Advantage Investing Inc.

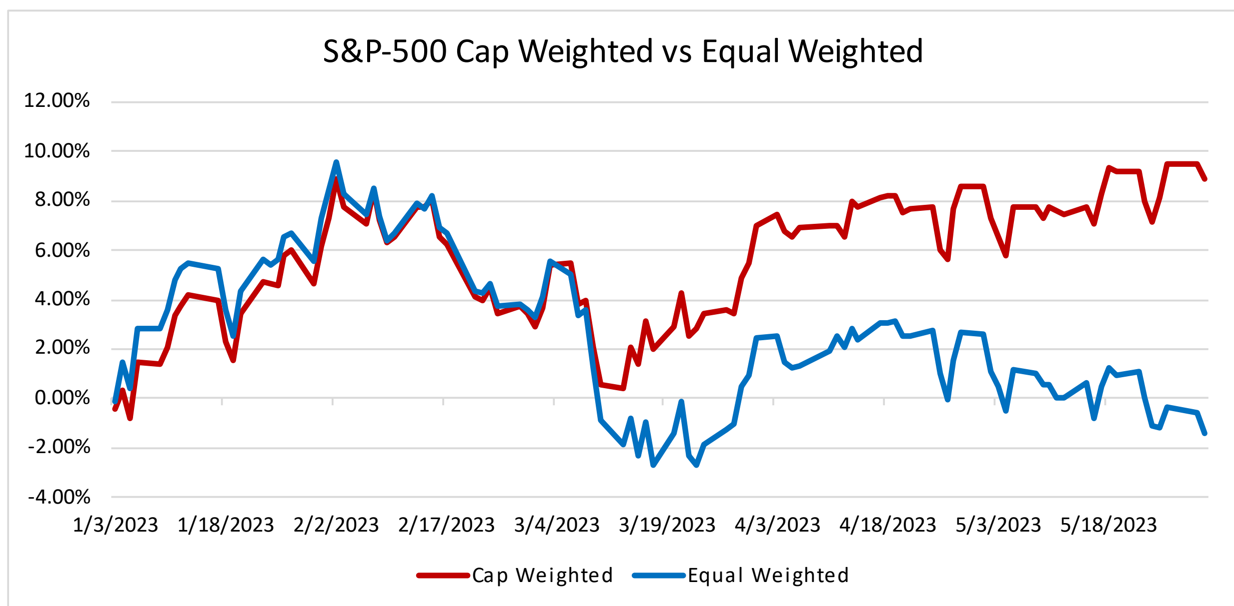
Professional Investment Management Services

Financial Markets Update – June 2023

Thinking back to the economic reopening after the pandemic driven shutdowns, there was quite the debate about what shape the recovery might take. Would it be a V-shaped recovery or a U-shaped recovery? There were even exotic shapes discussed, such as the square root shaped $\sqrt{\quad}$ recovery. What finally settled out though, was what came to be known as a K shaped recovery. This is because while some economic sectors recovered strongly, others remained weakened by the shutdowns. In 2023 we are seeing another K shaped recovery, but this time it is in the stock market.

Just looking at the YTD returns for the S&P-500 Stock Index, one might easily be led to believe that all is well. However, there is something concealed beneath the surface, hidden by the unique way in which many market indexes are calculated. You see, the traditional S&P-500 Index that we hear about is a market cap weighted index. This means that the largest stocks have the greatest impact in the returns for the index. That also means that the index does not actually represent the average return for all 500+ stocks.

This year, a handful of the largest companies have made very strong gains, thanks mostly to the current fascination with Artificial Intelligence technology. However, the same is simply not true for the rest of the stock market. This can be seen in the chart below, which compares the returns for the traditional, cap weighted S&P-500 Index (Red line) versus an equal weighted S&P-500 Index (Blue line) for the first five months of this year. While the return for the cap weighted index looked great at +8.9%, the equal weighted index, which removes the influence of company size, actually lost -1.4%.



Source for data: Investor's FastTrack

A divergence of this magnitude between the two index measures is quite unusual. In fact, the last time we saw something like this was during the dot-com bubble which burst in 2001. One of the hopes that keeps being discussed in the financial news media is the idea that the average stock will rise to equal the performance that we have already experienced in the largest stocks. While this hope is understandable, the history is just not that clear cut. As you can see in the table below, during the time leading up to the tech bubble, both indexes produced very similar returns. Then, as the internet driven dot-com mania took hold, the largest stocks outperformed the average stock by a very wide margin. As the tech stocks peaked on 3/24/2000 and began to fall, the average stock still had room to grow because they had not become so excessively overvalued as the bubble stocks had. However, on 5/21/2001 the bull market run finally ended for all stocks, and we saw both indexes fall in lockstep right to the bottom of the bear market on 9/21/2001.

