Insight Newsletter
SUMMER 2023

Litman Gregory
WEALTH MANAGEMENT

What's Inside

Investment Commentary: July 2023

Market Recap

Global equities continued to rally in the second quarter, led by surging U.S. mega-cap technology and growth stocks, particularly anything related to Artificial Intelligence (AI).

The S&P 500 index gained 6.6% in June and 8.7% in the second quarter, driving its year-to-date return to 16.9% overall. The technology heavy Nasdaq Composite has driven the majority of returns in U.S. stocks, rising over 13% in the second quarter, and 32% year to date.

Outside the U.S., stocks in Europe and emerging markets have also posted solid results. Developed international stocks (MSCI EAFE Index) rallied 4.6% in June, gaining 3% for the quarter and 11.7% YTD. Emerging markets stocks (MSCI EM Index) rose 3.8% in June, resulting in a 0.9% gain for the second quarter and a 4.9% return YTD.

Moving to the fixed-income markets, core bond returns (Bloomberg U.S. Aggregate Bond Index) were slightly negative for the quarter as interest rates slightly rose/prices fell. The benchmark 10-year Treasury yield ended the second quarter at 3.8%, up from 3.5% at the end of March. Riskier high-yield bonds (ICE BofA U.S. High Yield Index) gained 1.6% for the quarter and are up 5.4% YTD. Municipal bonds (Morningstar National Muni Bond Category) were generally flat on the quarter and up 2.3% YTD. Actively managed flexible/nontraditional bond funds (Morningstar Nontraditional Bond Category) gained around 2% and are up over 5% for the year.

Finally, multi-alternative strategies (Morningstar Multistrategy Category) and managed futures (SG Trend Index) underperformed stocks but outperformed core bonds for the quarter. Trend-following managed futures had a strong rebound after a tough first quarter, gaining around 8%.

The Narrowest Market in at Least 50 Years

The market-cap-weighted S&P 500 Index's rally this year has been one of the narrowest on record, with less than 28% of the index's constituents beating the overall index return. In an average year around 49% of the index's 500 companies beat the overall index. The only other year comparable to this year was 1998, as the Tech/Internet stock bubble was inflating.

More granularly, with the sudden frenzy in all things AI, the average YTD return for Amazon, Google, Meta, Microsoft, NVIDIA, and Tesla is 96%. The gains in these six mega cap tech stocks are responsible for almost the entire S&P 500 return for the year. Moreover, the combined market cap of these six stocks (plus Apple), now comprises over 27% of the total index, the largest concentration in history for the top seven stocks.

It remains to be seen whether this extremely narrow market rally resolves via the rest of the market catching up or the mega-cap tech stocks referenced above "catching down," but improved market breadth would be a plus. On a positive note, it appears the rally is potentially broadening; the small-cap Russell 2000 index shot up 8. 1% in June, while the large-cap Russell 1000 value index climbed by 6%.

Investment Outlook and Portfolio Positioning

Macroeconomic data remains mixed. On the one hand, the U.S. economy has been more resilient than most expected through the first half of the year, with the labor market remaining strong, supporting consumer spending; and headline inflation dropping meaningfully, thanks to a sharp decline in energy prices. On the other hand, key leading indicators of an impending recession are still flashing red, including a deeply inverted yield curve and tightening credit conditions, among others. Moreover, core inflation (excluding food and energy) remains stubbornly high, with the Fed signaling it will resume rate hikes later this year, further raising the likelihood of a recession.

We maintain our view that a recession is the most likely outcome over the next few quarters, however, a near-term recession is not a certainty. Each cycle is somewhat different and this one is considerably so due to the pandemic dislocations, and there have been three instances (out of 13) where the Fed tightening cycle ended without a recession.

Just as the U.S. economy has been more resilient than expected in the face of aggressive Fed tightening this year, the U.S. stock market (S&P 500) has been as well — and then some — gaining nearly 17%. The key drivers of this year's strength include the fact that the economy and corporate earnings have held up better than many expected, optimism that the Fed will soon end it's tightening cycle, and most importantly, investor euphoria around Artificial Intelligence.

Specific to the last point, while it is likely Ai will have a huge impact on society and the global economy, that doesn't necessarily mean these companies' underlying earnings fundamentals are justified. It may be in some cases, but we remember the tech/internet stock bubble in 1998-2000. The internet obviously has had huge economic impact over the past 25 years, but very few tech stocks were priced appropriately in early 2000 and even successful tech giants like Cisco are still below their tech-bubble highs of more than two decades ago.

