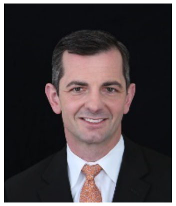


"It is not certain that everything is uncertain."

~ Blaise Pascal

In a poker game, the dealer has an exceptional level of control. He or she shuffles and distributes the cards and set the rules of the game. However, they can't control how players will react to their hands, or how players will react to each other. Now imagine the Federal Reserve is the dealer, the cards being shuffled are interest rates, and the rules of the game are monetary policies. While long-term investing should not be categorized as a high-stakes poker game, the analogy resonates.

The dealer must maintain a delicate balance, and there is a lot at stake. Raising the stakes too high can lead to players dropping out of the hand, just as the Fed raising interest rates too high can slow down the economy as borrowing becomes more expensive.

On the other side of the table are the players, in the economic analogy the market participants. In both a poker game and the economy, participants' strategies are heavily influenced by leadership's actions, while also taking cues from each other. If the dealer or the Fed gets the risk/reward balance wrong, it can cause those participants to panic. But if the risk is too low for too long, the pot (inflation) can become too large, destabilizing the game (the economy).

When we advise our clients how to navigate challenging, high-risk markets, we stress the importance of education about market conditions as well as Fed expectations. This helps them make measured decisions based upon their own risk/reward balance, while resisting emotional moves that may cause them to "go all in" to any one strategy.

A CIO's View

Here are my summaries on several topics affecting markets, all monitored daily by our models. We regularly cover these topics in our monthly Navigator and quarterly Fixed Income Commentary.

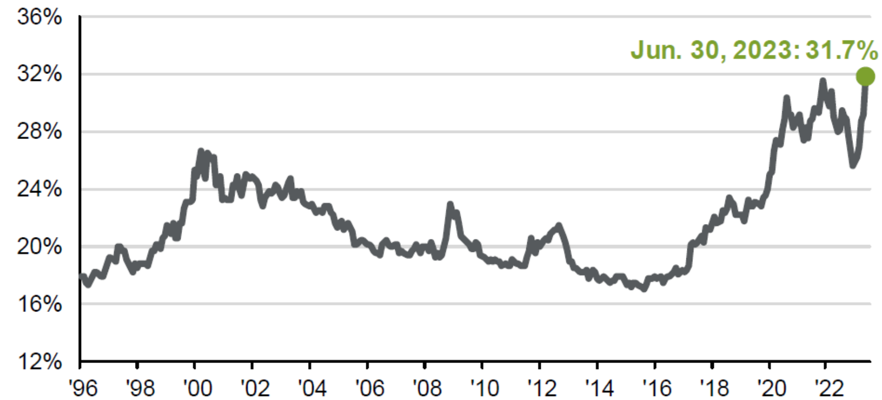
Market Return: A Historical Narrow Rally

We had mentioned in a previous newsletter the potential impact of Artificial Intelligence ("AI"), but have been surprised by the magnitude of appreciation in a handful of stocks. We warrant caution around AI stocks – having seen excessive tech-related enthusiasm before (dot-com, biotech, crypto, SPACs, etc.). We have also seen break-through innovations (computers, internet, mobile phones, smart phones, etc.) but we cannot ignore all the critical elements necessary for a true transformation: think cloud infrastructure, connectivity, smart devices, low information cost, computing power.

At the half-way mark of the year, seven stocks account for almost 75% of S&P 500 returns. Those stocks have an average return of 82%. The median S&P return is under 5%, with 39% of the S&P500 stocks in negative territory and 72% of stocks returning less than the index. This indicates a very narrow rally and a difficult environment for stock pickers.

As of the end of this quarter, the top 10 stocks in the S&P500 represent 32% of the weight in the S&P500, a new high, while contributing to just 21.5% of the earnings (Exhibit 1).

