



FROM THE DESK OF KEN SOUTH

May 17, 2023

Our team adheres to a set of principles designed with a goal to provide an exemplary client experience.

We believe the trust of our clients is earned over time and remains our most important asset.

We take great pride in the professional quality of our work. We strive to provide exceptional client service that is proactive, thoughtful, and customized.

Competitive investment returns with a focus on risk management.

Sophisticated financial planning — an essential pillar in the development of your customized investment strategy.

We believe in continuous improvement. As our clients' needs change, we learn and adapt.

We stress teamwork in everything we do and remain accountable for our responsibilities.

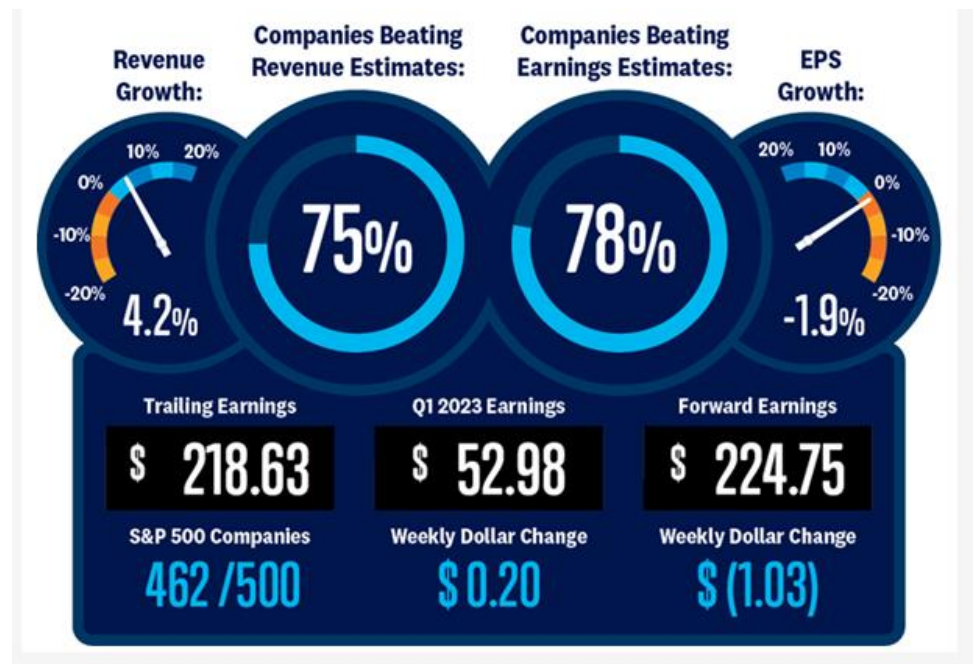
Integrity and honesty are at the heart of our business. Integrity: we do what we say we're going to do, full disclosure and no surprises.

Honesty means we give it to you straight, even if means having a difficult conversation

We regularly receive confidential information as part of our normal client relationship. It is our responsibility to protect against the unauthorized disclosure of this information.

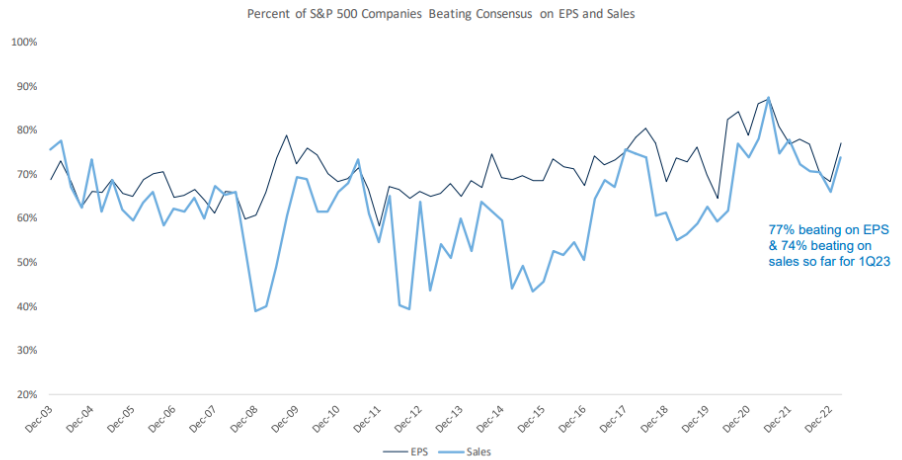
All Eyes on The Debt Ceiling and The Fed's Next Move

In this week's note, I am going to pretty much take you from soup to nuts on what has gone on, what is going on, and where it "appears" we could / should be going. Since this is clearly an imperfect science, I ask you to indulge me with your patience and allow me to give you what I glean to be most important. I will begin with the earnings reports from the first quarter as this is the most recent litmus of what is going on in our domestic economy and our domestic trade. Then I will go into the markets: US Dollar, bonds, and stocks. I will attempt to explain what I see going on here and what the Fed can or can't do to affect these markets.



