

July 17, 2023

Dear Friend,

For the past year, many economists and major banks have been forecasting a looming economic downturn in the U.S. It didn't arrive in the first half of 2023.

The Commerce Department reported that real gross domestic product grew at a 2% annualized rate in the first quarter, which marked a significant upward revision from the previous 1.3% estimate. The Labor Department also reported that employers have added an average of 278,000 new jobs each month this year, which is above the pre-pandemic average. Workers are making more, too. Nominal wages have grown by over 14% over the past two years.

With still elevated inflation and below-average GDP growth, it would be wrong to say the economy is in great shape and firing on all cylinders. But it is also not faltering as many anticipated it would be by now. The second quarter likely registered a downshift in growth from Q1, but not a significant one—JPMorgan estimates real GDP growth of 1.7%.

From an investment standpoint, the stock market has a long history of performing well in a 'balanced economy.' Boom times make for exciting headlines, but an economy with very strong growth and full employment are subject to excess risk-taking, ballooning asset prices, inflation, and monetary tightening—none of which are ultimately good for financial markets. Today, inflation and tight labor markets remain focal issues, but the economy has charted only modest growth, and the Fed is closer to the end than the beginning of monetary tightening. We think these conditions are supporting stocks. The S&P 500 index officially entered a new bull market with a 20+% bounce off October 2022 lows, with the index rallying +16.9% in the first six months of the new year.

*"It took Netflix 3.5 years
to reach 1 million users
and Instagram 3 months.
For ChatGPT, it took
just 5 days."*

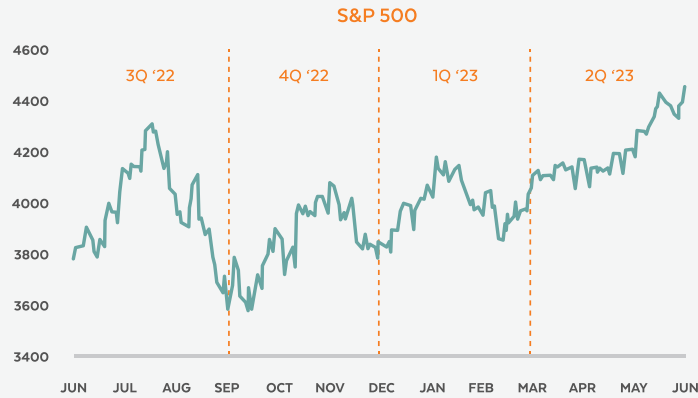
- WORLD OF STATISTICS

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STOCKS HAVE BEEN RALLYING SINCE OCTOBER



Source: Strategas Research

US equity performance was strong, but it’s important to acknowledge how mega-cap companies contributed to total returns, particularly in the technology sector. Enthusiasm for artificial intelligence (A.I.)—which we covered in detail in last quarter’s review—led to a buying spree in shares of some of the US’s biggest tech companies, with high-profile stocks like Microsoft and Alphabet (Google) posting big gains. Overall, the top 10 stocks in the S&P 500 contributed 76.9% of the index’s total return, with the top 5 companies now accounting for 24.1% of the entire index.