While our portfolios maintain significant exposure to U.S. stocks overall and many of the mega cap tech stocks mentioned previously, we remain slightly underweight U.S. stocks and favor foreign stock markets where we believe valuations and return potential is a bit more attractive. Meanwhile, our view of the U.S. fixed-income markets is more positive. With rising yields over the past year, most bond market sectors now offer attractive expected returns relative to their risk. In addition to our core bond exposure, we continue to have a meaningful allocation to higher yielding, actively managed, flexible bond funds run by experienced teams with broad investment opportunity sets. These funds are currently yielding in the high single-digits, and while they carry more credit risk than core bonds, all our active bond managers are very attuned to risk management and have the flexibility to tactically vary their portfolio exposures in response to market risks and return opportunities.

Finally, we maintain core positions in trend-following managed futures funds. We remain confident in trend-following managed futures' powerful long-term portfolio benefits in providing alternative and non-correlated returns relative to traditional stock and bond holdings. Trend following strategies don't depend on a single macro environment and can perform well whether the backdrop is deflationary, recessionary, inflationary, or growth oriented.

Closing Thoughts

While we believe a recessionary bear market is the most likely outcome over the next few quarters, as we extend our time horizon over the next five to ten years, we see reason for optimism. Within the U.S. stock market there are companies and sectors that are reasonably priced and offer attractive return potential. The fixed-income landscape is also attractive, thanks to higher yields and inefficiencies that can be exploited by skilled active managers.

We also see strong total return potential from international and emerging market stock markets, which have been out of favor and underperforming for more than a decade. These markets are not "priced for perfection" as the U.S. market seems to be and instead seem more susceptible to "upside surprise" – better-than-expected earnings growth and valuation expansion. While foreign markets will get hurt in a near-term recession, we don't want to try to time getting out and getting back in given their attractive five-year return outlook.

Successful investing requires a balance between offense and defense. Earning superior long-term returns does require one to take calculated risks when opportunities present themselves, but to also exercise caution during periods of market exuberance. By maintaining a disciplined and balanced investment approach, we are well-positioned to weather the inevitable market storms and capitalize on the opportunities that are also sure to arise. From all of us at Litman Gregory Wealth Management, we thank you for your trust.

Gauging the Odds of a Recession and What it Would Mean for Investors

In past quarters, inflation has been the big story in news headlines and in our own investment commentaries, but in recent months the increased likelihood of a recession has been moving to the front of the news cycle. In this article, we revisit thoughts from our latest quarterly commentary to review the chances we will experience a recession in the near term and what that could mean in the shorter and longer-term for the investment strategies we manage.

Assessing the Data

The current macroeconomic data are sending mixed signals. On the one hand, the U.S. economy has been more resilient than we (and many others) expected through the first half of the year. GDP has grown, and actually accelerated in the second quarter which surprised most analysts; the labor market has remained very strong, supporting consumer spending; and headline inflation has dropped meaningfully, thanks largely to a sharp decline in energy prices and consumer goods disinflation as supply and demand normalize after the pandemic disruptions.

On the other hand, key leading indicators of an impending recession are still flashing red, e.g., Conference Board Leading Economic Index (LEI), deeply inverted yield curve, tightening credit conditions. And although the Federal Reserve paused its aggressive interest rate hiking campaign in June, core inflation (excluding food and energy) remains stubbornly high, with the Fed signaling it will resume rate hikes later this year, further raising the likelihood of a recession.

As we read the muddy economic tea leaves through our cloudy crystal ball, we maintain our view that a recession is the most likely outcome over the next few quarters. Historically, the odds are unfavorable for the economy avoiding a recession after the Fed has been aggressively tightening – after all, the purpose of tightening is to slow the economy. And we have yet to see the full impact of this cycle's monetary tightening on the real economy since the effects are lagging. That said, we don't expect a severe 2008 or 2020 type of recession. Household and corporate balance sheets are in good shape, and by raising rates to 5% the Fed now has room to cut them again in the next recession, softening the downturn.

And a near-term recession is not a certainty. (1) There are not a lot of historical data points: this is just the 14th Fed tightening cycle since WWII. (2) Each cycle is somewhat different and this one considerably so due to the pandemic dislocations. And (3) there have been three instances (out of 13) where the Fed tightening cycle ended without a recession. (We discuss this further below.) So, a more benign near-term outcome is certainly possible, and the current growth and inflation trajectory is not inconsistent with that.

In gauging the likelihood of a recession, the interrelated variables are inflation, the labor market, Fed tightening, and the impact that has on the economy and in turn on corporate earnings. We'll look at those in more detail before talking about how it informs our investment decisions.

