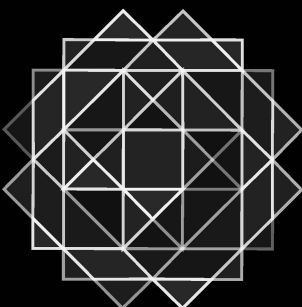
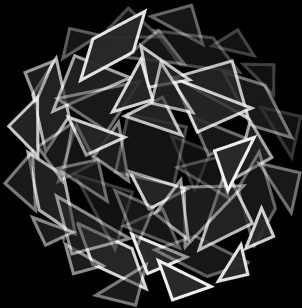
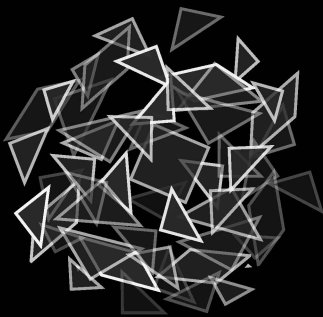
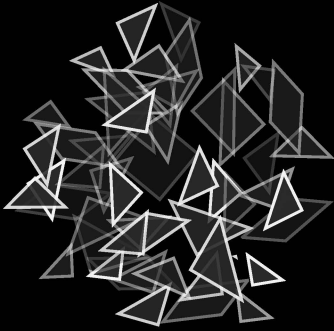




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Banking With Thinking

2Q 2023 COMMENTARY

CARY STREET
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JUNE 2023

BY THOMAS O. HERRICK

Cary Street Partners, Chief Investment Officer

Nvidia, Apple, Microsoft, Alphabet, Amazon.... equity investor experience so far in 2023 largely boils down to one's degree of ownership of these names. The NASDAQ 100 Index, where mega cap growth companies are most pronounced, is up 38.39% year-to-date as of this writing. The source of this crushing outperformance is partly related to the degree of underperformance in calendar year 2022, a year in which the NDX was down 32.38%. For context, QQQ, the ETF which tracks the NDX, is still about 10% below its peak price in November 2021. Mega cap out performance is also attributed to the fact that these are long duration equities most sensitive to yields. They react to any indication around the central bank ending its Fed funds rate increase campaign. Finally, as a group, mega cap names have not disappointed versus earnings expectations and in some cases have seen dramatic improvements in forward guidance driven by generative AI business.

Nevertheless, despite the concentration of winners for the bulk of the first half, as we approach the halfway point in 2023 investors will find global equity and bond markets considerably improved from January 1st, although still well below peaks reached in 2021. The high-level year to date report card for equities is the S&P 500 Index 15.78% higher, along with the MSCI ACWI global index gaining 14.20%. Bond returns are also positive, with Bloomberg US Aggregate up 2.22% and the Bloomberg Global Aggregate up 1.97%. For context the S&P 500 is approximately 10% below its peak in late 2021. The US economic backdrop remains solid, continuing to be fueled by the massive excess savings consequent to the massive pandemic induced money supply increase. Unfortunately, that money supply increase did not cease until early 2022, continuing far too long, creating the higher inflation dynamic that, while improved, remains the greatest economic challenge¹.

Inflation, as measured by CPI, peaked about a year ago, with 11 consecutive declines in headline CPI reports through May. Our base case for inflation remains for improved monthly prints, and we are increasingly of the viewpoint that CPI will begin to surprise to the downside. Money supply growth, as measured by M2, has been negative over the last six months, the only time that has happened since data began collection in 1959. This is the polar inverse to the massive M2 increase in 2020 through Q1 2022. To paraphrase Milton Friedman, ultimately inflation is always and everywhere a monetary problem. The dramatic reversal in M2 is the driver of the lower prints recently, just as it was the driver of higher prints previously.

Within the data, most of the recent CPI increase has been found in the shelter component. Here is also a good reason to be optimistic. Shelter data is collected every six months and is comprised of six sub-categories that are collected incrementally. This creates a lag as one component is collected in January, and then again in July, another in February and then again in August, and so on. Real time data on rent and shelter, such as the Redfin May rent report, show large declines. In summary, as shelter declines begin to be reflected in monthly CPI reports expect a large swing in this sticky component that constitutes about 40% of the index.

