Palisade
CAPITAL MANAGEMENT

Second Quarter
2023

Private Wealth Management

Q2 2023 Review and Second Half Outlook

	2Q23 Return	1Q23 Return
S&P 500® Index	8.7%	7.5%
Dow Jones Industrial Average	4.0%	0.9%
NASDAQ Composite Index	13.1%	17.1%
Russell 2000® Index	5.2%	2.7%
VIX Volatility Index	-27.3%	-13.7%
Barclays U.S. Aggregate Bond Index	-0.8%	3.0%
10-Year U.S. Treasury Yield	9.5%	-10.3%
Baltic Dry Index – Spot (Ocean Cargo Shipping Rate)	-21.4%	-8.3%
Gold ($ per ounce) – NY Spot	-2.5%	8.0%
Oil ($ per barrel – West Texas intermediate)	-6.6%	-5.6%
Bitcoin ($)	5.8%	72.6%

Source: *FactSet Research Systems, Inc.*

A Great First Half. The S&P 500® Index gained 17% in the first half of 2023, its second strongest first half performance this century. Though welcome, this occurrence strayed far from most strategists' predictions back in January; the consensus then was a weak first half and a stronger back half of 2023. At that time, the landmarks on the investment landscape were mostly gloomy: high inflation, rising interest rates, and poor returns from both stocks and bonds in the just-ended 2022; the S&P 500® had dropped by approximately 19% last year and the Aggregate Bond Index had fallen by approximately 15%.

So, what caused this welcome, if sudden, change of market direction from last year to this one? And more important: how sustainable is the market's recent upward direction?

What Happened? U.S. consumer price inflation peaked in June 2022 at 9.1% but has fallen each month since then and now stands at 3.0% as of June 2023. Consequently, the Federal Reserve Bank has modestly relaxed its rate stance. The federal funds rate – the Fed's policy rate on which most other interest rates are based – was raised *ten times* since March 2022, taking the rate from near-zero last year to 5.00-5.25% today. In the last few months, the Fed has moderated both the *size* of its rate increases and the *frequency* of those hikes. And at its most recent monthly meeting the Fed opted not to raise rates *at all* – its first pass in a year.

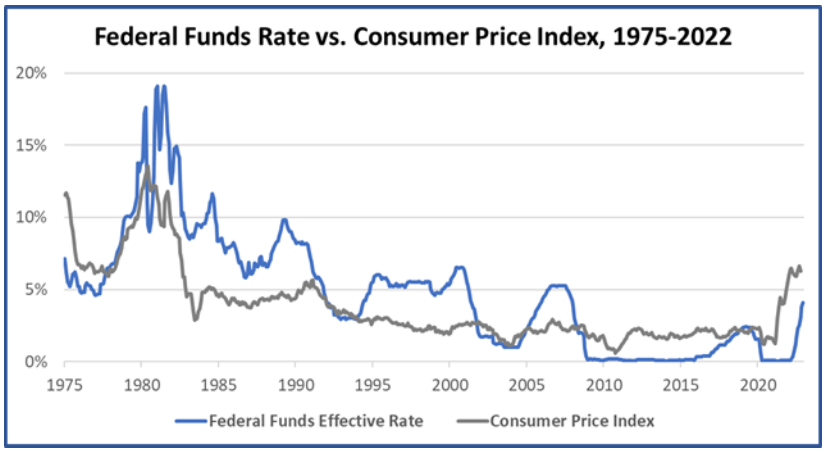
Another factor that likely boosted stocks was the Fed's policy decision to inject funds into the banking system – about $755 billion – after the high-profile failures of several regional banks this spring. And in the drama before Congress's 11th hour agreement to raise the federal debt ceiling, the Treasury, too, drew down funds from its General Account to help keep the financial system highly liquid. Some of this liquidity likely found its way into U.S. equities in the quarter.

A Lopsided Stock Market. Because the S&P 500® is a capitalization-weighted index, its largest members by market value have an outsized effect on its performance. Just a handful of technology stocks, dubbed "The Magnificent Seven," accounted for most of the index's growth this year. Had the index been *equal-weighted* – if all 500 members of the S&P 500® had the same market value on January 1 as every other member – then the S&P would have risen just 7% through June 30 instead of its actual 17%. It's understandable that capital would flow into the tech companies since their size in the S&P 500® – 28% of the index, the S&P's largest sector – allows them to absorb capital flows easily.

