

Quarter-In-Review – Global equities are having a good year despite all the angst about the debt ceiling and the banking crisis. But navigating the market has been far from easy because a few large-cap U.S. growth stocks are overshadowing every other sector and region. For example, roughly three-quarters of the S&P’s gain this year (12.3% of the 16.8% YTD return) comes from just seven stocks and only 25% of all U.S. stocks have outperformed the S&P. That’s the lowest beat rate ever. This is far from the end of the world as most equity indexes are in the black this year, but the headline numbers do overstate things a bit. It’s also worth remembering that short-term returns are notoriously volatile, and we think it is important to zoom out the time frame somewhat. Doing so offers us an old lesson, but one worth reiterating – big down years require much larger up years just to get back to even. Growth stocks are the winners this year, but not by enough to offset last year’s losses, as you can see in the table at the bottom of the page.

For bond investors it was a quarter to forget. Both short-term and long-term rates increased noticeably over the three months, and most bond categories gave back some of the gains realized during the first quarter. For example, short-term Treasury bonds lost -0.6% for the quarter, pulling the YTD return down to +1.0%. Intermediate-term Treasury bonds saw larger losses for the quarter (-1.9%) but remain in the black for the year (+2.0%).

Anticipating a Trickier Second Half – It’s probably not a stretch to say that equity market returns in the first half of the year surprised most people, us included. We’ve leaned against the idea that the wheels were going to come off the economy or the markets because of inflationary pressures, the banking crisis, or the debt ceiling debate, but we would not have bet on close to +20% returns for the S&P in six months. Why have returns been so strong? Part of it is certainly a rebound from a poor 2022, but investors also started to anticipate three somewhat mutually exclusive events this year, namely, 1) global central banks cutting rates in the second half of 2023, 2) inflationary pressures moderating, and 3) a continued global economic expansion. We think the

Market Benchmarks			
Market Indices	2Q23	YTD	3-Yr An
S&P 500 Index	+8.7%	+16.8%	+14.4%
Russell 2000	+5.3%	+8.1%	+10.7%
Global Equities	+6.0%	+13.7%	+11.3%
Int'l Index (EAFE)	+3.3%	+12.5%	+9.1%
Emerging Mkts	+1.0%	+4.7%	+3.3%
Other Indicators	6/30/23	3/31/23	12/31/22
Fed Funds Rate	5%-5.25%	4.75%-5.0%	4.25%-4.50%
2-Year Treasury	4.87%	4.03%	4.43%
10-Year Treasury	3.81%	3.49%	3.88%
S&P 500 P/E Ratio*	19.1	17.8	16.7
Crude Oil	\$70.56	\$75.67	\$80.35
Core Inflation	4.6%	4.6%	4.7%

*Forward 12-month operating earnings per S&P

markets will soon realize that, at best, only two of these three macro trends can coexist at the same time. For example, over the last few days the markets have moved to price out one leg of the stool, namely central bank rate cuts. If anything, rates are more likely to rise than fall in the second half of the year. And while this doesn’t necessarily mean an end to the economic expansion, we suspect it does mean the markets will become less forgiving. But first let’s talk about why the global expansion is proving so durable before getting into the inflation and rate outlook.

Economic Resiliency – There was a surprising consensus among market pundits at the end of 2022. Virtually every Wall Street bank expected the S&P 500 to finish lower in 2023 because they thought the U.S. would fall into a recession. Granted, the year is only half over, but the recession call is looking more and more off base, at least as 2023 goes. Growth in the first quarter was just recently revised higher to a solid +2% pace, and early indicators for second quarter growth are running at +2.1%. Only three months ago expectations for second quarter growth were just +0.2%. That’s a big move higher in a short period of

time and highlights how the U.S. economy has surprised all but the ardent optimists.

