Monthly Commentary

May 3, 2023

When in Doubt, Zoom Out!

Investing your life savings over time will be an emotional journey. Investors will find themselves exuberant by rapid growth in value at the start of a new bull market. And then become exasperated when bear market conditions erode gains and value in quick fashion. During years of managing investment portfolios, it most often feels like a slow random walk; sometimes like a walk in the desert that is boring. Since the onset of current bear market conditions 15 months ago, it is understandable for investors to get caught up in stress, anxiety and even unhelpful thoughts and emotions. Rainy days are never fun compared to sunny times. Comedian and actor Reggie Watts[(1)] shared this phrase, and Melli O'Brien[(2)], a mental strength coach, promotes the idea by sharing about a favorite practice called "when in doubt, zoom out." When we become fixated on our anxieties and struggles, our problems and worries, or our insecurities, they can become very intense and overwhelming; even giant -like. Everything else gets overshadowed and hidden. The practice to "zoom out" from whatever negativity is creating issue, helps one see a wider perspective and thereby find some "breathing room" or much-needed mental space. Let's develop this thought relative to our current bear market concerns or worries. Let's "zoom out" on two topics influencing current and near-term market action.

This commentary – "When in Doubt, Zoom Out" - will briefly share market performance for April and discuss two market influences: market valuation (from a simple perspective), and the anticipated ugly process of raising the US debt ceiling in the coming weeks and/or months.

Style	April	YTD
Foreign Stocks	+2.3%	+10.3%
S&P 500	*+1.6%*	*+9.2%*
Large-Cap Stocks	+1.1%	+6.9%
Bloomberg Bond Idx	+0.6%	+3.6%
Avg US Stock Fund	+0.1%	+4.4%
Mid-Cap Stocks	-0.6%	+2.8%
Small-Cap Stocks	-2.1%	+1.1%

Client Objectives (Stocks/Bonds)	April	YTD
20/80	+0.5%	+2.7%
35/65	+0.6%	+3.2%
50/50	+0.6%	+3.9%
65/35	+0.6%	+4.4%
80/20	+0.6%	+4.8%
95/5	+0.6%	+4.6%

April provided a second consecutive monthly gain for the financial markets. That's helpful given the Fed is still raising interest rates to arrest sticky inflation (which is declining from its peak levels). All client investment objectives produced small gains; client portfolio's stock allocations were softer than the S&P500 index; bonds did well.

Are you aware that since October 12, a rally (of sorts) is reducing the effects of the bear market drawdown that started January 3, 2022? Unfortunately, we are still working through the life of the bear market. Since October 12, the S&P500 recovered +17.6% with both bonds and stocks advancing along with client portfolio values. We cannot, however, declare victory in the Fed's inflation fight, or call this rally the start of a new bull market. The broad market and average stock are not advancing in unison, a condition which occurs at the start of a new bull market. There is split-market action. "Strife" exists under the surface, as the percentage of stocks making new highs is soft; investors remain gloomy. Recall, the effects of changing monetary policy (raising interest rates and tightening monetary conditions) tend to be felt with a 6-12 month lag. We are now seeing some effects of the aggressive rate increases over the past 12 months by the Fed on inflation, the economy and labor markets, and banks. Risk is still being unwound and new market leaders are still being identified, which is the normal experience in most bear markets.

The Fed again raised interest rates +0.25% in early May, it is likely to be their last increase, probably pausing for a while thereafter. They might be in a quandary now as the recent banking crisis can create market concern and pressure to ease. From the last rate hike to the first cut, stocks on average rise about +5% over 100 trading days. Since monetary policy acts with a long lag, the market is not hurt by the Fed's last rate increase even if "weak links break"; it can be hurt by the cumulative effect of rate increases – the ultimate interest rate, and impact on slowing economic growth.

