Investment Tally & Perspective

MAJOR ASSET CLASS RETURNS	2nd Qtr. 2023	1-Year	3-Year	5-Year
Equities				
S&P 500	8.7%	19.6%	14.6%	12.3%
MSCI EAFE	3.0%	18.8%	8.9%	4.4%
MSCI Emerging Markets	0.9%	1.7%	2.3%	0.9%
Fixed Income				
Bloomberg US Aggregate	-0.8%	-0.9%	-4.0%	0.8%
Bloomberg US Corp. Inv. Grade	-0.3%	1.6%	-3.5%	1.8%
Bloomberg Emerging Market	1.1%	5.6%	-2.7%	1.0%
Other Assets				
MSCI US Reit Index	2.7%	-0.1%	8.9%	4.6%
S&P GSCI	-2.7%	-14.2%	25.1%	2.8%
ICE WTI Crude Oil	-6.6%	-33.2%	21.5%	-1.0%
Comex Gold	-2.9%	6.8%	2.3%	9.0%

Source: Capital IQ — All returns greater than one year are annualized

Market Activity - The S&P 500 posted strong returns in the second quarter as investors began to embrace the vigor of the economic expansion and reversed their overly bearish positioning. Fixed income returns were negative for the quarter, while the Bloomberg US Aggregate bond index posted returns of 1.5% for the year-to-date period.

Economic Activity – Despite calls for the economy to stall out, there have been very few signs of lost momentum. The few remaining indicators showing stress are market and survey based, not actual hard data like employment, incomes, and spending. Per capita personal income, after accounting for inflation, is reaccelerating after posting negative growth in 2022, which was dragged lower due to fewer government transfers in 2022 compared to 2021. For spending after accounting for inflation, services continue to surge while goods are starting to rebound as well. As a display of the recovery's durability, housing has gone from being a drag to again adding to growth.

Residential fixed investment, which subtracted 0.93%, 1.42%, and 1.20% from the last three quarters of 2022 GDP, has now stabilized. In Q1, residential investment subtracted only -0.16% from GDP, while May new home sales were up 20% from last May. Motor vehicle sales are another sizable portion of the economy that is interest rate sensitive yet, here too, growth is seen. After facing supply chain issues, inventories are slowly being rebuilt and consumers are buying. New unit sales in the first half of 2023 are expected to be up 13% from last year. Motor vehicles and parts added 1.1% to Q1 2023 GDP.

The employment picture is showing some signs of moderating, but in general the labor market is still very tight. Job openings are down 18% from their March 2022 peak, yet still 40% above February 2020 levels. Initial jobless claims are

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Our 33rd Year as a Registered Investment Advisor (RIA) Providing Fiduciary Asset Management and Financial Planning Services

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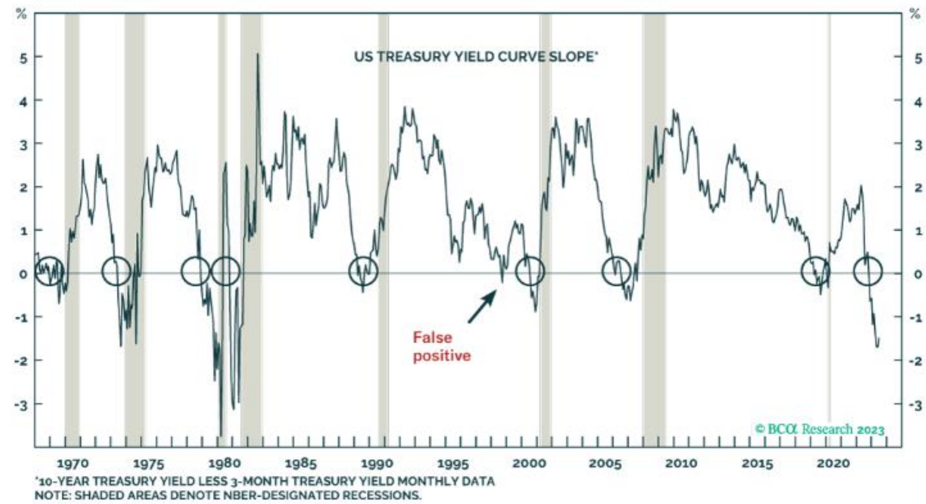
moving higher, above pandemic lows and above pre-pandemic levels. The hours worked per week are also declining; however, employment growth is still well above the level needed to keep up with population growth. The outcome of the tight labor market is wages that are growing briskly and pressuring corporate margins.

