

Patten & Patten, Inc.

3Q23 Market Outlook

July 17, 2023

Patten & Patten



Market Outlook

Market Commentary

- In the Second Quarter, stock market momentum accelerated as the NASDAQ Composite Index posted double-digit returns. The NASDAQ's year-to-date returns are reminiscent of the late 1990s. However, headline index performance masked a wide and growing divergence among constituents. A mere seven large-cap technology stocks account for more than 75% of the S&P 500's mid double-digit year-to-date gains. In particular, performance among companies with leverage to artificial intelligence was extraordinary. For the other 493 stocks in the index, performance has been modest. Meanwhile, the Dow Jones Industrial Average has lagged the other indices, with single digit year-to-date returns comparable to yields on short-term bonds. The lack of breadth in market leadership is worrisome. Concentrated stock market leadership is unsustainable, although narrow markets often persist for lengthy periods.
- It is without question AI is transformative and disruptive. The world is in the early stages of AI adoption, and we agree with the view that AI-related projects will explode in growth. AI represents a breakthrough innovation with the potential to radically alter many industries. Applications with artificial intelligence ("AI") functionality will expand and improve over coming decades. Entrepreneurs will introduce new products and services that capture our imaginations. We expect corporations and governments will invest heavily to explore the capabilities of AI and LLM ("Large Language Models").
- Yet, we are also cautious as valuations for technology stocks and AI, in particular, seem excessively optimistic. Many growth forecasts seem unsustainable and, perhaps, unrealistic. Nevertheless, high growth rate forecasts and valuations attract capital, competitors, and performance-chasing investors. As capital is re-allocated to such projects, there is high probability specious business models will emerge. In addition, excess capacity is generally the outcome of such developments. Thus, we prefer to tread carefully whenever the market seems inordinately enamored of new paradigms. At the same time, we acknowledge the fundamental appeal of new technology, particularly one with the transformative potential of AI. In our view, selectivity and patience will be rewarded.

Market Commentary, continued

- The tone of the economy changed considerably during the Second Quarter. In February and March, there was fixation on a growing probability of recession, with some prognosticators suggesting economic contraction was imminent. The narrative was disproportionately negative. In fact, market participants, convinced the Fed had already tightened policy rates too far, extended fixed income duration in anticipation of Fed rate cuts during the Fourth Quarter. Economic data during the Second Quarter, appearing obstinate, confirmed a resilient US economy with moderating inflation. Because of moderating inflation, the Fed granted investors a reprieve from rate hikes with the so-called “pause” at its June meeting. Fed officials, however, reiterated their vigilance against inflation with the possibility of further rate increases. A pause, in other words, does not necessarily mark the terminal point of policy rates.
- We acknowledge encouraging inflation trends, but the level remains well above the Fed’s target. At a minimum, it seems clear from Fed rhetoric that rate cuts are unlikely. Thus, we remain both confused by and concerned with market positioning in certain sectors. There is a disconnect between the Fed and the market, in other words, implying a necessary adjustment at some point. Such adjustments are usually characterized by heightened volatility. As these dynamics eventually resolve, we continue to take advantage of attractive yields offered by short-term Treasuries.
- We also note that China’s post-COVID recovery seems to be faltering. In response, the Chinese government reverted to a stimulative monetary policy stance. China’s economic uncertainties could weigh on global GDP growth, but their economic deceleration could also have a favorable impact on inflation. We look forward to meeting with you to review your accounts and further discuss our outlook.

Markets

Year to date and historical performance of select asset classes

Asset Class	YTD	1 year	3 Year Annualized	Total Returns since...	
				2/24/2022	1/4/2022
Domestic Equities					
S&P 500	18.41	20.91	13.89	7.53	-3.59
S&P 500 Equal Weight (RSP)	8.66	16.12	15.68	3.43	-4.82
Dow Jones Ind. Avg.	5.30	15.12	11.23	6.96	-3.16
NASDAQ Comp	35.47	26.57	11.26	6.01	-8.49
Russell 2000 (IWM)	10.55	14.80	11.92	-1.25	-13.08
International Equities					
Shanghai Composite (CIN)	8.23	2.17	1.38	-0.36	-5.24
Hedged Japan (DXJ)	28.00	33.36	22.90	38.80	31.73
Hedged Europe (HEDJ)	20.58	29.38	13.06	18.86	5.95
Emerging Markets (EEM)	9.06	9.18	0.45	-8.96	-13.68
Canada (EWC)	8.76	12.69	12.29	-1.93	-4.73
Bonds					
Long Treasuries (TLT)	3.33	-9.72	-13.65	-23.13	-26.74
Inv. Grade Corporates (LQD)	3.93	0.53	-4.93	-8.26	-13.86
High Yield Corporates (HYG)	5.09	6.63	1.62	-2.46	-6.18
Real Assets/Commodities					
Commodities (BCI)	-5.48	-3.36	17.37	-5.58	7.61
Gold (GLD)	6.95	13.87	2.15	2.42	6.99
Oil (BNO)	-4.56	-9.55	34.15	1.81	25.83
Real Estate Investment Trusts (RMZ)	8.89	4.60	10.54	-7.85	-17.52
Agriculture (DBA)	7.15	11.15	17.45	1.91	9.57

YTD through 07/14/2023

Note: returns presented as %, assumes dividends are reinvested

Year to date and historical performance of select equity sectors

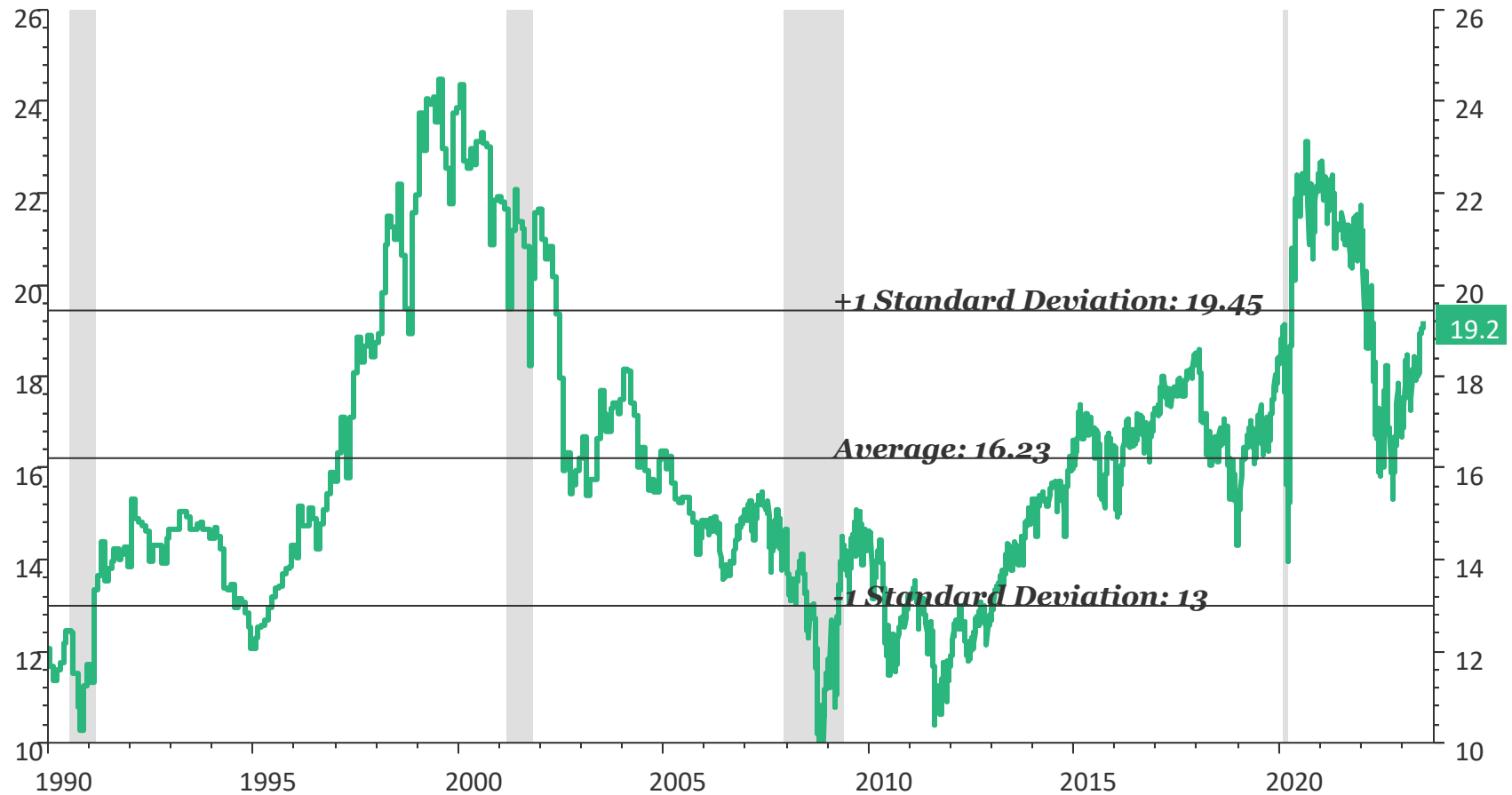
Domestic Equity Sectors	YTD	1 year	3 Year Annualized	Annualized Total Returns since...	
				Trough*	Peak*
Domestic Equities					
Consumer Discretionary	37.03	23.82	8.03	22.64	9.23
Retail	29.74	20.99	4.03	19.33	9.47
Consumer Staples	4.12	13.24	12.14	19.41	8.82
Energy	-5.10	25.39	36.95	52.29	19.00
Oil & Gas Exploration	-6.14	26.37	45.05	61.01	23.17
Financial Services	-0.72	11.23	15.75	24.74	5.06
Regional Banks (KRE)	-25.26	-21.75	9.48	16.84	-4.30
Health Care	-1.09	5.06	8.27	19.40	7.95
Industrials	13.57	27.63	15.89	27.44	8.36
Materials	9.79	22.63	15.41	30.55	12.63
Technology	42.92	33.72	14.55	28.74	15.11
Communication Services	43.71	34.28	16.04	28.80	15.37
Utilities	-1.70	1.27	8.15	16.30	1.51
Transportation (IYT)	19.99	23.12	16.13	26.90	9.40
Real Estate	6.67	-0.26	7.16	17.46	-1.01

*Stock market trough at 03/23/2020. Stock market peak at 02/18/2020. YTD through 07/16/2023

Source: Thomson Reuters Datastream

S&P 500 Valuation

S&P 500 - Price to Next Twelve Month Earnings Ratio



Source: Refinitiv Datastream

Credit Spreads have Widened

High Yield Credit Spread

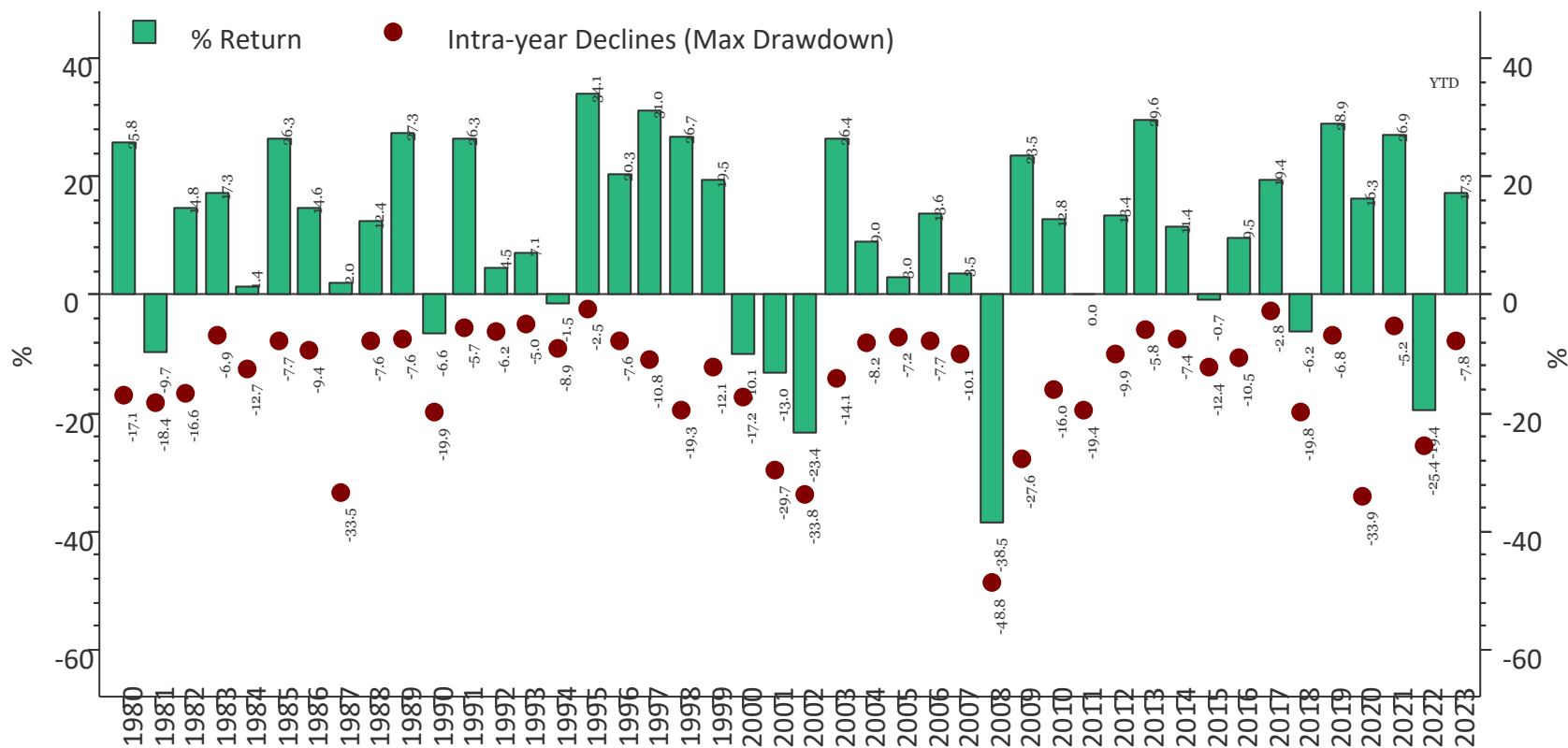
Barclays US Corp. High Yield - 10 Yr. Treasury Yield