Why has the consensus been so wrong? After all, the Fed has hiked rates aggressively over the last year taking the Fed Funds rate from 0% to over 5% and triggered a mini-banking crisis. In the past such rate increases and financial instability would be

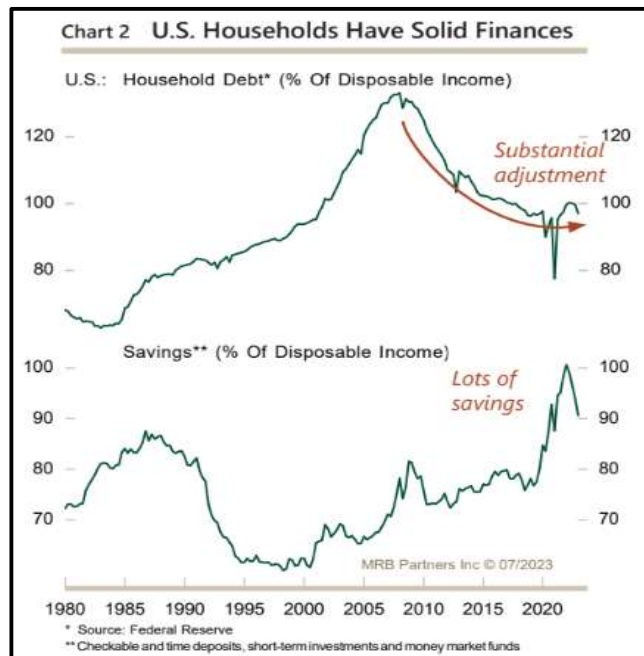
Index	YTD As of 6/30/23	Full Year 2022	Total Return 12/31/21-6/30/23
Dow Jones Average	+4.8%	-7.0%	-2.5%
Russell 1000 (VONE)	+16.5%	-19.1%	-5.8%
Russell 1000 Gth (VONG)	+28.9%	-29.2%	-8.7%
Russell 1000 Value (VONV)	+5.0%	-7.7%	-3.0%

Source: Bloomberg

early warning signs of a pending recession. However, the U.S. economy seems to be percolating along quite nicely. Households and businesses have adjusted to the new cost of capital, and housing, the most interest rate sensitive sector of the economy, is doing fine. This isn't the sort of activity you'd expect to see if a recession was imminent. We'd argue there are a few things taking place:

Consumer strength – One of the bedrocks of the economic expansion since COVID hit has been consumer spending. Spurred by stimulus payments, but also supported by record low unemployment levels, consumer spending has so far been immune to the effects of higher interest rates. Part of the reason is that for those consumers who own a house, the majority do so at mortgage rates that are currently unthinkable (the vast majority of mortgages are below 4%). Additionally, as you can see above, consumers in general have solid balance sheets and elevated savings levels. Furthermore, falling energy costs are a tax cut for consumers. The bottom-line is that the U.S. economy today is far less sensitive to higher rates than it has been in the past due in part to the consumer.

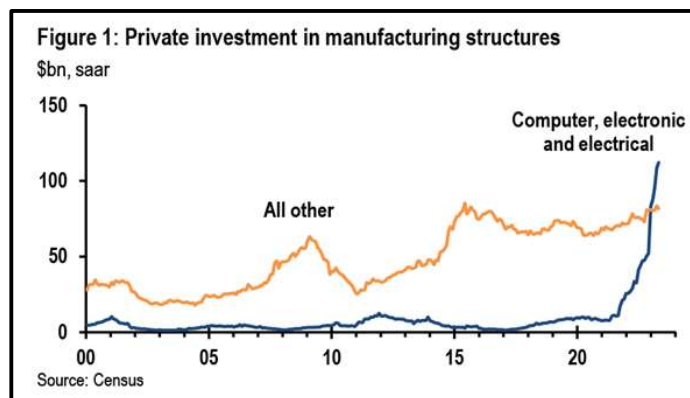
Capital Expenditures – Corporate spending on plant and equipment is growing rapidly and is tied to four major trends – 1) efforts to improve efficiency to offset rising labor costs, 2) building U.S. based manufacturing facilities to harden supply chains, 3) renewable energy investments, and 4) manufacture semiconductors in the U.S. What's interesting is that only the first item on the list has a cyclical component to it, meaning investment is tied to the business cycle. The other three are being driven by needs either somewhat or totally divorced from the swings in the economy. Take the so-called CHIPS Act. This directs \$280bn over the next ten years towards semiconductor research and domestic based manufacturing. This money will be spent regardless of the whether we are in recession or not, and as you can see below, spending has soared lately. Furthermore, we are only starting to see the impact from last year's Inflation Reduction Act show up in the economic data. In this case, over \$750bn will be spent on alternative energy projects over the next few years. All



