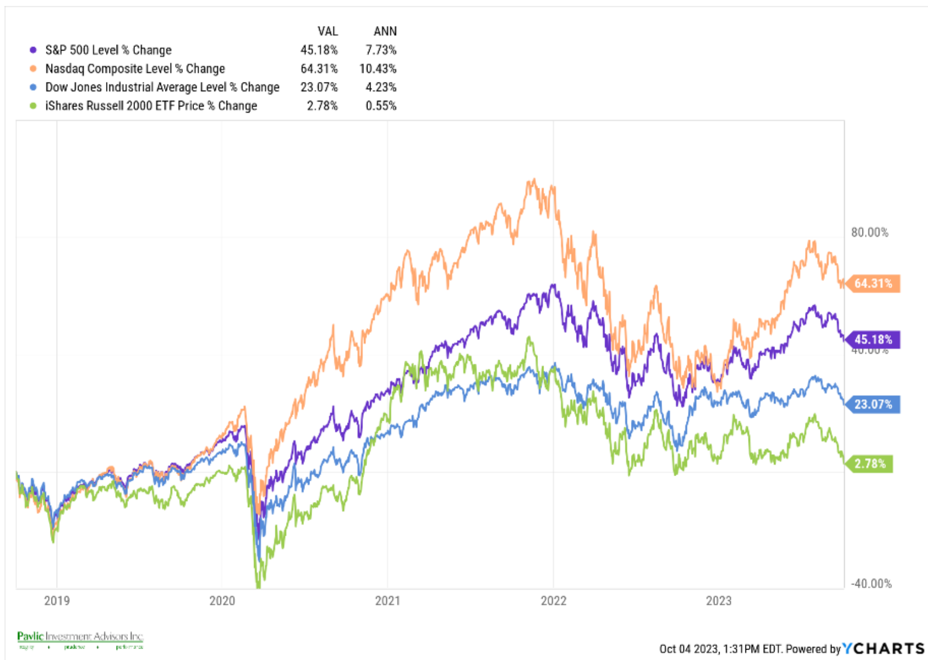
Pavlic Investment Advisors

Client Review & Outlook

3rd Quarter, 2023

Dear Client,

The S&P 500 rose to the highest level since March 2022 early in the third quarter, but rising global bond yields, fears of a rebound in inflation, and concerns about a future economic slowdown weighed on the major indices in August and September. The S&P 500 finished the third quarter with a modest loss, while the Dow Jones and Russell 2000 slipped into negative territory for the year. **Our all-stock equity strategy continues to perform well relative to the broader indices, outperforming two of the three major indices in the first three quarters of the year.**



To start the quarter, stocks rose primarily as a result of "goldilocks" economic data, meaning the data showed economic growth, but not to the extent that would have forced the Federal Reserve to hike rates even further than investors expected. That solid economic data combined with a decline in inflation boosted stock prices. The Federal Reserve, meanwhile, increased interest rates in late July and offered a tone that further fueled optimism that one of the most aggressive rate hike cycles in history was soon coming to an end. Second quarter earnings were also better-than-feared with mostly favorable corporate guidance, which supported expectations for strong earnings growth into 2024.

The market dynamic changed on the first day of August, when Fitch Ratings, one of the largest U.S. credit rating agencies, downgraded its rating on U.S. debt. Fitch cited the long-term risks of the current U.S. fiscal deficit trajectory as the main reason for the downgrade which put immediate upward pressure on U.S. Treasury yields. The 10-year Treasury yield rose from 4.0% on August 1st to a high of ~4.7% in early October. In late September, volatility returned as most Fed members reiterated the need for an additional rate hike before the end of the year and forecast only two rate cuts for all of 2024, down from four cuts forecasted at the June meeting.

In summary, volatility returned to markets during the third quarter, as rising bond yields pressured stock valuations. Some inflation indicators pointed to a bounce back in inflation and the Fed reiterated a "higher for longer" interest rate outlook.

