HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

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We have expressed concern since the outset of 2023 that the stock market would need time to sort itself out. Like many analysts, we were surprised as investors have blown past the obvious concerns: a debt ceiling brawl, a potential banking crisis, continued interest rate increases, and an imminent recession. It seems this year has been a lesson in not getting overly pessimistic.

That said, our concerns remain. We must observe that most of the market gain has occurred in the so-called Magnificent Seven stocks of the giant technology companies. That growth seems driven by emotion and momentum rather than fundamentals. We question the sustainability of this peculiar boom in technology. We also agree with the term S&P 493 (minus the seven) which conveys that most stocks are indeed unsettled and uncertain.

We retain our opinion that the market will struggle in the months ahead. We expect the Federal Reserve to hike interest rates several times more to combat still stubborn inflation. We expect the much-anticipated recession will still occur albeit if delayed until 2024. These forces will weigh down the broader market even if the technology boom has more legs.

We advise our clients to have broadly diversified portfolios avoiding concentrated risk and look to a long-term strategy. As stated, we are cautious about the near-term outlook – but always optimistic about the future potential of the overall equity market.

MARKET TRENDS

The accompanying chart summarizes stock and bond market trends in the second quarter and first half of 2023. The stock market indexes have been positive while bond prices have fluctuated.

Equity Market: The large technology company stocks were beaten up in 2022 but have soared ahead in 2023 – a trend related to investor excitement over the potential of artificial intelligence. The heralded Magnificent Seven includes Nvidia, Meta, Tesla, Amazon, Apple, Microsoft, and Google. These seven stocks now account for one-third of the total S&P 500 market cap of $37 trillion.

The strong performance of technology is seen in the Nasdaq Composite Index which was ahead 13.05% in the second quarter and 32.32% for the year-to-date. The S&P 500 was ahead 8.74% for the quarter and 16.89% for the year. The leaders in the S&P 500 have been Information Technology and Communications Services. Most sectors in the S&P 500 have lagged the total index. The Russell 2000 index of small stocks was positive by 5.21%. for the quarter and 8.09% for the year. Perhaps the best indicator of actual market performance was the Dow Jones Industrial Average, which moved ahead only 3.97% for the quarter and 4.94% for the year.

Fixed Income Market: Our aversion to long-term bonds remains and is reinforced by the inflationary situation. We like bond maturities under two years which now have higher rate returns than previous years. We like laddered investments with a mix of U.S. Government, municipal, and high- quality corporate bonds. We also like the new better-paying opportunities in money market funds. The bond market has been on something of a round trip in 2023. The yield on the 10-year U.S. Treasury note – which moves inversely to prices – rose to 3.861% on June 30. It was 3.481% on March 31 and 3.826% at the end of 2022. Investors usually flock to U.S. Treasuries when they want safety. Some of the worries that drove prices higher in the first quarter seem to have abated in the second quarter.

MAJOR MARKET INDEXES

	2023 YTD Return
Dow Jones Industrial Average TR	4.94
S&P 500 Index TR	16.89
Russell 2000 Index TR	8.09
NASDAQ Composite TR	32.32
EAFE Index NR	11.67
Bloomberg Aggregate Bond Treasury TR	1.59

Source: Morningstar® as of June 30, 2023

THE OUTLOOK

The Economy: The story of the U.S. economy is buoyancy in the face of higher interest rates. To fight inflation, the Federal Reserve has boosted benchmark rates by 500 basis points – the steepest rate increase since the 1980s. Economic growth has slowed but the labor market and consumer spending are still strong. Inflation has

subsided but is still way above the Fed's target rate of 2% annually. We expect the Fed may increase rates twice more this year to ensure that inflation is subdued.

In our April commentary, we quoted the prediction from the Conference Board of a mild recession in the second half of 2023. We note that the forecast is now pushed forward into 2024. The logic is that the policy of Fed tightening is taking longer to have impact but eventually will take hold. Additionally, red alerts are flashing internationally. The U.S. will feel the effect of Eurozone economies that are also slowing and at risk from aggressive central bank tightening. China's growth impulse is faltering after the post pandemic lockdown surge. Global commodity prices have declined more than 25% in the past year, a signal of imminent recession.

The Market: Given the probability of recession, corporate earnings have already weakened. Profits of stocks in the S&P 500 are predicted to show about 10% average earnings drop when second quarter numbers are reported compared to the same stretch in 2022.

We always look carefully at Price/Earnings ratio for the S&P 500. The forward 12-month P/E ratio is now 19.3 -- much higher than the 100- year average of 15. The ratio grew from 17.8 on March 31 because of the positive market performance in the first quarter. The effect of lower corporate earnings may push the ratio even higher in the months ahead.

So, we view the U.S. equity outlook cautiously due to the expensive valuations and deteriorating business cycle. We think the recent fascination with the large tech companies may fade considerably as fundamentals come into view. We believe the overall market will stay in its current trading range for the remainder of 2023. Further growth of 5% would be our most optimistic outlook. As stated, we think the forces of inflation and recession need to play themselves out for the stock market to see a reliable and sustained rally.

OUR STRATEGIES

Asset Allocation: Most clients should stick to portfolio strategies previously identified. We advise against an increased allocation to equities at this time. For some clients, we may recommend taking some money off the table right now. For new clients, we will recommend a 60% allocation to equities to be phased in over a 12- to -18-month period. The other 40% of assets will be short to intermediate term bonds, cash, and alternative investments.

Preferred Equities: As always, despite market conditions, we look for long-term equity opportunities. Our focus is on companies that can weather both the short-term period and flourish in a longer time frame. We want fundamentally sound companies with reasonable valuations and that pay dividends. In that context, we are looking at these sectors which are similar to last quarter.

ENERGY: Companies in this sector are undervalued at present and have favorable cash flow.

UTILITIES: Companies in this sector have provided consistent earnings and good dividends.

CONSUMER STAPLES AND DISCRETIONARY: Staples can do well in uncertain times where consumers stick to basics like food and household items. Affluent shoppers have made the discretionary category a consistent good performer.

INFRASTRUCTURE: Federal government investment should work in favor of basic materials and construction companies.

FINANCIALS: The S&P Regional Banking sub-sector has lagged YTD nearly 30% leaving room for a turnaround when rates moderate or decline. While we have been favoring larger institutions and investment banks, there has been unjust punishment to select regional banks.

Other Assets:

We continue to explore alternatives to public markets and believe that Private Credit and Private Equity positions could provide similar return opportunities with less volatility. Private credit, which includes direct lending, mezzanine debt, and distressed debt investments, offers the potential for attractive risk-adjusted returns while exhibiting a lower correlation to traditional public markets. We have been utilizing Broadly Syndicated Loan vehicles and Collateralized Loan Obligations structured as BDCs which can provide investors with greater security through collateral, yields, and a hedge against inflation through floating rate structures.

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