Q2 Overview:

A Pause in **Rate Hikes, Falling Inflation, and a Resilient Economy Power Stocks** Higher in the Second Quarter

The S&P 500 ended the second quarter and first half of 2023 at a 14-month high, and most major stock indices logged solid gains in the second quarter following a pause in the Fed's rate hike campaign, stronger-than-expected corporate earnings (especially in the tech sector), and the relatively drama-free resolution of the debt ceiling.

In sum, markets were impressively resilient in the second quarter and throughout the first half of 2023, as better-than-feared earnings, expectations for less-aggressive central bank rate hikes, more evidence of a "soft" economic landing, and relative stability in the regional banks pushed the S&P 500 to a 14-month high.

The second quarter of 2023 saw an acceleration of the tech sector outperformance witnessed in the first quarter, as AI (artificial intelligence) enthusiasm drove several mega-cap tech stocks sharply higher. Those strong gains resulted in large rallies in the tech-focused Nasdaq and, to a lesser extent, the S&P 500 as the tech sector is the largest weighted sector in that index. Also like in the first quarter, the less-tech-focused Russell 2000 and Dow Industrials logged more modest, but still solidly positive, quarterly returns.

By market capitalization, large caps outperformed small caps, as they did in the first quarter of 2023. Regional bank concerns and higher interest rates still weighed on small caps as smaller companies are historically more dependent on financing to maintain operations and fuel growth.

From an investment style standpoint, growth handily outperformed value again in the second quarter, continuing the sharp reversal from 2022. Tech-heavy growth funds benefited from the aforementioned AI enthusiasm. Value funds, which have larger weightings toward financials and industrials, relatively underperformed growth funds, as the performance of non-tech sectors more reflected the broad economic reality of mostly stable, but unspectacular, economic growth.

Stock Index Performance

Index	Week	YTD	12-mo.	2022	5-yr.
Dow Jones Industrial Avg. (34,408)	2.02%	4.94%	14.23%	-6.86%	9.58%
S&P 500 (4,450)	2.36%	16.88%	19.56%	-18.13%	12.27%
NASDAQ 100 (15,179)	1.94%	39.35%	33.13%	-32.38%	17.64%
S&P 500 Growth	2.08%	21.24%	18.24%	-29.41%	12.99%
S&P 500 Value	2.70%	12.13%	19.94%	-5.25%	10.54%
S&P MidCap 400 Growth	4.14%	10.41%	19.15%	-19.01%	7.12%
S&P MidCap 400 Value	4.54%	7.13%	15.89%	-7.01%	7.95%
S&P SmallCap 600 Growth	4.12%	6.95%	10.52%	-21.13%	5.16%
S&P SmallCap 600 Value	4.61%	5.04%	8.81%	-11.09%	4.90%
Russell 2000	3.75%	8.06%	12.27%	-20.46%	4.17%
MSCI EAFE	1.66%	11.67%	18.77%	-14.45%	4.38%
MSCI World (ex US)	1.32%	9.47%	12.72%	-16.00%	3.51%
MSCI World	2.24%	15.09%	18.51%	-18.14%	9.06%
MSCI Emerging Markets	-0.04%	4.89%	1.75%	-20.09%	0.93%
S&P GSCI	-0.10%	-7.54%	-14.22%	25.99%	2.75%

Source: Bloomberg. Returns are total returns. *5-yr. return is an average annual.* One-week, YTD, 12-mo. and 5-yr. performance returns calculated through 6/30/23. An index cannot be purchased directly by investors. Past performance is no guarantee of future results.

On a sector level, eight of the 11 S&P 500 sectors finished the second quarter with positive returns. As was the case in the first quarter, the Consumer Discretionary, Technology, and Communication Services sectors were the best performers for the quarter. The surge in many mega-cap tech stocks such as Amazon (AMZN), Apple (AAPL), Alphabet (GOOGL), Meta Platforms (META), and Nvidia (NVDA) drove the gains in those three sectors, and they handily outperformed the remaining eight S&P 500 sectors. Industrials, Financials, and Materials saw moderate gains over the past three months, thanks to rising optimism regarding a "soft" economic landing.

Turning to the laggards, traditional defensive sectors such as Consumer Staples and Utilities declined slightly over the past three months, as resilient economic data caused investors to rotate to sectors that would benefit from stronger-than-expected economic growth. Energy also posted a slightly negative return for the second quarter, thanks to weakness in oil prices.

S&P Sector Performance

Index	Week	YTD	12-mo.	2022	5-yr.
Communication Services	0.37%	36.24%	17.28%	-39.89%	9.27%
Consumer Discretionary	2.48%	32.97%	24.64%	-37.03%	9.93%
Consumer Staples	0.58%	1.28%	6.60%	-0.62%	11.06%
Energy	4.82%	-5.55%	18.58%	65.43%	6.52%
Financials	2.96%	-0.53%	9.45%	-10.57%	7.13%
Health Care	0.58%	-1.48%	5.38%	-1.95%	11.78%
Industrials	3.90%	10.19%	25.12%	-5.51%	10.48%
Information Technology	2.93%	42.77%	40.26%	-28.19%	21.78%
Materials	4.04%	7.74%	15.12%	-12.28%	9.74%
Real Estate	5.14%	3.72%	-4.20%	-26.21%	6.48%
Utilities	0.69%	-5.69%	-3.68%	1.56%	8.23%

Source: Bloomberg. Returns are total returns. *5-yr. return is an average annual.* One-week, YTD, 12-mo. and 5-yr. performance returns calculated through 6/30/23. An index cannot be purchased directly by investors. Past performance is no guarantee of future results. On 9/28/18, the Global Industry Classification Standard (GICS) was reconstituted and the Telecommunications Services sector was renamed Communication Services. GICS sector information for periods prior to 9/28/18 may not necessarily be comparable to the reconstituted sectors.