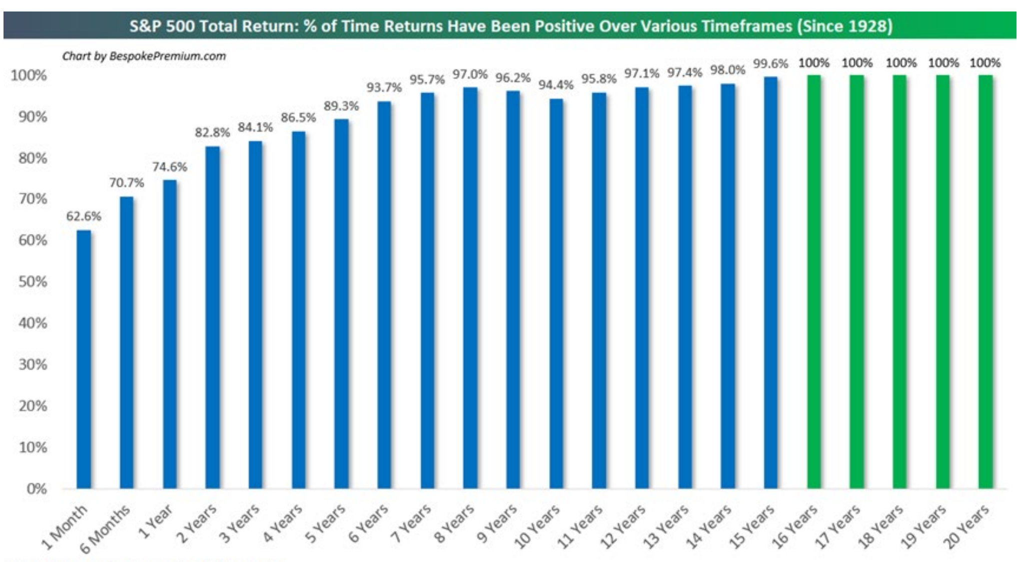
Stock Market Review

We focus our stock market review on the most common questions we have been asked by our clients during the previous quarter. This quarter, client questions have focused on the "higher for longer" interest rate environment, the benefit of time horizon in the stock market, and recent portfolio adjustments.

"Higher for longer" interest rates—what does it all mean? About 18 months ago, the Federal Reserve began raising interest rates to slow the pace of inflation after massive amounts of stimulus flooded the market, post-COVID. The amount of stimulus stirred up inflationary pressures across the globe. The Federal Reserve's main tool to slow inflation is to increase the Federal Funds Rate, or the rate that banks can lend to each other overnight. While this rate is not relevant to the individual investor, it is the shortest-term rate, and it puts pressure on other parts of the yield curve which do impact individual consumers and investors. Currently the Federal Funds rate is set at 5.33% with the expectation of an additional 0.25% increase later this year. Expectations are now for just two 0.25% rates decreases in all of 2024. In other words, the Federal Reserve expects to hold the Federal Funds rate above 5% for the next 15 months. Hence, "Higher for longer" interest rates seem like they are here to stay.

What does this all mean for investors and consumers? For our investors, the story is simple—a higher federal funds rate means we can earn higher money market fund returns by taking minimal risk and maintaining transaction cost-free liquidity. The money market fund is on average our second largest position across accounts, second only to our largest stock position Visa (V). As of the date of this report, we are earning 5.24%/year (paid monthly at 0.44%/month) in interest payments—the highest return we have seen in money market funds in decades. This is a major benefit to investors and stands in sharp contrast to the experience of the previous decade of low interest rates where "savers" were penalized and "borrowers" were rewarded.

