Four Observations, Entirely Reasonable **Late August 2023**

The S&P500, our preferred measure of U.S. equity performance, is about where it was in the summer of 2021. So what? You ask. That was approximately when the inflation alarm bells started going off. The Fed's 'transitory' narrative was falling apart as inflation measures failed to cooperate. Inexplicably, the Fed kept pouring on the stimulus and the investment party rolled on, basically right up until the New Year's celebrations ended. Of course, we all know what happened in 2022, a sobering event as the Fed embarked on a historic about-face, and we all (and I mean all) began to fret about a recession. The point here is the market hasn't gone anywhere since the inflation problem became obvious. We haven't had a recession and the Fed may not be done hiking rates. This whole two-year period is just one long pause as we await our fate. This seems entirely reasonable.

This year's advance has been exceptionally narrow, led by seven mega-cap stocks, now referred to as the Magnificent Seven. The Seven, for various idiosyncratic reasons, are only tangentially aligned with the economy as a whole. Their growth drivers— humanity's digital migration, electric vehicles, generative AI—are the great technological themes of our times and seem destined to outpace the broad economy, at least for the foreseeable future. The Seven are exceptionally profitable, near monopolies if not actual monopolies. They are deservedly expensive but not absurdly so. Given the backdrop of slowing growth, an aggressive Fed, and extreme political and geopolitical uncertainty, this leadership seems entirely reasonable.

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As we come into the final weeks of summer, we’ve had some weakness in the markets, both bond and stock. Ten-year treasury bond yields have broken and stayed above 4% for the first time in 15 years. As always, there are a number of factors responsible. Stronger than expected economic growth is one, but massive fiscal deficits both here and abroad play some incalculable role. The CBO estimated in May that our 2023 fiscal deficit will be $1.5 trillion, and that is with a growing economy at full employment. With the end of quantitative easing (the Fed purchasing our debt), someone else will have to buy it…trillions of it. Rates may have to stay higher for longer as competition for the world’s savings gets serious. Stocks, especially expensive stocks, don’t typically do well in rising rate environments as this restricts credit and diminishes the value of future cash flows. Or…it may have nothing to do with any of that. It’s the end of summer and CEOs and Wall Streeters are all in the Hamptons or Italy. Nobody’s home. So, you see, a little weakness in the markets seems entirely reasonable.

With perfect hindsight and selective use of time periods we’ve tried to sound like we know something, but do we? Interest rate increases work with a long lag, 12 to 18 months. Like slowly pouring sand into your car’s engine, at first...nothing. But eventually…something. This economy can handle higher rates for some period—it already has—but if rates are permanently higher, growth will be more difficult or worse. How much sand? How much time? Market commentary is an exact science, like astrology. But what we are certain of is that our economy (the U.S. economy) adapts and grows—one day the Seven, the next day likely something different. But it can take a little time and be a little messy. Stocks have danced to the tune of the moment, but they really haven’t gone anywhere for two years, and that seems entirely reasonable.

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