Inflation

Despite the still-high core inflation readings, the Fed Open Market Committee (FOMC) unanimously decided not to raise interest rates at its June 14 meeting, after 10 consecutive rate hikes since March 2022 totaling five percentage points (500 basis points). The Fed had signaled this pause was likely coming and the financial markets were expecting it.

However, we don't believe this pause signals a lessening of their resolve to fight inflation, so we consider it a "hawkish pause" because contrary to expectations the Fed projected 50 basis points (0.5%) of rate hikes later this year. The markets were expecting maybe one more hike at most.

Of course, as we've frequently noted, the Fed's projections of its own behavior are often wrong. No one knows, not even the Fed itself, what it will do three or six months from now. There is too much uncertainty and variability in the economy, at least in the current macro environment.

The Fed also revised up its forecasts for GDP growth, employment, and core inflation for 2023, reflecting the resilience of the economy so far this year and consistent with its projection for further interest rate hikes later this year (the blue lines in the chart below).

At his post-FOMC meeting press conference, Fed Chair Jerome Powell conveyed a hawkish message to those expecting Fed rate cuts any time soon. "Nearly all committee participants view it as likely that some further rate increases will be likely this year," he said. "Not a single person on the committee wrote down a rate cut this year, nor do I think it is at all likely to be appropriate if you think about it." Nevertheless, the markets remain skeptical the Fed will actually hike rates twice more.

We think it will take a sharp economic downturn and surging unemployment for the Fed to start cutting rates. But they may continue to hold the Fed funds rate at current levels (or 25 basis points higher) if core inflation drops convincingly towards 2% over the second half of the year.

Meanwhile, the Fed is still hoping they can land the economy softly without causing a recession and a large increase in unemployment. This occurred in the 1965, 1995 and 2018 hiking cycles. But history is not on the Fed's side. The challenge is daunting given the complexity of the task and the multitude of economic, geo-political and other variables far beyond the Fed's control.

One can see from the table below that a recession has started an average of 7-8 months after the last Fed rate hike. Based on the historical average, if the Fed's last rate hike is at the July FOMC meeting, the recession would begin in early 2024.

Most Fed Tightening Cycles Result in Recession, But with a Several Month Lag

Beginning of Tightening Cycle	End of Tightening Cycle	Fed Funds Rate at Beginning	Fed Funds Rate at End	Core PCE	Real Fed Funds Rate	Recession Start	# Months from Start of Tightening to Recession	# Months from End of Tightening to Recession
Jan-48	Feb-53	1.00	2.00	-	-	Jul-53	66	5
Apr-55	Aug-57	1.50	3.50	-	-	Aug-57	28	0
Sep-58	Sep-59	1.75	4.00	-	-	Apr-60	19	7
Jul-63	Dec-65	3.00	4.50	1.46	3.04	No recession	-	-
Nov-67	Apr-69	4.00	6.00	4.66	1.34	Dec-69	25	8
Jan-73	Apr-74	4.50	8.00	6.48	1.52	Nov-73	10	-5
Aug-77	Feb-80	5.25	13.00	8.97	4.03	Jan-80	29	-1
Sep-80	May-80	10.00	14.00	8.84	5.16	Jul-81	10	14
Sep-87	Feb-89	5.50	7.00	4.71	2.29	Jul-90	34	17
Feb-94	Feb-95	3.00	6.00	2.30	3.70	No recession	-	-
Jun-99	May-00	4.75	6.50	1.72	4.78	Mar-01	21	10
Jun-04	Jun-06	1.00	5.25	2.60	2.65	Dec-07	42	18
Dec-15	Dec-18	0.25	2.50	2.08	0.42	No recession	-	-
Mar-22	?	0.25	5.25	4.70	0.55	?		
Average					2.89		28	7
Median					2.85		27	8

Source: Board of Governors of the Federal Reserve System, U.S. Bureau of Economic Analysis, Federal Reserve Bank of San Francisco.

However, there has been wide dispersion. The lag has been as long as 18 months in the 2007-2008 financial crisis recession. (After they stopped tightening in June 2006, the Fed actually started cutting rates in September 2007 before the recession started in December 2007.) And in the two rate hiking cycles during the inflationary 1970s, both recessions began a few months before the Fed stopped hiking.

We believe Powell would accept a recession in exchange for bringing inflation sustainably down to the Fed's 2% target, although the political pressure (from both sides) will ratchet up as we get closer to the November 2024 election.