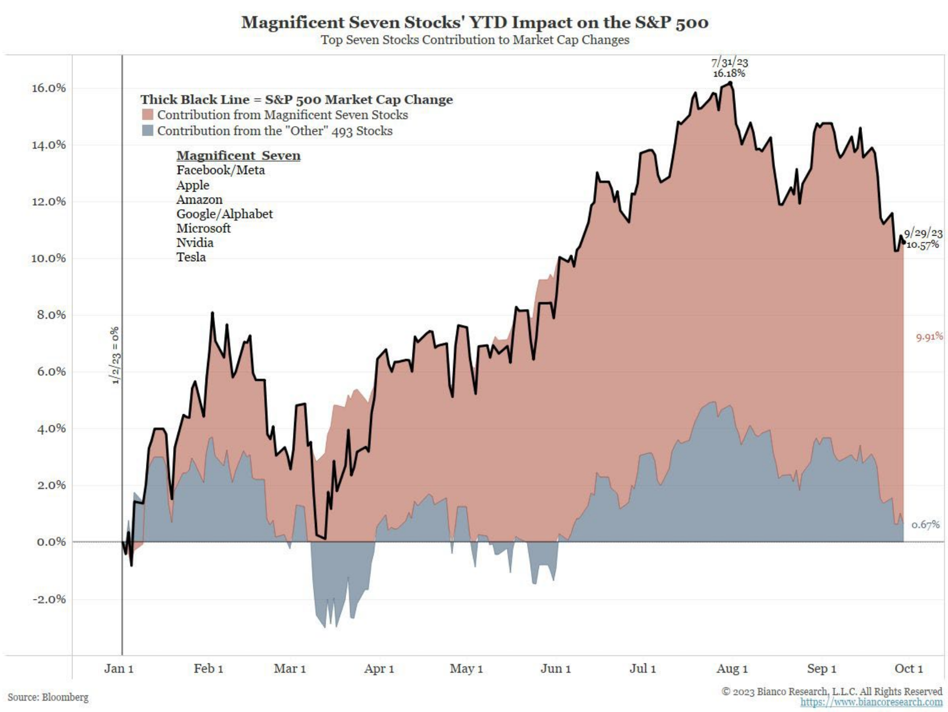
The upward movement of the Federal Funds rate causes upward pressure on interest rates across the U.S. Treasury rate yield curve. Banks and institutions that make loans to businesses and individuals use the U.S. Treasury rate curve as the "risk free rate". Therefore, making a loan to an individual or to a business should have a rate *higher* than that to the U.S. government. We see this with the home mortgage market now pricing the 30-year fixed mortgage rate at ~7.5% nationally and auto loans over ~8.5%. **These are the highest levels in over twenty years**. Borrowers, especially new borrowers, looking for a new home loan or auto loan, are materially punished in this environment. This is how the Federal Reserve is trying to tame inflation—reduce the buying power of individuals and businesses who rely on debt to fund their purchases by pushing up interest rates to levels where payment affordability becomes an issue for most borrowers.



"Time IN the market always beats *timing* the market." The left chart shows, historically, that the odds of the S&P 500 being up over any one-month timeframe is **62.6%**. The same figure for a year (12 months) is **74.6%. This 74.6% figure means, stocks are up three of every four years, and we are coming off a down 2022.** Over eight years, this figure jumps to **97%,** which means if you hold stocks for 8 years, you are very, very likely to earn a positive return. Since 1928, all 16+ year time frames have seen positive returns.

But, this only works if you stay *IN* the market. The more you weave in and out of the market, the more you risk missing out on those important stretches of gains that can make or break your long-term performance. In the stock market, time pays.

Recent portfolio adjustments include trimming high flying technology stocks and adding to beaten up value names. During the quarter, we trimmed our position in Microsoft (from a 7.5% weight in the portfolio down to a 5.5% weight at $365/share—which was an all-time high for Microsoft). On the day of sale in mid-July, a report came out that Microsoft was unveiling its artificial intelligence tools for its Office software, known as 365 Copilot at a cost of $30/user/month, significantly raising the price of its software. While revenue generation through price hiking is an undeniable strength for the company, we are mindful of the price investors are currently willing to pay for its shares. With our sale price of $365/share, the stock was trading at 38x current earnings per share and 33x forward earnings per share. With valuations particularly lofty in the technology sector of the market, we felt it was prudent to trim back this position and recognize the tremendous gains we have experienced in our portfolios. As they say, "Bulls make money, bears make money, but pigs get slaughtered." While we considered trimming more of our position in Microsoft, we are a long-term believer that artificial intelligence will enhance productivity to companies that use it and secondly, we want to be mindful of any long-term capital gains taxes.



As shown in the left chart, the narrow market breadth discussed last quarter continued during the third quarter. The "Magnificent Seven" (Facebook, Apple, Amazon, Google, Microsoft, Nvidia, and Tesla) accounted for virtually all of the returns in the S&P 500 market cap weighted index. As of 9/29/2023, these seven stocks added 9.91% of the 10.57% year-to-date performance of the S&P 500, leaving the remaining 493 companies adding just 0.67% of the year-to-date performance. In other words, just seven stocks have delivered virtually all of the return this year.

