Portfolio Commentary

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The "Recession Coming In The Next 6 Months" Keeps Getting Delayed

Market Review

As the first quarter ended, markets endured the turbulence of major bank failures, but staged a late March rally when sentiment reached a pessimistic extreme. The hawkish Fed continues to be the major concern, and after that March rally, markets stalled in April. However, when the Fed raised rates 25 basis points in early May, investors celebrated, as the Fed's language was interpreted as signaling a "pause" in its hikes. Markets rallied immediately following, as their belief in a less hostile Fed combined with dramatic improvements in earnings expectations and a strong job market/consumer.

The rally was fueled, in particular, by the broader adoption of AI technology; while the market move in this space has been dramatic, it is too early for us to tell if the gains are sustainable, or if AI faces a crowd-driven bubble. Nevertheless, leadership among Technology has been dramatic, as the sector is up 44.5% year to date, accounting for 10.2% of the S&P 500's 16.4% gain.

During the first half of the year, the market's distribution proved enormously uneven as Technology, Consumer Discretionary, and Communications Services each gained over 34%. Combined, the three sectors drove 16.2% or over 98% of the S&P 500's 16.4% gain! Healthcare, Utilities, and Energy are down for the year, in contrast.

Market breadth did improve somewhat in June, as mid-caps and small-caps have produced short-term chart breakouts. As we will discuss below, a number of prominent warning signs of recession have proven to be incorrect, and June's unemployment report showed a 3.6% unemployment rate. We believe we are unlikely to face a recession, while the jobs market upholds this level of robustness.

Second Quarter Portfolio Highlights

- The portfolio entered the quarter defensively positioned with maximum allocations to U.S. Treasuries, but markets had already begun recovering from the regional banking crisis. In early April, equity and credit markets continued to improve, and thus on April 13th, our models recommended risk-on allocations, increasing equity to maximum weights and reducing U.S. Treasuries to minimum weight. Since the trade on April 13th, the S&P 500 gained 7.6%, while U.S. small-caps were up 4.1%. International equities lagged, as broad international equity increased by 0.2%, while international small-caps fell by 0.7%. As the quarter developed and the rally expanded, our models have maintained their strong bullish bias.

- The portfolio usually employs a 70-30 mix between U.S. equity and international equity; however, in May, we deviated from this and

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overweighted international equities, moving to a 60% U.S. and 40% international mix. This change was driven by a large valuation gap between U.S. and international equities, and our belief that the Fed's eventual pause will create downward pressure on the dollar and will boost international equities.

- For the entire quarter, U.S. equities outperformed international, driven by mega-cap Technology. The S&P 500 was up 8.7%, while U.S. small-caps gained 3.4%. Broad international equity was up 2.7%, while international small-cap was up 2.0%. U.S. Treasuries produced losses as interest rates slowly ground higher, losing 1.9%. Cash equivalents were up 1.1%, and cash continues to compete well against bonds, given the inverted yield curve

Positioning and Outlook

Let's examine the four market segments important to the portfolio and their relative yields (as seen in the table below):

Market Segment and Yield	06/30/23
3 Month U.S. Treasury Bill Yield	5.3%
10 Year U.S. Treasury Yield	3.8%
Bloomberg High Yield Corporate Bond Index Yield	8.5%
S&P 500 Forward Earnings Yield	5.4%

Source: Ned Davis Research, Bloomberg. For illustrative purposes only. Past performance is not indicative of future results.

As of June 30th, T-Bills yielded 5.3%, while 10 Year Treasuries yielded only 3.8%, resulting in a 1.5% yield curve inversion, which was the largest to end any quarter since 1981. Remarkably, cash nearly exceeded the earnings yield of the S&P 500 itself (of course without the potential for earnings growth). As a result, you will not be surprised that cash would currently be our defensive vehicle of choice.

The inverted yield curve is often viewed as a predictor of a recession, as every recession in history has been preceded by an inverted yield curve; however, not every inverted yield curve is associated with a recession. Despite persistent employment market strength, economic fears took hold of markets. In April, a Wall Street Journal survey of economists 65% expected a recession in the next 12 months. To add to that, the Index of Leading Economic Indicators (LEI) has been declining since mid-2022, and its year-over-year change is not much above COVID lows.

With recession warning signs flashing from many corners, many investors found good reason to position themselves defensively. However, the worries of a looming recession have not yet come to fruition (though they persist, and may one day come true). Credit conditions improved notably after the regional bank failures, showing the drama to be isolated and limited in nature. More significantly, in our opinion corporate earnings expectations improved, largely due to the resolute job market. While market participants (ourselves included) will closely monitor recession warning signs, we believe a recession is unlikely to occur amidst such strong employment.

Looking into the second half of this year and into 2024, we believe investors will face the same dilemma that got the bears into trouble – forcing them to chase performance and buy out of FOMO (fear of missing out). Warning signs of economic trouble facing us in the future remain, including the aforementioned yield curve inversions and LEI. More significantly, perhaps, will be the fact that sentiment has improved, and has become overly optimistic in the short term and slightly bearish in the long term.

Another large unknown will be financing costs, as new home payments have skyrocketed amidst rising rates, and many new car purchases can lead to payments of over $1,000 per month. While all these concerns are real, and make us glad to have a defensive, capital preservation methodology in place, the first half of 2023 has proven that in an inflationary environment, employment markets, and the economy can surprise to the upside. We believe a number of bullish factors endure, including:

- Strong first half gains of over 10%, which 75% of the time leads to further markets gains, with a median gain of over 9%.
- Strong, stable credit markets and slowing inflation after a spike in 2022.
- Forward earnings expectations that bottomed in late April.
- Cyclical market leadership from Technology, Consumer Discretionary, Communication Services, and Industrials.

We are closely watching the lower tiers of credit quality in both the high yield and bank loan spaces for signs that lender confidence has soured. When that trend turns negative, we would turn defensive and right now, we would favor cash as king. As of today, though, the strong jobs market and stable credit markets will keep us bullish over the intermediate term.

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The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 80% of U.S. equities.

A Treasury Bill (T-Bill) is a short-term U.S. government debt obligation backed by the Treasury Department with a maturity of one year or less. Treasury bills are usually sold in denominations of $1,000.

The 3 Month Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 3 months.

The 10-year Treasury yield is the yield that the government pays investors that purchase the specific security. Purchase of the 10-year note is essentially a loan made to the U.S. government.

The Bloomberg USD High-Yield Corporate Bond Index is a rules-based, market-value-weighted index engineered to measure publicly issued non-investment grade USD fixed-rate, taxable and corporate bonds

A leading economic indicator (LEI) is economic data that may correspond with a future movement or change in the economy. Leading economic indicators can help to predict an occurrence or forecast the timing of events and trends in business, markets, and the economy.

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