Source: Bloomberg

Stock Market Performance and Max Drawdowns by Year

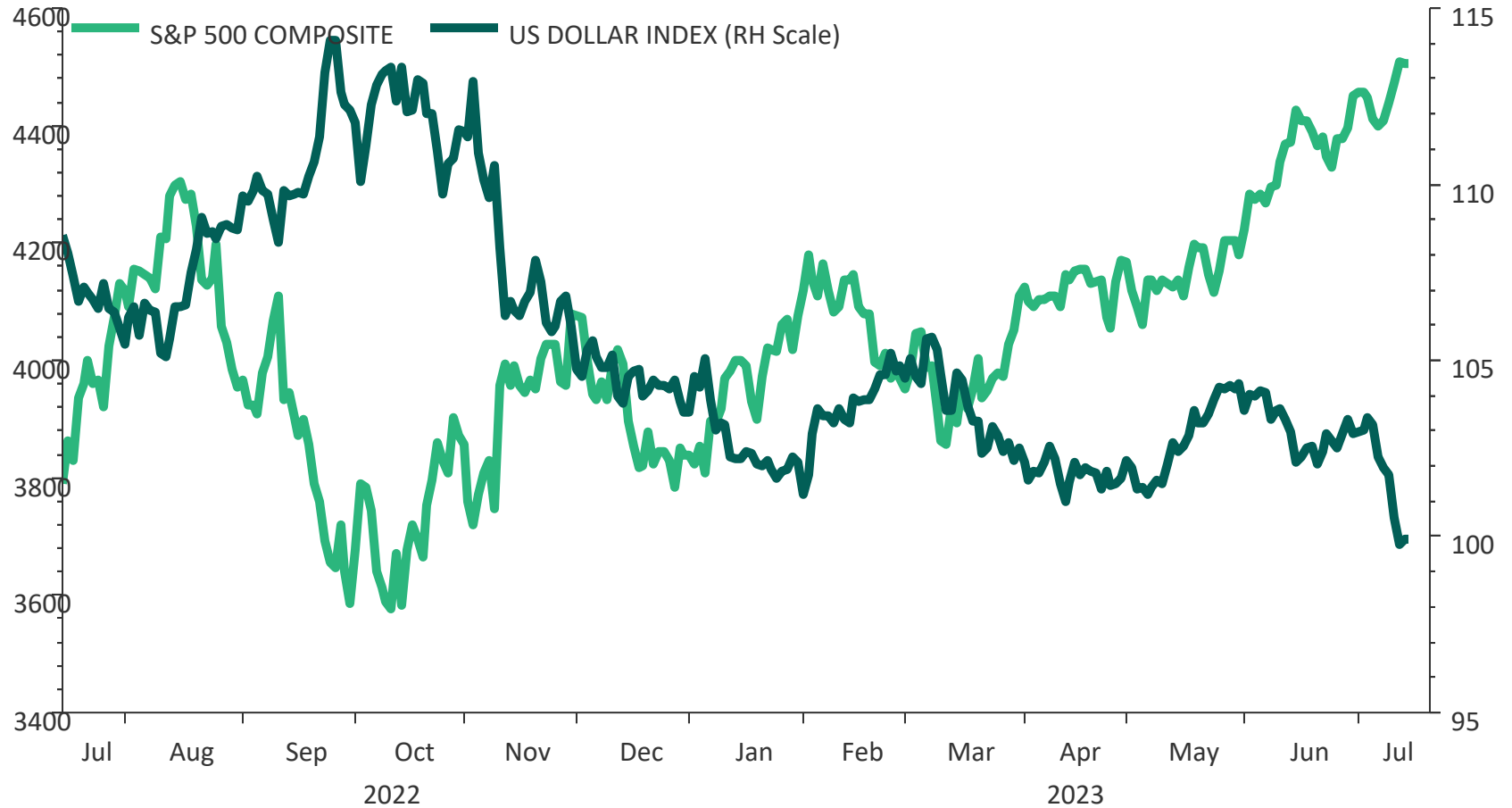
S&P 500 Intra-year Price Declines (Max Drawdown) vs. Yearly Price Returns



