2023
REVIEW AND OUTLOOK

ADVISORS CAPITAL
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2Q

MACROECONOMIC

OVERVIEW

On the Road Again: Dr. Charles Lieberman, Chief Investment Officer

Economic growth is holding up quite well, as the labor market plows ahead. After pausing rate hikes at the last meeting, we expect the Fed to resume with another 25-basis points increase at its next meeting on July 25-26. Higher interest rates are a headwind to growth, but only a modest one so far and they are overshadowed by solid spending in a variety of economic sectors. A number of additional rate hikes may be needed before the Fed brings inflation back to its 2% objective.

No doubt, higher interest rates slow economic growth. But how high do rates have to go to cause a recession or to bring inflation back to the Fed's target? We don't know, nor does the Fed. And can the Fed get to 2% inflation without precipitating a recession? Theoretically yes, but that requires a level of precision with policy that is widely regarded as extremely difficult to achieve. What we do know is that the economy is holding up very well despite the Fed's aggressive rate hikes through May, so more rate hikes will be coming, including at the Fed's very next meeting later this month.

Economic weakness is limited to a small number of sectors. Export demand is mixed, as some of our key foreign customers suffer from weak economic growth. Housing, the most interest-rate sensitive sector within our own economy, declined sharply last year in response to the Fed-engineered rise in rates, which some people extrapolate into the future. And some people and companies are struggling with higher inflation. Some judge that the pool of excess savings that was funded by the government's numerous programs during the pandemic is almost gone. The resumption of student loan payments will cut into household spending, albeit just slightly. And banks have turned a bit more cautious about lending in the wake of the failure of Silicon Valley Bank. None of these is powerful enough or large enough to push the economy into a downturn.

The strength in the economy is coming from a variety of places. Housing is already rebounding after its soft spell, reflecting the dramatic shortage across the nation. Demand for goods surged during the pandemic, even as demand for services declined sharply. They have since reversed positions. Demand for goods is quite soft, except for autos, while business just can't keep up with the surge in demand for services. (Check out airline ticket, hotel rooms or restaurant prices.) So, firms keep hiring and that provides households with more income that they are happy to spend. Significantly, household income is running slightly ahead of spending, so the savings rate has actually increased a little this year, leaving consumers with greater capacity to fund spending.

Two key industries, aircraft and autos, are still very much in recovery mode. Boeing, the nation's largest exporter, is still seeing tremendous demand for new planes and its order book stretches out over five years. But it is more important that the company is ramping up current production, as supply chain disruptions ease and airlines are anxious to take deliveries. The Chinese, who have declined to take deliveries for political reasons, have already placed almost their entire fleet back into service, including the 737s that were grounded for "safety" reasons. They will need more aircraft soon. Similarly, auto production was severely hampered by supply chain disruptions and the situation has improved considerably. Production is rising, but has a way to go to meet demand and refill dealer lots with inventory.

Government spending will be another source of some strength. The mis-named Inflation Reduction Act is subsidizing investment in green infrastructure. Along with the government's efforts to on shore manufacturing, capital investment is likely to perform well. And governments are also spending to improve our nation's deteriorated infrastructure.

The U.S. unemployment rate has been oscillating around 3.5% for more than a full year, despite very strong job growth. The saving grace has been the rebound in labor force participation, which added over 1 million people to the workforce in search of jobs. Without this influx, the U.S. unemployment rate would be below 3.0% and wage inflation would likely be rampant. The Fed is surely watching this data closely to see if it can continue, or if labor scarcity worsens even further. It is critical to making progress on reducing inflation.

There has been some tempering of expectations for reducing inflation. Fed Chair Powell recently stated publicly that he doesn't expect inflation to revert to the Fed's 2% target until 2025. But it won't be possible for the Fed to avoid rate hikes for such a long time while it waits for such an outcome unless growth slows visibly or inflation moderates more. Indeed, the latest minutes indicate that a substantial majority of the FOMC expects two rate hikes this year, no reductions in the visible future and imply a hike at the July meeting. The case for this playbook seems quite strong. But more rate hikes are also possible, especially if inflation fails to moderate on a path to meet Powell's low expectations.

Investors appear to be coming to similar conclusions, albeit reluctantly. While news headlines continue to report that the pace of job growth is slowing, which is factually correct, interest rates having been working their way higher. Treasury yields are now close to their recent highs, but likely still need to move upward to provide investors with real returns. Stocks, after falling sharply last year to discount the impending recession that didn't happen, are holding up quite well, at least superficially. But they are a tale of two cities. The large cap tech and consumer stocks, the magnificent seven, have rallied strongly in 2023, while the rest of the market has languished. So, is the stock market cheap or expensive? I think the answer is yes. It is both, depending on where you look. There is certainly value to be found with plenty of cheap securities, if the market ever can divert its attention from the magnificent seven. Eventually, that should happen.

