Stapp Financial Investment Letter

Stapp Wealth Management, PLLC **Second Quarter 2023**

"Successful investing is about having people agree with you ... later."
- James Grant

Market Recap

Despite a series of potential crisis events occurring this year, 2023 has been a strong year for most investment assets. Stocks saw strong performance, with the stocks of the larger US tech companies leading the way. The focus of markets has been shifting at a rapid pace, but the theme that has endured is the emergence of generative AI. This has been a big benefit to the Nasdaq as many of the companies in the Nasdaq are tech focused companies that have exposure to AI. This resulted in the Nasdaq 100 seeing its best first half performance ever, up 39.36%. The remaining stocks have posted positive results, but not quite as strong as the Nasdaq's. Small company stocks were up 10.8%, developed international stocks were up 10.7%, and emerging market stocks were up 4.9%.

The path of interest rates continues to be volatile and uncertain, but for now, bonds continue to remain positive for the year. Higher quality investment grade bonds lost a bit of value in the 2nd quarter, but are still positive for the year, up 2.1%. Floating rate loans and high yield bonds are the best performers in the fixed income space so far this year, up 6.4% and 5.4%, respectively. Gold and managed futures, the portfolio diversifiers, have been mixed this year, with gold down in the 2nd quarter and up for the year, whereas managed futures were up in the 2nd quarter but down for the year. Managed futures have performed well, apart from a week-long period of poor performance during the banking crisis. The losses realized then have hindered their otherwise strong performance.

Asset Class Performance		
	2nd Quarter	Year-to-date
Investment Grade Bonds	-0.8%	+2.1%
Floating Rate Loans	+3.3%	+6.4%
High Yield Bonds	+1.8%	+5.4%
US Large Cap Stocks	+9.8%	+19.3%
US Small Cap Stocks	+5.6%	+10.8%
Developed International Stocks	+2.8%	+10.7%
Emerging Market Stocks	+0.9%	+4.9%
Gold	-3.4%	+5.4%
Managed Futures	+5.4%	-2.6%

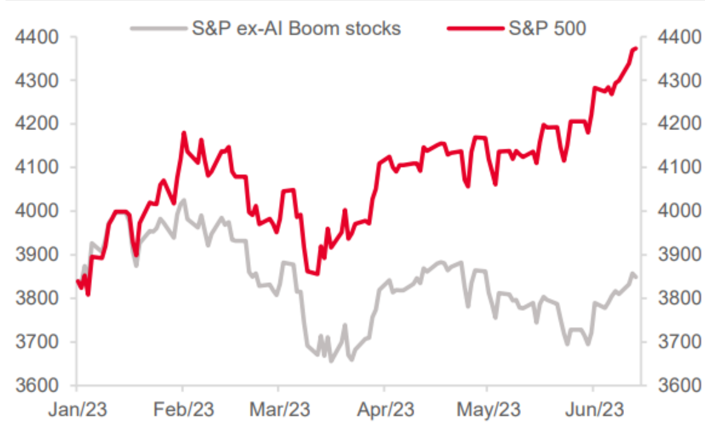
Data as of 6/30/2023. Source: Kwanti Analytics, Morningstar.[1]

[1] Indexes used: Barclays US Aggregate Bond Index, Morningstar LSTA US Leveraged Loan 100 Index, Barclays US Corp High Yield, Morningstar US Large Cap TR, Morningstar US Small Cap TR, Morningstar Developed Markets ex-US, MSCI Emerging Markets Index TR, Gold represented by the change in the gold spot price, Managed futures represented by a 50/50 allocation to ASFYX and PQTIX set to rebalance quarterly.

