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QUARTERLY INVESTMENT PERSPECTIVES: **Q3 2023**

Second Quarter Review

Both the economy and the stock market delivered to the upside during the second quarter despite the Federal Reserve continuing to raise interest rates. U.S. large cap stocks rose 8.7% during the quarter, bringing their returns for the first half of the year to 16.9%. Returns were driven by large cap technology stocks such as Nvidia, Meta Platforms (Facebook), Tesla, and Amazon, among others. Fueling the technology sector's returns were a positive outlook for artificial intelligence and the potential earnings growth it can deliver for these companies. In terms of the broad economy, the recessionary slowdown that many have feared as a result of higher rates has yet to come. Hiring in the job market has cooled, but remains positive with unemployment near a multi-decade low level of 3.6%. While some economists expected economic activity to be flat or negative during the second quarter, the Atlanta Federal Reserve estimates U.S. GDP grew at 2.1% rate in the second quarter.

Mid and small cap stocks rebounded from a difficult end to the first quarter, as the fallout from the Silicon Valley Bank failure appears to be contained. The Russell Mid Cap index rose 4.8% while the Russell 2000 Index (measuring U.S. small cap stocks) jumped 5.2%. Looking abroad, international developed markets gained 3.0% during the quarter and are now up 11.7% for the first half of the year. Conversely, emerging markets have faced headwinds as Chinese economic growth has slowed significantly. These trends have surprised many strategists who thought the Chinese economy would see elevated growth after their long-awaited post COVID reopening.

Fixed income returns were challenged during the quarter as interest rates climbed and the uncertainty over the short-term path of the Federal Funds rate has brought about volatility within bond investments. Interest rates remain at very attractive levels, however, as two-year Treasury Bills ended the quarter with a yield of 4.87% and intermediate term corporate bonds have a yield of 5.48%.

In summary, the first half of the year has provided a welcome bounce in both stocks and bonds and investors have been rewarded for not reacting to the volatility of 2022. As we navigate the remaining half of 2023, we would not be surprised to see some uncertainty return to markets and the economy as the effect of elevated interest rates works through the system and brings about slower growth. However, valuations across stock, bond, and alternative investment markets remain at levels where investors can expect to achieve positive returns over the intermediate- and long-term.

Investment Market	Q2 - 2023	YTD 2023
U.S. Large Cap Stocks	8.7%	16.9%
U.S. Mid Cap Stocks	4.8%	9.0%
U.S. Small Cap Stocks	5.2%	8.1%
International Developed Stocks	3.0%	11.7%
Emerging Market Stocks	0.9%	4.9%
Barclays US Aggregate Bond	-0.8%	2.1%
Barclays Global Aggregate Bond	-2.2%	0.8%

