BIECHELE ROYCE ADVISORS

2nd Quarter 2023 Review

The equity markets continued to show impressive resiliency in the face of an increasingly uncertain outlook for the strength of the U.S. economy. Stock markets continue to be led by the largest of the large cap growth companies that dominate the S&P 500 and NASDAQ indices.

The quarterly returns for the major averages were: The Dow Jones Industrial Average rose 3.41%, the S&P 500 was up 8.74%, the Russell 2000 Small Cap Index rose 4.91%, the NASDAQ gained 12.81%. International equities were also up for the quarter with emerging market stocks rising 1.71%, while the MSCI EAFE Developed International Index rose 4.28%. The broad U.S. bond market gave up some ground with the Aggregate Bond Index declining 0.84% for the quarter as yields moved higher.

It was just about a year ago that stock markets were in a period of upheaval, with stocks dropping about 16% in one quarter to ignite the declines that markets experienced in 2022. We pointed out then that the recovery potential can be strong for fundamentally sound companies that get oversold quickly relative to their long run earnings power. While a recovery has certainly ensued, and our equity holdings have been rewarded, the recovery has been quite narrow and concentrated in nature.

Seven of the largest growth stocks (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, Tesla) account for about three quarters of the gains for the S&P 500 year to date. Goldman Sachs did some research on the share of the top 10 stocks on their contribution to annual S&P 500 returns and found that they contributed about 32% on average. The year-to-date contribution from the top 10 at the end of June was 82%. So, we definitely have a top-heavy concentration exerting its force on markets right now. While the top-heavy market leadership can certainly continue on, we think it is prudent to be aware of the risks building in areas of the market (and conversely, areas where attractive return potential still lies) to understand the potential for significant drawdowns when the inevitable tide turns. As long-term investors we seek to compound returns over time and recognize the detrimental impact on the compounding machine that results from large drawdowns that interrupt the process and require even higher returns just to recoup those losses.

The table below compiled by Bloomberg and Wells Fargo, is an important reminder that the level of concentration among the top 10 companies by market capitalization in the S&P 500 now make up nearly 32% of the index. This is even higher than the 25% weight of the top 10 stocks back in

1999. Now we are not predicting that the same outcome will follow this time, but it is important to be aware of the upward valuation pressure that is being exerted on the index from these companies. While it is very difficult to know with any level of certainty what a market will do in the short run, market history is riddled with examples of periods where excessive exuberance is followed by severe pain.

S&P Top-10 Concentration

12/31/1999		6/22/2023	
Name	**Weight**	**Name**	**Weight**
Microsoft Corp	4.91	Apple	7.56
General Electric	4.14	Microsoft	6.90
Cisco Systems	2.85	Alphabet	3.73
Walmart Inc	2.51	Amazon.com	3.18
Exxon Mobil	2.27	NVIDIA	2.91
Intel	2.24	Tesla	1.95
Nokia	1.91	Meta	1.72
IBM	1.59	Berkshire Hathaway	1.64
Citigroup	1.53	UnitedHealth	1.22
Time Warner	1.37	Johnson & Johnson	1.18
	25.30		**31.98**

Source: Bloomberg and Wells Fargo Securities, LLC

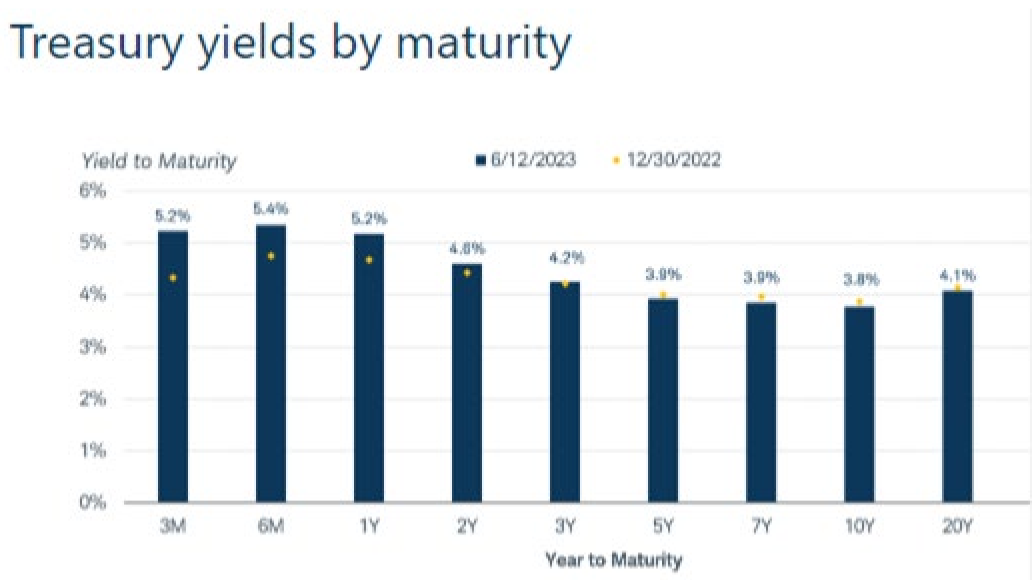
While market leadership is still very narrow, we have been encouraged by the broadening out of the rally that we experienced in the month of June with the Equal-Weighted S&P 500 Index edging out the Market Cap-Weighted S&P 500 for the month. It's impossible to know with any level of confidence in advance whether the market will reconcile around the rest of the stocks that have lagged playing catch up, or whether today's market leaders will fall. What we do have a high level of confidence in is that valuations do indeed matter in time. The stocks on the right side of the chart above trade at an average forward Price Earnings Multiple (P/E) of 30X. The S&P 500 trades at over 20X, and the NASDAQ trades at 27X.

