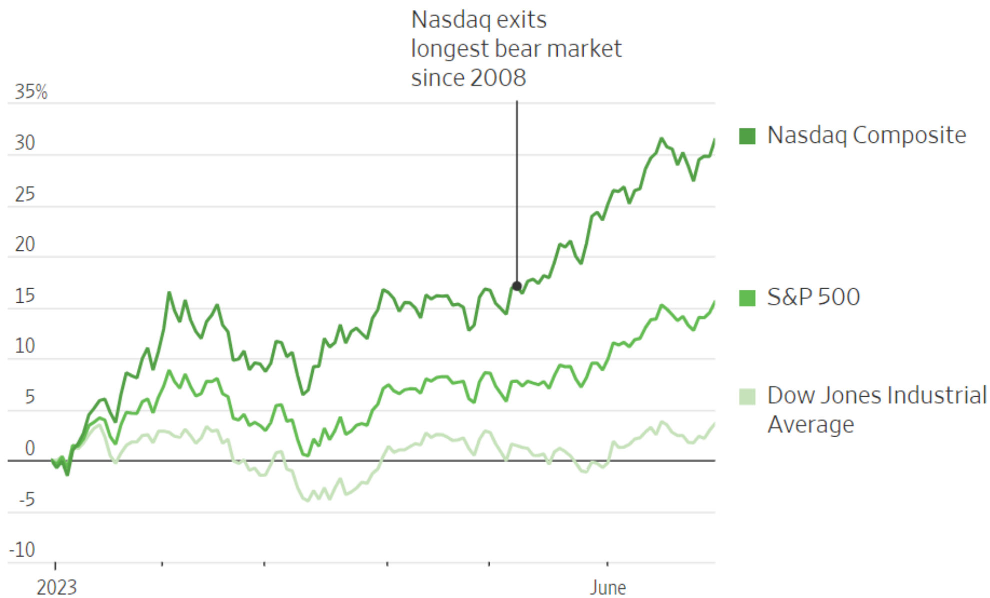
Good morning,

As we head into the second half of the year, I'm reminded of the opening line of A Tale of Two Cities; "It was the best of times, it was the worst of times." We've certainly had our share of unsettling developments in the economy so far this year: the failure of Silicon Valley and First Republic Bank, fears of a U.S. default stemming from the stand-off over raising the debt ceiling and additional rate hikes by the Federal Reserve, to name a few.

On the other hand, the economy remains on solid footing and earnings estimates are once again climbing. Inflation continues to decline, albeit at a pace that is a bit too sluggish for the Fed. Interest rates, therefore, remain elevated.