Exhibit 1: Weight of the Top 10 Stocks in the S&P 500 (% of market capitalization of the S&P 500)



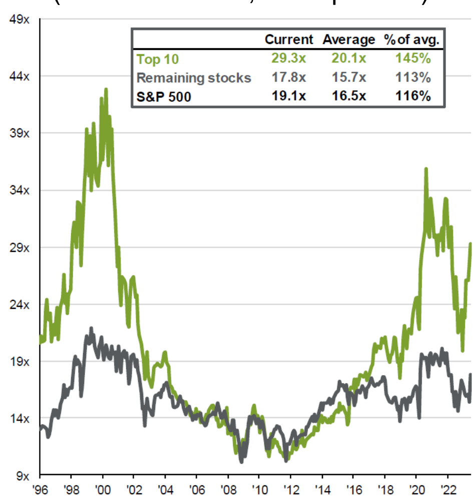
Source: J.P.Morgan, Guide to the Markets 3Q 2023.

Earnings Contribution of the Top 10 in the S&P 500 (Based on last 12 months' earnings)

Source: J.P. Morgan, Guide to the Markets 3Q 2023.

Furthermore, these top 10 stocks are now trading at a multiple about 45% higher than the historical average. Note that over the past few months the rally has broadened a bit and non-Top 10 stocks are also trading at a historical premium, despite a higher rate and a less dovish FOMC outlook (Exhibit 2).

Exhibit 2: P/E Ratio of the Top 10 and Remaining Stocks in the S&P 500 (Next 12 months, 1996-present)



Source: J.P. Morgan, Guide to the Markets 3Q 2023.

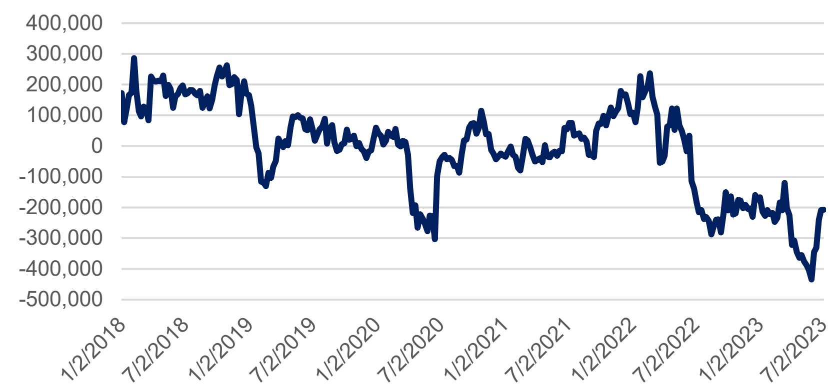
The mega-cap concentration effect is so pronounced in the Nasdaq 100 index that Nasdaq has announced it will undergo a Special Rebalance effective July 24, 2023 to address the overconcentration in the index.

We wrote a note ("Why Equal-Weight Portfolios Can Outperform Cap-Weighted Portfolios") on this topic last month (June 2023), with a longer-term perspective of cap-weighted indices and relative performance versus a broader index.

Recession: Same likelihood, just pushed back

Recession risks have been pushed back for several months, forcing some with bearish positioning to adjust their stance. Looking at the short covering of bearish positions on the S&P500 puts the recent S&P500 appreciation in perspective: at the end of May the non-commercial positioning in S&P500 E-mini futures contracts was at its most bearish point in the past five years, and in less than a month that bearish positioning was sharply cut in half as participants unwound half of their positions by buying back some of their contracts. Notably, this intense net buying activity could be one of the factors behind the sharp appreciation of the market over that period, in which it has more than quadrupled (annualized return for June 2023 was 118%, while the annualized return for 2023 YTD is 25%) (Exhibit 3).

Exhibit 3: Bloomberg CFTC CME E-Mini S&P 500

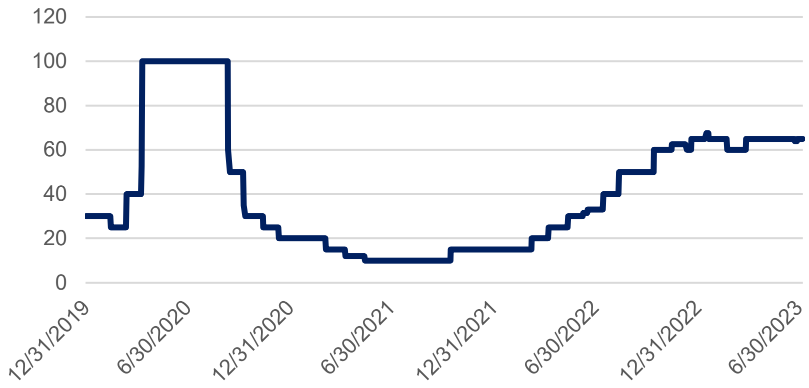


Source: Bloomberg.