The Labor Market

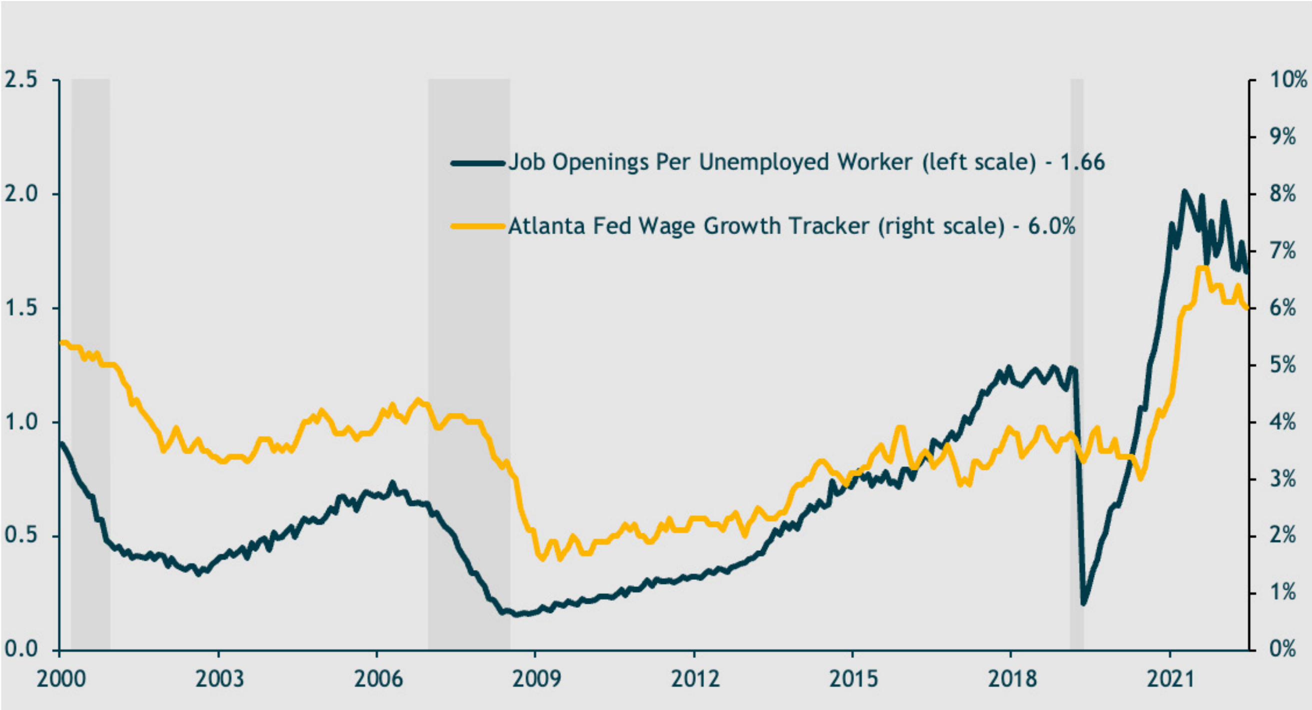
Wages and salaries account for 60% of personal income, according to Ned Davis Research, so the strength of the labor market has been key to the strength in consumer spending and the economy's resilience this year.

On the other side of the coin, the largest input cost for most businesses is wages. Wages in turn are partly a function of inflation expectations, which can feed into a self-reinforcing wage-price spiral — the Fed's biggest fear.

The good news is that the risk of a wage-price spiral now looks very low. Much like the core inflation readings, wage inflation appears to have peaked and has started to fall. But is still too elevated at around 6%. Annual wage growth of around 3%-4% would be consistent with the Fed's 2% inflation target, assuming productivity growth of 1%-2%.

The ratio of Job Openings to Unemployed workers is one measure of labor demand versus supply. It remains near all-time highs, with 1.8 job openings per unemployed worker. As shown in the chart below, there is a strong positive relationship between this ratio and wage inflation.

The Labor Market Remains Strong, Keeping Wage Inflation High



Source: Board of Governors of the Federal Reserve System, Federal Reserve Bank of Atlanta, and Bureau of Labor Statistics. Data as of 05/31/2023.

The Fed's hope is that tighter monetary policy will reduce the number of job openings, relieving pressure on wages without causing a big increase in actual layoffs and unemployment. That's a possibility given the unprecedented number of job openings relative to very low unemployment. But it's not our base case.

We'd also point out the Fed itself is projecting roughly a one percentage point increase in the unemployment rate over the next year. The U.S. economy has never experienced more than a 0.5 ppt rise in unemployment from its cyclical low without the economy falling into a recession.