A tale of two markets

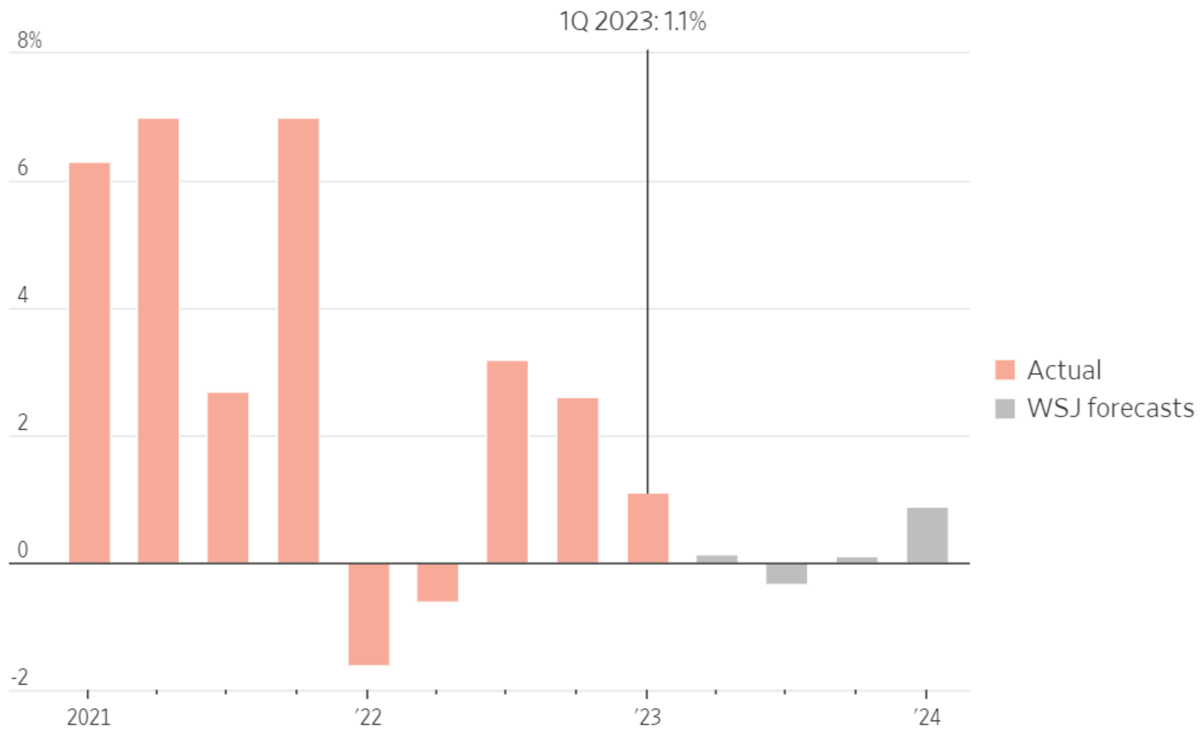
Normally, when asked how the markets are doing, I can give a straightforward answer. This year so far, the answer is "it depends." Much of the rise in the overall market has been concentrated on just seven Mega Cap tech stocks such as Apple and Tesla; thus, the dichotomy as illustrated in the chart below. The Nasdaq is up close to 32% year-to-date, while the Dow Jones Industrial average has gained a more modest 3.8%.



I'd like to touch on what I consider to be the major themes in the economy and the markets so far in 2023.

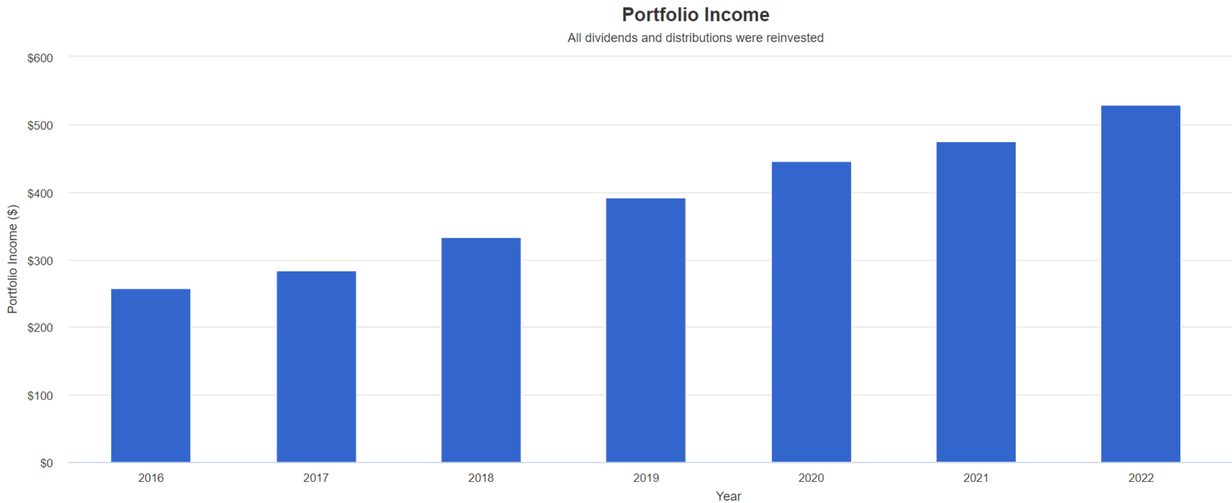
Are we heading into a recession?