The Dot-com Bubble Forms and Bursts

	Early Bull Market (10/01/1998 - 6/30/1999)	*Dot-com Bubble Peaks* (7/1/1999 - 3/24/2000)	*Broad Market Peaks* (3/25/2000 - 5/21/2001)	*Bear Market for All* (5/22/2001 - 9/21/2001)
S&P-500 Cap Weighted	39.2%	11.3%	-14.1%	-26.2%
S&P-500 Equal Weighted	37.1%	-5.0%	19.3%	-26.3%

Source for data: Investor's FastTrack

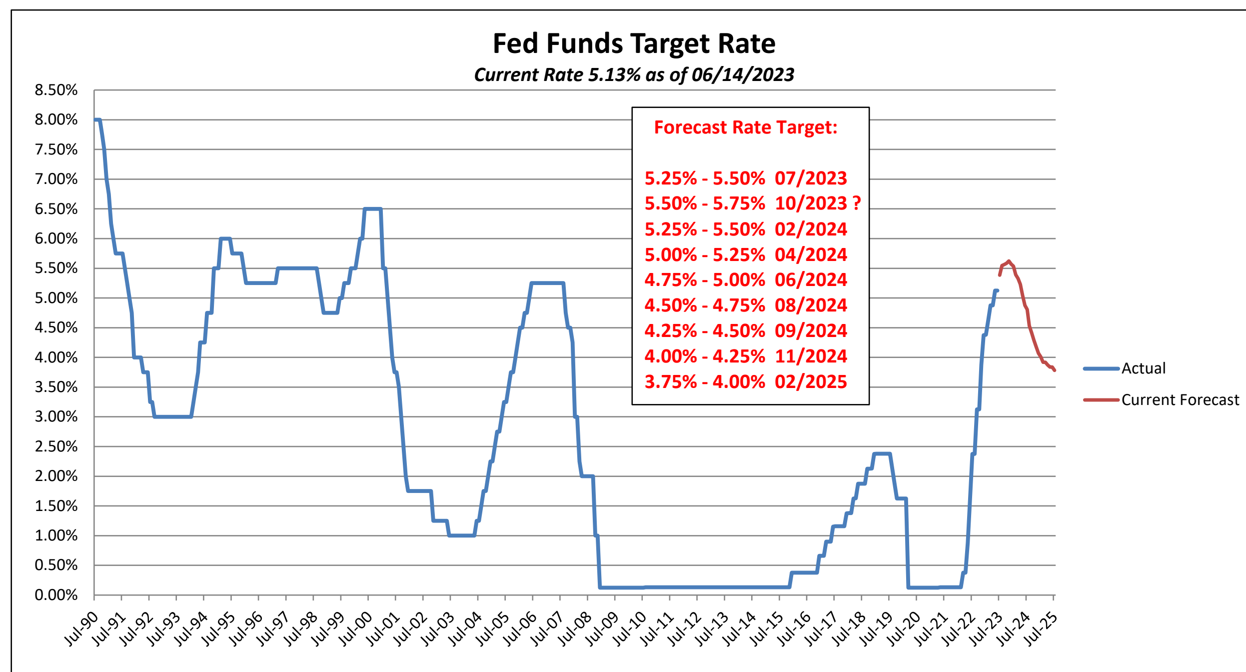
An important issue that remains unknown is just how far along we might be in this AI Technology bubble, and what might cause it to come to an end. We do know that there were several factors that brought the dot-com bubble to an end, and there are some significant similarities happening today. In both eras we have the Fed moving through a significant tightening phase after a period of easing. We also saw tech stock valuations driven to very high levels by the fear of missing out on the next big thing. During both eras there was also substantial a rise in retail day-trading activity and online "experts" based in internet chat sites and social media. And, in both eras we have seen an increase in overall debt levels, which bring greater risk into the picture.

Again, we simply cannot predict when the current mania will end, therefore we must be cautious, realistic, and nimble in our approach. Within our six-stage economic cycle framework, we remain in Stage Five, early recession, in spite of the recent positive market performance. There are signs of weakening developing in parts of the US economy and broad consensus of forecasters expect to see recession within the next 6 to 12 months. Even at that, the strength of the US job market remains a powerful mitigating factor, so while the odds of a US recession in the second half of 2023 remain elevated, it is likely to be shallow and relatively short compared to other recessions.

