MALVERN CAPITAL MANAGEMENT

2nd Quarter 2023 Commentary and Market Outlook

July 2023

2nd Quarter 2023 Review

Despite the gloom and doom projections from many of Wall Street's "best" and "brightest" analysts, equity markets moved higher in the 2nd quarter of 2023. On the heels of its performance in the 1st quarter, the NASDAQ 100 Index led all major indices again in the 2nd quarter by advancing 15.39%. The technology-heavy index, with its artificial intelligence (AI) stock subset, outshined all other indices for the quarter. Many of those same technology and AI stocks make up a portion of the S&P 500 Index which also posted impressive gains. The S&P 500 Index rose by 8.74% in the quarter.

The Dow Jones Industrial Average has been a laggard index all year but still was able to jump 3.97% for the quarter. The mature, blue-chip companies that comprise the Index have not garnered the same attention this year as the technology sector. Likewise, "value" stocks have posted relatively unimpressive returns so far this year compared to "growth" stocks. Growth stocks have outperformed value stocks by nearly 24 percentage points year-to-date mostly because the Russell 1000 Growth Index includes a 43.3% allocation to the technology sector. Conversely, value stocks barely moved in the 1st quarter this year and managed to gain 4.07% in the 2nd quarter.

Developed international stocks have had a decent year so far with the MSCI EAFE Index up 11.67% year-to-date and 2.95% in the 2nd quarter. Emerging Markets equities are relatively "cheap" compared to US stocks but have not been able to take off yet. However, these stocks may offer the best value globally of any market.

With rising interest rates in the quarter, high-quality, investment-grade bonds did not do as well as stocks in the quarter with the Bloomberg Barclays US Aggregate Bond index declining by 0.84%. With fears of

Indices Performance

Category	Representative Index	2nd Qtr 2023	Y-T-D 2023	12 Months	3 yr*	5 Yr*	10 Yr*
Mature US Large Companies	DJ Industrial Average	3.97	4.94	14.23	12.30	9.59	11.26
Broad US Large Companies	S&P 500 Index	8.74	16.89	19.59	14.60	12.31	12.86
US Small Cap Companies	Russell 2000 Index	5.21	8.09	12.31	10.82	4.21	8.26
US Mid Cap Companies	Russell Mid Cap Index	4.76	9.01	14.92	12.50	8.46	10.32
Largest 100 NASDAQ Companies	NASDAQ 100 Index	15.39	39.35	33.13	15.23	17.66	19.22
Large "Value" Stocks	Russell 1000 Value Index	4.07	5.12	11.54	14.30	8.11	9.22
Large "Growth" Stocks	Russell 1000 Growth Index	12.81	29.02	27.11	13.73	15.14	15.74
Developed International	MSCI EAFE Index	2.95	11.67	18.77	8.93	4.39	5.41
Emerging Markets	FTSE All Emerging Markets	0.69	3.64	0.89	3.17	1.95	3.33
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	-0.84	2.09	-0.94	-3.96	0.77	1.52
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	1.75	5.38	9.06	3.13	3.36	4.43
Commodities	Bloomberg Commodity	-2.56	-7.79	-9.61	17.82	4.73	-0.99
Total US Market (all cap stocks)	Russell 3000 Index	8.39	16.17	18.95	13.89	11.39	12.34
Real Estate Investment Trusts	Wilshire US REIT Index	3.31	6.74	-0.31	8.55	4.40	6.39
Cash	US T-Bill 90 Day	1.24	2.40	4.10	1.50	1.59	1.01

** 3 year, 5 year and 10 year returns are annualized. All periods ending June 30, 2023.*
All returns include the reinvestment of dividends.

recession cooling off and default rates at near-record lows, high-yield or junk bonds advanced in the quarter by 1.75%. Despite rising interest rates, REITs posted respectable gains in the quarter with the Wilshire US REIT Index gaining 3.31%. Also, with rising interest rates, cash has become a viable asset class within investors' portfolios.