A large rally in stocks has occurred within a backdrop of slowing or declining earnings growth. This has caused the valuation multiple to rise to a level where the median P/E ratio on the S&P 500 is now at 26. As mentioned, even higher valuations can be seen in growth sectors. According to data from Ned Davis Research, the median P/E for their multi-cap growth series is double that of the historical mean. More attractive valuations do exist, however, in their multi-cap value series, where the median P/E remains below its historical median.

Active managers like us are able to construct a high-quality portfolio of companies trading at significantly lower starting valuations with a favorable reward to risk over the next 5-plus years. We continue to be encouraged by the forward return potential of our holdings, where we feel we have stacked the deck in our favor via valuation discipline and patience.

Turning to another asset class, the bond market, we want to provide some insight into how we are thinking about the role of bonds in portfolios and the fast change in yields that has occurred over the last year. These higher yields present a more favorable risk/reward for bonds now and could improve further if the yield on the 10-yr Treasury were to reach 4% or above.

The Federal Reserve held their Fed funds rate steady at their meeting in June after the 10 consecutive hikes since March 2022. After this dramatic change in rates where they have taken short-term rates from near zero to over 5% in such short order, the shape of the yield curve in the U.S. is deeply inverted. This means that yields on short maturity instruments (think T-Bills and 2-Year Treasuries) are higher than longer dated maturity instruments (like the 10-year Treasury or the 30-year Treasury). This is not the normal shape of the yield curve. Normally, one would expect to earn a higher yield the further one goes out along the maturity spectrum. The Federal Reserve directly controls the rates on the short end of the yield curve- and they have driven those higher. If the expectation was that the economy was going to be able to readily absorb all of the Fed hiking (with its notable lag effect) then it would follow that the rest of the yield curve would shift upward as well (higher rates along the curve). We show in the chart below that since the beginning of the year yields have continued to move higher on the shorter maturity part of the yield curve but have remained rather stable in the intermediate and longer end.



Source: Bloomberg US Treasury Actives Curve, as of 6/12/2023 and 12/30/2022. Past performance is no guarantee of future results.

One interpretation from this reaction in the yield curve is that the bond market is not convinced that the economic growth outlook for the U.S. requires a move higher in longer term yields; and further, that it is possible that the Fed rate-hiking cycle is closer to being over. These clues from the yield curve have some important implications for investors who either own or are considering owning bonds or bond funds in their portfolios.

The investing environment for fixed income has changed remarkably given the increase in yields from their very low levels of the last few years. The current inverted shape of the yield curve has historically been a strong indicator of an oncoming recession. The Fed raises rates to slow growth or inflation and then reaches a point where they stop and see what the impact of their actions will have on the economy. In past cycles, the onset of recession arrives around 6-7 months after the last Fed rate hike. And what does the Fed do in the case of a recession to reignite growth? They ***cut*** interest rates.

Reinvestment risk and interest rate risk have become important considerations when investing in the bond markets today. Given the higher yields on the short end of the yield curve, there is nothing wrong with having an allocation to this area. But if the next move in the cycle is for rates to come down, and an investor has all or too much exposure only on the shortest end or cash, reinvestment risk becomes a factor. What we mean by this is the risk that as short rates come down, there is little to no exposure at the intermediate or longer maturities that could have locked in the higher yields for longer. The T-Bills would mature and be reinvested at lower rates, or the rates on cash instruments would reset lower along with the decline in rates. So, reinvestment risk is higher now than it was earlier in the Fed cycle.

Interest rate risk is likely lower now given the higher yields on offer and the likelihood of the rate cycle being in its later stage. Interest rate risk is related to how bond prices react to changes in rates (if rates go higher, bond prices go down; and if rates go lower, bond prices go higher.) Duration is the measure of bond price sensitivity to changes in interest rates. Having some duration exposure in the fixed income sleeve of a portfolio offers a higher level of income (that has not been available for many years) for a longer period of time; and the potential for returns to be higher than just the income yield in the event that interest rates eventually fall, leading to an increase in the prices of the bonds. Finally, the bond component of a portfolio should be thought of as a buffer to overall portfolio volatility given the historical negative correlation of bonds to stocks during periods of economic and market stress. Importantly, the last point is in reference to high quality, investment grade bond portfolios- not high yield bonds, which tend to exhibit a much higher correlation to the stock market. These considerations and more go into our assessment of how we construct the fixed income component of our portfolios.

In the span of a year, we have seen tremendous volatility in both the stock and bond markets. They have collectively had to deal with extraordinary levels of both monetary and fiscal largesse; a deeply inverted yield curve; the unintended consequences of Fed actions such as the regional bank stress (and the tightening of consumer and business credit that follows); geopolitical risks rising (especially as they relate to China); and growing risks of a recession (though the severity of such is up for debate). Markets have done a good job of climbing the proverbial “wall of worry” to date.

For stocks from here, it will be about profits catching up with valuations that have expanded, and how much optimism has been rightly or wrongly priced into stocks. For bonds, we'll be watching the levels of rates and inflation and seek out the areas of the market where attractive yields and total return exist within a risk-managed duration and credit profile. Finally, where appropriate, we continue to like alternative investments that offer diversification of return streams and low correlation to traditional stocks and bonds in strategies run by best-in-class managers in their respective niche markets.

Thank you for your trust and confidence. We are here to answer any questions you may have and provide thoughtful guidance to you in meeting your financial goals.

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