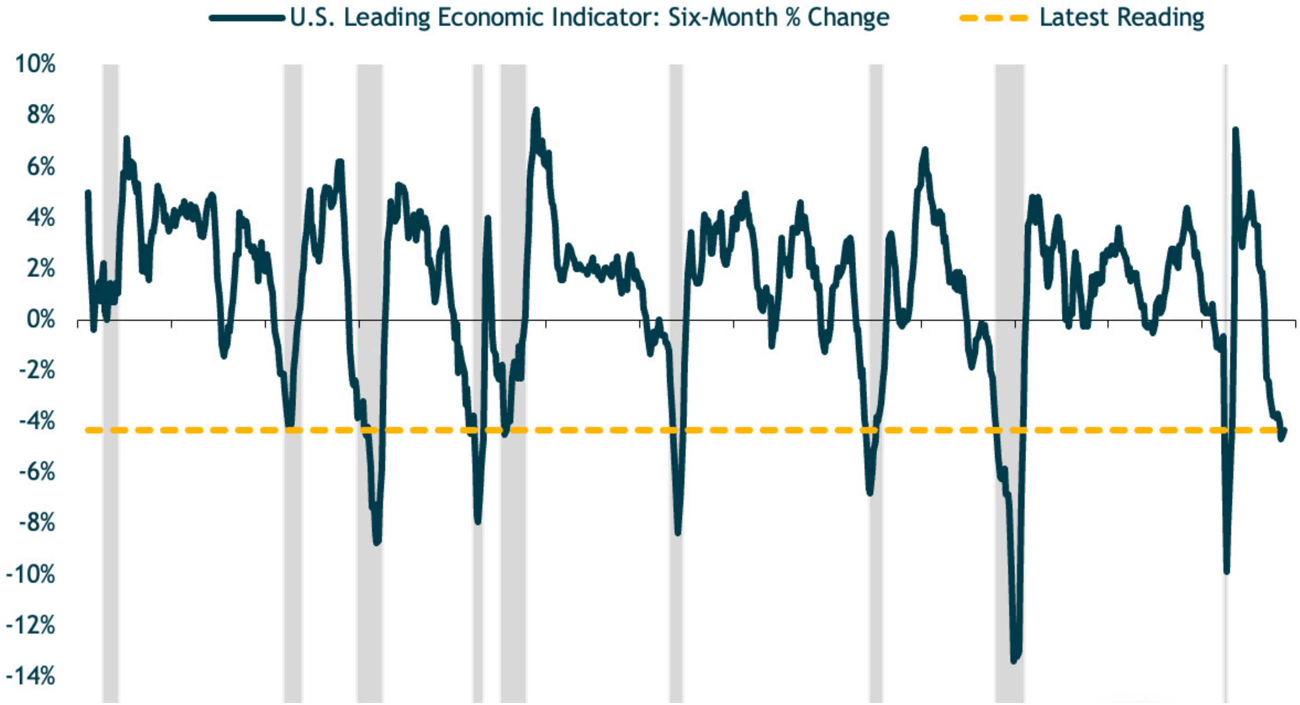
Economic Growth

So far this year, the U.S. and global economy have held up better than we expected in our base case, with sub-par (below-potential) growth but no recession. As shown in the chart below, this is due to the continued strength in the Services sector (a PMI above 50 is expansionary), while Manufacturing activity has been contracting.

However, the key economic leading indicators that have driven our base case U.S. recession expectation have shown no sign of improvement over the past quarter. In addition, we do not think the Fed is close to loosening monetary policy any time soon, barring a recession. And the full, lagged, economic effects of the Fed's aggressive monetary policy tightening have not yet played out.

Revisiting our key leading indicators, the Conference Board Leading Economic Index **(LEI) has declined for 14 straight months, the longest negative streak since the 2008 financial crisis, and its six-month rate of change is deeply in recessionary territory**.

The U.S. Leading Economic Indicator (LEI) is Plunging, Signaling Recession is Likely

