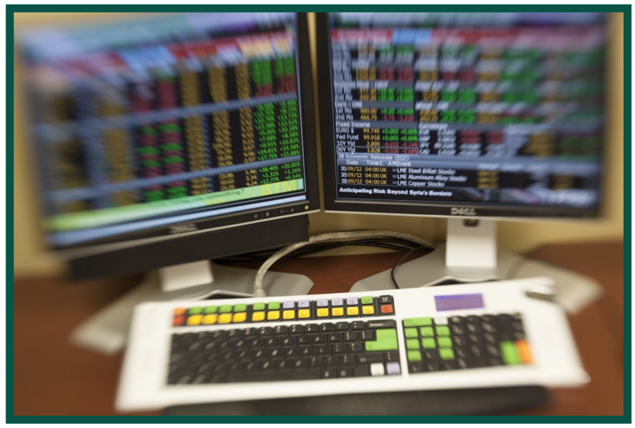
Quarterly Newsletter

2023: Second Quarter **138[th] Edition**



" It is incumbent on every generation to pay its own debts as it goes. A principle which if acted on would save one-half the wars of the world."

~ Thomas Jefferson, U.S. Founding Father and President

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CAPITAL MARKETS SCOREBOARD

Equities					
Indices	**2Q23 Total Return (%)**	**2023 Total Return (%)**	**Index Characteristics**		
Domestic			**NTM P/E**	**P/B**	**Div. Yld. (%)**
S&P 500	8.7	16.9	19.3	4.3	1.5
DJIA	4.0	4.9	17.2	4.2	2.0
NASDAQ	13.1	32.3	27.9	5.5	0.8
Russell 1000 Growth	12.8	29.0	27.0	12.0	0.7
Russell 1000 Value	4.1	5.1	14.5	2.3	2.3
Russell 2000	5.2	8.1	21.3	1.9	1.4
International*					
MSCI EAFE	3.2	12.1	13.0	1.7	3.0
MSCI Emerging Markets	1.0	5.1	12.3	1.7	2.7
MSCI United Kingdom	2.2	8.4	10.2	1.6	3.8
MSCI France	3.8	19.1	13.1	1.9	2.7
MSCI Germany	3.5	18.8	10.7	1.4	3.0
MSCI Japan	6.4	13.2	14.9	1.4	2.3

Fixed Income		
Indices**	**2Q23 Total Return (%)**	**2023 Total Return (%)**
Domestic		
U.S. Corp - Gov (1-3 Years)	-0.3	1.1
U.S. Corp - Gov (3-5 Years)	-0.9	1.3
U.S. Corp - Gov (10+ Years)	-1.4	4.2
U.S. Treasuries Master	-1.4	1.6
U.S. Corporates Master	-0.2	3.2
U.S. Municipals Master	0.0	2.8
U.S. High Yield Master	1.6	5.4
International*		
Developed Markets Sov Bond	-2.5	0.5

Commodities		
Resource	**2Q23 Total Return (%)**	**2023 Total Return (%)**
Precious Metals		
Gold	-2.4	5.6
Silver	-5.9	-6.2
Industrial Metals		
Copper	-8.9	-1.7
Aluminum	-10.3	-11.2
Energy		
Brent Crude Oil	-5.4	-9.6
WTI Crude Oil	-6.7	-11.9
Natural Gas	26.3	-37.5

Key Rates				
Rates	**6/30/2023**	**3/31/2023**	**12/31/2022**	**6/30/2022**
U.S. Target Fed Funds Rate	5.25	5.00	4.50	1.75
2-Year U.S. Treasury	4.87	4.06	4.41	2.92
10-Year U.S. Treasury	3.81	3.48	3.88	2.98
30-Year U.S. Treasury	3.85	3.67	3.97	3.14
10-Year German Bund	2.41	2.33	2.53	1.38
10-Year Japanese Bond	0.39	0.32	0.42	0.22
30-Year Fixed Mortgage	6.71	6.54	6.36	5.52

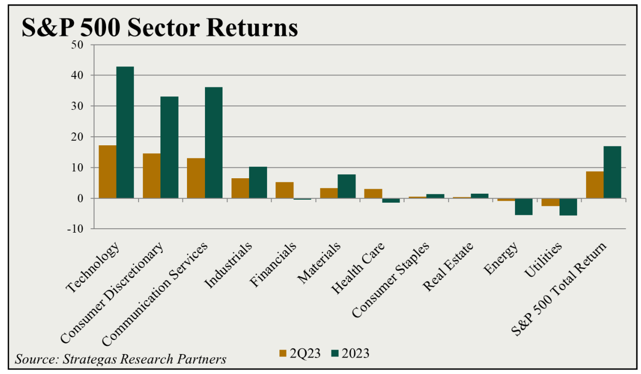
Currencies				
Indices/ Exchange Rates	**6/30/2023**	**3/31/2023**	**12/31/2022**	**6/30/2022**
ICE U.S. Dollar Index	102.91	102.51	103.52	104.69
USD per EUR	1.09	1.09	1.07	1.05
USD per GBP	1.27	1.24	1.20	1.21
JPY per USD	144.54	133.09	131.95	135.86
CAD per USD	1.32	1.35	1.35	1.29

