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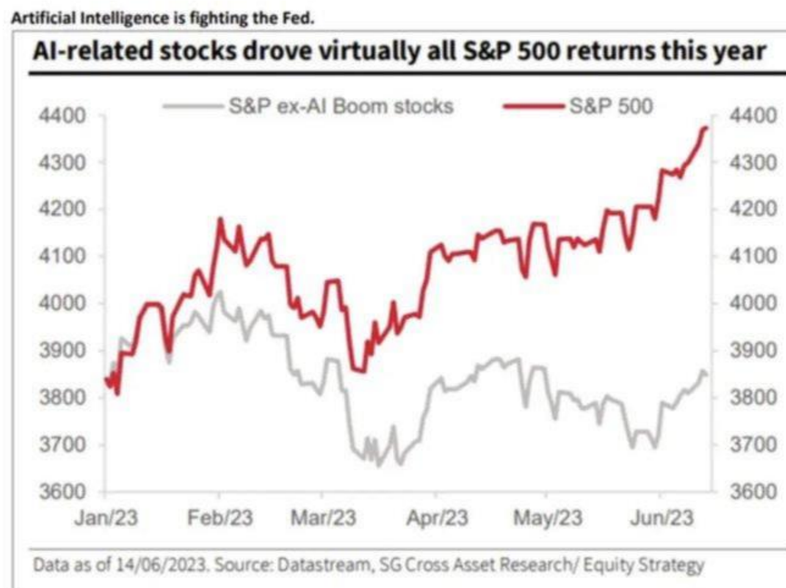
2023 Second Quarter Review
Land Mines and Moon Shots

We are 16 months into the Fed's rate raising cycle, and short-term interest rates have risen to over 5%, with another increase likely to come in the next few weeks. For the first time in many years, investors can receive a reasonable rate of interest on cash and treasury bills that is higher than current inflation while taking minimal risk. Normally, this competition for investment dollars would put stocks at a disadvantage. Why risk loss when you can lock in a near-riskless higher return on cash than the dividend yield on stocks? In spite of interest rate increases, inverted yield curves (with short-term rates higher than longer-term rates), historically large bank failures, quantitative tightening by the Fed (reducing liquidity), and looming major real estate defaults, the stock market indexes rose quickly in the second quarter. Inflation has come down quite a bit, from an annual rate of 9.1% one year ago to 3% recently by one measure (there are many). With that, a small contingent of technology stocks have moved up aggressively. In fact, some calculations show that almost all of the gains in the stock indexes this year were attributable to only 7 stocks representing plays in AI (artificial intelligence). Absent those few large stocks, the vast majority of stocks were on average flat to down so far this year. Technicians call that a "narrow" market, and it is not considered a healthy sign.



Because preservation of your capital is of utmost importance to us, we tend to invest defensively when so many of our valuation and historic indicators suggest that risk of loss of capital is high and the "riskless return" is greater than normal. That is now the case. Some stocks this year, such as those bankrupt bank stocks, have represented investment "land mines" while the "magnificent 7" stocks represented "moon shots." We largely avoided the land mines but did not have sufficient investment in the "moon shots" to keep up with the indexes.

One thing to bear in mind is that when the Fed raised interest rates this aggressively in the past, there has almost always been a recession that begins an average of 19 months after the beginning of the rate hikes. We are now 16 months into this rate-hike cycle. Just because a recession has not yet arrived does not mean that there will not be one. Many of the leading indicators point to a recession as being unavoidable, unless "it's different this time." It is often joked on Wall Street that thinking "it's different this time" has cost investors more money than any other investment theory.

Alternatively, it is possible that the economy will pull off a "soft landing" where any recession will be mild. The current primary narrative among bullish investors is that we will experience such a "soft landing" and that we have already entered a new bull market that will ultimately lead to new all-time highs for stocks.

This recent market rise may be another "echo rally" from the liquidity pumped into the economy during the pandemic and then again during the recent major bank failures. Economic conditions have become more restrictive with higher interest rates, more constrained bank lending, commercial real estate defaults, higher credit card balances, increasing defaults in car loans, and a Fed that is determined to pursue a path of "quantitative tightening" and "higher for longer" interest rates for at least the near future. For these and other reasons, we think caution is warranted.

After the recent frenzy of speculation, it would not be surprising to see an 8% to 10% pull back in stock prices between now and the fall with all of the signs of current over-valuation. We would like to maintain ample cash reserves to take advantage of any such decline, especially when those reserves are earning 5% with very little risk. Areas of opportunity may exist in high-quality, high-dividend-paying stocks that are increasing their payouts and in precious metals that are beginning to climb back to their old highs.

At any rate, it has been a wild first half, reminiscent in many ways of the "Internet Bubble" of 1999. In case you thought you had missed the opportunity after that rally, you may remember that you had many chances to buy those same stocks demonstrably cheaper a short time later.

As always, please give us a call if you would like to adjust your portfolio weightings or strategy. In the meantime, we will take advantage of the very good yields currently offered with so little risk and plan for the days when investor euphoria turns more somber. Although complacency may now reign, we should remember that "risk happens fast!" We plan to have the flexibility to take advantage when the pendulum inevitably swings back from "greed" to "fear."

Please review your reports at your leisure and contact us with any questions or suggestions that you may have.

Best regards,

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