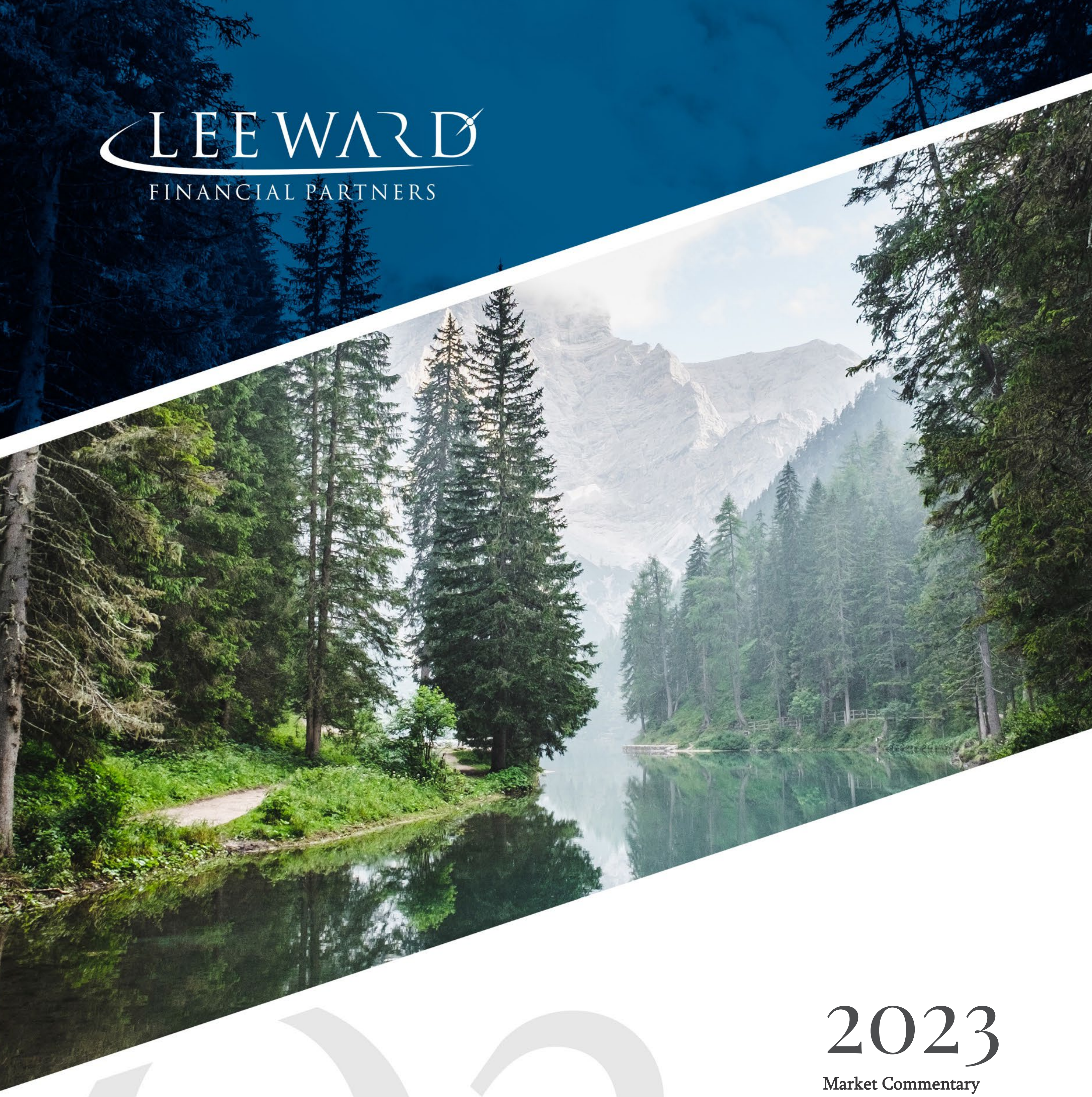

Q2 2023

Market Commentary

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2Q 2023 Market Commentary

LEEWARD FINANCIAL PARTNERS

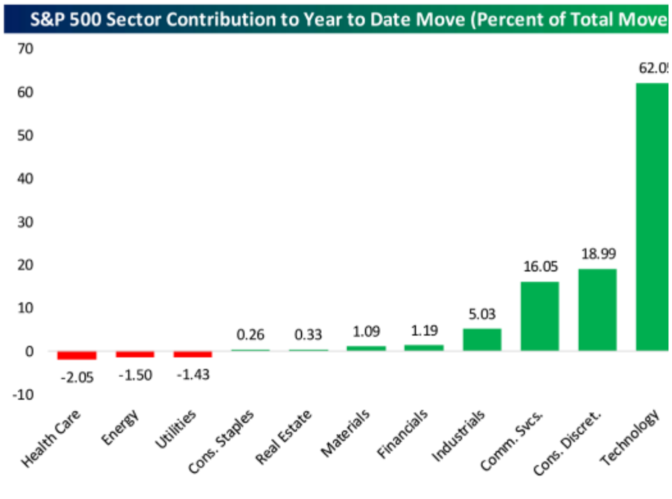
Bear Market Rally or New Bull Market?