Sources: Eaton Vance, as of 6/30/2023

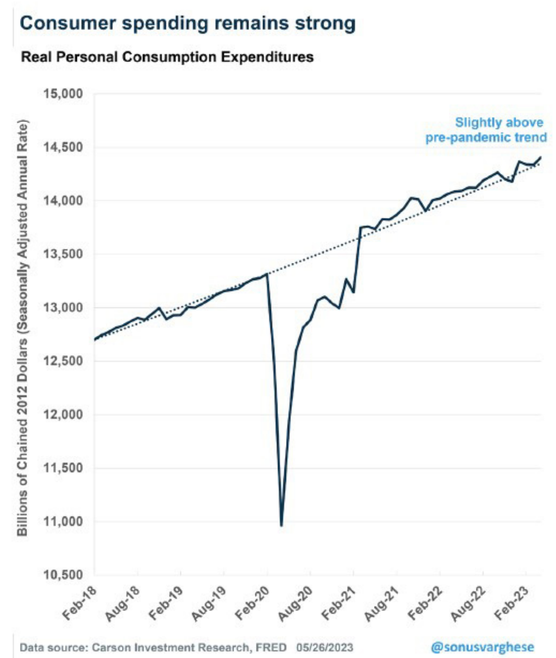
MARKET REVIEW AND OUTLOOK

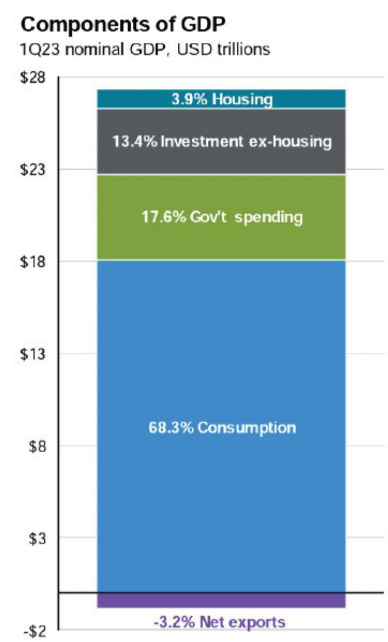
Consumers Keep the U.S. Afloat

After navigating the last year's market volatility, persistent inflation, and interest rates reaching their highest level in over a decade, one would think the U.S. consumer would be tapped out. While the pace of growth has certainly cooled over the last year, it is cooling at a very high level rather than falling. The Wall Street Journal noted in a recent report that "inflation and economic activity haven't eased as much during the first half of 2023 as Fed officials anticipated. Layoffs retreated, adding to evidence of a solid labor market. Economic growth was stronger than previously estimated in the first quarter. Other recent data showed rising new-home sales, orders for long-lasting goods and consumer confidence." The recession that has been long feared as a result of rising interest rates has not materialized yet, thanks in part to the U.S. consumer.

We can see in the chart above that consumer spending, after taking a historic plunge during 2020, has rebounded and subsequently risen above its long-term trend line. In essence, this means that consumers continue to spend money at a rate above historic average levels. When we consider that the U.S. economy, as measured by Gross Domestic Product (GDP) illustrated in the chart on the right, is about 68% consumption, it is hard to make a case for a recession if consumption remains above trend.

The primary question we consider as we look at the economy is "how long?" can spending increase at an above trend rate, especially when inflation is still elevated. The answer there depends upon the job market as well as the balance sheet of the consumer. First, on the job market, we continue to see robust demand for workers across a variety of industries, save for the technology sector, which over hired into COVID and is now undergoing rounds of layoffs. Through the first half of the year, the economy added 1.67



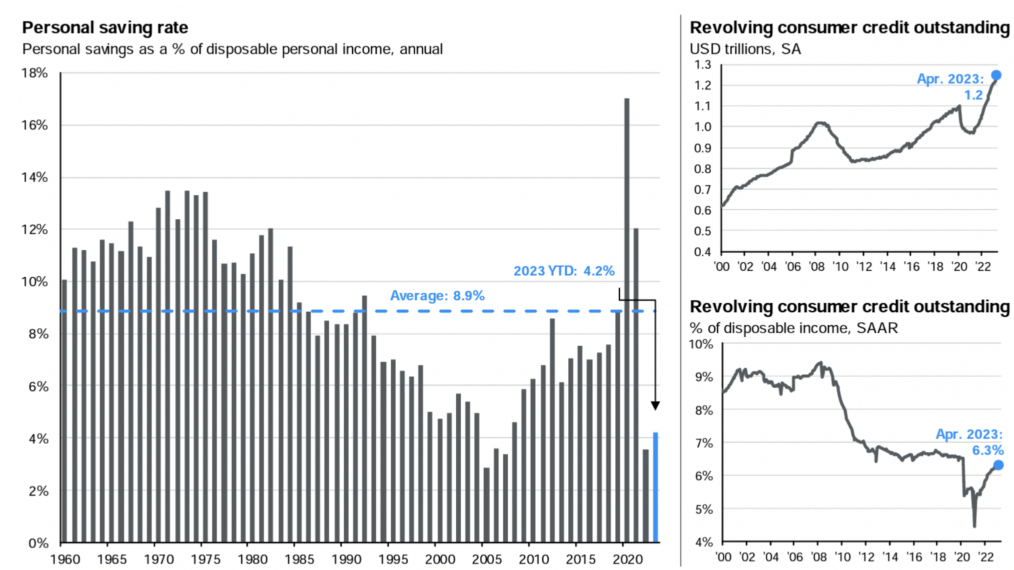


MARKET REVIEW AND OUTLOOK

million jobs and the unemployment rate held steady at 3.6%. For some historical perspective, since 1939, the economy has added, on average, 1.49 million jobs in each calendar year. In essence, the job market is currently hiring at twice the average rate which is not typical heading into a period of economic weakness.

