarter experienced an exceptional surge driven by companies with exposure to artificial intelligence lines of business. This remarkable rebound stands in sharp contrast to the difficulties faced by the technology sector in 2022, which experienced a prolonged slump and saw widespread layoffs affecting tens of thousands of technology workers during the winter months. The Federal Reserve stoked the fire by opting to pause its monetary policy tightening at its June 2023 meeting. This decision was influenced by the Q1/Q2 banking turmoil and potential repercussions on credit conditions, reflecting the central bank's cautious stance at that time. The pause in the interest rate hiking cycle comes after the Federal Reserve elected to hike interest rates an additional 0.25% during its May 2023 meeting, resulting in the current federal funds range of 5.00% – 5.25%.

One of the most prominent uncertainties that *seems* clearer in recent quarters is whether the U.S. economy is headed for a recession. The macroeconomic data monitored by the National Bureau of Economic Research (NBER), who serve as the official recordkeepers of U.S. recessions, show no clear evidence of a recession so far. Consumer spending and wage growth appear robust and the June 2023 measurements of inflation and unemployment sit at 3.1% and 3.6%, respectively. None of these economic datapoints indicate a current recession but one of the difficulties of forecasting an official recession is that macroeconomic data is inherently backward-looking while the financial markets are forward-looking.

Financial markets often decline <u>and</u> recover far in advance of when economic peaks and troughs are declared. For example, the NBER declared in June of 2020 that a U.S. recession began in February of 2020. Months before the announcement was made, the market declined a total of -34% during February and March of that year. By the time the recession was *announced* in June, the equity market had already fully recovered behind a +45% rally. In July of 2021, more than a full year later, the NBER made an official determination that the U.S. recession ended in April of 2020. From when the beginning of the recession was first announced to when the end of the recession was declared, the S&P 500 rallied an additional +35%. While observers waiting for official declarations sat on the sidelines, the market delivered generational returns to investors, more than compensating for the extreme uncertainty introduced during the era of COVID-19.

The equity market decline of -25% in 2022 seemed to indicate that a recession was on the immediate horizon. Coinciding with the market downturn, we also experienced (1) two quarters of negative GDP growth in Q1 and Q2 of 2022, (2) a massive wave of layoffs in the technology industry, (3) geopolitical conflict and uncertainty abroad, (4) the highest level of inflation in over 40 years, and (5) three of the top five largest bank failures in U.S. history. Most economic forecasters concluded the U.S. would undeniably be entering a recession given all those negative macro factors. However, despite those significant economic headwinds, the U.S. economy avoided a recession. Meanwhile, as prognosticators debate over whether the U.S. is or isn't in recession, we find ourselves amid a +25% equity market rally since the October 2022 lows, further validating the notion that markets move far in advance of economic outcomes.

How has the U.S. avoided recession given all those negative factors? The only reasonable explanation is that we are in the midst of a rebound within a downturn. The advent of generative artificial intelligence has given lift to an unexpected, yet organic, boom for the overall economy. Enthusiasm behind the AI-wave has created a treasure trove of GDP-growth revisions, has reinvigorated investor sentiment, and has seemingly offset the technology winter experienced in 2022. A wise man once said, "when the wind shifts, adjust your sails to stay on course", and that's precisely what the U.S. economy has done. Whether or not we are experiencing a "Dot.com 2.0" moment is yet to be seen, but for now, on the back of the AI-boom, the U.S. economy is attempting to sail away from the economic doldrums that we've faced in recent quarters.

Economic and Tactical Market Outlook

While there is much to be hopeful about regarding the resiliency of the U.S. economy, setting optimism aside and taking a healthy dose of skepticism, we acknowledge that some concerning data points and portfolio construction implications have taken form. Still, our outlook has improved marginally from last quarter and, while we know we are not completely out of the woods, we are starting to see a clearing.

Economic Considerations:

- While the Federal Reserve left interest rates unchanged last month after consecutively raising the fed funds range 10 times in a row from 0.00% - 0.25% in early 2022 to 5.00% - 5.25% as of June 2023, they indicated two additional rate hikes may be implemented by the end of 2023. This would provide further restrictiveness on the economy, before the full effects of prior interest rate hikes fully materialize.

- Monetary policy changes come with *long and variable lags*. Meaning, policy action takes a significant amount of time to fully percolate through the economy and therefore the timing and magnitude of its impact are difficult to predict. Estimates range from 12 months to as long as 18 months to see the full impact that interest rate changes have on the economy. Of course, over that same period, various other independent economic variables evolve and change, so ongoing monetary policy actions are aimed at a perpetually moving target.

- In addition to the evidence of a historical lag in the effects of interest rate policy, the current hiking cycle has taken longer to influence the economy relative to prior cycles due to multiple factors including the large amount of consumer debt and corporate loans locked in at historically low interest rates. The most prominent example of which is the considerable amount of mortgage refinancing that occurred during COVID-19, as homeowners locked in 30-year mortgage rates at below 3.0% and are now reluctant to sell and buy a new property financed at 7.0%+ rates.