Investment Outlook and Portfolio Positioning

Across the board, markets ended the quarter enchanted with AI. Tech experts, such as Dylan Patel of SemiAnalysis, have stated that the impact of AI will be somewhere between the invention of the internal combustion engine and the invention of the Internet. This hype has caused tech and AI adjacent stocks to far outperform everything else this year. Wisdomtree's $121 million WTAI fund is perhaps the best example of the AI hype. WTAI was launched in late 2021, but there was almost no money in the fund until just recently. Of the $121 million that is in the fund now, $118 million was added this year, with most of the inflows occurring in May and June. This performance chasing into the AI theme has caused a large bifurcation in markets. Due to the market cap weighting of the S&P 500 being tilted to the tech sector, the index benefited from AI stocks' strong performance. However, if you were to remove the AI boom stocks from the index, the remaining stocks are essentially flat for the year. The result is that we now have extremely rich valuations for many of these AI adjacent companies. Nvidia is a good example of this. Nvidia is a company that is benefiting significantly from AI development. You could think of Nvidia as being part of the "picks and shovels" of AI as they produce much of the hardware that is necessary for AI applications to function. Because of this, Nvidia has been the best performing stock of the year. This strong performance has caused Nvidia's valuation to surge to more than 20x its forecasted revenue over the next 12 months. That is twice the valuation Sun Microsystems had at its peak during the dot-com bubble before it lost more than 90% of its value when the bubble popped. If Nvidia was an upstart company, 20x revenue might not be too bad, but Nvidia is a mature company that has been in business for 30 years. The stock price implies a level of growth that would be very difficult for them to achieve. While not an impossible outcome, it's hard to justify owning the stock here. We are seeing egregious valuations like this across the AI space, which is concerning from an investment standpoint as this all looks characteristic of a market bubble. These types of bubbles can continue for a while, but they often don't correct themselves in a calm fashion. From an economic standpoint, compared to many of the other recent bubbles (SPACs, crypto, meme stocks, etc.), we believe AI could be the real deal. We are seeing significant efficiency gains from tech workers that are utilizing GPT-4, and we are already seeing tasks in many fields being replaced by AI. The possibilities of what AI could achieve go far and wide. For these reasons, AI is a theme that cannot be ignored, but we believe a prudent approach should be taken when thinking about it from an investment perspective.

AI-related stocks drove virtually all S&P 500 returns this year



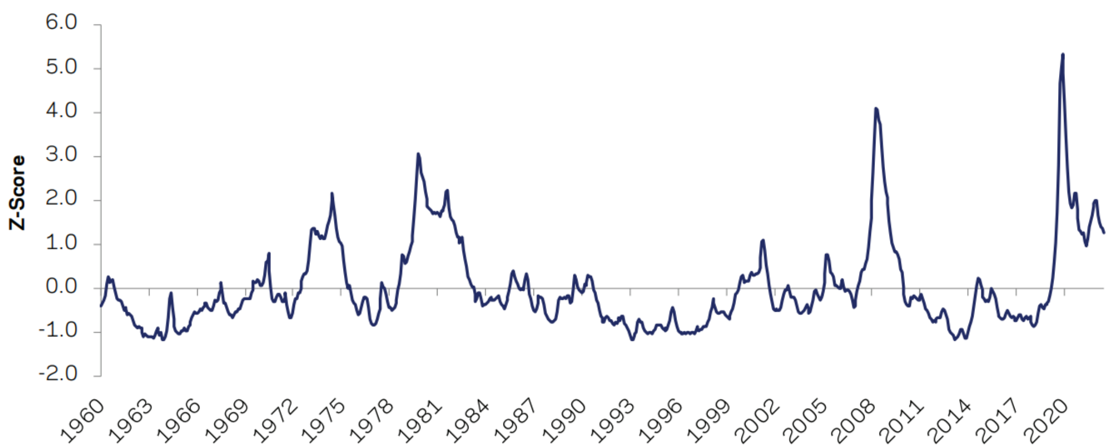
Data as of 14/06/2023. Source: Datastream, SG Cross Asset Research/ Equity Strategy

When confronted with a bubble, an investor has two options: 1) buy into the bubble and try to sell before it pops, or 2) sidestep the bubble and invest in things that are not associated with the bubble. As we are not traders with a high proficiency in trading around stock market bubbles, our selection of the two choices is option two. We are doing research on AI and the beneficiaries of AI that we believe may not yet be recognized by the market, but for now our positioning is largely sidestepping the AI bubble.