While this rally may embolden the bulls and invigorate the market FOMOs (Fear Of Missing Out), we remain skeptical since the probability of a recession is still unchanged at an elevated 65% (Exhibit 4).

The risk-reward ratio remains high for the remainder of 2023: the stock market displays expanded multiples despite a rise in policy rates and real rates with cash yielding 5%, and a decelerating economy due to the Fed's action along with softening consumer trends. This all contributes to lowering the potential for further appreciation.

Exhibit 4: U.S. Recession Probability Still 65%



Source: Bloomberg.

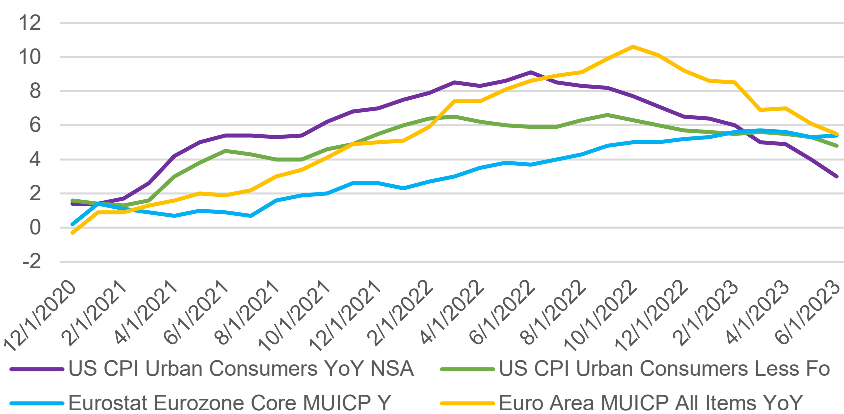
Inflation: Improvements so far but resilience ahead

Updating our inputs from last quarter, we continue to see the same pattern: core inflation is still somewhat stubborn at 4.8% year-over-year (Exhibit 5), while headline inflation is showing signs of deceleration.

The outlook is optimistic regarding shelter inflation and used car prices which soared during the pandemic. However, a tight labor market continues to pressure wages, which could have an inflationary effect as consumers could keep spending more as they feel increased job security.

Core inflation above 3% for the remainder of 2023 and 2024 is a scenario which would trigger hawkish actions from the Federal Reserve.

Exhibit 5: U.S./Europe Core Inflation



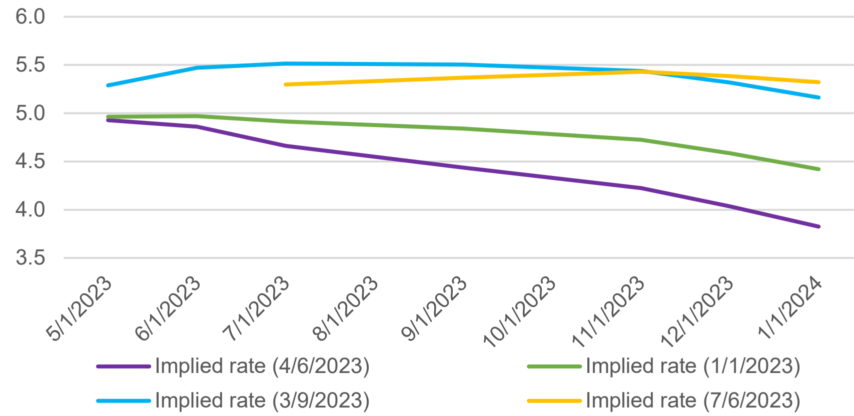
Source: Bloomberg.

Federal Reserve actions: Pause but more hikes signaled.

In June, the FOMC decided to pause, which was first interpreted as a dovish shift. But subsequent communication showed the division within the FOMC and the continued focus on bringing the inflation down, especially within the context of a tight labor market. As can be seen in Exhibit 6, while the rate expectation decreased after the SVB crisis, it has increased substantially to the point of even being higher than the expectation at the beginning of the year for the remainder of 2023: “Higher rates for longer.”

