Second Quarter 2023 Investor Letter
Market Review

Equity markets rallied strongly in the second quarter, led by large capitalization technology stocks. For the period, the S&P 500 rose 7.7% and the Barclays Aggregate Bond Index fell 0.2%.

The strongest performers during the quarter were companies which have a large exposure to the rapidly developing field of Artificial Intelligence. In fact, 10 of these companies accounted for 73% of the gain in the Index. Bonds were essentially flat during the period, as were many of the so-called "value" stocks which had held up well during the market decline in 2022.

The rally during the quarter was substantial enough that the stock market is officially no longer in a bear market but has entered a new bull market phase. By way of perspective, since 1932 the average bull market lasted about five years, and the average gain was almost 180%. The bear market which just ended lasted 9 months and saw a decline of 25%. This was slightly less than the average since 1950 of 13 months and 34%, making it relatively short and mild by historic standards.

Stock Market Rally Unanticipated by Experts

Investors might reasonably ask how the market has risen so much given all the concerns which existed at the beginning of the year. In our view, there are four primary explanations. **First**, inflation came down rapidly. As we've mentioned in previous letters, unexpectedly high inflation was the primary reason the market fell. As inflation has now fallen faster than almost any economist predicted, this source of pressure on markets has been lifted. **Second,** the economy has performed better than expected. The ability of the US economy to remain strong through a period of rapid rate increases surprised many experts. In the past, rapid rate increases such as seen in the past two years have often led to recessions, especially when inflation was high. Economists will be studying this period for years to understand why they were wrong. **Third,** the economy has proved to be less interest rate sensitive than it was in the past. As we've previously written, this may be largely due to the high portion of economic activity which is unrelated to interest rates. These areas include government expenditures, health care and many services. Taken together these make up two thirds of the US economy. If this is the case, central banks will find it increasingly difficult to control the economy using their traditional tools. **Fourth**, rapid advances in AI gave investors an area to be excited about and opened a very promising area of earnings growth.

To be clear, the fact that the economy is less interest rate sensitive than it was previously does not mean that the Fed is irrelevant. Even if the Fed cannot fine tune the economy, it could still set off a financial crisis which would slow the economy. In such a case, the Fed's tools could still be construed to work, but obviously not in the desired manner.

Financial markets continually swing between extremes of emotion. It is well known that investors may become overly optimistic during good times. Carried away with easy profits it is easy to forget about the risks and assume a market rise will continue forever. It is less well understood that excesses of pessimism can be just as extreme (and costly). Recall that it was only a few months ago that many experts were predicting some combination of continued high inflation, stagflation, the end of globalization, a generation of poor equity returns, a debt crisis and a banking crisis. Were these possibilities? Yes, but it is rare that events unfold in as simplistic a manner as they forecast. It was the realization that the worst-case scenario probably would not happen that made it possible for the market to rally.

A Different Sort of Market Low

The market low last October was unique among market lows in recent decades in that it did not coincide with a loosening of liquidity by the Fed. Nor did equity prices reach levels generally considered to be bargains, at least by historic standards. That said, levels of pessimism by market participants last fall were consistent with previous market lows.

Investors often talk about what market highs and lows look like so it may be instructive to recall what was going on last October 13, which was the day of the market low. We asked AI engine Google Bard to summarize the financial market headlines for that day. Here was the response:

• *U.S. stock markets closed lower on Wednesday following the release of an inflation gauge. The Dow Jones Industrial Average fell 200 points, the S&P 500 lost 25 points, and the Nasdaq Composite Index declined 30 points. The sell-off came after the Labor Department reported that consumer prices rose 0.6% in September, the largest increase since August 2021.*
• *The yield on the 10-year Treasury note rose to 1.5%, its highest level since May 2019. The rise in yields came as investors bet that the Federal Reserve will raise interest rates more aggressively in order to combat inflation.*
• *Oil prices rose to $80 per barrel, their highest level since November 2014. The rise in oil prices was due to concerns about supply disruptions in the Middle East.*
• *Gold prices rose to $1,800 per ounce, their highest level since August 2020. The rise in gold prices was due to investors' demand for safe-haven assets amid rising inflation and geopolitical uncertainty.*

As you can see, all the news was negative. At the same time, Wall Street strategists were calling for more pain ahead. One top tier firm called for the market to fall 10% in the fourth quarter. Another prominent strategist predicted a severe recession would start soon. A prominent market analyst published a book predicting a trifecta of doom including a severe recession, a debt crisis and currency crisis.

We point these forecasts out because they illustrate why our advice of maintaining an investment strategy through good and bad periods in the market is vital for your long-term success. We are not aware of any forecaster who successfully forecast both the beginning and end of the bear market, and there are unlikely to be forecasters who do this in the future. See the section below for more on the perils of being a market forecaster.

In our last quarterly letter, we included a section called Market Rises over Time Despite Bad News. In this section we included a chart which showed all the concerns that stock market investors have faced since 1990, along with a graph illustrating that the trend in stock prices has nevertheless trended steadily higher. The reason for this rise is because earnings have grown over time, which is a trend expected to continue.

The Problem with Market Gurus

During periods of market turbulence, investors understandably look to experts to try to make sense of what is going on and what will happen next. This is why the financial media provide a seemingly unending stream of such people to opine on that market's outlook. Economists, strategists, and successful portfolio managers are regularly interviewed for this purpose. All of these people are smart, successful, and well informed, and can provide insight into current market developments. But readers and viewers should be wary of making investment decisions based on their advice. The simplest reason for this is that, for all of their qualifications, none of them became successful doing what they are asked to do in the media, which is to forecast the direction of financial markets. Economists study the economy, portfolio managers pick stocks and strategists do whatever it is they do. None are professional market timers. There is a simple reason none of them became successful forecasting the short-term direction of the market—it cannot be done. This is why we encourage investors not to become too caught up in short term market moves.

In our experience, prominent market forecasters come in three types:

(Almost) Always bearish. These people peddle scary stories about all the things that could go wrong in the world. Politics, geopolitical concerns, and other ominous long-term issues are all part of their story. Some of them masquerade as "value" investors, but unlike actual value investors they are usually mostly invested in cash or gold. They play on investors' fears in order to get attention, a tactic which is especially effective during difficult periods in the market.

Always bullish. Since the market goes up over time, this group is better than the first one, but can also be harmful. Unfortunately, their message of permanent optimism is most appealing when the market is at high levels, and investors may follow them into stocks at the wrong time.

Extremely short term. This group seeks to forecast short term market moves based on current news, earnings reports, stock charts and other tools. While these tools may be of some use to those who are traders or professional short-term investors, they generally are of no use to most market participants.

One type of investment advice we have not touched on is valuation. This falls into a different category because it actually works, although only over a time frame which is too long for most of the financial media. As we said in a previous letter, the ability to select and value stocks is literally what it means to be an investor. Investors (both value and growth) who patiently follow a disciplined strategy of buying outstanding companies at reasonable prices can still be expected to have good long-term success. The investment managers our firm works with all have a demonstrated track record, organizational strength, and long-term commitment to their investment discipline. Investing with these managers, combined with a good investment policy, can form the basis for sound long-term investment results.

Thank you as always for being a client. Please feel free to reach out to me or Roger should you wish to discuss any topic.

William R. Andersen, C.FA.
Chief Investment Officer and Partner