COMBINED WEIGHT OF FIVE LARGEST S&P 500 COMPANIES

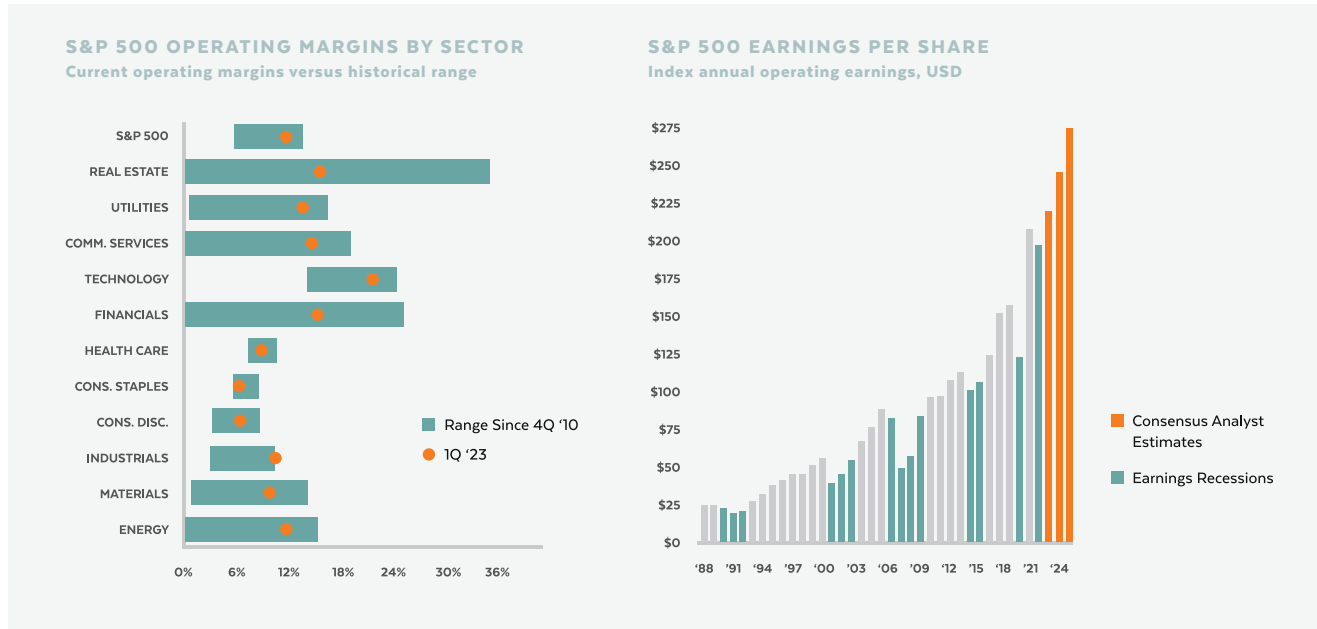


Source: Strategas Research

Highly concentrated returns in just a handful of stocks is generally not a sign of a healthy bull market. But it’s also true that the rally started taking on more breadth in June, with cyclical stocks recovering. The Technology sector was the clear leader in the second quarter with a +17.2% return, but Consumer Discretionary (+14.6%) and Communication Services (+13.1%) also posted strong performance. Enthusiasm was not limited to large-cap stocks either, with the Russell 2000 (small-cap stocks) rising +5.2% and the S&P 400 index (mid-cap stocks) moving +4.9% higher in the second quarter.