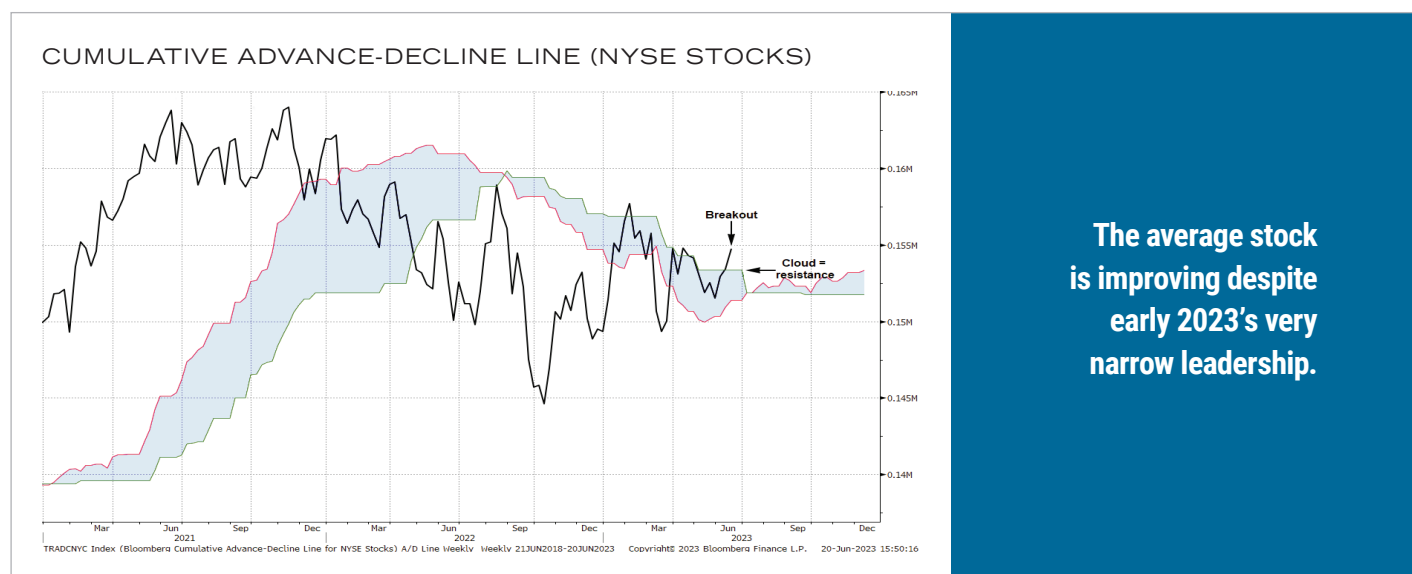
What has not occurred in this inflation cycle is a wage price spiral, similar to the late seventies. Most commentators and a very confused FOMC continue to be obsessed with tight labor markets. The Fed's own data as demonstrated in a recent deep dive by the San Francisco bank concludes that very little of the recent increase in inflation can be attributed to wage growth. Confused messaging from the FOMC around this topic and future Fed fund rate policy has created large swings in yields over the last few months, creating an opportunity in bonds.

CONTNUED...

2Q COMMENTARY

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From an equity market perspective, the greatest challenge in the first half of 2023 has been the very narrow leadership characterizing most of this period. A handful of 5 to 10 mega cap growth stocks constituted almost the entire S&P 500 gain over the first five months of the year. The challenge was resolved in a positive manner during June. There has been a recent breakout in breadth proxies such as RSP (equal weight S&P) and the advance-decline line that support much improved S&P 500 and NASDAQ 100 momentum. Continued follow through in breadth proxies will be necessary for market advancement over the second half.



The average stock is improving despite early 2023's very narrow leadership.

Source: Fairlead Strategies

Our 2023 Market Outlook, published in December 2022, concluded with four positioning recommendations; we grade and update those recommendations as follows:

1. Constructive on bonds, emphasizing longer duration Treasuries.

This would have been an A+ a month ago, prior to all the former FOMC doves that have transformed into hawks taking speaking engagements. Proxies for this recommendation, TLT and SPTL, are ahead 4.38% and 4.11% YTD and are also ahead of the broad bond market. In the last month, yields have backed up, and both proxies are oversold. This allows bond investors to act on an additional entry point for long-duration Treasuries that will ultimately respond to lower inflation prints and historically have proven to be a good purchase when the yield curve is inverted.

GRADE B+

2. Constructive on equities, with an emphasis not to ignore the growth side of the market. This was not a common thought on the street last December and is probably our most important recommendation. Exposure to long-duration growth stocks has been vital to capturing market upside this year. As mentioned, much of the YTD return attributes to narrow, mega-cap growth leadership. This is vivid in YTD returns for the Russell Large Cap Growth (IWF) and

Value (IWD) indexes, with Growth up 27.56 % and Value up a much more modest 4.25%. As we move forward, this dynamic is less of an issue as markets broaden beyond mega-cap growth. However, we would still maintain a balanced exposure to Growth and Value. Long-duration equities on the growth side still have lots of room for upside.

GRADE A+

3. Equities and bonds strongly correlate in a higher inflation world, and the typical 60/40 stock/bond allocation does much better in 2023. Lower inflation = lower yields = improved equity/bond returns remain in place for the remainder of 2023.

GRADE A

4. Use equity hedging strategies to reduce risk and add portfolio diversification. The CSP Global Hedged Equity model is ahead 9.92% YTD with less drawdown, standard deviation, and beta than the broad equity market.² This approach to diversification creates a smoother sequence of returns and high income sourced differently than long-only equity and bonds.

GRADE A

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¹ Bloomberg

² CSP Asset Management/Morningstar

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