The 180-degree reversal in trends this year is something to behold. The three worst-performing sectors in 2022 (Communications, Consumer Discretionary, and Tech) are the three best performers thus far in 2023, while the leading sector from 2022 (Energy) is down 9%.

Trends: US Sectors (5/31/22)

			% Change			Trading Range			
Tickers	Name	Price	YTD ↑	5-Day	50-DMA	Current	OS	50-DMA	OB
XLE	Energy Select Sector	85.35	58.57	3.90	10.12	Extreme OB			
XLU	Utilities Select Sector	73.26	4.53	2.38	1.17	Neutral			
XLP	Consumer Staples Sector	73.45	-2.98	3.20	-2.56	Neutral			
XLB	Materials Select Sector	84.98	-4.70	2.50	[illegible]	Neutral			
XLV	Health Care Sector	130.66	-5.85	1.00	[illegible]	Neutral			
XLF	Financial Select Sector	35.10	-8.82	[illegible]	-1.94	Neutral			
XLI	Industrial Sector	93.47	-10.20	3.83	-3.02	Neutral			
XLRE	Real Estate Sector	43.48	-14.15	3.08	-4.84	Neutral			
XLK	Technology Sector	139.45	-19.07	4.76	-3.65	Neutral			
XLC	Comm. Svcs Sector	59.91	-22.33	2.19	-5.02	Neutral			
XLY	Cons. Discret. Sector	153.88	-24.29	9.25	-8.00	Neutral			

2022

Trends: US Sectors (5/30/23)

			% Change			Trading Range			
Tickers	Name	Price	YTD ↑	5-Day	50-DMA	Current	OS	50-DMA	OB
XLK	Technology Sector	165.66	33.41	4.99	10.23	Extreme OB			
XLC	Comm. Svcs Sector	62.26	29.74	0.47	6.09	Overbought			
XLY	Cons. Discret. Sector	152.99	18.45	1.26	4.18	Extreme OB			
XLI	Industrial Sector	98.19	0.39	-1.57	-0.88	Neutral			
XLB	Materials Select Sector	75.83	-2.38	-3.06	-3.98	Oversold			
XLP	Consumer Staples Sector	72.59	-2.63	-2.92	[illegible]	Oversold			
XLRE	Real Estate Sector	35.81	-3.03	[illegible]	-2.24	Oversold			
XLF	Financial Select Sector	32.10	-6.14	[illegible]	-0.45	Neutral			
XLV	Health Care Sector	126.74	-6.35	-3.58	-3.52	Oversold			
XLU	Utilities Select Sector	64.34	-8.74	-2.71	-5.01	Oversold			
XLE	Energy Select Sector	77.96	-10.87	-1.70	-4.83	Oversold	[illegible]	[illegible]	

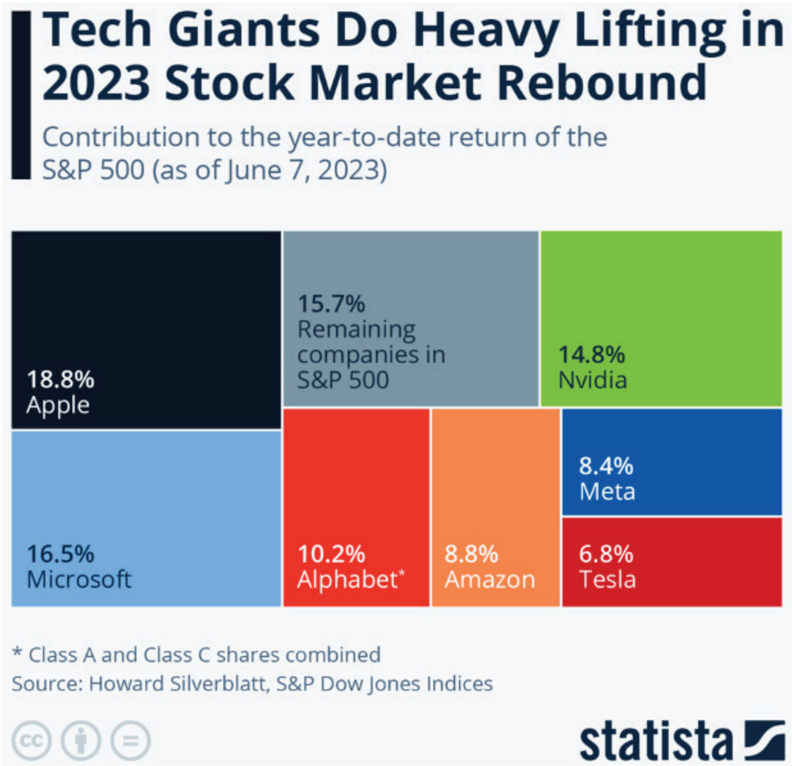
2023

Source: www.bespokepremium.com

In the dynamic world of investing, it's easy to be captivated by the high-flying stocks that dominate the market. After all, they are the ones usually generating the most exciting advancements in technology.