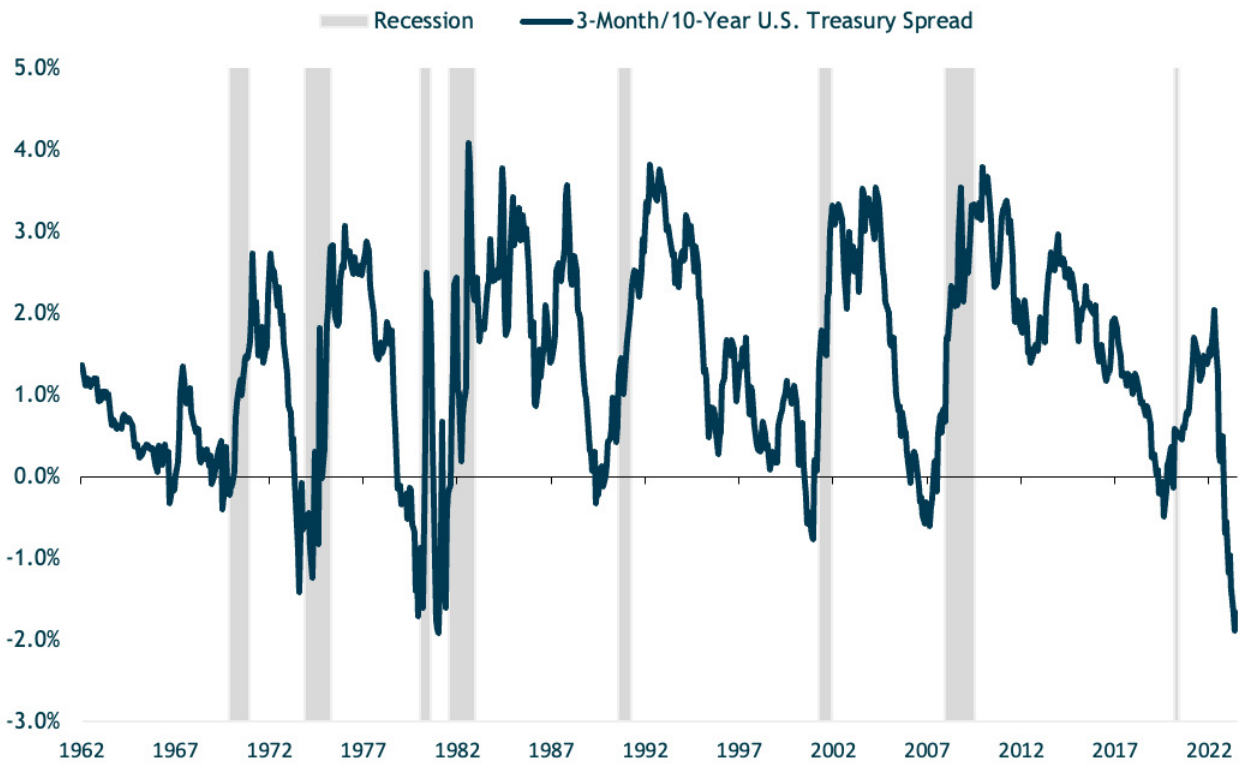


Source: Bloomberg LP. Data as of 5/31/2023.

The second key recession indicator is the inverted Treasury yield curve – meaning short-term Treasury yields are above longer-term Treasury bond yields. An inverted yield curve is usually (but not always) a leading indicator of recession. As with the LEI, the depth and duration of the current inversion has never occurred without a subsequent recession in the U.S.

However, the timing from initial curve inversion to the onset of recession has been highly variable. According to BCA Research, across the eight U.S. recessions dating back to 1969, the average lead time from the initial yield curve inversion to the onset of recession has been 11.3 months; but it has varied from 5 months to 16 months (using the 10-year/3-month yield curve). **The current inversion started in November 2022, so a second half 2023/early 2024 recession would be in line with the historical range.**

A Deep and Sustained Inverted Yield Curve is Another Recessionary Signal



Source: Federal Reserve Bank of St. Louis. Data as of 6/27/2023.

Bank lending standards are another economic leading indicator. Lending standards impact overall credit conditions, which in turn impact economic growth via consumer and business borrowing and spending. Thankfully, the worse-case scenarios swirling during the regional banking turmoil in March have not come to pass. (We were not expecting the worst case given the Fed/FDIC's quick responses.) However, **lending conditions remain tight and at levels consistent with recession** in the past. And at this late stage in the economic cycle, credit conditions are likely to tighten further. This will further weigh on business investment (capital expenditures, or CAPEX) and consumer spending.