- It is possible that 6-12 months from now, after the economic effects of prior interest rate hikes are more prominent, the Fed will have "overshot" and the economy may very well enter a recession forcing the Fed to then take a dovish stance and cut interest rates to stimulate the economy. The bond market is communicating exactly that outcome through two main signals: (1) the yield curve remains inverted, which has historically served as a reliable predictor of future recessions and interest rate cuts and (2) the futures market on interest rates set by the Federal Reserve are pricing in 4-5 interest rate *cuts* by the end of 2025.

Tactical Asset Allocation Considerations:

- As a result of the recent rebound in technology stocks, the top eight companies in the S&P 500 (the "Mega-Cap 8") now account for nearly 30% of the total market capitalization of the S&P 500 index. The Mega-Cap 8 includes Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, NVIDIA, and Tesla. This represents an extreme concentration, in just a handful of companies, that happen to be all direct potential beneficiaries of the artificial intelligence boom.

- The Mega-Cap 8 trade at a valuation of 31 times earnings. All other stocks in the S&P 500 trade at an average of 17 times earnings. This valuation divide is a result of the Mega-Cap 8 driving nearly 70% of the overall return in the S&P 500 this year. Mega-Cap 8 valuations have ballooned while the average company is flat to slightly-up on the year.

- International equities, small-caps, and value stocks continue to trade at attractive valuations compared to their U.S., large-cap, and growth stock counterparts. While seeking safety from a potential mega-cap tech "bubble", international, small-cap and value stocks trade at relative valuations that are as attractive as any other point in history. We experienced the success of allocating away from growth stocks and their associated massive drawdown in 2022, and today we find ourselves having similar concerns of excessive valuations and potential risk of large drawdowns.

Weighing together both our economic and tactical asset allocation considerations, we are confident our current positioning in client portfolios will benefit from a continued recovery in financial markets. Our cautiously optimistic approach ensures that we maintain a high-quality/defensive tilt, designed to help buffer against additional volatility that may arise from the delayed effects of previous monetary policy actions.

Final Thoughts

Forecasting economic outcomes is a very challenging task given the unpredictable complexities of a constantly evolving system. Further, the ability to use recession signals to forecast short-term market movements is especially challenging because warnings signs of recession are usually coincident with market declines. While understanding, broadly, where we are in the market/economic cycle can prove useful for mitigating risks via tactical asset allocation positioning, we are highly confident trying to time the market or predict short-term market moves is an exercise in futility and ultimately detrimental to the long-term success of investment portfolios. As we've echoed many times prior, staying invested over the long term is the single most viable investment strategy. While we know that sounds cliché, we say it regularly because history shows it results in the best investment outcome. It is important to note that staying invested does not mean staying blindly invested, and that being mindful of investment risks and opportunities is still a critical component of managing an investment portfolio, which is the impetus of our Investment Committee monitoring the economy and markets for potential intermediate-term and long-term secular trends.

Strategic Asset Allocation Update

At the start of 2022, our Investment Committee proudly launched updated strategic asset allocation models with the introduction of two new asset classes: **Private Debt** and **Private Equity**. The overall objective: to deliver our legacy model return objectives but with more consistency, less volatility, and better overall diversification. The eventual outcome: new strategic models that we are confident will deliver an improved all-weather experience for our clients. We expect our new strategic framework to enhance long-term growth of capital, provide a reliable stream of income, and improve downside protection to increase the probability of financial success for our clients.

These enhancements would not have been possible without the democratization of alternative investments that unfolded in the financial services industry over the last 5 years. Historically, Private Equity and Private Debt were available only to the world's largest financial institutions, such as pension funds, insurance companies, and university endowments. Financial product innovation has introduced new types of funds, specifically *interval funds* and *evergreen funds* that provide access to private markets in a new *semi-liquid* format. The introduction of these new private fund structures has leveled the playing field for non-institutional investors by providing efficient access, periodic liquidity, and the same SEC-regulated investor protections that allowed the mutual fund industry to become the behemoth it is today. With that said, private investments are not always available or suitable in certain situations based on client eligibility requirements and/or liquidity needs. In light of that, we will continue to manage and update our legacy asset allocation models.

To date, we have implemented Private Debt for all clients who have signed updated Investment Policy Statements and have successfully reached our targeted allocation of 10% in Private Debt across all models. Next on the horizon is the implementation of Private Equity. We have been thoughtful and diligent in our approach to Private Equity due to a few main considerations: (1) private equity requires *accredited investor* and/or *qualified client* status and (2) Private Equity is inherently *illiquid*. Members of our Investment Committee have been researching Private Equity funds for over 12 months and have conducted multiple due diligence meetings with the leading asset managers in the space. The Committee will soon vote on the approval of 2-3 private equity funds for implementation across client portfolios. Once approved, our goal is to begin implementation in Q1 of 2024 but market conditions and other factors may delay our initial implementation target. Our primary mission is to implement Private Equity *the right way* by focusing on funds that have (1) investor friendly fee structures, (2) a high potency to quality private companies, and (3) experienced management teams that display integrity and competency.

For clients who have not signed updated Investment Policy Statements, we strongly encourage you to engage in conversation with your Investment Adviser to inquire if these enhancements are appropriate for your financial situation. We appreciate the trust our clients place in us and encourage you to reach out with any questions or concerns. Regular communication with our clients is essential to ensure we're meeting your investment and financial planning objectives.

Cordially,

Causey Demgen & Moore Investment Committee
Robb Stone, Nathanael Koch, Stephen Warren, Paul Demgen, John Connell