In just the past month, we've seen two examples of this. First, Apple (AAPL) introduced its new virtual-reality headset—the company's biggest product launch since the Apple Watch in 2015. Second, Nvidia (NVDA) announced positive demand forecasts, continuing to ride the growing wave of excitement around artificial intelligence (AI).

As you'll see below, according to Statista, approximately 84% of the S&P 500 gains this year have been driven by just seven companies: Apple, Amazon (AMZN), Alphabet (GOOGL), Meta Platforms (META), Microsoft (MSFT), Nvidia, and Tesla (TSLA):



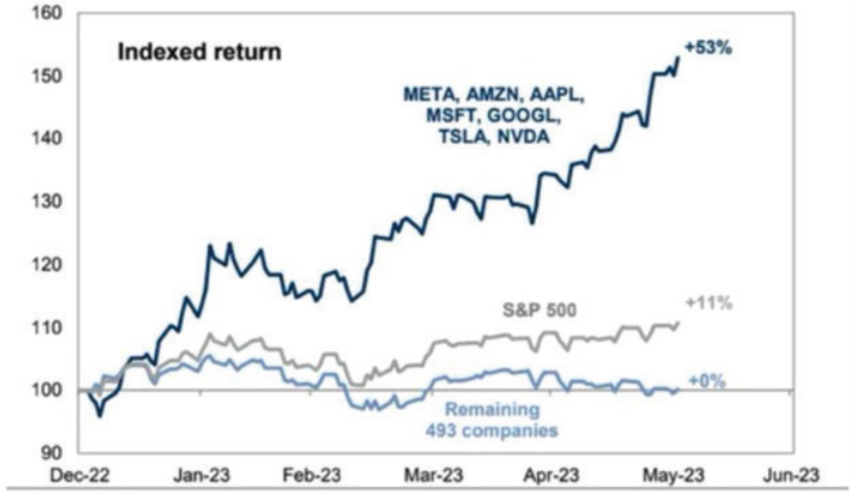
Apple, Microsoft, and Nvidia alone are responsible for more than half of the index's gains this year, with Alphabet, Amazon, Meta, and Tesla contributing another 34 percent. Taking these companies out of the equation, the S&P 500 would have returned a meager 1.88 percent this year, and no one would be talking about a bull market right now.

Market performance is usually tracked on an "indexed return" basis. We measure the performance of an index over a specific period of time, with a specific "reference date." That reference date has an initial value of 100. In this case, our reference date is December 2022.

You can see that the seven companies we mentioned earlier are at an "indexed return" of 153. That means they are up 53% from December 2022. The remaining 493 S&P 500 companies are at an indexed return of 100, which means they are relatively flat over the same period.

Exhibit 2: Mega-cap tech has led the market higher YTD

as of June 1, 2023

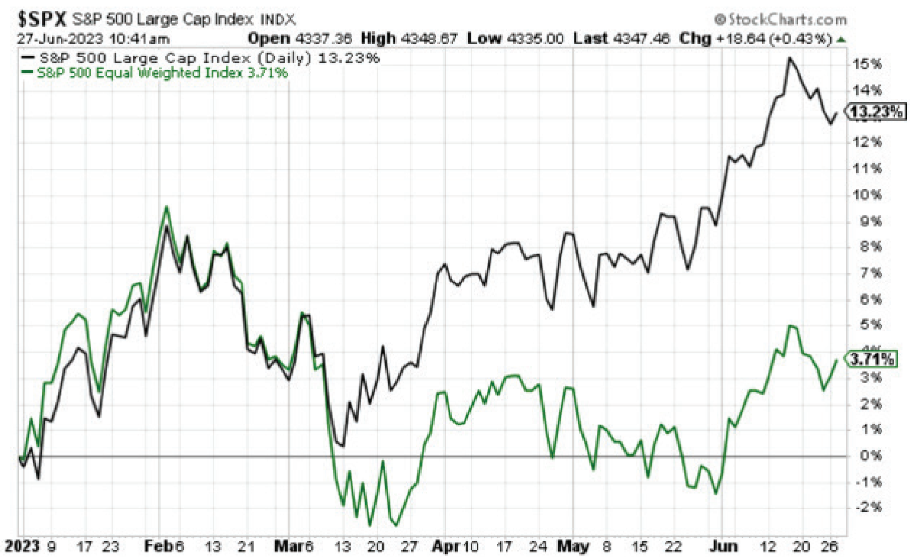


Source: FactSet, Goldman Sachs Global Investment Research

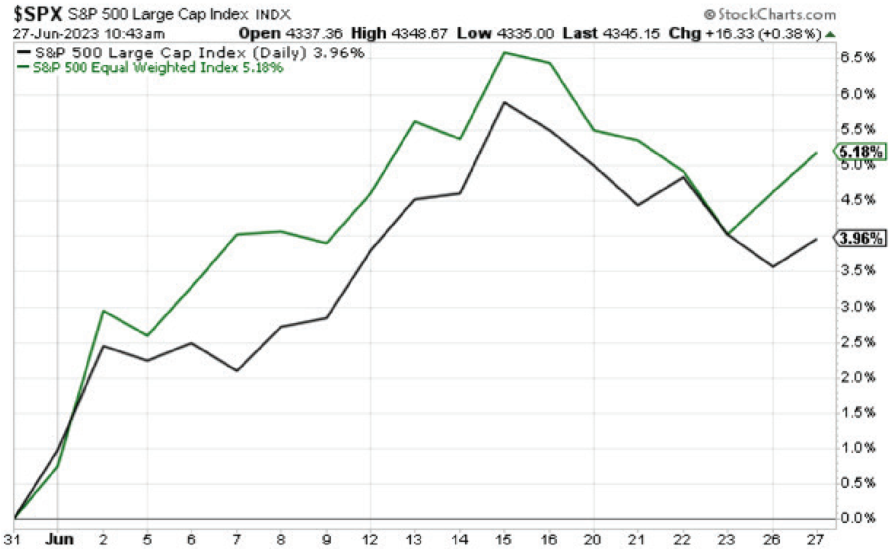
We need to see an increase in the sectors and the number of stocks going up. One way to see this broadening out of gains is by comparing the S&P 500 Index with the S&P 500 Equal Weight Index. To make sure we're all on the same page, the S&P 500 Index comprises a shade more than 500 of the largest companies in the United States (503, to be exact).