Source: Refinitiv Datastream

S&P 500 vs. the US Dollar Index

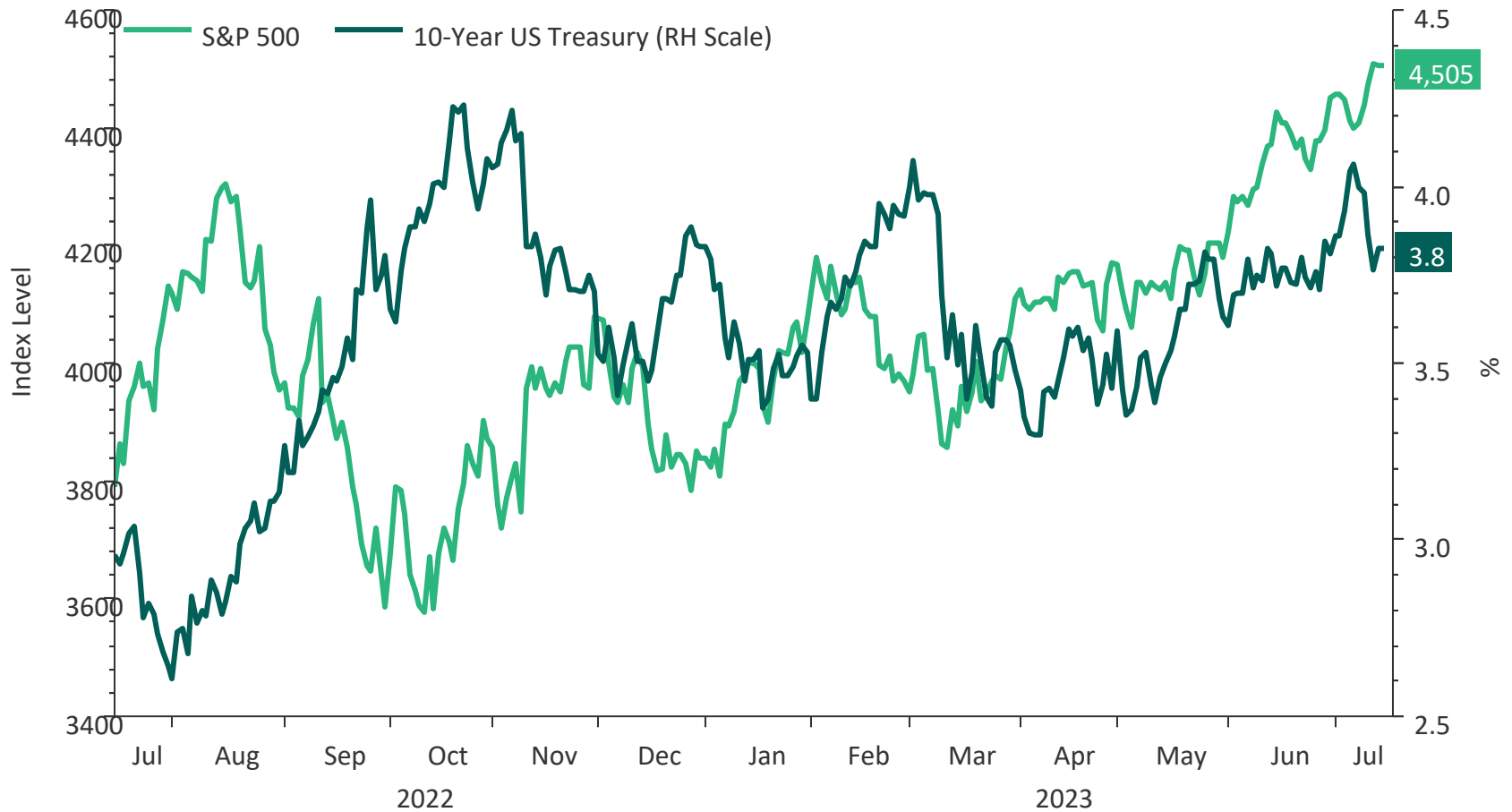
S&P 500 vs. the US Dollar Index



Source: Refinitiv Datastream

S&P 500 vs. the 10-Year Treasury Yield

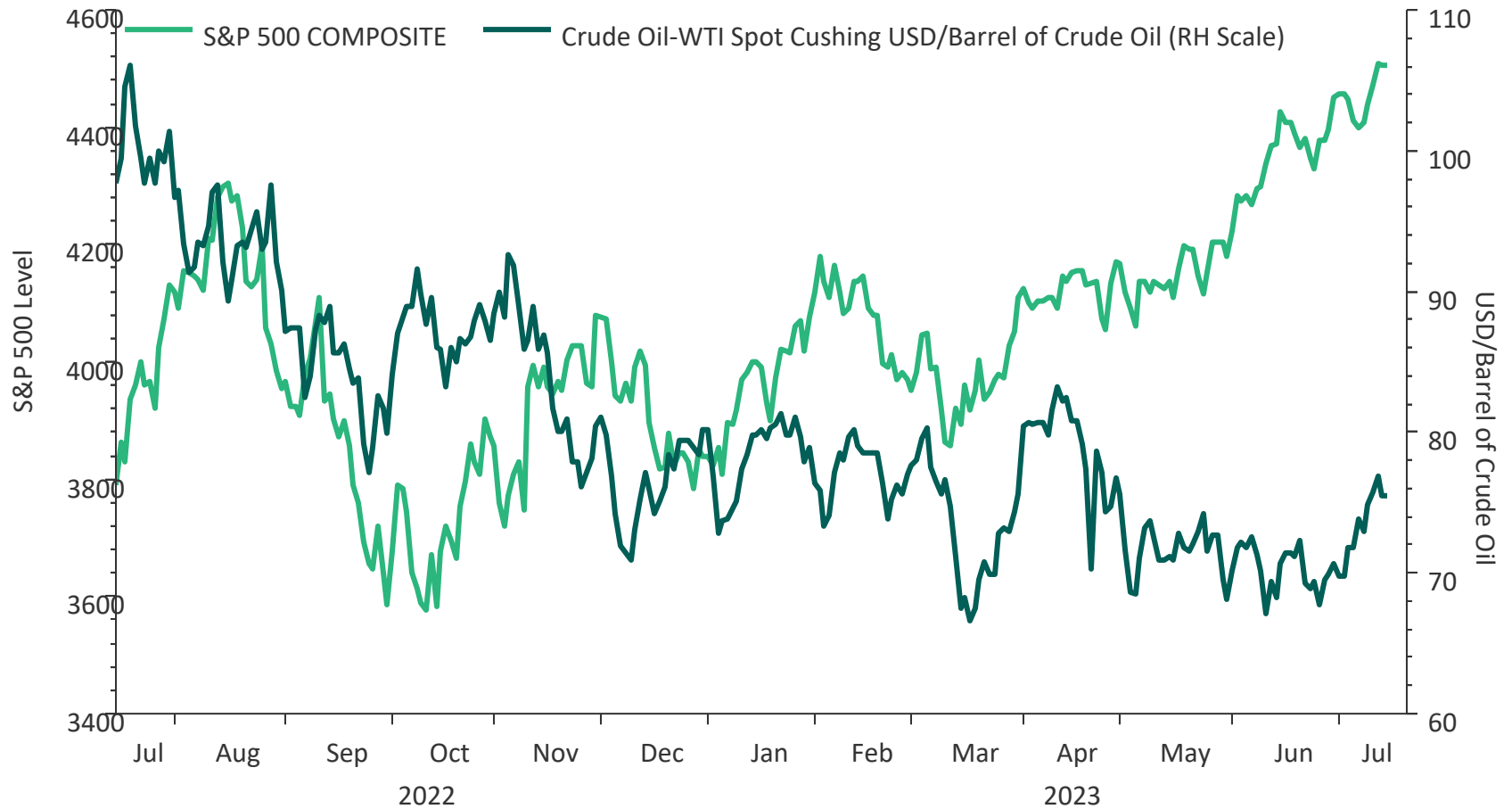
S&P 500 vs. the 10-Year Treasury Yield



Source: Refinitiv Datastream

S&P 500 vs. the Price of Crude Oil

S&P 500 vs. WTI Crude Spot



Source: Refinitiv Datastream

Dr. Copper

London Metal Exchange Copper Spot Price

\$/Metric Ton

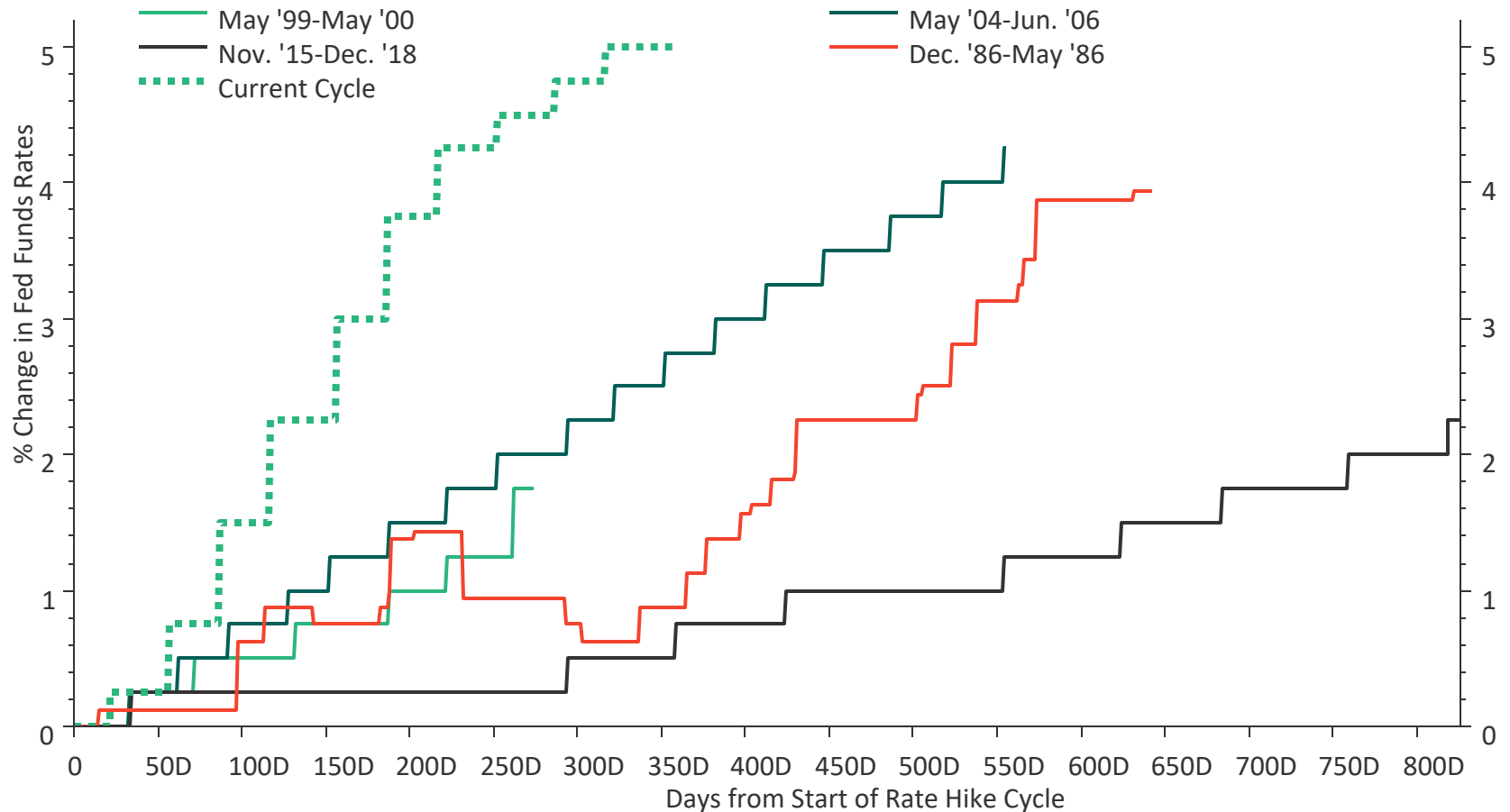


Source: Refinitiv Datastream

Interest Rate Outlook

Historical Perspective of Current Fed Policy

Cumulative Change in Federal Funds Rate Since First Hike



Source: Refinitiv Datastream

Global Interest Rates

Global Bond Yields on July 17, 2023

Maturity	US	Canada	UK	Germany	Switzerland	Japan	Spain	Italy	Brazil	Greece
2 year	4.753	4.678	5.184	3.260	1.166	-0.037	3.493	3.854	10.545	NA
5 year	4.033	3.799	4.569	2.608	1.012	0.131	3.292	3.760	10.625	3.581
10 year	3.824	3.391	4.433	2.453	0.965	0.482	3.523	4.172	10.830	3.961
30 year	3.940	3.266	4.542	2.512	0.948	1.400	3.951	4.587	NA	NA

Change in Global Bond Yields since July 10, 2023

Maturity	US	Canada	UK	Germany	Switzerland	Japan	Spain	Italy	Brazil	Greece
2 year	-0.006	0.025	-0.005	0.005	-0.041	0.012	0.000	0.014	-0.469	NA
5 year	-0.005	0.022	-0.004	-0.021	-0.020	0.007	0.002	0.006	-0.005	-0.009
10 year	0.000	0.020	0.009	-0.022	-0.032	0.002	-0.009	0.003	0.077	-0.002
30 year	0.014	0.025	0.000	-0.018	-0.030	0.009	-0.003	0.017	NA	NA

Source: Patten & Patten

Fed Rate Hike Probability

Rate Hike Probability by Meeting

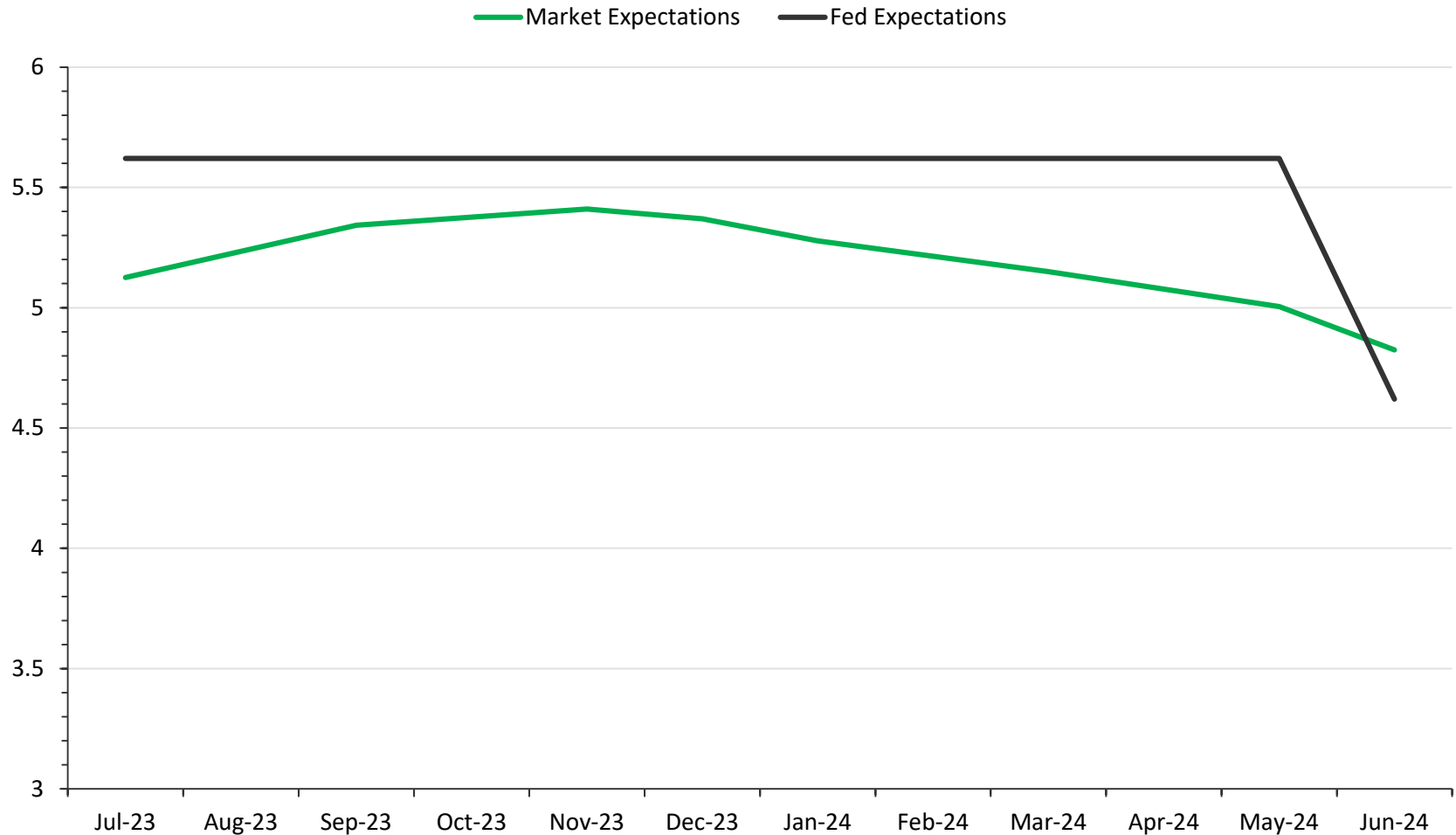
Meeting Date	Expected Target Rate (%)	Cumulative Probabilities		
		Cut	No Chg	Hike
7/26/2023	5.3560		7.6%	92.4%
9/20/2023	5.3910		6.5%	93.5%
11/1/2023	5.4427		5.2%	94.8%
12/13/2023	5.3835	1.2%	19.4%	79.4%
1/31/2024	5.2760	9.6%	35.2%	55.2%
3/20/2024	5.1060	33.5%	39.2%	27.3%
5/1/2024	4.9123	63.9%	25.8%	10.3%
12-Jun-24	4.7011	85.7%	11.4%	2.8%

Meeting Date	Scenario - Mid-Point of Fed Funds Target Range				
	5.125	5.375	5.625	5.875	6.125
7/26/2023	7.6%	92.4%			
9/20/2023	6.5%	80.5%	12.9%		
11/1/2023	5.2%	65.2%	26.9%	2.7%	
12/13/2023	19.4%	56.1%	21.2%	2.0%	
1/31/2024	35.2%	41.1%	12.9%	1.2%	
3/20/2024	39.2%	22.0%	4.9%	0.4%	
1-May-24	25.8%	8.8%	1.4%	0.1%	
12-Jun-24	11.4%	2.5%	0.3%	0.0%	