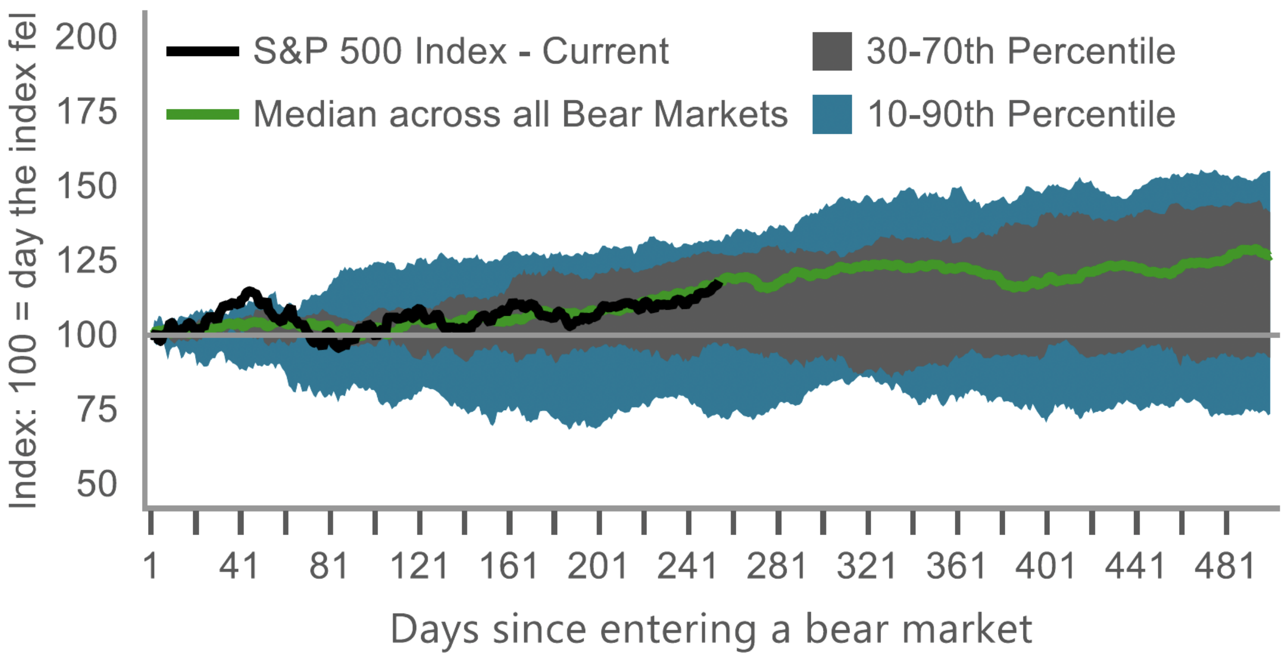
On the consumer balance sheet, the amount of savings that piled up due to COVID stimulus have waned, but remain present. The $2 trillion that went into consumer bank accounts due to stimulus and a decline in spending, has fallen to around $800 billion in excess savings, according to JP Morgan estimates.

In terms of credit usage, the degree to which spenders are utilizing revolving credit lines - credit cards and home equity lines of credit as two examples – has increased over the last two years. However, the absolute level of revolving consumer credit relative to disposable income is well below levels reached before the recessions of 2002 and 2008. Recent research from Goldman Sachs notes that 89% of 30-year mortgage rates are locked in below 5%. Debt service, which has stayed relatively flat due to locked in rates, relative to income, which risen due to inflation pressures, shows that consumers are not tapped out. Add in that gas prices have fallen around 30% from last year and headline inflation levels have cooled from 8% to 4%. Given everything above, it appears the biggest risk to consumers being stretched too thin appears to be a significant decline in the jobs market, which has not surfaced yet. In summary, the consumer balance sheet is in solid shape thanks to elevated savings, a strong jobs market, and low locked in interest rates.



Source: BEA, Federal Reserve, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of June 15, 2023.

S&P 500 Performance after entering a Bear Market



Source: Macrobond, BNY Mellon Inv. Management, Data as of 16/06/2023

The market rebound since October has followed other rebounds after a bear market.