"Soft" data and market derived indicators paint a more dire picture. Manufacturing purchasing manager indices (PMI) are signaling contraction while consumer confidence is still well-off peaks. The yield curve is signaling one of the deepest inversions on record. The Conference Board's Leading Economic Indicators Index is also predicting a recession, but the details are telling—the yield curve, PMI New Orders and consumer expectations are driving the reading, not hard data.

In summary, data can be found to support any view one may take on the economy. We continue to expect the lagged impact of tight monetary policy in conjunction with slowing credit growth to weigh on the economy moving forward.



Source: BCA

Monetary Policy – Major central banks, outside of China and Japan, are implementing some form of tight monetary policy; however, many are at key inflection points. The Fed paused its rate rising campaign in June, but is expected to resume hiking in July and potentially again in September. Projections displaying the Federal Open Market Committee's views on year-end rates showed the median member saw two hikes between June and year-end. This begs the question: If more tightening is required between now and year-end, why skip June? The Fed was unsure if it is already too tight, and spacing out future hikes will allow for more data and time to reassess monetary policy's impact on the economy.

Globally, the scene is similarly perplexing. Some central banks, like the ECB are continuing to hike interest rates while others – like Canada and Australia that had paused their tightening campaigns – are once again resuming rate increases.

Valuation & Sentiment – All signs point to improved sentiment and positioning from the start of the year. Goldman Sachs' sentiment indicator is now positive by more than one standard deviation. U.S. equity fund flows are now strongly positive after being negative since December. The S&P 500 is trading at 19.0x the earnings per share (EPS) estimates for the next twelve months, a historically rich valuation, especially when compared to short-term rates of more than 5%. The outlook for earnings depends on your perspective. EPS for the S&P 500 in the second quarter is expected to decline by 6.8% and grow by 0.9% for the full year. While not growing much, if at all, estimated earnings have been getting marked down less than is typical, providing hopeful light at the end of the tunnel.

LINCOLN CAPITAL – INVESTMENT OUTLOOK & STRATEGY

We often hear institutional and individual investors state that these are unprecedented times of great uncertainty. While we agree, truth be told, we cannot remember a time when uncertainty did not exist. At the present time, primary investment related questions with uncertain answers include the following.

Question #1 - COVID caused severe economic dislocations resulting in upward price pressures that caused the Fed to belatedly pivot from being accommodative to being restrictive in the past 18 months. In their quest to stop a wage/price inflation spiral, will the Fed raise interest rates to levels that cause a recession?

Measures of inflation have been declining toward Fed target levels, yet we give 50/50 odds that the Fed raises interest rates to levels that may tip economic activity into recession territory.

Question #2 - If we enter a recession (two quarters of declining GDP) in the next 6 to 12 months, what is the impact on stock and bond prices?

Short-term interest rates are determined by Fed policy, longer-term rates are driven by market forces and reflect the market's opinion of future Fed policy and interest rate expectations. In a recession, we expect interest rates across the curve to drop, boosting treasury prices. Corporate and municipal bonds would have more nuanced behavior as the compensation required for bearing credit risk increases in a recession typically. Investors price stocks more on estimated revenues and earnings versus past and current actual results. Even though we attribute the severe decline in 2022 as the market (investors) discounting a recession, we anticipate the market moving lower again if we enter a recession in the next six to twelve months.