1Q23 Reporting Season Update / Large Caps

Pace Of EPS Beats Has Jumped, With Revenue Beats Now Rising As Well For The S&P 500



In looking at the current earnings report dashboard, it is clear that the majority of companies are beating the earnings and revenue numbers that Wall Street was expecting. I've also included the picture of what has been expected vs. what has been reported as this gives you an indication of how things are changing right now on the far right with comments underneath it. What this says to me is that the Fed, although doing what is clearly painful to companies, consumers, and those trying to borrow money at the cheapest rates possible, they are weaning the economy off the heroin of free money fairly well.

CURRENCIES:

In looking at the currency markets:



I think it is important to recognize the relationship between the US Dollar being “stronger” or “weaker” versus a basket of foreign currencies. You will note that the US Dollar hit its high point at basically the same time the S&P 500 (stock market) hit its low point. This is saying that as the US Dollar weakens (weak doesn’t mean bad) our goods and services are cheaper outside the US. This is good! This means we become more competitive and therefore do more business. Hence this is a positive for our economy and our companies. Why is this happening? Because interest rates have hit a high point and as our interest rates decline, foreign currencies discontinue rushing in to buy our bonds and take advantage of our uncharacteristically high interest rates. See below.

BONDS:

I will be giving you two charts as interest rates are super important and the direction of them reflects this, but I also am going to show how interest rates are moving relative to our GDP. Why? Because this is the predicament the Fed is in. They need to raise rates to stifle inflation, but if they raise them too much, they slow the economy and raise the cost of the debt too much and put us into a nasty spiral. Sort of like weaning the economy. You can put it on a diet, but you still have to provide some food, or it just starves and dies. Not good!



Exhibit 3 - US Total Fiscal Operating Debt as a % of GDP



In my view, the banking stresses, or the problems that some banks have exhibited, I expect the monetary authorities (the Fed) will have their next steps in the direction of waiting on raising rates to avoid a continuation of this. The ultimate effect of higher interest rates has caused the banking system to show signs of stress. We can go into detail about the mismanagement of deposit duration (maturity levels of invested assets on bank balance sheets) but the reality is that the system is fragile after interest rates move up at speeds never before seen. We cannot afford for these stresses to spread too much more. If we do, we are then forced with the need to add capital once again and the Fed will be forced into the endless spiral that we are trying to avoid. Instead, holding off raising rates more here and letting the 10 back-to-back rate hikes take their desired effect would be preferable and should achieve their desired results. At this point, the environment appears overly pessimistic, understandably, but the setup to commit more capital is rarely perfect. As seen below, the year-over-year change in the Consumer Price Index is coming down to the Fed's desired level. This is a reflection of what they are trying to achieve.

Inflation Getting Closer to Fed's Target

But Cool Down Period May Take Longer from Sticky Services Prices



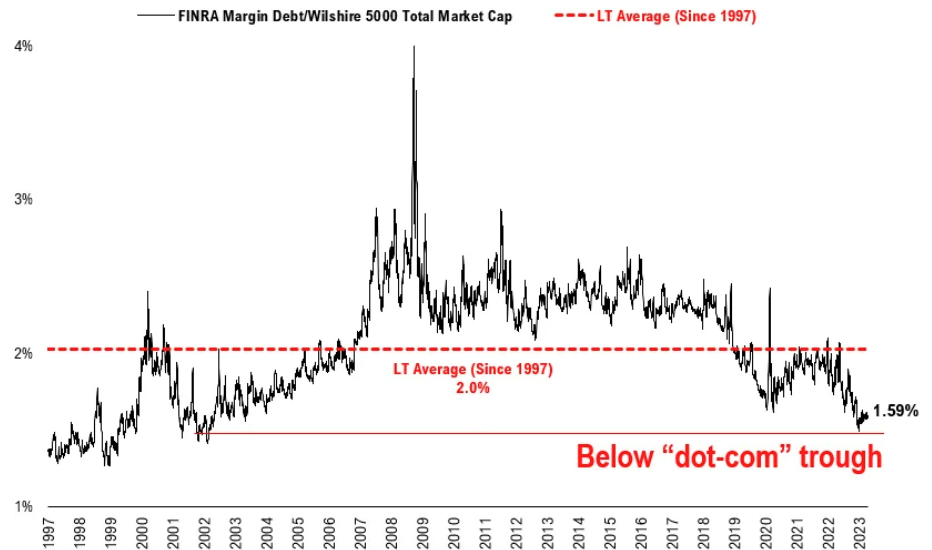
EQUITY MARKET:

I have intentionally left the equity markets (stocks) for last. Predominately because the actions of stocks tend to depend upon the trading advantages/disadvantages of a US Dollar based economy and the cost of capital of debt and the trade-off of bonds vs. stocks as an investment of choice. So, where are we? The picture below is the exact analysis of the broad market (S&P 500). Please note that it rallied very hard (up) from the COVID lows due to the incredible liquidity funded by the Fed, then digested this runup due to rising interest rates and a decrease in M2 money supply, and since October 14 of last year it is attempting to move higher:

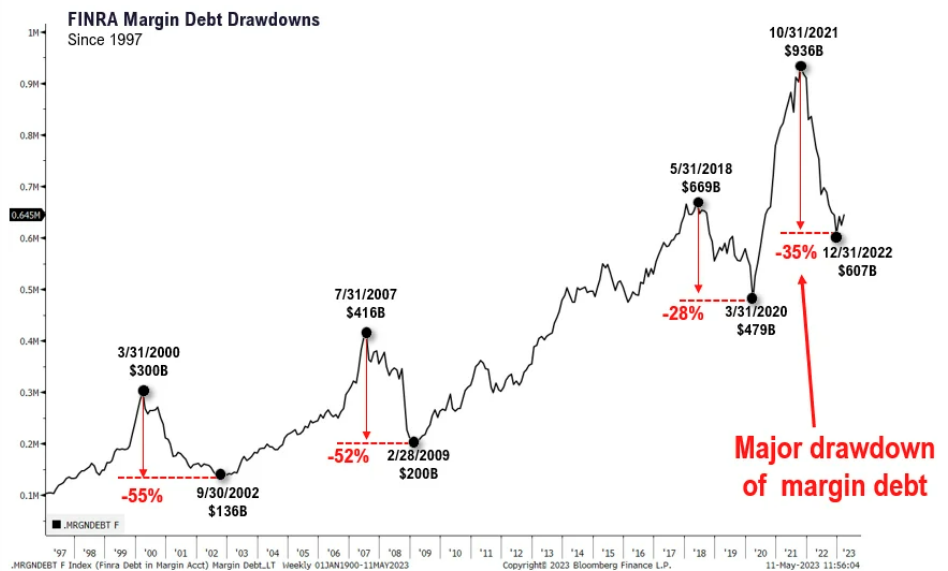


The problem is that we are at incredibly low levels of confidence from the standpoint of investors at all levels. How do I know this? One of the clearest illustrations is the level of margin debt by investors. If investors are positive, they will “gamble” and leverage up. If they are scared, they will deleverage and decrease the amount they are levered. Here is an illustration of this going back to the late 1990s. Please note that in the Dot Com Bust of 2000 the decline, the Great Financial Crisis of 07-09 the decline, into the COVID shutdown the decline, and the current decline. It is fairly clear I believe:

FINRA Margin Debt as a % of Wilshire 5000 Total Market Cap
Since 1997



Source: Fundstrat, Bloomberg, FINRA



Source: Fundstrat, Bloomberg, FINRA

In closing, I want to make it clear that there is really not a clear answer to be had at this moment. Over the last few months, I have provided



statistics on what to expect when markets have moved in a similar fashion before. I have also gone over some analysis of what is currently the case and the way the tide seems to be moving (higher or lower in each case) but in the end, I believe that the economy and the markets at this point are at the mercy of the Fed. The resiliency of the equity markets seems to be hinting that the Fed might be done at least for a while. The concept of an impending recession is still looming as is the most current media focus, the Debt Ceiling.

THE DEBT CEILING:

We've been here before, and as we have seen in the past, we think an agreement will be reached and that all bond payments will be made on time. We also think it's very unlikely that any payments on entitlements will get delayed. Much more likely is that the Congress (Republican-led) and White House (Democrat-led) will agree on some sort of framework to hold the line on increases in discretionary (non-entitlement) spending. In other words, lots of smoke and very little fire. If an agreement is reached to limit discretionary spending, those limits are not likely to last. History is clear. In the past 90 years, non-defense government spending has grown ten times faster than GDP, and that trend is unlikely to change anytime soon.

All of this is important because the path of federal spending, largely dominated by entitlements, is unsustainable. According to the Congressional Budget Office, this year Social Security, Medicare, Medicaid, and other health-related entitlement programs will cost the federal government 10.8% of GDP. Thirty years from now these same programs will cost 14.9% of GDP. We know what is probably clear; taxes higher, entitlement spending frozen, and pharma benefits challenged.

Please feel free to call with any individual questions you may have.



Important Disclosures:

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial professional prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

All information is believed to be from reliable sources; however LPL Financial makes no representation as to its completeness or accuracy.

Investing involves risks including possible loss of principal.

The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Dow Jones Industrial Average is comprised of 30 stocks that are major factors in their industries and widely held by individuals and institutional investors.

The Nasdaq-100 is a large-cap growth index. It includes 100 of the largest domestic and international non-financial companies listed on the Nasdaq Stock Market based on market capitalization.

The Russell 2000 Index is an unmanaged index generally representative of the 2,000 smallest companies in the Russell 3000 index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index.

This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