*Returns denominated in U.S. dollars

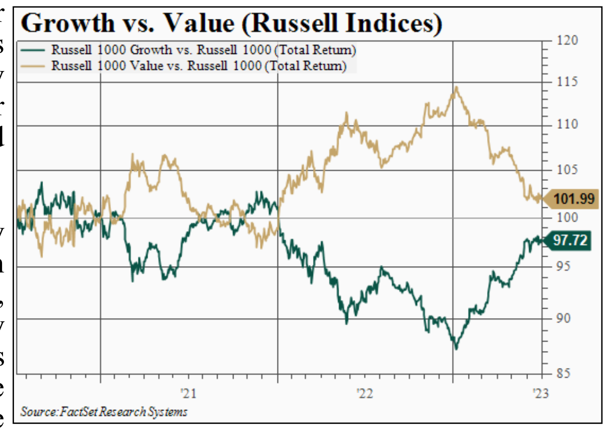
**ICE Bank of America Merrill Lynch (BofA-ML) indices

EQUITIES

- The Standard & Poor's 500 (S&P 500) index posted a total return (price change plus dividends) of 8.7% for the second quarter, bringing its year-to-date (YTD) return to 16.9%. The Technology (17.2%), Consumer Discretionary (14.6%), and Communication Services (13.1%) Sectors led the way while the Consumer Staples and Energy Sectors lagged, both posting negative returns. Smaller U.S. company stocks underperformed domestic large caps, with the Russell 2000 Index returning 5.2% for the quarter. When denominated in U.S. dollars (USD), international developed and emerging market stocks returned 3.2% and 1.0% respectively as measured by MSCI indices.

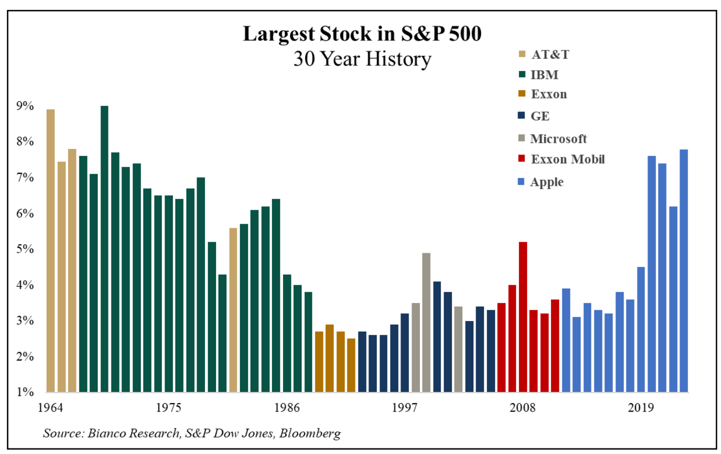


- In 2022, Federal Reserve (Fed) interest rate increases caused longer-duration growth stocks to lead the S&P 500 into bear market territory (a decline of 20%). This year, persistent recession fears have driven last year's laggards to outperform, with investor favor migrating to growth companies whose earnings are less correlated with economic cyclicality. After trailing by nearly 22% last year, growth stocks returned 12.8% for the quarter (29.0% YTD), while value stocks returned 5.1% (just 4.1% YTD) as measured by Russell indices.



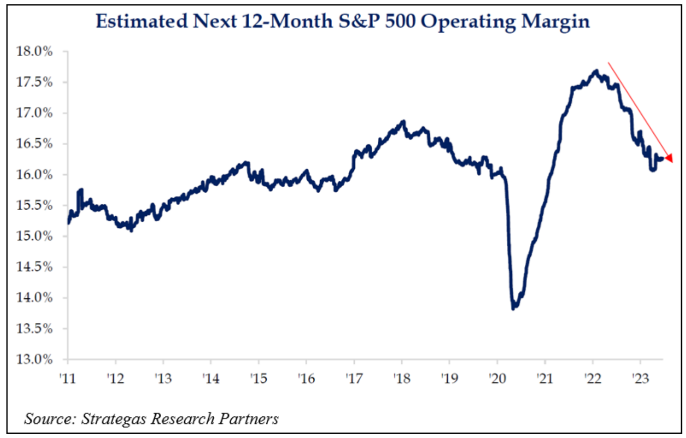
- The growth versus value performance disparity underscores a lack of breadth in the S&P 500. Just seven large, tech-based growth stocks (Apple, Microsoft, Meta, Alphabet, NVIDIA, Tesla, and Amazon) drove virtually all of this year's S&P 500 return before the market's performance finally began to broaden in June. Volatile growth names such as NVIDIA and Netflix, which trade at significant premiums to their earnings, have led tech-based performers after losing more than half of their market values last year. Most of the seven have yet to fully recover their 2022 losses.

- Recent constituent performance has caused significant but often-unseen concentration risk behind the scenes, leaving many index-based investors less diversified than perceived. Apple, for example, reached a $3 trillion market cap in the quarter, making it larger than the German stock market (DAX), French stock market (CAC 40), and Russell 2000 Index, among others. Its commitment to innovation and ability to shape consumer trends have created significant growth opportunities, driving it to comprise nearly 8% of the S&P 500 index. The seven names listed previously were the seven largest weights in the S&P 500 at the end of the second quarter, and at more than $10 trillion in collective market value, account for nearly 28% of the index. Please refer to the enclosed commentary, ***Narrow Markets and Concentration Risk***, for more information on concentration risk within the equities market.

