In our 2022 year-end letter we referenced a Buddy Holly song (*Wait Till The Sun Shines Nellie)* and its message – look to the future, it's going to get better – in an effort to instill confidence that financial markets would eventually recover from the difficulties experienced last year. Even as we wrote those words, we did not expect the recovery to come so quickly and to be so powerful. Indeed, half-way through 2023 U.S. stocks, as measured by the S&P 500, are up nearly 16% (excluding dividends), including a more than 8% increase in the second quarter. Foreign stocks, as measured by the MSCI ACWI Ex USA Index, were up modestly during the most recent quarter, but are still up almost 8% year-to-date. Emerging market stocks have been a laggard, up only 3.5% for the year. Fixed income/bond returns were slightly negative during the quarter, as investors came to terms with the possibility that interest rates aren't coming down as previously expected. While not as exciting as equity returns, bonds are up over 2% year-to-date and, assuming interest rates don't rise materially from current levels, the asset class is on pace for 4%-5% returns for the year.

Equity Indexes	Q2, 2023	YTD	2022
S&P 500	8.3%	15.9%	-19.4%
Russell 2000 (Small Cap)	4.8%	7.2%	-21.6%
MSCI EAFE (Developed)	1.9%	9.7%	-16.3%
MSCI Emerging Markets	-0.1%	3.5%	-22.3%
MSCI ACWI Ex USA	1.4%	7.7%	-17.9%

Note: All returns exclude dividends

Fixed Income Indexes	Q2, 2023	YTD	2022
Bloomberg Barclays US Agg Bond	-0.8%	2.1%	-13.0%
Bloomberg Barclays Municipal Bond	-0.1%	2.7%	-8.5%

Source: Orion

While we certainly welcome the strong start to the year, we think it is important to point out that much of this rally has been driven by the remarkable performance of a handful of large, technology-related companies – Apple, Microsoft, Amazon, Nvidia, Google, Meta, and Tesla – now being referred to as the 'Magnificent Seven'. These seven companies are up an average of 61% for the year, adding over $4 trillion in market value. According to Bloomberg Intelligence, the return spread between the seven largest stocks in the S&P 500 compared with the rest of the index hit the widest since the dot-com bubble. Excluding the performance of these seven companies, the index would have returned closer to 5% or 6% for the year, instead of 16%. Moreover, over 40% of the companies in the benchmark were ***down*** for the year. The performance profile of the 'S&P 493' (excluding the Magnificent Seven) is more in-line with that of small/mid cap sectors in the U.S. as well as foreign stock markets. It also seems more consistent with some of the economic challenges we are facing, including persistently high levels of core inflation, an aggressive Federal Reserve, rising interest rates, tightening financial conditions, an inverted yield curve, and problems in the banking sector.

The catalyst behind the performance of the Magnificent Seven was growing hype around artificial intelligence (AI). The excitement began in the first quarter with Microsoft's announcement of a large investment in ChatGPT maker OpenAI and subsequent inclusion of ChatGPT/AI in its software and search engine products. This was followed in May by a massive increase in Nvidia's earnings guidance on the back of strength in demand for semiconductor chips that power so-called generative AI. Together, these events touched off a speculative frenzy based on the perception of almost limitless possibilities for artificial intelligence, despite substantial uncertainty as to how and when those possibilities might be realized. Indeed, by the end of June, the weight of the top 10 stocks in the S&P 500 (which includes the Magnificent Seven) reached 31.7% even though these companies only account for 21.5% of the earnings. This level of market concentration is unprecedented, surpassing prior peaks in the early 1970's (the Nifty 50), the late 90s (the dotcom bubble) and more recently during the pandemic. Market strategists are divided concerning the implications of this market phenomenon. Some note that stock markets with narrow leadership sometimes broaden out, and we may have seen signs of this at the end of June and into early July. Others, however, note that these situations have often preceded a bear market.

Our view is that equity market valuations are once again aggressive and pricing-in an optimistic future (S&P 500 forward P/E of 19.1x vs. the 25-year average of 16.8x). This is particularly true of the top 10 holdings in the benchmark (29x forward P/E) and certain sectors like technology (28x forward P/E) and consumer discretionary (27x forward P/E). Combining these elevated valuations with a clearly slowing economy likely means we are due for lower returns and higher volatility in the near term. However, given the wide dispersion of recent returns and current valuations, we see an opportunity to begin to reposition the portfolio. We are considering selective sales/trims to reduce exposure to the high-flying consumer discretionary and technology sectors. We are also finding opportunities in areas of the market that have lagged including energy (uranium and natural gas), healthcare, certain financial services companies that were beat up during the banking crisis, and international markets. We also continue to think bonds look attractive, both for their own return potential and as a hedge to our equity investments.

Heading into this year, we felt prospects for future returns looked more favorable given the reset we experienced last year. We were particularly favorable on bonds. With stocks, we were thinking the first half of the year could prove challenging, and we expected to use any weakness to get more aggressive with our portfolios. Despite this somewhat cautious outlook, we have been able to keep pace with what we would characterize as a speculative market. While we only owned five of the 'Magnificent Seven', we also held five other companies that were up 45% or more during the first half of the year. In addition, only 29% of our equity holdings were down year-to-date, compared to over 40% of the benchmark holdings. Our optimism about bonds looks misplaced given their performance relative to equities. However, our bond holdings are on pace to deliver mid-single digit returns for the year, they have outperformed the bond benchmark, and they are fulfilling their historical role in (adding income and stability to) a balanced portfolio. So, client accounts have done well over the past six months.

However, we think there is a bigger lesson/takeaway to the strong start to this year. That lesson is one that we repeat often - that investors stack the odds of investment success in their favor when they stay the course and take a long-term view. At the end of last year, most Wall Street 'strategists' were bearish, and we were receiving many inbound calls expressing concerns about the market. And, as stated above, we were also cautious about the near-term outlook for stocks and had built an extra cash cushion into our portfolios. If we had acted more aggressively in response to Wall Street expectations, client concerns and our own misgivings, we would have risked missing out on this strong market rally.

As always, please do not hesitate to reach out with any questions or concerns you may have regarding your individual investment portfolio.

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