Also, the tech giants enjoy wide margins and large cash balances; that makes them comparatively recession resistant, an appealing feature to investors. Finally, the recent excitement around generative artificial intelligence (AI) benefited many tech-focused stocks in 2023. AI offers the promise of being a radical force-multiplier of both brains and brawn. We suspect, though, as is often the case with new technologies – for example, dot.com stocks in the late-'90s and crypto shares more recently – AI's true potential and pitfalls may not be known fully for years. But investors aren't waiting for thoughtful answers; in the first half of 2023, they embraced AI investment plays with alacrity.

Are We in A New Bull Market? Many investors enjoyed a great first half of 2023. We would be careful, though, not to commit the folly of "recency bias": the belief that what has come just before will occur just ahead. We do *not* believe that investors are now out of the woods. We are cautious for several reasons:

***First,* we take Federal Reserve Board Chairman Powell at his word that the central bank will not rest until core inflation drops to the Fed's long-term goal of 2%.** The easy work of battling food and energy inflation might be behind the Fed, but its hard work may lie ahead: lowering "core inflation" (*e.g.*, services), which tends to be more stubborn than commodity-based inflation. Even if core inflation fell to 2% tomorrow, the Fed would not likely drop rates quickly. With very few exceptions, the Federal Reserve Board has kept the federal funds rate 2-3 percentage points above the inflation rate over many decades (see chart on left). The exceptions occurred during and after the Great Financial Crisis of 2008/2009 and in the COVID-19 pandemic. The historical record suggests the Fed will keep interest rates "higher for longer". We do not expect the Fed to lower rates this year.



Source: Federal Reserve Bank of St. Louis data as of December 31, 2022.

***Second*, the Fed and the Treasury must now restore the liquidity they drained from the *federal* financial system during the second quarter**. We believe that could pull as much as $1 trillion *out* of the *commercial* banking system, which could impact U.S. equities much like government action did in the spring – only this time sucking the air *out* of stock prices rather than pumping it in.

***Third*, stock prices are already elevated**. The market's price/earnings ratio stands at 19.2 times the next 12 months' predicted earnings, which compares with its 25-year average of 16.4x. There are few times in recent history when the market has sold at a richer valuation: the dot.com era of the late-'90s and the first year of the pandemic when price/earnings ratios were elevated because company earnings were depressed. We suspect that surprises from here are more likely to be negative than positive: higher labor costs, higher capital costs, and higher consumer outlays for student debt repayments and revolving credit charges could all depress corporate earnings.

How Should We Invest Now? We are impressed by the enduring appeal of technology *as an industry*. After all, there can be no productivity growth without innovation. But tech *shares* may be another matter. Tech-focused stocks in the S&P 500® now trade at nearly 28 times next 12-month estimated earnings – this is the highest valuation of any S&P sector and is also about 30% higher than the sector's own 15-year relative valuation. We will tread carefully in this sector.

We do not foresee a sharp drop in equities generally; rather, we see a broadening out of interest in stock market sectors beyond just technology in the second half of 2023. This includes sectors trading below their historical valuations relative to the S&P 500®. We would include small-cap and mid-cap shares in this group.

As for bonds – especially lower-rated long duration bonds – nothing good is likely to happen there so long as interest rates are rising. On the other hand, short-duration government obligations (Treasury bills) yield 5.00-5.50% – now above the inflation rate – are perhaps the most rewarding and safest part of the yield curve.

Thank you for allowing us to manage your investments. We aim to reward your faith in us with creativity, diligence, and good results.

Sincerely,
Palisade Capital Management

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IMPORTANT INFORMATION

The S&P 500® Index is an unmanaged index that is widely recognized as an indicator of general market performance, based on the market capitalizations of 500 large companies having common stocks listed on the NYSE or NASDAQ. The S&P 500® Index does not have a defined investment objective, nor does it charge fees and expenses.

The Dow Jones Industrial Average (The Dow), is a price-weighted measure of 30 U.S. blue-chip companies. The index covers all industries except transportation and utilities.

The NASDAQ Composite Index measures all NASDAQ domestic and international based common type stocks listed on The NASDAQ Stock market.

The Russell 2000® Index (the "Index") measures the performance of the small-cap segment of the U.S. equity universe. It consists of approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. Source: London Stock Exchange Group plc and its group undertakings (collectively, the "LSE Group").

VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500® Index options.

The Bloomberg Barclays U.S. Aggregate Bond Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities.

The Baltic Dry Index (BDI), is issued daily by the London-based Baltic Exchange. The BDI is a composite of the Capesize, Panamax, and Supramax Timecharter Averages. It is reported around the world as a proxy for dry bulk shipping stocks, as well as a general shipping market bellwether.

West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing and is the underlying commodity of the New York Mercantile Exchange's oil futures contracts.

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