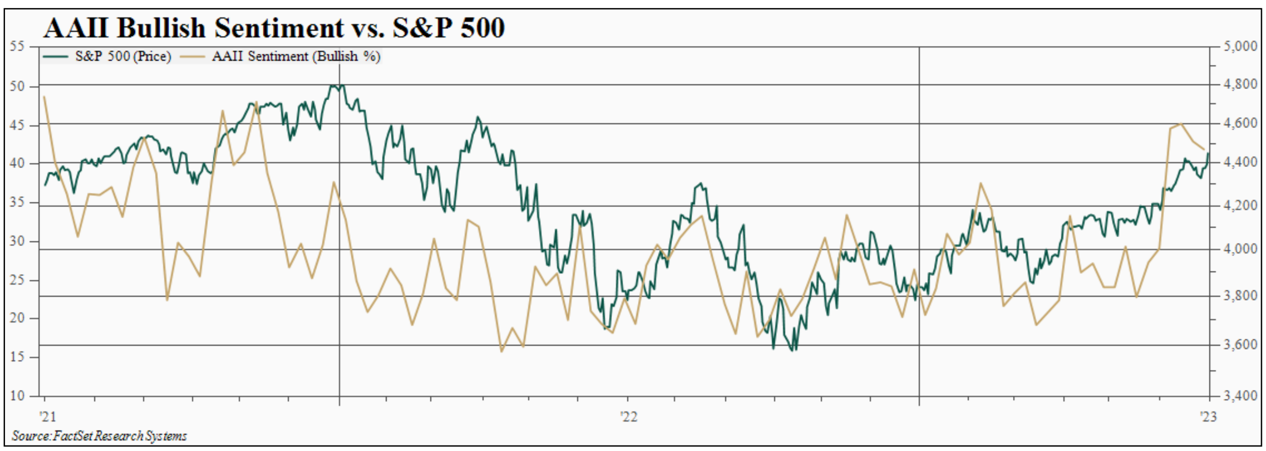


EQUITIES

- As of June 30, S&P 500 companies in aggregate were expected to post an earnings decline for the second quarter of -6.8% versus the same quarter last year. If earnings per share (EPS) estimates are correct, this would mark the largest year-over-year (Y/Y) quarterly earnings decline since the COVID shutdown. Persistent inflation and Fed tightening continue to challenge earnings as consumers become decreasingly tolerant of cost pass-through, also causing margins to contract. In addition, the labor market has become more expensive but less productive. Declining EPS and productivity, even as wages and other costs remain elevated, have spurred growing mention on earnings calls of Artificial Intelligence (AI) to boost efficiency.



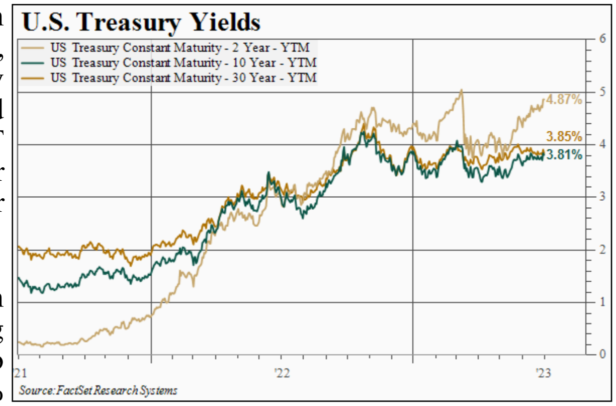
- The American Association of Individual Investors (AAII) sentiment survey measures the percentage of individual investors who are bullish, bearish, and neutral about the stock market over the next six months. In the latest survey, bullish sentiment increased to 46.4%, above its historical average of 38.4%. While market declines have often followed peaks in bullish sentiment, current AAII levels are below levels historically associated with peaks. Also of interest, through the October 2022 market trough, investor sentiment oscillated around its most bearish level since the bottom of the Great Recession (March 2009).



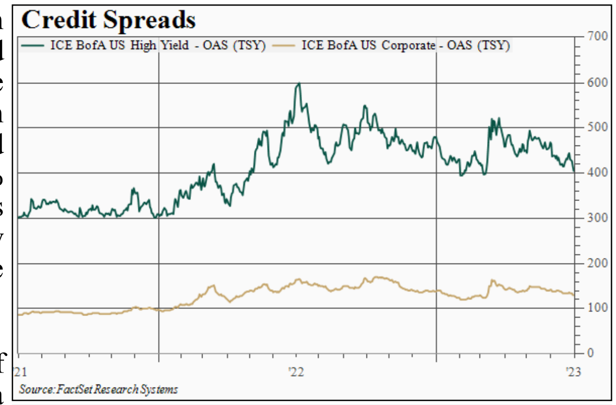
- Lower interest rates generally support higher equity valuations. After compressing significantly under last year's rising rates, S&P 500 company valuations marched higher for the second straight quarter this year despite additional rate hikes. The S&P 500 closed the second quarter with a price-to-earnings (P/E) ratio of 19.1x next twelve months (NTM) earnings. While it may appear overvalued on the surface versus a 25-year average of 16.8x, market P/E does not tell the whole story. Valuations within the index are significantly bifurcated. The Technology Sector trades at a 27.6x multiple versus 10.7x for the Energy Sector. The previously mentioned seven names responsible for this year's S&P 500 performance traded at an average P/E ratio of more than 40x in mid-June versus about 17x for the remaining companies. Importantly, higher valuations do not correlate closely with positive near-term performance. Rather, they are a measure of the underlying price risk equity investors assume.

