Good afternoon Megan,

Halfway through the year and halfway through summertime! I hope you all are enjoying trips, vacations, and time spent with family and friends before the school season starts in about another month. Below I outline the changes in the portfolio due to the semi-annual rebalance. I was nearly finished making the changes in the portfolio when a surprise popped up, requiring me to make some unexpected changes shortly after completing the rebalance. At this time, I have completed the buying and selling and don't anticipate further changes until the next rebalance in January.

**Executive Summary:**

- **The semi-annual rebalance is now complete.**
- **The portfolio is more balanced with the addition of growth-oriented investments, and there remains a sizeable exposure to international equities.**
- **In a surprising development, one of the three main risk charts now suggests reducing risk levels.[1] This occurrence has necessitated a decrease in the equity percentage of the portfolio and an increase in cash. The cash resides in a money market account currently yielding approximately 4.99%.[2]**
- **Except for that particular risk chart changing, the overall weight of evidence still looks attractive, with the path of least resistance still trending to the upside.[3]**
- **Currently, the asset allocation for the aggressive portfolio is at 80% equity and 20% cash.**
- **The asset allocation for the moderately aggressive portfolio is 65% equity, 15% fixed income, and 20% cash.**
- **The asset allocation for the moderate portfolio is 55% equity, 30% fixed income, and 15% cash.**
- **The asset allocation for the conservative portfolio is 35% equity, 50% fixed income, and 15% cash.**
- **Three stocks were removed from the portfolio due to a deterioration in technical attributes below the required minimum score. The removed stocks are General Mills, United Health Care, and H&R Block. Amazon, Advanced Micro Devices, and Google have replaced them.**

As I mentioned in my last email, most gains seen in the NASDAQ and the S&P 500 for the first half of the year came from a handful of mega-cap stocks.[4] Over the past three weeks, I have seen a notable broadening in the number of stocks that appear to be breaking out of a nearly one-and-a-half-year trading range that a very sizeable number of stocks have been stuck in.[5] Trading ranges that last for that length of time can create frustration given that it feels like for every two steps forward, you take two steps back, and hence, minimal forward movement in the portfolio. The portfolio showed minimal progress for the first half of 2023 due in large part to the asset allocation. In early January, the technical data indicated we should avoid growth-oriented investments and remain invested in value-oriented investments.[6] That served us well for 2022, but changes started to occur in the first half of 2023, thus, the reason we rebalance semi-annually in January and in June/July each year.

The semi-annual rebalance allows me to realign the portfolio allocation to where the strength is in the markets. It also allows me to remove the dead weight in the portfolio and replace it with more productive investments. To that effect, I have eliminated the direct portfolio exposure to Asian/Chinese equities and commodities and reduced, but not eliminated, the portfolio weighting in value-oriented investments. I have added growth-oriented assets to the portfolio, which are exposed to the tech sector. Part of that exposure is in the three new stocks in the portfolio: Amazon, Advanced Micro Devices, and Google. A large reason for adding these stocks is that each of those companies have exhibited five consecutive years of increasing funds from operations, a line item taken from the cash flow statement of each company.[7] That is a high hurdle for any company to achieve and typically indicates a well-run company.[8]

Another big reason is that each of those companies is heavily involved in the emerging area of artificial intelligence (AI). AI is not simply another investing fad. AI will be as transformative to society as the cotton gin during the Industrial Revolution[9], as personal computers were back in the 80s and 90s, and the internet was back in the early 2000s. We are in the very early innings regarding AI's growth, and there will undoubtedly be attractive investment opportunities to capitalize on this transformative technology. Amazon[10], Google[11], and Advanced Micro Devices[12] sit squarely in that opportunity set. As it now stands, the seven individual stocks in the portfolio are essentially a barbell approach to the markets. Three of the stocks are involved in the tech sector, which is more of an offensive sector[13], while the other four stocks, Merk, Republic Services, Williams Companies, and Marsh McLennan are generally seen as more defensive plays in the market. Some technology stocks, such as those in the portfolio, could also be considered defensive plays in a weakening economy, i.e., a recession.[14]

I bring up the word recession because it still looms over the economy.[15] Over the past year, I felt that the economy would be heading into a recession due to the number and pace of the interest rate increases, but to date, we haven't seen it materialize.[16] That is probably due to the solid employment numbers that the country is experiencing.[17] However, the Treasury yield curve is very inverted, which has historically been a harbinger of recessions,[18] and interest rate increases generally work with a lag of about eighteen months,[19] which means we still have a number of rate increases to be felt. That may be why the chart that measures whether it is better to be in cash or bonds flipped in favor of being in cash back on June 29th.[20] Historically, this chart has been the most accurate suggesting negative mark action coming down the pike.[21] If you'll recall, this chart flipped in favor of holding cash back in the spring of 2021. At that time, everything was going smoothly in the financial markets.[22]

Then, the tech bubble started to burst in the fall of 2021,[23] which led to a disastrous stock market in 2022.[24] This chart change may suggest a possible recession towards the latter part of this year or sometime in early 2024. I don't know, but the flip to "negative" means that I need to lower some of the risk exposure in the portfolio, which has been done. The good news is that the money market fund in your portfolio is currently yielding 4.9% (subject to change),[25] which may increase by the time August rolls around if the Fed raises rates. The Fed has another meeting July 25th – 26th,[26] and there is a strong chance we will see another .25% increase.[27] If that occurs, the money market could yield north of 5% by the end of the month (no guarantees). Remember that the risk charts are not infallible, and this recent change may prove to be a head fake. I hope that turns out to be the case, and if it does, I will reinvest those funds in the market. But, at this time, I have to respect the suggestion from the data to reduce risk levels in the portfolio.[28]

Outside of the risk chart change, the overwhelming majority of technical indicators look very healthy at this time,[29] and I am of the mindset that the stock market appears to be poised to retest the all-time highs seen in the stock market back in early 2022.[30] I know that may sound contradictory to what I mentioned in the above paragraph, but the data seems to have gotten stronger and healthier as the year progresses.[31] As I mentioned above, I am seeing more and more stocks starting to break out of their trading ranges, suggesting higher stock prices going forward. Three reasons come to mind when I question how and why this stock market would want to go higher. The first reason is the bank failures back in March. Why would bank failures be a good thing for stocks to advance?