Corporate Earnings

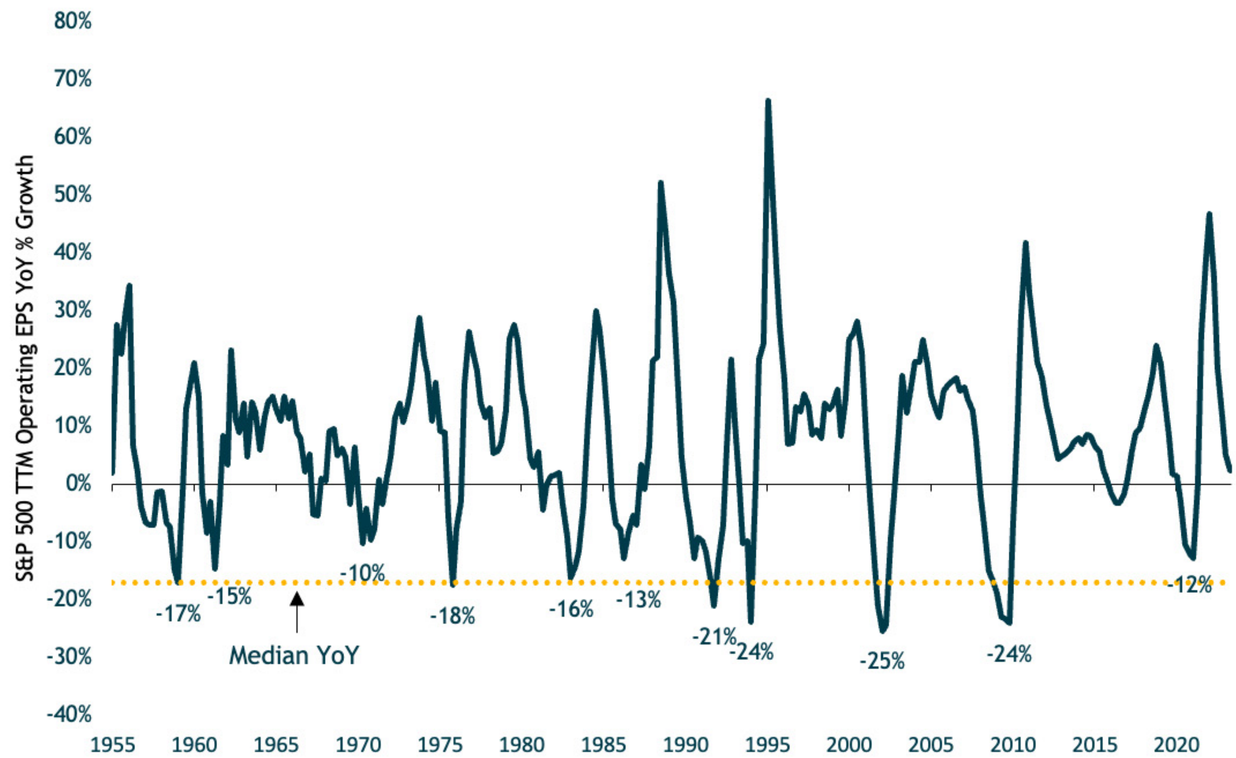
Although the markets can be driven by investor sentiment and momentum in the shorter-term, ultimately it is corporate earnings — "fundamentals" — and the price one pays for those earnings that drive stock prices and investor returns over the medium to longer term.

Our assessment, as well as that of many investment strategists we respect, continues to be that consensus/analyst earnings expectations for the remainder of 2023 are too high given the likelihood of an economic recession. Put differently: **We do not believe the S&P 500 at current levels is adequately pricing in the likelihood and magnitude of a near-term earnings recession.**

An economic recession implies a corporate earnings recession as profit margins compress and sales growth slows. In fact, it is the compression in profits that typically lead companies to lay off workers, which further exacerbates the recessionary impulse from shrinking demand for goods and services.

Even if this recession is relatively mild, earnings could decline by 10% or more. (The average historical earnings recession is negative 15-20%.) In contrast, the current consensus earnings forecast is for a slight increase in earnings through year-end, followed by double-digit growth in 2024; and analysts have recently been revising upward their earnings growth expectations. This is inconsistent with a recessionary scenario, in our view.

S&P 500 Earnings Typically Declines Mid-Teens During Recessions



Source: Bloomberg LP. Data as of 6/30/2023.

If and when actual earnings fail to meet expectations, we estimate the potential downside for the S&P 500 to be as high as 20-30% from current levels before the market cycle bottoms and the next bull market and economic recovery begin. That is the magnitude of decline we believe long-term investors need to be prepared for.

Timing and Outlook

In terms of timing, every U.S. bear market associated with a recession has bottomed during the recession—on average several months after the recession has started. Again, there is wide dispersion historically in terms of the exact timing, but in no cases did the S&P 500 hit its cyclical low prior to the onset of recession. On the positive side, the market typically starts recovering before the recession clearly ends — once all the bad news (and then some) is fully priced in and investors start anticipating the next up cycle.

Though we think it more likely than not that we will see a recession in a 12-18 month time frame, with commensurate short-term downside for stocks, as we extend our time horizon to the medium-term (five to 10 years), we see reason for optimism, or at least comfort. While the U.S. stock market in aggregate is vulnerable to earnings disappointment, there are companies and sectors within the U.S. market that are reasonably-priced, e.g., areas not swept up in the current AI frenzy. The fixed-income landscape is also attractive, thanks to higher yields and inefficiencies that can be exploited by skilled active managers.