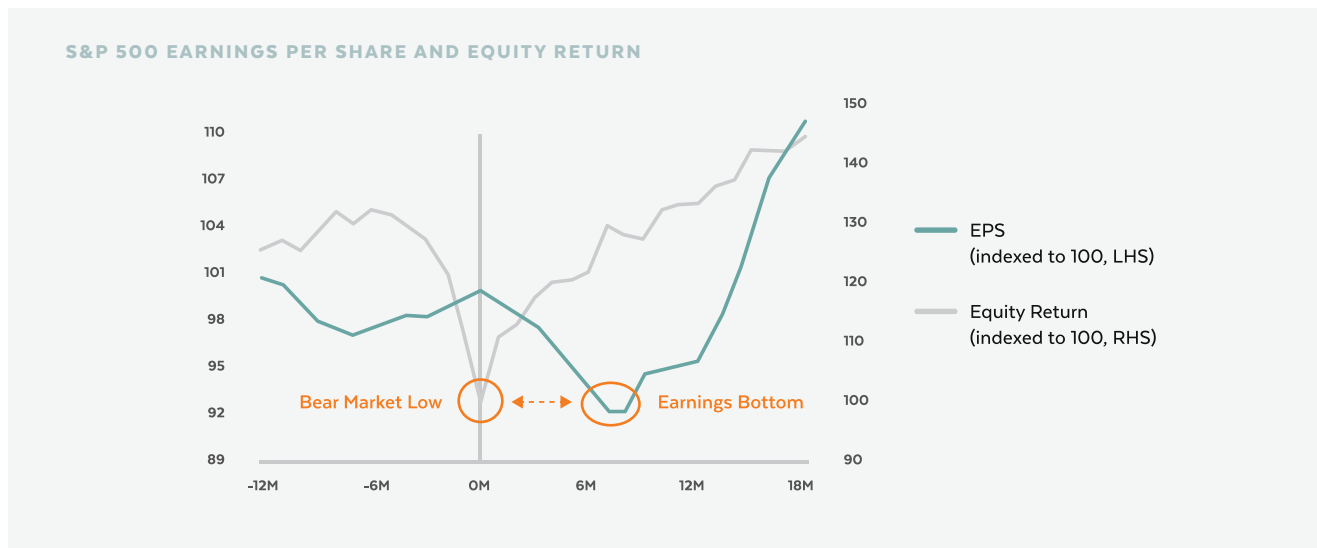


Strong equity performance may also be attributed to resilience in corporate fundamentals, namely in the realm of profitability. Operating margins peaked sometime last year but appear to be stabilizing at relatively high levels (see chart on the left-hand side), while consensus is for corporate earnings to stage a significant rebound sometime next year.



Source: JP Morgan

As we've written in past letters, stocks are discounters of future economic and profitability conditions, which explains why they tend to rally when earnings are weak but expected to strengthen – which we think describes the current environment.



Source: Cambridge Associates



“GOLDILOCKS AND THE THREE BEARS”

A ‘balanced economy’ is often referred to in financial circles as a “Goldilocks economy,” in reference to the children’s story where Goldilocks’s porridge is neither too hot nor too cold, but just right. In economic terms, Goldilocks describes an economy with stable growth and low inflation, or even disinflation. The economy is not too hot and not too cold.

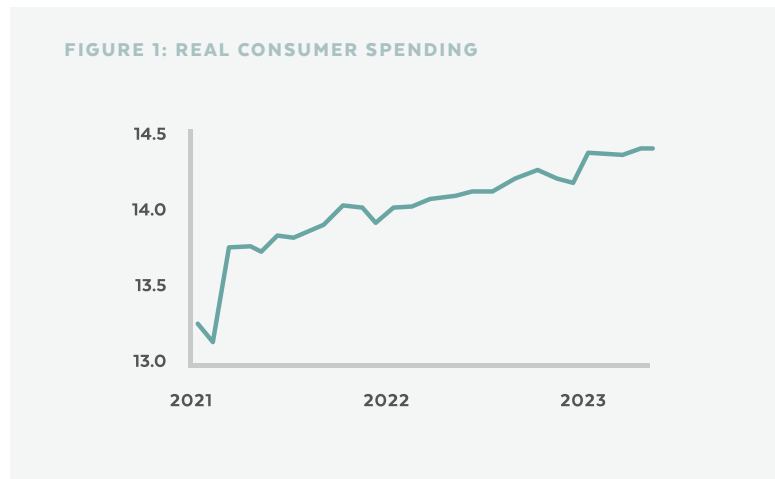
With modest GDP growth and inflation trending downward, there could be a scenario where the economy settles into some type of equilibrium state. But there are also good reasons that outcome is not assured. Here are three.

1. The U.S. Consumer

Consumer spending accounts for nearly two-thirds of US economic output, which makes it one of the most critical metrics to monitor. Economic growth since post-pandemic ‘reopening’ has been on the shoulders of US consumers, bolstered by stimulus money, rising wages, and plentiful job opportunities. But these tailwinds are arguably starting to fade.

Spending growth has started to plateau (see chart below), with retail spending up a modest 0.1% in May but flat when adjusted for inflation.

As mentioned above, the labor market remains tight, with 209,000 new jobs added in June. But payrolls do not tell the entire story, and other key metrics suggest the jobs market may be slightly weaker than headlines suggest. Initial applications for unemployment benefits, a proxy for layoffs, are up approximately 20% this year, and workers are quitting jobs at a much slower rate than last year – suggesting that prospects for better jobs with higher pay are diminishing.