A Look Around the World

UPDATE

World Market & Economic Update: David Ruff, CFA®, Portfolio Manager

Global equity markets climbed for the three months ending June 2023, marking the third consecutive quarterly gain. The MSCI Investable Market Index Net returned 5.89% in the second quarter. This index represents a good proxy for global equities, covering 99% of the global investable universe, including large, mid, and small-cap companies across developed and emerging markets. This puts the index gain at 16.14% for the trailing year and up an impressive 27.67% from the 2022 intra-day low, registered on October 13th. The stunning recovery moves the benchmark to just 8.54% below the November 2021 all-time high. Information Technology (+44.05%), benefiting the most from AI-popular stocks, led sector gains, trouncing sector laggard Energy (+5.96%), but also handsomely ahead of second place Industrials (+29.23%). Regionally, Western Europe provided the biggest boost from the October low (+36.36%), with Asia Pacific (+25.63%), and the US (+20.30%) also posting strong advances. In the June quarter, however, the US (+8.20%) played catch up, significantly outpacing Europe (+3.64%) and Asia Pacific (+1.26%). Interestingly, mega caps skewed the US return with just nineteen stocks, or two percent of the total US-based stocks in the index, accounting for 82% of the US return. The remaining 98 percent of US stocks returned 1.52%. Ergo, 40% of US names finished in the red for the June quarter. Notably, much of the global equity quarterly gain occurred in June (+5.83%) as there were few significant negative news items reported in the month. For instance, absent additional bank failures like those reported in March, concerns about a potential financial crisis dwindled in the second quarter, and by June, investors perceived this risk as transitory. Accordingly, June equity volatility dropped to the lowest level since November 2021.

The Coup that Wasn't

Surprisingly, June risk premiums also declined from geopolitical developments, a rare occurrence over the last few years. An attempted coup d'état by the private military Wagner group against the Russian government raised investor hopes for a change in Russian leadership and policy, leading to an end to the Ukrainian invasion. Indeed, many political analysts stated the mutiny reflects significant internal turmoil between the Russian military and government leaders, putting immense pressure on President Putin's political system. They argue a weakened Putin, combined with an increasingly unpopular War in the minds of the Russian public will result in a collapse of his rule. This is the beginning of the end for Putin, they say. Although this could be a positive development from both a humanitarian and market perspective, we say, "not so fast".

Importantly, Yevgeny Prigozhin's coup attempt, garnered little support from other military leaders, corporate elites, or government officials. Knowing other front-line commanders shared his frustration over incompetence displayed by Russia's top military brass, Wagner's leader believed the march toward Moscow would gain significant heft as other Russian armed forces groups and elites defected to his side. Fed up with corruption and mismanagement resulting in ongoing weapon supply shortages, weak intelligence, and poor logistical coordination, the mercenary leader sought regime change to end the outsized losses of soldiers and equipment. Unfortunately for him, this didn't happen. The regular military stayed loyal to Putin, and the elites, hating the War, don't see a mercenary military commander or any other military leader as

a good alternative to Putin's rule. Outnumbered and outmaneuvered, the skilled military leader lost the political battle to the savvier Putin. Thus, the trek to Moscow had to be cut short, and Prigozhin, negotiating from a much weaker position than hoped, focused mainly on his personal safety.

In contrast to most media covering the ramifications of the event, this has not weakened, but likely strengthened Putin's grip on power. Seeing the threat from independently operated mercenary groups, they're being disbanded and integrated into regular Russian armed forces. Further, deprived of cell phones and any other form of communication besides formal military commands, it's thought most Russian soldiers don't know of the coup attempt. Additionally, history teaches that successful coups are typically done by the element of surprise, a conspiratorial palace takeover, not a long-telegraphed military convoy to the capital. Thus, it's doubtful there will be another challenge to Putin or the government by a semi-autonomous mercenary or other military group. Moreover, leaders surviving thwarted coups typically emerge stronger. Recent examples include Bashar al-Assad in Syria, Recep Erdogan in Turkey, and Nicolás Maduro in Venezuela. Authoritarian leaders reward loyalty and severely punish even hints of disloyalty. In this way, they consolidate power. Although hating Putin's evolution to dictator, for fear of self-preservation, the corporate elites and public will be reticent to plan any secret plot to remove Putin. Revolutions occur when the oppressed have nothing to lose. This is not yet the case in Russia.