We also see strong total return potential from developed international and emerging market stocks, which have been out of favor and underperforming for more than a decade. These markets are not "priced for perfection" as the U.S. market seems to be. Instead, they are susceptible to "upside risk" – better-than-expected earnings growth and valuation expansion. While foreign markets will get hurt in a near-term recession, we don't want to try to time getting out and getting back in given their attractive five-year return outlook.

Closing Thoughts

Even if a recession is pushed out beyond the next 12 months, the business cycle has not been repealed. A "normal" business cycle recession is inevitable at some point. And as an investor, that's to be expected. In fact, it is healthy to periodically clear out speculative excesses and reset expectations and market valuations. As with past cycles, we are confident the economy and financial markets will survive the next recession and go on to higher highs in subsequent cycles, albeit with bumps and dips along the way.

Earning superior long-term returns does require one to take calculated risks when opportunities present themselves, but to also exercise caution during periods of market exuberance. At present, we remain patient and are confident that our research will enable us to identify these opportunities when they occur, while helping us remain patient in the meantime.

Wealth Management Team Updates

Wedgewood Partner's Private Client Team Joins Litman Gregory Wealth Management

We are pleased to announce that the St. Louis-based private client advisory business of Wedgewood Partners Inc. (WPI) has joined Litman Gregory Wealth Management (LGWM). The WPI team has many longstanding client relationships with individuals and families and manages approximately $275 million in private client assets. Most importantly, they share Litman Gregory's belief that serving clients' needs first will ensure the longevity of the business and provide services for generations to come.

We are proud to welcome WPI's Tony Guerrerio, who founded WPI and is the lead relationship manager for private clients, as well as two additional experienced team members Sheila Kilper and Jason Siedle. All three share our values, including a deep commitment to caring for our clients. The addition of this team and their clients serves the broader LGWM business as we grow and enhance our industry-leading wealth management capabilities. The addition of the St. Louis office location also furthers our geographic reach, helping serve what is already a national client base.

Please join us in welcoming Tony, Sheila, Jason and their clients to the LGWM family.

Our Larkspur Office Has Moved — Next Door!

The Litman Gregory Wealth Management Office in Larkspur has made a move! We relocated into a beautifully renovated suite designed with more space for hosting visitors and collaboration among team members. We look forward to hosting our clients and friends of the firm in this new office.

Please come visit our new office, located in The Exchange at:

Litman Gregory Wealth Management
1100 Larkspur Landing Circle • Suite 300 • Larkspur, CA 94939

Please update your records and feel free to contact us with any questions. We look forward to welcoming you to our new location!

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Index Disclosure

Any reference to a market index is included for illustrative purposes only, as it is not possible to directly invest in an index. Indices are unmanaged, hypothetical vehicles that serve as market indicators and do not account for the deduction of management fees or transaction costs generally associated with investable products, which otherwise have the effect of reducing the performance of an actual investment portfolio.

The Standard & Poor's 500 Composite Stock Price Index is a capitalization-weighted index of 500 stocks intended to be a representative sample of leading companies in leading industries within the U.S. economy. Stocks in the Index are chosen for market size, liquidity, and industry group representation.

The MSCI ACWI Index represents the performance of large- and mid-cap stocks across 23 developed and 24 emerging markets. The index covers 2,900 constituents across 11 sectors and approximately 85% of the free float-adjusted market capitalization in each market.

The MSCI EAFE Index is an equity index which captures large and mid-cap representation across 21 Developed Markets countries around the world, excluding the US and Canada. With 799 constituents, the index covers approximately 85% of the free float- adjusted market capitalization in each country.*

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 23 emerging market country indexes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and the United Arab Emirates.

The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar- denominated, fixed-rate taxable bond market.

The US High-Yield Market Index is a US Dollar-denominated index which measures the performance of high-yield debt issued by corporations domiciled in the US or Canada.

The ICE BofA US High Yield Index is market capitalization weighted and is designed to measure the performance of U.S. dollar denominated below investment grade (commonly referred to as "junk") corporate debt publicly issued in the U.S. domestic market.

The ICE U.S. Dollar Index is a geometrically-averaged calculation of six currencies weighted against the U.S. dollar.

The S&P/LSTA Leveraged Loan 100 Index (LL100) dates back to 2002 and is a daily tradable index for the U.S. market that seeks to mirror the market-weighted performance of the largest institutional leveraged loans, as determined by criteria. Its ticker on Bloomberg is SPBDLLB.

The MSCI Hedged Indexes include all of the securities and weights of each corresponding unhedged MSCI Parent Index, enabling investors to measure the impact of hedging currency, for all the constituents of the Parent Index.

Contact

Contact our team for more information on our services

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