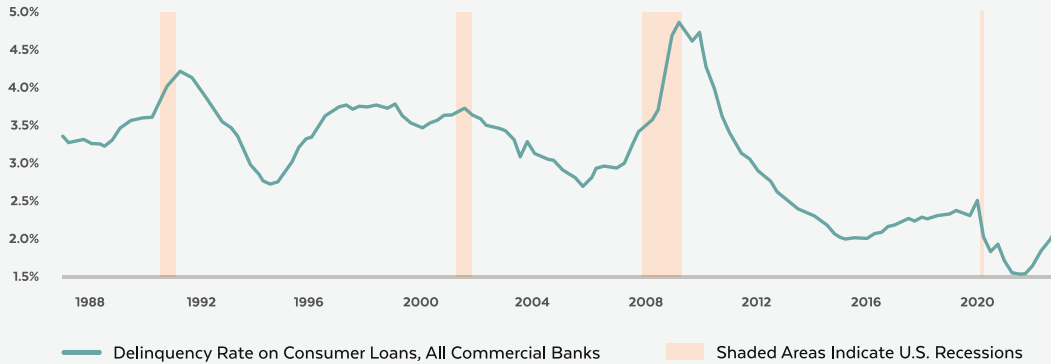


Source: JP Morgan

For households, interest rates are also rising for credit cards, auto loans, and mortgages. Higher rates have also taken a toll on loans with adjustable interest rates, which we think has factored into more households falling behind on payments. As seen in the chart on the next page, delinquency rates on consumer loans are on the rise:



DELINQUENCIES ARE RISING



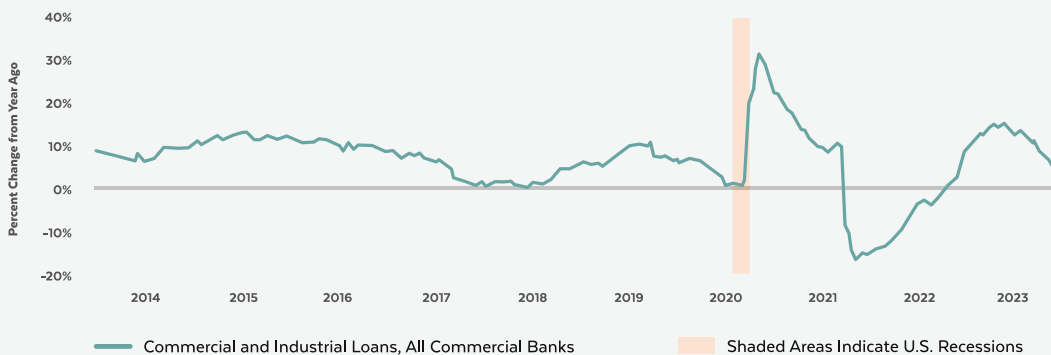
Source: Federal Reserve Bank of St. Louis

We may also see more downward pressure on consumer spending in the fall, when federal student-loan borrowers must resume making monthly debt repayments in October, with interest accruing starting September 1. Estimates show that student loan payments amount to about \$6 billion to \$9 billion a month, which can have knock-on effects on borrowers’ desire to spend. These figures are very small relative to the \$1.5 trillion that consumers in the US spend every month, so we shouldn’t see market impact, but it is nevertheless worth watching.

2. Bank Lending and Commercial Real Estate

In the wake of the Fed’s interest rate hiking campaign and the regional bank stress this spring—the two of which are related—we’re starting to see banks requiring more collateral from borrowers and charging higher interest rates on loans. Lending conditions for companies, households, and especially real estate developers are now nearly as tight as they were during the pandemic.

LOAN GROWTH IS FALLING



Source: Federal Reserve Bank of St. Louis



In the corporate world, sales of new bonds have fallen fairly dramatically, and corporate bankruptcy filings are also starting to rise as cash dries up, with the highest number of filings since 2010.

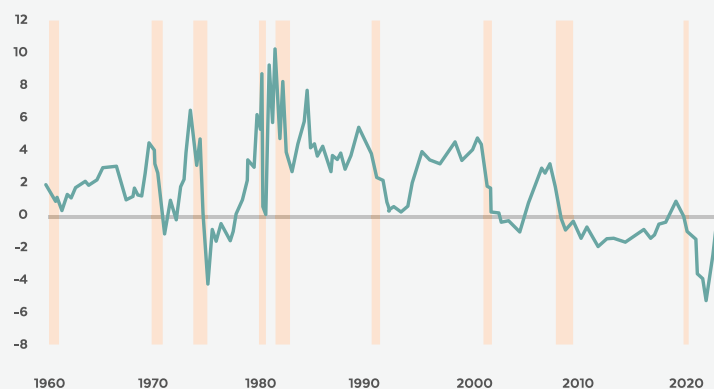
Nowhere has credit tightening been more apparent than in the commercial real estate market, however. In the office space, landlords are not only collecting less revenue from tenants who are not returning to offices, they are also facing higher interest expenses. Banks surveying the environment don't like what they see—the ratio of money lent to property value has fallen to a 30-year low, and the debt markets are signaling the trouble. In June, commercial mortgage-backed bonds with AAA credit ratings paid ~2% higher yields than comparable US Treasury bonds.