Question #3 - Will there be some resolution in the Ukraine-Russian war, or will this turn into another 'Iraq or Afghanistan' endurance test that lingers with an uncertain outcome?

The daily battles continue one and a half years after Russia invaded Ukraine with no end in sight. Though no one knows for sure, we anticipate a negotiated resolution/truce with timing in 2024.

Investment Strategy

Though we are pleased with our account performance in recent months, we continue to invest with a defensive bias. Volatility and periods of decline are normal market movements for risky assets such as common stocks and, if we enter a recession or bear market, we expect declines that are short and shallow (barring an unexpected major economic shock like COVID).

The companies we own are managed by seasoned executives with ample experience navigating recessions, which are normal occurrences in market economies. In closing, we will continue to hold positions that we view as undervalued and offer attractive risk/return relationships, while maintaining some reserves to employ if a market decline presents buying opportunities.

To Our Clients - Earning Attractive Returns on Cash Reserves - Lincoln Capital's Laddering Service
Could be appropriate for individual, business, retirement, and non-profit accounts with excess cash reserves, we have been increasing client investment income by laddering short-term Treasury bonds and FDIC-insured bank CDs. With yields over 4% - 5%, if you have excess liquid funds outside of your Schwab managed accounts, please contact us to determine if our Laddering Service can add to your overall account returns.

IMPACT OF FED POLICY ON BORROWERS AND SAVERS

Last month the Fed decided against raising interest rates after 10 consecutive interest rate hikes over a 15-month period. This began after inflation peaked at 9% in 2022, well above the Fed's target of 2% inflation. This past May's inflation reading came in at 4.1%. The pause has left the Fed Funds rate at 5% – 5.25%, and though they skipped raising this rate at their last meeting, the Fed has left the door open for future rate hikes depending on economic data. We highlight below how the Fed's fight against inflation has impacted both borrowers and savers.

The most closely followed consumer loan rate is the 30-year fixed conventional mortgage rate. While these rates are only influenced by (and not tied directly to) the Fed Funds rate, in early 2022 the 30-year fixed mortgage rate was 3.2%. Today, that same rate is 6.9%. At a rate of 6.9%, a $400,000 mortgage would have monthly payments of principal and interest of $2,634.40 vs. $1,729.87 if the rate was 3.2%—an increase of more than 50%. This naturally has a significant impact on housing and economic activity. With the pause, experts expect mortgage rates to stay close to this level, though other factors because of the Fed's fight again inflation could cause fluctuations. For example, mortgage rates dipped following the collapses of Silicon Valley Bank and New York's Signature Bank and could also decline further if the economy slows. In addition to higher rates, banks have also tightened their lending standards due to the economic uncertainty, and it is widely expected that upcoming regulations will require larger banks to increase their reserves which will further tighten credit cost and availability.

Along with mortgages, the average credit card annual percentage rate (APR) is over 20%, up from 16% last March. This is the highest rate since 1994. Credit Card APR is tied to the prime rate, which is based off the Fed Funds rate. Issuers add a markup to arrive at the card's interest rate. Paying off credit card balances now, before the APR could rise further, is advisable. Auto loan rates have also increased, up from 5.1% last year to 7.1% for a new car in May of this year.

Though bad for borrowers, rising rates have been a welcome sight for savers. The average yield on savings rate is up to 0.58% according to Bankrate's July 3rd survey, with many banks offering yields over 4.5%. Though yields on bank saving accounts rise and fall with the Fed Funds rate, saving rates are normally slow to come into effect.

While the consensus today believes there will be one, if not two, more interest rate hikes this year, it is still not entirely clear what the fastest rate hike cycle in 40 years will do to the economy due to the lagging effect of changes in monetary policy. Consumers, however, should not expect borrowing costs to significantly decline this year, and in fact, they may increase further.

Please view us as a resource for all your financial questions and needs, and as always, please contact us if we may be of assistance.