Our game plan at this point is to approach the current run up in stock prices as a bubble in development. This means that we can carefully hold positions to take advantage of the upswing in its early stages, but also watch carefully for the turn when we need to quickly exit those positions and hedge against the potential losses to come. We have many tools and portfolio management techniques at our disposal which we have used very successfully in the past. The key is to always be aware of the risks and manage them appropriately.

Economic Update – Where are interest rates heading next?

After hiking interest rates by more than 5% in fifteen consecutive months, the Fed finally took a break and kept rates unchanged in June. Questions now remain as to what the Fed will do next, but it does seem clear that we are very near the end of this rate hiking cycle. The chart below shows the market forecast of where the Fed will move next. The blue line represents where we have been, while the red line represents the current market forecast for rates over the next 2 years.



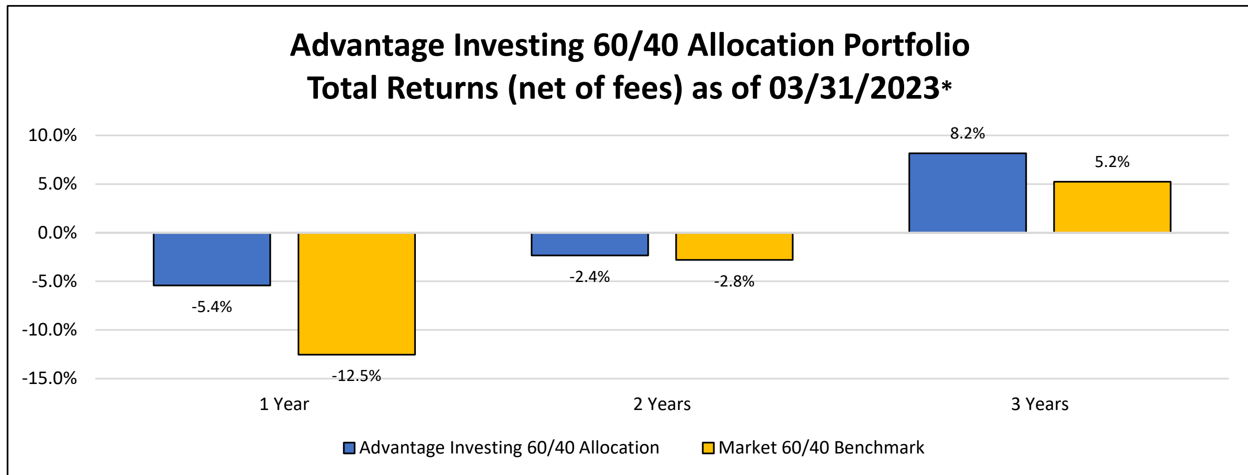
Source for Data: US Federal Reserve

Investor expectations are for another ¼% increase in July with the possibility of one more increase early in the third quarter. The probability of that second increase is rather low, and I believe there is a good chance that the increase in July may actually mark the end of the tightening cycle. After this, you can see that investors are expecting the Fed to reverse course sharply and bring rates down by a full 1.25% over the course of 2024. This is generally in line with the Fed's own projected rate path according to their most recent Summary of Economic Projections (SEP). In the June release of the SEP, the FOMC members project that the Fed will cut rates by 1% in 2024 and by another 1.2% in 2025, and eventually bring the rate down to a long-term level of around 2.5%.

The implications for this forecast are that the Fed believes it will have achieved its goal of taming inflation and that it needs to bring rates back down quickly in order to avoid a recession. This is what is referred to as a soft-landing scenario. Another less optimistic implication of this forecast is that the Fed has already moved too far and will have to cut rates sharply because of a recession which has been brought into existence by the Fed's own too aggressive policies. At this point in time there is just no way to be certain which, if either, of those two scenarios plays out. Once again for us the key is to closely monitor our risk exposures and be ready to move quickly when needed.

Investment Strategy Performance

Advantage Investing uses proprietary portfolio models to create customized investment portfolio allocations for our clients, based upon their individual goals and risk profiles. The chart below shows the return of a moderately aggressive portfolio which is invested 60% in stocks and 40% in bonds. The benefits of our actively managed strategies can be clearly seen as the losses which were limited during the past twelve months allowed us to significantly outperform the market benchmark over the past three-year period, which includes both up and down market conditions.