gets to a fact that we've touched on when talking about the debt ceiling. There is simply no faction on either side of the political isle arguing for austerity today. Back in 2011 or 2012 campaigning on the back of lower government spending was a vote winner in the U.S. and Europe. No longer!! Why is the economy surprising to the upside and why is inflation proving to be so sticky? Fiscal policy is playing a key role, and there's little appetite to turn off the taps any time soon.

What's it Mean For Inflation and the Fed? – There are a few moving parts to the inflation debate. First, much of the pandemic-related surge in goods inflation has already been unwound. Think of the shortage of Peloton machines turning into a surplus or the fact that you hardly read about supply chain problems anymore. Furthermore, oil prices are well off their highs, and the much-anticipated energy shock in Europe never materialized. Both factors should weigh on inflation the rest of the year.

On the other hand, core inflation hasn't budged. There are a couple things going on. The shelter component in the inflation data is still on the upswing, but this could very well be a timing issue. More real-time data on rents indicates that housing costs will have a much smaller influence on core inflation later this year. But core service inflation is also heavily influenced by wage growth, and here the data continues to point to further inflationary pressures. Throw in the fact that government deficit spending is likely to continue to set records, and in the absence of a recession that materially weakens employment, core inflation is not heading back to 2% as the



Fed wishes. We aren't talking about 1970's style inflation, but certainly hotter than what we've experienced since the 2008 financial crisis.

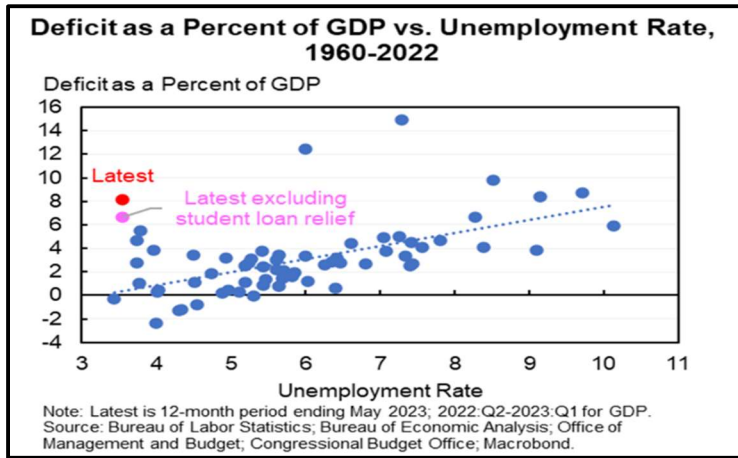
This means that the market is currently adjusting to the prospect of more rate hikes to come around the world. Central banks in the U.S., the U.K., and Europe as well as those in Canada and Australia have all indicated that tighter policy is likely in the months to come, and this outlook jives with where real interest rates are currently trading. As you can see from the chart at the bottom of the page, inflation adjusted policy rates for the big seven countries remains below inflation. As hard as it may be to believe, policy today isn't yet very restrictive. And this ties with some of the anecdotal evidence. New homes sales are on the upswing and the AI boom/mania(?) is something you usually only see during periods of easy liquidity, not tight money.

How many more rate hikes are we looking at? It's awfully hard to guess given the crosscurrents with inflation and growth, but our suspicion is that in the U.S. we could see two more quarter-point hikes. Beyond that we think the Fed will have a hard time justifying further tightening if core inflation is falling, but we will have to be flexible. If core inflation doesn't moderate this fall, it's not unreasonable to think the Fed keeps on pushing until unemployment rates start to increase materially.