Financial market returns came in stronger than anticipated in the second quarter, as the pullback many expected after a solid first quarter failed to materialize. Market resilience can be attributed to the convergence of positive developments at central banks, politics and geopolitics, technology, and across corporate balance sheets. We will discuss these market drivers in further detail later in this piece. First, we will provide an update on market performance.

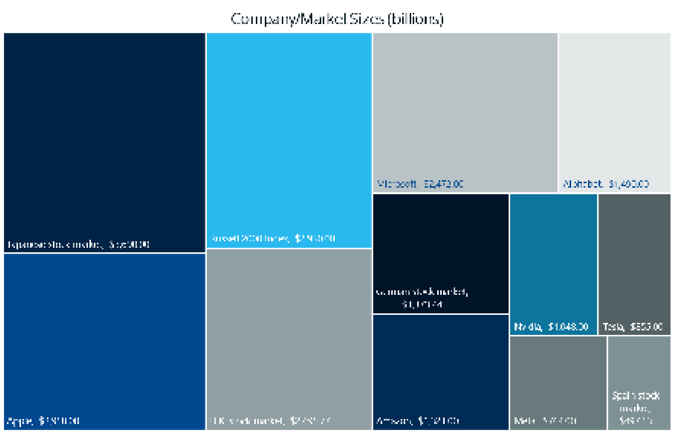
Market Developments

The U.S. equity market was where you wanted to be invested in Q2. Over the quarter, large-cap U.S. equities (S&P 500 Index) returned +8.7%, extending year-to-date gains to +17.3%. In comparison, U.S. investors in developed international markets (primarily Europe and Japan) generated returns of +2.9% in Q2 (+10.7% YTD) and investors in emerging market equities picked up +2.0% in Q2 (+5.8% YTD). Within the U.S. equity market, small-cap companies (+5.3%) lagged large-cap counterparts but began to show some improvement over the last weeks of June.

The major story was the U.S. tech sector. The Nasdaq Composite Index notched its best first half of the year since 1983 as investors flocked to companies they expected to benefit from the growth of artificial intelligence. The largest contributors to the rally have been a handful of giants: Apple, Amazon, Microsoft, Nvidia, Alphabet, Meta, and Tesla. Below is a chart that shows technology stocks contributing 62% (almost two-thirds!) of the S&P 500 Index total return in first half of the year.



Apple closed the quarter with a valuation north of 3 trillion dollars, which makes its market-cap bigger than the Russell 2000 Index, which tracks 2000 of the smallest publicly traded companies in the United States, as well as the entire U.K. stock market. Below is a comparison of the size of several mega-cap stocks compared to the entire stock markets of other countries.



Critics remain skeptical that the market will be able to continue to deliver gains once mega-cap technology company stocks stop moving up. In short, we wouldn't be surprised by a big-tech pullback. It might even be healthy given year-to-date market movements, but we retain a high level of conviction in the prospects for the U.S. tech sector to deliver long-term earnings growth and to drive the overall market higher going forward.

Outside of the tech sector, other growth sectors like the Consumer Discretionary (+12.4%) and Communication Services (+10.3%) sectors outperformed the overall market. Industrials tracked the market, while all other sectors lagged considerably. Fixed income markets were relatively quiet, with government bonds falling very slightly (-0.9%) as interest rates inched higher, and riskier corporate bonds posting modest returns (+0.7%) as corporate bond spreads compressed about a half a percentage point to 4.0%. The dollar weakened marginally in Q2, and oil prices declined from $75/barrel to $71/barrel.

Economic Landscape

On the economic front, the labor market remained rock solid with nonfarm payroll growth averaging 244,000 per month in Q2. However, we continue to see deceleration both in the pace of job growth and the quantity of job openings. Manufacturing sector activity has contracted a bit, but the larger services sector in the economy expanded considerably in June, and we're expected to see solid GDP growth of around 2.3% in Q2, and that number has been trending higher. Inflation is now sitting at 3.0% and we expect to see the cooling trend continue for the next few months. Consumer sentiment about the year ahead appears to be improving starkly as debt ceiling concerns have faded and inflation has softened, but feelings about personal financial situations have been little changed due to the impact of higher-than-usual prices. Single-family homebuilder sentiment has sharply improved since last winter, though buyer traffic remains anemic, as owners with mortgages below current rates are electing to stay put, resulting in limited home supply. Overall, there is a lot to like about this economy – there are no doubt some issues, but we aren't seeing any flashing red lights.