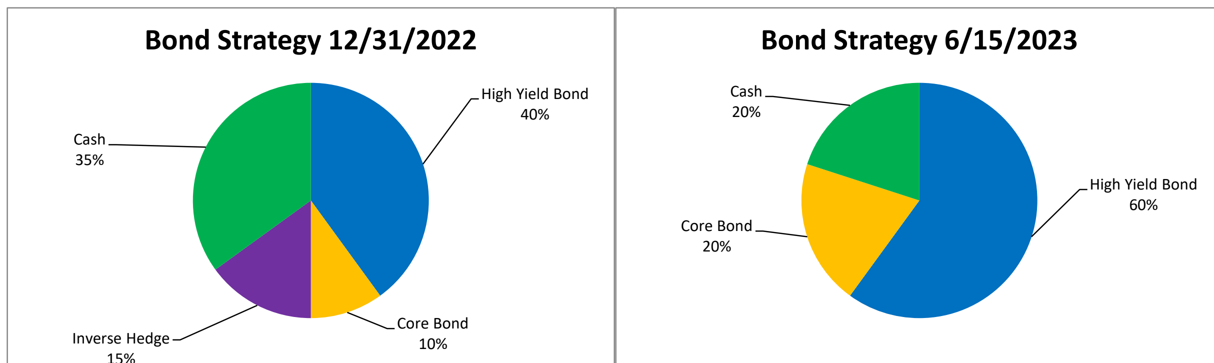


**All Investment Strategy Returns shown are net of asset management fees. Investment returns are aggregated from all client accounts managed by Advantage Investing for the time period shown. Individual account performance will vary. Past performance cannot guarantee future results.*

Current Investment Strategy Allocations

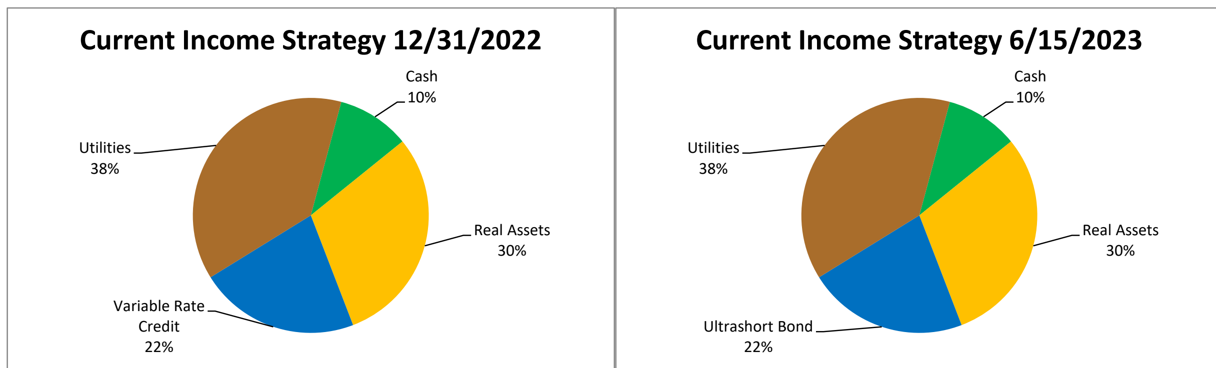
The past several weeks have led to significant changes in the composition of our investment strategy allocations. The benefit of our actively managed strategy is the ability to move quickly when needed in order to meet both the current environment as well as in preparation for what is coming next. I have included a comparison of where our models stood at the beginning of 2023 and where we are as of our most recent adjustments. As you can see, things can change quite dynamically when necessary.

Bond Strategy: *60% High Yield Bonds, 20% Core Bonds, 20% Cash*



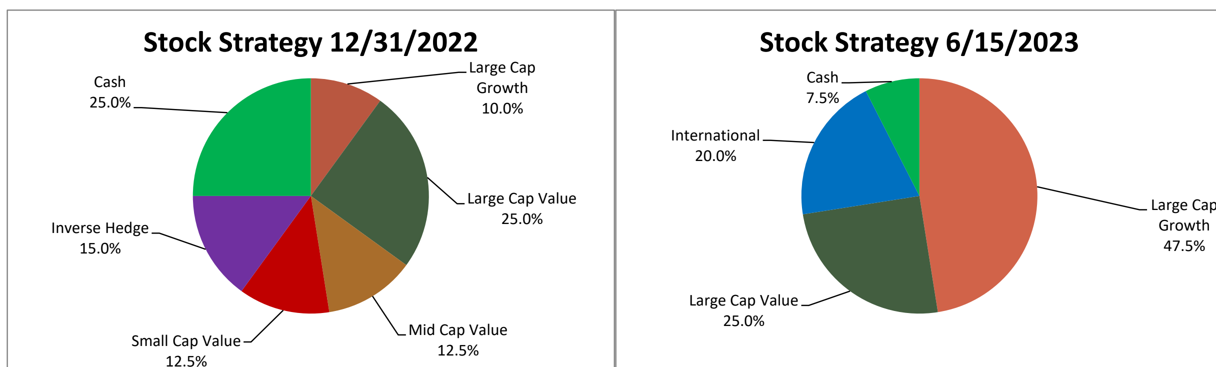
As the Fed has neared the peak of their rate cycle, we have adjusted our Bond allocations to take advantage of a stable to declining interest rate environment. While we still remain somewhat cautious and are maintaining a 20% allocation to cash, the current high-rate environment provides some additional support as the cash allocation is invested in high yielding money market funds.