Market valuation is not yet "on sale" across the board. Several areas, like the banks, are looking beat-up (cheap). But the S&P500 still trades at a multiple of 18 times earnings (P/E) compared to its long-term historical average of around 16x; at several previous bear market bottoms, the ratio was around 10 times. Valuations are cheaper and more attractive than 15 months ago but could still decline further. While they are an unreliable tool for timing and should not be construed to mean that the market will decline, they can be useful in providing perspective about long-term return opportunity (higher opportunity when multiples are low, and vice versa); this implies investors may be pushing their luck, especially with respect to several mega-cap stocks. Even as the S&P500 provided a YTD return of +9.1%, the average stock is underperforming. 70% of the S&P500's gain this year can be traced to just 5 stocks that trade at lofty P/E multiples – Microsoft (33x), Apple (29x), Facebook (30x), Google (23x), and Nvidia (159x). Recently, many companies without earnings were outperforming those with profits; companies that pay dividends were also underperforming. If inflation and interest

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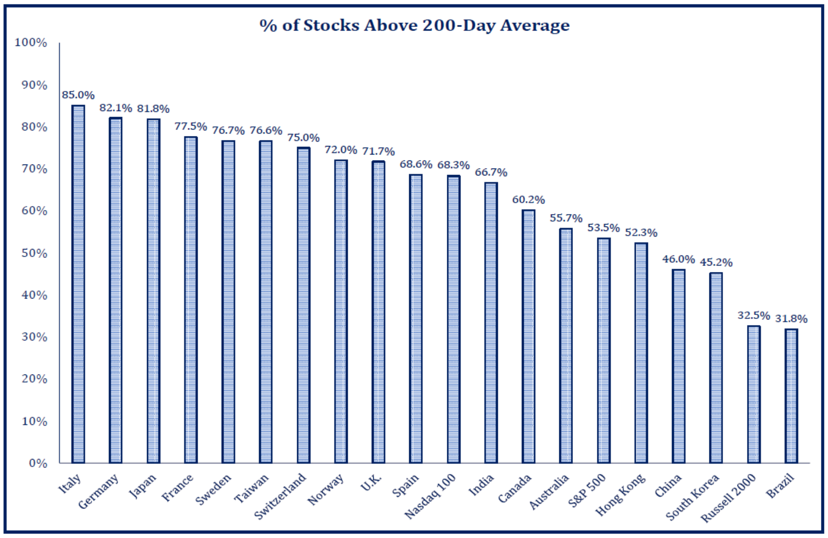
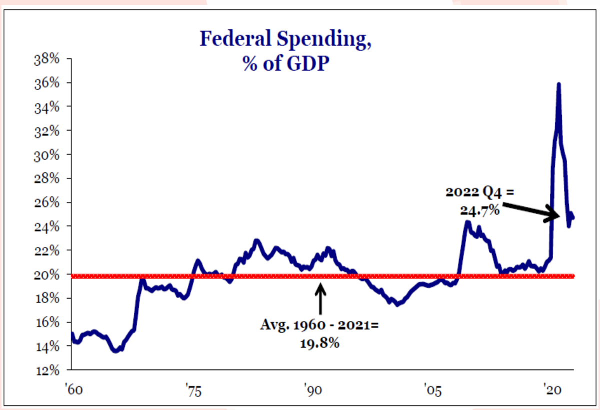
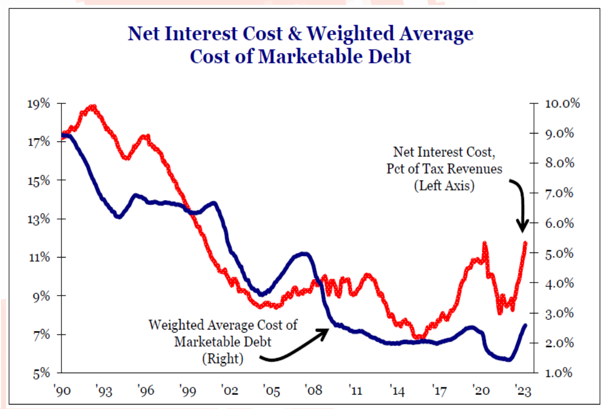
rates are binding constraints on valuation, these recent stronger performers are vulnerable particularly if recessionary conditions develop. P/E ratios could soften further because inflation (one of two investor enemies) is still above 4% and sticky, implying interest rates remain higher for longer as well. Bond yields now provide reasonable return competition to stocks and other risk assets. Zooming out - valuation is always important for long-term investor and portfolio success. Warren Buffett did not accrue his reputation by investing in expensive, current (or recent) faddish investments. No; he keeps it simple focusing on companies that are unloved, well managed with earnings and low debt, and selling at attractive valuations. He then holds them for long periods of time, avoiding paying taxes (the second of two investor enemies) on gains. If you take valuation one step further, improving economic growth trends are better in many foreign markets (chart) which offer more attractive valuations than the US domestic markets. And, if the US dollar continues to weaken, foreign stocks should also receive a "tailwind" boost in their performance (already evident in 2023 and since October 12).