We benefitted from large positions in Apple as well as Microsoft, but like many investors, we wish we would have owned more of these seven performance dominating names. In focusing on where the puck is going versus where it has been, we have shifted our portfolio to more value-oriented names including defense contractor RTX (a combination of Raytheon and United Technologies) and Teradyne, a semiconductor test company supporting the major companies that make AI chips. While Nvidia may be the only game in town today, big cap tech names (the Magnificent Seven) are all in advanced stages of making their own semiconductor chips which will be a benefit to companies that we hold positions in such as Applied Materials (AMAT) and Teradyne (TER).

Bond Market Review

"Higher for Longer" is here to stay. Bond yields continued to rise for a second consecutive quarter as hawkish Fed rhetoric and hints of a rebound in inflation continued to push yields higher. The Fed did not signal it intended to raise interest rates any higher than previously expected, but they did signal that they intend to keep the Federal Funds rate at or above 5.0% for the rest of this year and all of 2024. This creates upward pressure on interest rates that we believe will stay in place for at least the next 18 months. Our investment grade bond strategy, by design, does not attempt to predict the future path of interest rates. For those bond managers that do proclaim they can predict the future movement in interest rates, we would ask them if years ago they foresaw interest rates where they are today--a Federal Funds rate near 5.5%, a 2-year U.S. treasury rate near 5.0%, and a 10-year U.S. treasury rate near 4.7%. Our guess is no one foresaw this new interest rate regime years ago. Yet, because our bond strategy looks to minimize interest rate risk by buying bonds with relatively short maturities (1-10 years), most of our bond portfolio has not suffered the large market losses that have been experienced by many widely-held bond mutual funds and ETFs. Many of those hold bonds that mature in well over 10 years.

As bonds mature, we take the opportunity to review your asset allocation and liquidity needs. One option is for a client to use the bond maturity and final interest payment for spending needs so we make a distribution of the newly available cash. A second option would be to use the bond maturity to invest in stocks that are trading at more of a discount than they were six weeks ago. A third option is continuing to roll each bond maturity into the next rung of the bond ladder, which is usually 10 years out, i.e., a 2033 maturity. We have been finding investment grade bonds maturing in 2033 at rates above 6.5%/year—which is a return that is near the most attractive we have seen in the investment grade bond market in the last two decades.

2023 Market Outlook and Commentary

Will Santa bring toys or coal this Christmas? Although there are legitimate risks to the outlook, underlying economic fundamentals remain generally strong. Employment, consumer spending, and business investment were all resilient during the third quarter. While a future economic slowdown is certainly possible given higher interest rates, the resumption of student loan payments, and declining U.S. savings, the actual economic data is clear: It isn't happening just yet. To be fair, there's a lot to be worried about these days: interest rates are rising, oil prices are up, the dollar has been strengthening, monetary policy is tight, and debt delinquency rates are normalizing. There's also China's slowing economy, ongoing labor strikes, and the ever-present threat of a U.S. government shutdown. For investors in the stock market, the time-tested move is to give it time with the understanding that prices can be volatile over the short-term. The longer you're able to hold, the higher the likelihood that you will have better returns.

The risks today are largely the same risks that markets have faced throughout 2023 and over that period the economy and markets have remained impressively resilient. As we begin the final quarter of 2023, we remain vigilant towards economic and market risks and are focused on managing the portfolio considering both risk and return potential. We remain firm believers that a well-prepared, long-term-focused, and diversified financial plan can withstand virtually any market surprise and related bout of volatility, including "higher for longer" interest rates, stubbornly high inflation, geopolitical tensions, and recession risks. We are committed to effectively navigating this challenging market environment. Successful investing is a marathon, not a sprint, and even intense volatility is unlikely to alter a diversified approach set up to meet your long-term investment goals. Therefore, it's critical for us to stay invested, remain patient, and stick to the plan, as we've worked with you to establish a unique, personal allocation target based on your financial position, risk tolerance, and investment timeline.

"In investing, what is comfortable is rarely profitable." – Robert Arnott