Source: Eikon

Fed vs. Market Expectations for Fed Funds Rate

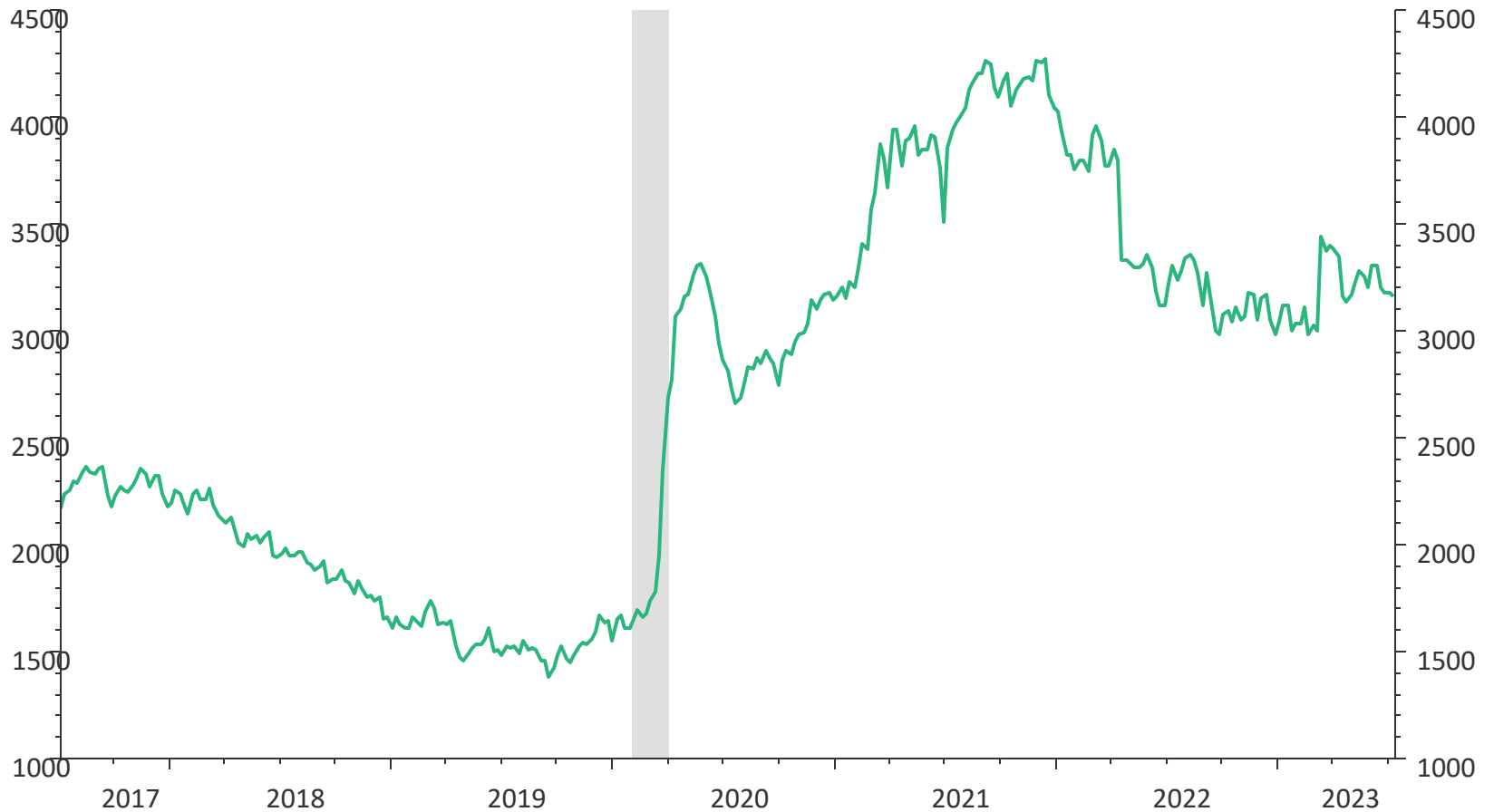
Fed Funds Rate Expectations



Source: Bloomberg, Bianco Research

Fed Balance Sheet

Fed Reserve Balances with Fed Reserve Banks (\$Bn)



Source: Refinitiv Datastream

Forward Interest Rates

Forward Rate Analysis US Dollar Swap Curves

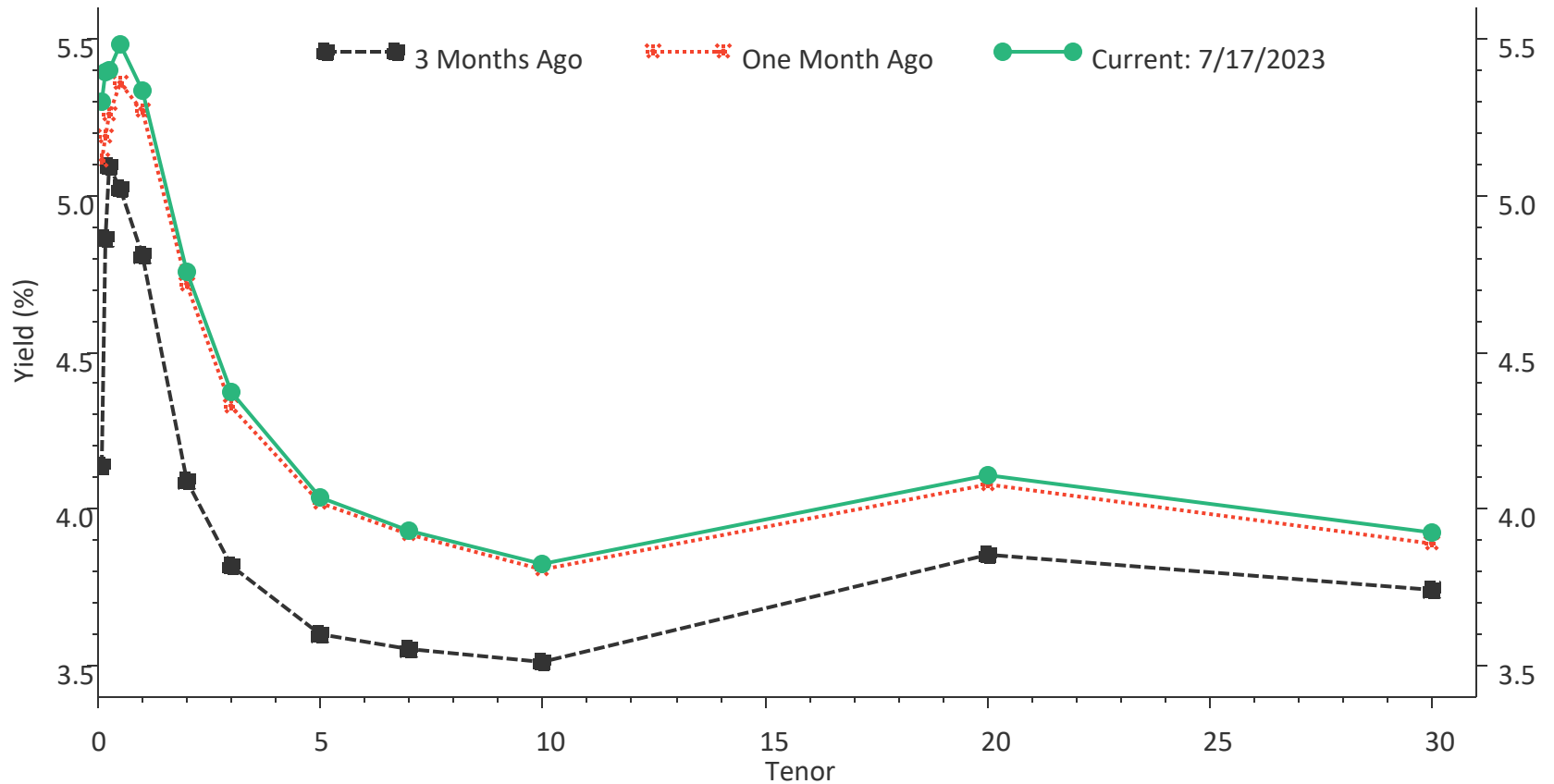
Maturity	Forward Rates						Difference between Current and 10 Year (in bp)
	Current	6 Mo	1 year	2 year	5 year	10 year	
1 year	5.552%	4.958%	4.277%	3.562%	3.441%	3.673%	(188)
2 year	4.933%	4.396%	3.927%	3.472%	3.447%	3.707%	(123)
3 year	4.506%	4.073%	3.751%	3.448%	3.459%	3.726%	(78)
5 year	4.094%	3.820%	3.624%	3.448%	3.501%	3.727%	(37)
10 year	3.836%	3.683%	3.589%	3.519%	3.604%	3.631%	(21)
30 year	3.540%	3.450%	3.391%	3.322%	3.228%	3.013%	(53)
2 - 10 Curve (in bp)	(110)	(71)	(34)	5	16	(8)	
1 - 30 Curve (in bp)	(201)	(151)	(89)	(24)	(21)	(66)	

*market rates as of 07/17/2023 and based on 3 month LIBOR.

