Market Update
Q3-2023

Aletheia Private Client Group's 2022/2023 Letter

As we browse financial media, the focus is almost always on topics that only matter if you have a very short timeframe. The questions below, which are irrelevant to most economic participants and investors alike, dominate financial discussions these days:

- Is the Fed done raising interest rates?
- When will the Fed start lowering interest rates?
- When will inflation hit the Fed's two percent target?
- Will the Fed raise its inflation target above 2%?
- Is the dollar over/ undervalued?
- Are interest rates going higher/lower?

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It feels like a good time to share a few thoughts on the current environment. If you're wondering why, while major indexes have pulled back a little and volatility has picked up, beneath the surface the dispersion has increased significantly. In other words, an increasing number of stocks are performing much worse than the index YTD; this is often a better indicator than what shows up in the headlines. As described below, the concentration of market cap and performance in just a handful of stocks—terrific businesses aside—strikes us as simply not healthy. We can't fix it but it certainly has our attention.

As you know from our discussions, we have been cautious regarding the near term prospects for broader equity markets, given the historically expensive valuation levels and slowing growth – particularly for the S&P 500 and NASDAQ (the NASDAQ now trades at a forward P/E of 36x).

Following significant corrections in 2022, Apple, Microsoft, Nvidia, Amazon, Tesla, Meta and Alphabet drove over 70% of year-to-date performance for the S&P 500 index, due to a combination of factors, such as liquidity expected to be removed from the system starting in Q4 did not materialize, perceived mega-cap safety, and exposure to Artificial Intelligence ("AI") innovation. As for AI, it likely will have a profound impact on our economy over the long-term, but it is too early to declare definitive winners, and these stocks may experience a challenge of sustaining lofty valuations.

Therefore, instead of chasing recent winners, investors may be better served seeking out underperforming areas and more reliable diversification, such as value or small-cap equities (which both seem to have much more reasonable valuations). We still believe there are opportunities in the broader markets – particularly when considering unique managers that do not overlap with the major indexes.

Nevertheless, we think our mandate is to have a view, use our experience to avoid the noise and assess the data presented to ensure our portfolios align with client objectives. Our view is the near term macro environment remains uniquely complicated and, therefore, increased market volatility over the next number of quarters seems more likely than not. The primary reasons for continuing with this view are driven by the following:

1. Continued Earnings Weakness

a. In Q2, S&P 500 earnings declined approximately (6.4%) vs. last year – its largest year-over-year decline in earnings since Q2 2020. This is the third quarter in a row of earnings declines (3.4%) in Q4 2022, and (1.5%) in Q1 2023)

b. What is more concerning is revenue has declined on a real basis even further, which means companies are managing their earnings through cost reductions only (vs. growing sales)

2. **European Recession**
   a. The region has been in a recession since the start of 2023, but the most recent economic readings continue to show stagnation
   b. The gloomy outlook is due in part to a collapse in credit growth, as the Eurozone's money supply declined in July for the first time in 13 years. In addition, manufacturing output has declined in each of the past five months
   c. It is noteworthy that, of the four largest Eurozone economies, Spain was the only one registering continued positive growth in the month of July (latest data)

3. **Lower Growth in China**
   a. After abandoning severe lockdowns post-COVID, the economic re-opening has been much weaker than expected; the country's currency and economy, particularly in real estate, are experiencing negative dislocations

4. **Inflation and Restrictive Federal Reserve Policy (i.e., higher interest rates)**
   a. Whether or not the U.S. Federal Reserve raises rates any further at their upcoming meetings in September and November, is less relevant in our minds than the prospect that interest rates will remain elevated for longer than the market expects
   b. Consensus believes the Fed will start cutting rates in early 2024; this may be too optimistic (given inflation is not yet at the levels the Fed is targeting (Fed wants 2% Core CPI inflation, and its currently still above 5%, year-over-year) or sanguine (given cutting rates so quickly means things are much worse than the Fed's expectations)
   c. As you will see below, interest rates have risen in the past few weeks, as the market-implied odds of a quarter-point Fed rate increase in November climbed to around 60%, from closer to 50%, after the latest data (the odds of a hike that month peaked at around 75% last week)

5. **U.S. Consumer…Important indicator but with a caveat**
   a. The U.S. consumer is the largest contributor to the economy and they are showing signs of softening
   b. Even with unemployment at historically low levels (under 4%), revolving credit is increasing and delinquencies on mortgages, HELOCs and auto loans are increasing at rates not seen since 2007-2009
   c. Last month, Target missed quarterly sales expectations and slashed its full-year forecast, as it again had trouble convincing shoppers to buy more than necessities…"As we look at the consumer landscape today, we recognize the consumer is still challenged by the levels of inflation that they're seeing in food and beverage and household essentials," CEO Brian Cornell said on a call with reporters. "So that's absorbing a much bigger portion of their budget."

Respectfully yours,

The Aletheia Private Client Group

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