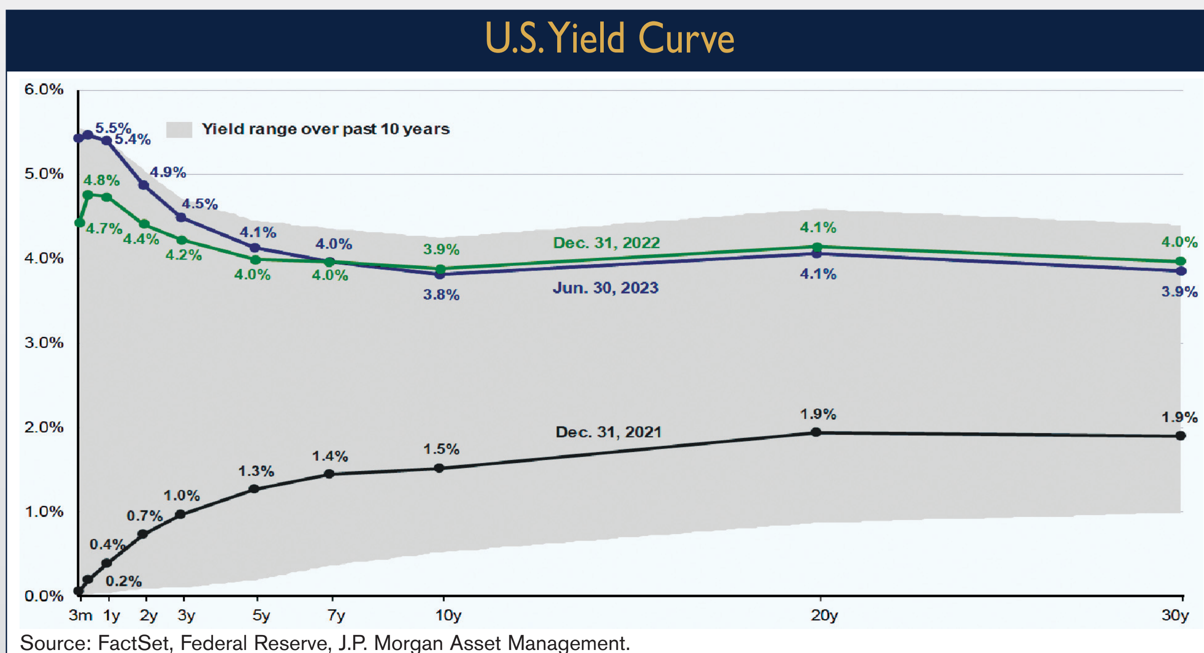
It seems like there is a lot of negative sentiment toward the equity markets this year. With the S&P 500 Index ending the 2nd quarter at 4,450.38, many analysts are still calling for a drop as low as 3,200 or 28% down from here. We do not share those dire forecasts and maintain a somewhat positive outlook on the markets going forward this year. Our thoughts on the markets and economy are as follows:

Federal Reserve and Interest Rates

At the Federal Reserve's June 2023 meeting, the Fed "paused" raising interest rates but went on to state that the board was likely to raise interest rates two more times this year. After the May 2023 meeting, we were fairly convinced that the Fed was done raising interest rates for this interest rate cycle. At the May meeting, the inflation readings had been trending in the right direction, and much progress had been made up to that point on the inflation front. The Fed seemed as if it was finished at the time. What had changed between May and June's meetings? It seems as if the Fed is not satisfied with the progress that has been made so far. The Fed's target inflation rate is 2% and with the headline Consumer Price Index rate at 4.0% year-over-year (May 2022 to May 2023), it must feel that inflation is still too high even though inflation is moving in the right direction. After the June meeting and the Fed's statement that it could raise rates two more times, the market reaction was somewhat muted with a slight downward bias. Many market participants had been expecting that the Fed would be finished or may just have one more increase in it. It was quite surprising that we did not see more of a negative reaction to the Fed's statement.

Investors will be very focused on every inflation data release that comes out. The markets will remain very sensitive to possible rate increases. The market's lack of a negative reaction to the latest Fed announcement may be due to the fact that more certainty has been placed on the decision to raise interest rates and that it appears that the Fed is now closer to being done. The Fed's own forecast is for the Fed to cut interest rates in 2024 by a full point. The financial markets may be looking forward to the eventual interest rate decreases.