Source: Patten & Patten

US Treasury Yield Curve

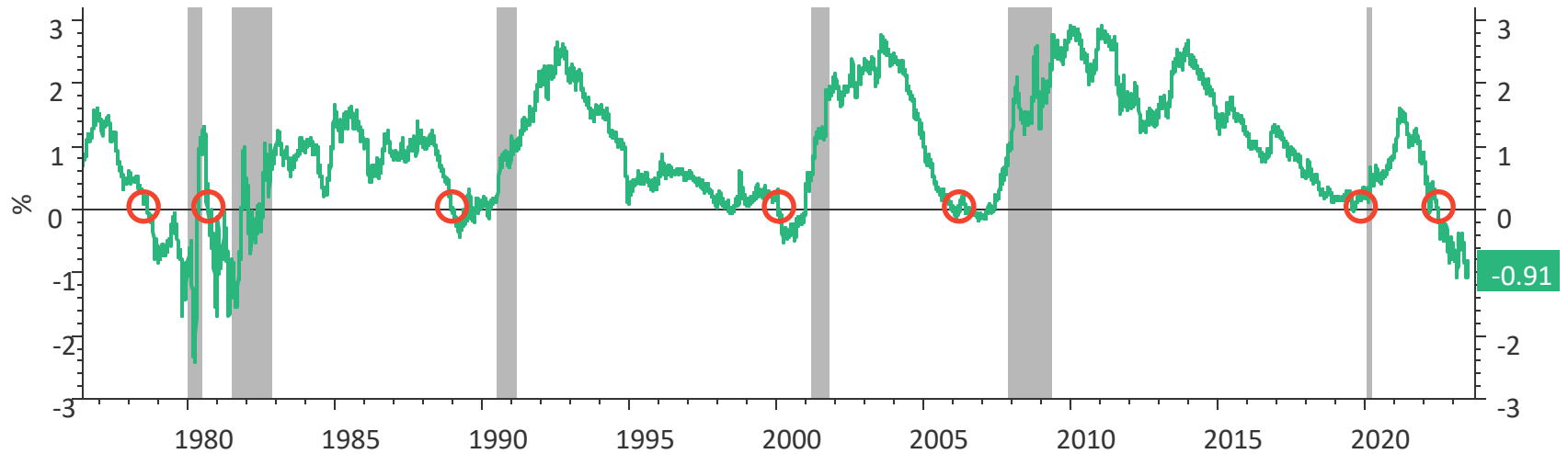
US Treasury Yield Curve



Source: Refinitiv Datastream

Treasury Yield Spread

2Yr/10Yr Spread

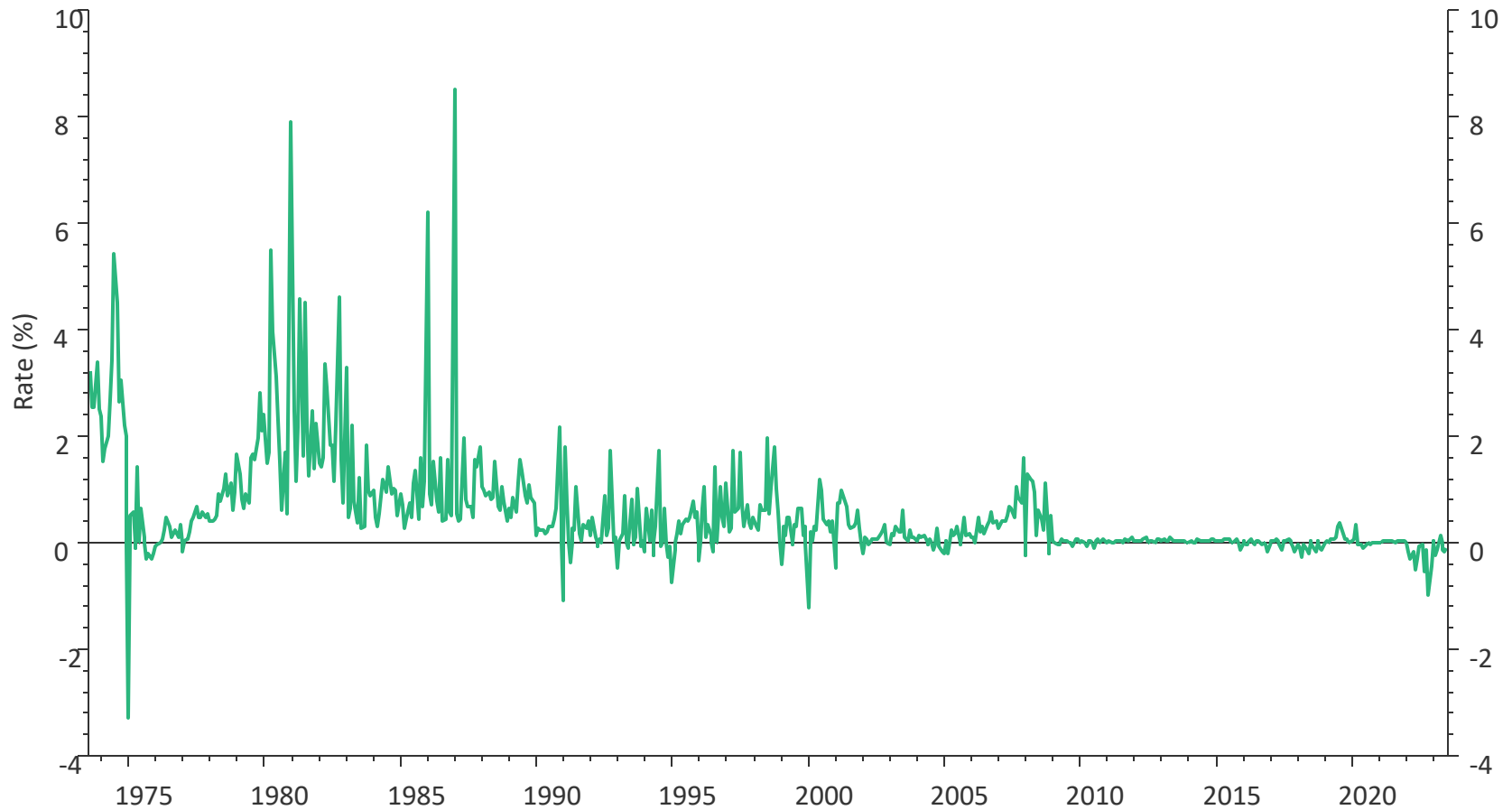


Source: Refinitiv Datastream

Yield Curve Inversion	Recession Lag	S&P 500 Peak Lag	S&P 500 Return to Peak post Yield Curve Inversion
Aug-78	17 months	19 months	17.70%
Sep-80	10 months	3 months	13.60%
Dec-88	19 months	20 months	35.70%
Feb-00	13 months	2 months	8.40%
Dec-05	24 months	23 months	23.50%
Aug-19	6 months	6 months	0.75%

Interest Rate Spreads

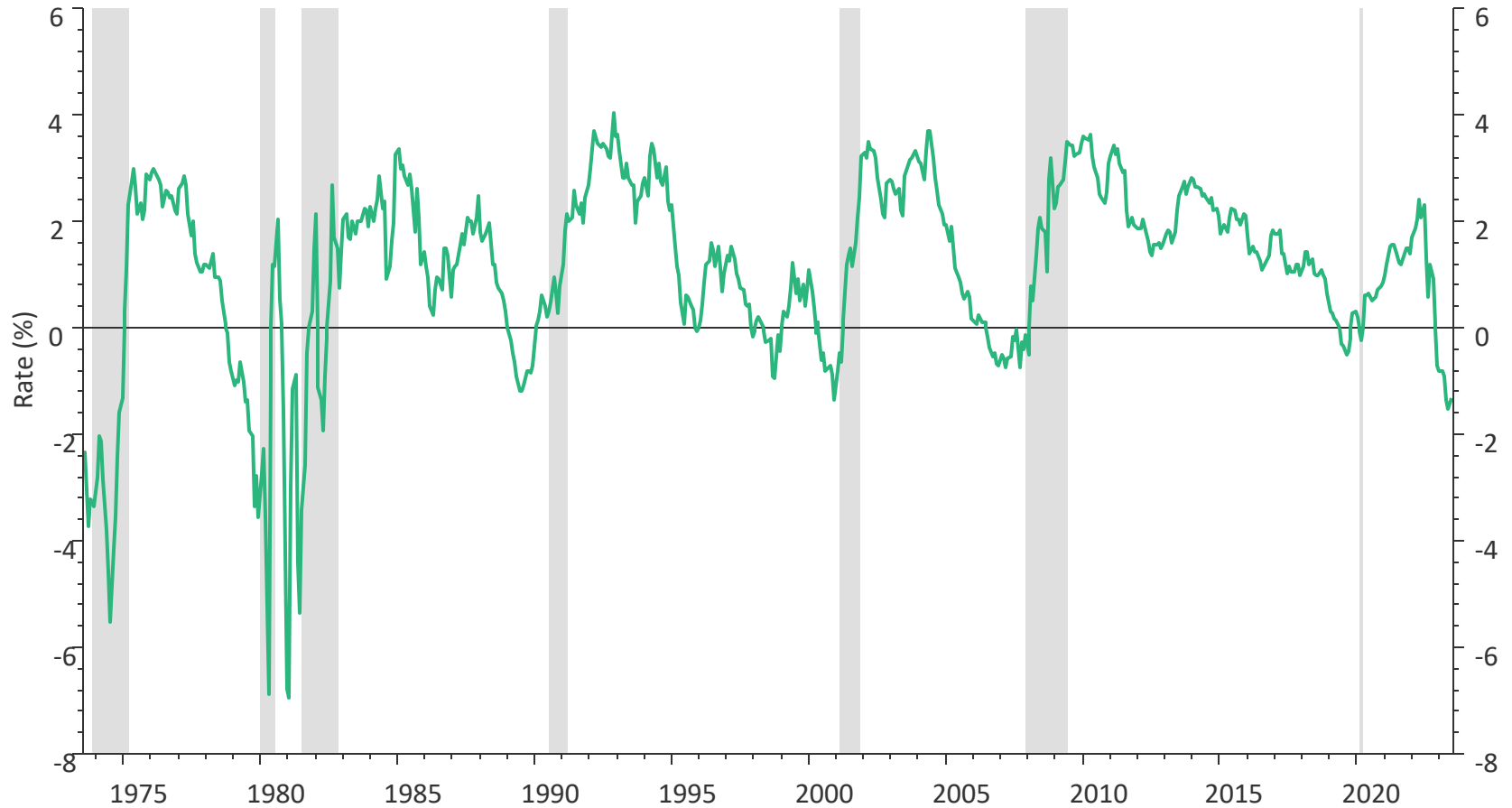
Fed Funds Effective Rate - 3-Month T-Bill