2. The Federal Reserve

Inflation has been trending lower but remains well above the Fed's 2% target. Headline Personal Consumption Expenditure (PCE) inflation was up 4.9% year-over-year in the first quarter, though May's print broke below the 4% level with a 3.8% annualized increase. Core prices, which exclude food and energy, registered at 4.6% in May, a slight improvement from April's 4.7% level. We believe inflation should continue to trend lower in the second half of the year, but the distance between current readings and the Fed's target suggests at least one or two more rate hikes are likely in 2023.

The good news is that the market is already well aware of the Fed's plans, and the policy terminal rate (where the fed funds rate will peak) is visible on the horizon. There is also a good argument that financial conditions are already sufficiently tight, with the softness in bank lending mentioned above and with the effective fed funds higher than the inflation rate (chart below). If inflation continues to fall in the coming months—which we expect it will—then policy gets tighter by default, even without further rate hikes.

REAL FED FUNDS RATE
Effective Fed Funds Rate Less Core PCE



Source: Strategas Research



There is a risk the Fed will go too far in raising rates. As JPMorgan pointed out, “a lot of lip service is being given to the lagged effect of monetary policy, but very little patience in waiting to see those lags play out.” The upshot is that an acknowledgment of over-tightening—which would almost certainly accompany recession, especially in an election year—would likely lead to rate cuts, which could factor as a forward-looking positive for the economy and stocks.

A BRIEF NOTE ON THE DEBT CEILING STANDOFF

Though it probably feels like old news now, the big story in the second quarter was the debt ceiling standoff. After months of political wrangling, the two sides ultimately reached a deal with spending cuts. Two examples are \$20 billion in reduced funding for the IRS and setting an official end date to the Biden administration’s pause on student loan repayments. For all the bluster and chaos, estimates say the deal would reduce federal spending by about 0.2% of GDP through 2025.

Debt ceiling drama has seemingly become a fixture of US politics, meaning investors will almost certainly have to confront the issue every few years. As we saw in Q2 and past instances, the threat of default can cause much distress in the media and worry amongst everyday investors, even though the issue has consistently proven to be a “looming catastrophe” that never materializes. In our view, investors might be best suited to ignore these debt ceiling flare-ups in the future altogether.

CONCLUSION

There has been no shortage of headline risk in the first half of the year, but the US economy avoided worst-case scenarios at every turn. Growth has been modest and inflation has been falling, which suggests the economy is moving towards a state of not being too hot or too cold—a so-termed Goldilocks economy.

In the first half of 2023, the failures of Silicon Valley Bank, Signature Bank New York, and First Republic sparked fears of financial contagion. But strong capital positions across the largest money center banks—combined with emergency government measures—managed to stave off a crisis. Investors then worried the debt ceiling standoff would result in the US defaulting for the first time in history, which fortunately did not occur.

Instead, the US economy continued growing, and employers added new jobs at a strong clip.

The simple fact is that the US economy has been performing better than expected, which is delaying recession forecasts and also pushing interest rate projections slightly higher. The bright spot looking forward is that monetary policy is already tight, and inflation is poised to continue falling. This means the peak in the interest rate cycle is likely very close.

As Private Wealth Partners had positioned portfolios in light of shifting themes well in advance of the first half of 2023, we expect to ‘stay the course’ with our investments. We will be of course monitoring for new opportunities, while doing our best to protect capital in case of any new important changes to the environment.



If you have any questions about this review or your portfolio, please do not hesitate to contact us. We hope you're enjoying the summer months.

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