Stepping away from AI and reviewing where the overall economy and market stands, we are now labeling the economy a *Waiting for Godot* economy. Samuel Beckett's *Waiting for Godot* is a play that was first performed in 1953 and quickly rose in popularity due to its unique style, ultimately being deemed the "most significant English-language play of the 20th century" in a poll conducted by the British Royal National Theatre. Throughout the play, the two main characters, Vladimir and Estragon, are seen by a tree having a series of what seem to be pointless conversations. Occasionally, the conversation is interrupted with one of them suggesting to leave, but the other replies, "Oh no, we can't; we're waiting for Godot." At the risk of spoiling the play, this dialogue continues until the play ends, yet Godot never arrives.

For the past year and a half, economic forecasters, market strategists, and financial media personalities have been decidedly negative, saying that we're either in a recession or that a recession is right around the corner. Yet, as if we were the ones waiting for Godot, it has been a year and a half since these recession calls began, and still no recession. In defense of all the market pundits, this has been an extremely abnormal environment for the economy and for markets. AQR published a paper during the quarter reviewing "macro uncertainty." In this paper they showed the JLN Macro Uncertainty Index, which measures the accuracy of economic forecasts. The farther the index is from the zero line, the less accurate forecasts have been. As is evident by the results of the last several years, the index shows that forecasts have been among the least accurate since 1960.

Figure 1: JLN Macro Uncertainty Index
July 1960 - December 2022



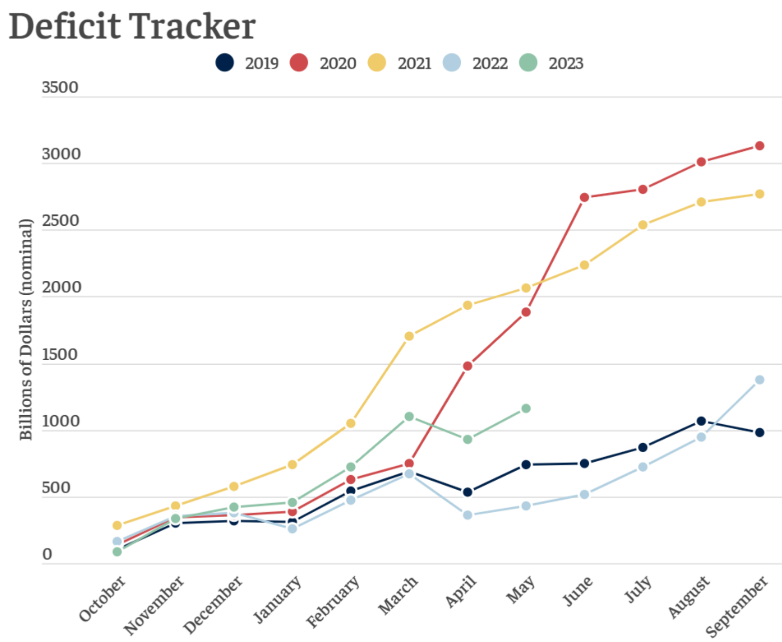
Source: Kyle Jurado, Sydney Ludvigson, and Serena Ng (2015)

Compounded with this, we find that many of the recent economic data releases are suspect. For example, the 1st quarter GDP was revised from 1.1% in the first estimate to 2% in its final revision. This is a massive adjustment. Changes to the economic environment from pre-Covid to post-Covid must be causing issues with the accuracy of the economic data that is being collected. This only makes it harder to gauge where the economy stands today. Despite this challenging environment, our baseline view continues to be that we will head into a recession. We see this as a slow-moving environment, so we may not see a recession until the first half of 2024, but the evidence of an oncoming recession remains compelling. Fred Hickey in his newsletter *The High-Tech Strategist* outlines the developing recession view in detail:

> The Fed is tightening, the money supply is dropping, banks are pulling back on credit, residential existing home sales are extremely weak (though construction is still holding up), inflation-adjusted retail sales are falling and all the major retailers (Walmart, Target, Costco, Amazon and more) noted recent decelerations in their sales. Stressed U.S. consumers are trading down (from beef to chicken) and spending more money on groceries rather than bigger

ticket discretionary items. There are no more “stimmy” checks, consumers are increasingly relying on credit card and auto loan delinquencies are on the rise, SNAP (food stamp) monthly benefits were lowered, tax refunds are down, student loan payments will begin again in October ($393 per month on average), corporate bankruptcies are running at the fastest level since 2010 (286 filings through May) and corporate capex spending has been cut back.