Source: Refinitiv Datastream

Interest Rate Spreads

10-Year Treasury - Fed Funds Effective Rate

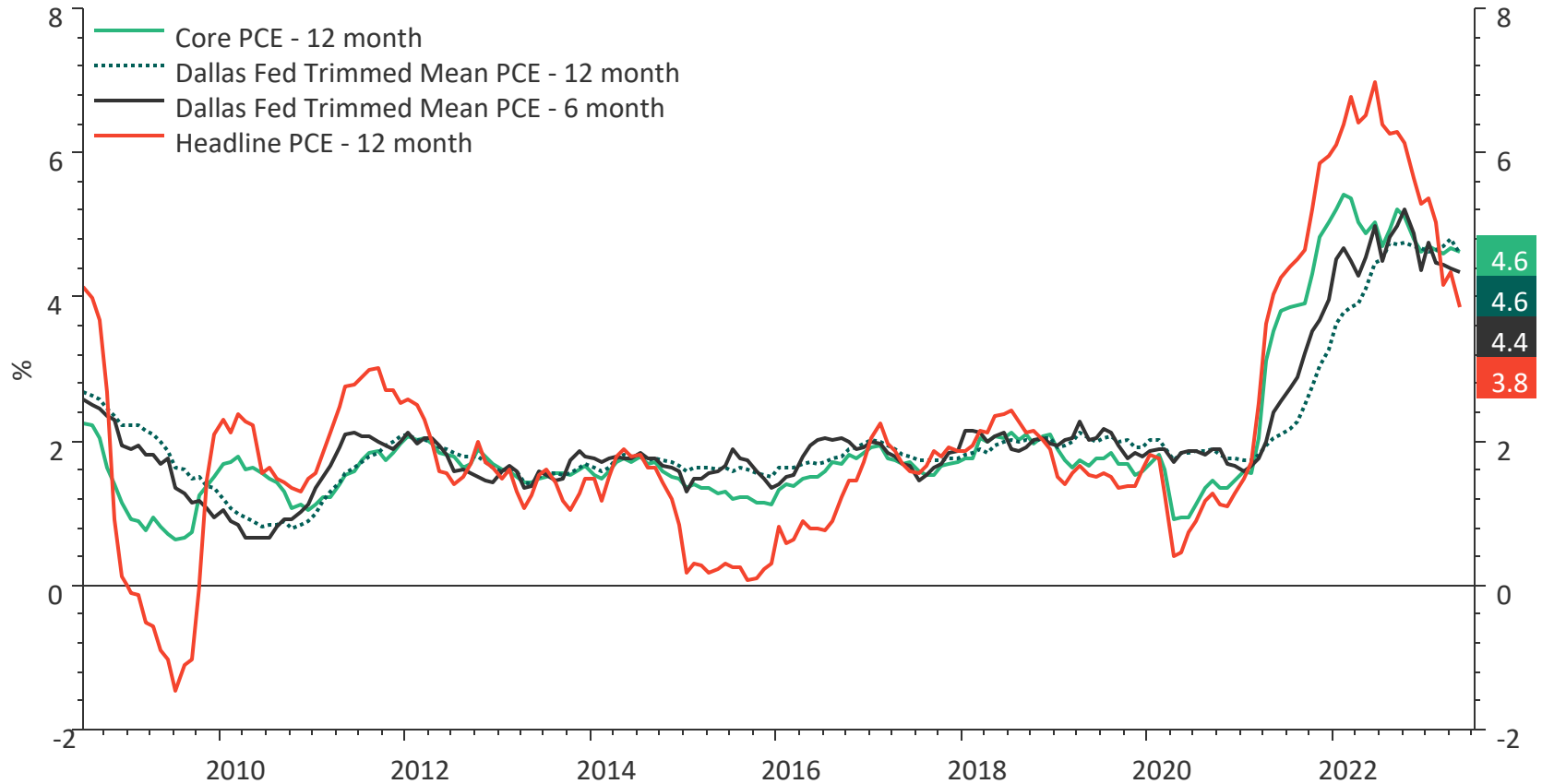


Source: Refinitiv Datastream

Inflation Measures

Core PCE vs. Dallas Fed Trimmed Mean PCE

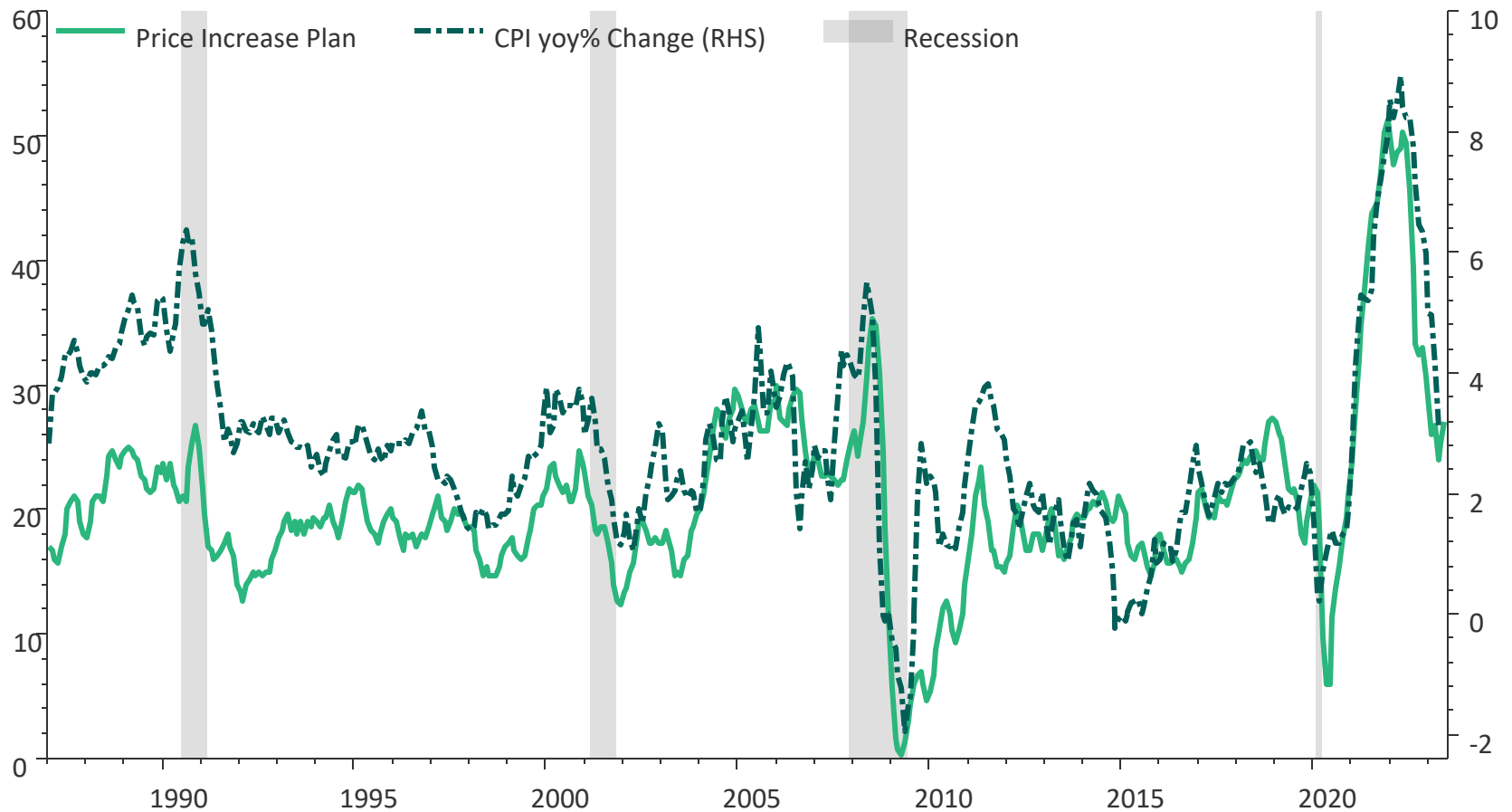
Year-over-Year Percent Change



Source: Refinitiv Datastream

Fewer Businesses Plan Price Increases

NFIB: Net % of Employers Planning Price Increases

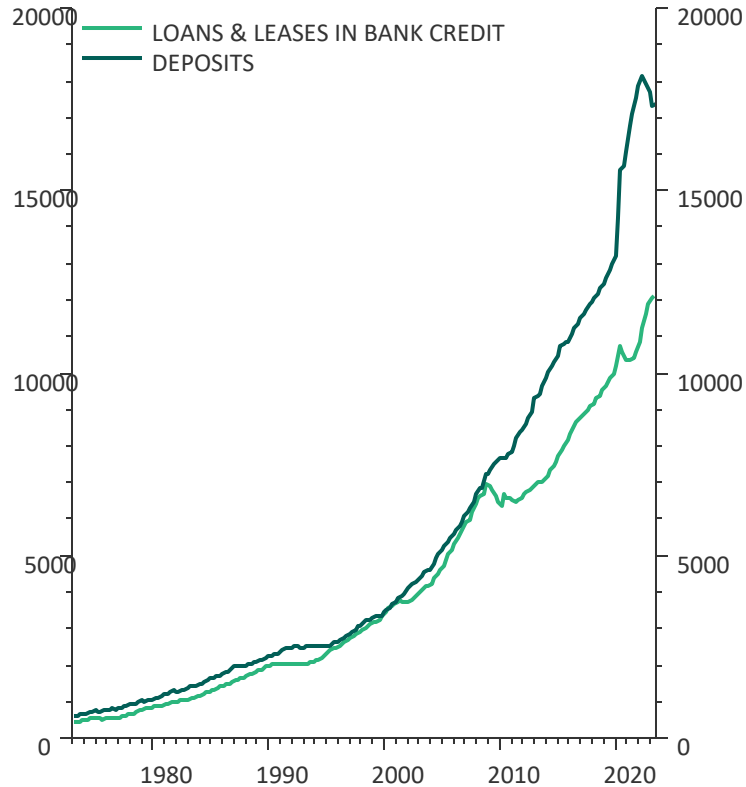


Source: Refinitiv Datastream

Credit Growth has Lagged Deposit Growth

US Commercial Bank Loans and Deposits

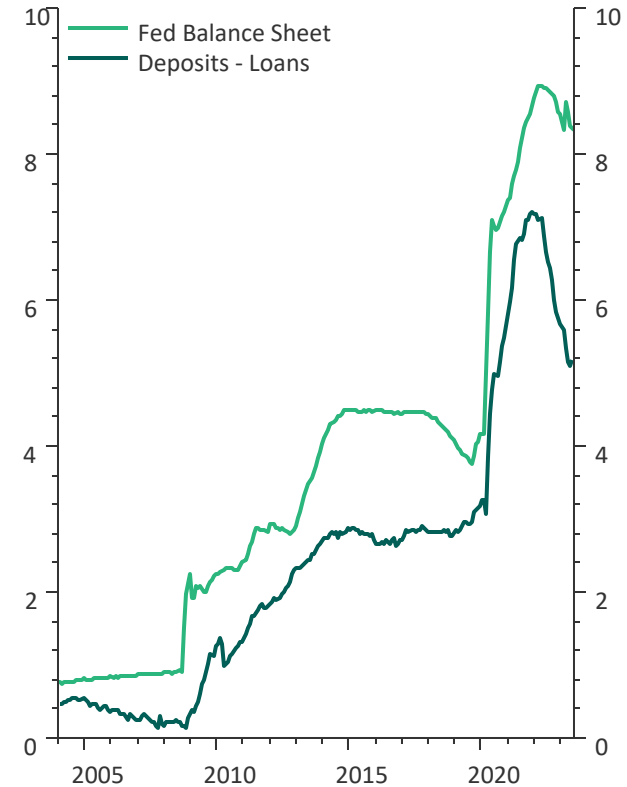
\$ Billions