However, all these companies don't get equal representation in the index. That's because the S&P is "weight-averaged." In other words, the bigger the company, the more "representation" it has in the index. Given this, when we look at the S&P, we're not viewing an accurate depiction of how its average stock is performing. For that information, we'd look at a different index, the S&P 500 Equal Weight Index. As the name implies, this gives us the equal representation we're looking for.

Below, we compare the S&P Index (in black) and the S&P Equal Weight Index (in green) on the year. As you can see, the S&P has dominated its equal-weight counterpart.



Here's how the two indexes have performed since June. As you can see, the Equal Weight Index (again, in green) has turned the tables and has been outperforming the regular S&P.



As we look for evidence that this bull market has staying power, we want to see these broadening gains.

The Buzzword of the Investment World: Artificial Intelligence (AI)

The artificial intelligence (AI) mania started when Nvidia reported earnings on May 24th, transforming the AI boom into a full-fledged mania. While Q1 revenues were actually down 13% year-over-year, all the attention was on forward guidance. Nvidia said revenues in the current quarter would hit $11 billion, a new record high for the company (prior high was $8.3 billion) and 50% above Wall Street estimates. What's driving this? Surging demand for the AI chips in which Nvidia is currently the dominant player (> 90% market share for discrete GPUs).

From a CNBC headline on May 24th:

Nvidia shares spike 26% on huge forecast beat driven by A.I. chip demand

PUBLISHED WED, MAY 24 2023·4:28 PM EDT | UPDATED WED, MAY 24 2023·6:52 PM EDT

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KEY POINTS

- Nvidia reported first-quarter earnings for its fiscal 2024 on Wednesday, with a stronger-than-expected forecast that drove shares up 26% in extended trading.
- Nvidia CEO Jensen Huang said the company was seeing "surging demand" for its data center products.

Nvidia CEO and CEO Jensen Huang said during his earning call:

"The computer industry is going through two simultaneous transitions—accelerated computing and generative AI.

"A trillion dollars of installed global data center infrastructure will transition from general-purpose to accelerated computing as companies race to apply generative AI into every product, service, and business process.

"Our entire data center family of products—H100, Grace CPU, Grace Hopper Superchip, NVLink, Quantum 400 InfiniBand, and BlueField-3 DPU—is in production. We are significantly increasing our supply to meet surging demand for them."

Nvidia is powering the computing side of generative AI. What is generative AI? Generative artificial intelligence or generative AI is a type of artificial intelligence system capable of generating text, images, or other media in response to prompts. Generative AI models learn the patterns and structure of their input training data, and then generate new data that has similar characteristics.

The other, very important side is data.

The large language models like ChatGPT will make everyone a computer programmer. With simple, plain-English text prompts, the models will ultimately do the work of hundreds of coders—perhaps months of work—in seconds. But the output is only as good as the prompt it's given, and the data it is trained on.

With that, in the era of generative AI, companies that are data-rich are in a position of strength. These companies will have the data to train their own models. They will enhance their decision-making, identify opportunities to create new products, and improve customer experiences. And those with rich and unique data will have an opportunity to monetize that data—to become a new revenue source. The speed of change in this "industrial revolution" could be unlike those of the past. It's moving fast.

And it seems pretty clear that the productivity gains will be huge. As an example (from an OpenAI case study), CarMax used ChatGPT to summarize 100,000 customer reviews to include on their website, for every make, model, and year. They say it would have taken their editorial team 11 years to complete the job.

So, who are the kings of data? Meet the new kings, same as the old: Google, Amazon, Facebook, Apple, Microsoft.

What Happened to the Impending Recession?

We seem to be waiting in slow motion for an imminent recession that has yet to arrive but was a foregone conclusion as we entered 2023. The markets, ever forward-looking, had an awful 2022 largely due to rising rates and the belief that a recession was going to overtake the economy at some point in 2023, the only questions being when and how bad it may be.

But what if the consensus is wrong, or whatever type of slowdown we're heading into is milder than feared? So far, this seems to be the case. Here is a headline from CNBC.com:

MARKETS

First quarter economic growth was actually 2%, up from 1.3% first reported in major GDP revision

PUBLISHED THU, JUN 29 2023-8:37 AM EDT | UPDATED 6 MIN AGO

A lot of people thought we were already in a recession in 2021 and 2022. Check out this headline from last July's Washington Post:

Wall Street Says a Recession Is Coming. Consumers Say It's Already Here

Shoppers are getting squeezed and money is disappearing fast

What seems to be the most anticipated recession ever still has not arrived, but its effect on the market is being felt today nonetheless. There has been a sense of foreboding and apprehension hanging over the market since the Fed started aggressively raising interest rates last year. The S&P 500 is down about 11.5% since peaking in early January of 2022. And since the end of April 2021, it has a total return of 2.4%, essentially "unchanged." In other words, we have chopped sideways for the last two years. That does not sound positive, but it is worth putting into context to get a better understanding of where we are currently given the relevant circumstances.