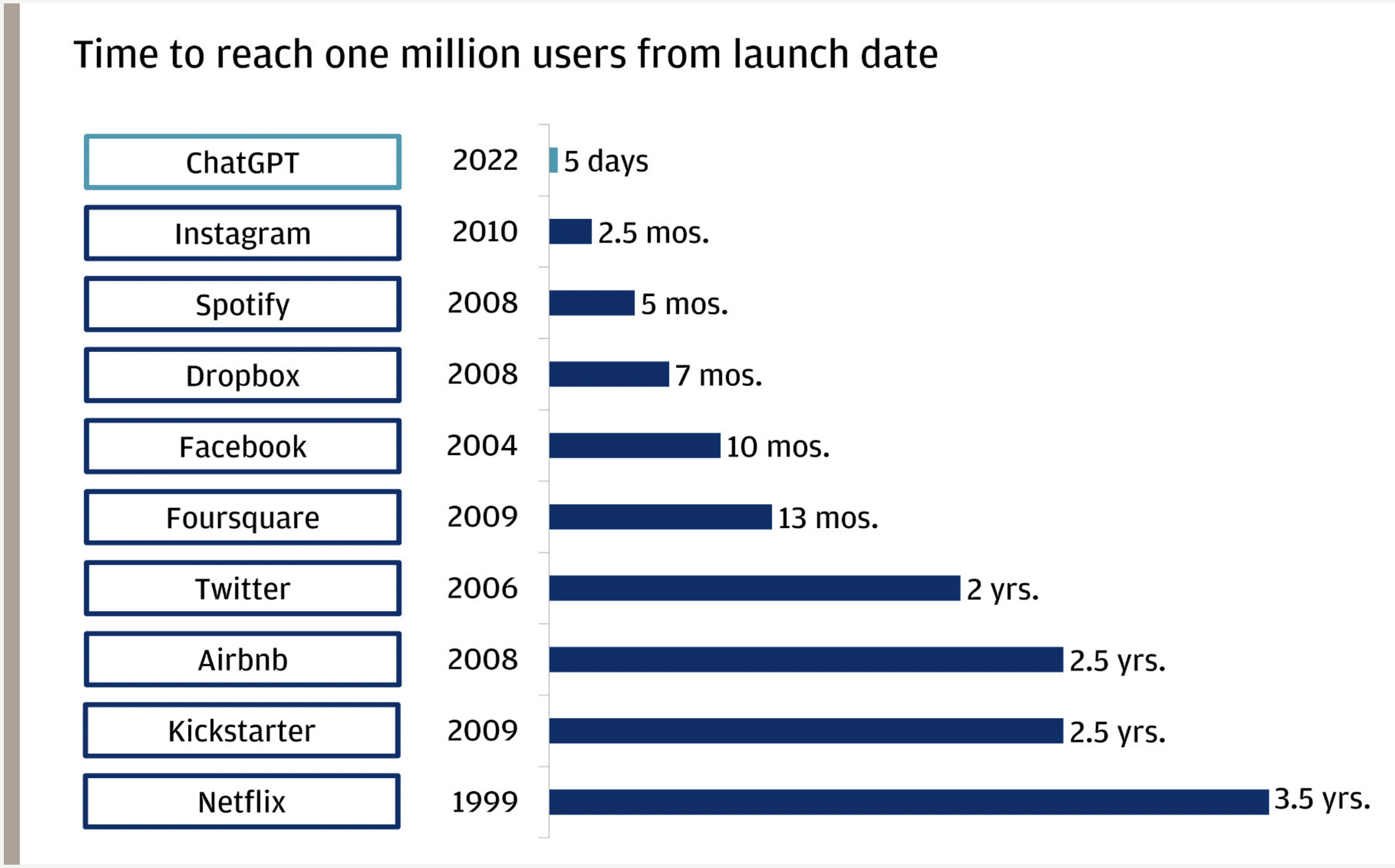
MARKET REVIEW AND OUTLOOK

The Age of Artificial Intelligence

Interest in artificial intelligence (AI) has increased fourfold over the last year as ChatGPT and other machine learning technologies have pushed their way to the front of the national conversation. Fear and excitement abound as onlookers try to determine whether this is the precursor to Robot Overlords or new, beneficial technology advancements will occur at a much more rapid rate and revolutionize how we go about our daily lives. Elon Musk and other tech leaders have called for a pause on AI development so we can better understand the potential ramifications and Sam Altman, the founder of ChatGPT is heavily lobbying for government regulation.