Source: Refinitiv Datastream

Fed Balance Sheet and Deposit Growth

\$ Billions

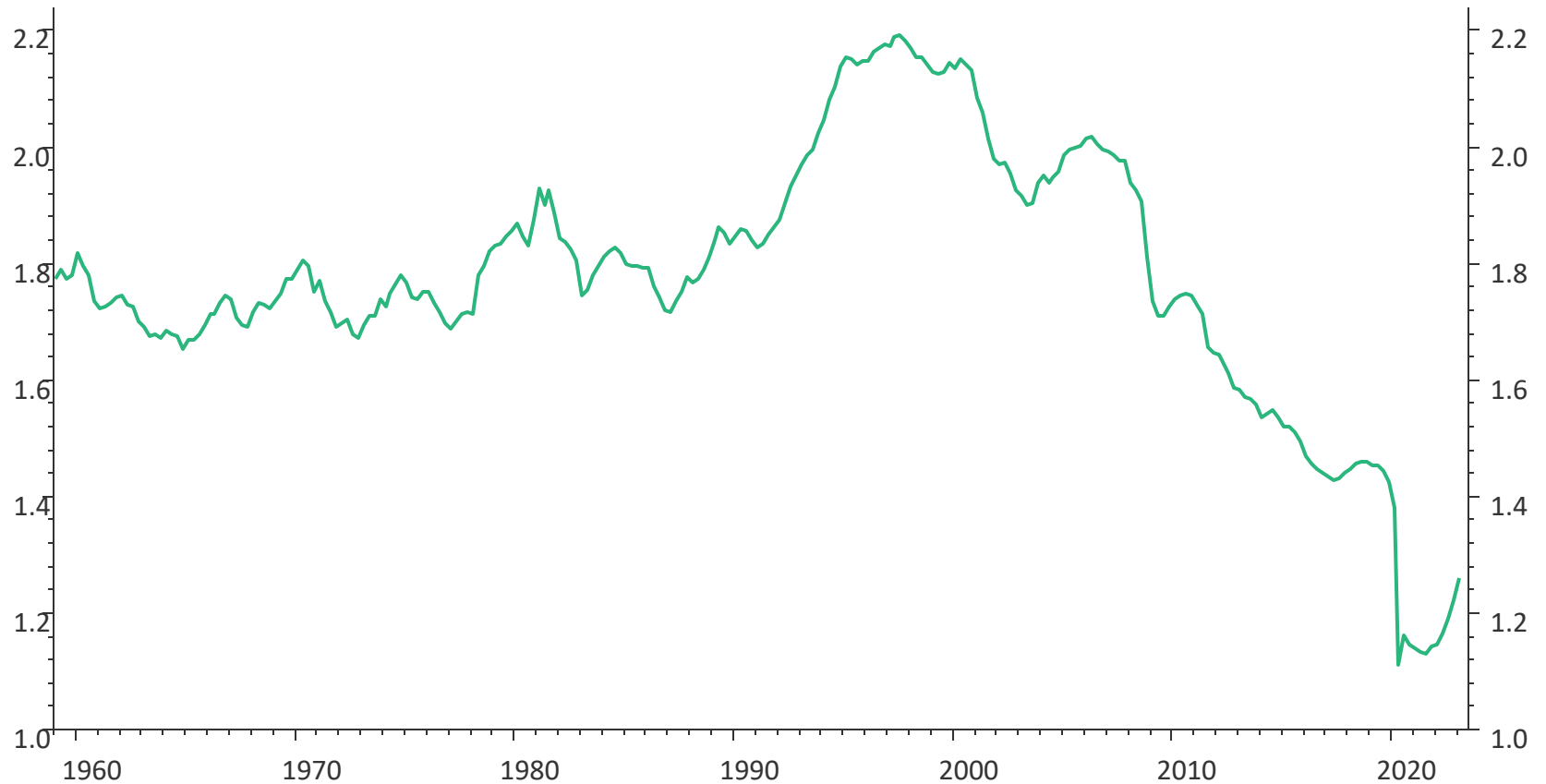


Source: Refinitiv Datastream

Velocity of Money Near All-Time Lows

Velocity of Money

GDP/M2 Supply

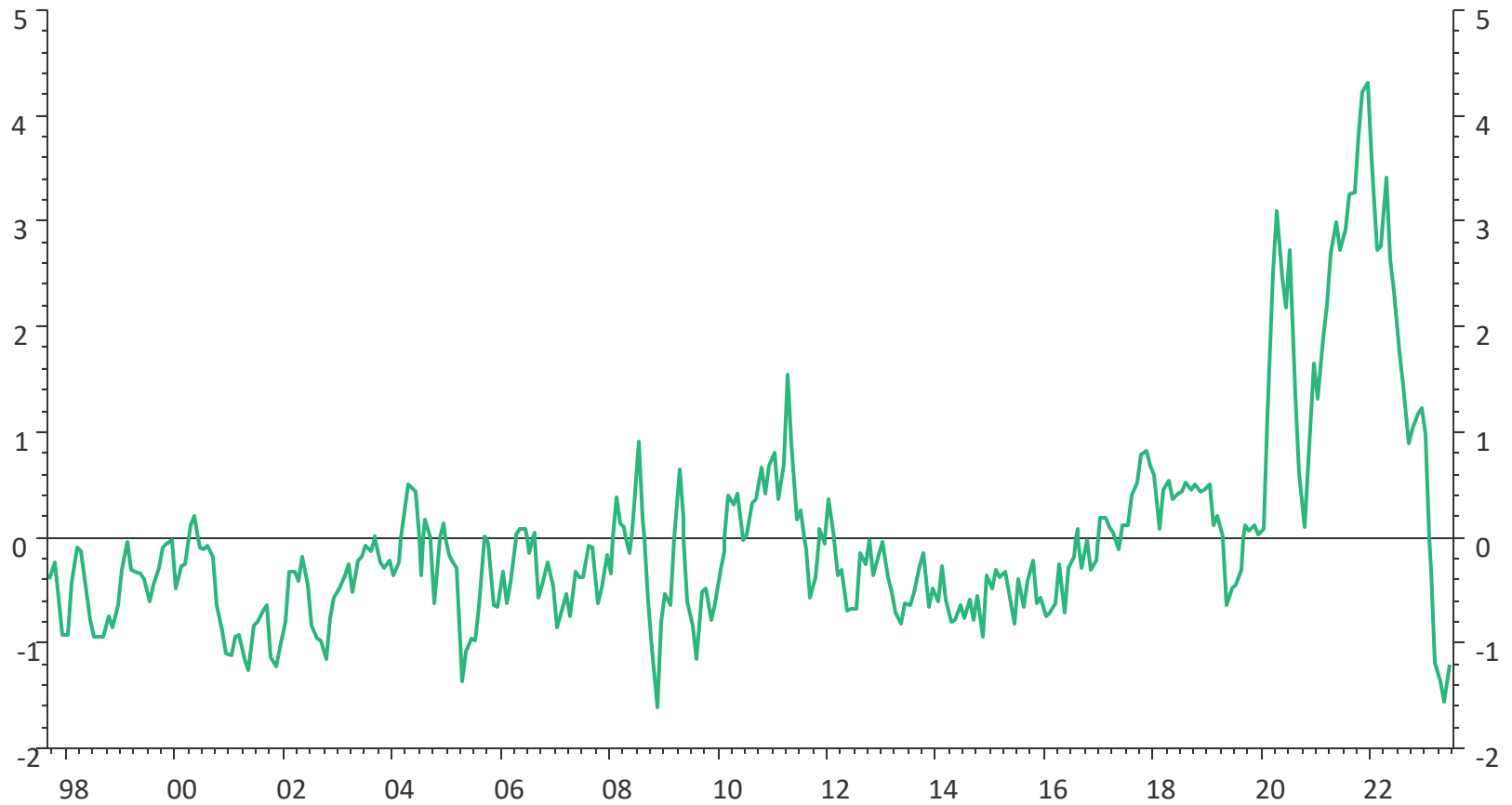


Source: Refinitiv Datastream

Economic Backdrop

Supply Chain Improvement

Global Supply Chain Pressure Index

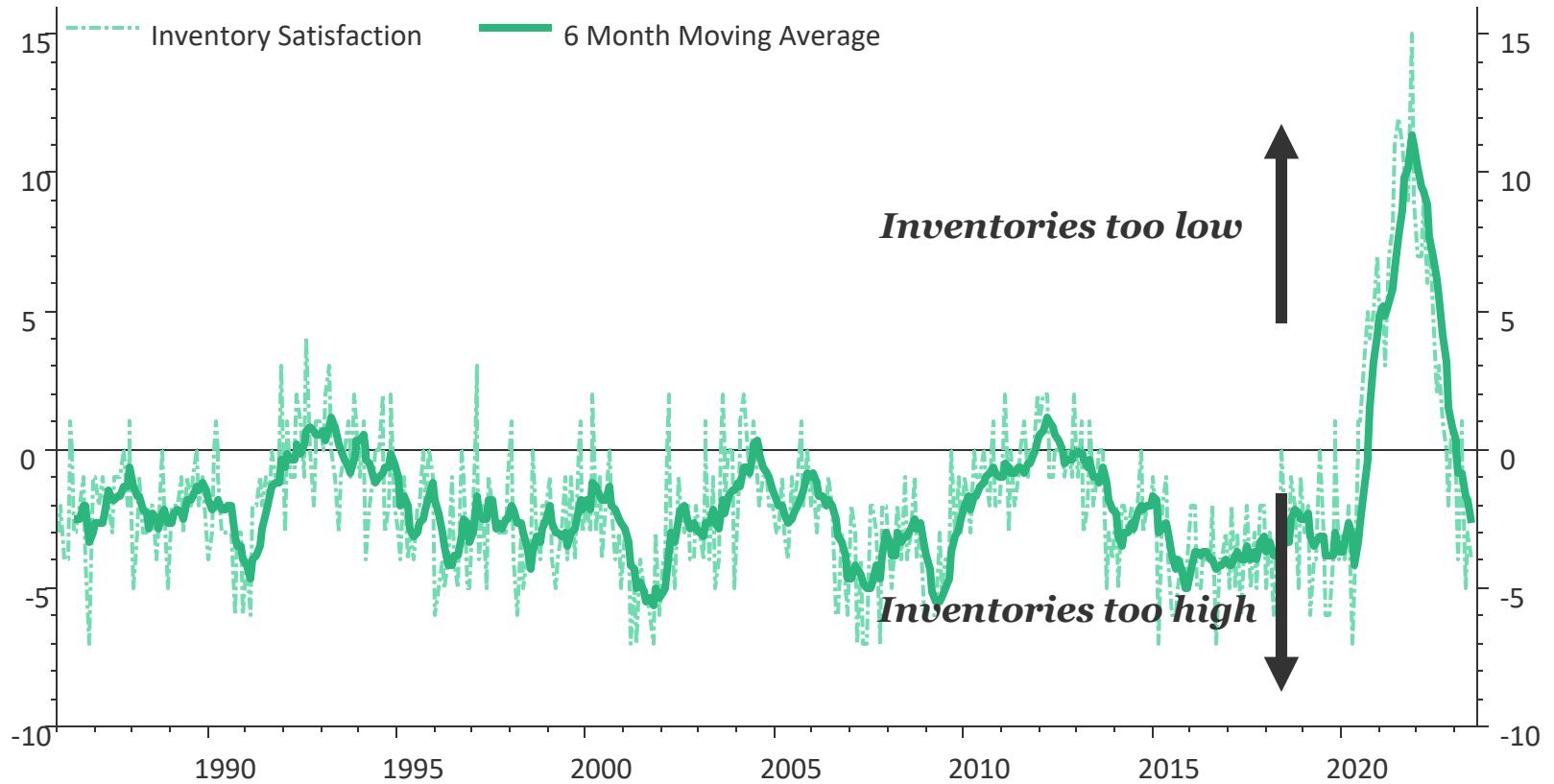


Source: Refinitiv Datastream

Shortages to Gluts?

NFIB Small Business Inventory Satisfaction

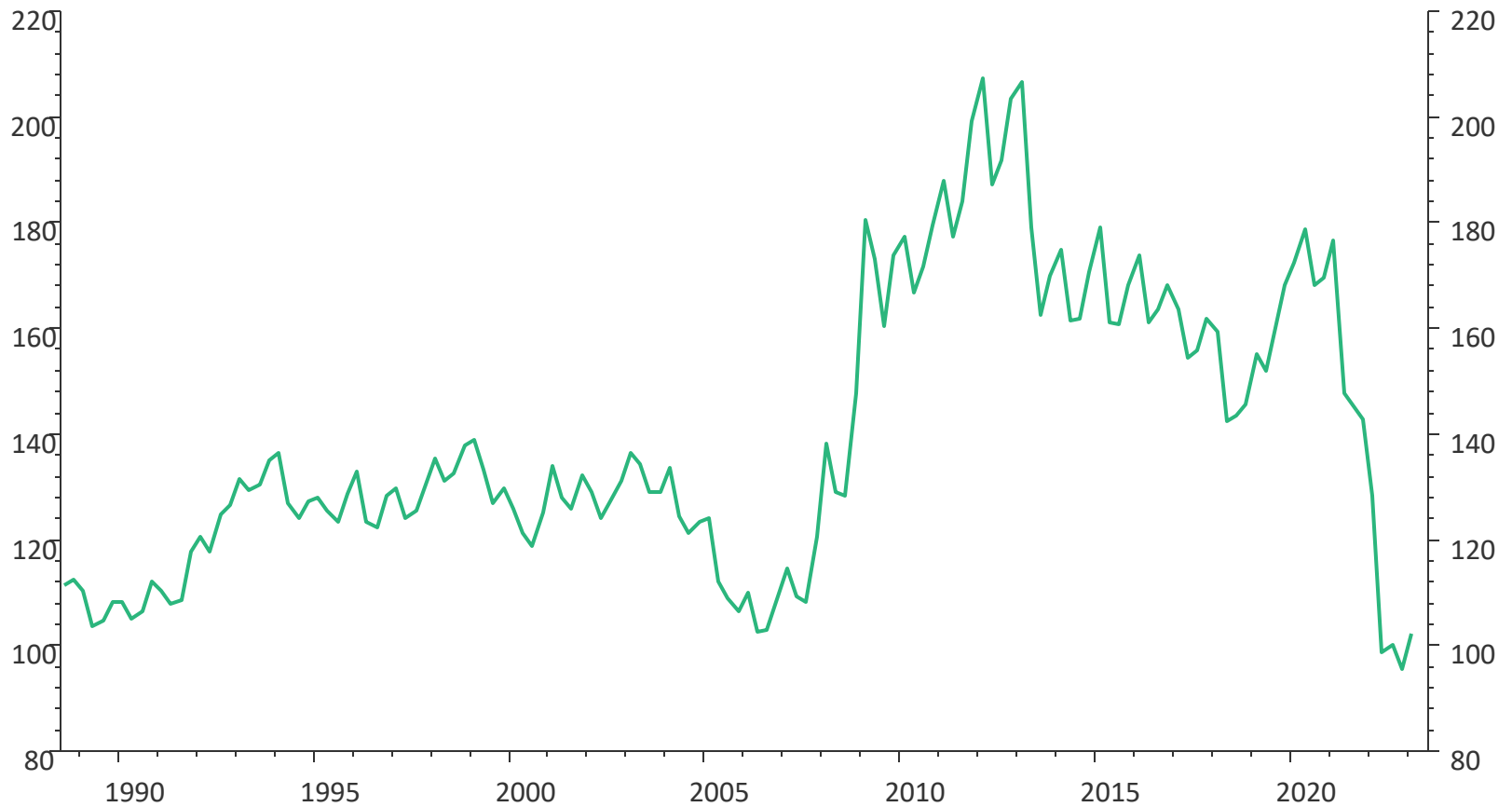
(Net Percent "Too Low minus Too High" at present time, seasonally adjusted)