In multiple ways, this is the most difficult time we have ever seen to make a forecast. "Unprecedented" actions by the government (locking down the economy, printing, borrowing, and spending trillions of extra dollars) artificially boosted economic activity. This may be why the majority of analysts and economists that have predicted that the U.S. is in or will enter a recession this year have been wrong.

While many are anticipating inflation to fall and that a recession is right around the corner, there are many data points that suggest that the economy continues to show resilience.

New U.S. home construction surges by most in three decades and permits for future construction also climbed, suggesting the housing market may be turning a corner after getting clobbered by Federal Reserve interest rate hikes. Indeed, recent data implies that a recovery in housing activity is already underway. As well, consumers continue to spend. Recent earnings results from the payments companies show consumers willing and able to spend on travel, dining out, and entertainment. This rise in travel demand is even more striking despite the 17% rise in airfares over last year. This summer's travel forecast is set to be the strongest in over 40 years.

In 2022 we saw equities (using the S&P 500) have a total return of -18.1% and bonds (using the iShares Core U.S. Aggregate Bond ETF) have a total return of -13%. The S&P's return was its fourth worst since its inception in 1957. And why not? The Fed raised rates by 450 bps last year and their messaging has been relentlessly consistent that rates will need to go higher for longer. This is in response to the highest level of inflation (9.1% in June of last year) since the early 1980s, which was in direct response to the unprecedented amounts of fiscal and monetary stimulus as a result of COVID-19.

So, what are some of the market and economic indicators looking like currently? Importantly, unemployment stands at a remarkably low 3.5% (its lowest level since December 1969). We have seen layoffs in the tech industry, but to date, it's largely been contained in that industry. And the tech industry's layoffs are largely related to their over-hiring during the pandemic, which was based on assumed high growth demand being extended indefinitely out into the future.

Powell: Higher for Longer Than You Can Imagine

The message is clear—if you're listening to it…

The Federal Reserve says the inflation "fight" is more a years-long ordeal than simply a few more months—or even another year. But still it seems enough folks don't want to or just simply can't believe Fed Chair Jerome Powell.

In a 45-minute press conference that followed the Federal Reserve's policy meeting on June 15th, Powell said a lot. But what Powell said toward the end about when the Fed might possibly cut rates, it really got my attention.

He was talking about "maintaining real rates," meaning a lending rate to banks that is above inflation. In monetary-policy land, that acts as a headwind for the economy (and inflation). Powell said (with emphasis added):

"We're having real rates that are going to have to be meaningfully positive and significantly so for us to get inflation down…that certainly means that it will be appropriate to cut rates at such time as inflation is coming down really significantly. And, again, we're talking about a couple of years out. I think as anyone can see, not a single person on the committee wrote down a rate cut this year, nor do I think it is at all likely to be appropriate if you think about it. Inflation has not really moved down. It has not reacted much to our existing rate hikes. We're going to have to keep at it."

After hearing that, if anyone is still betting on the Fed cutting rates this year, we don't know what else to say…. The central bank decided to pause its rate-hiking spree at their June meeting that brought the federal funds rate from near zero to more than 5%, so it can evaluate the effects on the economy before making more moves.

But along with its policy announcement, the Fed also published its quarterly economic projections. These showed a doubling of their previous 2023 outlook for gross domestic product (GDP), a lower projected unemployment rate, and higher-than-expected inflation.

- The Fed no longer expects the U.S. to enter a recession in 2023.
- The Fed predicts the unemployment rate will be 4.1% at year-end, down from the previously estimated 4.5%.
- The Fed sees annual gross domestic product rising 1.0% instead of the prior forecast of 0.4%.

In other words, the central bank sees a stronger U.S. economy for the rest of this year than they were expecting three months ago…and six months ago…and nine months ago (based on its past quarterly projections).

Table 1. Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy, June 2023

Percent

Variable	Median[1]			
	2023	2024	2025	Longer run
Change in real GDP	1.0	1.1	1.8	1.8
March projection	0.4	1.2	1.9	1.8
Unemployment rate	4.1	4.5	4.5	4.0
March projection	4.5	4.6	4.6	4.0
PCE inflation	3.2	2.5	2.1	2.0
March projection	3.3	2.5	2.1	2.0
Core PCE inflation[4]	3.9	2.6	2.2	
March projection	3.6	2.6	2.1	
Memo: Projected appropriate policy path				
Federal funds rate	5.6	4.6	3.4	2.5
March projection	5.1	4.3	3.1	2.5

Here's the important part in all this...What's next? From CNBC.com:

FEDERAL RESERVE

Fed holds off on rate hike, but says two more are coming later this year

PUBLISHED WED, JUN 14 2023•2:00 PM EDT | UPDATED WED, JUN 14 2023•4:13 PM EDT

When the Federal Open Market Committee members wrote down their projections for the rest of 2023, they showed the likelihood of two more rate hikes this year, which would bring the fed-funds rate range to around 5.5% to 5.75%. And they certainly didn't expect rate cuts, at least in Powell's estimation, though he and the Fed have been wrong many, many times before.

It's still about the path of inflation...