Well, back in March, some bank failures were largely a result of the Fed's constant interest rate raises over the course of 2022 and into 2023.[32] Banks hold U.S. Treasuries, the gold standard for Tier 1 capital. Over the past fifteen years, when the Fed was conducting its ZIRP (Zero Interest Rate Policy) operations,[33] banks had been buying U.S. Treasuries with near-zero interest rates attached to those bonds because they had a large incentive to hold them for operating and regulatory reasons. While U.S. Treasuries are considered the most risk-free investment in the world,[34] they are still subject to secondary bond market action. When rates started to rise last year and into this year, those Treasury bond prices began to drop in value, severely impairing banks' balance sheets.[35] Those unrealized losses on some banks' balance sheets eventually turned into realized losses, resulting in some banks going under.[36] Around the March timeframe, the Fed had a good idea that they would be raising rates further in 2023, and if they continued to do that, then they risked causing more bank's balance sheets to suffer losses, hence, the possibility of more bank failures as a real risk. To mitigate this situation, the Fed developed a new program called the Bank Term Funding Program (BTFP).[37] What the Fed did with this program was to allow banks to swap their underwater Treasury bonds for cash at par value in the form of loans.[38] This has allowed the banks to move those unrealized losses off their balance sheets (the Fed takes those Treasuries onto its balance sheet) and replace them with cash at the face value of the bond. Not a bad deal for the banks!

Essentially, this is equivalent to a stealth quantitative easing (QE)![39] Liquidity in the financial system has increased, and as we know from prior episodes of QE, when liquidity goes up, so too do financial assets, i.e., stocks.[40] Therefore, it isn't surprising that stocks have been going up over the past few months, albeit primarily in just a small handful of stocks which recently has seen more stocks participate in the broadening in scope. The program is slated to go until March 2024, at which point banks are supposed to bring those same Treasuries back onto their balance sheets and repay the Fed the borrowed money.[41] In my opinion, there is a high likelihood that when that time comes, we could potentially see the Fed extend the program in another act of kicking the proverbial can down the road. Time will tell, but the BTFP should be a tailwind to the stock market until next year.[42]

My second reason why I think the stock market wants to retest its all-time highs is due to the corporate buyback window that reopens later this month. Companies generally cannot buy back their stock during the period of the last two weeks of the quarter until 48 hours after they announce earnings.[43] With Q2 earnings season nearly upon us, the opportunity for corporations to buy back their stock should reopen from mid-July into early August after most companies report earnings. Those buybacks should help increase the earnings per share since fewer shares are outstanding, all else being equal.[44] Financial alchemy at its finest!

The third reason I think stocks want to move higher is from the conversations I have with people across the country. These are folks working in various industries and company sizes, and the vast majority tell me how strong their businesses are! From my conversations, it does not feel like the economy is approaching or going through a slowdown. The biggest complaint I get from business people is that they can't find anyone to hire! Yes, several high-profile corporate layoffs have been announced this year, but it seems like those getting laid off are finding jobs quickly since the unemployment numbers haven't meaningfully moved up.[45] I don't know if that resiliency can or will continue nationwide, but the employment numbers do not suggest that a recession has started.[49]

It would be wonderful if the Fed could pull off the proverbial soft-landing, something it has only done once after implementing a policy of increasing interest rates.[46] As I have mentioned in prior emails, recessions typically result in price to earnings (P/E) multiple contraction, with the P/E multiple contracting to somewhere between 10-15 times earnings.[46] Where are we currently? Using Generally Accepted Accounting Principles, otherwise known as GAAP Earnings, on a trailing twelve-month basis, the current estimated P/E as of the end of Q2 2023 is around 25 times earnings.[47] That would imply a drop to about 2698 on the S&P 500 at a 15 P/E, a decline of nearly 39% if we have a mild recession. That's why we respect the risk charts when they suggest reducing portfolio risk!

To wrap this up, I believe that we stand a good chance of seeing the stock market over the next six months retest the all-time highs last seen in 2021. The data is simply that strong, and there are numerous tailwinds at our back right now. However, it can't be dismissed that the Fed has been raising interest rates at an accelerated pace over the past year, and the full effect of those increases has yet to be fully seen. The Fed intends to slow the economy down so that inflation returns to its 2% mandate.[50] Even though a recession is not seen in the economy today, it can't be ruled out that one won't materialize later this year or next.[51] That is what the inverted yield curve suggests. No one has a crystal ball to definitively say what will happen in the financial markets over the next six months, so we need to be cognizant that something could come out of left field to derail any upward movement in the stock market. However, as always, I will stay vigilant about any possible changes in the outlook for the markets and act accordingly when necessary.

I feel good about the current holdings and allocations in the portfolio, which could yield some good results for the second half of the year! Until then, I hope you all are enjoying your summer.

Jim