FIXED INCOME

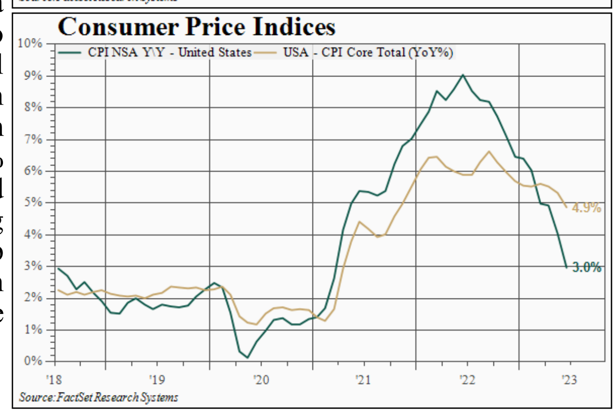
- U.S. Treasury (UST) returns were broadly negative in the second quarter. In aggregate, USTs returned -1.4%, bringing their YTD return to 1.6% as measured by BofA-ML indices. Rates across the yield curve shifted up over the course of the quarter with the 2-year UST yield increasing from 4.06% to 4.87%, the 10-year increasing from 3.48% to 3.81%, and the 30-year increasing from 3.67% to 3.85%.



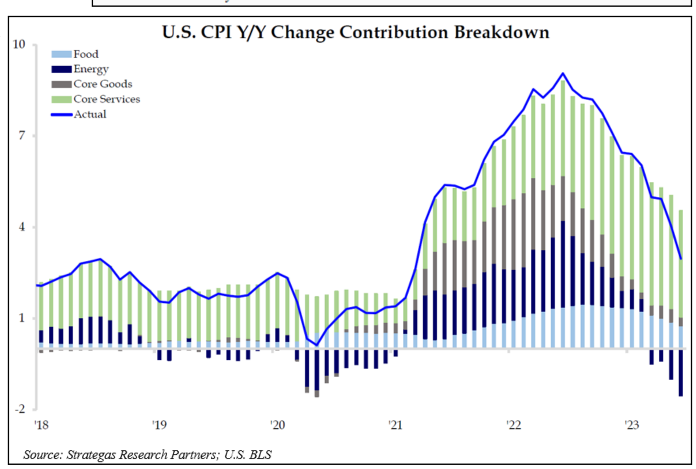
- Credit spreads (the yield differential between government and corporate debt) remained stable during the second quarter, allowing corporate bonds to outperform. Investment grade bonds broadly lost 0.2% for the quarter, bringing their YTD return to 3.2%. High-yield ("junk") bonds outperformed USTs and investment grade bonds as they returned 1.6% in the quarter, making a total first half return of 5.4%. Both investment grade and high-yield credit spreads finished at their lows for the quarter at 1.30% and 4.05% respectively. Despite various other recession indicators creating concern, high-yield spreads remain well below the level they averaged at the start of the past three recessions.



- Bond prices continue to adjust to the Fed's use of interest rates to battle inflation; however, they got a break in June with the Federal Reserve deciding not to raise rates for the first time in ten meetings. The overall June Consumer Price Index (CPI) was up 3.0% Y/Y in June, the lowest Y/Y reading since March 2021. Month-over-month (M/M) increases have stayed below 0.4% since January. Core CPI, which excludes food and energy, decreased to 4.8% Y/Y, the lowest reading since November 2021. Notably, Core CPI was only up 0.2% M/M. Without rounding, this equated to 1.9% on an annualized basis, the smallest M/M increase since February 2021.

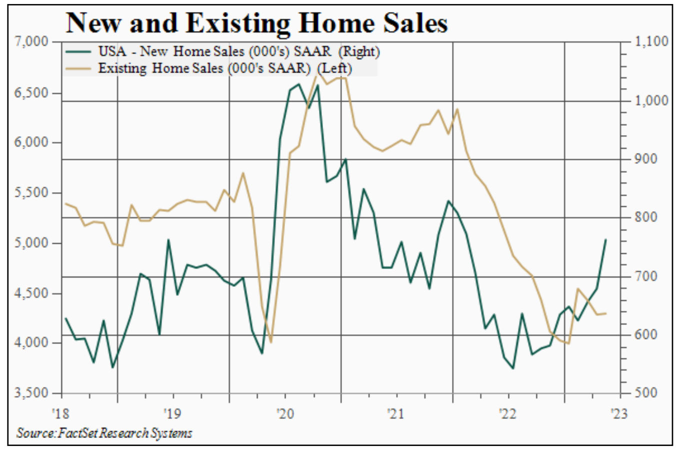


- Despite the "pause" in hikes, Federal Open Market Committee (FOMC) members were hawkish in their projections of the path of the fed funds rate. The median FOMC member indicated they expect the fed funds rate to reach 5.6% by year's end compared to the 5.1% they expected three months ago. Fed Chair Jerome Powell has indicated they intend to stay the course until they reach their stated 2% inflation target, and several datapoints will make this a difficult endeavor. While CPI goods inflation has decreased to 1.4% Y/Y, services inflation remains robust at 6.2%. Labor accounts for a large percentage of the total costs in the service sector, and the job market remains strong. Shelter costs are also a major contributor to services inflation, up 7.8% Y/Y.