Three years on from the economic stimulus dump in response to the pandemic that started this whole inflation run, the Federal Reserve narrative is still about higher prices. The Fed has been expecting a spike in unemployment in response to higher rates that would typically make an "official" recession obvious to anyone and everyone. That just hasn't happened. And Powell said during his press conference that he felt supply constraints were becoming less of an issue and that in housing, new rents and new leases are showing signs of disinflation. Still, in non-housing "services" (making up more than half of the inflation measure the central bank weighs the most), the Fed is seeing "only the earliest signs of disinflation."

As Powell said, "I would almost say that the conditions that we need to see in place to get inflation down are coming into place. And that would be growth meaningfully below trend. It would be a labor market that's loosening. It would be good [supply] pipelines getting healthier and healthier and that kind of thing. The things are in place that we need to see, but the process of that actually working on inflation is going to take some time."

How Long Is "Some Time"?

I can't give you an exact date, but the answer is probably longer than most people think.

After inflation running below 2% for almost the entire previous decade before 2021, core PCE[1] peaked at 5.3% in early 2022. And after five percentage points of Fed rate hikes since then, it has still been around 4.7% for the past six months. That's a dent, not a smash.

As Powell said:

"Remember, we're two-and-a-half or two-and-a-quarter years into this, and forecasters, including Fed forecasters, have consistently thought inflation was about to turn down and typically forecasted that it would—and been wrong. Over the last six months, you're just not seeing a lot of progress. It's running at a level over 4.5%, far above our target, and not really moving down. We want to see it moving down decisively…

"We are going to get inflation down to 2% over time.… We want to do that with the minimum damage we can to the economy, of course. But we have to get inflation down to 2%, and we will. And we just don't see that yet."
He's trying to tell you it's going to take a really long time…

As we entered 2023, analysts and economists expected the Federal Reserve to pause rate hikes sometime in mid-year, and then begin to cut rates in the late spring or summer because the economy will soften and inflation will have returned to the Fed's target range. Bottom line up front: we believed this view was incorrect. Over the last several months, we have seen the bond market adjust to a more resilient economy with higher interest rates.

[1] A measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

What Does This Mean for Stocks?

Well, we've seen over the past several months that stock prices can go up even as interest rates have remained "higher for longer." The question, again, is how much higher rates will go…and for how much longer.

So far, in the past two years, the answer has always been higher and higher, and longer and longer, than most people think. It still seems that this is the case today. Headline from CNBC.com:

June Inflation Report

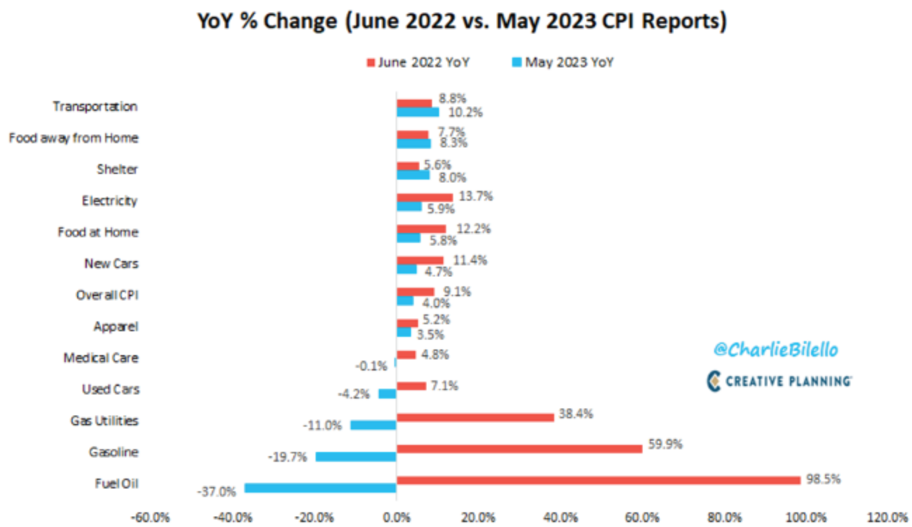
ECONOMY

Inflation rose at a 4% annual rate in May, the lowest in 2 years

PUBLISHED TUE, JUN 13 2023•8:31 AM EDT | UPDATED TUE, JUN 13 2023•11:41 AM EDT

The inflation rate cooled in May to its lowest annual rate in more than two years. What is driving the decline?

Lower rates of inflation in Fuel Oil, Gasoline, Gas Utilities, Used Cars, Medical Care, Apparel, New Cars, Food at Home, & Electricity. Rates of inflation in Transportation, Food Away From Home, and Shelter have increased since last June, but declines in the other major components have far outweighed these increases.



	Fuel Oil	Gasoline	Gas Utilities	Used Cars	Medical Care	Apparel	Overall CPI	New Cars	Food at Home	Electricity	Shelter	Food away from Home	Transportation
June 2022 YoY	98.5%	59.9%	38.4%	7.1%	4.8%	5.2%	9.1%	11.4%	12.2%	13.7%	5.6%	7.7%	8.8%
May 2023 YoY	-37.0%	-19.7%	-11.0%	-4.2%	-0.1%	3.5%	4.0%	4.7%	5.8%	5.9%	8.0%	8.3%	10.2%

Sea Change

We get asked by many of our clients what we believe the market will do over the next one to two years and beyond. To help answer this question, I am going to provide an overview based on one of my favorite analysts I follow, Howard Marks, and his most recent report titled "Sea Change."