U.S. Yield Curve



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.

New Recession Worries for 2024?

It looks like we are going to avoid a recession in 2023. Surprising nearly everyone, the final read for the first quarter of 2023 Gross Domestic Product (GDP) came in at 2.0%. The consensus estimate of economists was a reading of 1.6%. The Personal Consumption Expenditures price index (the Fed's favorite inflation gauge) rose at an unexpected 3.8% year-over-year rate for May 2023. This was down from 4.3% in April. This may be a sign that the Fed does not need to be as "hawkish" in its fight against inflation. It also lessens the potential that the Fed induces a recession by going too far with its interest rate policy changes.

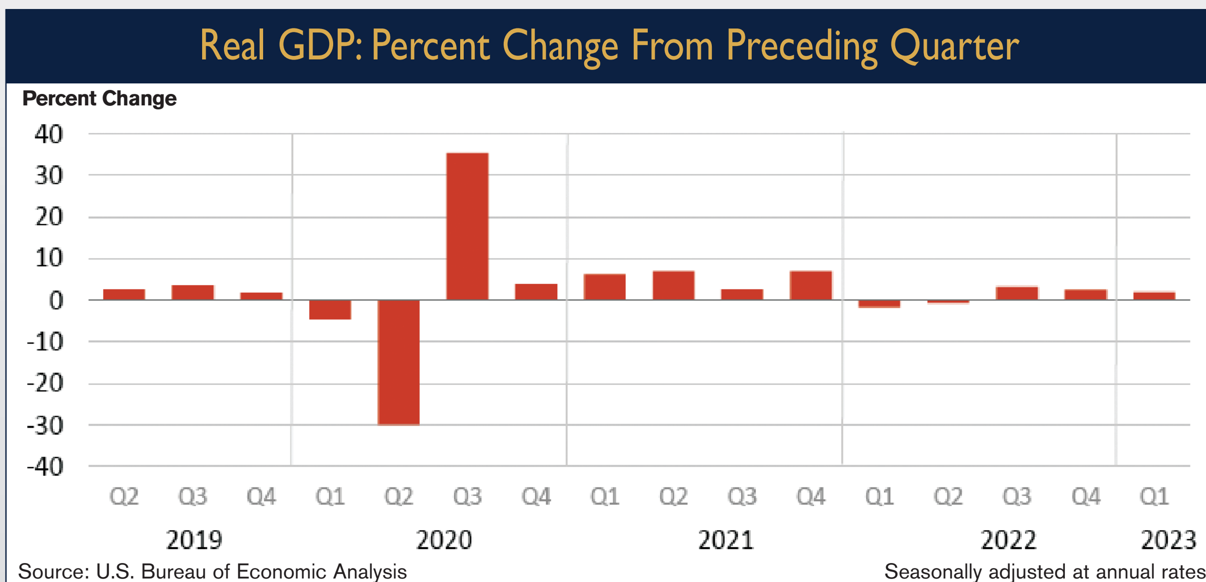
We will most likely avoid a recession in 2023, but what about 2024? There are some headwinds that could give us some concerns about a 2024 recession. There will be a resumption of student loan payments later this fall as the Supreme Court struck down President Biden's student loan relief plan. This will result in lower consumer spending as student loan borrowers will now have to resume paying debt service on those loans. There are higher interest rates on mortgages, car loans, and credit cards which will eat into consumers' disposable incomes. Also, there is a lot of floating-rate debt (both personal and corporate) out there that will have to be refinanced at a higher interest rate at some point. Further, wage growth has not kept up with inflation so many consumers are forced to borrow just to make ends meet.

Also, the Institute for Supply Management's (ISM) Manufacturing Purchasing Managers Index (PMI) came in at 46.9 in the month of May. Any reading below 50 is considered recessionary. The ISM's Services PMI came in at 50.3 in May, just slightly over the 50 level.