Current Income Strategy: *30% Real Assets, 22% Ultrashort Bond, 38% Utilities, 10% Cash*



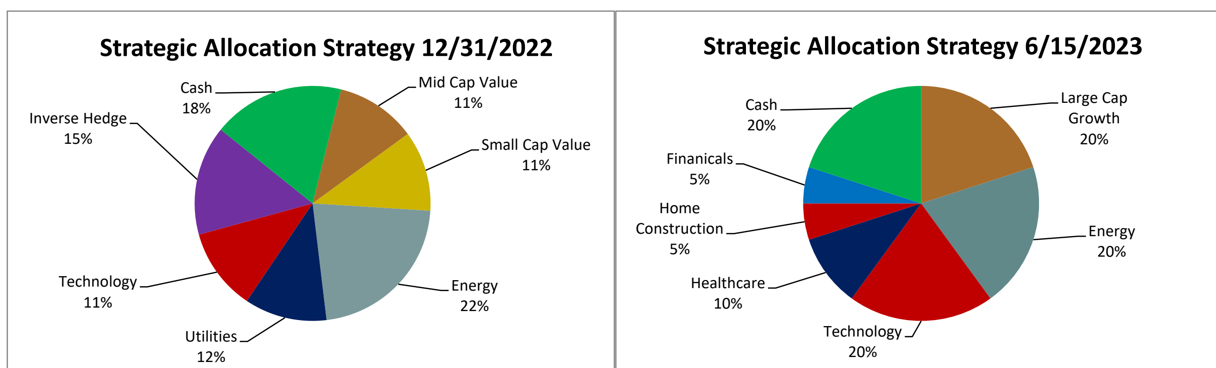
Our Current Income Strategy has seen the least amount of change over the past several months. The primary adjustments have been where we hold our cash position (high yield money market funds) and a shift away from variable rate credit into an ultrashort bond/bank loan portfolio.

Stock Strategy: *47.5% Large Cap Growth, 25% Large Cap Value, 20% International equities, 7.5% Cash*



Our Stock Strategy has seen significant changes over the past several months. As we look toward a move into a stage six - recession economic environment, this style-based strategy has shifted into large cap stocks with a significant bias toward growth versus value. We have also removed all the inverse hedge and added 20% exposure to international equities for the first time in more than a decade.

Strategic Allocation Strategy: *20% Large Cap Growth, 20% Energy, 20% Technology, 20% Cash, 10% Healthcare, 5% Home Construction, 5% Large Financials*



Our Strategic Allocation Strategy has experienced the most change of any of our four strategies. All of the hedging has been removed in favor of a 20% position in cash (holding high yield money market funds). This strategy is also focused on large cap growth stocks, which includes additional focus in energy and technology stocks. We have also added several sector-based positions in large financials, healthcare providers, and home construction.

Final Thoughts

This year I celebrate 30 years of working in the field of investment management and advice. Those years have brought me much experience and important lessons learned. One of the most important lessons I have learned is to never chase after performance, and most especially not in an irrational and unpredictable market. Someone once compared this to picking up quarters in front of a steam roller – it all seems to be going well until it goes suddenly and catastrophically wrong. Navigating diverging market environments like these can be extremely confusing and difficult. The impulse to follow the crowd and chase after performance can be almost overwhelming. This is one of the primary reasons that our analytical framework is driven by economic analysis rather than just trying to "time the market".

We remain in a dynamic and rapidly changing environment, but that is exactly what our actively managed models are designed around. For now, please rest assured that we are watching things closely and making adjustments as needed in order to minimize the impact of these volatile markets as much as possible.

Thanks so much,

Ronald A. Wright, CFA
President

All Advantage Investing, Inc. Investment Strategy Returns shown are net of all asset management fees and expenses. For any periods less than one year the fee is pro-rated for the period shown. All returns for periods greater than one year are annualized. Individual Investment Strategy returns are aggregated from all actual client accounts within each respective strategy. Individual account performance will vary. Past performance cannot guarantee future results.

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