The potential consequences would be twofold: more rate hikes down the road and later rate cuts as inflation could be more persistent than predicted.

Exhibit 6: Implied Rates first moved up in 2023, dropped in March, higher in July

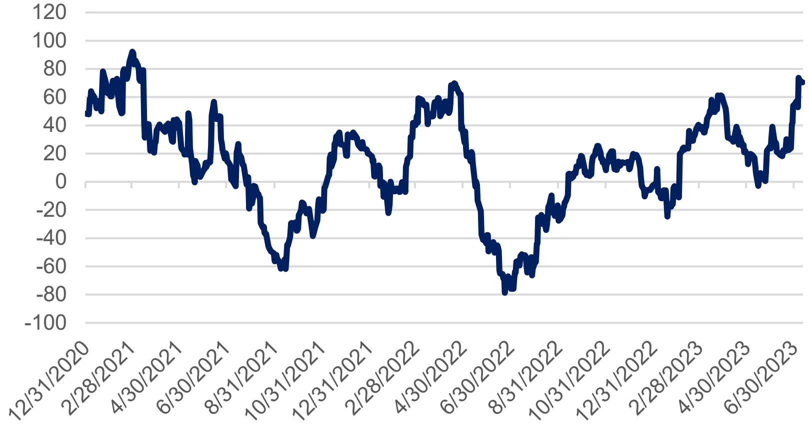


Source: Bloomberg.

Economy: Resilient with some cracks

The Citigroup economic surprise index illustrates the resilience of the US economy: beating expectations and it is almost as high as it was at the end of 2020 (Exhibit 7).

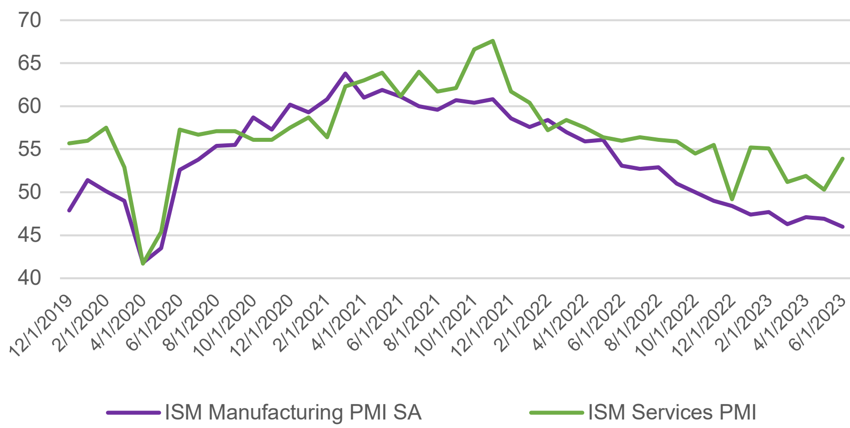
Exhibit 7: Citigroup Economic Surprise - US



Source: Bloomberg.

But beneath that, the effects of the more restrictive monetary policies are starting to show results: the ISM indices have been steadily declining (Exhibit 8), and the conference board leading indicators are in a recessionary phase.

Exhibit 8: ISM Manufacturing and Services PMI



Source: Bloomberg.

Looking forward, we anticipate more weakness in the economy from the lagged effects of the Federal Reserve's tightening policy, combined with banks restricting credit.

Investment Implications

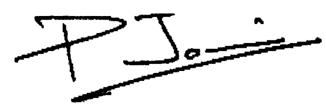
In summary, I have a few considerations for your portfolio given market conditions:

- Remain cautious in the current environment
- Diversify your investments
- Focus on active risk management, and equal-weighted approaches
- Consider getting paid to be on the sidelines with 5% cash yields

Remember like in a poker game, resist emotions that cause you to act impulsively and go all in from a fear of missing out. Thoughtful, measured consideration and diversity in your investment allocations according to your risk tolerance should be made with your advisor.

I hope this letter finds you and your family happy, healthy, and enjoying the warm weather. If you have any questions about your portfolio or would like to discuss your current positioning, please contact your advisor at any time. Our team has your interest at heart and stands ready to help you meet your goals with the proper allocations and financial planning. As always, we thank you for your business. Enjoy your summer!

Warm regards,



Patrick Jamin
President & CIO

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