On the positive side, jobs have been plentiful. If the current strong job growth continues into 2024, it is hard to believe that we could see a recession. There is an argument to be made that the strong jobs growth is not newly created jobs but rather existing jobs returning that were lost or temporarily placed on hiatus during the pandemic.

Housing has been quite strong. Housing starts for May 2023 were up 21.7% over April's reading. It is also 5.7% higher than the May 2022 housing starts. Even with the rising mortgage rates, housing is still rather strong. Or are home buyers rushing to lock in interest rates and buy a new home before mortgage rates go even higher?

Many forecasters, who incorrectly predicted a recession in 2023 (we were not included with them), are now projecting a recession in 2024. We believe that despite the negatives, the naysayers will be wrong again.

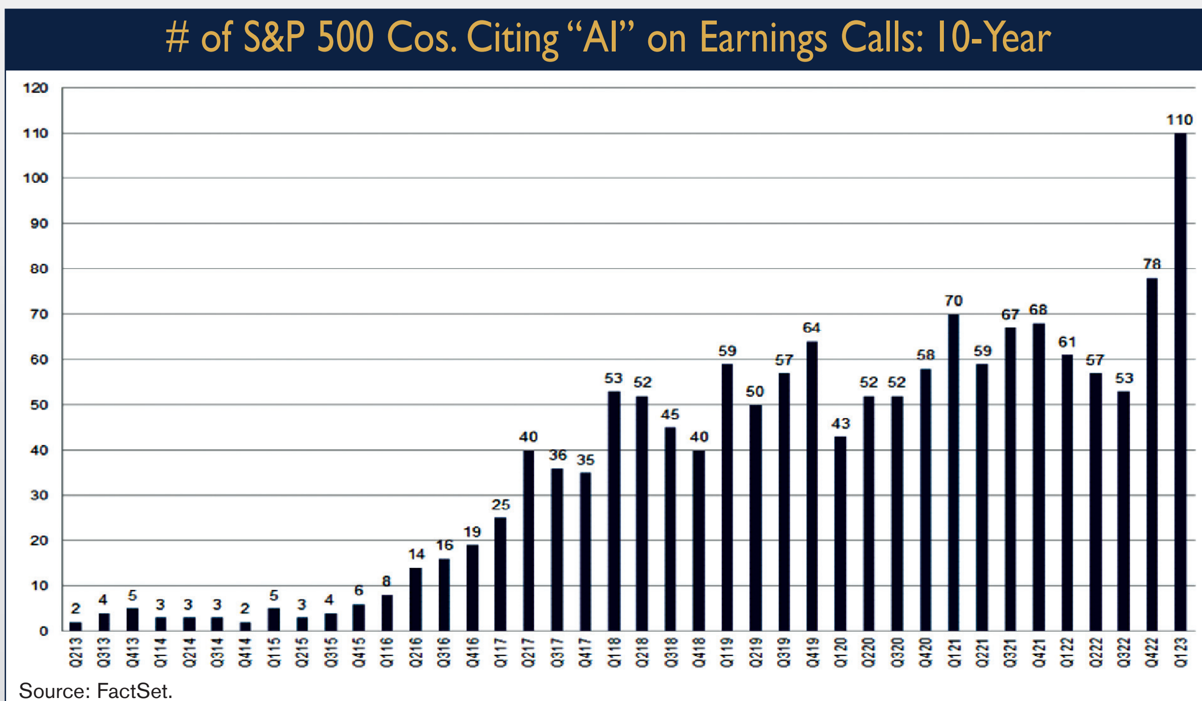


Artificial Intelligence, the Next Technology Wave?

What is artificial intelligence (AI)? Simply defined it is the use of computers to undertake tasks that are generally performed by human beings which entail human intelligence. These tasks include such things as seeing, hearing, and thinking. It uses computer learning to assume tasks that usually require human intelligence. The utilization of AI can potentially increase global productivity and have a positive impact on the Gross Domestic Product (GDP) of other nations. We have not seen such a potential impact on GDP since the advent of the internet.