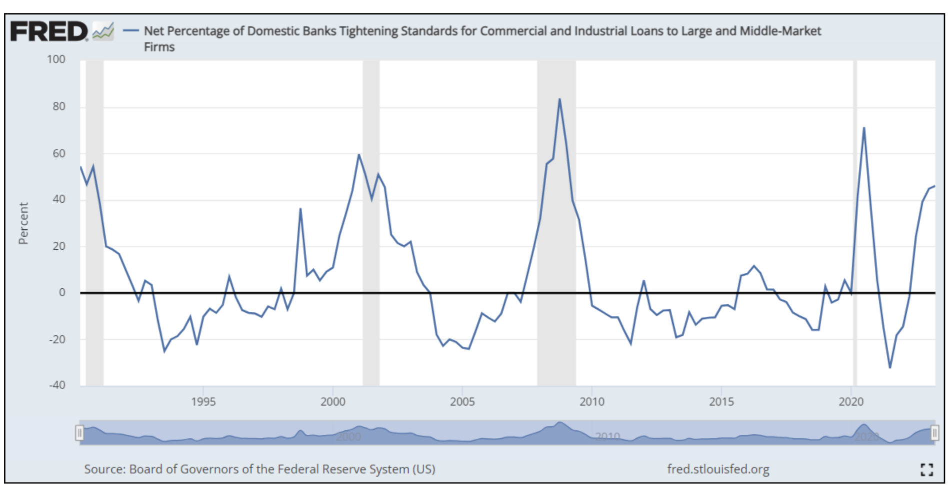
FIXED INCOME

Although rapidly increasing mortgage rates have dramatically decreased the number of houses being bought and sold, prices have remained resilient. There are also signs prospective buyers have begun to adjust to higher interest rates with seasonally adjusted New Home Sales, Existing Home Sales, Housing Starts, and Building Permits all higher than their recent lows.



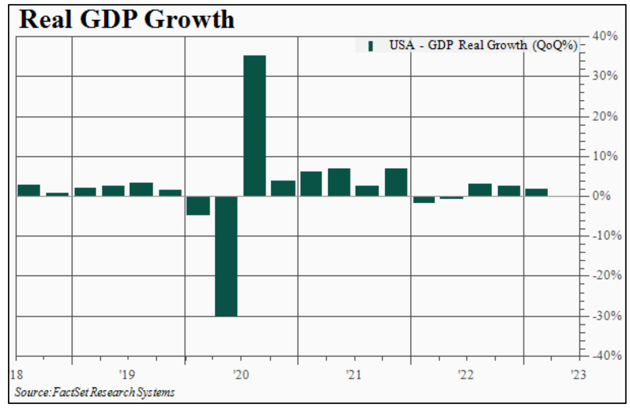
- The UST 3-month/10-year spread closed the quarter slightly more inverted than it began with 10-year yields trading at substantially lower levels than 3-month yields. This inversion has been the deepest in over 40 years, and it set a new low in early June. On average, 3-month/10-year inversions have occurred 11 months before the start of an ensuing recession. As of late June, the yield curve has been inverted for eight months, implying a recession will begin in September. However, economic activity has surprised to the upside, with the Bloomberg U.S. Economic Surprise Index rising to its highest levels since 2020. The dichotomy has led some market commentators to ponder that the yield curve may not be as predictive as it has been historically.

- The April 2023 Senior Loan Officer Opinion Survey displayed the impact of the Fed's hawkish rate hiking of the past year on banks' willingness to provide funding to debtors. Respondents were pessimistic across the board, reporting tighter standards, more expected tightening, and weakening demand for loans. Bank respondents indicated they plan to continue to tighten lending standards across all loan categories as they expect a "deterioration in credit quality of their loan portfolios and in customers collateral."