Beyond the need for regulation, and despite some of the initial concerns, the promise for AI is significant and could have widespread investment implications. AI tutoring could assist children with difficult schoolwork in a way that a human teacher or parent could not given their potential lack of expertise in the subject matter. Scientists working to solve difficult disease related health issues could have an assistant which would expand their scope, efficiency, and achievement. Engineers trying to find new ways to address vehicle efficiency and reduce emissions would be aided by the computing power and routing solutions that AI can help implement. The key distinction we keep coming across as we research use cases for AI in society is aid and help achieve, not replace and rule.

What investment conclusions have we reached as it relates to AI? First and foremost, we believe that betting against innovation and growth in the U.S. economy is a fool's errand. Despite a perfect storm of inflation, the fastest rate hikes in decades, and a new wave of geo-political risk, AI developments have helped fuel growth in the economy and push the stock market well into positive territory over the trailing year. It's not a coincidence that exciting new technological developments continue to be made in the U.S., that technology as a sector is the largest part of our stock market, and that U.S. stocks have led return categories against international developed and emerging markets over nearly all trailing return periods.



The adoption of artificial intelligence has been breathtaking

MARKET REVIEW AND OUTLOOK

Second, it will be incredibly difficult to find the next Nvidia (NVDA), which is up 188%, YTD, as their chips are key components of AI computing technology. However, we continue to seek the broad winners of these trends which could take shape in many different forms. AI could benefit themes already in place like onshoring, as greater manufacturing efficiencies are achieved and costs are reduced. It could lead to continued earnings strength in the largest tech companies like Microsoft, Amazon, and Alphabet, as they use their lobbying power in Washington to secure greater regulation against upstart U.S. firms or foreign technology companies based in China. As the largest tech companies combine the embedded relationships with policy makers with their existing presence in cloud computing and hardware, it seems as though they will find themselves at the forefront of this trend. Add in the fortress balance sheets with significant amounts of cash and it seems corporate America's reliance on large tech companies for software and hardware will continue to increase. In addition to the technology space, it will be fascinating to see how AI infiltrates the healthcare field as pharmaceutical and biotech companies use the tools to aid their R&D process and find cures to many difficult diseases.

In closing, regulation will come into play within artificial intelligence and there will be anxious moments over its implementation and use, particularly in the form of cybersecurity. However, we are approaching the advent of AI with an open mind and continue to research ways in which it will benefit investor portfolios from a long-term perspective.

MARKET REVIEW AND OUTLOOK

The Interesting Thing about Interest Rates

Bond yields have been on a roller coaster over the last twelve months, as the Federal Reserve has hiked interest rates from 0% to 5.25% as of the end of the second quarter. 2-year U.S. Treasury yields jumped from 0.78% at the start of 2022 to 5.05% in March of this year. After the Silicon Valley Bank failure, the 2-year yield plunged to 3.76% as investors expected the Fed to immediately start cutting rates to stave off a banking crisis. As the crisis appeared contained, yields rose back up to 5% at the end of the quarter.

Treasury bonds, usually the sleepy backwater investment realm of retirees and savers, have experienced their greatest degree of volatility since 2008. Conversely, stocks have marched higher up the wall of worry and experienced their lowest levels of volatility (as measured by the VIX index) since before the pandemic.

We've discussed the TINA (There Is No Alternative to Stocks) mindset as it relates to investing before – why bother allocating elsewhere when stocks have gotten the job done so consistently. The COVID stock market drawdown lasted a quarter before quickly rebounding. 2022 was painful for stocks and growth equities in particular, but this year has seen a sharp bounce back and growth stocks, as measured by the Nasdaq, have risen 39%. Bonds experienced their worst year in history last year and have been especially volatile in 2023, so again, why bother with bonds? From our perspective, it is important to acknowledge the pain of bond investing over the last decade, which was a zero interest rate environment punctuated by a sharp decline as rates rose, while embracing the new reality that investment pain usually precedes investment gain. Since 2009, the 2-year Treasury yield has given investors an average yield of 1.0%. If we exclude the last year and a half, where rates rose, it was an average yield of just 0.83%. With the 2-year now yielding 4.87% as of the end of the quarter, investors are getting nearly 5x the return from risk-free Treasury bonds that they have gotten over the last decade.