What happens if the economy slides into a recession? In general, recessions are not favorable for stock returns since corporate earnings slow or decline during that period, and stocks prices typically follow suit. That being said, the economy continues to grow, and corporate earnings estimates have turned higher as well. With the unemployment rate near a 50-year low at 3.7% we may avoid an outright recession.



Dividend Growth

As mentioned earlier, the biggest returns so far in 2023 have come from large growth stocks. This does not reduce the attractiveness of companies with a long track record of stable and rising dividends, and I continue to hold them in portfolios. Consider the following: A $10,000 investment seven years ago in a portfolio of Dividend Growth stocks, as represented by the iShares Core Dividend Growth ETF, had a dividend of $258, or 2.58%. By the end of 2022, the dividend more than doubled to $525, while the value of the initial $10,000 investment grew to $23,000.

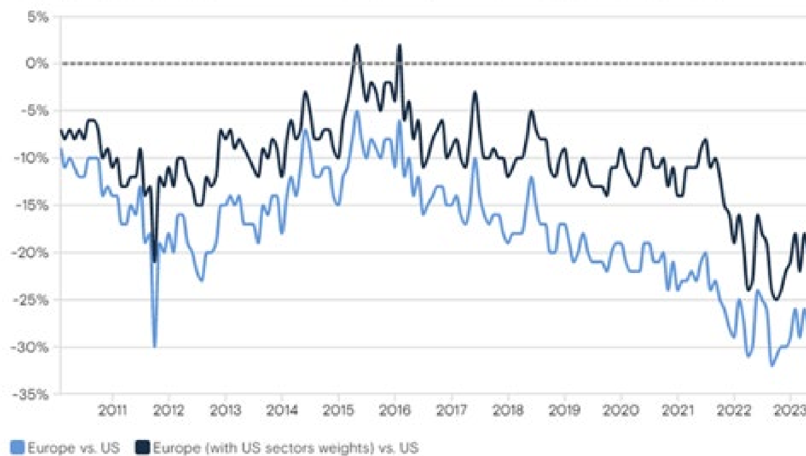


Source: Portfolio Visualizer

As Warren Buffet wrote in his annual letter to shareholders with regards to Coca Cola (one of the stocks in the Dividend Growth index) "Growth occurred every year, just as certain as birthdays. All Charlie [Munger] and I were required to do was cash Coke's quarterly dividend checks."

The case for International investment is becoming more compelling.

Considering that international stocks have underperformed those in the U.S. for so long, it pays to be a bit cautious when allocating to them. However, at current prices, the discount of European stocks to their U.S counterparts is the largest it's been in over 10 years. Possible catalysts to reverse this trend could include a drop in the U.S. dollar and improving economies abroad.



Portfolio Updates:

1. Reduced the overweight in value stocks. I feel leadership exhibited by the largest growth companies should narrow and a more broad-based price recovery should follow.
2. Increased Small Cap stocks. I am being proactive in starting to increase the allocation to smaller capitalization stocks. This sector historically outperforms their large cap counterparts following a recession.
3. Reviewed and in some cases reduced holdings in TIAA Real Estate. There have been some changes to the way TIAA allows transactions in their real estate fund. In addition, the high interest rate environment and an increase in remote work have changed the fundamentals for this sector. We still believe commercial real estate plays a valuable role in a portfolio, but are looking at the amount allocated and, in some cases, moving some of the funds into TIAA traditional.
4. Began to move back into Intermediate-term bonds. Short-term rates remain elevated, but when the Fed indicates that it is done raising rates, intermediate bonds will benefit the most.

In summary, I continue to be encouraged by the positive returns in the stock market and the resilience of the U.S. economy so far this year. Longer term, the picture continues to improve as inflation declines, and corporate earnings estimates improve.

I'd be remiss if I didn't mention that we passed our 1-year milestone as a new company on May 22nd. Our success is attributable entirely to you, and we thank you for the trust you continue to place in us. As always, please feel free to call or email me directly if you would like to discuss the markets or your investments in greater detail.

Very truly yours,

Jim

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