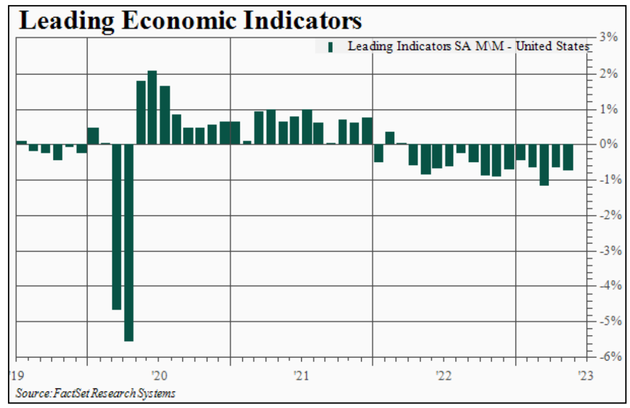


ECONOMICS

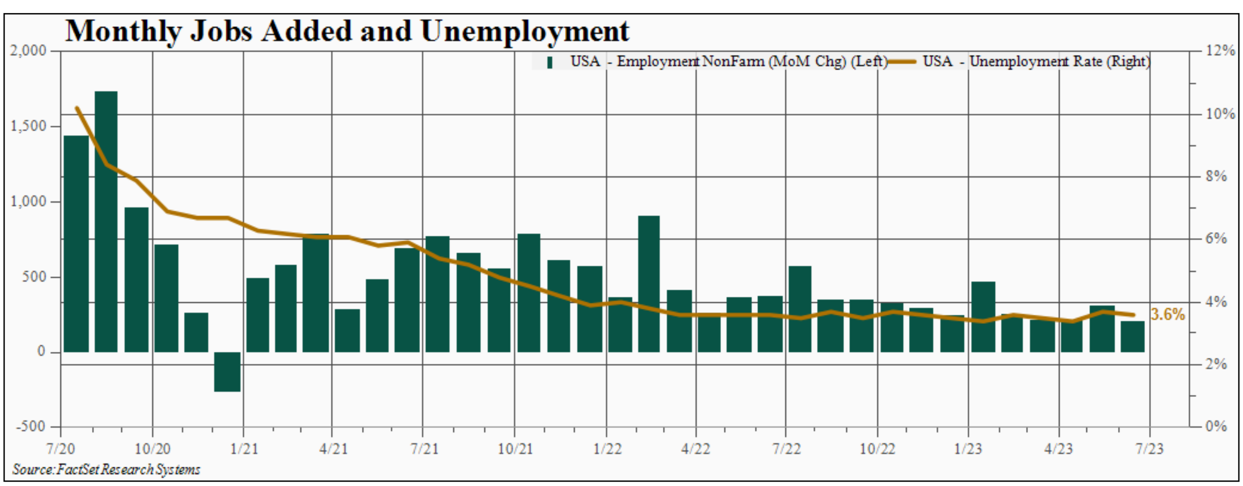
- The economy continues to grow but at a slower pace. Gross domestic product (GDP) increased at an inflation-adjusted annual rate of 2.0% in the first quarter versus 3.2% and 2.6% in the third and fourth quarters of 2022. First quarter GDP was bolstered by consumer spending increasing 4.2%. Economic growth continued in the second quarter, as consumer spending was up 0.6% in April from the previous month and 0.1% in May. Retail sales were also up 0.4% in April and 0.3% in May, but this has largely reflected inflation with core CPI also going up around 0.4% monthly.



- Economic data trending favorably has caused some economists to dial back their calls for a recession. The economy has remained resilient because of lower energy costs, an economy less sensitive to rising interest rates, a strong labor market, and the lasting effects of the pandemic stimulus programs. In May, the San Francisco Fed estimated that approximately $500 billion of excess pandemic savings remained. Continued large fiscal deficits are also stimulative. The World Bank and International Monetary Fund both expect global economic growth to be lower in 2023. The World Bank expects global growth to be 2.1% in 2023, ersus 3.4% in 2022, and U.S. growth to be 1.6% this year versus 2.1% in 2022. But the Fed continues to raise interest rates and the lag effects are long and variable. The Conference Board's composite of leading economic indicators has been negative for 14 consecutive months, and June surveys show manufacturing contracting and the services sector growing at a slower pace.

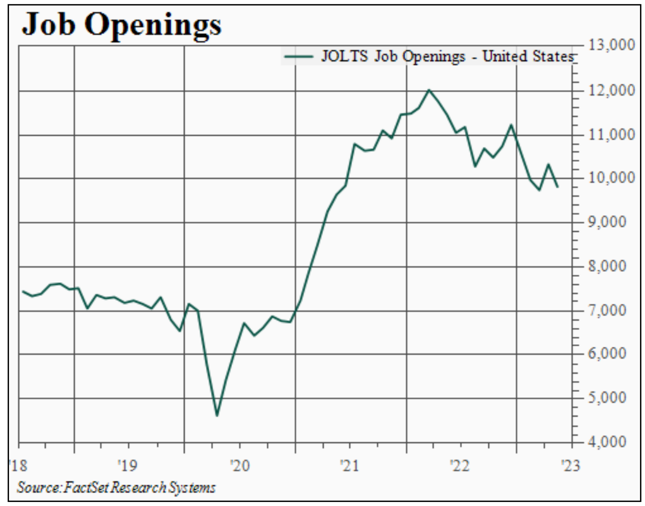


- While the labor market has remained strong, signs of weakness are beginning to show. Initial jobless claims have trended upwards for nine months. White collar layoffs have started in the finance, media, and tech sectors. 209,000 jobs were added in June versus a monthly average of 292,000 in the first five months of 2023. The unemployment rate was 3.6%, up from a decades-low of 3.4% in April. The labor force participation rate was 62.6%. While this is still below the pre-pandemic rate of 63.3%, it should be noted that the participation rate for those of prime working age, 25-54 years old, is at its highest level since 2002 (83.5%).