Some examples of AI in current use would include such things as Siri and Alexa which understand human speech, as well as advanced web searching capabilities, self-driving cars, and creative tools such as ChatGPT. ChatGPT (GPT means generative pre-trained transformer) allows a computer to understand and implement conversational dialogue. The commercial uses of AI are limitless. From a business's marketing standpoint, AI can potentially understand every aspect of a consumer's life so that targeted marketing can be employed. Human drivers can potentially be eliminated so that a company no longer needs to employ truck drivers or cab drivers. Many "thinking" type jobs could be replaced by a machine. Waiters, waitresses, and fast-food counter workers may lose some of their jobs. The future could be bleak for many types of current jobs as those jobs can be substituted with a machine. But, as always occurs when technology disrupts the current workforce, workers adapt and new occupations, some unimaginable occupations, will evolve.

Is AI simply a new dot.com bubble in the making? We think not, at least not at this time. We believe we are still in the early innings of AI's transformation and development. Although there are many publicly traded companies available for investment, some will fail while others will prosper. If you are so inclined to invest in AI, we think that the best way to invest in these companies is through a mutual fund or exchange-traded fund. A professional manager evaluating these companies is the best approach. However, these investments are not without risk and may be too volatile for some investors.



Source: FactSet.

Corporate Earnings

Analysts at the Standard & Poor's Corporation project full-year 2023 earnings for the S&P 500 Index at $216.89 per share. On March 31, 2023, those same analysts had projected full-year 2023 earnings of $218.38 per share. We are seeing a continuation of the earnings estimates being cut over the past several quarters. As of June 30, 2023, the trailing 12-month earnings for the S&P 500 Index were $205.56 per share with a forward 12-month projection of $228.19 per share.

Perhaps the degradation of earnings estimates is based on analysts' consensus belief that we will fall into a recession. As discussed above, we do not believe we will see a recession for the remainder of 2023 or 2024. Actual earnings have come down which reflects the slowing economy. But forward earnings may have a built-in recession discount on them and actual earnings may come in higher than projected.

Operating margins on the S&P 500 Index are an impressive 11.64% while the average operating margin since the 1st quarter of 1993 is 8.31%. The high operating margins indicate that companies are more efficient at managing their revenues than in the past. This bodes well for future earnings. The annualized corporate tax rate as of December 2022 was 19.66% which is up from an annualized tax rate as of March 2022 of 17.54%. Historically, 19.66% is still very low as the average tax rate since 1993 is 30.87%. The low tax rate is a result of the tax policies implemented by President Trump. Lower corporate taxes result in higher corporate earnings. Interestingly, Information Technology companies pay the second lowest tax rate of all sectors (behind real estate) at 16.75% as of December 2022.

S&P 500 Operating Margins from 2018:

QTR	2023	2022	2021	2020	2019	2018
Q4		10.92%	13.41%	10.39%	10.61%	10.10%
Q3		11.28%	13.17%	10.93%	11.21%	12.13%
Q2		10.86%	13.54%	8.49%	11.41%	11.55%
Q1 (Q1,'23 Prelim.)	11.64%	11.93%	13.02%	5.86%	11.21%	11.40%

Source: Standard & Poor's Corporation.

Market Valuation

At the end of June 2023, the "trailing" price-to-earnings (P/E) ratio on the S&P 500 Index was 21.65 times. The 25-year average trailing P/E ratio (average of the past 25 years of quarter-end P/E ratios) is 19.94 times. A 21.65 P/E could suggest that the market is a little expensive at this time. The 12-month "forward" P/E ratio is currently 19.50 times. The 25-year average "forward" P/E ratio is 16.79 times. Such a high relative forward P/E ratio also may suggest that the market is expensive. The question is, can the market get more expensive allowing the price multiples to expand in the face of declining earnings estimates?

Many of the "bears" on Wall Street use the high relative interest rates as the rationale for the market to decline. But our position is that historically, a 10-year U.S. Treasury Note yielding around 4% is still a very low-interest rate. The yield on the 10-year U.S. Treasury Note currently stands at 3.819% (June 30, 2023). Such a low interest rate suggests that the P/E ratio on the S&P 500 Index can expand which may mean that

stock prices rise further. The "Fed Model" (a model that has no connection to the Federal Reserve) currently shows that stocks are undervalued. If the earnings yield, which is currently 4.62% on the S&P 500 Index is greater than the yield on the 10-Year U.S. Treasury Note, stocks are undervalued (4.62% > 3.819%). The earnings yield is the inverse of the P/E ratio which we pointed out above was 21.65 on June 30, 2023.