I read his quarterly letters generally two to three times or more. His latest is one of his best. I am going to summarize a little and quote some, but you can read the full letter here. Let's jump in:

"Sea change (idiom): a complete transformation, a radical change of direction in attitude, goals... (Grammarist)

"In my 53 years in the investment world, I've seen a number of economic cycles, pendulum swings, manias and panics, bubbles and crashes, but I remember only two real sea changes. I think we may be in the midst of a third one today."

The first change he vividly describes was the creation of high-yield bonds and an increased appetite for balanced risk. Prior to Milken, et al., bonds rated below B weren't considered investable. The only way a company could acquire another company was for cash or by borrowing, but borrowing was limited to the amount you could get without changing your rating.
With the advent of high-yield bonds, leverage became available to boost asset prices and capital investment, balanced by higher interest rates to offset the additional risk. This created a monster new wave of investment and what became "financialization" of the markets.

The second sea change was Volcker's breaking of inflation and then the beginning of a 40-year bond bull market. Ever-lower rates coupled with increasing availability of funds created two massive tailwinds for the greatest stock and bond bull markets in history. If you borrowed at 10% and then a year or so later prime was 8%, you could refinance and lower costs, increase leverage, or both. Stocks, homes, real estate, private businesses, a host of enterprises all rose in value.

But that brings us to where we were in 2020. Quoting Howard Marks again:

"For what felt like eons—from October 2012 to February 2020—my standard presentation was titled 'Investing in a Low Return World,' because that's what our circumstances were. With the prospective returns on many asset classes—especially credit—at all-time lows, I enumerated the principal options available to investors:

- Invest as you previously have, and accept that your returns will be lower than they used to be;
- Reduce risk to prepare for a market correction, and accept a return that is lower still;
- Go to cash and earn a return of zero, hoping the market will decline and thus offer higher returns (and do it soon); or
- Ramp up your risk in pursuit of higher returns.

"...The overall period from 2009 through 2021 (with the exception of a few months in 2020) was one in which optimism prevailed among investors and worry was minimal. Low inflation allowed central bankers to maintain generous monetary policies. These were golden times for corporations and owners thanks to good economic growth, cheap and easily accessible capital, and freedom from distress.

"This was an asset owner's market and a borrower's market. With the risk-free rate at zero, fear of loss absent, and people eager to make risky investments, it was a frustrating period for lenders and bargain hunters." (Emphasis in original)

Then he gives us a tour de force analysis of where we are and how we got here. I highly suggest you read it, but the conclusion is we're not going back to ultra-low rates, barring a severe recession.

"The progression of events described above caused pessimism to take over from optimism. The market characterized by easy money and upbeat borrowers and asset owners disappeared; now lenders and buyers held better cards. Credit investors became able to demand higher returns and better creditor protections. The list of candidates for distress—loans and bonds offering yield spreads of more than 1,000 basis points over Treasuries—grew from dozens to hundreds. Here's how the change in the environment looks to me:

	2009 to 2021	Today
Fed behavior	Highly stimulative	Tightening
Inflation	Dormant	40-year high
Economic outlook	Positive	Recession likely
Likelihood of distress	Minimal	Rising
Mood	Optimistic	Guarded
Buyers	Eager	Hesitant
Holders	Complacent	Uncertain
Key worry	FOMO	Investment losses
Risk aversion	Absent	Rising
Credit window	Wide open	Constricted
Financing	Plentiful	Scarce
Interest rates	Lowest ever	More normal
Yield spreads	Modest	Normal
Prospective returns	Lowest ever	More than ample

Source: https://www.oaktreecapital.com/insights/memo/sea-change

"If the right-hand column accurately describes the new environment, as I believe it does, then we're witnessing a complete reversal of the conditions in the middle column, which prevailed in 2021 and late 2020, throughout the 2009-19 period, and for much of the last 40 years.

"How has this change manifested itself in investment options? Here's one example: In the low-return world of just one year ago, high-yield bonds offered yields of 4 5%. A lot of issuance was at yields in the 3s, and at least one new bond came to the market with a "handle" of 2. The usefulness of these bonds for institutions needing returns of 6 or 7% was quite limited. Today these securities yield roughly 8%, meaning even after allowing for some defaults, they're likely to deliver equity-like returns, sourced from contractual cash flows on public securities. Credit instruments of all kinds are potentially poised to deliver performance that can help investors accomplish their goals."

Finally from Howard Marks:

"What we do know is that inflation and interest rates are higher today than they've been for 40 and 13 years, respectively. No one knows how long the…[the current economic situation]…will continue to accurately describe the environment. They'll [the Fed] be influenced by economic growth, inflation, and interest rates, as well as exogenous events, all of which are unpredictable…

"As I've written many times about the economy and markets, we never know where we're going, but we ought to know where we are. The bottom line for me is that, in many ways, conditions at this moment are overwhelmingly different from—and mostly less favorable than—those of the post-GFC climate described above. These changes may be long-lasting, or they may wear off over time. But in my view, we're unlikely to quickly see the same optimism and ease that marked the post-GFC period.

"We've gone from the low-return world of 2009 21 to a full-return world, and it may become more so in the near term. Investors can now potentially get solid returns from credit instruments, meaning they no longer have to rely as heavily on riskier investments to achieve their overall return targets. Lenders and bargain hunters face much better prospects in this changed environment than they did in 2009 21.

"And importantly, if you grant that the environment is and may continue to be very different from what it was over the last 13 years—and most of the last 40 years—it should follow that the investment strategies that worked best over those periods may not be the ones that outperform in the years ahead.