Although a near-term change is unlikely, Putin has not come out of the ordeal unscathed, and public opinion regarding Putin and the War continue to fall. The first chance for the public to voice their displeasure will be the next Presidential election, scheduled for March 2024. Although assuming this will be free and fair may be a stretch, it's possible he may not run. Failing health, a no-end-in-sight War effort, and slumping economy may induce him to step down. That said, there is no guarantee the next leader will change course, and Putin may exert significant influence on the next President selection. Sadly, Putin has given no indication of wanting to retire, and since losing the War would be an existential threat to his position of power, he may escalate the Ukrainian attack to try and achieve victory.

Although our view of Putin staying in power and an elongated War is not viewed as the ideal path by investors, we don't believe it's necessarily detrimental for global equities. War has plagued humankind since the beginning of recorded history, and there are 27 armed conflicts occurring in the world at the moment. Four countries in these conflicts are nuclear capable. While Putin may increase threats of using tactical nuclear weapons, the widespread devastation and massive loss of life would be internationally condemned. This would widen the conflict and cause more direct involvement by the West. Needless to say, nobody wins from the usage of these weapons of mass destruction. Fortunately, President Putin understands this.

A Desynchronized World

Moving into the second half of 2023, cross currents abound across the globe. This was highlighted by the world's major central banks responding differently in June. The US paused interest rate hikes, China cut rates, but Europe hiked despite the continent being in technical recession. The US economy also reflects slowing but heretofore, more resilience than expected, while China's economic reopening has been modest relative to early 2023 expectations, especially in the area of domestic consumption. Globally, while goods inflation generally continues to fall, developed countries continue to deal with stubbornly high services prices underpinned by strong labor markets as companies struggle to find the workers they need. The Bank of England's 50 basis

point hike despite the UK's anemic economic growth illustrates the quandary facing central bankers. This will likely continue in the near term. It will take time to solve the labor supply challenge, and the impact of higher rates with tighter credit conditions will drag the world into a lower growth gear. Such an outlook, however, is not a revelation to the market, and as we've pointed out in previous commentaries, market cycles differ from economic cycles as the market looks forward not backward. Witness the recent weakening global economy, yet positive equity market. Sector performance demonstrates this as well.

The Rebound of Growth Stocks

UPDATE

The Super 7: Dr. JoAnne Feeney, Portfolio Manager

The market appears to have rewarded investors thus far this year after a difficult 2022. The total return for the S&P 500 was 16.8% through June as stocks during both the first and second quarters delivered solid appreciation. This cursory examination of the market, however, ignores the far more complex dynamics behind changes in company valuations in 2023.

While the S&P 500 Index has surged higher, its rise was driven by a small collection of growth stocks, all of which had fallen sharply in 2022. That index is constructed based on the market capitalization of its constituents so that bigger companies play a larger role in how much the index rises or falls. Apple's stock made up 6.9% of the Index in the first half, for example, while Microsoft's accounted for 6.1% of the Index. AAPL rose nearly 50% in 1H, while MSFT rose over 40%, and AAPL and MSFT are not the only outliers this year. The market's move higher was driven by the "Super Seven," the seven largest technology and consumer companies in the US: Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, and Meta. Their stocks rose on average over 40% in the first quarter and over 25% in the second quarter. During the first quarter, the news was dominated by how narrow was the stock market's rally because 82% of the climb came from the Super Seven. Even within growth indices, the rise was concentrated in the Super Seven. In the second quarter, we started to see some broadening of the market's rally: those eight stocks accounted for "only" 65% of the market's total return (Alphabet has two stocks, GOOG and GOOGL). The average stock in the S&P 500, by contrast, rose a mere 2.4% in the first quarter and 3.4% in 2Q.

This year, the market has told a tale of two economies: the growth economy and the recession economy. Over in the growth economy, the party was fueled by enthusiasm over the potential of artificial intelligence (AI), or more specifically, artificial general intelligence, which powers large language models such as ChatGPT. When ChatGPT hit the scene in November 2022, investors saw its potential to create a new world of applications for consumers, firms, and governments. Companies across the economy are tapping into AI's potential and that demand is causing a surge in investment in the hardware (servers and their chips) and software (cloud services providers, among others) on which it relies. In addition, deployers of AI applications (including advertisers, social media, self-driving cars, industrial control systems, health care, smart manufacturing, and more) will likely see a boost in productivity and product offerings – few today, but many in the years to come.