Additionally, we are in the third year of a presidential cycle which historically is the best year for stocks. Also, it is very rare for there to be two consecutive negative years in the market with 2022 as a negative year.

We have been "Bullish" on the markets since the beginning of the year and we believe that the October 12, 2022 low was the "bottom" for the markets. We do not expect a so-called "re-test" of the October lows. For the reasons stated above despite the seemingly high P/E ratios, we continue to believe the equity markets are at worst, "fairly valued" and are likely under-valued at this time and further gains are to be expected. Certainly, equity markets are volatile and we could see a short-term pullback. If we do see a pullback, we do not expect such a pullback to be long-lasting and the markets will adjust and continue their upward trajectory. In our opinion, we are in a new bull market.

However, the technology sector, which is further limited to just a handful of technology stocks, has been in a roaring bull market this year while the broader market has given us just rather modest gains so far. Most of the S&P 500's gains, year to date, have come from that handful of stocks or the top 10 stocks in the index. According to an analysis by JP Morgan Asset Management, the top 10 stocks in the S&P 500 Index have a "forward" P/E ratio of 29.3 times while the remaining 494 stocks in the index have a forward P/E ratio of 17.8times (there are currently 504 stocks in the index). Those top 10 stocks make up 31.7% of the total index's market capitalization. The earnings contribution of those top 10 stocks is just 21.5% as of June 30, 2023.

We can surmise from the relative P/E ratios of the top 10 stocks versus the bottom 494 stocks that the top 10 stocks are very expensive while the bottom 494 are reasonably valued. This would suggest that we may see a market rotation out of the top 10 stocks into the bottom 494 stocks. Plus, the earnings contribution of the top 10 stocks versus the bottom 494 stocks would also support some rotation into the bottom 494 away from the top 10. That is, the top 10 stocks have a market cap of 31.7% but only contribute 21.5% of the earnings. How can the market continue to justify paying more for a smaller piece of the earnings pie?

Such market rotation may be indicative of a shift toward value stocks away from growth stocks. As we mentioned earlier, value stocks have trailed growth stocks significantly this year. But investors may seek out better or more reasonable valuations for the stocks in which they invest. New leadership may be on the horizon.

Note that the top 10 stocks include Apple, Microsoft, Amazon, Nvidia, Alphabet, Meta (or Facebook), Berkshire Hathaway, Tesla, United Healthcare, and Exxon Mobil. Of the top 10 stocks, all are considered growth stocks except for Berkshire Hathaway, United Healthcare, and Exxon Mobil.

Conclusion

In our opinion, we are in a new bull market. So far, leadership in the markets has come from the technology sector but also largely from the top 10 stocks in the S&P 500 Index. The market is very sensitive to everything the Federal Reserve says or does. At its last meeting the Fed "paused" and did not raise interest rates but indicated that we may see two more interest rate increases this year.

We have avoided a recession so far in 2023 and due to the strong jobs data, it is unlikely we will see a recession for the remainder of 2023. We also think we will avoid a recession in 2024. We are not without things to be concerned about, but at this point, the positives outweigh the negatives in the economy.

Artificial intelligence is the next technology wave. We do not see the growth or current investor interest in these stocks as a bubble in the making, at least not yet. The best way to approach these investments is to allow a manager of a mutual fund or Exchange Traded Fund to select the appropriate stocks in which to invest.

Corporate earnings estimates continue to come down although the reduction in estimates is slowing down. Market valuations based on P/E ratios seem a little rich at the present time but other valuation measures suggest that the market is more reasonably valued. Most of the extreme over-valuation is contained in the largest 10 companies in the S&P 500 Index. The broader market seems a lot more reasonably valued. We may begin to see a shift toward value stocks away from growth stocks.

As such, we are here to listen, counsel, and provide direction to all of our clients.

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