Bond Market Outlook – In our view it doesn't pay to take much risk in the bond market today. Investors aren't being compensated well for taking either maturity or credit risk, and in some cases, they are paying a penalty. For example, twelve-month T-bills are yielding roughly 5.4% as we write while 10-year bonds yield just 4%. Granted, in a recessionary scenario the yield on the 10-year will fall and holders will see capital gains, but you are giving up almost 1.5% per year for this insurance policy. Likewise, AA rated corporate bonds are generally yielding less than 5%.

While small, there is default risk in AA bonds, so there's little appeal in higher quality corporates relative to Treasury bonds. This situation will undoubtedly change, but for now high-quality short-term bonds are attractively priced.

Let's quickly circle back to the idea of buying longer-term bonds to lock in rates



ahead of the next recession and deflationary period. We think it is too early to make this allocation change. Historically, long-term term yields have only started to decline significantly when the Fed begins to cut rates. If you look back at the 2006/2007 period as shown in the chart at the top of the next page, you can see that yields traded within a range

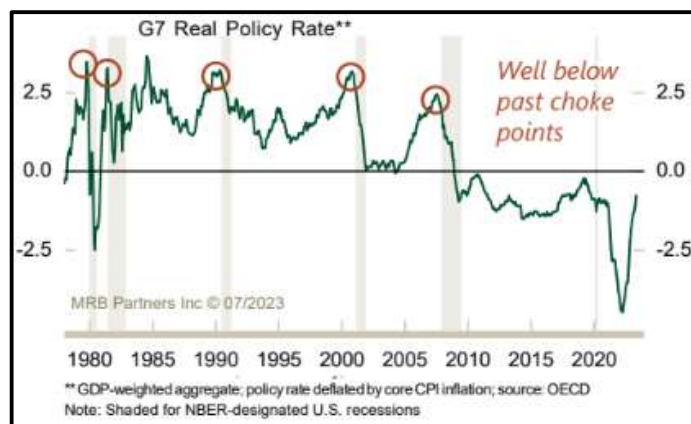
until we got close to the first rate cut. We see no reason why this cycle should be different. If anything, longer-term yields may remain higher for longer due to the fiscal backdrop and persistent inflationary pressures. What this means is that there is little reason to give up higher short-term yields now unless you think we are near a rate cutting cycle. We contend that we are at least six-to-nine months away from this.

More fundamentally, are longer-term bonds still an appropriate component of an investor's portfolio? Much depends on what the secular path for inflation is going to be. This seems the most contentious issue among the analysts we follow and respect. One side of the debate argues that both interest rates and inflation are likely to mirror the period after the financial crisis. Namely, sub-2% inflation rates in the developed world leads to low rates in the years to come. Their argument rests of the idea that a rapidly aging world is still plagued by excess savings, and these two forces combined with excessive global debt levels means a deflationary outcome (especially if the AI phenomena proves to be a massive boost for productivity). If this proves to be the case, bonds with yields approaching 6% should generate attractive real returns over the next few years.

Conversely, there is a small but growing contingent that takes the other side of the argument. Aging societies are inflationary, they argue, because fewer workers equals less production. Furthermore, governments are likely to favor an inflationary outcome in the years to come to handle both

high debt levels and massive retirement liabilities. And proactive fiscal policies will continue as long as the markets don't revolt, and more fiscal spending in today's environment almost guarantees higher inflation for longer.

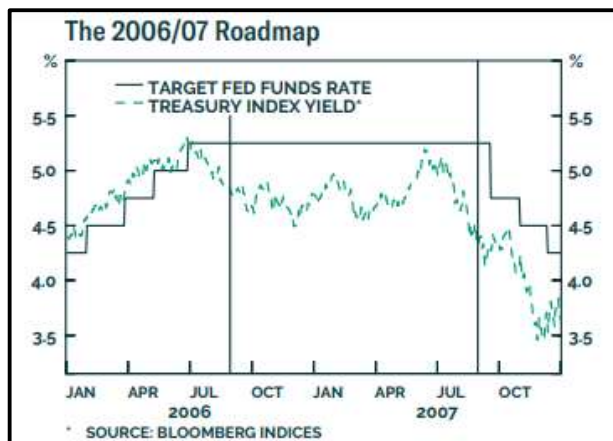
The beauty for investors today is that you don't have to pick sides in this debate when short-term bond yields exceed



5%. We suspect the true nature of the inflationary outlook will only become clear after the next recession. Quite possibly the next downturn fails to extinguish the inflationary embers, but for now we are all being paid a decent yield to wait.