Some of these growth stocks have become "expensive" as conventionally defined. The most commonly used valuation metric, the price-to-earnings ratio, looks at a stock's price relative to a single year's earnings. Owning a share of a company, however, gives the investor a claim to the entire future path of earnings. We will not see an instantaneous jump in profits from AI in most cases. We are seeing instead a step-change in the expected future sales and earnings growth of companies enabling this "irrefutable" change. Investors have found companies that can provide years of growth at a time when growth more broadly is slowing down. And investors, of course, are forward-looking and have been bidding up the value of such companies.

The rest of the market, however, been more tied to the broader macroeconomic threat: recession. Continued strength in the US labor market, combined with slowly falling inflation, though, have pushed that threat further into the future. The Fed's rate path still points to a Federal Funds Rate higher than it is today, but there are far fewer rate hikes ahead of us than behind and investors recognize this. Hence, the broader enthusiasm for stocks in 2Q as the economic data improved. If those rate hikes continue to slow inflation such that recession risks recede further, we would expect enthusiasm for equities to continue to broaden through 2023.

The Market is Finally Believing What the Fed Has Been Saying

UPDATE

Fixed Income Update: Kevin Kelly and Kevin Strauss, CFA®, Portfolio Managers

Many investors are trying to precisely time interest rate movements. We believe this approach is more of a gamble than a fixed income strategy. Some investors have gone so far as to invest a large portion of their assets into money market funds / short-term Treasuries/CDs. While an unknown number of additional Fed Funds rate interest hikes appear likely on the docket for 2023, the current Fed tightening cycle is well past the mid-way point with a Fed Funds rate currently at 5-5.25%.

The market is already pricing in another hike to 5.25-5.50% at the July meeting (in late July) versus February 2022 at 0-0.25%. This compares to the Fed's June 2023 prediction of a Fed Funds Rate of 3.4% in 2025 and 2.5% over the longer run. Even if the Fed's forecast is wrong and inflation remains elevated, the Fed would still hike more aggressively in the near-term.

Consequently, the Fed Funds rate would likely experience a steeper decline over the medium-term. Therefore, over the next few years the risk is asymmetrically skewed towards the Fed Funds rate eventually declining. The Fed is extremely motivated to ensure this is true because a persistent Fed Funds rate over 5% means inflation has not declined anywhere close to the Fed's 2% inflation goal.

As the market now believes what the Fed has been consistently stating for months, interest rates across the Treasury curve have risen. This has provided an attractive opportunity for those in ultra short-dated fixed income. Investors who buy / own individual bonds must remember that over time the duration of a security declines as maturity gets closer and closer. This requires investors to ensure they are owning securities that will benefit when interest rates do eventually decline.

At the extreme end of low duration, money markets do not benefit one iota when overnight interest rates eventually do decline. Additionally, the yield upon reinvestment instantly declines. We also would advise against the other extreme of buying exclusively very long-dated bonds. Long-dated bonds are exposed to market expectations over many economic cycles both domestically and globally. Also, long-dated U.S. Treasury yields can be heavily influenced by the competitiveness of U.S. rates versus global rates. An intermediate duration focused portfolio will benefit from the eventual decline in the Fed Funds rate (overnight) without being overly exposed to long-term rates. Furthermore, a portfolio focused on intermediate bonds (2-7 years) will disproportionally benefit from the Treasury yield curve eventually normalizing (versus being currently inverted). We think investors sitting on excess cash, money market funds, and short-term Treasuries/CDs need to strongly reconsider owning an intermediate duration, actively managed, fixed income portfolio.

Q & A with the Advisors Capital Investment Team

UPDATE

Question 1: AI is the first half story of the year. What has your exposure been to the space and what are your expectations going forward?

Dr. Charles Lieberman, CIO, Portfolio Manager - Income with Growth
This often doesn't apply to Income with Growth, although there are some exceptions. Our info tech companies, STX, AVGO and TSM, are all generally beneficiaries. But none of them have the full brunt effect of NVDA, which also happens to be true for most tech companies. AI's effects are mostly highly concentrated, although Wall Street tries to make a case that many companies are affected. In my judgment, few of my companies affected either positively or negatively.

Dr. JoAnne Feeney, Portfolio Manager – Growth, Balanced
We see AI powering sales in earnings growth for many years to come in several areas of the global economy. First, the enablers: the technology that makes AI possible. Then, the deployers: the companies building AI applications or using AI to enhance products for customers or to raise productivity internally.

We have multiple stocks exposed to AI in Growth, though none as much as NVDA. Others with fairly direct exposure include AVGO, AMD, MSFT, AMZN, GOOG, NOW, and SPLK.

We also have exposure to AI in Balanced: CSCO, TSM, MSFT, GOOG, AMZN, AVGO, and IBM.