MARKET REVIEW AND OUTLOOK

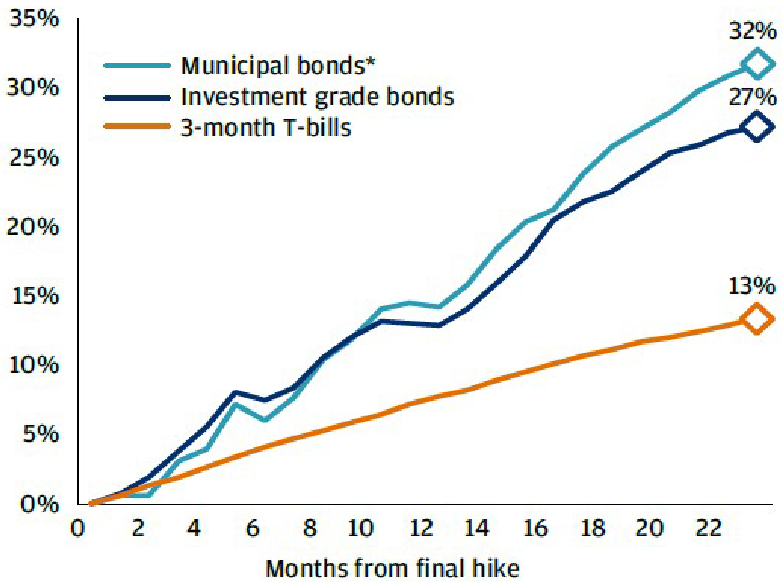
The Two-Year Treasury Yield Has Risen from Under 1% at the Start of 2022 to 4.87%.

MARKET REVIEW AND OUTLOOK

While it is impossible to know if the Federal Reserve is done hiking rates, they are most likely near the apex. History has shown that when the Fed is finished with its rate hiking cycle, bond returns are very strong in the following period. Some of this return is from elevated coupons that are paying more attractive interest to investors while some of it is from rising prices and the Fed has usually started to cut rates after they stop hiking them.

With inflation data falling and economic growth performing well despite expectations for a slowdown, stocks have done very well to start the year while bonds have been modestly positive. However, there is still a good deal of uncertainty over the longer-term effects of high interest rates and a pull bank in bank lending, which could lead to slower growth in the back half of the year and reintroduce equity volatility. For clients with equity valuations that have grown substantially over time due to rising markets and lackluster yields within the bond market, it may make sense to consider shifting a greater portion of their assets back into bonds. Particularly as markets have rallied this year and short-term bond yields remain elevated. There are also opportunities to invest in short-term T-Bills with yields around 5%, using liquidity that has built up within checking and savings accounts at banks that are not paying anywhere close to a market rate.

Bond returns after the last rate hike



Source: Bloomberg Finance L.P. Data as of 2018. Includes seven hiking cycles: 1981, 1984, 1989, 1995, 2000, 2006 and 2018. *Tax-equivalent yield assumes a 40.8% tax rate. Municipal bonds shown using the Bloomberg Municipal Bond Total Return Index, and investment grade bonds by the Bloomberg U.S. Aggregate Index.

MARKET REVIEW AND OUTLOOK

Closing Thoughts

The first half of 2023 has gotten off to a strong start as U.S. equity markets have risen significantly off the heels of positive economic growth and better than expected earnings. While the Federal Reserve has continued to hike rates, the immediate effects of higher borrowing costs have not been as negative an effect as anticipated. As we look ahead to back half of the year, it seems apparent that the Fed will not cut rates as quickly as anticipated, as they balance their dual mandate of stable employment (which has been strong) and price stability (inflation is falling but remains elevated).

While economic growth has been resilient, we remain vigilant as it could slow in the back half of the year as ripple effects from high interest rates continue to weigh on corporate investment and consumer spending. Bank lending has been constrained and likely will remain so given the SVB fallout in the regional banking sector. Given this environment, combined with the attractiveness of fixed income yields, we think investors must be realistic in assessing their portfolio diversification and exposure to bonds and alternatives.

As we navigate the rest of the year, we will continue to manage both the short-term risks and the long-term opportunities that have been presented. We are particularly keen on exploring ways in which artificial intelligence will transform various sectors of the economy and become a driver of potential investment gains. While the past year has been volatile for stocks, we see the promise of innovation combined with valuations close to historic averages as a reason to be positive on equities over the intermediate to long-term.

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All data as of 6/30/23 via Bloomberg, Eaton Vance, St Louis Federal Reserve JP Morgan, the Wall Street Journal, and Bloomberg.