"That's the sea change I'm talking about."

The chart comparing 2009-2021 to today is a very powerful visual of the differences in the current investment environment to the 2009-2021 investment environment. In summary, we do believe we will be in a much tougher investment environment at least over the next decade. As Howard Marks wrote in his "Sea Change" memo, strategies that worked in the past may not work as well going forward. We will have to adapt based on the current economic and financial environment. For example, we can now generate dividends and interest from fixed-income investments with yields the highest we have seen in over 17 years.

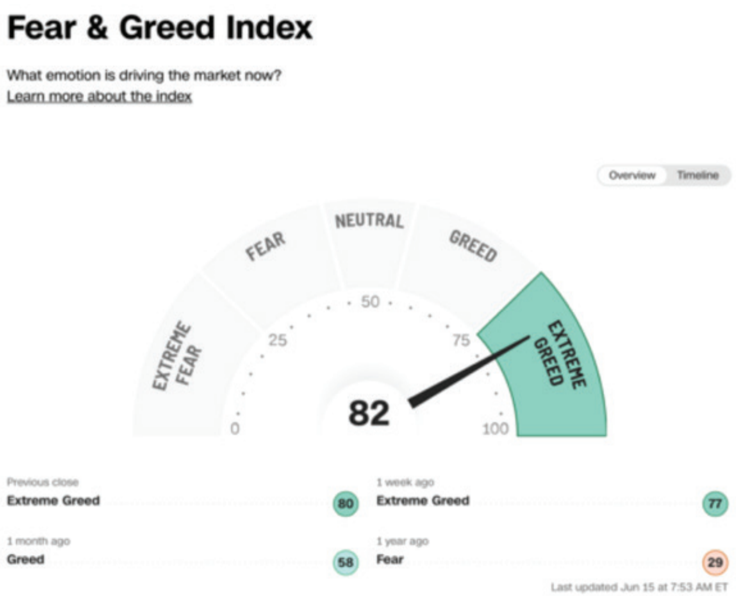
Here's an Important Update About Market Sentiment

One of our favorite indicators is the Fear & Greed Index, which you can find at https://money.cnn.com/data/fear-and-greed.

One way to quantify investor sentiment is CNN/Money Fear & Greed Index. Investors are driven by two emotions: fear and greed. Too much fear can sink stocks well below where they should be. When investors get greedy, they can bid up stock prices way too far. The answers tell us whether investors are mostly bullish, bearish, or neutral. And taking the pulse of investors this way is important, which is why market sentiment drives stock prices.

When the bullish reading is between 50-75, it's usually a bad sign for stocks as investors are getting bullish for higher stock prices. A reading between 75-100 marks a reading of extreme greed showing investors are very bullish. But a low reading between 0-25 means investors are scared, and a rally is possible.

In fact, CNN's Fear & Greed Index shows that we recently hit "Extreme Fear" levels for the first time since February 2023. Take a look:



And as we've seen throughout history, these moments of extreme pessimism and fear (like what we're seeing right now) make the best opportunities for investors...

We saw it back in 2009, when everyone was still too spooked to buy. And yet it turned out to be the greatest buying opportunity in American history.

Of course, we saw it again in mid-2020, when COVID-19 was still casting a long shadow of pessimism over our country's economy. And yet we all know what happened next: stocks went on to double off their March 2020 bottom.

Currently, we are at the other end of the spectrum at "Extreme Greed," meaning a lot of investors are bullish and expecting higher prices after a 14% increase in the S&P 500, which means it is time to be cautious in anticipation of a potential market pullback. An "Extreme Greed" reading has allowed us to take some profits and wait for a pullback to redeploy some capital.

Due to the length of our 2nd quarter market and economic update and the inclusion of the "Sea Change" section, we will be releasing our 2nd quarter strategy update as a separate update. Watch your email for our strategy update, which will be released very soon.

We understand the risks facing both the markets and the economy, and we are committed to helping you effectively navigate this challenging investment environment. Successful investing is a marathon, not a sprint, and even intense volatility is unlikely to alter a diversified approach set up to meet your long-term investment goals.

Therefore, it's critical for you to stay invested, remain patient, and stick to the plan, as we've worked with you to establish your unique, personal financial plan.

We remain focused on both opportunities and risks in the markets, and we thank you for your ongoing confidence and trust. Please rest assured that our entire team will remain dedicated to helping you successfully navigate this market environment.

About Matthew

Matthew Gaude is an *investment advisor representative and the co-founder of Live Oak Wealth Management, a financial services firm in Roswell, Georgia. He serves the planning and investment needs of corporate employees, those approaching or in retirement, and 401(k) plan sponsors. Working first as a commodity broker and then as a Business Development Manager for a national broker-dealer in previous jobs, he has the insight and experience to help clients understand the complexities of the market and implement strategies to minimize risk. To learn more about Matthew, connect with him on LinkedIn or visit www.liveoakwm.com.

About Shawn

Shawn McGuire is a financial advisor and the co-founder of Live Oak Wealth Management, a financial services firm in Roswell, Georgia. He serves the planning and investment needs of corporate employees, those approaching or in retirement, and 401(k) plan sponsors. He has worked in financial services since 2002 in positions ranging from financial advisor to stock broker and portfolio manager. As a CERTIFIED FINANCIAL PLANNER™ professional, he is trained to help clients with virtually all their financial needs. To learn more about Shawn, connect with him on LinkedIn or visit www.liveoakwm.com.

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