Source: Refinitiv Datastream

Housing Affordability Has Declined

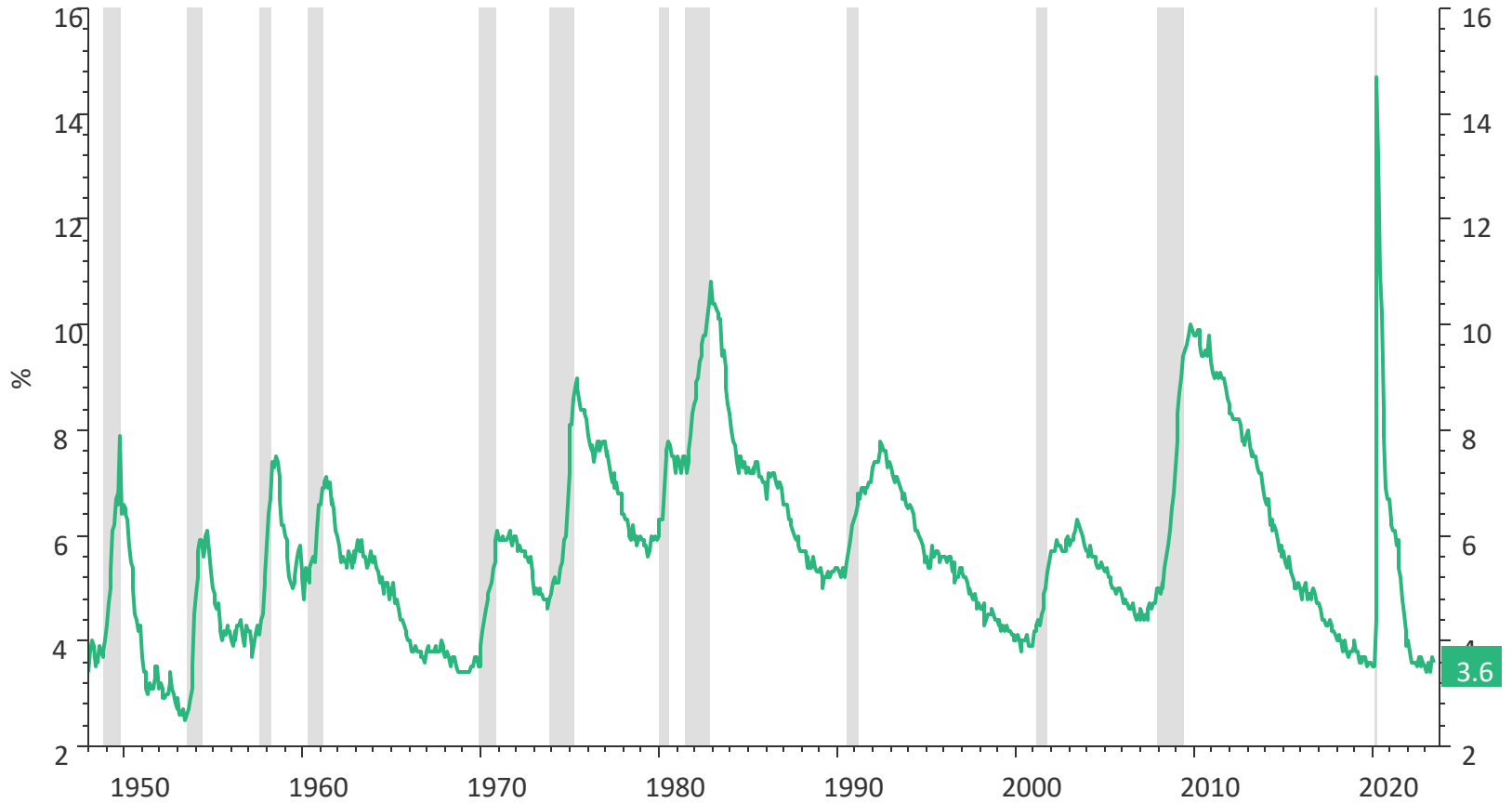
Housing Affordability Index



Source: Refinitiv Datastream

Strong Domestic Labor Market

Unemployment Rate

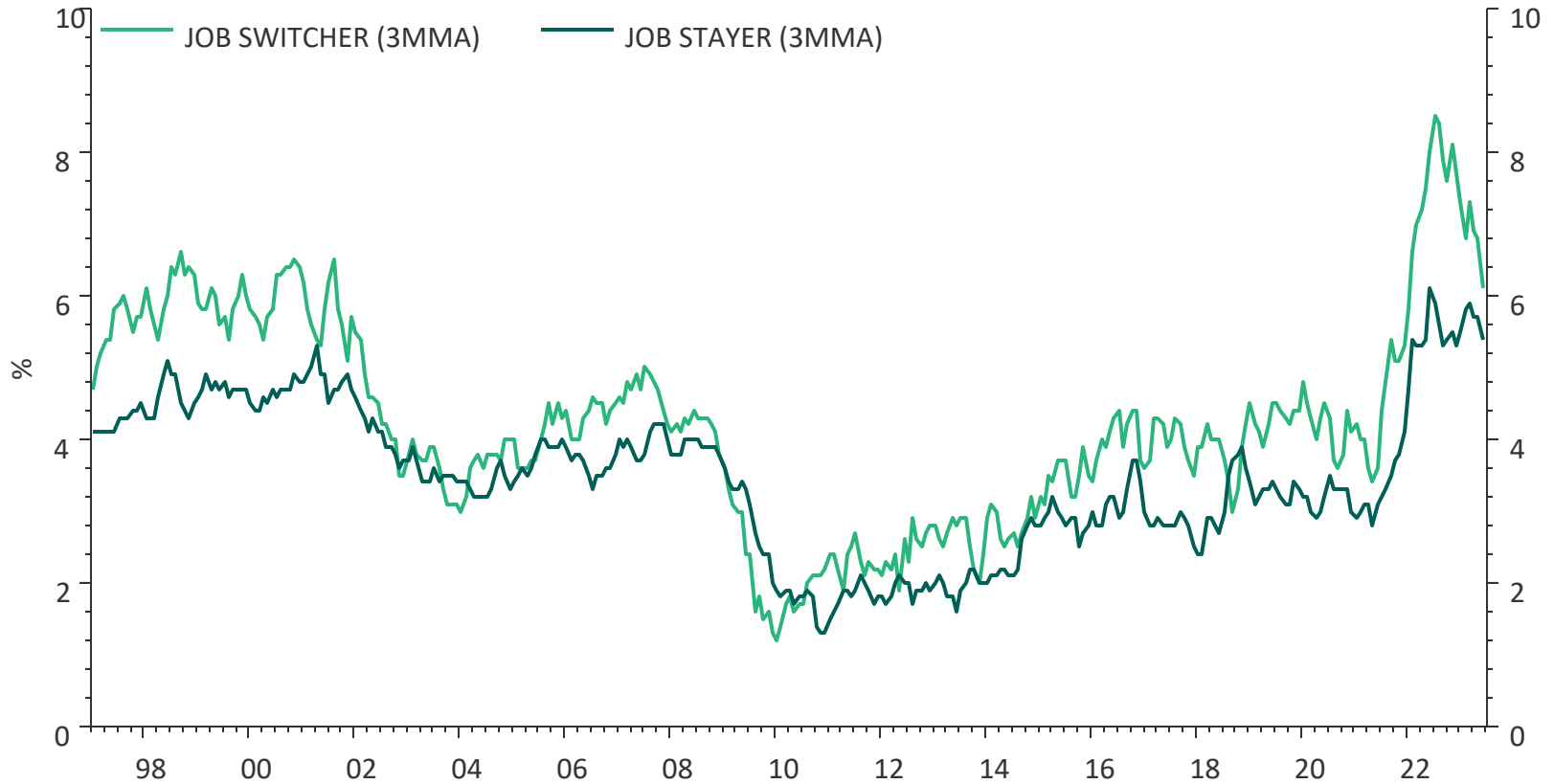


Source: Refinitiv Datastream

Wage Inflation High but Moderating

Atlanta Fed Wage Tracker: Job Switcher vs. Job Stayer

Year-over-Year % Change in Wages

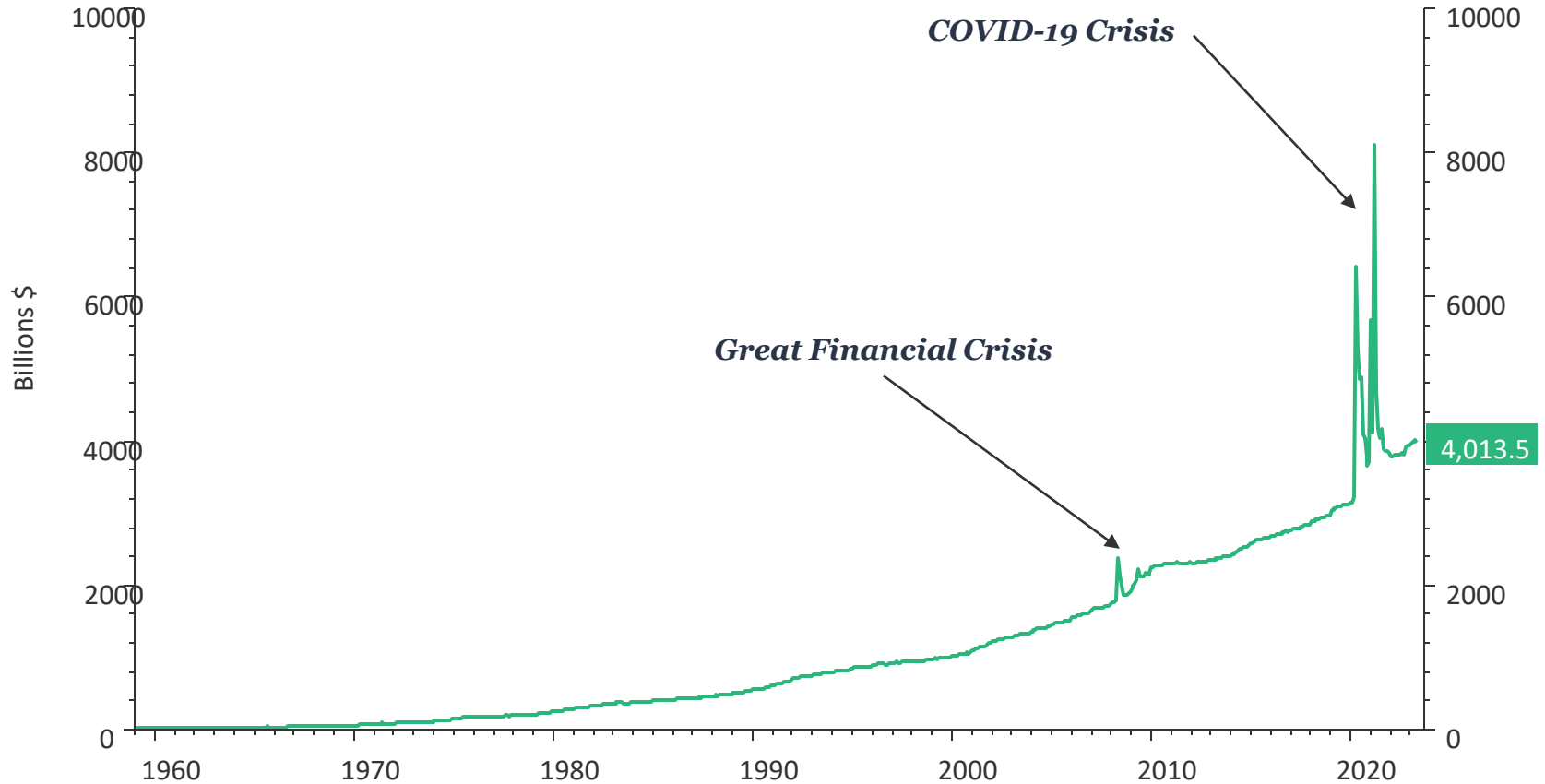


Source: Refinitiv Datastream

Rapid, Large-scale Support for the Economy

Government Social Benefits

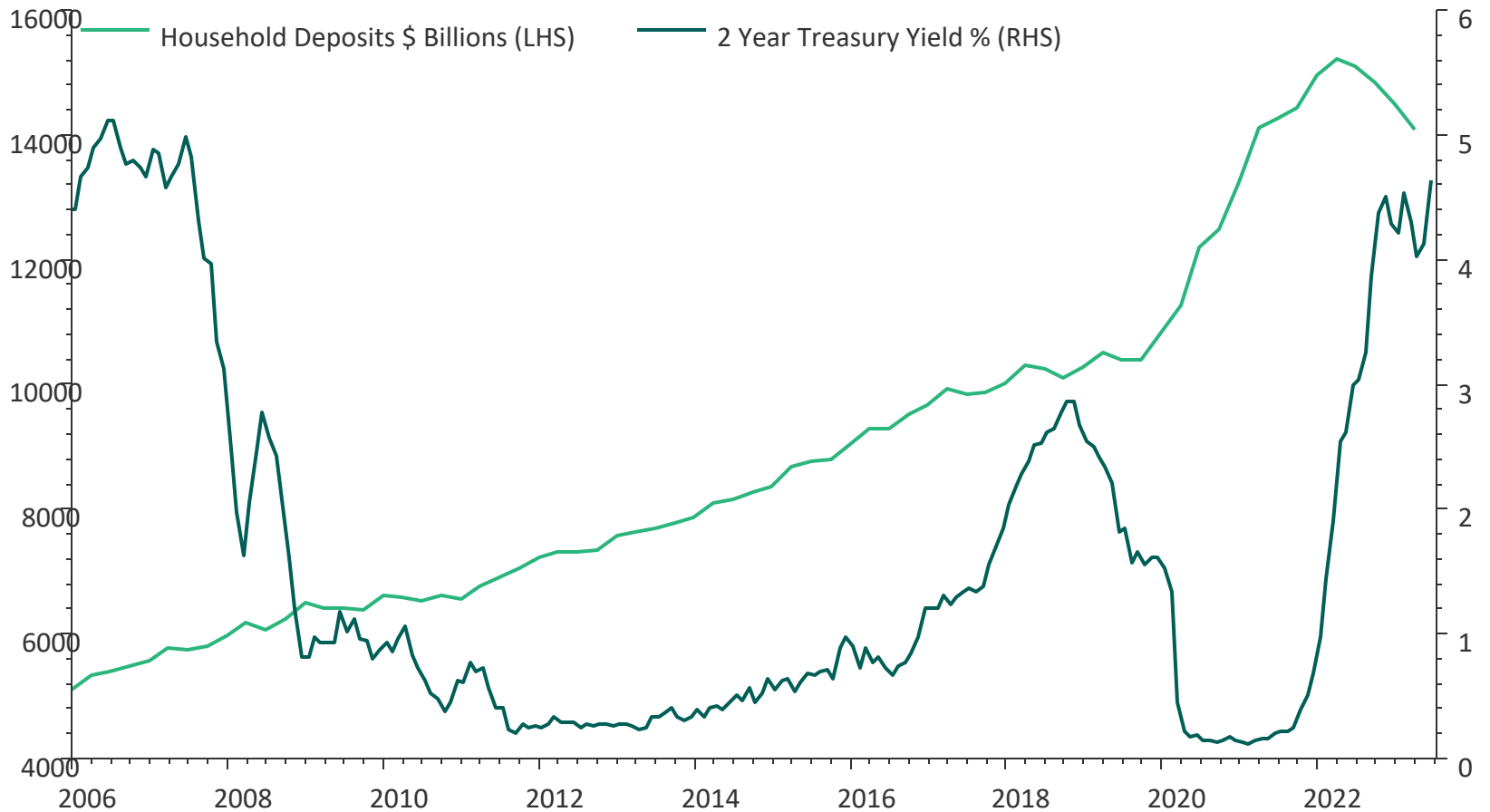
Annualized Rate, Seasonally Adjusted



Source: Refinitiv Datastream

Households Hoard Stimulus

Household Deposits vs. 2 Year Treasury Yield



Source: Refinitiv Datastream