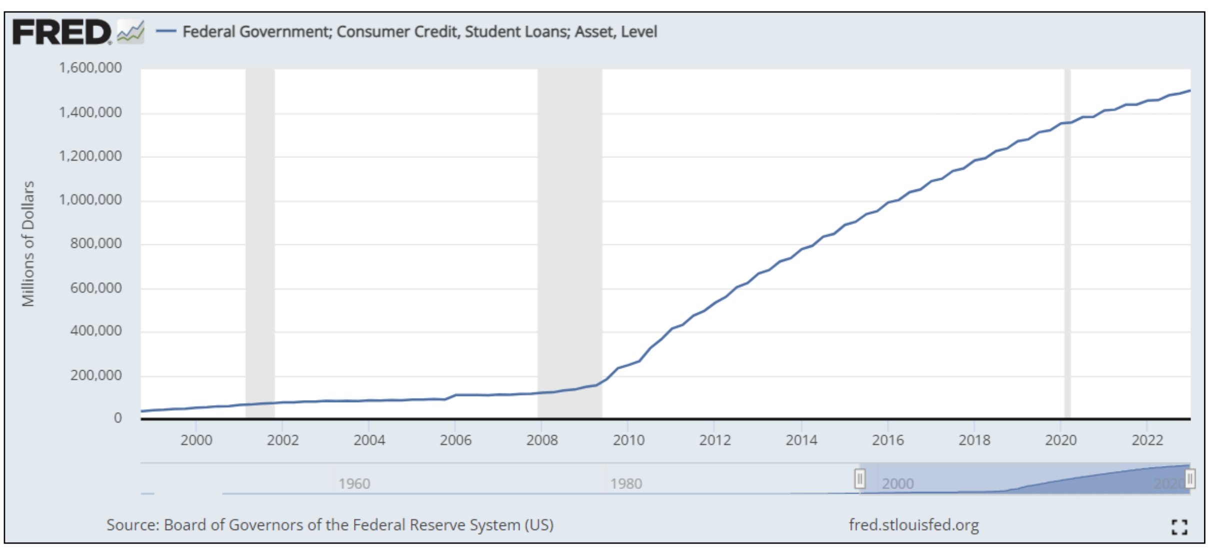
ECONOMICS

- There were 9.8 million job openings at the end of May, which equated to 1.6 jobs per unemployed worker. Aging demographics are causing worker shortages in many countries. However, the U.S. is deemed an attractive place to pursue a career. At the end of 2022, the foreign-born workers' share of the U.S. labor force rose to 18.1%, the highest since records started in 1996. Their share rose 1.8 million or 6.3% to 29.8 million in 2022; the native-born workforce only grew 1%. Data suggests foreign-born workers are more likely to take lower-paying jobs.



- The U.S. economy has added millions of jobs post-pandemic. However, job growth has come with a cost to the economy. The Labor Department reports that labor productivity (output per hour worked) fell at an annual rate of 2.1% in the first quarter of 2023 and was down 0.8% from a year earlier. This was the fifth straight quarter of negative Y/Y productivity growth – the longest negative run since records began in 1948. While a major factor contributing to macro-declines in productivity is a mix-shift, i.e., lower output service jobs being re-added to the economy, other factors are likely having an impact as well. After struggling to hire and retain workers during the pandemic-induced labor crunch, employers are now resistant to letting them go and are hoarding labor. Another reason could be changes in workplace practices with increased remote work and newly coined "quiet quitting," which means doing the absolute minimum on the job. There have also been record numbers of job quits and job changes in the last three years which could affect productivity in the short term. Many are optimistic that AI will boost productivity gains, especially in knowledge industries, but this will not happen overnight.

- To end the quarter, the Supreme Court of the United States of America struck down President Biden's Debt Forgiveness plan. The resumption of student loan payments is scheduled to begin in October and will undoubtedly impact the financial circumstances of many individuals and the broader economy. Increased financial strain may lead to decreased consumer spending. This could impact various sectors of the economy, particularly those reliant on discretionary spending from the millions of students and graduates across the nation with student loan debt.



The Escalating Trend of Public Spending: A Call for Prudence and Austerity

Congress passed the Fiscal Responsibility Act (FRA) in late May, and President Biden signed the bill on June 3, two days before the government would have run out of money to pay its obligations. The Treasury general account (the federal government's main account at the Federal Reserve used for official payments) fell to $23 billion in early June, less than the amount of net spending on a typical day. The Treasury prefers to maintain a balance of at least $500 billion in the general account, enough to cover about a week of spending.

U.S. Government spending in 2022 totaled $6.3 trillion. If this seems significantly more than anticipated, it may be due to a harkening back to the pre-COVID era. In 2019, the last year before the COVID pandemic, federal spending was $3.5 trillion. An 80% increase in spending over three years, from 2019 to 2022, is extraordinary. While it may have been justifiable due to the huge uncertainties surrounding the pandemic, revenues could not keep pace. They increased from $3.5 trillion in 2019 to $4.9 trillion in 2022, a very respectable 40% increase.

The federal government classifies spending into three segments: mandatory (non-discretionary), discretionary, and net interest. Defense spending is classified under discretionary expenses. Non-defense discretionary spending is only 16% of total spending. The other 84% includes interest costs, defense spending, and mandatory spending for entitlement programs such as Social Security, Medicare, and Medicaid. Spending on these entitlement programs has not been subject to congressional review for nearly 20 years, even though Medicare is projected to run out of money in 2028 and Social Security in 2034. If Congress doesn't allocate additional funding for these programs, they will have to operate on a pay-as-you-go basis. Spending on these programs is impacted more by demographics, inflation, and other factors.

Interest costs represent another compounding factor in the government's ever-escalating spending pattern on the federal outstanding debt. In 2022, the Treasury had $475 billion in net interest expenses, or 7.5% of the total budget. As medium and longer-term Treasury bonds mature and are reissued with much higher interest rates, net interest costs will rise significantly. The Congressional Budget Office (CBO) has projected that annual net interest costs will total $640 billion in 2023 and double over the coming decade to $1.4 trillion in 2033.