Beyond these enablers of AI, we expect many of our companies in sectors beyond consumer and technology to increasingly use and benefit from AI (health care, industrials, etc).

Kevin Strauss, CFA®, Portfolio Manager – US Dividend, Municipal
Exposure to AI comes from MSFT, GOOGL, AVGO, ACN, ADBE and ORCL primarily. Other companies in the portfolio will certainly benefit from AI such as ETN and HON. We expect all of these companies to benefit from AI which is still in the very early innings.

Question 2: Is such a narrow rally healthy for investors? Does it lead to performance chasing?

Dr. Charles Lieberman, CIO, Portfolio Manager - Income with Growth
It does lead to some performance chasing, but I think that's fairly limited and mostly doesn't apply to Income with Growth. What you're really asking is whether the "Super Seven" are exceptionally vulnerable now after having run up. I think they are far more vulnerable, but only if they fail to deliver on the strong growth implicit in the AI advance. And I think that has little relevance for the rest of the market.

Kevin Strauss, CFA®, Portfolio Manager – US Dividend, Municipal
The narrow concentration is not healthy long term. We believe that the market will need to broaden in order to continue to perform over the medium to long term.

Dr. JoAnne Feeney, Portfolio Manager – Growth, Balanced
The narrow rally is merely a reflection of the disparate growth opportunities for different companies. A broader rally would require investors to see recession risk as fading. This has already started, but it remains a concern. Investors may be tempted to chase performance or may even be frightened away from stocks that have risen. Neither is appropriate in all instances; investors must continue to apply a disciplined approach to compare intrinsic value to a stock's market price and buy or sell accordingly.

David Ruff, CFA®, Portfolio Manager – International & Global Strategies, Small/Midcap
Thus far in 2023, Information Technology companies report the weakest earnings growth globally, but best price performance as the AI future captures investors' imagination. It's currently driving the prices of a relatively narrow list of mainly US-based technology companies, probably to price levels exceeding economic reality, but this powerful innovation will be much more pervasive, significantly impacting other sectors and industries as it develops. This may account for the broadening of the market advance in June with the more cyclical sectors providing leadership including Consumer Discretionary, Industrials, Energy, and Financials as well as leadership exhibited by small and midcaps. This is usually a healthy development for the market.

Question 3: The regional bank issues seem over. Does this present opportunity?

Dr. Charles Lieberman, CIO, Portfolio Manager - Income with Growth
Yes, it does present an opportunity, but the recovery of banks generally requires them to demonstrate that 1) deposit outflows have largely ceased (which seems to have occurred already for most banks) and 2) the cost of their deposits has not impaired profitability too much. This is still to be determined. Q2 earnings may shed some light on this questions, but it may be a little early. A new wrinkle is the likelihood of new regulations that force up capital requirements, which may also hurt profitability or returns on equity, since equity will rise to meet the new requirements. We don't yet know just how much capital requirements will rise. That's still undetermined. And the Fed knows that higher capital means less favorable terms for borrowers, which impairs economic growth and benefits large banks versus small ones, which they want to avoid. Another likely fallout of higher cap requirements is pressure on smaller banks and regionals to merge. That may also discourage a large increase in cap requirements. This is still all something of an unknown at this point and some of it is likely to be implemented only slowly

to avoid being disruptive. But the regionals are quite cheap and will likely perform well compared to the rest of the market. I bought Fifth Third on the basis that regionals are cheap.

Dr. JoAnne Feeney, Portfolio Manager – Growth, Balanced
We believe regional banks are attractively valued and have selectively added to both Growth and Balanced strategies.

Kevin Strauss, CFA®, Portfolio Manager – U.S. Dividend, Municipal
Regional banks will see increased regulation and an increase in bad loans so other than the largest and strongest banks, we would be concerned about increasing our exposure.

Question 4: What are your biggest concerns for the second half of the year?

Dr. Charles Lieberman, CIO, Portfolio Manager - Income with Growth
1) Inflation doesn't moderate as quickly as the Fed hopes 2) No recession, so the labor market stays tight and inflation doesn't come down much 3) Market overreaction in either direction; so rates fall sharply because of some "improvement" in inflation, and growth strengthens OR inflation doesn't recede and the Fed tightens again and by too much.

Dr. JoAnne Feeney, Portfolio Manager – Growth, Balanced

Recession, rates, war.

Kevin Strauss, CFA®, Portfolio Manager – U.S. Dividend, Municipal
Biggest concerns are earnings disappointments, higher rates leading to lower multiples and a weaker economy than expected.

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