As you can see, a strong case can be made for an oncoming recession. However, a case could also be made that we may not see a recession until 2025, if at all. In a recent interview, the former Dallas Fed president, Robert Kaplan, explained that one thing many economists are overlooking is all the funds that state and local governments received from the Biden administration’s American Rescue Plan Act (ARPA) that have yet to be spent. State and local governments received approximately $350 billion from ARPA, and they are required to spend it before 2025. From our own discussions with government employees that have a view of their agency’s budget and from reviewing the financial positions of many of the other beneficiaries of ARPA funds, much of this funding still has not been spent. This means that they will be spending these funds over the next year and a half or else they will expire. This will be a boost to the economy. Additionally, the Federal deficit continues to remain well above historical levels, which promotes economic activity and pumps money into the financial system. Monetary policy remains tight and may tighten further, but the fiscal authorities are keeping policy loose. These may be sources of economic strength that will continue to confound the overly negative market pundits. It could very well turn out to be a *Waiting for Godot* recession.



NOTE: GRAPH SHOWS CUMULATIVE DEFICITS OVER THE FISCAL YEAR, WHICH BEGINS IN OCTOBER.
SOURCE: U.S. DEPARTMENT OF THE TREASURY, CONGRESSIONAL BUDGET OFFICE.

The possibility of either of these two diametrically opposed outcomes lends itself to what we call the art of turtle investing. The turtle is a resilient creature that thrives in environments filled with dangerous predators. The turtle always protects itself but is willing to stick its neck out and strike when an opportunity presents itself. Given the degree of uncertainty and the likelihood of a looming recession being a key risk, the portfolios continue to be tilted defensively, but overall, the portfolios are positioned in a way where they should be resilient regardless of the outcome going forward, whether positive or negative. Positioning hasn’t changed much from last quarter to now, so the key investment themes remain essentially the same: 1) an underweight to stocks and lower quality bonds, 2) a decent sized weighting in the bond-bullion barbell, 3) an allocation to alternatives that we believe will continue to benefit in this environment, but also

Spotted turtles can live for more than 100 years!

benefiting the overall portfolio by increasing diversification, and 4) emphasizing emerging markets, value, and commodity sectors within our stock allocation as we continue to believe they will best benefit in this environment and for several years to come. These themes have underperformed so far this year relative to the AI focus of the market, but several signs are indicating a reversal may be afoot that could result in outperformance in the second half of the year.

Closing Thoughts

We continue to live in interesting times. If we go back just five years ago, there is no one who could have possibly predicted the events that have gotten us to where we are today. We might expect that the next five years are similar in this regard, being equally unpredictable. If we could accurately predict where markets were going, we most certainly would, but any investor knows this is a fruitless exercise. Instead, we rely on analyzing the economic and market environment to identify where the best risk/reward opportunities are and then we wait for the passage of time to do the work.

One opportunity that an investor is always looking for is the “fat pitch.” In baseball parlance, the fat pitch is a pitch that’s right in the sweet spot, where if you swing at it, you’re likely to hit it out of the park. In investing as in baseball, fat pitches are rare, but in times of large market swings, you could get one. Right now, we are finding opportunities, but we don’t see anything that we would describe as a fat pitch. Over the next year, however, we see there being a high likelihood of a fat pitch somewhere in the markets. For now, we’ll continue to be patient, not overextending one way or the other.

We thank you for the trust you place in us to be the stewards of your capital. As we are in the summer doldrums, there might not be a lot going on in markets, but we continue to put in the work necessary for when the turbulence picks up again. As they say, “luck is where opportunity meets preparation.” If you have any questions or if you want to discuss your specific situation, please do not hesitate to reach out.