Deficits

Federal deficits occur in any year that spending exceeds revenue. The amount of government deficit (and debt) is often shown relative to Gross Domestic Product (GDP) because it is a rough measure of a country's ability to service its debt. Since the Great Recession of 2007-2008, government deficits and the debt issued to finance them have risen dramatically. In the decade following fiscal year 2009, annual government deficits averaged around -3.0%, as revenues averaged around 18% and expenditures 20-21% of GDP. Government deficits and debt exploded during the pandemic. The deficit was $3.1 trillion (-15% of GDP) in fiscal 2020, $2.8 trillion (-12.4%) in fiscal 2021, and $1.4 trillion (-5.2%) in fiscal 2022. Fiscal austerity has not improved; the deficit is already $1.2 trillion through May of this fiscal year and the CBO, a non-partisan entity, projects deficits of $1.5 trillion in fiscal years 2024 and 2025 with increases thereafter. Government revenues are now running at 18-19% of GDP and expenditures 24%. This is likely not sustainable and certainly not fiscally responsible.

The FRA capped non-defense discretionary spending at $704 billion for fiscal year 2024. That is a compromise between the House GOP's demand that spending will remain at 2022 levels ($689 billion) but less than the projected 2024 baseline budget ($757 billion). The non-defense discretionary spending cap will rise 1% to $711 billion in fiscal 2025. This legislation cuts projected spending by $136 billion over the next two fiscal years. But, in reality, total federal spending will likely not drop by $136 billion in the fiscal years 2024 and 2025. As with previous discretionary spending limits, the FRA designates certain spending as effectively exempt from these limits. Spending designated as an emergency requirement would be exempt up to any amount, while funding for certain purposes – such as program integrity initiatives, disaster funding, and reemployment services – would be exempt up to specified amounts. Additionally, the cap only relates to non-defense discretionary spending, which as mentioned, is only 16% of total spending. The remaining 84% of spending is not subject to the aforementioned cap. Cutting $136 billion (1.1%) out of two fiscal year budgets (2024 and 2025) when spending is projected to be around $12 trillion will not have a significant impact on economic growth, inflation, or jobs. However, a more profound issue needs to be addressed: the U.S. federal budget is continuously losing money, which is gradually undermining long-term growth prospects and diminishing America's ability to exert economic power on a global scale.

The CBO is tasked with forecasting the impact of all spending bills over the next decade. Based on their earlier forecasts, the entity had projected that budget deficits would total $20 trillion over this time period. Prior to the enactment of the FRA, the original bill passed by the House GOP was expected to cut the federal deficit by $4.8 trillion. As enacted, the FRA is predicted to decrease the $20 trillion deficit by $1.5 trillion. Yet, several mutually agreed-upon adjustments have potentially lowered the projected deficit reduction to only $1 trillion. Future spending bills may also significantly alter the deficit reduction. At this juncture, the only certainty is the level of non-defense discretionary spending in fiscal years 2024 and 2025.

Debt

Annual deficits accumulate to form the federal debt level. There are two segments that comprise total federal debt. For instance, prior to the FRA, the debt ceiling was set at $31.4 trillion. This accounted for total debt, out of which approximately $25 trillion was public debt. Public debt encompasses all debt owed by the federal government to entities outside the federal government. The remaining $6.4 trillion, known as intragovernmental debt, is held by agencies such as Social Security, Medicare, and federal employee retirement funds. As previously mentioned, the ratio of government deficits and debt to GDP serves as a rough measure of a country's ability to service its debt. In the U.S., at the end of fiscal year 2000, the public debt-to-GDP ratio stood at 32.7%. Following the Great Recession, this ratio increased to 52.3% by the end of fiscal year 2009. Over the next decade, due to the government running annual deficits averaging approximately 3% of GDP, the public debt-to-GDP ratio further increased to 76%. Government deficits exploded during the pandemic, resulting in a substantial expansion in public government debt, currently near 100% of GDP and continuing to rise. In fiscal year 2022, the total national debt-to-GDP ratio, considered by many to be a more accurate reflection of the federal government's actual obligations, reached 121%.

Source: OMB; St. Louis Fed

In Closing

Continuing the trend of trillion-dollar-plus deficits without implementing fiscal austerity measures could have serious economic repercussions for the U.S. in a competitive global landscape. While the exact threshold on the level of U.S. debt remains uncertain, there is a tipping point. Interest on the debt will exceed non-defense discretionary spending in the foreseeable future. Assuming CBO projections on the deficit prove accurate, the result will be additional government debt of $19-20 trillion by the end of the next decade, creating a substantial liability for future generations. Excessive debt would also likely impact the role of the dollar as the global reserve currency. Currently, the CBO predicts that government deficits will average 6.1% of GDP over the next decade, compared to 3-4% over the two decades preceding the pandemic.

There are potential solutions to reduce the debt-to-GDP ratio, but the longer we wait to pursue them, the tougher the consequences. One is for government to pursue policies that hopefully lead to the nominal GDP growth rate exceeding the interest rate on the debt. This phenomenon was observed after World War II when the public debt-to-GDP ratio decreased from 106% to 23.2% in 1974. Moreover, since a significant portion of government debt is not adjusted for inflation, higher inflation can alleviate the debt burden by favoring debtors over creditors. The most controllable and obvious solution is for the government to begin following a policy of disciplined fiscal austerity; generating a budget surplus which has not been accomplished since fiscal year 2001. This would require the implementation of spending cuts and/or tax increases, likely both. Since non-defense discretionary spending accounts for only 16% of budgeted expenses, tough choices will need to be made. The longer those choices are deferred, the tougher the consequences. Commitment and contribution from both sides of the political aisle are necessary to protect the future of the country and well-being of future generations. The actions taken need to be substantially more significant than we witnessed with the recent Fiscal Responsibility Act, a moniker for the legislation that is misleading, just like it was for the Inflation Reduction Act passed last year.