The Debt Ceiling debate is just beginning, and will create noise during May and until resolution occurs. Stock market performance could be very bumpy during this time. Be aware the Fed (not US Treasury) will keep money (M2) available and flowing during the debate to "manage" (or mitigate if it can) what might otherwise be greater levels of market volatility. Volatility is an expression of risk; worry about the unknown.

Treasury Secretary Janet Yellen (former Fed chairperson) just announced June 1st being the "X" date by which the US debt ceiling should be increased. June 1 is a conservative date, but earlier than anticipated, because tax receipts are coming in lower than expected. June 1st accelerates the debate and forces policymakers to determine how to "save face" after boxing themselves in on political views. There is pressure on both sides of the isle – negotiate to raise the debt ceiling only with no adjustments to government spending, or to raise the debt ceiling when/as modifications are made in discretionary government spending. Budget reforms are needed. The iconic Eagles song, "Hotel California" lyrics "You can check out any time you want, but you can never leave" is timely perspective for this issue. It means choices are challenging; significant because spending is high and growing which requires government borrowing and refinancing maturing debt at higher interest rates than at any time in the last decade.





"Zooming out" – We are on the doorsteps of a period where hard work is just beginning. This will involve brinksmanship with political toxicity that can wobble markets and investors' confidence in the short run. There are congressional members on both sides of the isle who understand a slowdown in the growth rate of discretionary spending, the end of unobligated COVID funds, some changes to income support eligibility programs are imperative. Currently, federal spending as a percent of GDP is +400 basis points (4%) over its historical average (charts above). When this level was reached in the past, financial markets levied more pressure on government to enact austerity and spending cuts. Thereafter, slower economic growth resulted because higher interest rates crowded out the ability to spend. A very volatile process is set to occur; yet we will arrive at the ending point as we did in 2011 and past. The stock and bond market will resume providing returns to investors, while the composition of market winners and losers is expected to change (as is currently quietly occurring). Lest anyone feel highly discouraged, financial market research firm, Leuthold Group reminds that during past debt ceiling expirations, "it was a losing proposition" to manage stock and bond portfolios by assuming the worst.

Let's really "zoom out." Allow your thoughts to find joy – hearing birds singing outside, flowers blooming, trees gently moving in the springtime winds, the sun shining, and more. Life is much greater than worrying about short-term market wiggles and fluctuations of your investment portfolio values. And, life is certainly more enjoyable without news media and politics.

(1) Reginald Lucien Frank Roger Watts is an American comedian, actor, beatboxer & musician who improvises musical sets using only his voice, a keyboard, and a looping machine; refers to himself as a "disinformationist" who aims to disorient his audience in a comedic fashion.

(2) Melli O'Brien is a mental strength coach; co-founder of mindfulness.com and creator of "Mindfulness-Based Mental Strength Training," with a mission to make the world mentally stronger.