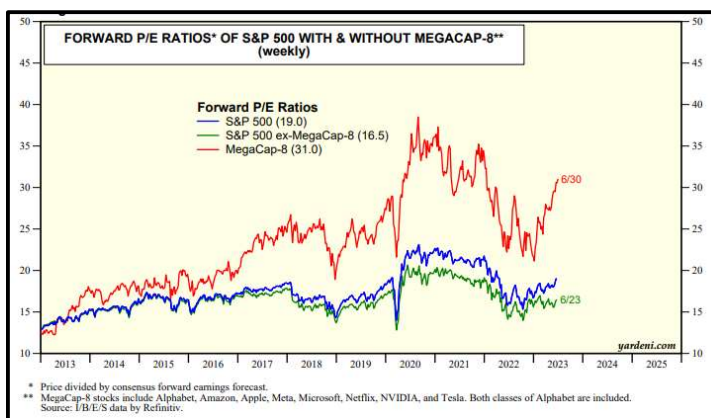
Equity Market Outlook – If we are right and we lose one of the key assumptions underpinning the market rally this year (rate cuts, falling inflation or resilient economy), then the environment for stocks in the second half is likely to become trickier. For now, we think the U.S. economy will remain pretty resilient while at the same time inflation has some room to move modestly lower. However, the assumption that central banks will be cutting rates by year-end appears misplaced. Why does this matter for equity investors? Because as you can see from the chart below, valuations are once again getting rich in select areas. The chart shows the forward price-to-earnings ratio for the S&P 500 (blue line) as well as largest market-cap stocks (red line) and everything else (green line). The big winners in the first half have been bid up to what has historically been rich valuations on a couple things: 1) the hope that AI will revolutionize business models, and 2) that rate cuts later this year will entice investors to pay more for future earnings. We won't claim any expertise on the first point other than to observe that guessing the winners and losers from technological revolutions is fraught with uncertainty. But on the second point, investors expecting rate cuts are likely to be disappointed.

Parts of the equity market have priced in a lot of good news, and at a minimum we think the markets could rotate away from the winners in the first half to recently unloved sectors. There are a number of historical precedents of market leadership moving from one area to another over time, and



we think the prospect of more rate hikes to come is a potential catalyst for another rotation. The rotation scenario would be good news for all diversified investors as it would mean small-caps and value stocks could play catch up. We also can't rule out a more meaningful market-wide correction if interest rates overshoot on the upside, but this is not our base-case expectation.

Final Thoughts – It was a tricky first half of the year for many investors. There were a lot of temptations to make big portfolio changes (debt ceiling, recession talk), and the market was frustrating for anyone without a large allocation to just seven stocks – which basically meant everyone who was diversified. But it was a profitable six months, which is a welcome change from the market we had in 2022!! Going forward, we suspect we are going to see another change of character. At least one of the three ideas that underpinned the market rally in the first half – rate cuts are coming in the second half, inflation will moderate significantly, and we avoid recession - are likely to be challenged in the second half. The most likely is the rate cut view. This seems very unlikely given the fact that rates aren't even in restrictive territory yet and core inflation is proving to be stubborn. It would take a meaningful spike in unemployment to get the Fed to abandon their inflation goals, and we simply are not seeing that in the data yet. Much more likely in our mind is that the Fed keeps on pushing rates higher until they can



slow growth. Another half-point in rate hikes is quite possible, although we can't rule out more. This isn't the end of the world by any stretch, but we do suspect it makes the second half of the year trickier to navigate for both stock and bond investors.

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