Market Drivers

The markets' resilience is due to several factors, which can be boiled down to the reduction of risks, and excitement about new innovations and opportunities. On the risks side:

1. The debt ceiling issue was reduced to a relatively small kidney stone – obnoxious to pass, but not all too painful.
    a. The Federal Reserve decided to skip hiking rates in June, and is now expected to pass just one more interest rate hike before pausing indefinitely. Taken alongside inflation data that has been cooling consistently, the upside risks for interest rates are less concerning today than they were this time last quarter.
    b. The Fed could hike interest rates further and risk recession in order to prevent an entrenchment of excess wage inflation which they view as an obstacle for getting inflation back to their 2% target. While we believe this is a poor excuse for risking recession, it doesn't matter what we think. What matters is what the Fed does, and we'll be watching carefully.

2. The regional banking issues which first appeared last quarter remain a risk, but

the consolidation we've already seen, paired with the Fed's apparent willingness to continue with potentially two rate hikes post-kerfuffle, tells us that monetary policymakers are not overly concerned about further issues. We aren't either.

The sticks look a little less pointy, but where are the carrots?

1. Investor exuberance about the economic value that could be unlocked through broader utilization of artificial intelligence "AI" boosted many prospective winners of an AI revolution – including the mega-cap tech companies, chipmakers, cybersecurity firms, and electric vehicle manufacturers.
    a. NVDA (+190%), META (+138%), TSLA (+113%), PANW (+83%), and AMD (+76%), all ranked in the top 10 in terms of year-to-date performance of S&P 500 companies.

2. Recession fears coming into this year created cover for many large tech companies to cut payrolls substantially, and most of those cost-savings have flowed straight to the bottom line. In Meta's Q1 earnings call, CEO Mark Zuckerberg declared 2023 a "year of efficiency".
    a. For high margin businesses with lots of intellectual property, the biggest cost for the business is generally people, so cutting headcount can boost profitability substantially.

3. Earnings are expected to come in much better than what was predicted last quarter. Per FactSet, 46 S&P 500 companies issued positive guidance for Q2, the highest mark since Q3 2021.

4. In China, central bankers cut interest rates for the first time since last August, and expectations are building for further stimulus to support the domestic property sector.

Portfolio Positioning

Market behavior was momentum-driven in Q2, so we added to risk exposure throughout the quarter. Given geopolitical and interest rate developments, our conviction that the U.S. will continue outperforming global equities hardened, and we trimmed international and emerging market positions. Within U.S. stocks, we're taking advantage of opportunities to take profits on some of the large-cap names which have run the most and reallocating to small-cap companies in favorable sectors. Within the large-cap universe, we've nudged our Information Technology and Consumer Discretionary exposure higher and cut exposure to Financials overall. Within the Health Care sector, we've reallocated from pharmaceuticals to biotech, though we remain underweight Health Care at the total portfolio level.

In fixed-income markets, longer-term bonds and credit look attractive. This view led us to buy slightly longer-maturity government bonds and make small increases to holdings in corporate bonds. While interest rates could move a bit higher from current levels, interest rates are near peaks, and a potential decline in interest rates will generate attractive total returns. We're also increasing our focus on tax-advantaged holdings to broaden our offerings for tax-sensitive clients.

Looking Ahead

The market feels momentum driven and over-bought near-term, but that isn't necessarily a signal for an impending collapse. Sentiment around the economic outlook has improved, margins have strengthened as some of the biggest companies in the world have cut costs and gotten down to fighting weight, earnings guidance is positive, and AI excitement appears to be providing tailwinds for the market overall. In this environment, we think new market lows are off the table and view sizable pullbacks as buying opportunities.

Economic data, Fed policy, and earnings reports will drive market outcomes throughout the year. There is still some fogginess in the outlook, which could create air pockets – financing costs are higher, and the impact of those elevated costs will take time to be felt across the economy. Should earnings estimates become pressured, we'll have to take a longer, harder look at valuations, but by and large, they look reasonable in most parts of the market. We would like to see a broadening in market leadership and a greater participation within the small-cap segment of the market. If that were to materialize, the U.S. market would be more insulated from a pullback in the mega-cap tech names, and we might start to see the IPO market, which has been dormant over the last 12-18 months, pick up again.

We're excited to see what opportunities develop throughout the rest of the year, and we're thankful for your business and partnership.

Sincerely,

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